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# DIRECTOR/OFFICER LIABILITY IN EVENT OF BANKRUPTCY

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## Can You Count on Your D&O Policy?

**WHEN NEW DIRECTORS OR OFFICERS** are elected to their positions at public companies, they often are given a notebook that contains a variety of basic company information. Behind one of the tabs is a copy of the company's directors' and officers' insurance liability policy ("D&O policy"). Most directors and officers assume that the policy will stand behind them if necessary unless they act fraudulently. The continuing financial meltdown and bankruptcy of some of America's well-known companies and the emphasis on corporate compliance should cause directors and officers not only to dust off their company's D&O policies but also, more crucially, to evaluate whether that policy and its proceeds will be there when it is needed most, when the company files for bankruptcy protection. This issue is critical now, when insurance companies often argue that they are entitled to rescind policies because of inaccuracies in financial statements and annual reports.

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By David I. Sunkin and Kirk A. Pasich

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Directors and officers normally receive indemnification from the company for liability and expenses unless, of course, the individual has engaged in self-dealing or intentional wrongdoing. The indemnity obligations commonly arise in charter provisions that are designed to exculpate an individual from personal liability for breaches of the duty of care pursuant to the company's applicable state law. Delaware's General Corporation Law § 102(b)(7) provides the most typical example of exculpatory state law provisions. Additionally, separate indemnification agreements that are designed to provide individuals additional protections from exposure are also commonplace in this arena. Of course, the long-standing business judgment rule, which protects individuals from the second-guessing of trial courts as long as those individuals act in a reasonably informed manner and with due care, still exists today in addition to these indemnity measures.<sup>1</sup> Corporate charter indemnifications and indemnification agreements are, however, only as strong as the financial health of the indemnifying company. As a company's financial health deteriorates, especially when a bankruptcy results, the D&O policy becomes crucial. More often than not in a financial meltdown, someone, such as a shareholder, a class, a bankruptcy trustee or a creditors' committee, will try to blame the company's implosion on someone else. In such situations, directors and officers become targets of all of these constituencies.

Increasingly, in a bankruptcy, the directors and officers not only find themselves in the crosshairs of liability claims and coverage disputes with insurers, but also experience attempts by creditors' commit-

tees or others to prevent the proceeds of those D&O policies from being paid out even if coverage for directors and officers is not disputed by the insurer.

This article will explain the nature of D&O coverage, outline the effects of an insured's bankruptcy, and offer practical tips to help your company get the most out of its D&O policy in the event of bankruptcy, all while complying with the applicable law.

## NATURE OF D&O COVERAGE

### "Directors and Officers" and "Company Reimbursement" Coverages

A D&O insurance policy typically provides two types of coverage: one for individual directors and officers and one for the company itself if it indemnifies the directors and officers against covered claims.

The "directors and officers liability" coverage typically obligates the insurer to pay on behalf of each director or officer all "loss" for which the director or officer is not indemnified by the company and for which the director or officer becomes legally obligated to pay because of a claim first made during the policy period for a "wrongful act" committed during or before the policy period. The "company reimbursement" coverage typically obligates the insurer to pay on behalf of the company all "loss" for which the company indemnifies any director or officer who has become legally obligated to pay a covered claim. "Loss" typically is broadly defined to mean the "total amount" that a director or officer is obligated to pay for "wrongful acts," including damages, judgments, settlements, costs, and defense costs.

Although most D&O policies do not obligate the insurer to defend a director or an officer, the insurer typically is obligated to pay defense costs. A dispute may occur, however, as to when that obligation arises. Courts have reached differing conclusions as to whether D&O insurers are obligated to pay defense costs before resolution of the claim when the policy does not expressly obligate the insurer to do so. Some courts have held that, because "loss" is defined to include "defense costs," the insurer must pay for defense costs on an "as incurred" basis.<sup>2</sup> Some courts have, however, held to the contrary. These courts have noted that it is

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- *Directors' and Officers' Insurance: Putting the Safety Net in Place*, PLC MAGAZINE, at [www.practicallaw.com/A31046](http://www.practicallaw.com/A31046).
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- John Howard and Timothy Donovan, "On Duty at the Corporate Helm: An Overview of Director and Officer Responsibilities," *ACCA Docket* 18, no. 9 (October 2000): 36–52, available on ACCA Online<sup>SM</sup> at [www.acca.com/protected/pubs/docket/on00/officer.html](http://www.acca.com/protected/pubs/docket/on00/officer.html).

