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Financial Crisis: Bankruptcy Implications for D&O Insurance

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focus on:

Financial Crisis:
Bankruptcy Implications for D&O Insurance

By Keith Lavigne, Scott Meyer and Carol A.N. Zacharias

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The alarming rise in the number and scope of corporate bankruptcy filings, added to a similar spike in seizures of insolvent or financially troubled banks by the Federal Deposit Insurance Corporation (FDIC), underscores the critical necessity of directors and officers (D&O) liability insurance.

More than any other cause of litigation against corporate officers and directors, bankruptcy poses the greatest threat of personal financial risk and the most complicated coverage issues. This paper examines the rise in bankruptcy filings, explicates the bankruptcy process and participants' roles, illuminates D&O liability and key coverage concerns, and posits best practices with regard to quality insurance protection.

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Upswing in Bankruptcy Filings

The global recession spawned by the subprime mortgage and credit crisis in the United States fostered a steep rise in the number of personal and business bankruptcy filings in 2009, soaring thirty-two percent (1.44 million filings) from the prior year. Even worse was the increase in business bankruptcy filings alone. More than 15,000 businesses filed Chapter 11 petitions to reorganize or liquidate in 2009, up fifty percent from the previous year. Including Chapter 7 liquidations, in which the company ceases operations and its assets are sold to compensate creditors, commercial or business bankruptcy filings in total surged thirty eight percent (89,402 filings) in 2009.[1]

More than 150,000 U.S. companies—approximately one in every 200 American businesses—filed for bankruptcy protection in 2008 and 2009. The rate of bankruptcy filings has more than doubled in the last two and one-half years, while the number of filings by publicly traded companies in 2009 (207 bankruptcies) was the third highest in a single year since 1980. Public companies filing bankruptcy in 2009 also reported nearly $600 billion in assets, the second largest on record.[2]

While U.S. Court records indicate that business bankruptcies account for approximately five percent of all filings, recent research by bankruptcy scholars Robert Lawless and Elizabeth Warren suggests that the percentage is closer to fifteen percent.[3] Many economists predict the surge in bankruptcy filings will not abate in the first quarter of 2010, not with unemployment hovering around ten percent, banks continuing to restrict lending terms and covenants, rising anxiety over inflation, weak consumer spending, and mounting uncertainty over government policies.

Indeed, more business bankruptcies may lie ahead. "Bankruptcies are a lagging economic indicator, tending to follow poor financial news by a period of three quarters and more," says Carol A. N. Zacharias, Senior Vice President and Chief Counsel, North America, ACE Group. "Obviously, the worst is not yet behind us."

Mike Bickford, president of Automated Access to Court Electronic Records (AACER), which tabulates bankruptcy statistics, agrees. "I don't think (2010) will be less than 2009 (in terms of bankruptcies)," Mr. Bickford says.[4] The alarming rise in both Chapter 11 and Chapter 7 bankruptcy filings complements an even greater increase in the number of businesses that simply close their doors without seeking bankruptcy protection.

Bank Seizures Soar

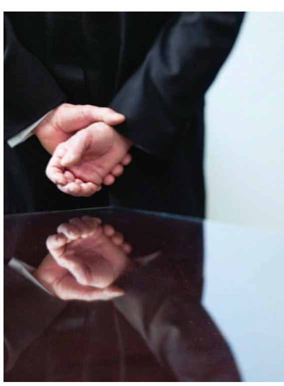
There has been a wave of bank failures, with more than 174 banks seized by the FDIC since 2008.[5] In January 2010, the FDIC seized another nine banks. Two of the banks seized by the FDIC had assets in excess of $1 billion.

The number of bank failures is the highest on record since the savings and loan crisis of the 1980s. The pace of bank failures is expected to continue through the remainder of 2010 before peaking, FDIC Chair Sheila Bair has warned. The FDIC remains committed to preserving its prerogative of asserting claims against the directors and officers of failed institutions, and has already filed multiple notices of claims, raising the spectre of significant D&O lawsuits in 2010.[6]

When banks fail, Ms. Zacharias says, "the odds are much higher for a D&O lawsuit than when non-banks fail. Regulators pull out the books prepared to sue, wanting money back in the till to help people survive and to quell public frustration. With financial institutions in the crosshairs right now because of the recession, the pressure is on regulators,"

Yet another disturbing statistic raising the liability stakes for directors and officers is the rapid increase in the volume of securities lawsuit filings. In 2009, 910 suits were recorded, up thirteen percent from 2008, when 804 suits were recorded, a thirty-three percent rise from 2007. More than one-quarter (234) of the filings in 2009 were securities class action lawsuits.[7]

Directors and Officers Liability Insurance



The risk of liability for directors and officers of a bankrupt company is the principal reason Lloyds of London created D&O insurance in the 1930s. "At the time, corporations were not allowed to indemnify their directors and officers," says Wayne Borgeest, partner and specialist in D&O litigation at law firm Kaufman Borgeest & Ryan LLP. "Bankruptcy risk was the flashpoint (for developing D&O insurance)."

