Legal Ease

PLAIN TALK ON LEGAL TOPICS

BY SCOTT SINDER

Bankrupt Coverage

Think you as an officer or director are covered in a bankruptcy? Think again. The devil is in the details of the D&O policy.

WE MAY BE IN A PRECARIOUS MOMENT. ALTHOUGH THERE ARE SIGNS THAT THE ECONOMY is stabilizing, credit markets are still effectively frozen, and hundreds of billions of dollars of commercial mortgages will mature over the next year. Without liquid credit markets, it may remain difficult, if not impossible, for landlords to refinance these obligations, and that may lead to a business failure domino effect in some sectors.

Lehman Brothers and, most recently, Chrysler and General Motors have filed for bankruptcy. General Growth Properties—the second-largest mall owner in the U.S.—also filed for bankruptcy in April for both itself and scores of the Special Purpose Entities through which it has financed the bulk of its shopping mall investments. Bankruptcy cases of the day are accompanied by insurance claims that directors and officers have breached their obligations to the companies. The real question for you and yours is: Are the companies and their directors and officers adequately insured?

Here are a few lessons to help get them on the right track:

Lesson 1: Once in bankruptcy, the company may be limited in its ability to help its directors and officers. The moment a company files for bankruptcy, its assets effectively become the property of the bankruptcy estate. Distributions to creditors are in the order of priority of payment under the bankruptcy code. As a practical matter, this could mean the availability of assets to cover the company's indemnification obligations for its directors and officers may not exist or could be severely limited.

Since companies typically cover the policy retentions, this has real implications for insured officers and directors. The individuals can retain their full protection if their D&O policy's non-indemnified or non-indemnifiable loss definitions clarify that the retention does not apply if the company is foreclosed from satisfying the retention obligation by virtue of its filing for bankruptcy. Provisions tied to the commencement of a bankruptcy may be unenforceable in a bankruptcy case. It may be helpful if the policy explicitly clarifies that a company's filing for bankruptcy does not obviate the coverage (some insurers have argued to the contrary).

Lesson 2: In bankruptcy, it's the company versus its directors and officers. In the normal course, the interests of the company and its directors and officers are closely aligned. This is especially true for D&O claims because companies generally indemnify their directors and officers to the full extent permitted. Filing a bankruptcy petition changes that:

- D&O policies generally exclude claims brought against directors and officers by the company itself (although those claims still are indemnified by the companies). In the bankruptcy context, the trustee or the creditors' committee could stand in the shoes of the company and they often look to assert claims against directors and officers, but the company's indemnification obligations may be obviated, leaving directors and officers in a very vulnerable position. Some insurers argue (largely unsuccessfully) that a company claim exclusion should apply when the bankruptcy trustee stands in the shoes of the company during the bankruptcy proceeding. A clarifying clause that makes clear that the policy does not apply in this manner in bankruptcy may be helpful.
- D&O policies that contain order-of-payments provisions and that have separate coverage limits that apply to the company and the individual directors and officers should clarify how these provisions run if the company files for bankruptcy; although, such provisions could be deemed unenforceable in a bankruptcy if conditioned upon the filing of a bankruptcy. There is a risk that the individuals will be forced to wait to receive their policy coverage until after the company has exhausted its coverage needs. Outside of bankruptcy, this is not a concern because it is the company that has the first line indemnification obligation for its individual leaders. But, as already discussed, because the company may no longer be in a position to satisfy such obligations, these coverage application issues become much more sensitive.

This is true not only for the base coverage, but also for any excess coverage that is in place. Such excess policies should "follow form" with the underlying coverage.

Try to include language that makes clear that the trigger for the individuals' excess coverage operates separately and distinctly from the bankruptcy trigger for the company.

Lesson 3: Once the bankruptcy petition is filed, it's every director and officer for himself or herself. A D&O policy should include a severability clause that makes clear that a misrepresentation or omission by one individual may not be relied upon to rescind the coverage of another insured on the same policy. Also, the policy should clarify that insured individuals are entitled to the payment of their covered defense costs.

Without these two provisions, an individual's indemnification rights against a bankrupt company that has neither the ability nor the means to satisfy those obligations could be further adversely affected.

Heeding these lessons may help to ensure that directors and officers receive the indemnification they thought they were being afforded at the outset of a bankruptcy.

SINDER, A PARTNER AT STEPTOE & JOHNSON, IS CIAB GENERAL COUNSEL. ssinder@steptoe.com