SUBPRIME/CREDIT CRISIS & GOVERNMENT BAILOUTS (Impact On D&O/E&O Coverage)

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The current economic crisis, including the subprime lending crisis and the subsequent credit crisis, **has resulted in hundreds of lawsuits and scores of government investigations** seeking to hold someone anyone responsible for the billions of dollars that virtually evaporated in the past two years. **The categories of defendants in these lawsuits are wide ranging**: from the issuers of the securities backed by subprime loans, to the rating agencies that effectively put their stamps of approval on these securities. By some accounts, the exposure to the insurance companies that insure the defendants in these lawsuits (mainly directors and officers liability (D&O) and errors and omissions liability (E&O) insurance) could be as high as $8 billion. **Notwithstanding the federal government's continuing efforts to address the liquidity vacuum characterizing the subprime and credit crisis, the lawsuits and market capitalization losses continue to mount.**

As the economic downturn deepened, the federal government arguably entered a state of near-emergency, requiring and justifying government intervention to avert bankruptcies of major financial institutions and thus, potentially profound, long-term injury to the U.S. economy. The federal government has taken strong measures to encourage economic participants, including banks, corporations and investors, to resume normal operations. These measures have included traditional measures such as decreasing the Federal Reserve's benchmark interest rate, as well as increasingly innovative and aggressive measures, such as providing economic stimulus payments to taxpayers and temporary incentives to first-time home buyers. Most notably, the federal government has engineered, either overtly or quietly, the rescue of numerous financial institutions and major employers like the Big Three automobile manufacturers from possible bankruptcy, including providing economic incentives to induce the facilitated acquisitions of weakened companies such as Bear Stearns and Merrill Lynch, by providing emergency credit to AIG and the Big Three, and by placing Fannie Mae and Freddie Mac into conservatorship.

It is currently unclear what impact these extraordinary financial interventions by the federal government into previously private markets will ultimately have on the insurance coverage available for the rescued corporations. This article poses several scenarios where the federal government's bailouts and its imposed conditions could arguably impact coverage under D&O and E&O policies, including issues arising from: (1) "change in control" provisions; (2) corporate indemnification obligations; and (3) conduct exclusions.

"Change in Control" Provisions

The federal government's approach to bailouts of financial institutions has taken on many forms. For those financial institutions that were most severely impacted by the subprime and credit crisis, the federal government, **in exchange for an ownership stake** in these companies and certain imposed conditions, made billions of dollars in capital infusions and provided certain guarantees against the possibility of losses arising out of risky loans and securities backed by commercial and residential mortgages.

For example, in exchange for the federal government's plan to rescue Citigroup, Citigroup will give the federal government billions of dollars in common stock, preferred shares and warrants and agree to certain restrictions on quarterly dividends, executive compensation and lending practices.

The federal government's ownership stake in, and new control over, rescued corporations raises the issue of whether there has been a "change of control" at these corporations for the purpose of D&O and E&O insurance coverage for subsequent lawsuits. Most D&O policies have what are generally referred to as "change in control" provisions that limit coverage when there are "change in control" events, such as: (1) a third-party's acquisition of the voting securities or the majority of the assets of the insured entity, (2) a corporate merger in which the insured entity ceases to exist, or (3) the appointment of a receiver, liquidator or trustee. Most "change in control" provisions provide that upon the occurrence of a "change in control" event, the policy covers only those wrongful acts of the corporation and its directors and officers committed prior to the time of the change in control. **This can be a problem if the federal government takes a significant ownership stake in a corporation because many directors and officers may continue to act on behalf of the corporation even after the federal government's intervention.**

Corporate Indemnification Obligations

Corporations, pursuant to state statutes, corporate charters and employment contracts, are permitted and/or required to indemnify their directors and officers for certain legal liabilities arising out of their exercise of corporate functions. **However, in situations where the corporation is not financially able to honor its indemnification obligations, the director or officer may end up having to bear his or her own costs.** In this situation, the affected director or officer may look to the D&O policy coverage part that provides coverage for non-indemnifiable loss (commonly referred to as "Side-A" coverage). Side-A D&O policies provide insurance coverage only for non-indemnifiable loss and typically provide that coverage can be triggered by the insured corporation's financial inability to indemnify its directors and officers. Many Side-A D&O policies contain "presumptive indemnification" provisions under which it is presumed, for insurance coverage purposes, that the insured corporation will indemnify its directors and officers to the fullest extent permitted by law (if not, the Side-A D&O insurer may deny coverage).

