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Directors and Officers Liability Insurance in Bankruptcy Settings – What Directors and Officers Really Need to Know

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While director and officer (“D&O”) liability insurance is important for any company, the importance of D&O insurance increases exponentially for both public and private companies (the “Corporation”) when the Corporation is insolvent or involved in a financial restructuring. When a Corporation is economically viable, a directors and officers liability insurance policy (hereinafter, a “D&O Policy”) is generally used to advance defense costs, indemnify judgments, and pay for settlements (collectively, the “Losses”) with respect to claims against the directors and officers after the policy’s self-insured retention (which works like a deductible) (hereinafter, the “Retention”) is satisfied. However, when a Corporation files for bankruptcy, the D&O policy becomes one of the few protections a director or officer has against lawsuits and claims targeting his or her personal assets. Many of these lawsuits and claims stem from alleged violations of the 1934 Securities and Exchange Act (the “Securities Claims”) or the Employee Retirement Income Security Act of 1974 (“ERISA”).¹ In bankruptcy, D&O Policies need to be as comprehensive as possible to protect the Corporation’s directors and officers in the event claims are asserted against them.

This article identifies the issues that Corporations should analyze when developing their D&O insurance program and focuses primarily on those issues arising in corporate reorganization and bankruptcy settings. Moreover, the article discusses the difficult determination of how much coverage a Corporation should procure under its D&O Policy, as well as how to choose an insurance carrier (the “D&O Insurance Carrier”). It should be noted that some of the coverage discussed in this article may not be available under a Corporation’s D&O Policy because its D&O Insurance Carrier does not offer such options. If this is the case, the Corporation should try to negotiate a solution with the D&O Insurance Carrier to provide as much certainty as possible to management and the board of directors with respect to the availability of coverage. A good insurance broker may be able to assist in finding alternative primary carriers or alternative coverage solutions that will better satisfy a Corporation’s needs.²

Side A Coverage/Non-rescindable Side A Endorsements

There are generally two basic insuring clauses in the insuring agreement of any D&O Policy (the “Insuring Agreement”): Insuring Agreement A (“Side A”) and Insuring Agreement B (Side B”). The Corporation itself is not insured under the Side A coverage provisions of the typical D&O Policy. Rather, Side A coverage is for non-indemnifiable Loss that occurs when a Corporation is unable to advance costs or pay expenses on behalf of its directors and officers. On the other hand, Side B coverage in D&O Policies provides for (i) reimbursement to Corporations for defense costs paid in excess of the Retention or (ii) reimbursement for Loss in connection with Securities Claims made directly against the Corporation.

Corporations organized in Delaware are generally authorized under their charters or bylaws to advance defense costs or indemnify their directors and officers for lawsuits commenced against them, or which have been settled. However, if the Corporation is in bankruptcy, it may be unable to advance or indemnify Losses associated with these settlements, either because it cannot afford to do so or because it cannot, as required under title 11 of the United States Code (the “Bankruptcy Code”), get approval from key constituents and ultimately the bankruptcy court to make such payments. Side A coverage is particularly important in these situations, especially because a Corporation’s chapter 11 filing is often a catalyst for litigation against the Corporation’s directors and officers. For example, shareholder derivative actions, by which a shareholder or group of shareholders of a corporate debtor brings an action against the directors or officers of the debtor for a breach of fiduciary duty, are common when a Corporation is in bankruptcy. Another example is when a chapter 11 filing is caused by reports of accounting irregularities in the Corporation’s financial statements. In such cases, it is typical for a securities class action lawsuit to be filed against the Corporation and its directors and officers, either before or after the Corporation files its chapter 11 petition. The litigants in the securities class action suit typically claim that they, as shareholders, relied on publicly filed financial statements that were fraudulently maintained by the Corporation’s directors and officers. In such a lawsuit, the insurance carrier will generally be required under the Side A provisions of the Corporation’s D&O policy (subject to its other terms and conditions and limitations), to pay the director’s or officer’s defense costs and directly fund litigation settlements without the need to satisfy the specified Retention in the D&O Policy that must be paid by the Corporation before the D&O Policy is authorized to respond to Losses.

