



EVALUATING YOUR D&O INSURANCE AFTER SARBANES-OXLEY

DANIEL BUKOVAC

IN JULY 2002, FORMER FBI DIRECTOR WILLIAM Webster resigned from U.S. Technologies' board. According to Webster, the company could no longer provide adequate insurance for its officers and directors. Webster was later appointed to the Public Company Accounting Oversight Board, established under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), to oversee the audits of public companies subject to federal securities laws. However, Webster resigned that appointment on November 12, 2002, after it was revealed that U.S. Technologies had fired its auditors when Webster chaired the company's audit committee. Webster's fears about his directors and officers ("D&O") insurance proved to be well-founded. On December 19, 2002, U.S. Technologies' CEO was charged with securities fraud, mail fraud and wire fraud in a federal criminal complaint.

After Sarbanes-Oxley was signed into law on July 30, 2002, concerns like those voiced by Webster about the adequacy of D&O coverage have heightened. Reacting to financial scandals like Enron, Congress not only imposed additional legal requirements on officers and directors, but criminalized certain violations of those requirements, and established a longer time period for investors to file lawsuits to recover their losses.

With the risk of investor claims escalating, **what steps should officers and directors take**

to find out whether their D&O insurance is adequate?

Understand Your D&O Policy.

To evaluate the adequacy of coverage, some basic understanding of the policy is essential. A typical D&O policy provides direct coverage to directors and officers for losses, including attorney's fees and expenses, arising from specified claims, when those losses are not indemnified by the company under state law provisions or the corporation's articles or bylaws (commonly referred to as "Side A Coverage"). The typical policy also provides indirect coverage to pay the company's expenses when the company does indemnify officers and directors for losses (commonly referred to as "Side B Coverage").

Many D&O policies also provide "entity coverage" to insure losses from claims asserted against the corporation.

Evaluate Your Primary and Excess Coverage Limits.

In evaluating the adequacy of policy limits, the impact of "entity coverage" must be considered. "Entity coverage" necessarily reduces coverage available to the directors and officers because, in most policies, the same limits applicable to claims against the directors and officers also apply to claims against the corporation.

Directors and officers may want to request

a specific allocation of limits in a D&O policy containing entity coverage to provide certainty that some coverage exists for their exclusive benefit. One insurer is recommending "excess" Side A Coverage that would protect only directors and officers after the underlying limits are exhausted. Another insurer has introduced "Personal Director's Liability Insurance" providing the insured director with a personal, dedicated limit.

Seek Non-Rescindable Separate Coverage.

Typical D&O policies include language about the insurer's reliance on the application for insurance. Applications may require financial statements and reports to the SEC to be provided to the insurer; or policy endorsements may define "application" or "renewal application" to include such filings. Insurers have sought to rescind D&O coverage after a company issues restated financials, on the theory that the original financial statements that were part of the "application" were misleading. Some policies exclude claims arising from "Listed Events," often defined to include "restated" financials.

An "independent director" should consider separate coverage that cannot be rescinded based on the company's misstatements, which may include restated financials. One insurer has introduced "Independent Directors Liability

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GETTING A PIECE OF THE PIE

Using Government Contract Receivables and Claims as Collateral

LAWRENCE P. BLOCK

GOVERNMENT contract receivables are an under-utilized source of collateral for many banks and financial institutions. Knowledge of the relevant Federal Acquisition Regulations and the Assignment of Claims Act and incorporation of those provisions into loan documents, as well as adherence to other ancillary requirements will provide, for many lenders, new sources of collateral or potential new clients.

As President Harry Truman stated on May 15, 1951:

I have today approved S. 998, "To facilitate the financing of the defense contracts by banks and other financing institutions, to amend the Assignment of Claims Act of 1940, and for other purposes. I have signed this bill because it is important to encourage private financial institutions to make loans for defense production. It is particularly important that small business be given this kind of financial aid in order to increase its participation in the defense program as promptly as possible."

S. 998 is Public Law 30, 82d Congress (65 Stat. 41).

Many banks and financial institutions decline to use federal government contract receivables and claims for collateral. For those

that do, they may well fail to protect their interests properly. Simply filing normal UCC documents will likely not protect the lender's position. Rather, lenders should utilize the Assignment of Claims Act for the protection of their security position.

Why Bother?

Annually, the federal government spends billions of dollars through government contractors. Particularly under the new Department of Homeland Security, there is an increasing need for all types of government contractors who previously did not provide goods and services to the federal government.