#### **ON PAPER:**

- KIRK A. PASICH, JAMES E. HANLON JR., ROBERT E. GOODING JR., AND J. ERIK CONNOLLY, *DIRECTOR'S AND OFFICERS: LIABILITIES AND PROTECTIONS* (Matthew Bender 2003).

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not possible to determine the actual covered "loss" until the claim has finally been resolved.<sup>3</sup>

D&O policies cover many alleged acts or omissions by a director or officer. The term "wrongful act" typically is defined to include any breach of duty, neglect, error, omission, act, misstatement, or misleading statement made by an insured in his or her capacity as a director or an officer. The requirement that the director or officer be acting solely in a capacity as a director or an officer typically is enforced.<sup>4</sup>

#### **"Entity" Coverage for Securities Claims and EPLI Claims**

Some D&O policies also contain "entity" coverage for certain types of claims, such as securities claims and employment practices claims. The "entity coverage" is somewhat different from the other two forms of coverage provided by a D&O policy. "Entity" coverage typically applies to "securities claims." For example, one policy form defines a "securities claim" to be a claim made against an insured that alleges a violation of the Securities Act of 1933 or the Securities Exchange Act of 1934, rules or regulations promulgated thereunder, and the securities laws of any state or any foreign jurisdiction and that alleges a wrongful act in connection with the claimant's purchase or sale of, or the offer to purchase or sell to the claimant, any securities of the company, whether on the open market or arising from a public or private offering of securities by the company.<sup>5</sup>

In fact, this definition was broadened by an AIG "Securities Plus" endorsement to include "a civil lawsuit or criminal proceeding brought by the Securities & Exchange Commission."<sup>6</sup>

Entity coverage also may apply to "employment practices" claims against the company, such as claims of discrimination, harassment, and wrongful termination. This coverage, called employment practices liability insurance ("EPLI"), also may extend to "employment practices violations," "workplace torts," or other broad catch-all categories.

#### **EFFECTS OF AN INSURED'S BANKRUPTCY**

##### **General Considerations**

A bankruptcy filing often significantly alters the relationship between the company and its directors

and officers. The level of control that directors and officers have is lessened and sometimes eliminated. Many times, the level of acrimony between the now previous directors and officers and the company is very high. Consequently, the only thing to “stand behind” these directors and officers for their previous actions on behalf of the company is the D&O policy.

Until recently, many assumed that the D&O policy did not belong to the company to be controlled by bankruptcy courts upon a bankruptcy filing. Now, however, because the proceeds from D&O policies may be the only meaningful asset of the bankrupt estate, creditors are attempting to keep those proceeds from leaving the estate. The “automatic stay” created as soon as a company files for bankruptcy protection prevents any action against the debtor or its property. The automatic stay codified at 11 U.S.C. § 362, however, does not stay actions against directors and/or officers. Directors and officers facing individual claims expect the D&O policy to step up and protect their personal assets from these claims. Two issues emerge:

- Is the D&O policy property of the estate?
- Are the proceeds of the D&O policy property of the estate?

Courts have distinguished these two questions and have held that liability insurance policies are property of the estate,<sup>7</sup> but that often the proceeds of those policies are not.<sup>8</sup> The case is not clear, however, for D&O policies that offer entity coverage to the debtor. The Enron creditors unsuccessfully tried to block the directors and officers from accessing the proceeds of the D&O policies to pay their rapidly mounting legal costs.<sup>9</sup> The argument against paying out proceeds is that payment of proceeds for the benefit of directors and officers reduces the policy’s aggregate limits for all coverages, including the company’s entity coverage, thereby violating the automatic stay by diminishing the value of company property.<sup>10</sup> It appears that, although the D&O policy itself is an asset of the estate, whether the proceeds are also and subject to the automatic stay will likely be determined on a case-by-case basis. Pure D&O policies that contain no entity coverage are likely not property of the estate because the main argument noted above does not apply.<sup>11</sup> Nevertheless, you can expect creditors to try to block policy payments because those funds may be the only true asset in the bankruptcy estate.

Insurers will also be very careful before making any payments under the D&O policy. Insurers do not want to violate the automatic stay, which could result in any payment that it makes later being characterized as a gift rather than a policy payment that reduces the aggregate limits. Therefore, insurers—or directors and officers, in the event that the insurer refuses—may seek an order from the bankruptcy court that the proceeds are not property of the estate and not subject to the automatic stay. At a minimum, directors and officers should expect a legal battle and considerable delay in the payment of D&O policy proceeds.

