HUNTON ANDREWS KURTH

Lawyer Insights

Bankruptcy and D&O Insurance: 10 Issues to Consider One Year into the COVID-19 Pandemic

By Geoffrey Fehling and Justin F. Paget
Published in Business Law Today | March 12, 2021


A year ago, many predicted that the COVID-19 stay-at-home orders and social distancing guidelines – and their impact on the economy – would result in a deluge of bankruptcy filings that could rival the Great Recession of 2008-2009. However, as we approach the one-year anniversary of former President Trump declaring the SARS-CoV-2 novel coronavirus a national emergency, that prediction has not come to pass.

In fact, overall bankruptcy filings dropped by more than a quarter last year compared to 2019. But looking behind that figure, Chapter 11 business bankruptcies climbed 35% year over year and for corporations with more than $50 million in assets, the number rose by 194%. The majority of these new filings were from the retail industry and other businesses that suffered from the precipitous drop in consumer foot traffic and spending. The end of government-sponsored loans, rent forbearance, and similar stimulus packages may place additional stress on balance sheets and increase these numbers in 2021.

As directors and officers evaluate the ongoing financial uncertainty arising from COVID-19 and consider seeking bankruptcy protection, they might assume that they will be adequately protected by the directors' and officers' liability insurance put in place to protect them from situations in which the company is unable to meet its indemnification and advancement obligations.

While insurance can provide peace of mind to executives should an insolvency-related lawsuit or investigation arise, directors and officers are often surprised to learn about exclusions, conditions, or other provisions in the company's D&O policies that insurers may rely upon to significantly limit or even outright deny coverage. In addition to disputes with insurers, executives may also face opposition from bankruptcy trustees, creditors' committees, or third parties seeking to limit insurance payments to preserve policy proceeds to pay claims, such as for possible breach of fiduciary duties.

While the goal of protecting executives through D&O insurance is simple, the policies themselves are complex documents with multi-faceted coverages that can be heavily modified by endorsement or even manuscripted to address particular exposures within an industry or business segment.

This article highlights 10 common insolvency-related topics for a company and its directors and officers to consider before, during, and after bankruptcy to minimize risk of uncovered losses and to maximize recovery under different types of D&O policies implicated during bankruptcy.

Bankruptcy and D&O Insurance: 10 Issues to Consider One Year into the COVID-19 Pandemic
By Geoffrey Fehling
Business Law Today | March 12, 2021

1. MITIGATE RISK WITH D&O INSURANCE BEFORE BANKRUPTCY

Robust D&O insurance programs protecting both the entity and its current and former officers and directors should be part of a company's regular risk mitigation strategy well before any potential insolvency proceedings. Prior to any bankruptcy, however, the company should ensure that the policies it purchases will afford "runoff" coverage (also referred to as "tail" coverage or "extended reporting periods") once the policies expire or a "change in control" (discussed below) occurs during bankruptcy.

Tail or runoff coverage is an extension of the D&O policy that allows insureds to continue reporting claims to the insurer after the policy expires or terminates. If a company sells its assets, is acquired, or otherwise undergoes a change in ownership, tail coverage protects former directors and officers, usually for a period of a year or more, for future claims alleging conduct by the directors and officers that occurred prior to the time the policy expired.

Many D&O policies provide automatic runoff at policy termination, subject to payment of additional premium or satisfying other conditions; but companies also can often negotiate new or different runoff coverage terms in advance of any planned bankruptcy.

In addition to ensuring adequate runoff coverage, executives should also consider a number of other policies to protect their interests in the event that the company's D&O policy falls short. This includes purchasing policies to indemnify the individual directors and officers in circumstances:

- where the company refuses or is unable to indemnify executives due to insolvency (often referred to as "Side-A only" coverage);
- where the company's primary or excess policies do not respond to a particular loss, leaving individual insureds personally exposed ("difference-in-conditions" insurance);
- where executives are retained by a debtor to assist with the remaining operation, liquidation, or winding down of the debtor's business ("winding down" coverage); or
- where independent directors sitting on public, private, or non-profit company boards may benefit from specialty umbrella coverages tailored to protect personal assets.

While D&O insurance issues can be addressed immediately preceding, or even during, insolvency proceedings, the best time to consider all of the above coverages and how they work together to best protect the company and its directors and officers is on a "clear day." There are better opportunities to tailor favorable coverage at policy placement or renewal when there may be fewer financial constraints in devoting resources to more fulsome insurance protections, and the company's and executives' interests are more likely to be aligned.