When evaluating the use of government contract receivables and claims as collateral, banks must be aware of the Assignment of Claims Act and the procedures for using them. Under the Assignment of Claims Act, any government contractor may assign its rights to be paid amounts due or to become due on government contracts as long as the assignment covers all moneys due or to become due under a particular contract and the contract does not prohibit any assignment. Ninety-five percent of government contracts allow assignment. Once a proper assignment of claims has occurred, *the Government is liable*

to the financing institution if the Government pays the contractor.

What does this mean to you and to your business? The U.S government encourages their vendors to seek accounts receivable



factoring of their invoices in order to help them grow, improve cash flow, increase performance, and level the playing field. Utilization of government contract receivables as collateral requires certain additional investigation and precautions. Nonetheless, if properly pursued, they can yield a fresh source of both new collateral and new lending clients.

Stinson Morrison Hecker has the expertise necessary to advise clients on avoiding the pitfalls of assignments of government contract collateral and how to reap the benefits of additional collateral or new clients. ■

EVALUATING YOUR D&O INSURANCE

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Insurance," stand-alone coverage designed to protect the personal assets of independent directors. According to the insurer, the policy provides "non-rescindable" coverage for outside directors only.

Anticipate exclusions and determine whether defense costs will be advanced. Most D&O policies exclude claims for illegal gains or profits which result from insider trading. Such exclusions take on additional significance with Sarbanes-Oxley's new

"disgorgement" and insider trading provisions. Another standard clause in D&O policies is the exclusion of claims arising out of criminal or "deliberate" acts. With the addition of new securities crimes under Sarbanes-Oxley, it is critical that the policy expressly provide that defense costs are advanced until the criminal or "deliberate" act is proven. Similarly, directors and officers should determine whether the conduct of one director or officer falling within a policy

exclusion eliminates coverage for the other "innocent" officers and directors.

Consult with a professional. Evaluating the adequacy of D&O coverage can be a difficult task made more complicated after Sarbanes-Oxley. Any officer or director would be well-advised to consult with an attorney as well as an insurance broker with expertise in D&O coverage matters. ■

SUSPICIOUS ACTIVITY REPORTS

Affirmation of Unqualified Protection for Financial Institutions and Their Employees



LISA R. WESTERGAARD

BANKS, THRIFTS, BANK HOLDING COMPANIES and their non-bank subsidiaries, credit unions and certain other financial institutions are required to file Suspicious Activity Reports (“SARs”) with the U.S. Department of Treasury’s Financial Crimes Enforcement Network (“FinCEN”) pursuant to federal regulations. The SAR rules generally require these financial institutions to file SARs whenever they know or suspect suspicious or potential criminal activity. Federal law and regulations protect financial institutions and their employees from civil liability for filing a SAR or disclosing information in a SAR. This safe harbor has been in place since 1992. In recent years, some courts have disagreed regarding the scope of the safe harbor protection.

A few courts have limited the safe harbor protection in the following ways: (i) disclosures given subsequent to a federal official’s seizure warrant are protected, but disclosures pursuant to verbal instructions prior to warrant are not (*Lopez v. First Union National Bank*, 129 F.3d 1186 (11th Cir. 1997)); (ii) a financial institution or its employee must have a good faith basis of suspicious activity before

disclosing customer information (*Coronado v. BankAtlantic Bancorp, Inc.*, 129 F.3d 1186 (11th Cir. 11997)); and (iii) financial institutions cannot claim blanket protection if they misrepresent facts in order to report a possible

“ . . . financial institutions and their employees that follow the prescribed agency regulations and SAR filing institutions should be fully protected . . . ”

violation of law (*Bank of Eureka Springs v. Evans*, 109 S.W.3d 672 (Ark. 2003)).

However, a majority of courts have ruled that financial institutions and their employees have unqualified safe harbor protection from civil liability for filing SARs. The Second Circuit Court of Appeals, the United States District Court for the Southern District of Indiana, and the United States District Court for the District of Puerto Rico are a few such

courts. Notably, in *Whitney National Bank v. Karam*, 306 F. Supp.2d 678 (S.D. Tex. 2004), the court held that all communications and information exchanged between a financial institution and government agencies or officials are protected from discovery. This includes preliminary, preparatory, follow-up and any other disclosure related to a SAR filing. The *Whitney* court recognized that the safe harbor protections do not apply to documents produced in the ordinary course of business, but they do apply if those same documents reveal whether a SAR has been or will be filed.