Certain Side A policies (including so-called Side A Difference-in-Conditions policies) can be triggered by the insured corporation's simple refusal to indemnify its directors or officers. **When the federal government injects government capital into a corporation to stave off an inevitable bankruptcy, the federal government could impose conditions requiring the corporation to cease its indemnification obligations to its directors and officers (e.g., to conserve badly needed resources to operate the company).** Even though the bailout will allow the corporation to remain solvent, the corporation will effectively be forced to cease its indemnification obligations or risk that the federal government will withdraw its financial assistance effectively forcing the corporation into bankruptcy. In this situation, the corporation's directors and officers are left unprotected and will likely look to the Side-A D&O insurer to pay legal costs for any lawsuits or investigations. **However, the Side-A D&O insurer, depending on the precise terms and conditions of the policy, may be justified in denying coverage to the directors and officers because the corporation that owes the indemnification obligation is technically solvent and is likely permitted or required to indemnify its directors and officers. This would be a regrettable result for all involved.**

Conduct Exclusions

When the federal government injects capital into a corporation, the federal government may insist that the corporation abide by terms and conditions that could directly or indirectly impair shareholder interests. The federal government's imposed conditions may be in the best interest of the national economy, but not necessarily in the best interest of the corporation's current shareholders. For example, 1 The federal government could insist on confidentiality provisions relating to the reasons for, and nature of, a governmental capital infusion. In this situation, the corporation and its directors and officers that failed to make the requisite disclosure could be alleged to have violated the federal securities laws by not making a timely disclosure of these material events to its shareholders. 2 The federal government itself likely would be protected from securities law liability exposure by the doctrine of sovereign immunity. 3

In this context, a number of legal commentators have explored the possibility of adopting a national interest exception under which a violator of the federal securities laws would be immune from liability for government-directed actions that serve the national interest. 4 **To our knowledge, there is no current legal basis for such a national interest exception.** Given that a national interest exception would leave injured shareholders with no legal remedy and would eviscerate the disclosure requirements of the federal securities laws, it is unlikely that the U.S. Congress would enact such an exception without some spirited debate about this and related issues.

Absent a change in existing law, government intervention and national interest will not absolve a corporation and its directors and officers from alleged violations of the federal securities laws. However, it is less clear whether government intervention and national interest would absolve the corporation and its directors and officers from the conduct exclusions in their D&O and E&O policies.

D&O and E&O policies generally provide that coverage is excluded for claims that arise out of intentional, dishonest or fraudulent conduct. These exclusions often contain limiting language that require the conduct in question to be proven "in fact" or by "final adjudication."

Similarly, most jurisdictions recognize the public policy principle that insurance coverage should not be available for intentional wrongful acts because of the perverse incentive or "moral hazard" such insurance coverage would create. 5 A corporation's (or its directors' or officers') dishonest or fraudulent acts, even if undertaken at the behest of the federal government, would likely trigger the conduct exclusion in a D&O and E&O policy. It is possible, although unlikely, that a variation on the criminal defense of duress might preclude the application of the conduct exclusion in a D&O or E&O policy. It could be argued that conduct exclusions are not intended to preclude coverage for an insured's acts performed at the direction of the federal government, either because such acts are not "intentional" or because the conduct exclusion is not intended to apply to misconduct where the insured's motivations are "innocent." Ultimately, however, it is unlikely that a court would read a duress defense into a conduct exclusion.

Additional issues also are likely to arise as the federal government takes increasingly-substantial steps to intervene in the ongoing subprime and credit crisis. Just as government intervention in the private sector can disrupt the affected companies' contractual and fiduciary obligations to its owner constituencies comprised of equity holders and debt holders, such intervention can also impact the potential liability exposure of the affected directors and officers, and give rise to coverage defenses under D&O and E&O policies.

D&O and E&O policyholders and their insurers should proceed carefully under these circumstances to avoid creating coverage defenses or incurring unnecessary liabilities.

Footnotes
1 *See* Advisen Special Report, *The Subprime Mortgage Meltdown, the Global Credit Crisis and the D&O Market* (Nov. 4, 2008), http://corner.advisen.com/The_Global_Credit_Crisis_and_D_O_final_2.pdf; Advisen Special Report, *The Crisis in the Subprime Mortgage Market and the Global Credit Markets: The Impact on E&O Insurers* (Nov. 6, 2008), http://corner.advisen.com/Subprime_E_O_final_3.pdf.
2 The federal securities laws were enacted to promote public confidence in the capital markets and mandate full and fair disclosure of all "material" facts information that investors would consider important in deciding whether or not to invest. *See SEC v. Texas Gulf Sulphur, Co.*, 401 F.2d 833, 847-848 (2d Cir. 1968).
3 *See Howe v. Bank for Int'l. Settlements,*194 F.Supp.2d 6, 18-20 (D. Mass 2002).
4 *See* Dennis K. Berman, *BofA's Merrill Deal Exposes Myth of Transparency*, Wall St. J., Jan. 20, 2009; Larry E. Ribstein, *Is There a "National Interest" Exception to the Securities Laws?*, Jan. 21, 2009, http://busmovie.typepad.com/ideoblog/2009/01/is-there-a-national-interest-exception-to-the-securities-laws.html.
5 *See Central Dauphin School Dist. v. American Cas. Co.*, 493 Pa. 254, 259 (Pa. 1981).

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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