### **INSURERS DO NOT WANT TO VIOLATE THE AUTOMATIC STAY, WHICH COULD RESULT IN ANY PAYMENT THAT IT MAKES LATER BEING CHARACTERIZED AS A GIFT RATHER THAN A POLICY PAYMENT THAT REDUCES THE AGGREGATE LIMITS.**

#### **Effects on Retention and Deductibles**

D&O policies typically have “deductibles” or “self-insured retentions” (“SIRs”). Historically, there has been a distinction between a deductible and an SIR. When a policy has a deductible, an insured should anticipate that, of the total amount of coverage afforded by the policy, the insured is responsible for the deductible amount. In other words, if a policy provides \$1,000,000 in coverage, with a \$100,000 deductible, then the insured should expect to pay \$100,000, with the carrier to pay \$900,000. With an SIR, an insured would expect to receive the full limits of the policy, once the retention has been satisfied. In other words, if the insured has a \$1,000,000 policy and a \$100,000 retention, once the \$100,000 SIR has been paid, the carrier would be expected to pay \$1,000,000.

This historical distinction, however, between deductibles and SIRs has become, at best, a blurred

distinction. Thus, the terms often are used interchangeably, and sometimes both terms are found in the same provision in an insurance policy. Indeed, the lack of clarity is evidenced by insurance dictionary definitions of the relevant terms. For example, one insurance dictionary states the following about an SIR:

A dollar amount specified in an insurance policy (usually a liability insurance policy) that must be paid by the insured before the insurance policy will respond to a loss . . . . An SIR differs from a true deductible in at least two important ways. Most importantly, a liability policy's limit stacks on top of an SIR while the amount of a liability insurance deductible is subtracted from the policy's limit. As contrasted with its responsibility under a deductible, the insurer is not obligated to pay the SIR amount and then seek reimbursement from the insured; the insured pays the SIR directly to the claimant. While these are the theoretical differences between SIRs and deductibles, they are not well understood, and the actual policy provisions should be reviewed to ascertain the actual operation of specific provisions.<sup>12</sup>

When policies contain SIRs or deductibles, two questions often arise. The first question is whether the SIR or deductible can be satisfied only by the insured's own contribution. This issue is particularly important when the insured company is a debtor in a bankruptcy proceeding and might not be able to readily fund an SIR or deductible. It might not need to, however. In *Vons Cos., Inc. v. United States Fire Ins. Co.*,<sup>13</sup> the court addressed the question of how an insured satisfies an SIR. The court concluded that payments made by one insurance carrier could satisfy the SIRs in another policy:

[T]he SIR, construed in light of the other insurance provisions to which it was subject, in fact permitted payment of the SIR amount through other valid and collectible insurance. That is the most reasonable construction given that the SIR was subordinate to the other insurance provisions. If nothing else, the conflict between [U.S. Fire's] interpretation of the SIR and the other insurance provisions renders the SIR ambiguous on this point. Nowhere does the SIR expressly state that

Vons itself, not other insurers, must pay the SIR amount. Because the SIR was subject to the other insurance provisions, which also made the Vons policy excess if there were another policy covering the accident, Vons as a reasonable insured could read the policy as permitting the use of other insurance proceeds to cover the SIR amount.<sup>14</sup>

The second question that often arises when policies have SIRs or deductibles is how many SIRs or deductibles must be paid when multiple policies apply to a claim. Insurance carriers often argue that all SIRs and deductibles must be paid before any insurer must pay under any policy. This argument has been rejected. In *Montgomery Ward & Co. v. Imperial Casualty & Indemnity Co.*,<sup>15</sup> for example, the court discussed the rule of "horizontal exhaustion," pursuant to which some courts have held that, before an excess insurer must respond, all applicable primary insurance must be exhausted. The carriers argued that the SIRs were "primary policies" for purposes of the horizontal exhaustion rule. The court rejected this argument, noting that the policies "make it clear there is a difference between underlying insurance and [SIRs], and the Insurers understood this difference when they entered into these contracts. As the court stated, "We are offered no public policy or other compelling reason to engraft new meaning on plain language, and accordingly '[w]e may not rewrite what they themselves wrote.'"<sup>16</sup>

Therefore, when multiple policies apply to a lawsuit, an insured may be able to tap its insurance coverage under one policy by paying only the SIR or deductible for that year, without paying all other SIRs and deductibles.

