

Trials and Tabulations

Shareholders, Insurers Cover Some Executives' Legal Fees

By Carrie Johnson and Ben White

Washington Post Staff Writers

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When corporate executives wind up in court, who pays the legal bills?

Sometimes, it is the executives themselves. But in many cases, shareholders wind up covering the tab. And just as often, insurance companies pay -- and then pass along their costs by raising premiums across the board, making it costlier for scandal-free firms to do business.

The question of who pays the bills is playing out in nearly every high-profile corporate fraud case.

Frank P. Quattrone, the former star investment banker at Credit Suisse First Boston who was convicted Monday of obstructing justice, has had his multimillion-dollar legal bills paid by his company through two trials. Quattrone's lawyer signaled he would appeal the verdict. A CSFB spokeswoman declined comment on whether the firm would continue to pay his bills.

In another case in a New York courtroom, three members of the Rigas family are defending themselves against charges they siphoned off millions of dollars from the nation's fifth-largest cable television firm to pay for a golf course, luxury cars and church dues. And shareholders of bankrupt Adelphia Communications Corp. are partly on the hook for the defense.

Lawyers for Adelphia founder John J. Rigas and his sons Timothy and Michael already have received \$24 million from the company and an additional \$1 million from Adelphia's insurers to cover legal expenses.

The practice of advancing legal fees to executives in trouble is common in the corporate world, according to legal experts and insurance industry executives, because of state laws and company policies designed to protect the innocent and help attract the most qualified job and board candidates.

But some vocal critics of the idea are calling on businesses to set limits on how executives can be reimbursed for legal bills when they come under the scrutiny of regulators and prosecutors.

"Don't they have any responsibility to the company?" asked Harvey L. Pitt, former chairman of the Securities and Exchange Commission who now runs the consulting firm Kalorama Partners LLC. "Why should the company reward them if they have caused the company irreparable harm?"

The issue is brewing in part because of the sheer number of ongoing federal probes in the post-Enron era and the often enormous costs of paying for legal defense. For instance, in the case of former Cendant Corp. chairman Walter A. Forbes, whose fraud trial began April 19, the bills recently have topped \$1 million per month, according to court filings.

A spokesman for Cendant, the New York conglomerate, said the company is "obligated" to pay for legal expenses for its executives though it may have legal grounds to seek the return of the money if Forbes is convicted of the fraud, conspiracy and insider trading charges against him. But actually getting money back can be difficult, according to analysts and defense lawyers, because executives who admit wrongdoing often have spent the majority of their own funds on government fines. A defense lawyer for Forbes did not return calls.

McLean-based Freddie Mac, the mortgage financing company whose books are being probed by the SEC and the U.S. attorney in the Eastern District of Virginia, has paid about \$2.2 million so far to cover legal bills for executives and board members, said spokesman David R. Palombi. Former chief executive Leland C. Brendsel, who has not been charged with wrongdoing, has not asked the company to pay for his legal fees, said a source who spoke on the condition of anonymity.

In some of the biggest corporate fraud cases, top executives are paying their own way -- at least for now.

Former Enron Corp. chief executive Jeffrey K. Skilling already has shelled out \$23 million to his legal team at the firm O'Melveny & Myers LLP, according to court papers. And HealthSouth Corp. founder Richard M. Scrushy has paid his lawyers more than \$21 million out of his own pocket, prosecutors said. Charles A. Russell, a spokesman for Scrushy, said he would try to recover some of the money through insurance policies.

Martha Stewart paid for her own criminal defense, but her media firm, Martha Stewart Living Omnimedia Inc., has been covering her costs in shareholder lawsuits connected to her role as an officer of the company. The company expects to seek reimbursement for those costs from its insurers.

Other executives have battled mightily to preserve their rights to collect money they believe they are owed, often with the backing of the courts.

Former Rite Aid Corp. chief financial officer Frank M. Bergonzi sued the drugstore chain, which stopped payment on a multimillion-dollar check to his lawyers shortly after Bergonzi pleaded guilty to a single conspiracy charge last year.

