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LIABILITY INSURANCE

Two Davis Polk attorneys discuss the importance for directors and officers to review insurance coverage protecting their personal assets from lawsuits before their company prepares to file for bankruptcy.

INSIGHT: Directors and Officers Insurance Policies—Are You Covered?

By Marshall S. Huebner and Benjamin M. Schak

Directors and officers of corporations commonly require insurance (D&O insurance) to protect their personal assets from lawsuits arising out of their service. Yet this insurance may not protect them in their hour of need.

When their company files for bankruptcy, directors and officers are most likely to face lawsuits, their company is least able to indemnify them, and insurers may seek to limit or evade their payment obligations.

Instead of waiting until insolvency approaches to review coverage, directors and officers should consider the issues discussed in this article and renegotiate their policies well before those issues arise.

Insurance Proceeds as Property of the Estate

Many companies purchase a single policy (often called an ''ABC tower'') that provides direct coverage for directors' and officers' losses and legal costs (Side A), for the company's indemnification of directors and officers (Side B), and for the company's own losses and legal costs (Side C), all within a single policy limit. When a company with an ABC tower enters bankruptcy, its stakeholders may argue that the policy and its proceeds are property of the estate because any payments under Side A will reduce the amount available to the company under Sides B and C. If the proceeds are found to be estate property, the Bankruptcy Code's automatic stay may prevent directors and officers from accessing the proceeds.

As an initial matter, a D&O *policy* is almost always part of the debtor's bankruptcy estate. *See MacArthur Co. v. Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 837 F.2d 89, 92 (2d Cir. 1988); *La. World Exposition, Inc. v. Fed. Ins. Co.* (*In re La. World Exposition, Inc.*), 832 F.2d 1391, 1399 (5th Cir. 1987). However, case law is far from settled as to when insurance *proceeds* are part of the estate as well. Courts undertake a fact-intensive analysis, generally focusing on whether the proceeds are for the debtor's benefit. If a policy includes only Side A coverage or if Side B exists but provides only hypothetical benefits to the debtor, a court will likely find that the proceeds lie outside the estate. *See, e.g.*, *La. World Exposition*, 832 F.2d at 1401 (holding that proceeds benefitting directors and officers were outside estate); *In re Mila, Inc.*, 423 B.R. 537, 545 (B.A.P. 9th Cir. 2010) (allowing one officer to use proceeds because debtor could not identify any others that it needed to indemnify).

However, if the policy includes Side C coverage for the debtor's benefit or if the debtor may need Side B proceeds to cover other indemnification claims, the court will more likely consider the proceeds to be part of the estate. *See, e.g.*, *SN Liquidation, Inc. v. Icon Int'l, Inc.* (*In re SN Liquidation, Inc.*), 388 B.R. 579, 584 (Bankr. D. Del. 2008); *In re CyberMedica, Inc.*, 280 B.R. 12, 15–16 (Bankr. D. Mass. 2002).

Further complicating the law, some courts do not reach the question of whether proceeds are estate property.

Instead, they modify the automatic stay to allow directors and officers to receive proceeds, based on a conclusion that the harm to the directors and officers in advancing defense costs outweighs any harm to the estate.

For example, in the MF Global cases, the court initially declined to determine whether proceeds were property of the estate, and permitted the individual insured to access a limited amount for defense costs. *In re MF Global Holdings Ltd.*, 469 B.R. 177, 194 (Bankr. S.D.N.Y. 2012). However, the court later increased the cap and determined that nearly all of the proceeds lay outside the estate. *See* 515 B.R. 193, 196, 204 (Bankr. S.D.N.Y. 2014). *See also In re Enron Corp.*, No. 01-16034 (AJG), 2002 WL 1008240, 2002 Bankr. LEXIS 544 (Bankr. S.D.N.Y. May 17, 2002) (modifying stay to permit access to insurance without addressing whether proceeds were estate property.

To mitigate the risk that proceeds may be considered property of the estate in an insolvency case, companies should consider purchasing additional stand-alone Side A coverage for their directors and officers, which would remain available if the primary ABC tower is unavailable. In purchasing stand-alone Side A policies, companies should be aware that ''follow the form'' coverage, which conforms to the terms of the primary policy, will usually not pay out until the insured has exhausted the underlying policy's limits. *See Citigroup Inc. v. Fed. Ins. Co.*, 649 F.3d 367, 373 (5th Cir. 2011) (holding that excess policy unambiguously required primary insurance to be exhausted or depleted first, so that excess coverage was unavailable when parties had settled with primary insurer for less than the policy limit); *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London*, 161 Cal. App. 4th 184, 193–203, Cal. Rptr. 3d 770, 777–85 (2008) (similar).