Another decision, however, arguably casts some doubt on the question of how an SIR retention or deductible gets satisfied when the insured is a debtor in bankruptcy. In *Insurance Co. of the State of Pennsylvania v. Acceptable Ins. Co.*,<sup>17</sup> several insurance carriers had a dispute as to their respective obligations to pay for the defense and settlement of certain construction defect lawsuits against the insured. One carrier, North American, contended that its obligations had not been triggered because the insured had not exhausted the SIR in its policy. North American argued that the insured had not paid any portion of its defense or settle-

ment costs and that those amounts were paid by other insurance carriers. Another carrier disagreed, however, arguing that North American's SIR could be satisfied by payments made by the other carriers. The court acknowledged *Vons* and other authorities, noting that "[i]f the policy is silent or ambiguous as to the source of funding for an SIR, then the ambiguity is resolved in favor of the insured and the insured need not pay the SIR out of its own funds."<sup>18</sup> The court noted, however, that, "through

**SOME COURTS SCRUTINIZE THE CLAIMS TO DETERMINE WHETHER THE CLAIMS ARE BROUGHT BY THE DEBTOR OR ON ITS BEHALF OR ON BEHALF OF ANOTHER GROUP, SUCH AS A CREDITOR, IN CASES IN WHICH THE EXCLUSION HAS BEEN HELD TO BE INAPPLICABLE.**

an express contract provision, an insurer can require the insured to satisfy the SIR with its own funds."<sup>19</sup> The court distinguished the situation before it from that in *Vons* by noting that the North American endorsement stated that it "changes the policy," that North American's coverage shall apply "in excess of the Self-Insured Retention as stated in this endorsement," and that the insured "agrees to assume this retained amount." The court also observed that North American's "other insurance" clause specified that, regardless of other insurance, the insured "will continue to be responsible for the full Self-Insured Retention before the limits of insurance under this policy apply."<sup>20</sup> The court concluded that this provision clearly operated to place "responsibility on [the insured] for the SIR regardless of applicable insurance coverage."<sup>21</sup>

Finally, the court rejected an argument that, because the insured had commenced its Chapter 11 proceeding before purchasing the North American policy, any requirement that the insured pay the SIR out of its own funds would make the contract illu-

sory. The court explained that the insured "was reorganizing under Chapter 11 and attempting to continue as [a] viable business enterprise. This is consistent with the purpose of Chapter 11 and with [the insured's] subsequent procurement of an additional insurance policy."<sup>22</sup> The court also stated that the insured "was able to fund the premium itself, a substantial amount of money. Thus, it is not unlikely that [the insured] could obtain authorization to expend additional sums if needed for insurance funding of defense and settlement costs."<sup>23</sup>

**"Insolvency of the Insured" Clause**

D&O policies typically include a provision addressing the bankruptcy or insolvency of an insured. For example, one common version of this provision states, "Bankruptcy or insolvency of an Insured Person or the estate of an Insured Person shall not relieve the Company of its obligations nor deprive the Company of its rights under this policy."<sup>24</sup> Another insurer's form states, in relevant part, "Bankruptcy or insolvency of any Organization or any Insured Person shall not relieve the Insurer of any of its obligations hereunder."<sup>25</sup>

The purpose and effect such clauses has been explained as follows:

[The] clause allows an injured party to sue the insurer directly if the insured is bankrupt.

The purpose of this clause is to spare the injured person from the futility of bringing suit against a bankrupt insured and having this claim aborted by the automatic stay provisions of the bankruptcy laws.<sup>26</sup>

The presence of an insolvency clause, however, does not necessarily obligate an insurer to pay amounts arguably due under the policy if the insured has not complied with any of its duties, such as the duty to pay the SIR or the deductible. As the court explained in *Insurance Co. of the State of Pennsylvania*, an insolvency clause does not relieve the insured of its obligation to pay the policy's retention:

[B]ecause the SIR was never satisfied per the conditions of the Endorsement, its obligations were never triggered. [North American] is not attempting to avoid its obligations because of [the insured's] inability to pay. Rather, . . . it does not have any obligations because [the insured] has not satisfied the SIR.<sup>27</sup>

### Effects of the Automatic Stay on Coverage

When a company files a bankruptcy petition, there is an immediate automatic stay that bars creditors from taking action against the debtor's assets and precludes the prosecution of claim or lawsuit against the debtor without specific authorization from the bankruptcy court.<sup>28</sup> According to at least one court, "[t]he purpose of the stay is 'to preserve remains of the debtor's insolvent estate and to provide a systematic equitable liquidation procedure for all creditors . . . .'"<sup>29</sup> Furthermore, in the words of one commentator, "actions taken in violation of the automatic stay are void and without effect, even if the entity that violated the stay had no knowledge or notice of the filing of the bankruptcy petition or automatic stay."<sup>30</sup> The automatic stay also bars cancellation of insurance policies unless a bankruptcy court has first approved the cancellation.<sup>31</sup> The automatic stay provisions are, however, subject to certain exceptions.<sup>32</sup> For example, the automatic stay typically does not prevent litigation from pro-

ceeding against codefendants who are not debtors in the bankruptcy proceeding.<sup>33</sup> The automatic stay also may not apply to a lawsuit against the debtor's insurance companies.<sup>34</sup> Furthermore, a party with a claim against a debtor may be able to obtain approval from the bankruptcy court to pursue litigation against the debtor, at least when the judgment against the debtor would be payable only out of the debtor's insurance coverage.<sup>35</sup>

