CORPORATE counsel

AUGUST 2002

OUTSIDE PERSPECTIVES

INSURANCE

"Uh-Oh"; D&O Insurance In Bankruptcy

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Directors' and Officers' ("D&O") liability insurance is on the tip of every officer's and director's tongue these days. This is especially true in our "post-Enron" world. Ever since the efforts by insurance companies to rescind Enron's insurance policies once the house began to crumble, policyholders no doubt have faced a challenging environment to purchase D&O insurance. More money to buy less insurance coverage has become the rule too often. The fact of the matter is, however, that dependable D&O insurance was getting harder to secure even before the fallout from Enron reared its head. Some recent huge claims and turbulent capital markets had D&O insurance companies running for the hills and away from coverage.

Now, with the numbers of bankruptcies escalating, company senior management acknowledge the import of reliable and sufficient D&O insurance protection. Understandably, officers and directors are concerned that, should the prospect of a bankruptcy ever be realized, sufficient insurance protection be available to them where debtor assets are in limited supply. Set forth below is an overview of just a few of the issues that crop up with D&O insurance in the context of bankruptcy proceedings.

As a general matter, bankruptcy proceedings of the policyholder do not negate the obligations of the policyholder's insurance companies to provide insurance coverage for claims brought by underlying claim-ants. Indeed, insurance policies often expressly provide that bankruptcy proceedings of the policyholder do not relieve the insurance companies of their insurance coverage obligations. For example, one form of a D&O policy provides in pertinent part that "[b]ankruptcy or insolvency of the Company or the Insured or of their estates shall not relieve the Insurer of any of its obligations hereunder." Case law addressing such provisions provides that insurance companies should not receive a windfall, and be relieved of their insurance coverage obligations, by virtue of their policyholder's filing for bankruptcy protection.

Nonetheless, some insurance companies may exploit certain circumstances arising in a bankruptcy situation to attempt to defeat insurance coverage.

Where a trustee in bankruptcy brings suit against current or former officers of the bankrupt company, a coverage battle with the D&O insurance company may ensue. Some D&O insurance companies argue that claims made by a trustee on behalf of the estate implicate and otherwise trigger the so-called "insured vs. insured" exclusion. By way of background, many versions of the insured vs. insured clause seek to bar insurance coverage for claims made by one "insured" against another.

Most commentators and courts agree that the insured vs. insured clause is designed to prevent collusive lawsuits brought by one insured against another with the purpose of tapping D&O insurance proceeds to bolster the company's bottom line. Despite the historic rationale for the insured vs. insured exclusion, too many D&O insurance companies seek a far broader application of the exclusion than its original intended purpose would suggest. The broad application sought by insurance companies carries over into the bankruptcy context. Although the vast majority of D&O insurance policy forms do not address lawsuits commenced by bankruptcy trustees (let alone define the terms "Insured" or "Company" for purposes of invoking the insured vs. insured exclusion), many insurance companies over the last decade have sought a forfeiture of insurance coverage for any lawsuit brought by a bankruptcy trustee. While cases have split on whether a trustee's claims against officers or directors of the company invoke the insured vs. insured exclusion, the majority of decisions rendered on this particular issue favor policyholders claims for insurance coverage. So long as the suit by the trustee is not collusive in nature, the exclusion should not effect a forfeiture of insurance coverage for the insured officers and directors.

A recurring question in bankruptcy proceedings is whether the benefits of a D&O policy are assets of the estate or personal assets of the insured officers and directors. Creditors of a bankruptcy estate often have an obvious interest in keeping available as many assets as possible, including insurance assets, in the debtor's estate to satisfy claims. In the Enron case, for example, a state attorney general attempted to bar Enron officers and directors from tapping the defense cost insurance coverage of Enron's D&O insurance, arguing that to permit payment of defense costs would siphon off money from the estate that could be used to pay creditors' claims. It appears now that despite the objections of the state attorney general, the officers and directors will be able to recover at least certain costs of defense from Enron's D&O insurance.

The question of whether a D&O insurance policy is property of the estate or the insured officers and directors becomes especially acute where the D&O policy expressly provides so-called "entity" insurance coverage to the company itself. "Entity" insurance coverage is one of the more recent features of D&O insurance being sold by the insurance industry. Historically, under D&O insurance policies without entity insurance coverage, D&O insurance companies had been taking the position that anytime the company itself was being sued along side its officers and directors (almost always the case), the D&O insurance company would argue that it was entitled to "allocate" the loss. The argument stemmed from the insurance companies' claims that only officers and directors were "insured" under the D&O policy and thus allegations made against the company itself were not covered. As such, many insurance companies would seek to allocate the loss and reduce insurance coverage–sometimes, by as much as 50 percent or more. After a string of losses in court by insurance companies on their allocation arguments, "entity" coverage was developed and sold to expressly grant insurance coverage to the company itself in certain circumstances (typically in securities cases naming the company itself as a defendant in addition to the officers and directors).

Some have argued that a D&O insurance policy which promises "entity" coverage transforms the policy into an asset of the bankruptcy estate with the potential effect of leaving the officers and directors "bare" in the event of litigation. The bulk of the cases rendered thus far do not necessarily support this conclusion, but it is an issue that continues to be debated and may well be tested in the courts with the recent spate of bankruptcy filings.

Policyholders should remember that most D&O insurance policies promise insurance coverage for "wrongful acts" which has been held repeatedly to provide a "broad" grant of insurance coverage to officers and directors. Nevertheless, D&O insurance policies are exclusion-laden and policyholders, therefore, must be vigilant when it comes to D&O insurance company claims handling. In the context of a bankruptcy, this rule proves especially true, where every asset becomes increasingly sought after by trustees, creditors and other claimants.

Joshua Gold is an attorney in the New York office of Anderson Kill & Olick, P.C. Mr. Gold specializes in insurance coverage analysis, consulting and litigation, with an emphasis on directors' and officers' (D&O) insurance, errors and omissions (E&O) insurance, online and internet liability and property insurance coverage issues and off-shore market insurance products. The firm also has offices in Philadelphia, PA, Newark, NJ, Greenwich, CT, Washington, DC, and Chicago, IL.

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