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Directors and Officers Liability Insurance

Subprime Credit Crisis: Changes to Your D&O Insurance Policy That You Should Negotiate Now to Protect Your Personal Assets

BY THOMAS H. BENTZ, JR.

As companies try to sort out the impact of the subprime credit crisis, many directors and officers are asking whether their D&O insurance will protect their personal assets if their company files for bankruptcy due to the subprime credit crisis.

Unfortunately, the protection provided by D&O policies varies significantly—especially when it comes to protecting directors and officers in a bankruptcy situation. Many ''off-the-shelf'' policies fall short or have significant holes in their coverage. Fortunately, most insurers will agree to amend their policies to provide stronger protection if asked. The following provides some examples of what directors and officers need to ask for to help ensure that they are protected.

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Why Some D&O Policies May Not Cover Subprime-Related Bankruptcy Claims

A typical D&O insurance policy offers three main types of protection:

(1) Side A coverage, which protects individual directors and officers when the company may not indemnify its directors or officers by law or for public policy reasons or cannot indemnify its directors or officers due to financial insolvency;

(2) Side B coverage, which protects the company by reimbursing the company for amounts it pays to its directors and officers as indemnification; and

(3) Side C coverage, which protects the company for its own wrongful acts. Side C coverage is typically limited to securities actions in public company D&O policies but may provide broader protection in private company and non-profit company policies.

Although most claims are paid under either the Side B or Side C coverage of the D&O policy, Side B and Side C coverage can have some real disadvantages from the perspective of directors and officers when the company becomes a debtor in bankruptcy. Chief among those disadvantages is that the bankruptcy court may consider the D&O policy proceeds to be an asset of the bankruptcy estate. As such, the policy proceeds may be subject to the automatic stay imposed by the Bank-

ruptcy Code when a company files for bankruptcy. Since the automatic stay typically does not apply to individual directors and officers, they may be left self-funding any defense, settlement and/or judgment until the bankruptcy case is resolved (a process that could take years). Worse yet, if the bankruptcy court ultimately decides that the policy proceeds are assets of the company's bankruptcy estate, the court could make those proceeds available to creditors to satisfy the company's liabilities, leaving the directors and officers with little or no coverage for their losses.

Courts are split on whether D&O policy proceeds should be considered an asset of the bankruptcy estate. Although the proceeds of a D&O policy are most likely to be considered an asset of the bankruptcy estate when the policy includes entity coverage (Side C coverage), some courts have ruled that the policy proceeds are part of the bankruptcy estate based solely on the existence of corporate reimbursement coverage (Side B coverage). Other courts have found that the policy proceeds should not be considered part of the bankruptcy estate regardless of whether there is corporate reimbursement or entity coverage. With such inconsistency, insureds should take steps now to make sure that their D&O insurance policy will protect them if the company becomes a debtor in bankruptcy in the future.

Making Sure Your D&O Policy Will Respond to a Subprime-Related Bankruptcy Claim

D&O insurance policies are highly negotiable. Although policyholders have the most leverage to negotiate improvements when they are purchasing a new D&O policy or when they are renewing existing coverage, it is possible to negotiate changes at nearly any time during the policy period. A D&O expert can help in this process. To be effective, such an expert must have the ability to identify shortcomings in the policy *and* have knowledge of what protection insurers are willing to provide (both the insurers on a particular risk and other insurers who might be able to compete for the business).

The following are some examples of the provisions that need to be negotiated in a typical D&O insurance policy.

1. Definition of Insured/Change in Control

When a company files for Chapter 11 protection, the company becomes a debtor-in-possession (DIP). A debtor-in-possession is considered a separate legal entity from the company. As such, it may not meet the definition of ''insured'' under the policy. This could leave a serious hole in the company's insurance protection. Fortunately, most insurers will amend the definition of insured to include a debtor-in-possession upon request.

It is also important to make sure that the policy does not consider the act of filing for Chapter 11 protection a ''change in control.'' Some D&O policies state that the appointment of a receiver, conservator, liquidator, trustee, rehabilitator, *or any comparable authority* shall constitute a change in control. Once there is a change in control, the D&O policy typically only covers wrongful acts of the directors and officers committed *prior to* the time of the change in control. This can be a problem in a Chapter 11 situation since many directors and officers continue to act on behalf of the debtor-in-possession after a Chapter 11 filing. To the extent that the policy considers the change to a debtor-in-possession a change in control, the policy may not cover the post-filing actions of the directors and officers.

To fix this problem, it is necessary to either delete the portion of the change in control provision dealing with bankruptcy or modify it so that it does not apply to a Chapter 11 filing.