### Defenses Commonly Asserted by Carriers

#### *Fraud and Concealment*

In the face of reports of wide-spread accounting irregularities and misstatements and omissions on corporate balance sheets, insurance carriers are raising the specter that, if claims are made against them for coverage, they may seek to rescind the policies on the grounds that the very alleged wrongs that gave rise to the claims against the officers and directors report a claim for rescission. Carriers typi-

cally will argue that the application for insurance submitted on behalf of the insured company requires the insureds to disclose acts or circumstances that they knew might give rise to a claim. In fact, in many states, an insurance carrier does not have to show that an insured acted with fraudulent intent or understood the significance of an omission of information from the application for insurance.<sup>36</sup>

**IN BANKRUPTCY, YOU WILL OFTEN SEE CLAIMS BROUGHT BY THE BANKRUPTCY TRUSTEE OR THE CREDITORS COMMITTEE AGAINST THE COMPANY'S FORMER DIRECTORS AND OFFICERS. NOT SURPRISINGLY, INSURERS WILL INVOKE THE "INSURED V. INSURED" EXCLUSION TO AVOID COVERAGE IN THESE INSTANCES.**

In response, however, an insured could argue that its general awareness of a particular risk did not transform a nondisclosure into a material misrepresentation. For example, in *Washington Sports & Entertainment, Inc. v. United Coastal Ins. Co.*,<sup>37</sup> the court addressed a situation in which an insurance carrier argued that the insureds had made a material misrepresentation on their application for coverage. Before they completed the application, the insureds had been engaged in "very preliminary discussions" with the Justice Department about potential violations of the Americans with Disabilities Act ("ADA") in the construction of an arena. The application asked, like most applications, whether the insureds had knowledge of any error, omission, or other circumstance that could be the basis for a claim under the policy. They answered "no." The court noted that the answer "may appear troubling under the floodlamp of hindsight," but held that it was not a misrepresentation:

[Insureds] may have feared a potential suit, but this concern alone does not convert [the answer in the application] into a material misrepresentation. [Insureds] were obviously wary

of a host of circumstances that *could* be a basis for a claim under the policy . . . . Indeed, no one buys insurance unless he is concerned about risks; [insureds] must have had some concerns, or they would not have paid \$500,000 for their insurance. However, there is no evidence that [insureds] had any knowledge that one of these manifold risks was on the verge of occurrence.<sup>38</sup>

Additionally, many D&O policies contain a severability clause. Such clauses commonly state that any misstatement or omission in the application form or attachments and materials submitted with it by a particular insured person or his cognizance of any matter which he has reason to suppose might afford grounds for a future claim against him shall not be imputed, for purposes of any rescission of this policy, to any other insured persons who are not aware of the omission or the falsity of the statement.<sup>39</sup> These clauses typically will protect "innocent" insureds from rescission or concealment claims.<sup>40</sup>

*"Insured v. Insured" Exclusion*

Insurance carriers will often argue that coverage is barred by the "insured v. insured" exclusion. D&O policies contain language to the effect that the insurer will not pay losses in connection with a claim against an insured (as defined in the policy) by any insured or on behalf of the company (as defined in the policy). In bankruptcy, you will often see claims brought by the bankruptcy trustee or the creditors committee against the company's former directors and officers. Not surprisingly, insurers will invoke the "insured v. insured" exclusion to avoid coverage in these instances.

Courts again are split on the applicability of the "insured v. insured" exclusion. Factual issues appear to dominate the inquiry. In certain cases, if the claim in question could have been brought by the corporation before the bankruptcy, then the exclusion would apply.<sup>41</sup> Some courts scrutinize the claims to determine whether the claims are brought by the debtor or on its behalf or on behalf of another group, such as a creditor, in cases in which the exclusion has been held to be inapplicable.<sup>42</sup> Some courts have found the exclusion inapplicable by determining that the trustee's claims against former directors and officers were made on behalf of the estate rather than the "company" itself.<sup>43</sup> This

line of cases looks at the bankruptcy trustee as a new entity distinct from the debtor company. Courts also look at the underlying purpose of the exclusion, which is to prevent collusive lawsuits among insureds being inapposite in certain bankruptcy claims.<sup>44</sup> At the end of the day, there is no clear rule to guide directors and officers or in-house counsel who are trying to advise the board.

