Insolvency Risk Considerations for Directors & Officers

UPDATED – January 2023

ProEx

Professional & Executive Risk Practice
hubinternational.com/proex

By Whitney Ross

OVERVIEW

Though operating a business can be exciting and rewarding, inherent in business is the risk that it may become insolvent. Whether it be based on product performance, the misestimation of necessary cash flow, or factors outside of a company's control (i.e., a global pandemic), businesses sometimes file for bankruptcy – and in certain circumstances seek restructuring. In addition to the possibility of bankruptcy and restructuring, companies and their directors and officers should also be aware of litigation risk exposures in connection with a bankruptcy.

Lawsuits can be filed against directors and officers by shareholders, creditors, consumers, and/or the bankruptcy trustee. They can come in the form of alleged securities violations, breach of fiduciary duties, corporate waste, and unjust enrichment, among other things. It is critical for directors and officers to understand the litigation exposures they face in connection with a bankruptcy and review their D&O insurance policies to ensure they are protected from such exposures.

Types of Bankruptcy

When a business fails and there is outstanding debt owed, bankruptcy is oftentimes a next step. There are two common types of bankruptcy filings for businesses – Chapter 7 (liquidation) and Chapter 11 (reorganization). If a business has no ability (or plan) to reorganize and move forward, it may file for Chapter 7 bankruptcy. Chapter 7 bankruptcy is typically referred to as "liquidation" and is filed when the debts of the business are insurmountable such that restructuring is not an option. When a company files for Chapter 7 bankruptcy, a trustee is appointed. The trustee compiles and sells the debtor's nonexempt assets and uses those proceeds to pay creditors according to the Federal Bankruptcy Code.[1] In Chapter 7 bankruptcy, a debtor may lose property.

[1] See https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-7-bankruptcy-basics

HUB

Alternatively, if a company has the ability and desire to move forward with the business, Chapter 11 bankruptcy is a common vehicle to do so. Chapter 11 is typically referred to as a "reorganization." In a Chapter 11 bankruptcy, the company will continue its business operations with a court-appointed trustee. Chapter 11 bankruptcy can be voluntarily commenced by the company, or involuntarily commenced by creditors that meet certain requirements.[2] The company will file a written disclosure statement (information concerning the assets, liabilities, and business dealings of the debtor so that creditors can make an informed decision about the debtor's plan to reorganize) and plan of reorganization which details how the company will move forward and address its creditors.[3] Once the plan is finalized, the creditors will vote on the plan. If the court deems the plan fair and equitable, the court will approve the plan.

Bankruptcy Exposures

Arguably the most common exposures to directors and officers in a bankruptcy scenario are claims made against them by the bankruptcy trustee. As part of the bankruptcy trustee's responsibilities, he or she has a duty to maximize the assets of the estate and will use claims against directors and officers to discharge that duty and recover amounts (either directly from the directors and officers or through their insurance policies). Claims by bankruptcy trustees typically take the form of alleged breach of fiduciary duties (i.e., the duties of care and/or loyalty), corporate waste, and unjust enrichment. These types of claims filed by a bankruptcy trustee are unique (and dangerous) in that the trustee already has access to the bankrupt company's documents – rendering the need for extensive discovery unnecessary. Trustees are also not required to make a formal demand on the company's board (as is the case in traditional derivative litigation) before filing suit against its directors and officers.