2. ACCESSING THE DEBTOR'S D&O INSURANCE POLICIES

It is well established that insurance policies issued to a company become property of the estate when that company files bankruptcy. When a policy provides for payment only to a third party, such as payments to officers and directors under an executive risk insurance policy, courts have generally held that the proceeds of such policy are not property of the estate. As a result, a bankruptcy filing should not bar directors and officers from accessing the proceeds of a D&O policy.

Frequently, the insurer and covered executives will coordinate to seek an order from the bankruptcy court authorizing the payment of policy proceeds. An estate representative, such as a Chapter 7 trustee or creditors' committee, may request that the bankruptcy court impose limitations on access to the policy proceeds if the estate representative believes that there may be claims against the executives. Such limitations might include a cap on payment of defense costs to executives or reporting requirements for the insurer so that interested parties can monitor the availability of remaining policy proceeds. Court orders governing access to D&O policy proceeds are typically negotiated and fact dependent.

Understanding and facilitating access to the debtor's D&O insurance is useful, not only for protection of the debtor's executives, but also for minimizing exposure of outside directors (including those appointed by private equity firms or other investors) who are sued in their director capacities on behalf of the debtor. It is critical to continually monitor and adjust D&O coverage across all potentially triggered programs, including management liability policies issued to cover outside directors, to avoid coverage gaps and maximize recovery in the event of a claim.

3. THE AUTOMATIC STAY DOES NOT AFFECT CLAIMS AGAINST DIRECTORS AND OFFICERS

While a company's bankruptcy filing generally stays all claims against the company, the automatic stay does not apply to a company's directors and officers. In certain circumstances, a debtor may seek to extend the stay to third-party claims against directors and officers if it can be shown that the continuation of such claims could impair a company's ability to effectively reorganize. Such a situation would not include the assertion of director or officer liability claims by a Chapter 7 trustee or other estate representative, such as a creditors' committee, if the company is not pursuing a reorganization.

An effective reorganization may include the negotiation of a release of directors and officers or limitations on pursuit of director and officer liability claims, such as limiting such claims to the proceeds of a D&O policy. Experienced bankruptcy and coverage counsel can ensure that executives navigate potential claims to minimize exposure and maximize D&O insurance protections.

4. WAIVER PROVISIONS AND THE AUTOMATIC STAY

While the automatic stay can protect a debtor from claims during bankruptcy, it can also pose issues to insureds in the event directors or officers need to submit their own "claim" to recover under the debtor's D&O policies – especially since the insurer, the court, or other stakeholders may oppose the claims. With respect to the rights of the parties to the insurance contract, those risks can be mitigated in part by endorsing D&O policies with provisions clarifying, among other things:

- that bankruptcy or insolvency of the company does not relieve the insurer of its obligations under the policy;
- that the policy is intended to protect the individual director-and-officer insureds; and
- that the parties waive any automatic stay that may apply to recovery of policy proceeds.

The effectiveness of such waiver may vary from jurisdiction to jurisdiction.

5. FILING A PETITION MAY NOT TRIGGER RUNOFF IN D&O POLICIES

Even where companies have adequate D&O insurance with runoff coverage that will continue to protect directors and officers long after the bankruptcy concludes, many executives assume that the policy's current coverage will terminate and go into runoff automatically upon the filing of a bankruptcy petition. That is not usually the case, although there are scenarios where a bankruptcy filing and runoff trigger may occur around the same time.

Instead, policies typically contain a "change in control" provision that provides a list of enumerated events that terminate current coverage and place the policy into runoff, limiting going-forward coverage to claims noticed during the extended reporting period that allege wrongful acts by the insured occurring before the change in control. Provisions vary between policies but generally speaking, a change in control occurs if:

- the named insured consolidates with or merges into another entity;
- the named insured sells all or substantially all of its assets to another entity; or
- any person or entity acquires management control (i.e., greater than 50% of voting power to appoint board or management committee members) of the named insured.

Those kinds of acquisitions or asset sales may not occur until after a plan of reorganization is confirmed or, at a minimum, until the debtor provides notice to interested parties of its intent to sells its assets, and the bankruptcy court approves the sale process, which can occur months after the petition date. The delay between the petition date and a change in control can raise a number of D&O insurance considerations – most notably a potential lapse in coverage if the company's policy is set to expire before a transaction or sale can be effectuated. This can be solved preemptively by negotiating an extension of the company's current D&O policies to continue coverage beyond the expected plan confirmation or transaction effective date, although any such extension likely requires additional premium payments.

