The Risk of Failure: Will Your Insurance Protect You in the Event of a Bankruptcy?

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Even the best laid business plans offer no guarantee of success. According to the Administrative Office of the U.S. Courts, business bankruptcy filings jumped 52% last year, a shocking increase, even higher than the 48% increase the year before.

With more companies fighting insolvency, it is critical that both financially healthy and financially stressed entities understand the implications of bankruptcy on an existing insurance program.

This white paper provides examples of common issues that arise from insolvency—whether the bankruptcy is yours, your customer's, or your vendor's. It also discusses the necessary coverage reviews that should be undertaken to ensure that an insurance policy will work as expected in the event of a claim—despite or because of an insolvency.

Does Filing for Bankruptcy Void Your Policy or Convert It to Run-Off Coverage?

For most lines of insurance carried by companies, the filing of a bankruptcy petition has no impact on the coverage in place at the time of filing. In fact, typical General Liability policy wording addresses this potential by clearly stating that "Bankruptcy or insolvency of the insured or of the insured's estate will not relieve us of our obligations."

However, not every type of coverage has such a statement. For example, claims-made D&O policies typically contain provisions which, upon certain events, cease to provide coverage for claims arising from acts after such event. These events typically include mergers or the sale of the company's assets. In many policies, these events also include the appointment of a receiver or trustee to manage the company. In some policies, even the mere filing of a Chapter 11 petition can turn the policy coverage into what is referred to as "run off" coverage.

How Does Insolvency Impact Your Deductible?

A bankruptcy filing may also impact the operation of a company's insurance coverage relative to deductibles or self-insured retentions (SIR). The terms "deductible" and "SIR" are commonly used interchangeably and, in many cases, have little or no economic impact on the insured. However, in a bankruptcy situation, the difference in the function of these terms may have a very important impact on paying losses.

First, the difference; a deductible typically requires the insured to pay a part of any loss, but the insurer pays from the first dollar of the loss. A policy with a self-insured retention, on the other hand, pays only after the insured has paid the SIR amount, not from the first dollar of loss. In this way, the insurance operates like excess

insurance, which pays only after the primary insurer has paid its layer of coverage. There are even certain policies that define the term "deductible" to mean what is generally understood to be a "retention." The lesson is to review, understand, and, if necessary, try to amend the provisions that speak to the amount of liability purportedly held by the insured.

The sticky situation arises because it may be difficult or impossible for an insured in bankruptcy to pay its SIR. The insurer, however, may assert that payment of the SIR is a condition precedent of their obligation to pay. Needless to say, this confusion can slow down or stop efforts to resolve a claim. These examples underscore how important it is to review the provisions in all policies that could be impacted by a bankruptcy filing.

Can a Third Party's Bankruptcy Impact Your Exposure?

Even a financially healthy company may face potentially greater D&O liability exposure due to, at least in part, the interconnectivity of companies coupled with the recent spike in bankruptcy filings. This is because shareholder lawsuits are typically triggered by an abrupt drop in a company's stock price. A stock drop may result, for example, from the announcement that one of the company's major customers has filed for bankruptcy protection. The loss in revenue or reduced likelihood that accounts receivable or other debts will be paid, coupled with inadequate reserves for those contingencies, can send a stock price falling, precipitating a D&O claim.

Because of this increased risk of bankruptcy-driven D&O claims, greater attention should be given during the D&O insurance renewal process to mitigate these risks. Additionally, one insurance product that may offer help in this area is Trade Credit insurance. This coverage protects policyholders from commercial accounts receivable losses following a customer's bankruptcy or payment default. While more difficult to obtain, the coverage can be a useful tool in managing corporate risk.

What Insurance Issues May Arise during a Reorganization?

As part of reorganization efforts, a debtor has the right to assume or reject "executory contracts." These are contracts to be performed in the future and include leases and many insurance policies. If assumed, both the debtor and other party (such as a landlord or insurer) must perform their contractual obligations. Rejected contracts are no longer the debtor's obligation. From an insurance standpoint, it is important to make sure that if lease contracts are rejected as part of the bankruptcy process, then appropriate adjustments are made to insurance programs. This is especially important with property coverage, as you want to make sure that those locations are no longer part of the values upon which premium is calculated.

Disposition of Assets in a Bankruptcy Reorganization

Part of a bankruptcy debtor's reorganization may include the disposition of assets through their sale. The same types of risk issues involved in a non-bankruptcy sale of assets may arise in connection with a sale as part of a plan of reorganization. The disclosures to potential buyers regarding known or expected claims are a potential source of exposure in the sale of any business and must be considered. To address this exposure, Representations and Warranties insurance coverage can be purchased to respond to such claims.

Additionally, the sale of a piece of the debtor's business also can bring claims for environmental liability or the failure to comply with various statutes such as the Worker Adjustment and Retraining Notification Act (WARN), which mandates employers to provide notice 60 days in advance of covered plant closings and covered mass layoffs. Insurance products are available in today's marketplace to deal with both of these risks.

Does Insolvency Trigger Change in Control Provisions?

Insurance policies often contain "Change in Control" provisions that exclude coverage for acts that occur after a merger, acquisition, or event such as an insolvency that fundamentally changes the essence of who is making decisions or the environment in which those decisions are being made.

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

Consider These Issues with an Experienced Team

The issues noted here only touch on the risk management and insurance issues that may arise out of a bankruptcy filing, whether yours or someone else's. To learn more about how to address these and other bankruptcy-related risks you may face, contact Integro today.

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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 headquarter office is located at 1 State Street, 9th Floor, New York NY 10004. 1-877-688-8701. www.integrogroup.com.

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