FEAR OF LOSING D&O INSURANCE IN BANKRUPTCY **IS OVERBLOWN**

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The typical D&O insurance policy covers not only a company's directors and officers, but also the company itself for amounts the company must pay to indemnify its directors and officers. Many policies also provide "entity coverage," protecting the company for securities-fraud claims made directly against it.*[1] The existence of these company-specific coverages creates some risk that in bankruptcy a company's D&O insurance policies may be deemed property of the bankruptcy estate, thus preventing individual directors and officers from accessing their coverage at the very time that they are likely to need it most. In an effort to sell companies additional policies—such as "Side A only" policies—insurers highlight this bankruptcy

*Endnotes for this story appear on page 54.

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risk to their customers. Chubb's marketing materials, for example, proclaim that "in bankruptcy, the D&O policy with entity coverage often becomes an asset of the bankruptcy estate and is unavailable to protect the personal assets of independent directors." (Chubb, *Personal Director's Liability Insurance*, http://www.chubb.com/businesses/csi/chubb805.html.) Similarly, AIG's sales materials warn that "if a company enters Chapter 7 or 11 Bankruptcy, its entity D&O policy may be frozen as an asset of the company's bankruptcy estate and will be unable to pay for existing or new claims made against directors and officers." (AIG, *ExecSecure Coverage Insights*, http://www.aignationalunion.com/nationalunion/public/natproductdetail/0,2128,422-14-556-13-4191,00.html.)

The fears trumpeted by insurers, however, are greatly overblown for a variety of reasons. First, in many jurisdictions, the mere fact that a D&O policy provides coverage for the company itself is not enough to render the policy *proceeds* (as apart from the policy itself) an asset of the bankruptcy estate, meaning that those proceeds are not subject to bankruptcy-court control. Second, even where courts find that policy proceeds are the debtor's property, and thus subject to an automatic stay, those courts have frequently lifted the stay to allow directors and officers access to at least some portion of the policy proceeds to fund their defense costs. Finally, all courts that have addressed the proceeds issue have agreed that the results are largely dependent on the policy language, meaning that purchasers of D&O insurance may be able to negotiate language at the time of purchase that will minimize the risk that a bankruptcy filing will affect their Side A coverage. In short, purchasers of D&O insurance should consider the real impact that bankruptcy would have on that insurance before incurring costs for additional policies that may provide little in the way of meaningful additional coverage.

POLICY PROCEEDS MAY OR MAY NOT BE WITHIN THE REACH OF THE BANKRUPTCY ESTATE

The bankruptcy estate is broadly defined by statute to include "all legal and equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). And courts have uniformly concluded that the D&O policy itself is included in the estate under this provision. The law is less well settled, however, with regard to the issue of whether the *proceeds* from the policy are also property of the debtor's estate.[2]

One point on which courts do agree is that if a debtor company's policy provides coverage solely to the company's directors and officers (*i.e.*, "Side A only" coverage), then the proceeds are outside of the bankruptcy estate. *See, e.g., In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987). This is true even if the company (or the trustee on the company's behalf) is asserting a claim against covered officers or directors for which there would be coverage under the policy. Courts have repeatedly reaffirmed that in such situations, where the company is "seeking to *recover from* the D&O policy" (by asserting a claim against insured parties) rather than "seeking to be *protected by* the D&O policy," the proceeds are outside the control of the bankruptcy court, meaning that those proceeds are fully available to officers and directors for both defense costs and any ultimate liability they may incur. *See In re Allied Digital Technologies Corp.*, 306 B.R. 505, 513 (Bankr. D. Del. 2004).

In practice, however, most D&O policies cover both individuals and the company itself. The coverage for the company can take the form of either indemnity coverage (*i.e.*, so-called "Side B" coverage) or entity coverage (*i.e.*, coverage for liability judgments against the corporation, which is usually, but not always, limited to coverage for securities claims) or both. Courts considering whether proceeds from policies that include such coverage are also property of the bankruptcy estate have reached differing conclusions, as courts struggle to balance two competing interests in the proceeds, as well as to interpret policy language that often varies from one policy to the next.