The cost of making even a seemingly simple modification to a debtor's D&O coverage can be substantial. While bankruptcy courts generally allow debtors to maintain D&O insurance, the need for ongoing insurance funding can be cause for alarm for former directors and officers and other individuals or entities who may need to access the debtor's D&O coverage but are not involved in the ongoing financial decisions of the company during bankruptcy.

6. RETENTIONS AND NON-INDEMNIFIABLE LOSS

Executives should be aware of all possible payments they may be called on to make in defending against claims in the event the company is unwilling or unable to indemnify them. Those "retention" payments – also called "deductibles" or "self-insured retentions" – are the amount of money the insured is required to pay before the D&O insurer will start paying. There are two primary issues in evaluating retentions in bankruptcy.

The first is understanding what retentions apply to each type of D&O coverage. Typically, retentions apply to claims made against officers and directors that are indemnified by the company ("Side-B" coverage), while there is usually no retention for claims against individual officers and directors that are "non-indemnifiable" by the company ("Side-A" coverage). Directors and officers should understand the difference between the two coverages and what, if any, retention applies to Side-A claims where they may be personally liable in the absence of reimbursement from the insurer.

The distinction between Side-A and Side-B coverage raises a second issue: what constitutes "non-indemnifiable" loss sufficient to avoid a retention and make sure that the insurer is paying "first dollar" for any loss? Policy language varies greatly, but many D&O policies have presumptive indemnification, meaning that the insurer assumes that the company will indemnify executives to the fullest extent permissible under the law and, as a result, will only consider loss "non-indemnifiable" if the company is truly unable to pay. Policies may also expressly recognize that a company in bankruptcy is presumed to be insolvent and, therefore, unable to indemnify.

Issues may arise in bankruptcy, however, where a policy does not make clear that the inability to pay includes financial insolvency, allowing the insurer to argue that Side-A coverage does not apply (and the executive is subject to a steep retention) because, even though the company has no resources to pay, it is still *permitted* to pay under controlling corporate governance documents and applicable law. Critical policy provisions addressing permissible, required, actual, and other variations on company indemnification can raise ambiguities impacting or even negating coverage for directors and officers during bankruptcy. These ambiguities can be avoided by adequately addressing financial insolvency and its impact on retentions during policy placement or renewal.

7. D&O EXCLUSIONS AND "FINAL ADJUDICATION"

D&O policies contain many exclusions, but the most common insolvency-related example is the "insured vs. insured" exclusion, which bars coverage for claims brought by or on behalf of one insured against another insured. The aim of these provisions is to discourage company infighting by removing it from the ambit of the company's D&O coverage and to avoid collusion between insureds who may assert claims driven in whole or in part by a desire to recover under insurance policies.

Serious issues can arise in bankruptcy outside of these traditional examples if, for example, a bankruptcy or liquidation trustee, creditors' committee with derivative standing, or receiver (including the FDIC) asserts a claim against directors and officers on behalf of the debtor. Absent appropriate carve-outs to the insured vs. insured exclusion, insurers may argue that coverage is negated because, as representatives of the debtor company, those bankruptcy entities are considered insureds subject to the exclusion. Executives should ensure that any D&O policy has appropriate exceptions to the otherwise broad insured-vs.-insured exclusion that protects coverage in these situations.

In addition to raising issues under the insured vs. insured exclusion, adversary proceedings brought by bankruptcy or liquidation trustees asserting claims against directors and officers can implicate D&O exclusions for deliberate criminal, fraudulent, or dishonest acts, such as allegations of reckless or intentional conduct in breaching fiduciary duties. Those allegations, even if groundless, can pose significant obstacles to advancing legal fees and expenses unless the D&O policy's "conduct" exclusions include a "final adjudication" requirement that prevents insurers from refusing coverage under the exclusion until the criminal, fraudulent, or dishonest acts are established by a final, non-appealable adjudication.

Even if conduct exclusions contain final adjudication language, the effectiveness of those requirements can vary widely between policies. For example, is the exclusion triggered based on final adjudications in any proceeding or only the underlying proceeding, and does such adjudication need to be adverse to the insured? These and other nuances in exclusionary language can play critical roles in maximizing executive protection during bankruptcy (and other proceedings).