A major issue that can arise with respect to a Corporation in chapter 11 is an attempt by the D&O Insurance Carrier to void or rescind the D&O Policy based on grounds of fraud. This can occur in situations where the D&O Insurance Carrier required the Corporation to attach its financial statements to its application when it first applied for the D&O Policy. If the financial statements were subsequently found to be materially misstated then the D&O Insurance Carrier may be able to seek rescission of the D&O Policy based on these misstatements. Because of the Bankruptcy Code’s prohibition against a debtor advancing any funds to directors or officers for defending lawsuits based upon pre-petition conduct, the directors and officers might have no other choice but to fund their own defense or default in their litigation. This could expose the directors and officers to potentially great monetary consequences. This scenario may be avoided by the Corporation’s purchase (for an additional premium) of something known as a non-rescindable Side A endorsement (the “Non-Rescindable Side A Endorsement”). Under the Non-Rescindable Side A Endorsement, coverage under Side A cannot be rescinded and will generally require a D&O Insurance Carrier to start advancing defenses costs to the directors and officers immediately, even in situations where the D&O Insurance Carrier may have depended on the alleged fraudulent financial statements of the Corporation in issuing the Policy.

Full Severability of the Application for Coverage

Full severability (“Full Severability”) is a provision in the D&O Policy designed to protect innocent directors and officers in the event that a Corporation’s financial statements are found to be fraudulently misstated. With a Full Severability provision, even if the person signing the D&O Policy is aware of a potential misstatement in the application for coverage (e.g., a material

problem with the Company's financial statements), this knowledge should not affect coverage for directors and officers who were unaware that potentially fraudulent financial statements were issued. For example, if the D&O Policy contains a full severability provision, then even if a CEO who signed a D&O Policy was aware of the fraudulent acts by the CFO in misstating the Corporation's financial statements, the innocent directors and officers covered under the D&O Policy should still receive coverage. More specifically, one type of Full Severability provision requires that the D&O Insurance Carrier, in order to rescind coverage in its entirety, must prove actual knowledge of the fraudulent acts as to every individual covered under the D&O Policy. Along with a Side A Endorsement, a Full Severability clause is necessary to mitigate any potential threat of rescission of a D&O Policy.

Priority of Payments Provisions

A "priority of payments" clause ("Priority of Payments") is a relatively new provision in D&O Policies that came into existence as a result of the wave of bankruptcy filings in 2000 and 2001. The Priority of Payments provision of a D&O Policy creates a clear path that allows for the contemporaneous payment of defense costs for directors and officers. An example of a general priority of payments provision is as follows:

In the event of Loss arising from a covered Claim for which payment is due under the provisions of this policy, then the Insurer shall in all events:

- (a) first, pay **Loss** for which coverage is provided under Coverage A of this policy;
- (b) then only after payment of **Loss** has been made pursuant Coverage A, with respect to whatever remaining amount of the **Limit of Liability** is available after such payment, the Insurer shall pay such other **Loss** for which coverage is provided under Coverage B of this policy.

Under the above clause, payments under the D&O Policy's Side A provision to the Corporation's directors and officers are paid first, before payments are made under the D&O Policy to any other covered entity. Moreover, under prevailing case law, a Priority of Payments clause provides directors or officers a contractual right to access the D&O Policy for the payment of defense costs, expenses, judgments and settlements regardless of whether the D&O Policy's proceeds are found to be property of the debtor Corporation's estate. The priority of payments provision has been enforced by courts around the country since the decision of the Bankruptcy Court for the Southern District of New York in *In re Enron*.³ Including a Priority of Payments provision in a D&O Policy is helpful in that it limits the uncertainty of whether a D&O Policy will be immediately available to fund the defense costs of directors and officers who are embroiled in litigation when a company files for bankruptcy.