An interagency advisory was issued in May 2004 in order to affirm *Whitney’s* ruling and the decisions of the majority of the courts. All of the federal financial institutions supervisory agencies and FinCEN believe that *Whitney* applies to all financial institutions that file SARs: “In light of the *Whitney* decision, the agencies remain confident that financial institutions and their employees that follow the prescribed agency regulations and SAR filing instructions should be fully protected by the safe harbor provisions of the law.” ■

A BANKRUPTCY DEBTOR MAY ASSUME A CREDIT CARD PROCESSING AGREEMENT WHEN THERE IS NO FINANCIAL ACCOMMODATION

LISA R. WESTERGAARD

THE SEVENTH CIRCUIT COURT OF APPEALS recently held that a trustee in bankruptcy or a debtor in possession may assume a credit card processing agreement despite the debtor’s deteriorating financial condition. See *In re United Airlines, Inc.*, 368 F.3d 720 (7th Cir. 2004). The debtor, United Airlines,

Inc. (“United”), has been in a Chapter 11 reorganization since December 2002. Two years earlier, United had signed a five-year contract with National Processing Company, LLC (“National Processing”) for National Processing to handle United’s customers’ VISA or MasterCard credit card transactions.

When a customer pays with a credit card, (i) United verifies the transaction and transmits a record to National Processing; (ii) National Processing enters the information into the credit card settlement network; (iii) the network dispatches the transaction to the customer’s bank, which advances funds to

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2004 MISSOURI LEGISLATIVE UPDATE

THE MISSOURI LEGISLATURE PASSED A NUMBER of bills of interest to the financial community this past legislative season. The effective date of the laws was August 28, 2004. First, the Missouri Uniform Trust Code (the "Code") comprehensively revises the previous state trust code. Second, exemptions from attachment and execution in bankruptcy have been increased. Third, the time for which a secured party must file a deed of release upon satisfaction has been extended from 15 days to 45 days. Fourth, commercial loan agreements must contain certain information to allow debtors to maintain an action or a defense against their creditors. Last, Article 6 of the Uniform Commercial Code, relating to bulk transfers, has been repealed in its entirety. The first four updates are described further below.

- The Uniform Trust Code of 2000 was the first national codification of the law of trusts approved by the National Conference of Commissioners on Uniform State Laws. Due to the greater use of trusts in family estate planning and in commercial transactions, the Missouri legislature passed legislation adopting most provisions of the Uniform Trust Code, which essentially rewrites existing Chapter 456 of the Revised Statutes of Missouri. The Code is principally a default statute. Most of the Code's provisions can be superseded by the terms of a trust. Among the Code's terms that cannot be overridden are: (i) the requirements for creating a trust, (ii) the duty of a trustee to act in good faith and with regard to the purposes of the trust, (iii) the requirement that a trust be for the benefit of its beneficiaries, (iv) the effect of a spendthrift provision and the rights of certain creditors and assignees to reach a trust, and (v) a court's power to modify or terminate a trust and adjust the amount of a trustee's compensations.
- As part of an omnibus judicial bill, the legislature exempted from attachment in bankruptcy the following property of a

person or a dependent of a person:

- Household goods, wearing apparel, appliances, books, animals and musical instruments not to exceed \$3,000 (increased from \$1,000)
- A wedding ring not to exceed \$1,500 and other jewelry not to exceed \$500 (wedding ring added)
- Wild card - any other property - not to exceed \$600 (increased from \$400)
- Implements, books and tools of trade not to exceed \$3,000 (increased from \$2,000)
- Motor vehicle in the aggregate not to exceed \$3,000 (increased from \$1,000 for a single vehicle)
- Mobile home used as a principal resident - not on or attached to real property in which a debtor has a fee interest - not to exceed \$5,000 (increased from \$1,000)
- Alimony, maintenance or support not to exceed \$750 a month (increased from \$500 a month)
- Head of household exemption not to exceed \$1,250 and dependent exemption - unmarried child under the age of 18 or disabled person - not to exceed \$350 (increased from \$850 and \$250, respectively)
- A law has been amended to require secured creditors to record a deed of release within 45 days of request and satisfaction (increased from 15 business days). A lender failing to do so will be liable to the borrower for the lesser of (i) \$300 a day for each day past the 45th day or (ii) 10% of the security instrument, plus court costs and attorneys' fees. It is unclear whether

the 10% penalty applies to the balance remaining on the loan at the time of satisfaction or to the entire original secured amount. In order for these penalties to apply, a borrower should provide the request in the form of a demand letter to the lender by certified mail in order to evidence the date of receipt.



A law has been amended to require secured creditors to record a deed of release within 45 days of request and satisfaction.

