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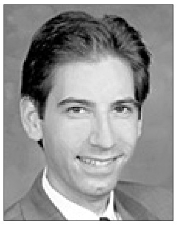
D&O defense policies not as certain as they seem

To recruit and retain qualified directors and officers, corporations must provide mechanisms to indemnify these individuals for personal liability arising from the performance of their corporate duties.

Accordingly, corporations traditionally purchase directors' and officers' insurance, commonly referred to as D&O insurance. In general, D&O insurance provides coverage for the defense of and liability for lawsuits brought against directors and officers for actions short of intentional wrongdoing.

GUEST OPINION
Andrew R. Shoemaker



GUEST OPINION
Lee C. Robinson

In light of the costs associated with legal representation, an important feature of D&O policies includes payment and, preferably, advancement of defense costs. But directors and officers may, however, be surprised to learn that the advancement of defense costs under a D&O policy may not be readily available when the corporation files for bankruptcy. This is a serious problem, given that lawsuits against officers and directors are common under such circumstances.

Historically, D&O policies offered two types of coverage — liability and indemnity. Both types of coverage benefit the officers and directors, but they differ in the manner of payment. Liability coverage pays benefits directly on behalf of officers and directors for claims brought against them by third parties, while indemnity coverage pays benefits to a corporation in the event it has to reimburse its officers or directors for such liability.

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In recent years, a third type of coverage, entity coverage, has become available in addition to D&O coverage. Entity coverage provides direct protection to a corporation for its own liabilities, typically for securities fraud, and not those of its management.

When a company files for bankruptcy, generally all efforts to collect against or to exercise control over the company's property are halted due to the "automatic stay" in the Bankruptcy Code.

In the past, many courts have held that while a D&O policy is itself an asset of the bankrupt corporation, the proceeds of the policy are not and are therefore not subject to the automatic stay. As a result, officers and directors may make claims against a D&O policy for an advancement of defense costs, and the insurance carrier may pay such claims without violating the automatic stay.

Recently, creditors and trustees, attempting to preserve and maximize assets for distribution to creditors, have attempted to block the advancement of defense costs to officers and directors under D&O policies by arguing that the proceeds of the polices are assets of the bankrupt company that cannot be distributed by virtue of the automatic stay.

One such notable case is the Enron bankruptcy, in which Enron's creditors attempted to block directors' and officers' access to the company's $350 million D&O policy.

Some courts have found that the creditors' arguments are strengthened when entity coverage is combined with D&O coverage in a single policy. When this happens, it is often the case that the entity and D&O coverage share the same pool of insurance proceeds, rather than having a defined priority of payment and independent policy limits.

In other words, the advancement of defense costs (and the payment of settlements) under the liability coverage necessarily reduces the amount of funds available to satisfy claims brought under the company's entity coverage.

Creditors and trustees therefore argue that all of the proceeds of the D&O policy must be frozen under the automatic stay so that they can be preserved for the benefit of the bankrupt company's creditors.

Thus far, courts have been reluctant to deprive officers and directors of the advancement of defense costs, but they have not completely rejected the creditors' arguments. In the Enron case, the court simply avoided the issue, opting instead to grant limited relief from the automatic stay.

Other courts have allowed payments when adequate proceeds exist to satisfy both non-speculative entity coverage claims and defense costs for the D&O claims. Nevertheless, the real potential exists that when a policy contains combined coverage, a sizable claim pending for entity coverage could result in the complete denial of advancement for D&O defense costs.

Also, the ambiguity created by these cases could possibly provide a basis for insurance companies to refuse to advance defense costs or for a bankruptcy trustee or creditor to object to the payment of defense costs until the bankruptcy court approves such advancement.

In sum, it is important for corporate management to recognize that having multiple coverage types in a single policy may result in their having to personally incur sizable legal costs until such time as the bankruptcy court rules on a motion for relief from stay, which may take months. Or, far worse, they could be deprived of the benefit of advancement altogether.

The insurance industry is making efforts to resolve this problem by offering insurance policies that include priority of payments or separate loss limits for traditional D&O coverage and entity coverage, by underwriting separate policies altogether, or by issuing "Side A" excess policies. Therefore, a careful review of the corporation's current D&O policy may enable management to avoid this potentially costly advancement quagmire before it occurs.

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