By way of example, in July 2019 Live Well Financial mortgage company was forced into bankruptcy by its three largest creditors. In June 2021, the trustee appointed to the Live Well bankruptcy filed a lawsuit against its directors in the U.S. Bankruptcy Court for the District of Delaware seeking to recover nearly $100 million. In the lawsuit, the trustee alleges that certain non-executive directors and shareholders aided in Live Well's insolvency through continuous breaches of fiduciary duties and self-dealing. The trustee alleges that the defendants were blindly loyal to the Live Well founder as he created a reverse mortgage bond pricing "Ponzi-like" scheme. The trustee alleges that the loyalty of the defendants was, in part, due to the millions of dollars that flowed to the defendants' own businesses in connection with the scheme. The trustee claims that the directors not only lined their own pockets and the pockets of their affiliates at the expense of Live Well and its creditors, but knowingly permitted all of the company's legitimate business assets to be dissipated through a massive fraud that began on their watch. A separate lawsuit was filed by the trustee against Live Well's founder, his wife, and their various businesses and real estate holdings to recoup approximately $110 million in damages for Live Well's creditors. Among other

[2] See https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics
[3] See 11 U.S. Code § 1125 Post Petition Disclosure and Solicitation

things, the trustee alleges that Live Well's founder transferred at least $26 million from Live Well to himself and his wife and provides records of hundreds of bank transfers from Live Well to the couple, and from the couple to their businesses.

Understanding D&O Insurance for Bankruptcy Exposures

Directors and officers that are potentially exposed to claims in bankruptcy should understand their D&O insurance policies, including their rights and potential coverage issues that may arise in the context of a bankruptcy claim. Below we highlight several D&O insurance policy considerations for directors and officers.

Runoff coverage is typically offered as an "extension" of the in-place D&O policy at the time the policy expires or terminates for other reasons. Typically, runoff coverage is secured for a period of time (between one and six years) after the policy expires or terminates for claims made against the company and its directors and officers during the runoff period for wrongful acts that occurred prior to the time of expiration. Securing adequate runoff coverage is crucial for directors and officers facing a bankruptcy situation, especially since the company is likely unable to defend and indemnify the directors and officers for claims made against them. If a company emerges from bankruptcy, and D&O insurance coverage is purchased, the go-forward interplay of the coverage for the emerged company and the runoff policy will be important to properly navigate with respect to the policies' terms and conditions.

D&O insurance policies are typically structured to provide coverage in three scenarios – Side A, Side B, and Side C. First, D&O insurance provides "Side C" coverage to a company for wrongful acts alleged against the company. Second, "Side B" coverage is provided for insured persons that are indemnified by the company for wrongful acts alleged against them. Both "Side C" and "Side B" coverage provide balance sheet protection to the company in the event of a claim. "Side A" coverage is provided to insured persons where the company cannot indemnify the insured persons for claims made against them. "Side A" coverage provides personal asset protection for individuals in the event of a claim where the company cannot indemnify them. Importantly, there is no self-insured retention that applies to "Side A" coverage and the coverage, once triggered, incepts at dollar one. "Side A" coverage is oftentimes triggered in the context of a bankruptcy (i.e., where the company cannot indemnify the losses) or in the context of a derivative lawsuit (i.e., where the nature of the claim does not allow for indemnification by the company for settlements and/or judgments). In the context of a claim filed after a company becomes insolvent, directors and officers risk facing personal liability since the bankrupt company can no longer indemnify the directors and officers for their exposures. This is why the appropriate amount and scope of "Side A" coverage is critical for directors and officers.

There are various exclusions that, if not properly worded, could have a negative impact on coverage for claims against directors and officers in bankruptcy. For example, the insured v. insured exclusion (the "I v. I exclusion"), which is common to every D&O policy, should have a carve-back for creditors committee, bankruptcy trustee, examiner, receiver, liquidator, rehabilitator, or similar official. If it does not, a carrier may deem a claim by any of the foregoing a claim by an insured against an insured (i.e., a director or officer), and coverage may be barred. With a carve back to the I v. I exclusion, claims by these individuals

will not be precluded from coverage. In addition, the D&O policy will almost always include a fraud/conduct exclusion that applies to claims alleging deliberate criminal or deliberate fraudulent conduct by directors and officers. The policy will also contain a personal profit exclusion which precludes coverage for the gaining of any personal profit or remuneration to which the insured was not legally entitled. While both exclusions are very common, the scope of the exclusions should be narrowed to claims "for" fraud/dishonesty and personal profit and should always include language that the exclusions only apply after a final non-appealable adjudication in an underlying action or proceeding. This will protect directors and officers from facing a coverage denial for allegations of fraud/dishonesty and personal profit unless and until there is a final adjudication that the individual acted as alleged. If these exclusions are drafted correctly, they cannot be used to deny coverage in the event of a settlement, which is more frequent than a final, non-appealable adjudication.