Presumptive Indemnification Clauses/Advancement of Defense Cost Provisions

Most D&O Policies include a "presumptive indemnification" clause ("Presumptive Indemnification"), which states that indemnification of a director or officer's defense costs is presumed under most circumstances. A D&O Policy should always include a caveat that bankruptcy or "financial impairment" is an exception to the Presumptive Indemnification clause, and that satisfaction of the D&O Policy's self-insured retention will thus not be required. This will ensure that directors and officers will still receive coverage and reimbursement for their

Losses even in the event of a chapter 11 filing. An additional safeguard that is sometimes added to a D&O Policy is a clause that states that upon filing for bankruptcy, the Corporation will automatically advance defense costs to the directors and officers in those circumstances.

Change of Control Provisions/Tail Coverage

Most D&O Policies contain a provision that details what constitutes a “change-in-control” (“Change-in-Control”) and what happens to coverage under the D&O policy when a Change-in-Control occurs.

A Change-in-Control is generally defined by two events: (i) a change in management control where a greater than 50% change of voting control at the board of directors level occurs, or (ii) the sale of all or substantially all the Corporation’s assets to another party. A Change-in-Control may occur in a variety of different ways in the restructuring setting:

- a pre-packaged bankruptcy or out-of-court restructuring where the Corporation is essentially being turned over to its creditors who will appoint a new board of directors;
- an asset sale in which one or more parties buy all of the operating assets of a chapter 11 debtor; and
- a plan of reorganization that provides for a new board of directors upon emergence from chapter 11.

There are other variations of a Change-in-Control situation that may not be as easy to identify. To prevent triggering the Change-in-Control provision in a D&O Policy, it is in the Corporation’s best interest to consult with its D&O Insurance Carrier before committing to any sale or restructuring transaction.

If the Change-in-Control provision is triggered, the Corporation’s D&O Policy terminates as to coverage for the claims arising out of wrongful acts of the entity that emerges post Change-in-Control. In such an event, new coverage will need to be put in place for the reorganized debtor, its board of directors, and management.

An important provision of any D&O Policy is the “tail” coverage of the policy (the “Tail”), which is the time period following the D&O Policy’s termination when the Corporation is entitled to report claims to the D&O Insurance Carrier based upon conduct occurring prior to the D&O Policy’s termination. Termination may be the result of expiration of the D&O Policy, the triggering of the Change-in-Control provision, or an action by the Corporation that triggers another termination provision of the D&O Policy. In many D&O Policies, the standard is one year of Tail coverage; meaning that post Change-in-Control or other termination event, the old board and management will have one year after such event to report Claims arising from conduct that occurred prior to the termination date.

There are some unique issues relating to Tail coverage. For example, one year of Tail coverage is not a long period of time to report claims, especially when many states have a statute of limitations for breach of fiduciary claims that is longer than one year. In addition, the Corporation normally pays for the premium for the Tail, which may not be possible when the Corporation is in chapter 11 if the creditors object to the payment. If the management of a Corporation is aware that chapter 11 is a near term possibility, it should consider making

payments for the Tail coverage that would alleviate some concerns that the subsequent payments under the Tail coverage may be rejected.

Insured Versus Insured Carve-out for Debtor-related Claims Against the Board and Management

Filing for chapter 11 increases the chances that the Corporation itself might actually bring a suit against its own directors and officers. This sort of suit is differentiated from a shareholder's derivative action, which is typically always covered under a D&O Policy. In chapter 11, either the Corporation is a debtor in possession, which may mean that the current management stays in place, or, less frequently, a chapter 11 trustee is appointed to manage the Corporation. Any claims that the debtor in possession or trustee has against other entities become property of the estate and any recoveries on such claims inure to the benefit of the Corporation's creditors. As such, the creditors often pressure the Corporation to bring such lawsuits or obtain the right to bring the lawsuits on the Corporation's behalf.