2. Insured vs. Insured Exclusion

D&O policies typically contain an ''insured vs. insured'' exclusion. This exclusion bars claims brought by or on behalf of one insured against another insured. The purpose of the exclusion is to avoid covering collusive, inter-corporate disputes. In the bankruptcy context, however, the insured vs. insured exclusion can cause unintended consequences. For example, it is not uncommon for a bankruptcy trustee or a creditors' committee to bring a lawsuit against directors or officers *on behalf of* the debtor company. Although these lawsuits are obviously not collusive, many insurers take the position that the bankruptcy trustee or creditors' committee stands in the debtor's shoes. As such, the insured vs. insured exclusion can bar coverage for the lawsuit.

To ensure full protection against this situation, it is necessary to modify the insured vs. insured exclusion to avoid this limitation. Many insurers will agree to ''carve out'' lawsuits by a bankruptcy trustee, examiner, receiver, liquidator, rehabilitator, creditors' committee, or any comparable authority from the insured vs. insured exclusion upon request and without additional premium. (If the insured vs. insured carve-out does not include each of the categories above—many carve-outs do not include lawsuits by a creditors' committee—the policy does not fully protect the directors and officers). Unfortunately, many companies do not request this change and only discover the limitation after it is too late.

3. Order-of-Payments Provision

A typical ''order-of-payments'' provision states that the D&O policy limits should be applied first to losses due under the Side A coverage (*i.e.*, the coverage for individual directors and officers). Then, if any limits remain, payments will be made to the company under the Side B and/or Side C coverage. Some order-of-payments provisions go further and permit the CEO of the insured company to defer any payments to the company until a later date after there are no more potential payments due under the Side A coverage.

Such provisions are an attempt to ensure that, in the event of a bankruptcy, the policy proceeds will be available to the directors and officers and not the debtor. The Bankruptcy Code prohibits *ipso facto* clauses that trigger modifications upon: (i) the filing of a petition in bankruptcy; (ii) insolvency; or (iii) the financial condition of the company. However, since it applies in all circumstances, some courts have cited the order-of-payments provision as evidence that the policy proceeds are intended to benefit the individual directors and officers as opposed to the company. Although not all courts agree with this conclusion, directors and officers should insist on an order-of-payments provision.

Be forewarned that provisions that allow a CEO to decide whether the proceeds should be held for the company or paid out to the individuals are likely to be

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unenforceable. Although such a provision has not been tested in court, if a CEO waived the company's right to insurance in favor of the directors and officers (including, potentially, him or herself), it is likely that this action would conflict with the CEO's fiduciary duties to the company's shareholders and/or creditors.

4. Cancellation Clause

The cancellation clause in a D&O policy establishes the circumstances under which an insurer may cancel its policy. Many D&O policies allow the insurer to cancel its policy for any reason or for no reason at all. That is not good; directors and officers do not want their D&O policy cancelled by an insurer that fears serious claims are coming (*e.g.*, when an underwriter fears a subprime-related bankruptcy filing may be in the company's future).

Many states attempted to address this problem by requiring all policies issued in their state to include a ''State Amendatory Endorsement,'' which limited when an insurer could cancel its policy. Unfortunately, few states have kept up with changing market conditions and now, insurers are often willing to provide more protection against cancellation than the states require in their mandatory endorsements. In fact, many of the mandatory state endorsements actually reduce coverage for insureds today rather than increase it. State laws on cancellation were intended to protect insureds by providing a minimum, not a maximum, amount of protection.

To be sure that a D&O policy has the broadest protection against cancellation possible, it is necessary to make sure that:

> (1) the D&O policy only allows the insurer to cancel coverage if the company fails to pay the premium when due; and
>
> (2) if the D&O policy has a state required endorsement that limits when the insurer may cancel coverage, it must also have a ''state amendatory inconsistent'' endorsement which states that, to the extent permitted by law, where there is an inconsistency between a state amendatory endorsement and any term or condition of the policy, the insurer shall apply the terms and conditions of either the amendatory endorsement or the policy that are more favorable to the insured.

5. Non-Rescindable Coverage

One of today's most highly publicized issues concerning D&O insurance is rescission by an insurer. Rescission is the act of completely voiding a policy due to a fraud or misrepresentation in the application for insurance. Rescission eliminates all coverage for all insureds back to the inception date of the policy and, quite obviously, is not something directors or officers want to have happen if their company may be moving toward bankruptcy.

Fortunately, rescinding a D&O policy is not an easy task. Although the exact requirements vary by state, before an insurer can rescind a policy it must generally prove that there was a *material misrepresentation* in the application for insurance and that the insurer *relied* upon that misrepresentation when underwriting the risk. Since the insurer bears the burden of proof in establishing these elements, it will typically have to bring a successful lawsuit against its insured before it can rescind its policy. For many reasons, this is not something insurers want to do except in the most egregious of situations.