D&O insurance protects directors and officers from liability arising from their actions or "wrongful acts." The insurance has evolved since its inception into three basic insuring agreements today. So-called "Side A" coverage directly insures directors and officers for their defense costs, settlements and judgments, which are not indemnified by the corporation.

Side B coverage reimburses the corporation for directors' and officers' losses, which are indemnified by the corporation. Side B coverage does not absorb the corporation's loss stemming from its own liability, however.

Side C coverage, also called "entity coverage," financially protects the corporation for its own liability, ordinarily, but not always, deriving from securities claims. The coverage was developed in the 1990s to eliminate the contentious allocation problems under standard D&O policies, which only covered directors and officers, necessitating splitting a shared loss between the insured directors and officers and the uninsured corporation.

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All three coverages are part of typical D&O insurance policies today, with Sides A, B and C included within one policy. Directors and officers thus share the limits of the policy with the company. If the company's indemnification obligations, or its separate liability, deplete the limits of insurance under the Side B and Side C coverages, the limits for individual directors and officers may be eroded, in some cases to nothing. To mitigate this possibility, a corporation can purchase a separate Side A policy, in which a specific financial limit of protection is dedicated exclusively to the directors and officers. The paper explores this protection further under the section, *Automatic Stay*.

Key Participants in Bankruptcy

The purpose of federal bankruptcy law and Chapter 11 of the Bankruptcy Code, in particular, is to create a temporary safe haven for a debtor company to reorganize in order to satisfy its obligations. Chapter 11 allows the debtor company to emerge from bankruptcy as essentially a new entity. In cases where it is unable to reorganize, Chapter 7 of the Bankruptcy Code allows for its orderly liquidation of assets and subsequent payment of claims based upon the types and priority of creditors.[8]

Bankruptcy has the potential to dramatically complicate D&O coverage issues. The filing of a bankruptcy petition significantly changes the rights and remedies normally afforded the insurer and insureds under a D&O policy, "adding an extra layer of complexity to coverage issues," says Margery N. Reed, a partner at law firm Duane Morris LLP.

As discussed in detail below, when a bankruptcy petition is filed, it triggers a stay that is a moratorium on a creditor's efforts to collect on the debtor company's pending obligations and potential liabilities. Often the company can continue to operate with either existing or new management as a debtor-in-possession, in control of the company's assets during a Chapter 11 debt and equity restructuring. When the debtor-in-possession is comprised of new management, however, it raises the risk of a lawsuit against the former directors and officers. "The new management looks around, doesn't like what it sees in terms of the prior management's conduct, and then authorizes the lawsuit," explains Dan A. Bailey, partner and chair of the D&O practice group at law firm Bailey Cavalieri.

Alternatively, the debtor company can be operated under the supervision of a bankruptcy trustee appointed by the court. The trustee is responsible for overseeing and monitoring a debtor company's business for the benefit of creditors in a Chapter 11 situation, and in a Chapter 7 filing, for assembling, liquidating and distributing the assets of the debtor. Often a creditors committee will be appointed, monitoring the actions of the debtor-in-possession or trustee. The creditors committee is comprised of individuals representing the different classes of unsecured creditors.[9]

When a corporation files for bankruptcy, the D&O risk appreciably rises. Because indemnification from the corporation may not be available, defendant directors and officers risk their personal assets in litigation, unless quality insurance exists. "Bankruptcy is the big driver of non-indemnified D&O lawsuits," Mr. Bailey says. "It is the single biggest personal asset exposure that directors and officers need to be worried about, and that Side A D&O insurance companies, which absorb risk, must carefully evaluate from an underwriting perspective."

How significant is this risk? "In many cases, creditors are taking huge haircuts, often going away without getting anything dollar-wise, even when the company is reorganized successfully," Mr. Bailey says. "The motivation of creditors to find a deep pocket to recoup their losses is huge."