However, when a debtor in possession files a lawsuit against the Corporation's directors or officers for breach of fiduciary duties, an exclusion problem may arise. Most traditional D&O Policies contain what is known as an "insured versus insured" exclusion (the "Insured Versus Insured Exclusion"). The purpose of this exclusion is to prevent a corporation or its officers and directors from collecting under a D&O Policy for a lawsuit that it or they themselves initiated. As such, if a D&O Policy contains this exclusion and the debtor in possession brings an action against the Corporation's directors or officers, the director or officer being sued may not be entitled to receive advances or indemnification for defense costs and settlements under the D&O Policy. This type of provision can render the D&O Policy ineffective if such a suit were filed. Many policies contain a carve-out from the Insured Versus Insured Exclusion provision for bankruptcy-related claims, but these carve-outs are typically concerned with providing coverage in the event of proceedings filed by a receiver, liquidator, or a chapter 7 trustee. This standard carve-out is a trap for those unfamiliar with how chapter 11 bankruptcy proceedings work. It is essential for a Corporation to add language to the carve-out for the Insured Versus Insured Exclusion that includes claims brought by a debtor in possession, chapter 11 trustee, creditors, bondholders, all committees, and other bankruptcy constituencies.

Conduct Exclusions Issues

Similar to the need for a Corporation to purchase a Non-Rescindable Side A Endorsement in the event there has been misconduct on the part of certain directors and officers in causing potentially fraudulent financial statements to be submitted with the application for D&O coverage, is the need for a D&O Policy to be drafted to ensure that the exclusion of "fraud and criminal acts" (the "Fraud and Criminal Acts Exclusion") in the Corporation's D&O policy is not automatically triggered in the event that a criminal proceeding or investigation is commenced against one or more of the Corporation's directors or officers, or if there are allegations of fraud or "criminality" alleged in a complaint.

The D&O Policy should be drafted so that the Fraud and Criminal Acts Exclusion provision is triggered only upon a final adjudication of the prohibited criminal conduct. Therefore, until a final, non-appealable judgment is entered or, in a criminal proceeding when the director or officer of the Corporation is sentenced, the D&O Insurance Carrier may not stop providing

coverage to the directors and officers. This will prevent a director or officer from having to pay for his or her own defense.

In addition, the Full Severability Clause discussed above should provide that the Fraudulent and Criminal Acts Exclusion provision is severable to ensure that a guilty plea or criminal conviction on the part of some directors and officers will not have an effect on coverage for innocent directors and officers.

Limits of Liability and Construction of the D&O Tower

In addition to purchasing a D&O Policy that is broad enough to cover all circumstances that may occur in chapter 11, a Corporation should also be mindful of purchasing a sufficient amount of coverage so that all potential claims against directors and officers will be covered under the D&O Policy. Deciding on how much coverage to obtain depends upon many different variables, including:

1. whether the Corporation is public or private;
2. if the Corporation is public, the Corporation's market capitalization;
3. the size of the Corporation's assets;
4. the amount and type of debt held by the Corporation;
5. parties that have claims against the Corporation;
6. other factors that are specific to each Corporation, i.e., other forms of debt the Corporation holds, the number of employees of the Corporation etc.

There are three suggested methods a Corporation may use to triangulate the best coverage:

1. **Benchmarking** – This is an exercise performed by brokers that looks at director and officer coverage purchased by similarly situated companies (in terms of size, customer base, number of employees etc.).
2. **Damage Analysis Modeling** – This is a service that some brokers and consultants perform that focuses on the market capitalization of the Corporation, as well as historical securities class action settlements.
3. **Consulting Defense Counsel** – Because the Corporation's defense counsel has the requisite depth of securities class action experience, they will likely be able to provide some guidance as to how much coverage their other clients generally purchase and the size of typical securities class action settlements.

Types of D&O Coverage to Purchase

There are several other types of director and officer liability coverage in the marketplace that a Corporation should consider in addition to the typical Side A and Size B coverage:

1. **Side A Excess D&O Policy:** This is an excess Side A non-indemnifiable Loss policy. If Side A coverage is exhausted on account of claims asserted against a Corporation's directors and officers, a Side A Excess D&O Policy will generally allow for payment for any Losses that are over the limit of the underlying Side A coverage.
2. **Side A Excess Difference in Conditions D&O Policy:** This is a specialized Side A Excess policy that allows for advancement or indemnification of claims of a director or

officer when the underlying tower of the D&O Policy is exhausted. Importantly, this policy contains a “drop down” provision, which generally allows it to advance or indemnify directors and officers for Losses incurred when the underlying D&O Insurance Carrier refuses to pay for claims or the Carrier is unable to pay for claims on account of insolvency. Side A Excess Difference in Conditions is similar to the Side A Excess D&O Policy in that it covers Losses when the initial Side A coverage is exhausted. And it covers Losses incurred by directors and officers when the D&O carrier refuses payments under the initial Side A coverage (whereas the Side A Excess D&O Policy does not).