For this and other reasons, many insurers today will provide non-rescindable coverage upon request. However, insureds must be very careful here as some non-rescindable endorsements may actually make it easier for insurers to deny coverage. For example, some endorsements make the policy fully non-rescindable but state that if there are statements in the application that are not accurate or complete and such statements materially affect either the acceptance of the risk or the hazard assumed by the insurer, then the policy shall be deemed void *ab initio* (as of inception). This language leaves the determination of whether there was a material misrepresentation or reliance upon such a misrepresentation up to the insurer and shifts the burden of disproving the insurer's position to the insured. Thus, instead of having to go to court to prove that there was a material misrepresentation *and* reliance on that misrepresentation, the non-rescindable endorsement allows the insurer to simply deny coverage for the claim. To dispute the insurer's position, the insured must now bring the lawsuit and bear the burden of proving that it did not make a misrepresentation in the application and/or that the insurer did not rely on the alleged misrepresentation. For many insureds, such a provision would be less favorable and should be avoided. This is an area where a review by a D&O insurance expert can be extremely helpful.

6. Definition of Application

Rescission is most likely to arise in cases of ''application fraud,'' that is, if material information is omitted from or misstated in the application for insurance. The potential for omissions or misstatements in the application is greatly increased because the term ''application'' is defined very broadly in most D&O policies to include not only the application form itself but all documents filed by a company with *any* federal or state regulatory agency.

One way to limit this risk is to narrow the definition of application. By limiting the documents considered part of the application to only those documents filed with the Securities and Exchange Commission in the last 12 months, directors and officers may reduce the chance that irrelevant, old, and potentially stale information could affect their coverage.

7. Application Severability Provision

Absent an ''application severability provision,'' if any insured had knowledge of a fact that was misstated in the application (regardless of whether the insured knew the fact was misstated in the application), coverage under the policy could be voided as to all insureds. An application severability provision avoids this potentially unfair result by making it clear that the knowledge of an insured who knew of facts that were misrepresented in the application will not be imputed to any other insured for the purpose of determining whether coverage is available under the policy.

The following is an example of an application severability provision:

Coverage under this policy shall be void as to the following:

> (1) any insured person who knew, as of the inception date of the policy period, the facts that were not ac-

curately and completely disclosed in the application;

(2) the company to the extent it indemnifies any insured person who knew that facts were not accurately and completely disclosed as of the inception date of the policy period; and

(3) the company if any past or present chief executive officer, chief financial officer, or chief operating officer of the organization knew, as of the inception date of the policy period, the facts that were not accurately and completely disclosed in the application.

Such a provision helps ensure that ''innocent'' insureds do not lose their coverage through no fault of their own.

8. Dedicated Limit Policies

Another option for directors and officers concerned about a subprime-related bankruptcy risk is to purchase a dedicated limit insurance policy such as a Side A only or an independent directors' liability insurance policy. These types of policies typically sit on top of a traditional D&O program and only cover non-indemnifiable claims against directors and officers. As explained above, non-indemnifiable claims are limited to those claims for which the company may not or cannot indemnify its directors and officers. Since there are only a handful of situations where a company may not or cannot indemnify its directors and officers, the coverage offered by a dedicated limit policy is limited.

The following are some examples of non-indemnifiable claims:

(1) Derivative actions where the company is not permitted by law and/or public policy to indemnify directors or officers for judgments or settlements;

(2) Certain registration and anti-fraud suits brought under the federal securities laws where indemnification would be against public policy;

(3) Any claim where the company is financially unable to fund the indemnification; and

(4) Any claim where either the applicable law or the company's certificate of incorporation or by-laws prohibit indemnification.

By limiting its coverage to only these non-indemnifiable claims, the dedicated limit policy avoids some of the main disadvantages of traditional D&O insurance. Specifically, since the company is not insured by the policy, company losses cannot erode or exhaust the limit. For the same reason, the proceeds of a dedicated limit policy should not be treated as an asset of the bankruptcy estate. Thus, it will remain beyond the reach of the bankruptcy court and any creditors of the company.

Conclusion

D&O insurance is often the last line of defense for the personal assets of a director or officer. As such, directors and officers cannot leave to chance whether this multi-million dollar asset will protect them if their company files for bankruptcy due to the subprime credit crisis. Directors and officers who assume that they are protected just because their company has D&O insurance may find out too late that their protection is inadequate. Only by hiring a D&O insurance expert to negotiate improvements to their D&O insurance policies *before their company is at risk of a subprime-related bankruptcy* can directors and officers be sure that their D&O insurance will protect them when they need it most.

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