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Project: *Corporate Counsel – Law Firms*

Directors & Officers Liability Insurance In An Era Of Enhanced Disclosure Requirements

The Editor interviews John H. Kazanjian and Christopher J. McKenzie, Partners, Beveridge & Diamond PC.

Editor: Would each of you gentlemen tell our readers something about your professional background and experience?

Kazanjian: Since 1975, when I graduated from law school, I have been practicing in New York City, principally in complex civil and commercial litigation. I was a litigation partner at Anderson Kill & Olick for several years and joined Beveridge & Diamond in 1999. I was attracted to the firm because it provided an excellent fit for my litigation practice, which is currently focused on insurance recovery for policyholders. I chair the firm's insurance recovery practice. I also defend product liability and toxic tort cases on behalf of manufacturers.

McKenzie: I have been with Beveridge & Diamond since graduating from Columbia Law School in 1992, and I am now a partner. I was drawn by the fact that Beveridge & Diamond was, and is, the preeminent firm in the environmental and regulatory areas and in environmental litigation. My practice involves environmental regulatory compliance, enforcement and litigation, and my clients are primarily corporations and municipalities.

Editor: Please tell us about your practice. How has it evolved over the course of your career?

Kazanjian: Over time my insurance recovery practice has evolved to include more counseling, in addition to litigation, on behalf of corporate policyholders. With the steady increase in potential liability, clients are increasingly concerned about the adequacy of their insurance protection. The



**John H.
Kazanjian**



**Christopher J.
McKenzie**

recent corporate scandals, and the more rigorous regulatory environment that has resulted, have served to accelerate this development. I do a great deal of consultation work in my practice these days, assisting clients in making sure that their insurance coverages are satisfactory.

McKenzie: When I began practicing environmental law, many of our clients were in a reactive compliance posture. With the adoption of management systems in the environmental area, the development of international standards for management systems, and with the efforts of a few leading companies, our clients have become much more proactive. Sarbanes-Oxley has certainly played a role in this development. Members of governing boards are asking questions of management about environmental, health and safety issues, in addition to the financial disclosure issues that are the focus of Sarbanes. Environmental professionals are also examining the extent to which Sarbanes applies to their areas of concern. All of this is forcing communication and the coordination of compliance strategies across a wide range of corporate departments and divisions in ways that seldom occurred in the past. This development is also forcing corporations to take a close look at their risk management programs.

Editor: What has the enactment of Sar-

banes Oxley, together with the securities exchange rules, the SEC regulations and the emerging case law that results from it, meant to your practice?

McKenzie: The enactment of Sarbanes has changed the landscape dramatically. The basic SEC requirements for disclosure of relevant financial and non-financial information concerning the environment have been present for many years, but Sarbanes raises the stakes. It imposes penalties for failing to disclose, and it creates mechanisms for enforcement, all of which serves to enhance the accountability of corporate insiders. Many of the concerns that I see expressed by officers and directors today were not present prior to Sarbanes, and that is clearly having an impact on my practice.

Kazanjian: It has affected my practice by shining a spotlight on corporate governance. The exposure of former directors of Enron and WorldCom to personal liability in securities litigation has resonated dramatically in board rooms across the country. Needless to say, the availability of D&O insurance to meet that exposure, and to protect directors and officers to the greatest extent possible, is at the very center of this discussion.

Editor: What does Sarbanes add to the environmental disclosure requirements that have been with us for many years? Is this something new, or does Sarbanes merely codify what has been understood to be best practices?

McKenzie: I would not say that it codified what is already there. It changes the consequences for failing to comply with what is there. But it also imposes new obligations on the company. Section 404, for example, which requires management to establish and maintain internal controls and financial reporting systems, has forced management to

Please email the interviewees at jkazanjian@bdlaw.com or cmckenzie@bdlaw.com with questions about this interview.

devote resources to assessing environmental risks and disclosing what is appropriate.

Editor: The personal liability to which corporate insiders are now exposed has insurance implications. You mentioned D&O coverage. What is available?

Kazanjian: D&O insurance is written, in the main, at several levels. It can be purchased to protect both individuals and the corporate entity. Most companies will indemnify directors and officers for liability arising out of their official duties. D&O insurance is structured to provide insurance for the liabilities of individual officers and directors to the extent that they have not been indemnified by the corporation. That is known as "Side A" coverage. In addition, D&O insurance will reimburse the corporation to the extent that it has indemnified individual officers. That is called "Side B" coverage. Many companies also purchase "Side C" coverage, which provides insurance to the corporate entity itself for certain types of claims. All of these coverages typically include the cost of defending litigation as well as judgments or settlements up to the policy limits. The market is now offering enhanced Side A coverage. More and more companies are interested in this as a consequence of Sarbanes-Oxley. It is written as excess insurance, and it comes into play to the extent that primary D&O insurance does not respond as a result of policy exclusions. The issue is really how much of such insurance constitutes sufficient protection, and that is something that each company must determine on its own.