On one hand, bankruptcy trustees typically argue that the debtor has an economic interest in the proceeds of the D&O policy because each dollar that is paid out to the directors and officers under the policy is one dollar less that the estate will otherwise possess in indemnification or entity coverage. Indeed, some courts have accepted such arguments, finding that if a policy contains entity or indemnification coverage, payments to or on behalf of the officers or directors (*e.g.*, for defense costs) would come from the "same pot" as potential payments to the company, meaning that the company has an "interest in the proceeds" "sufficient to bring those proceeds into the estate."[3] Other courts have relied on the more general proposition that a bankruptcy estate includes any assets that increase the value of the estate. *See In re CyberMedica, Inc.,* 280 B.R. 12, 17 (Bankr. D. Mass. 2002). *See also In re Minoco Group of Cos., Ltd.*, 799 F.2d 517, 519 (9th Cir. 1986). According to these courts, at least so long as the policy includes indemnification or entity coverage, the policy proceeds meet that "fundamental test" because the bankruptcy estate is worth more with the policy than without it. *See In re CyberMedica*, 280 B.R. at 17. For example, one court noted that the availability of D&O coverage can directly affect a debtor's efforts to attract new directors and officers to its team and that a bankrupt company may find it difficult to obtain new D&O policies when its current policy limits are exhausted. *See In re Circle K Corp.*, 121 B.R. 257, 261 (Bankr. D. Ariz. 1990). Thus, allowing the proceeds to flow to pre-petition officers and directors, who are admittedly also insureds under the policy, may directly affect the company's prospects of recovery by limiting its ability to offer meaningful indemnification. A similar argument could be made that when the proceeds of a wasting policy that provides entity coverage are distributed to officers and directors, less coverage remains for securities claims against the company itself. This reduces the funds available to the company and also increases the difficulties that the company may face in obtaining new capital investments, as investors may worry that their funds would go to satisfying liability judgments against the company, rather than into business operations, meaning that the company is arguably worth less once the policy proceeds have been distributed.

On the other hand, many courts have recognized the practical reality that in most bankruptcies, pre-petition indemnity or securities-fraud claims are likely to be treated as unsecured claims for which the company will not need to call upon its Side B or entity coverage. For example, some courts have noted that such claims would need to be listed on the plan of reorganization and that unlisted claims would be barred by the discharge, meaning that distributing the proceeds would not affect the debtor. *See In re Adelphia Communications Corp.*, 302 B.R. 439, 444 (Bankr. S.D.N.Y. 2003). Similarly, other courts have found that policy proceeds do not belong to the bankruptcy estate if it is speculative that the company will ever assert a claim against its indemnity or entity coverage.[4]

In short, even under D&O policies that include both entity and indemnification coverage on top of the Side A coverage,

the director and officer insureds may be successful in claiming that the proceeds used to pay their defense or liability indemnification costs are not property of the bankruptcy estate and thus are subject neither to the automatic stay nor to interference by the bankruptcy court.

EVEN IF POLICY PROCEEDS ARE FOUND TO BE AN ASSET OF THE BANKRUPTCY ESTATE, D&Os STILL HAVE ACCESS

Even those courts that have found that the policy proceeds at issue in a given case are property of the bankruptcy estate have sometimes allowed directors and officers access to those policy proceeds to fund defense costs. In such situations, courts generally use a balancing test in deciding whether to lift the automatic stay, in which the court balances the potential harm to the debtor against the potential harm to the individual directors and officers, paying special attention to the likelihood of litigation against each party.[5] It appears that to date no court, in weighing those competing concerns, has decided to deny an insured director or officer at least some access to policy proceeds while the company was in bankruptcy.[6]