**TODAY'S D&O INSURANCE MARKET GENERALLY IS DESCRIBED AS A "HARD MARKET," MEANING THAT PREMIUMS ARE HIGHER FOR LOWER COVERAGE LIMITS, COVERAGE IS MORE RESTRICTIVE, AND IT IS DIFFICULT, IF NOT IMPOSSIBLE, TO OBTAIN ANY SIGNIFICANT EXTRAS TO COVERAGE IN THE UNDERWRITING PROCESS.**

Some D&O policies contain language that a bankruptcy filing by the company terminates the policy. Claims made after the filing date would therefore not be covered. These "ipso facto" clauses have been deemed unenforceable in a bankruptcy court.<sup>45</sup> If, however, the policy or proceeds are not subject to bankruptcy court jurisdiction because the court determines that neither is property of the estate, then this language may provide an out for the insurer.

**PRACTICAL TIPS**

One step that in-house counsel should take is to conduct a review of current (and potential) D&O policies, including primary and excess policies. Such a review can identify potential shortcomings that might be corrected and, perhaps more importantly, enable insureds to make sure that specific policy requirements, such as the timing of notice to insurers, are honored, thereby minimizing possible coverage arguments. The review should also include a reexamination of the materials provided in

procuring the coverage. Thus, for example, if financial statements were provided to an insurer or statements were made about corporate compliance, then a more informed evaluation could be conducted as to the risk that an insurer might seek to rescind a policy based on erroneous information provided during the application process. Such a review might enable insureds to assess whether their coverage would be in jeopardy if a compliance issue later arose and could enable the company to consider how it might address any potential concerns before they became problems with an insurer.

**Obtaining Coverage under Current Policies before Bankruptcy Filing**

Today's D&O insurance market generally is described as a "hard market," meaning that premiums are higher for lower coverage limits, coverage is more restrictive, and it is difficult, if not impossible, to obtain any significant extras to coverage in the underwriting process. Furthermore, given the wide-ranging concern about corporate financial statements, insurance carriers may press for more detailed information in the policy placement and renewal process and likely will insist on broader exclusions from coverage for circumstances that may give rise to claims, particularly if those circumstances relate to financial reporting on balance sheet issues.

This situation does not mean that an insured will be left without coverage. Many D&O policies contain provisions that, if the insured gives written notice of circumstances that "may reasonably be expected to give rise to a Claim being made against an Insured Person," "with full particulars as to dates, persons and entities involved," then a claim subsequently made against the insured and reported to the carrier based on or arising out of those circumstances "shall be considered made at the time such notice of such circumstances was given."<sup>46</sup> If an insured gives notice under such a provision of circumstances that it anticipates could give rise to a later claim, it could obtain coverage for that claim under an existing policy—even though a claim has not yet been made. The policies typically are fairly specific in how much detail must be provided. If, however, an insured fails to provide or cannot provide the required detail, coverage still might be available. Although courts have reached varying

conclusions, at least some courts have held that general descriptions are adequate.<sup>47</sup>

In fact, even if an insured fails to give the required notice, there is the possibility that mention of the circumstances in a renewal application may suffice. In fact, several courts have so held.<sup>48</sup> The safer course, however, is to comply, to the extent possible, with a policy's reporting requirements.

### **Negotiate and Purchase Well-structured Policies**

Companies and their directors and officers may want to purchase two separate policies: one for entity coverage and one for the traditional D&O coverage. Similarly, if separate policies are not purchased, consideration should be given to obtaining separate, identifiable limits under a single policy for entity coverage and D&O coverage, thereby minimizing the risk of aggregate reductions and the resulting problems discussed earlier.

Purchasers of D&O policies should actively negotiate the form of the policy. A bankruptcy filing should not be a "termination event" under the policy because a bankruptcy is precisely when the directors and officers need the policy most. Purchasers should try to get "waiver of the automatic stay" language inserted into the policy to try to prevent some of the concerns previously addressed. Additionally, a well-negotiated policy would not exclude from coverage claims by a bankrupt estate or its constituents against directors and officers.