The next sections of this paper explore nuances in the Bankruptcy Code potentially creating deeper concerns for directors and officers.

Automatic Stay

When a business files a Chapter 7 or Chapter 11 bankruptcy petition, an "automatic stay" activates, relieving the debtor company from the pressure of demands by creditors. "An automatic stay is essentially an injunction or a freeze order that says all debts, assets and liabilities of the company are frozen the minute it files bankruptcy," says Bailey. "No one can do anything that might impair the company's assets or alter the debts and obligations. For the purpose of D&O litigation, this has several implications."

An area of concern for directors and officers is whether the automatic stay will prohibit access to D&O insurance proceeds, especially for upfront and continuing legal defense costs. "The issue is whether the insurance policy or proceeds are the property of the bankrupt estate, and therefore subject to an automatic stay," Ms. Zacharias says.

If the policy and its proceeds are subject to the stay, the insurance company is prohibited from paying defense costs or other losses of the directors and officers, unless the bankruptcy court authorizes the payment. "There is the risk of challenges from the creditors committee, a trustee or others who may oppose spending the insurance proceeds, which they would hope instead to recover for the benefit of creditors," Ms. Zacharias says. "Court rulings, although not uniformly, have generally held that D&O policies, but not proceeds, constitute property of the estate."

She adds, "However, the policy proceeds are more likely to be assets of the bankrupt estate if the D&O policy provides coverage for claims against the entity."

Ms. Reed agrees, noting the court's reasoning in such instances. "They see the addition of direct coverage for the corporation as changing the policy into a vehicle for both individual and corporate protection," she explains.

Mr. Bailey also shares this opinion. "Side C potentially impairs the coverage for directors and officers if the company files for bankruptcy. In that situation, the D&O policy may be subject to the automatic stay, preventing the insurer from making payments for the benefit of the directors and officers when they are likely to need it most," he says. "This is a real concern for directors and officers since insurance is the only available protection for their personal assets. As a practical matter, the litigation against the directors and officers would continue during the bankruptcy, but they would no longer able to use the company's deep pockets to help pay for their legal defense as a co-defendant. If insurance is not available because of the automatic stay, they have no protection."

The purchase of separate Side A D&O coverage exclusively for the directors and officers mitigates concern over an automatic stay. Says Ms. Zacharias, "The corporation is not covered under Side A policies so it is less likely that the policy or its proceeds will be considered an asset of the bankruptcy estate and therefore subject to the automatic stay."

Additional recourse may be found through a policy waiver, a provision inserted in the D&O policy that states the company agrees to waive the automatic stay with regard to the policy and its proceeds in the event of a bankruptcy filing. Not all courts have enforced the waiver, however; nonetheless, there is ample and emerging case law upholding the provision.

Insured versus Insured and Regulatory Exclusions

Another tricky situation in a bankruptcy involves the so-called "Insured versus Insured" exclusion found in most D&O policies. The exclusion essentially precludes coverage for causes of action asserted by one insured against another. In such cases where a claim is brought against a director or officer by or on behalf of the company or another insured person, the insurer is not liable for payment of loss. Amongst the rationale for the exclusion is the prevention of collusive litigation between insureds, as well as intra-corporate disputes.

According to Mr. Bailey, "In the context of a bankruptcy, a dispute frequently arises as to whether the exclusion applies to claims by or on behalf of the debtor's estate. For example, a lawsuit by the debtor-in-possession against the directors and officers won't likely be covered, as the debtor company is an insured as are the directors and officers. Moreover, there is a risk that even a lawsuit by the trustee against the directors and officers also would not be covered, although some courts have ruled that the exclusion is inapplicable in this context."

Ms. Reed agrees that courts generally have not construed a trustee or receiver as an insured, but that the exclusion may apply if the trustee sues the directors and officers on behalf of the debtor company. "Some courts have upheld the exclusion not wanting to enlarge the risk of the insurer," she explains.

To assure full coverage for directors and officers, Mr. Bailey says newer D&O policies contain exceptions to the exclusion, addressing claims brought by a bankruptcy trustee, examiner, liquidator or receiver. Ms. Zacharias from ACE notes that some insurers have inserted exceptions into the exclusions in D&O policies. She says, "This is the moment of need for directors and officers; they are at a critical point of exposure, and these exceptions can prove to be key in securing coverage."

