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## **IS YOUR D&O POLICY BANKRUPTCY-READY? 10 UNDERWRITING TIPS TO PROTECT YOUR DIRECTORS AND OFFICERS**

*By Rachel S. Kronowitz*

The deteriorating economic conditions threaten to lead to an unprecedented wave of corporate bankruptcy filings. The financial press is predicting that American companies are poised to default on a record number of corporate bonds and bank loans over the next two years. And new regulators in Washington, like Mary Schapiro the new chairman of the SEC, have made it clear that they will be increasing scrutiny at the top levels of corporate management and at the board level in order to determine whether boards and management conducted effective oversight of financially troubled companies.

This increased focus on what went wrong at the board level is certain to lead to increased scrutiny by not only regulators but by private claimants – shareholders or creditors who will claim that board members failed to act appropriately and as a result harmed shareholders or the ability of creditors to be paid. Defaults and bankruptcies also increase the possibility of claims against the directors and officers of troubled or bankrupt companies. This increased risk has led to additional focus on strong indemnification protections and comprehensive insurance for directors and officers.

The most dangerous situation for public company directors, as far as their personal assets are concerned, is when the company files for bankruptcy. At that point, the corporate directors are no longer able to look to the company to indemnify them against defense costs and damages for claims. Many corporate directors would be surprised to learn that the insurance purchased by the company to protect its directors and officers (“D&O policy”) against claims by shareholders and others may not be available to pay defense costs and liability for covered claims for the individual directors and officers if the company has sought bankruptcy protection. Spending some time reviewing the policy during the insurance renewal process can help minimize the possibility that directors and officers will be subject to

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expensive legal battles in bankruptcy over whether the proceeds of their D&O policy are available to pay claims and associated defense costs incurred by the directors and officers.

Although the hope is that corporations and their directors never have to deal with the challenges that arise at the intersection of the bankruptcy law and the coverage provided by D&O policies, prudent risk management suggests that a fundamental understanding of the interplay between typical D&O policy language and the bankruptcy law is essential to purchasing D&O policies that will provide for the most effective and efficient coverage of directors and officers in the event of a bankruptcy filing by the corporation. D&O policy forms and coverages vary widely and many of the policy terms are open to negotiation. This brief article provides a quick checklist of ten of the most important policy provisions that should be included in a D&O policy to protect directors and officers in the event of a bankruptcy filing. The underwriting and insurance renewal process provides the best opportunity for a company to put in place a D&O policy with a broad grant of coverage to protect the interests, and the personal assets, of corporate directors and officers.

## TOP TEN CHECKLIST

1. Severability Provisions related to both underwriting and exclusions: The D&O policy should include a full severability provision that specifies that the wrongdoing or the knowledge possessed by one insured cannot be imputed to another insured. If a suit is filed against a company by its shareholders or creditors alleging accounting fraud or other illegal activities, a D&O insurer is likely to claim that the policy should be rescinded because of misrepresentations or failure to disclose material facts on the policy application. A severability provision determines that innocent insureds will not lose coverage if the carrier successfully rescinds a policy. A full severability provision that applies to both the application process and to exclusions will protect the coverage for innocent or non-participating directors and officers. The severability provision should be drafted so that an insurer can only attempt to rescind coverage for an individual who has actual knowledge of material facts and the knowledge of one insured cannot be imputed to other insureds who do not possess such knowledge.
2. No application of retention: The definition of non-indemnified or non-indemnifiable loss covered under the D&O policy should include loss for which the company's insolvency prevents it from indemnifying an officer or a director. Often, D&O policies require the payment of a self-insured retention – an amount that could range from \$1 million to upwards of \$25 million – before the policy begins to provide actual coverage for defense costs; if these self-insured costs apply to the Side A coverage, they are typically picked up by the corporation if a claim is brought against its directors outside of the bankruptcy process. Because the company in bankruptcy cannot indemnify the directors for these selfinsured costs, the definition of loss that is paid directly by the insurer without the policyholder paying a retention – the non-indemnified or non-indemnifiable loss – should be drafted broadly enough to include loss that cannot be paid because of the corporation's bankruptcy. With such a provision, the directors and officers will

not have to pay out of pocket for covered defense costs if the corporation has sought bankruptcy protection because the D&O policy will be obligated to pay immediately.

