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D&O insurance issues in the context of a corporate bankruptcy

BY ALAN PARRY AND ANNA OSTERHOUT

In the last several years, an increasing number of companies in the United States have been forced to seek bankruptcy protection. Obviously, a bankruptcy filing presents a host of issues for the debtor entity, but it also can give rise to serious liability concerns for the company's directors and officers. D&O liability insurance provides the ultimate safety net for directors and officers who face claims arising in the scope of their duties, but even that protection can be compromised when a company enters the bankruptcy arena. Accordingly, companies should be mindful of potential bankruptcy implications when negotiating coverage and make sure that their D&O programs are structured to provide appropriate protection.

There is little question that directors and officers of financially distressed companies face a heightened risk of personal liability. Difficult decisions made by a struggling company's management may be more vulnerable to second-guessing by disgruntled shareholders, and can also be challenged post-filing by a trustee seeking recovery from pre-bankruptcy management for the company's failure. Furthermore, directors' fiduciary duties can expand to include the company's creditors as well as the shareholders once the company has entered the 'zone of insolvency'. Executives of struggling companies also face the significant practical concern that the company may not have the financial wherewithal to meet its indemnification obligations.

Against this backdrop, directors and officers today are more interested than ever in the scope of D&O insurance coverage available to them. However, absent careful front-end planning by the company during the process of obtaining insurance, a bankruptcy filing can present challenges for individual directors and officers seeking access to D&O policy funds. One such issue is whether and to what extent the proceeds of the D&O policy can be deemed property of the bankruptcy estate. The commencement of a bankruptcy case creates a bankruptcy estate comprised of all legal and equitable interests of the debtor in property, and the property of the estate is protected by the automatic stay imposed upon the filing of a bankruptcy petition. Accordingly, when a D&O policy provides coverage for both the individual directors and officers and the debtor entity, disputes can arise in bankruptcy court regarding whether the proceeds of the D&O policy are the property of the bankruptcy estate, and thus subject to the stay. If policy proceeds are deemed property of the estate, directors and officers may be precluded from accessing those proceeds without court approval. Because actions against the individual executives may not be subject to the automatic stay, the practical consequences can be very significant for individuals who are relying on insurance funds to cover their personal litigation costs.

Another unpleasant surprise that can arise in bankruptcy is an unexpected application of the D&O policy's 'insured v. insured' exclusion. This exclusion, which is standard in most D&O policies, precludes coverage of claims brought by or on behalf of one insured against another. The original intent of the exclusion was to protect carriers from collusive lawsuits designed to generate an insurance payout. However, some carriers take the position that the exclusion applies to bar coverage even for non-collusive claims, if the claimant arguably falls within the broad definition of an 'insured' under the policy. In the bankruptcy context, where claims may be asserted by a debtor-in-possession or trustee against pre-bankruptcy directors and officers, an aggressive carrier may seek to deny coverage on the basis that the debtor-in-possession or trustee 'stands in the shoes' of the debtor entity, and is thus an 'insured' subject to the exclusion.

The good news is that companies can side-step potential coverage landmines, including those arising in bankruptcy, by paying careful attention to the structure and wording of their D&O programs on the front end. Unlike some other types of coverage, the scope of D&O coverage available varies from one policy to the next, and key provisions and exclusions of such policies are often negotiable.

For example, an insured can protect against unreasonably aggressive interpretation of the 'insured v. insured' exclusion by negotiating for the inclusion of carve-outs that restore coverage for clearly non-collusive claims. Accordingly, there are several carve-outs that are commonly included in well-negotiated policies. One example is a carve-out for claims by or on behalf of the debtor in bankruptcy, including claims by the debtor-in-possession or a trustee. An insured can also attempt to contract around the problem of policy proceeds being deemed property of the bankruptcy estate. One commonly included option is a 'priority of payments' provision, which directs that if there are limited policy funds available, those funds will be disbursed first to cover the costs of the individual insureds, with only the remainder, if any, available to cover company costs. Some policies go farther, including provisions stating that bankruptcy or insolvency of the debtor entity does not relieve the carrier of any of its obligations, noting the parties' intent that the coverage is to protect and benefit the individual insureds, and providing that ▸▸

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the company waives any automatic stay to the extent it might apply to the policy proceeds. Such pre-petition waiver language is obviously helpful to show the parties' intent, but insureds will likely face challenges to the enforceability of the provision.

To avoid a fact-specific inquiry over priority of competing claims to policy proceeds, a company can maximise protection for its individual directors and officers by purchasing 'Side A Only' D&O insurance. 'Side A' refers to the part of the D&O policy that provides coverage only to the individual directors and officers, usually with no deductible, when the company is not legally or financially able to provide indemnification. D&O policies often include Side A coverage, along with coverage for the insured entity's indemnification obligations (Side B) and coverage for the insured entity in its own right for certain types of claims (Side C). It is the existence of the Side B and C coverage parts that give the entity a direct interest in the policy proceeds, and thus create the possibility for problems in the bankruptcy context. In contrast, since the company does not have any rights in 'Side A Only' coverage, the bankruptcy estate has no right to claim the proceeds of that type of policy as property of the estate. Some 'Side A Only' policies also have more insured-friendly terms than standard primary policies, including narrower exclusions. This 'Side A Only' coverage can be purchased either as a standalone program or as an excess program that sits atop the company's primary D&O policy. Either way, companies are increasingly considering this individual-only coverage as an option, in part to address the bankruptcy concerns that can arise when the company's policy includes entity coverage.

Companies and management should understand the risks associated with D&O coverage in the event the company files for bankruptcy protection. Directors and officers fighting to navigate a corporate bankruptcy need not be burdened by the spectre of catastrophic personal liability, and reasonable advance planning during front-end negotiations with the carrier can provide significant peace of mind.

Alan Parry is a partner and leader of the Insurance Recovery Litigation and Counseling practice group, and Anna Osterhout is a senior attorney, at Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, L.L.P.
Mr Parry can be contacted on +1 (919)821 6621 or by email: aparry@smithlaw.com
Ms Osterhout can be contacted on +1(919)821 6701 or by email: aosterhout@smithlaw.com

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Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, L.L.P.