Instead, companies should consider ''difference in condition'' coverage to insure against the risk that the primary policy is unavailable in bankruptcy. Independent directors should also consider insisting on separate insurance for their exclusive benefit, as management and interested directors may quickly consume shared insurance.

If separate Side A coverage is too costly, then directors and officers should seek a ''priority of payments'' provision that Side A coverage must be paid before other coverages. Ideally, a policy should also provide that no Side B or Side C coverage will be paid unless the company's board of directors certifies in writing that all claims against directors and officers have been resolved. This approach is better than allowing the board to cut off Side B and Side C while actions against directors and officers are pending, since such a notice may violate the automatic stay or raise fiduciary duty issues.

A final approach, though less ideal, is to create separate limits for Sides A, B and C. The advantage is that directors and officers should be able to access their portion of the proceeds without diminishing the amount available to the estate. The more serious disadvantage, though, is that, whether or not the company is in bankruptcy, the Side A coverage may run out before the policy as a whole is consumed. Thus, a predetermined allocation works best in conjunction with sufficient stand-alone Side A coverage as a reserve.

Retentions and Financial Impairment

A bankrupt company may be unable or unwilling to pay its retention, the amount that the company must pay before its insurer must pay with respect to a particular claim. For example, if a claim arose before the company filed for bankruptcy, bankruptcy law may forbid the company from paying the (prepetition unsecured) retention.

If the company cannot or will not pay the retention, its directors and officers may have to pay it themselves before they receive coverage, although the result may depend on a close reading of policy language. For example, if the policy provides that either the company *or* the insureds must pay a retention, then the directors and officers are likely to be required to pay the retention first; but if the policy states that the retention applies only when the company actually indemnifies the directors and officers, then they are more likely to receive proceeds without a retention. *Compare Republic Techs. Int'l, LLC v. Maley* (*In re Republic Techs. Int'l, LLC*),275 B.R. 508, 516–17 (Bankr. N.D. Ohio 2001), *with Bernstein v. Genesis Ins. Co.*, 90 F. Supp. 2d 932, 939 (N.D. Ill. 2000).

Even if the retention is satisfied or waived, the insurer may argue that it has no obligation to pay Side B coverage. Where the policy covers obligations that the company is ''required or permitted to pay as indemnification,'' an insurer may argue that the chapter 11 filing or plan of reorganization obviates the company's obligation to indemnify, especially if indemnification claims are classified in a subordinated class that receives no distribution.

These issues can be solved by expressly making coverage available to directors and officers with no retention in the event of ''Financial Impairment,'' which should be defined broadly to include any kind of voluntary or involuntary insolvency proceeding, collection action against a substantial part of assets, or admission of inability to pay debts as they become due. Additionally, a policy should clarify that ''no Financial Impairment of the company will relieve the insurer of any obligation'' and that the insurer must pay losses directly to directors and officers following any Financial Impairment.

Finally, a policy should not make Side A coverage unavailable when the company is ''permitted or required'' to indemnify directors and officers. The better formulation is for Side A to be available unless the company has ''actually indemnified'' the directors and officers.

'Insured vs. Insured' Exclusion

Almost every insurance policy contains an ''insured vs. insured'' exclusion that excludes claims of one insured against another, such as those brought by the company against its directors or officers. While this exclusion, which avoids collusion among insureds, is an appropriate component of D&O insurance, it may raise issues in bankruptcy, when the insurer may avoid indemnifying directors and officers against a suit by a bankruptcy trustee (or other estate representative) on the theory that the plaintiff has stepped into the company's shoes.