Editor: As a matter of public policy, things like gross negligence, acts of deliberate dishonesty and malfeasance have not been insurable. Has the current climate of enhanced responsibility on the inside of corporate life, and the enhanced scrutiny of corporate behavior from the outside, served to change what is insurable?

Kazanjian: As a coverage lawyer, I would have to answer that these factors have not changed what is insurable. Rather, they serve to highlight what always was insurable. The insurance is still there to cover lapses in judgment and even intentional acts which do not rise to the level of dishonesty or fraud. Certain insurance companies are taking a more aggressive stance, however, and are seeking to rescind D&O insurance for alleged misrepresentations or errors in, say, a company's insurance application or financial statements. They argue that they are entitled to unilaterally rescind the D&O coverage on the ground that they relied upon erroneous information and would not have issued the policy had they known the truth. This is caus-

ing considerable consternation in board rooms. But most courts that have looked at the issue have said that the insurance carriers cannot unilaterally rescind coverage – and walk away from their obligation to advance defense costs to the insured under a D&O policy – and that this obligation continues until they can actually prove wrongdoing supporting rescission. The best position for the insured is to have language in the policy requiring coverage *until* the carrier proves its case, and severability provisions preserving coverage for innocent officers and directors not involved in wrongdoing.

Editor: As these disclosure requirements become more burdensome and more expensive, are you finding a trend for public companies to go private?

McKenzie: Certainly the burdens of compliance can be significant, particularly for smaller organizations. While there are continuing complaints about this state of affairs, most of our clients consider the prevention of accounting fraud and the protection of investors to be laudable goals. I am not aware of any trend for publicly-held enterprises to go private in order to avoid the obligations of Sarbanes-Oxley. Indeed, I find some of our clients utilizing Sarbanes-Oxley as a lever by which to enhance the public's perception of company integrity and to extend the reach of the corporate governance team – the governing board and senior management – throughout the company.

Kazanjian: Most of the clients I work with believe that the focus on disclosure is a good thing. While it adds to the cost of doing business as a public company, it also adds to investor confidence, and that, in the long run, is a very good thing for business.

Editor: Mr. Kazanjian, some of these developments appear to evidence an exposure to risk and to potential liability that were not recognized in the past. Would you tell us about the impact this is having on your insurance practice?

Kazanjian: There is more concern in being proactive, making certain that the insurance in place will meet the company's liabilities in an appropriate way. Increasingly, I find myself working with risk management personnel and with their insurance brokers in providing an independent assessment of policy language. As a legal adviser, I am helping to develop a structure appropriate to meet the potential liabilities that the company faces, and this is in contrast to where I am called in to address the situation *after* a problem had arisen.

Editor: What about the future? In recent years we have seen increased public attention to financial disclosures concerning environmental matters, including organized shareholder and environmental advocacy in support of stricter requirements. Where are we going with this?

Kazanjian: I hope that this development will provide an opportunity for increased cooperation between policyholders and insurers. To the extent that underwriters are able to scrutinize potential risks to the best of their ability and to price those risks accordingly, the potential for disputes between policyholders and insurers will decrease. That is a good thing, and there is some evidence that we are moving in that direction.

McKenzie: There is no question but that the bar has been raised. Where one company makes an environmental disclosure – perhaps at great expense – other companies similarly situated are under pressure to make similar disclosures. If a company chooses not to do so, it runs the risk of being singled out, scrutinized and subjecting itself to investor disdain, something no publicly-held company can afford. Investor activism is on the rise. There is a pending petition before the SEC in which a number of socially responsible investment groups are seeking codification of two standards developed by the American Society of Testing Materials regarding the valuation and disclosure of environmental liabilities. While I do not see the SEC adopting these standards at the moment – they represent a significant enhancement of what is currently required – the fact that the SEC is being petitioned is indicative of the pressures to which it and the corporate community are subject today with respect to environmental disclosures.

Editor: The trend is toward greater disclosure. Would you share with us your thoughts about the pro's and con's of this development?

McKenzie: I would say that it is a positive step. A company operating in a transparent manner and making the disclosures it should is comfortable, both internally and in the perception of outsiders. I think that that is precisely where it wants to be in the eyes of investors.

Kazanjian: I would agree. The only negative I can see is hypothetical – that greater disclosure and the potential for enhanced liability might raise concerns about service on corporate boards. There is, however, little or no evidence that this is discouraging talented people from serving on boards of directors.