Whether directors and officers will be able to avoid personal financial liability for their actions on behalf of the company that they have served that has filed for bankruptcy protection will depend on corporate, bankruptcy, and insurance law. A careful understanding of the D&O policy in their notebooks must be one of the first actions that any corporate directors or officers undertake.

### **CONCLUSION**

D&O insurance can be a valuable asset, even if a company files a bankruptcy proceeding. As shown above, the key for directors and officers and thus in-house counsel is to evaluate fully the insurance coverage currently available under existing policies, as well as to ensure that appropriate care is exer-

cised in the renewal process or in the procurement of replacement coverage. If appropriate steps are taken, then directors and officers may find that, even in an era of heightened scrutiny on corporate compliance issues, their D&O policies will provide significant financial protection. ■

### **NOTES**

1. *See* *Smith v. Van Gorkom*, 488 A.2d 858 (Del. Supr. 1985).
2. *See, e.g., McCuen v. Am. Cas. Co.*, 946 F.2d 1401, 1406 (8th Cir. 1991); *Gon v. First State Ins. Co.*, 871 F.2d 863, 867-68 (9th Cir. 1989); *Nu-Way Envtl., Inc. v. Planet Ins. Co.*, 1997 U.S. Dist. LEXIS 11884, at \*6-7 (S.D.N.Y. 1997) ("The general rule . . . is that absent express language to the contrary, an insurer that does not undertake the duty to defend the insured has a duty to pay the insured's defense costs as they come due . . . . Therefore, . . . where the insurance policy does not impose a duty to defend, provides for payment of defense costs, and is silent as to the timing of payment of such costs, the insurer has a duty to contemporaneous payment of defense costs").
3. *See, e.g., Zaborac v. Am. Cas. Co.*, 663 F. Supp. 330, 332 (C.D. Ill. 1987); *In re Kenai Corp.*, 136 B.R. 54, 63 (S.D.N.Y. 1992).
4. *See, e.g., Bowie v. Home Ins. Co.*, 923 F.2d 705, 708-09 (9th Cir. 1991).
5. *American International Companies Directors, Officers and Corporate Liability Insurance Policy* (5/95 ed.).
6. *See American International Companies Directors, Officers and Corporate Liability Insurance Policy Securities Plus Endorsement*, ¶ 3 (6/96 ed.).
7. *See, e.g., In re Minoco Group*, 799 F.2d 517 (9th Cir. 1986).
8. *See, e.g., In re Louisiana World Exhibition*, 832 F.2d 1391 (5th Cir. 1987).
9. *See In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y. 2002).
10. *See, e.g., In re First Central Financial Corp.*, 238 B.R. 9, 17 (Bankr. E.D.N.Y. 1999) ("[I]t may well be that proceeds of certain D&O insurance policies, which provide direct entity coverage to a corporate debtor, can be considered property of the estate"). *But see In re Lernout & Hauspie Speech Prods., N.V.*, Case Nos. 00-4397 through 00-4399 (Bankr. D. Del. May 8, 2001) (under a D&O policy covering both directors and officers and debtor, advancement of defense costs to directors and officers allowed when no actual entity claims).
11. *See, e.g., In re Youngstown Osteopathic Hosp. Ass'n*, 271 B.R. 544 (Bankr. N.D. Ohio 2002).
12. INTERNATIONAL RISK MANAGEMENT INSTITUTE, INC., GLOSSARY OF INSURANCE AND RISK MANAGEMENT TERMS 124 (7th ed. 1999).

