

D&O insurance lessons from 'Just for Feet'

A classic disaster situation: Not enough insurance, bankruptcy, and inability to indemnify the directors. **BY SUSAN MINER AND LAURI FLORESCA**

A RECENT \$41.5 MILLION SETTLEMENT by five former outside directors of Just for Feet Inc. brings independent director liability back into the spotlight. Somewhat surprisingly, the size of the personal contributions in this case were significantly greater than the notorious outside director settlements involving WorldCom (\$24.8 million) and Enron (\$13 million).

The settlement ends litigation stemming from Just for Feet's collapse in 1999 relating to accounting fraud. After the company filed for bankruptcy in November 1999, a bankruptcy trustee was appointed to recover money for the company's creditors. The trustee filed suit in Alabama state court in 2001 against former directors and officers as well as former accountants Deloitte & Touche. The allegations included bad faith, breach of fiduciary duties in delaying filing for bankruptcy despite the advice of experts, misrepresentations, and conflicts of interest.

Where was the D&O insurance?

Quite simply, it was exhausted by shareholder class

action litigation filed two years before the bankruptcy trustee's lawsuit was even commenced. Court filings show only \$100,000 of D&O insurance was left for the outside directors after the preceding shareholders' securities lawsuit was settled for \$24.5M in 2002. Also, three former executives pleaded guilty to criminal charges and their defense costs likely further depleted the D&O limits.

Outside directors rarely contribute personally to settlements. A 2006 Stanford Law School study found only 13 instances in the past 25 years in which outside directors paid settlements out-of-pocket. After the Enron and WorldCom settlements in 2005, there was speculation that personal payments would become the norm. So far at least, that has not been the case.

In the Enron and WorldCom cases, plaintiffs aggressively sought personal contributions following the spectacular and highly publicized collapse of each company. Although court documents suggest their D&O programs had coverage flaws that weakened directors' arguments for coverage, it may be that no amount of insurance would have prevented those payments. (Indeed, at least in the WorldCom case the insurance limits were not exhausted.)

The Just for Feet facts are much more relevant to the average company. It appears the company simply did not have enough insurance, and it was bankrupt and unable to indemnify the directors. This is a classic scenario that a well-



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structured D&O program could protect against.

Action plan

A robust D&O program is critical to providing individual protection and minimizing the potential for personal contributions. Specific steps that directors can take include:

1. *Exercise due diligence over your D&O insurance.* Make sure the company is considering current data on settlement trends when deciding how much insurance to buy.
2. *Demand quality coverage* and check for key wordings in coverage provisions, such as severability of the application and the conduct exclusions. Consider: Would the policy cover executives who have

pleaded guilty to criminal charges? Is that consistent with the board’s wishes?

3. *Insist on a dedicated A-side layer* for the insurance program with broad Difference-in-Conditions (DIC) terms. A larger DIC A-side program might have given the outside directors the war chest needed to have avoided dipping into their own pockets.
4. Consider setting aside a portion of the *A-side coverage for outside directors only*. An A-side layer may not be enough protection if outside directors are sharing the policy with inside officers who may have had a direct role in the fraudulent activities. Modern D&O policies make it very difficult for the insurance carriers to cut off payments to culpable individuals, so limits can quickly be eroded when criminal charges are filed.

5. *A personal director liability policy* can serve as separate protection for a director when all company insurance has been exhausted. Venture funds and private equity firms can purchase policies protecting their employees sitting on multiple boards. (See exhibit for information on enhancing your A-side coverage.)
6. In the event of a claim, *stay on top of settlement discussions*. The interests of outside directors in a proposed settlement may be different from those of the company and its inside officers. If a settlement will exhaust the insurance program, there may be ways to still protect the outsiders against current and future claims.

Know your plan

If directors pay personal attention to seeing that the D&O program is carefully structured and negotiated with their interests paramount, in almost all situations they should be able to avoid personal liability.

There is no better time to consider an independent evaluation of your D&O program by an executive liability insurance specialist. ■

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