

By Louise Pennington and Donald Glazier

While the subject of natural disasters tends to dominate the insurance environment, we are witnessing a parallel *unnatural* corporate disaster involving the clearing services firm Refco. Revelations concerning Refco's activities and resultant claims scenarios add to the issues and contractual language a public company should review within its professional liability program portfolio. Illustrative of the growing breadth of potential claimants and defendants that may emerge, the Refco story underscores the need for a company to re-examine its risk profile and related risk transfer program. Just as property programs are re-evaluated in light of a current hurricane season's losses, a D&O program must continuously be analyzed for possible "catastrophic" coverage needs.

## **Refco Summary of Events**

- *August 11, 2005*: Refco goes public, offering 26.5 million shares at \$22 per share.
- *October 11 2005*: The company suspends its CEO, Phillip Bennett, after discovering he hid \$430 million in debts owed the firm. Refco indicates its financial statements, going back to 2002, are unreliable.
- *October 17, 2005*: Refco and 23 of its unregulated subsidiaries with operations in 14 countries serving some 200,000 customer accounts file for Chapter 11 bankruptcy protection.

Refco's bankruptcy filing represents the fourth largest in U.S. history, covering stated assets of \$48.8 billion. The company's largest unsecured creditors include BAWAG P.S.K. (a bank owned by Austria's trade unions), Wells Fargo Corporate Trust Services, VR Global Partners, LP (a Moscow hedge fund), as well as a myriad of other hedge funds and brokerage firms.

The international component in this array of creditors may prove significant as claims develop and jurisdictional issues arise. Specifically, there are often overlooked elements of a D&O program that address (or fail to address) a company's international risk exposure and coverage.

## **IPO Shareholder Suits**

While a shareholder suit emanating from the negative impact of corporate news on a company's stock price is not unique to Refco, what is uncommon is the magnitude of the drop in market capitalization, the compressed timeframe of the loss (three months), the broad scope of defendants, and a likely claimant pool that will undoubtedly include domestic, international, individual and institutional plaintiffs.

On the federal side, both the *1933 Securities Act* and *1934 Securities Exchange Act* may apply, each of which presents differing liability standards (strict liability under Section 11 of the 1933 Act), as well as state-determined fiduciary duty standards (business corporate law) and international duties owed given the extensive claimant pool.

The resultant implications for application of coverage from a D&O policy, and actual availability of the proceeds of the policy under the circumstances are accordingly complex. The Issue-Implication Table below illustrates only some of the relevant policy terms worthy of review and discussion.

### **Financial Restatement**

Refco's management has already admitted that its previous, publicly filed financial statements are unreliable. Clearly such admissions are precursors to a financial restatement for Refco, an event that often forms the basis for a company's insurer to rescind its policy. While rescission had heretofore been uncommon in the professional liability insurance arena, given the major corporate scandals of recent years, many D&O underwriters have not only increased threats of rescission, they have done so with the "approval" of the courts. Much to the dismay of many insureds, a recent California Federal Court decision (*Atmel Corporation v. St. Paul Fire & Marine*, 2005 WL 2562626 [N.D. Cal.]) offered precedent for an insurance carrier's position that if it believes there is a valid reason to rescind a policy, the carrier need not wait for a court order to cease advancing defense costs. Although the policy implicated in *Atmel* was an E&O policy, there is obvious potential for reverberations regarding all related policies.

In order to rescind a policy, the issue ultimately becomes one of reliance – what data the underwriters relied upon in order to offer coverage to the company and whether that data was reliable. While it is impossible to predict the specific outcomes in such situations, areas of a policy will clearly be implicated in the process, and those areas should be closely examined during the insurance placement process. (See *Issues/Implications Table*.)

### **Domestic and International Claimant/Defendant Pool**

Two of Refco's largest creditors, a Moscow hedge fund and an Austrian bank, are not U.S.-based. As of October 31, 2005 the bank, BAWAG, had already filed its own claim against Refco, separate and apart from the various other creditors and shareholders. The bank will not be alone in its efforts to recoup losses; thus begins a string of jurisdictional battles. Although many D&O policies claim "worldwide coverage," it is critical to review those policies for actual enforcement overseas, as well as to determine the applicability of the indemnification and other provisions.

Further, many policies require arbitration and restrict that arbitration to certain locales, which may run afoul of a defendant company's best interests depending on the nexus of the claim. Our *Issues/Implications Table* points out policy areas that should be addressed from both a claimant and defendant perspective by any company with international exposure.

Given the increased liability of service providers brought on by the Sarbanes Oxley Act, the potential naming of Refco's auditors (Grant Thornton), their investment bankers (numerous), and even legal counsel could be telling. While many cases are tried in the media well in advance of a court proceeding, the decisions as to co-defendant liability (under a possible strict liability standard) that will likely be rendered throughout the lengthy litigation process may offer an interesting, if not difficult, precedent for other companies considering going public.