13. 78 Cal. App. 4th 52, 63–64, 92 Cal. Rptr. 2d 597 (Cal. Ct. App. 2000).
14. *Id.* at 64.
15. 81 Cal. App. 4th 356, 97 Cal. Rptr. 44 (Cal. Ct. App. 2000).
16. *Id.* at 367. *See also* California Pacific Homes, Inc. v. Scottsdale Ins. Co., 70 Cal. App. 4th 1187, 85 Cal. Rptr. 2d. 328 (Cal. Ct. App. 1999) (principle of horizontal exhaustion does not apply to SIRs).
17. No. SACV 01-0225 DOC (C.D. Cal. Apr. 29, 2002).
18. *Id.*, slip op. at 7.
19. *Id.*
20. *Id.* at 10–11.
21. *Id.* at 11.
22. *Id.* at 12.
23. *Id.*
24. Federal Insurance Company D&O Policy, ¶ 22 (Form 17-02-1146 (Ed. 10-94)).
25. D&O First Executive Liability and Organization Reimbursement Insurance, ¶ 19 (Form 80894 (Ed. 9-02)) (American International Group, Inc. 2002) (hereinafter “D&O First Policy”).
26. 15 HOLMES’ APPLEMAN ON INSURANCE 2d § 111.1, at 42 (2000).
27. Insurance Co., Slip op. at 12.
28. *See* 11 U.S.C. § 362(a).
29. In re Transportation Sys. Int’l, Inc., 110 B.R. 888, 893 (D. Minn. 1990).
30. 9A AM. JUR. 2D *Bankruptcy* § 1544, at 390 (1991).
31. *See* In re Minoco Group of Cos., 799 F.2d 517, 519 (9th Cir. 1986).
32. *See, e.g.*, 11 U.S.C. § 362(d).
33. *See, e.g.*, Lynch v. Johns-Manville Sales Corp., 710 F.2d 1194, 1196–97 (6th Cir. 1983).
34. *See, e.g.*, In re Correct Mfg. Corp., 88 B.R. 158, 162 (S.D. Ohio 1988).
35. *See* In re Holtkamp, 669 F.2d 505, 508–09 (7th Cir. 1982).
36. *See, e.g.*, Cal. Ins. Code § 352 (a party to an insurance contract “shall communicate to the other, in good faith, all facts within his knowledge which are or which he believes to be material to the contract and as to which he makes no warranty, and which the other has not the means of ascertaining”); *id.*, § 351 (“Concealment, whether intentional or unintentional, entitles the injured party to rescind insurance.”); Oglesby v. Penn. Mut. Life Ins. Co., 877 F. Supp. 872, 889 (D. Del. 1995) (rescission allowed based on representation that the insured “had reason to believe [was] incorrect”). *But see* Pinette v. Assurance Co. of Am., 52 F.3d 407, 409 (2d Cir. 1995) (in order to rescind under Connecticut law, carrier must prove that insured knowingly made a misrepresentation material to carrier’s decision of whether to insure).
37. 7 F. Supp. 2d 1 (D.D.C. 1998).
38. *Id.*, at 30.
39. Federal Insurance Company D&O Policy, ¶ 18 (Form 17-02-1146 (Ed. 10-94)).
40. *See* JOHN K. DiMUGNO AND PAUL E.B. GLAD, CALIFORNIA INSURANCE LAW HANDBOOK § 23.09 (2002) (“[A] severability clause protects innocent insureds both against rescission and against the invocation of an exclusion based on the acts of a dishonest director”).
41. *See, e.g.*, Reliance Ins. Co. v. Weis, 148 B.R. 575, 580 (E.D. Mo. 1992).
42. *See, e.g.*, In re Pintlar Corp., 205 B.R. 945, 947 (Bankr. D. Idaho 1997).
43. *See, e.g.*, In re Buckeye Countrymark, Inc., 251 B.R. 835, 841 (Bankr. N.D. Ohio 2000); Alstrin et. al. v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376 (D. Del., 2002); Gray v. Executive Risk Indem., 2002 U.S. Dist. LEXIS 8155 (D. Mass. May 6, 2002).
44. *See, e.g.*, Level 3 Communications, Inc. v. Federal Ins. Co., 168 F.2d 956 (7th Cir. 1999); In re County Seat Stores, Inc., 2002 Bankr. LEXIS 716 (S.D.N.Y. July 10, 2002).
45. *See, eg.*, Spieker Props, L.P. v. MFM The SPFC Liquidating Trust, 268 F.3d 712, 715–16 (9th Cir. 2001) (noting that 11 U.S.C. § 365(e)(i) “protect[s] the debtor from the enforcement of unfavorable insolvency-triggered clauses in executory contracts”).
46. D&O First Policy, ¶ 7(c).
47. *See, e.g.*, Am. Cas. v. Resolution Trust Corp., 845 F. Supp. 318, 323 (D. Md. 1993) (letter stating that claims may be made against insureds as to certain transactions); FSLIC v. Heidrick, 774 F. Supp. 352, 358–59 (D. Md. 1991) (general notice of “possible self-dealing” by officers and directors and “violations of regulations” and “negligent acts,” coupled with an estimate of the exposure).
48. *See, e.g.*, United Ass’n Local 38 Pension Trust Fund v. Aetna Cas. & Sur. Co., 790 F.2d 1428, 1429 (9th Cir. 1986) (information in renewal application can serve as the basis of a notice satisfying a “potential claims” provision); Branning v. CNA Ins. Cos., 721 F. Supp. 1180, 1183 (W.D. Wash. 1989) (attachments to renewal request sufficient to constitute notice of an occurrence that could subsequently give rise to a claim).