8. PRIORITY OF PAYMENT PROVISIONS

In many instances, a debtor's insurance policies will be one of the more valuable assets of its estate. To make matters worse, as previewed throughout this article, insolvency can lead to a number of new claims against both the company and its directors and officers at a time when the company is not in a financial position to defend itself or provide indemnification. For those reasons, there often are competing claims to recover policy proceeds that involve losses far exceeding the available limits.

Claims against different insureds may proceed on different tracks. For instance, a settlement in one matter may risk exhaustion of full limits, while a separate lawsuit against only the company's directors and officers continues to trial after incurring millions of dollars in legal fees. This risk can be mitigated in large part by purchasing the "Side-A only" policies discussed above, which afford separate limits to executives that cannot be impaired by claims against the company (or reimbursement to the company for indemnification paid to individual insureds).

Where executives have access only to the company's D&O policies, however, they should ensure that all policies have a "priority of payments" provision that prioritizes "Side-A" payments to individuals before all other kinds of payments. A priority of payments provision can also clarify that the company has a right to coverage only after all claims against individual directors and officers have been satisfied or even prohibit any payments to the company absent written approval by the board.

9. ALLOCATION PROVISIONS

Claims during bankruptcy can involve a number of different theories of liability, different entity and individual defendants across different stages of the debtor's corporate history, and a variety of damages, not all of which may be covered by D&O policies. In these "mixed" claim scenarios, policyholders should understand how covered and potentially uncovered losses may be treated under D&O policies or, more specifically, what grounds insurers may raise to limit coverage to something less than all claims and damages asserted in the litigation.

Policies may be silent on "allocation," particularly with respect to defense costs incurred by a law firm representing multiple defendants, only some of whom are insureds under the D&O policy. In those instances, many courts have held that insurers must reimburse 100% of legal fees and expenses as long as they "reasonably relate" to covered claims, even if the defense benefits non-covered claims or non-insured defendants.

Other policies, however, have explicit allocation provisions that require a particular method of allocation, such as requiring the insurer and policyholder to use their "best efforts" to determine a "fair and appropriate allocation" between covered and uncovered costs based on "the relative legal and financial exposure of the parties." Such provisions commonly provide a process for resolving allocation disputes where the insurer must advance only those defense costs it believes to be covered until a different allocation is negotiated or determined in court or arbitration.

The best approach to avoiding allocation disputes is modifying the policy to include a provision explicitly stating that the insurer will advance 100% of defense costs as long as any claim triggers the duty to pay such costs. Working with coverage counsel and insurance brokers to understand allocation and, if needed, negotiate favorable terms well in advance of any claim is key to ensuring that directors and officers receive adequate protection for covered claims during bankruptcy.

10. AVOID CANCELLED POLICIES

In line with all of the commentary above, many directors and officers recognize the importance of placing and renewing D&O insurance protection well in advance of any insolvency, including runoff coverage to protect executives long after they have resigned. When a claim arises during bankruptcy, insureds understandably look to the debtor's coverage as the first line of defense.

In some instances, those directors and officers may be surprised to learn that the policy they had carefully crafted was cancelled – not by the company, but by the bankruptcy trustee, who recovered the policy premium for the benefit of the estate at the expense of leaving the debtor's officers and directors unprotected. Thus, policyholders should confirm that D&O policies have provisions stating that they cannot be cancelled for any reason except for non-payment of premium, even if the cancellation is being requested by the insured (including a bankruptcy trustee or other entity acting in the capacity of the insured).

Geoffrey B. Fehling *is Counsel in the firm's Insurance Coverage group in the firm's Washington D.C. office. Geoff represents corporate policyholders and their officers and directors in insurance coverage disputes involving directors' and officers' (D&O), errors and omissions (E&O), and other professional liability claims, cybersecurity and data breaches, representations and warranties, employee theft and fidelity claims, government investigations, breach of fiduciary duty, environmental liabilities, and property damage. He serves as the Vice Chair of the ABA Business Law Section D&O Liability Committee's Insurance Subcommittee and can be reached at +1 (202) 955-1944 or gfehling@HuntonAK.com.*

Justin F. Paget *is counsel in the firm's Bankruptcy and Restructuring group in the firm's Richmond office. Clients seek Justin's advice in restructuring transactions and defending litigation involving business and consumer bankruptcy law. He can be reached at +1 (804) 787-8132 or jpaget@HuntonAK.com.*