### **Bankruptcy**

The interlocking issues of bankruptcy and D&O policy coverage are not new. Nonetheless, the Refco scenario reminds the corporate public that no company, regardless of size or stature, is immune from a possible Chapter 11 filing. It therefore behooves all risk management professionals to review their current insurance programs to see what, if anything, can mitigate the potential that individual directors and officers will need to pay defense costs out of their own personal assets in the event of a bankruptcy. While purchasing a policy for non-indemnifiable loss is one solution, coverage provided under such a policy may be insufficient if it is rescindable or cancelable. That is especially true since, while the fiduciary duty of a company's board and its management is to the shareholders, the ultimate purpose of a D&O policy is to protect the assets and personal liability of the individual directors and officers.

### **Sale of Non-bankrupt Assets**

Not all components of Refco are included in the bankruptcy filing; significant assets outside the purview of the filing are now up for sale and being considered by numerous bidders. This raises issues of:

- continuity of coverage for any directors and/or officers who may continue on with a sold portion of Refco that is sold
- how best to address the past liabilities for those individuals on a going-forward basis
- the effect on the board should any contingent liability remain unresolved

**Issues/Implications Table**

<b>ISSUE</b>	<b>COVERAGE IMPLICATION</b>
<p><i>Litigation</i></p> <ul style="list-style-type: none"> <li>▪ <i>IPO</i></li> <li>▪ <i>Shareholder Suits</i></li> <li>▪ <i>Derivative Suits</i></li> <li>▪ <i>Regulatory</i></li> <li>▪ <i>Other</i></li> </ul>	<ul style="list-style-type: none"> <li>▪ Definition of loss</li> <li>▪ Definition of claim</li> <li>▪ Scope of investigative costs coverage</li> <li>▪ Scope of regulatory coverage</li> <li>▪ Scope of "damages" – monetary, non-monetary, punitive, etc.</li> <li>▪ Insured versus insured exclusion</li> <li>▪ Controlling shareholder exclusion</li> <li>▪ Road show/prospectus liability coverage</li> <li>▪ Warranty signatures</li> <li>▪ Severability of the application</li> <li>▪ Severability of the exclusions</li> <li>▪ Definition of "application"</li> <li>▪ Prior acts coverage</li> <li>▪ Advancement of defense costs</li> <li>▪ Order of payments</li> <li>▪ Entity coverage</li> <li>▪ Scope of professional services exclusion</li> <li>▪ Extension of coverage for co-defendant accountants/investment bankers</li> <li>▪ A-side coverage availability (rescission-proof)</li> <li>▪ Cancellation provisions</li> <li>▪ Limits sufficiency and depletion management</li> <li>▪ Availability of defense for "black hats" as separate from "white hats"</li> </ul>
<p><i>Sale of Futures</i> <i>Brokerage Business</i></p>	<ul style="list-style-type: none"> <li>▪ Continuity of coverage</li> <li>▪ Prior acts coverage</li> <li>▪ Pending and prior litigation exclusion</li> <li>▪ Breadth of specific claim exclusion</li> <li>▪ Run-off coverage</li> <li>▪ Warranty signatures</li> <li>▪ Aggregation of limits</li> </ul>
<p><i>Bankruptcy</i></p>	<ul style="list-style-type: none"> <li>▪ Entity coverage</li> <li>▪ Order of payments</li> <li>▪ A-side coverage</li> <li>▪ Debtor in possession coverage/language</li> <li>▪ Insured versus insured exclusion</li> <li>▪ Availability of policy proceeds to individual directors and officers</li> <li>▪ Advancement of defense costs</li> <li>▪ Change in control provision</li> </ul>

<i>Bankruptcy (cont'd.)</i>	<ul style="list-style-type: none"> <li>▪ Limits sufficiency</li> <li>▪ Effect of large international creditor pool</li> </ul>
<i>Claimant Pool</i>	<ul style="list-style-type: none"> <li>▪ Global extension(s)</li> <li>▪ Worldwide coverage</li> <li>▪ Choice of laws/jurisdiction</li> <li>▪ Arbitration provision/mandate</li> </ul>
<i>Defendant Pool</i>	<ul style="list-style-type: none"> <li>▪ Definition of insured</li> <li>▪ Contractual obligations between vendors (e.g., accountants, investment bankers, investors)</li> </ul>
<i>Financial Restatement</i>	<ul style="list-style-type: none"> <li>▪ Fraud exclusion</li> <li>▪ Personal profit exclusion</li> <li>▪ Illegal remuneration exclusion</li> <li>▪ Severability of exclusions</li> <li>▪ Severability of the application</li> <li>▪ Definition of application</li> <li>▪ Rescission</li> <li>▪ A-side coverage</li> </ul>

## Conclusion

The obvious worst time to “test” a D&O policy is when a claim is filed. Every insurance program should be periodically reviewed relative to its responsiveness in the event of worst case scenarios. Partnering with a broker who knows the issues and the marketplace is key to any risk management approach. Integro’s Management Risk Practice proactively brings value to our clients before the “event” occurs, so that when the time comes to access your policy’s coverage, it meets your needs and expectations. We encourage you to contact us directly about the content above in more detail and we look forward to speaking with you about Integro’s capabilities.

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