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## The Next Chapter for Chapter 11

The current economic crisis has prompted a steep rise in Chapter 11 federal bankruptcy filings. In 2008, there was a 49% increase in Chapter 11 reorganization<sup>1</sup>. Designed to help businesses in financial distress to reorganize and remain viable, changes in the U.S. economy threaten to compromise Chapter 11's fundamental purposes. Lenders have recently demonstrated a decreased interest in the modification of loans, equity, and other vehicles that are vital to Chapter 11 reorganization. A prominent retailer recently underwent Chapter 11 filings only to find itself forced to liquidate via Chapter 7 bankruptcy, partly because effective financing could not be achieved<sup>2</sup>.

With traditional means to save an ailing company in disarray, a growing number of companies are forced to deal with solutions that may include filing for bankruptcy. It is important that directors are aware of the insurance protection provided in the context of insolvency, and the potential impact of the application of terms and conditions within the insurance contract. Understanding how specific elements should be addressed by a directors and officers liability (D&O) policy can protect a vulnerable board of directors faced with a growing complexity of risk.

## Policy Terms and Conditions

### D&O Basics

Bankruptcy does not void a D&O policy, nor change the fundamental "A-B-C" protections provided. The primary focus of D&O coverage remains:

- Side A Coverage: provides personal asset protection for individual directors and officers; it is applicable for those claims where the company cannot, either for legal or practical reasons, indemnify directors or officers. Typically, there is no self-insurance retention applied to this coverage.
- Side B Coverage: reimburses the corporation for those payments it has made on behalf of individual directors and officers for indemnifiable loss. Self-insurance retentions will apply.
- Side C Coverage: reimburses loss on behalf of the corporate entity for securities claims.

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<sup>1</sup> *The National Law Journal*, "Federal Bankruptcy Filings Surge by 30%; Business Filings up 49%," Pamela A. MacLean, December 17, 2008.

<sup>2</sup> *The New York Times*, "Advantage of Corporate Bankruptcy is Dwindling," Jonathan D. Glater, November 19, 2008.

## **Terms of Note**

### **Named Insured**

When a company files for bankruptcy protection, it is treated legally as a “debtor-in-possession,” an entity distinct from its previous form. Coverage gaps can be avoided if the definition of the Named Insured contemplates the potential for insolvency, either by including “debtor in possession” wording or other recognition of the possibility of a bankruptcy filing. Proper preparation is a vital element in assuring that coverage will respond.

### **Change in Control**

Underwriters underwrite and price a D&O insurance policy based on the judgment, practices and policies of existing management in a fiscally stable entity. For obvious reasons, they do not want to cover the decisions of completely different management. Accordingly, D&O policies typically contain a “change in control” provision that excludes coverage for acts that occur after a merger, acquisition, or other event that fundamentally changes the essence of who is making decisions or the environment in which those decisions are being made.

For directors or officers who are helping to steer the company as a debtor-in-possession through its restructuring, it is important to ensure that change in control wording is included to remove a potential coverage gap. Reviewing options with the insurers for a waiver of change in control wording, where appropriate, is recommended.

### **Insured vs. Insured Exclusion**

D&O insurers are not interested in covering internal disputes among the company’s executives, and recognize that if they did offer inter-company protection, it could open up the potential for collusion. For this reason, D&O policies contain an “Insured versus Insured” exclusion. In the event of bankruptcy, it is foreseeable that bankruptcy trustees might bring litigation on behalf of the company against its directors and officers. In this instance, insurers might look to the Insured vs. Insured exclusion to deny coverage. Careful wording of this exclusion at policy inception can help avoid a problematic situation upon a bankruptcy event.

### **Presumptive Indemnification**

All D&O policies include language that presumes the individual insureds under the policy are indemnified by the named company to the fullest extent permitted by law. In times of bankruptcy, however, if the company is legitimately unable to indemnify its directors and officers, the Side A portion of the policy should apply. The use of additional Side A products can augment this coverage to provide the directors and officers with an even greater level of comfort.

### **Rescission**

The financial profile of a company at the moment of insolvency is usually vastly different from the fiscal status of the entity at the time of the D&O policy inception. It is prudent for an insured to purchase an endorsement to make sure a policy cannot be canceled or rescinded by the insurer in the event of bankruptcy.

For insureds with any concern about the future viability or solvency of their company, the Side A portion of the policy is critical. It is advisable to secure Side A non-rescindable coverage while the insurance market is still amenable to offering this extension.

## **Show Me the Money**

Even when the terms of a D&O policy prove iron clad, directors are still at risk if factors outside the four corners of the policy prevent access to its limit.

### **Insurance as Part of the Bankrupt Estate**

A bankruptcy trustee helps to determine which creditors are paid, how much they are paid, and in what order. Often the bankruptcy trustee enacts a “stay,” which effectively freezes the assets and buys the trustee time to identify the creditors and their respective rights.

Whether or not an insurance policy is part of a bankruptcy estate is an open question; judicial opinions on the subject vary. If a D&O policy’s proceeds are considered assets of the estate, then a stay may prevent directors and officers from accessing the policy proceeds necessary to help with defense and settlement costs for pending or new litigation. If Side B or Side C claims are filed, funds available for Side A claims (non-indemnifiable claims) may be reduced or even entirely depleted, leaving individual directors and officers to pay the costs of litigation out of their own pocket. Directors and officers can protect themselves by considering additional strategies in their risk transfer program.

### **Stand Alone Side A Policies, Difference in Conditions (“DIC”)**

The “A-B-C” D&O policy provides an attractive breadth of coverage for risks faced by entities and their management. To alleviate the concern of a single element of coverage consuming the entire limit, insureds may also choose to purchase stand alone Side A coverage. It provides dedicated limits for directors and officers and avoids potential erosion by other concerns. With this D&O-specific Side A policy, coverage for the company is excluded; therefore, it is less likely to be considered an asset of the bankruptcy estate.

Another option is a dedicated Side A Difference in Conditions (DIC) policy. It is designed to drop down when the underlying Side A coverage is triggered, but the traditional D&O policy is frozen by the debtor’s estate. It offers worthwhile extensions of coverage to fill the gap potentially presented by a company’s ability to indemnify, but unwillingness to do so. In these volatile economic times, many current Side A DIC policies include “drop down” coverage in the event that an underlying insurer in a company’s D&O program becomes insolvent.

### **Priority of Payments**

Another method to protect available limits for individual directors and officers is through an Order of Payments or Priority of Payments endorsement. Typically, the endorsement calls for payments under Side A coverage to precede payments for loss under Side B and Side C coverage. Granting access to policy proceeds helps ensure that policy limits will be there when directors and officers need them.

## The Importance of Coverage

The global economy is experiencing a downward spiral not seen in decades. Many companies are now in a very different financial position—due to no fault of their own. Establishing effective strategies through risk transfer is more important than ever. The allocation of funds for the purchase of insurance must be used with an eye to maximizing the breadth of coverage. And the ability to ultimately access the proceeds of the policy for which the expenditure has been made is critical.

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### About Integro

Integro is an insurance brokerage and risk management firm dedicated to serving the insurance and risk management needs of complex institutional risks. Integro has offices across North America, as well as in Bermuda and London. Its U.S. operations are headquartered at One State Street Plaza, 9th Floor, New York, NY 10004. Call 877-688-8701 and visit [www.integrogroup.com](http://www.integrogroup.com).

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