Courts are split on whether the insured vs. insured exclusion precludes coverage of a trustee's claims. Some have found that ''there is no significant legal dis-

tinction between [the company] and [the trustee for the] bankruptcy estate,'' *Reliance Ins. Co. of Ill. v. Weis*, 148 B.R. 575, 583 (E.D. Mo. 1992), *aff'd in part*, 5 F.3d 532 (8th Cir. 1993) (unpublished), while others have interpreted references to the ''company'' as excluding a bankruptcy trustee. *See Biltmore Assocs., LLC v. Twin City Fire Ins. Co.*, 572 F.3d 663, 670 n.15 (9th Cir. 2009) (listing cases holding that ''a post-bankruptcy entity as different from the debtor before it went into chapter 11 for purposes of the insured versus insured exclusion''); *Cohen v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.* (*In re County Seat Stores, Inc.*), 280 B.R. 319, 328 (Bankr. S.D.N.Y. 2002). Cases sometimes turn on whether the judge views the trustee as a separate entity from the company and whether the trustee is genuinely adverse to the directors and officers. *See, e.g.*, *Indian Harbor Ins. Co. v. Zucker*, 553 B.R. 633, 642–44 (W.D. Mich. 2016) (excluding coverage for claims that debtor had assigned to a liquidating trustee subject to a provision that directors and officers would only be required to pay insurance recoveries), *aff'd*, 860 F.3d 373 (6th Cir. 2017) (reserving question of excluding coverage for a chapter 11 trustee's claims).

Insurers will often agree to carve out suits brought by at least some bankruptcy-related representatives of the company. Ideal policy language should remove from the exclusion suits brought ''in or in connection with any bankruptcy, insolvency or reorganization proceeding, including by any debtor-in-possession, examiner, trustee, receiver or liquidator of the company or any subsidiary, any official or other committee, any post-bankruptcy or post-reorganization entity or any assignee of the foregoing.''

Imputation of Prior Knowledge and Wrongdoing

''Prior knowledge'' provisions allow an insurer to deny coverage if the company has made a material misstatement or omission in its application, and some policies may impute a misstatement or omission to each of the insureds, even when only a few knew the relevant facts. *See, e.g.*, *XL Specialty Ins. Co. v. Agoglia*, No. 08 Civ. 3821, 2009 WL 1227485, at *9–11, *32, 2009 BL 93787 (S.D.N.Y. Apr. 30, 2009) (denying coverage to all directors and officers based on CEO's knowledge of fraud). An insurer may also deny coverage for wrongful acts of a single director or officer, a serious problem for innocent insureds.

In order to preserve coverage for innocent insureds, companies should negotiate to eliminate provisions that impute wrongdoing or knowledge. Specifically, companies should obtain a full severability provision in each policy, so that an insurer may rescind coverage only for an insured who committed wrongdoing or knew material facts giving rise to a claim.

Change in Control and Termination

The vast majority of policies contain a provision that alters coverage when a company experiences a change in control. Policies should carve out the commencement of a bankruptcy proceeding from the definition of ''change in control.'' Even with such a carveout, a change of contral may occur during an insolvency proceeding, for example by the appointment of a new board, the redistribution of the debtor's equity or the sale of substantially all of the debtor's assets. Because coverage often applies only to claims for acts that occurred prior to a change in control, companies in insolvency proceedings should obtain coverage for events subsequent to any change in control. In chapter 11 cases, directors and officers may be able to obtain some additional protection through releases, exculpations or indemnifications in a plan of reorganization. (However, some courts have held, despite broad discretion over the terms of chapter 11 plans, that a bankruptcy court lacks authority to release non-debtors. *See, e.g.*, *In re Lowenschuss*, 67 F.3d 1394, 1401 (9th Cir. 1995); *Landsing Diversified Props.–II v. First Nat'l Bank & Trust Co. of Tulsa* (*In re W. Real Estate Fund, Inc.*), 922 F.2d 592, 600–02 (1990), *modified sub nom. Abel v. West*, 932 F.2d 898 (10th Cir. 1991); *Owaski v. Jet Fla. Sys., Inc.* (*In re Jet Fla. Sys., Inc.*), 883 F.2d 970, 972–73 (11th Cir. 1989); *see also In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142 (2d Cir. 2005) (''No case has tolerated non-debtor releases absent the finding of circumstances that may be characterized as unique.'').)

Relatedly, most policies contain ''tail'' coverage that allows insureds to submit claims for one year following policy termination in connection with pre-termination conduct. Besides the time limit, the company must typically pay a supplemental premium upon termination, which it may be unable to pay after filing for bankruptcy. Companies should therefore consider prepaying tail premiums and negotiating for a tail period longer than the statute of limitations for breach of fiduciary duty. Six years is not uncommon.

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