If more than one director or officer is named in a bankruptcy action, or there are multiple actions filed against directors and officers, the priority of payments from the insurance proceeds can be complicated. Oftentimes, directors and officers will retain their own counsel due to conflicts of interest in their defense, and defense costs are incurred by several law firms concurrently – depleting insurance limits available to the directors and officers. It is important for the policy to have a clear and appropriate "priority of payment" provision that protects directors and officers under the Side A coverage.

Claims pending against the company at the time of a bankruptcy/restructuring filing are typically stayed. However, as discussed above, claims are not automatically stayed against directors and officers – and oftentimes are brought against them – after a bankruptcy filing. If an action is proceeding in bankruptcy, there are certain steps that need to be taken in order for insureds to access the insurance policy to defend and resolve claims. Generally speaking, D&O policies issued to companies become property of the bankruptcy estate. Side B and Side C coverage, which provide indemnification to the company and its individuals, cannot be paid under the D&O policy without prior authorization from the bankruptcy court. On the other hand, proceeds under the Side A coverage (i.e., not indemnifiable by the company) are not generally considered property of the bankruptcy estate and are not subject to the bankruptcy stay. Given the complexities involved in how courts view the D&O policies, D&O insurers typically work together with counsel for the directors and officers to seek an order for relief from the bankruptcy stay to be granted permission to access policy proceeds to pay their defense costs and/or cover a settlement or judgment (i.e., a comfort order). A comfort order will partially lift the stay to permit payments under the D&O policy.

With respect to the market, bankruptcy is still a major concern for D&O underwriters. As we are feeling the overall D&O marketplace begin to stabilize, we are still seeing various approaches to the insolvency concern. There are significant changes being made to programs in which either a bankruptcy has been initiated, or there is a concern of bankruptcy. D&O underwriters are asking more questions regarding insureds who may pose a potential solvency risk – including questions around debt covenant violations, debt restructuring, plans for cash to fund debt, and impact from ownership. We are seeing increased premiums and retentions, and certain carriers are adding a bankruptcy/insolvency exclusion and/or creditor exclusion. After a restructuring has occurred, and a run-off policy has been put in place, the go-forward coverage will typically have a prior acts exclusion which will make the risk profile of the insured more appealing for D&O underwriters.

As highlighted above, there are many D&O issues that must be considered in the event of bankruptcy/restructuring – regardless of the type of filing. HUB International's Bankruptcy and Restructuring Team is experienced in complex transactions, bankruptcies and restructuring. HUB is keenly attuned to D&O underwriting criteria and whether a company is considered high risk versus low risk for exposure. HUB's Bankruptcy and Restructuring Team also understands the importance of cost reduction and can create alternatives to traditional D&O structures to mitigate the exposure risks in bankruptcies while being mindful of pricing.

If you would like to learn more about how HUB International's Professional & Executive Risks – ProEx Practice can assist you in considering and preparing for bankruptcy risks, please reach out to:

David Garrigus
Executive Vice President & North American Practice Leader
Professional & Executive Risks – ProEx
david.garrigus@hubinternational.com | LinkedIn

About the Author

Whitney Ross is North American Claims Leader, Professional & Executive Risks – ProEx for HUB International. Whitney specializes in management liability and cyber insurance coverage. Whitney is a licensed attorney, and previously worked at Chicago-based law firms as coverage counsel for various domestic and international insurance companies. LinkedIn