- A new law states that written commercial credit agreements (agreements to lend or forbear repayment of money, to otherwise extend credit or to make any other financial accommodation) signed by debtors must include the following language in boldface 10 point type: "Oral agreements or commitments to loan money, extend credit or to forbear from enforcing repayment of a debt including promises to extend or renew such debt are not enforceable, regardless of the legal theory upon which it is based that is in any way related to the credit agreement. To protect you (borrower(s)) and us (creditor) from misunderstanding or disappointment, any agreements we reach covering such matters are contained in this writing, which is the complete and exclusive statement of the agreement between us, except as we may later agree in writing to modify it." Rev. Stat. Mo. § 432.047. ■

A BANKRUPTCY DEBTOR MAY ASSUME A CREDIT CARD AGREEMENT

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the network, (iv) the network wire transfers to National Processing any balance due to United; and (v) National Processing makes the balance available in United's bank account.

Banks issuing the VISA and MasterCard credit cards, the interbank networks and National Processing collect fees for their services. Chargebacks can occur if a passenger has a refundable ticket and does not fly or if United cancels a flight and the passenger does not rebook. If chargebacks would exceed United's new sales, United would owe the difference to National Processing, which would pass along the proceeds to the issuing banks and their customers. However, the merchant bank, issuing bank or customer would bear the loss if United was unable to pay. National Processing's first argument was that issuing banks allocate losses to merchant banks. Since National Processing, as a merchant bank, has guaranteed United's debts, then under the Bankruptcy Code, that guaranty is a "financial accommodation." Therefore, the argument goes, the credit card processing agreement cannot be assumed.

"Financial accommodation" is never defined in the Bankruptcy Code, but it is understood to cover a guaranty or other form of suretyship. National Processing maintained that if any component of a complex business relationship constitutes a guaranty, then nothing may be assumed in bankruptcy. The appellate court disagreed and said that the contract as a whole must be determined to be a "financial accommodation," not just one clause. National Processing also argued that the credit card system operates as a revolving line of credit. The appellate court replied that National Processing does not lend "United (or any other merchant) one penny. Any loan is made by the issuing bank, not the merchant bank; the loan is to the issuing bank's customer (United's passenger), not to United." Essentially, National Processing acts only as an intermediary and

makes no financial accommodation to United.

National Processing then argued that the merchant agreements among merchants and issuing banks in the VISA and MasterCard networks obligate merchant banks to cover chargebacks should the merchant be unable to, and this obligation is equivalent to a guaranty. The court explained that the Bankruptcy Code covers

"Financial Accommodation" is never defined in the Bankruptcy Code, but . . . understood to cover a guaranty or other form of suretyship.

contracts that are financial accommodations, not those that have the economic effects for a party similar to a financial accommodation. National Processing's contract with United does not require National Processing to cover any of United's obligations. Likewise, United would not have a claim against National Processing if an issuing bank or passenger was stuck with a loss, and neither would a passenger have a claim against National Processing.

National Processing's last argument was that judicial approval for United's assumption should have been conditioned on United's willingness to set aside a reserve of funds to cover chargebacks in the event it stopped flying. The court stated that the Bankruptcy Code "requires judicial approval but does not say that approval must be (or even should be) contingent on steps that reduce the other side's risk to zero." Such requirement is only applied

when the debtor is in default, and in this case National Processing conceded that United had never defaulted on its obligations to National Processing.

The appellate court's final remarks address actions National Processing could have taken to reduce its risks in anticipation of United's financial position deteriorating. Already, the merchant agreement required United to agree to pay fees substantially higher than those of supermarkets and other merchants and to establish a reserve account in the event the credit rating of its bond fell, which it did. "If National Processing wanted a larger reserve, it should have negotiated for this ex ante rather than asking the bankruptcy judge to impose it unilaterally." Additionally, National Processing could have negotiated for a shorter term (rather than the 5-year term) or for a higher processing fee.

Only this circuit (the Seventh Circuit Court of Appeals includes Illinois, Wisconsin and Indiana) and the Eleventh Circuit Court of Appeals (which includes Florida, Georgia and Alabama) have addressed this issue. This court stated it was following the Eleventh Circuit's holding that a trustee in bankruptcy or a debtor in possession may assume a credit card processing agreement. However, it departed from the Eleventh Circuit's guidance that the principal or primary purpose of the contract should be ascertained. Instead, a court should concentrate on the actual features of the transaction. It also disagreed with the dicta that bankruptcy judges should not allow an assumption that exposes the other party to "unreasonable risk" because that term is too open-ended and such limitation does not appear in the Bankruptcy Code. ■

STINSON MORRISON HECKER'S FINANCIAL INSTITUTIONS UPDATE

Stinson Morrison Hecker's **Financial Institutions Update** discusses recent developments in 2004. The material contained herein is informational only and is not intended to serve as specific legal advice. For more information about how the issues discussed in this publication relate to your business, please contact a Stinson Morrison Hecker LLP attorney.

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