3. **Side A Independent Director Liability (“IDL”) Policy:** An IDL policy only covers, on a Side A basis, the independent directors of a Corporation (i.e., non-management). As such, IDL coverage is not available to officers or to management directors (like a CEO/Chairman). IDL coverage is also marketed by some carriers as “audit committee” coverage.

After determining how much coverage a Corporation should purchase, the next step is to determine whether any of these additional policies are necessary. IDL coverage should be of a higher priority especially for larger Corporations. Historically, when lawsuits are filed against the directors and officers of Corporations, CEOs and CFOs generally use up most of the coverage under the Corporation’s underlying D&O Policy, potentially leaving the independent directors with insufficient coverage to resolve the claims against them. Even though IDL policies are the most underutilized insurance policies, it is generally in the Corporation’s best interest to purchase IDL coverage if it suspects that there may be claims of any significance against the Corporation’s inside directors and management.

D&O Insurance Carriers

Determining which D&O Insurance Carrier to use to provide a D&O Policy is another difficult decision confronting management. There are scores of insurance carriers in the marketplace that offer most, if not all, of the director and officer products mentioned in this article. For many Corporations, the total cost of the D&O Policy is the primary driver for determining its D&O Insurance Carrier. Many Corporations have a fixed budget for the purchase of the D&O Policy and given the excess capacity of director and officer liability coverage available from insurance carriers, prices of director and officer liability coverage can vary considerably. Insurance brokers (understandably) try to come within the budget of a Corporation. However, this can result in a D&O program with *one* good primary D&O Insurance Carrier and many less expensive D&O Insurance Carriers in order to “make budget.” This is not necessarily a bad situation; however, experience suggests that less expensive D&O Insurance Carriers might not always be the best insurance carriers when there are multiple Securities Claims, derivative actions, and bankruptcy filings. These less expensive carriers are usually newer entrants into the D&O Policy marketplace and simply do not have the breadth of experience that the older and more established D&O Insurance Carriers have in handling the scenarios described in this article. Experience does count when handling claims against directors and officers and some D&O Insurance Carriers just do not have the internal resources to handle many of the complex issues that arise in the bankruptcy setting.

The best approach when choosing a D&O Insurance Carrier is to ask questions. There are many resources in the risk management community that can be accessed and insurance brokers are generally knowledgeable about the D&O Insurance Carriers in the marketplace. A Corporation's defense counsel may have a wealth of knowledge on which D&O Insurance Carriers are good to work with if they have had experience in handling Securities Claims. Again, using the triangulation method described in this article is a good approach to choosing a D&O Insurance Carrier and coverage under a D&O Policy. The more knowledge the Corporation has regarding its needs and the available coverage will lead the Corporation to make a more informed decision about what D&O Insurance Carrier would best suit the Corporation's needs.

For further information on D&O insurance or about Weil's Business Finance & Restructuring practice, please contact Paul Ferrillo at 212-310-8372, paul.ferrillo@weil.com; or Ronit Berkovich at 212-310-8534, ronit.berkovich@weil.com.

¹ ERISA Claims can sometimes be covered under a multi-part or broad-form D&O policy, but may also be insured on a stand-alone basis under a Fiduciary Liability policy.

² Because most relevant case law on D&O Policies has been developed under New York and Delaware state law, this article relies on those states' laws.

³ See *In re Enron* Case No. 01-16034 (Bankr. S.D.N.Y. Apr. 11, 2002) [Docket No. 3278] (holding that priority of payment provision was an enforceable contractual right).