Many D&O policies also attempt to narrow coverage by excluding claims brought by regulators—not the best course of action for insureds at a time when banking regulators, for instance, are hunting for culprits. "Some policies will exclude claims brought by a regulator against the entity, creating a gap in coverage," says Ms. Zacharias, noting that, however, other policies provide coverage for regulatory proceedings.

Factors to Consider

When purchasing D&O insurance, it may be instructive to bear in mind what insurance underwriters are scrutinizing in their evaluation of risk. Chief among all risks, underwriters maintain, is bankruptcy. "It's the key risk in a D&O context that we try to ascertain," says Scott Meyer, Executive Vice President of ACE Professional Risk.

While industry sectors under financial or regulatory scrutiny like the financial services and home-building industries, at present, may prompt deeper examination, for the most part underwriters give the benefit of the doubt to individual policy applicants. "Among other things, we look for things like is a company selling off good assets that it should, in fact, hold onto, as this may be an indication of behavior leading up to an eventual bankruptcy," says Keith Lavigne, Senior Vice President at ACE Professional Risk. "Another red flag from a balance sheet perspective is operating cash flow, and a company's ability to attract capital or funding. We look for companies that operate from cash flow, and not by selling off solid assets."

Mr. Meyer says, "Knowing who the creditors are also is very important from an underwriting standpoint, as different creditors have different attitudes and approaches to companies in financial distress. Some want to put the company immediately into bankruptcy to take advantage of asset sales to make a quick recovery. Each creditor—shareholders, suppliers, pension funds or mutual funds—has a different risk profile. We also look at the company's experience with the capital markets, understanding who its bankers are and examining their track record with regard to accessing capital. We're always searching for where the perceived risk is greater than the actual risk."

ACE underwriters are not averse to selling D&O insurance to a company confronting the possibility of bankruptcy or even one that has filed a petition for bankruptcy. In such cases, Mr. Lavigne says underwriters spend time in meetings with senior management of the company to discern their strategies and tactics to turn around the organization. "If a company is likely to come out of bankruptcy reorganized and renewed, we perceive the risk of a D&O claim as lessened," he says.

The ACE Difference

Due to the complicated nature of D&O litigation in a bankruptcy context, it is imperative that companies seek coverage that is world class from a highly-rated carrier with the reputation, financial strength and underwriting expertise to understand litigation risks and coverage nuances.

About the Author(s):

Keith Lavigne serves as Senior Vice President, ACE Professional Risk. With more than 16 years of finance, accounting and underwriting experience in the insurance and public accounting arena, Mr. Lavigne previously spent eight years at American International Group (AIG), serving in several senior leadership positions in the company, culminating with his appointment as Senior Vice President of its private and small public financial institutions division. He previously spent eight years in public accounting, including serving as a Corporate Controller at Global Specialty Risk, Inc., Mr. Lavigne received his bachelor of science degree in financial accounting from the University of New Haven and holds the Certified Public Accountant (CPA) professional designation. He is a member of the American Institute of Certified Public Accountants (AICPA) and the Connecticut Society of Certified Public Accountants (CSCPA).

Scott Meyer is Executive Vice President, ACE Professional Risk With more than twenty years of underwriting and risk management experience in the professional lines insurance arena, Mr. Meyer joined ACE USA in 2008. He previously held several senior leadership positions at AIG, most recently serving as President, Financial Institutions Group, Head of the Mergers & Acquisitions Insurance Group, and as Senior Vice President, leading efforts for the company's Strategic Risk Group. He previously co-founded a Managing General Agent (MGA) specializing in transactional risk management products. From 1997-2000, Mr. Meyer served as a Director, Financial Services Group, at Aon. He is a graduate of New York University, and holds a bachelor of science degree in economics.

Carol Zacharias serves as Senior Vice President and Deputy General Counsel for North America, ACE Group. Ms. Zacharias received her Master's degree in law from New York University School of Law. She has served as Chairman of the American Bar Association Business Law Section's Business Insurance Committee, and is currently Vice Chairman of the Professional, Officers' and Directors' Liability Law Committee of the Tort and Insurance Practice Section. She has also served as Co-Chair of the insurance subcommittee of the American Bar Association Litigation Section's Committee on Corporate Counsel. She is a member of the United States Supreme Court, Federal and New Jersey bars, the American Bar Association, and the American Corporate Counsel Association. Ms. Zacharias has been published in a securities law textbook and her articles on D&O and securities liability exposures have appeared in a variety of periodicals. She is a frequent speaker, and has taught liability at New York's College of Insurance, now part of St. John's University.

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