A Delaware judge ruled in Bergonzi's favor, reasoning that the company was on the hook until its onetime finance chief had been sentenced for the crime. Bergonzi's lawyers reached a confidential settlement with Rite Aid earlier this year, said Jeffrey W. Kilduff, a defense attorney for Bergonzi.

In the Tyco International Ltd. case, New York State Supreme Court Justice Helen E. Freedman ruled in

March that Federal Insurance Co., a unit of Chubb Corp., must pay for the legal defense, both civil and criminal, of former chief executive L. Dennis Kozlowski because he was insured by a policy covering his role as an officer and director at Tyco.

Federal had argued that Kozlowski misstated Tyco's finances and that his policy was therefore granted under false pretenses. But Freedman ruled that the insurer had no authority to "unilaterally rescind" the policy and ordered the company to cover defense costs until the validity of its decision to cancel the policy could be litigated.

In the Adelphia case, U.S. District Judge Michael M. Baylson ruled in March that Associated Electric & Gas Insurance Services Ltd. (Aegis) had to pay as much as \$300,000 each to several directors and officers -- including John Rigas and his sons -- who are defending themselves against civil litigation in the wake of the company's collapse. Aegis declined to comment.

J. Bradford McIlvain, a lawyer who represented the Rigases in the insurance matter, called the recent Tyco and Adelphia decisions "extremely significant."

"They reinforce the notion that the courts are the ones to make these decisions" about coverage, he said. "It's not a unilateral decision that can be made by insurance companies. . . . These policies only come into play when people are accused of improper activity. If merely being accused of something cancels a policy, that's a pretty drastic problem for officers and directors."

The rise in insurance claims has resulted in soaring premiums for policies that cover legal claims against officers and directors. According to a recent study by consulting firm Towers Perrin-Tillinghast, director and officer liability insurance premiums rose 33 percent in 2003. The increase came even as insurance carriers reduced the total amounts they pay on claims and increased deductibles, according to the study.

Robert C. Cox, an executive vice president at Chubb, said the rate of increase in premiums actually has slowed somewhat in recent months but probably will not fall because the number of civil securities fraud lawsuits -- and the size of judgments -- remains high by historical standards.

Cox said the average civil settlement has tripled, from \$8 million to \$24 million, since 1996. And he said investors are filing about 200 civil claims per year, twice as many as the average in the late 1990s. "You could argue that the numbers are no longer going up dramatically," Cox said. "But they are remaining steady."

Charles M. Elson, director of the corporate governance center at the University of Delaware, said courts have interpreted the issue "pretty liberally" partly because of the fear that putting limits on the payments could lead to abuse.

"The problem is, if you attempt to put collars on indemnification, the fear is that a CEO could use it against a dissenting officer or director," Elson said.

Roger W. Raber, president of the National Association of Corporate Directors, said corporate promises to pay for board members' legal fees in civil and criminal cases are "very important" to help attract the best candidates for the job.

"I don't imagine any director would come onto a company's board without indemnification," said Raber, who advises potential board members to seek guarantees about insurance and indemnification in writing.

In many instances, executives who collect legal fees from their companies sign a document agreeing to repay the money if a court finds they broke the law or violated their duty of loyalty to the company.

But some experts worry that the cash will be gone by the time the company wants a former official to make good on the promise. There are no publicly available statistics on such repayments, but former SEC chairman Pitt called them "minuscule" and said they are infrequent, in part because executives involved in civil cases frequently settle with regulators without admitting wrongdoing.

That's what happened last year when six former officials at Xerox Corp. settled SEC allegations that they took part in accounting fraud at the copier company. Xerox wound up paying the bulk of the \$22 million settlement, plus legal fees for its former chairman, chief executive and chief financial officer. It is now suing one of its insurers to recover the payout from a long-standing policy, a spokeswoman said.