3. Insured v. Insured Exclusion: The Insured v. Insured Exclusion in the D&O policy should provide a “carve-out” for the claims of bankruptcy trustees or creditors committees. The most likely claims against directors of a company in bankruptcy are claims by the bankruptcy trustee or a creditors committee for breach of fiduciary duty by the directors or the officers that led to the company’s financial difficulties. Insurers have attempted to defeat coverage for these claims by relying on the Insured v. Insured Exclusions in the typical D&O policy – these exclusions were designed to bar coverage for collusive suits – by claiming that the bankruptcy trustee or creditors committee stands in the shoes of the company and as a result the claims are not covered. As a general matter, courts have sided with policyholders on these claims and insurers have been unsuccessful in their efforts to obviate coverage for these claims. A carve-out in the exclusions will confirm the view that coverage for claims by bankruptcy trustees or creditors committees are not excluded under the policy.
4. Order of Payments Provision: The D&O policy should include a provision that clarifies if there is a single limit of liability and claims are brought that trigger coverage provided to both the corporate entity and to its directors and officers, that payments to or on behalf of directors and individuals are given priority over payments to or on behalf of the bankrupt company. If a D&O policy includes coverage for individual directors and officers and entity coverage for the corporation, these two coverages can conflict once the corporation files for bankruptcy protection. A bankruptcy trustee or creditor will argue that if the D&O policy provides entity coverage in addition to coverage for the individual directors and officers, the policy and its proceeds should be considered an asset of the bankruptcy estate and as a result the policy proceeds cannot be used to pay costs of directors and officers. Although the D&O policy is generally considered to be an asset of the estate of the bankrupt company, the case law is mixed as to whether the policy proceeds are also an asset of the estate. An order of payments provision that specifies that the directors and officers have first claim to the policy proceeds provides a basis for the bankruptcy court to allow the directors and officers access to the proceeds of the policy to pay for defense expenses and potential liabilities.
5. Allocation of Limits Provision: A D&O policy that has coverage for both individual directors and officers and corporate entity coverage should include a provision that allocates the applicable policy limits between the corporation and the directors and officers. Many of the same concerns outlined in the description of order of payments provision, above, apply here as well. If there are specific policy provisions that distinguish between the limits available to pay claims against the directors and officers and the associated defense costs and the limits available to pay claims against the corporation and the associated defense costs, the coverage conflict is avoided completely.

6. Payment of Limits by Insurer or Policyholder: An excess D&O insurance policy should have a provision that specifically states that payment of the underlying policy limits, by either the insurer or the policyholder, or a combination of both, is sufficient to exhaust the underlying coverage properly and trigger the excess coverage; once the underlying limits have been exhausted, the excess D&O insurance policy should then be obligated to pay defense and indemnity costs. Recent case law has held that in certain very specific situations, based on the specific language in particular primary and excess D&O policies, an excess D&O insurer is not obligated to pay covered claims or defense costs unless the underlying D&O insurer itself has fully paid the limits of its policy. If the D&O policy does not contain flexible exhaustion language that reduces restrictions on payments of loss, there is a possibility that the insurer will argue that the excess D&O policy's payment obligations will never be triggered if the underlying D&O policy settles with the policyholder for less than full policy limits.
7. Excess Follow Form Provisions: All D&O excess coverage should include clear follow form provisions that state precisely the policies that govern the application of D&O coverage in the portfolio. A policyholder purchases follow form excess D&O insurance in order to obtain seamless coverage for the same set of potential losses. If the excess insurance policy does not clearly provide that the excess coverage provides the same coverage as the underlying policies, the directors and officers of a bankrupt company may find themselves in a situation in which they must pursue costly coverage litigation, at their own expense, in order to obtain access to the coverage provided in a tower of D&O policies.
8. Insolvency Provision: The D&O policy should include a provision that states that the bankruptcy or the insolvency of the Company or the Insured shall not relieve the insurer of any of its obligations under this policy. An insolvency provision makes clear that insurance companies should not receive a windfall and be relieved of any of their coverage obligations simply because their policyholder files for bankruptcy protection. This provision insures that the bankruptcy of the policyholder will not affect the payment of policy proceeds.
9. Advancement of Defense Costs Provision: The D&O policy should have a provision that states that the insurer will pay covered Defense Costs on an as-incurred basis. If the D&O policy does not specify that an insurer must pay defense costs as they are incurred, then the directors and officers of a company in bankruptcy may find themselves in a situation where they are obligated to pay millions of dollars of defense costs out of their own pockets until a claim is finally resolved and the insurer is obligated to pay the covered defense costs and the damages. A typical D&O policy that has an advancement of defense costs provision will also provide that if it is finally determined that any defense costs paid by the Insurer are not covered under this Policy, the Insureds agree to repay those non-covered Defense Costs to the Insurer.

10. Non-Rescindable Side A/Difference-in-Conditions/Independent Director Liability Coverage: To place coverage that provides the greatest likelihood of providing protection to independent directors when the corporation on whose board the director sits files for bankruptcy protection, the corporation should purchase some combination of non-rescindable side A coverage, difference in conditions drop down coverage and/or independent director liability coverage. The case law addressing the application of different D&O policy provisions in the bankruptcy context continues to evolve and there is no certainty as to the ultimate interpretation of certain policy language in the event of a coverage dispute. The provisions described above provide protection and support for directors and officers in their effort to obtain coverage under their D&O policy once their corporation has filed for bankruptcy protection. The purchase of some amount of separate coverage for independent directors is the safest, if not the most cost effective, protection for independent directors to address the potential exhaustion of the policy proceeds from multiple simultaneous claims and to put in place insurance designed to ensure that some fund of money will be available to pay for the cost of defense and resolving claims, even if the corporate entity is bankrupt. This separate coverage might take any one of a number of forms, including a so-called Side A/DIC policy or even an individual director liability (IDL) policy. Because these policies are designed to protect only the individual outside directors, the policies' proceeds are unlikely to be held part of a debtor company's estate and, therefore, are not likely to be considered to be subject to the stay in bankruptcy. Excess Side A policies providing so-called "drop down" protection in the event the standard D & O policy is subject to the bankruptcy stay may be the most cost effective protection for outside directors.

## CONCLUSION

The D&O placement process and litigation landscape has become more complex as claims against directors and officers of financially troubled companies have become more commonplace. Individuals who are asked to serve as directors of these companies are insisting on increased protections provided by the D&O policies. This top ten checklist will assist prudent risk managers in constructing a D&O insurance program that provides the best available insurance protection for directors and officers in the event of a corporate bankruptcy filing.