While they have not denied access in total, however, courts have imposed limits on the directors' and officers' ability to deplete policy proceeds. Some courts, for example, have imposed caps on the amount of proceeds available to individual officers and directors. Thus, the court in *Boston Regional* lifted the stay but imposed a $600,000 limit on directors' and officers' defense costs.[7] In setting a cap, courts consider both the likelihood that the total potential claims will exceed the available insurance limit and the magnitude of the individual directors' and officers' estimated defense costs.[8] Likewise, at least one court recently limited individuals' access to insurance proceeds by judicially allocating funds between the company and individuals. The debtor in *In re National Century Financial Enterprises, Inc.*, had a $5 million D&O policy that also provided general liability coverage to the insured company. At the time it filed bankruptcy, there was more than $2.6 billion in potential liability claims against the company that would fall within the policy's terms. No. 02-65235, 2005 Bankr. Lexis 1052, at *21–31 (Bankr. E.D. Ohio, Jan. 10, 2005). The directors and officers were also seeking access to the proceeds, however, to pay their costs of defense. Noting that the primary purpose of D&O insurance is to protect directors and officers, the court held that the most equitable solution was to distribute 70 percent of the limit to the directors and officers and 30 percent to the company. *Id.* at *31. Another court adopted a slightly different approach, delaying the conflict over insurance proceeds by staying not only the debtor's litigation, but also claims against individual directors and officers, finding that it had

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authority to do so under the theory that the insurance proceeds were property of the estate and that the bankruptcy code precludes "any act to obtain possession of property of the estate."[9]

In sum, regardless of what coverage a D&O policy may ultimately provide, the consequences of a company filing for bankruptcy are not necessarily as draconian as insurance companies would like purchasers of D&O insurance to believe.

CONTRACTING FOR ADDED PROTECTION

Although bankruptcy courts consistently allow directors and officers at least some access to insurance proceeds, these courts often note that the particular policy language matters greatly to the analysis.[10] Thus, D&Os would be well advised to take steps at the time of purchase to avoid some of the uncertainty that results from a bankruptcy filing. First, a D&O purchaser should seek a policy that contains a "priority of payments" provision that contractually subordinates the company's entity coverage to the Side A coverage.[11] These provisions are becoming more and more common, and at least one recent court decision has confirmed the effectiveness of such a provision. *See, e.g., In re Enron Corp*., No. 01-16034, 2002 WL 1008240 (Bankr. S.D.N.Y., May 17, 2002). Whether or not that trend continues, and whether or not such provisions are truly effective in subordinating the company's interest,[12] there is very little downside to including such language from the D&O's standpoint. Second, a D&O purchaser should seek specific policy language that makes clear that a bankruptcy will not affect the payment of policy proceeds. For example, AIG's primary policy form provides that a bankruptcy will not relieve the insurer of any of its obligations and that the insureds will waive and release any automatic stay or injunction and not oppose any efforts by the insurer or any insured to obtain relief from any stay.[13] Third, the "insured v. insured" clause, which arguably applies to suits brought by a bankruptcy trustee, can be carefully crafted to exclude the trustee from the meaning of the provision. (Indeed, even apart from the issues addressed here, this is an important step in that one of the most typical claims against the D&O during bankruptcy is a claim by the debtor company itself. If such claims fall within the "insured v. insured" exclusion, even a "Side A only" policy would provide little real protection to the D&O.) Finally, in an abundance of caution, a company can always obtain excess "Side A only" insurance coverage to protect directors and officers in case no insurance is otherwise available to them. In that event, the company would have no claim to the coverage, which would mean, in turn, that the bankruptcy court could not interfere with the D&O's access to those policy proceeds.

CONCLUSION

In sum, while courts are deeply divided on the legal treatment of insurance proceeds in bankruptcy, especially where entity coverage is involved, the courts are still unlikely to deny individuals access to insurance proceeds to cover defense costs. Moreover, companies can negotiate language in their D&O policies to enhance individuals' protection in bankruptcy and avoid the expense and uncertainty of litigating over access to insurance proceeds. ■

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