Reorganization And D&O: Not Always Business As Usual

Law360, New York (March 14, 2012, 1:50 PM ET) -- Advisers to financially distressed companies and those companies' boards must be mindful of the impact that restructuring may have on the company's existing directors and officers, or D&O, insurance policy.

From the company's perspective, assuring directors and officers that they will be protected appropriately throughout and after the reorganization process is essential to retaining the individuals who will approve, and oversee implementation of, the company's plan to maximize the value of the enterprise.

The primary goal of this article is to explore best practices for preserving and optimizing protection for directors and officers before, during and after commencement of a bankruptcy proceeding. Protection of such interests will entail considering modifications to current coverage, determining the best available method for obtaining "run-off" coverage, and understanding the role the restructured entity will play — for example, as an insured or indemnitor.

In addition, this article highlights certain pitfalls that may arise in the post-restructuring era if there are multiple resources available to insure or indemnify directors and officers with respect to their pre-restructuring service.

"Change in Control" Under D&O Insurance

The primary function of D&O insurance is to insure company management. Significant changes to the management structure — for example, appointment of new directors after a reorganization — alter the insured risk and, depending on a host of factors, require important modifications to the coverage.

D&O policies generally define a "change in control" as when another person, entity or group of either of those acting in concert acquire 50 percent or more of the voting, appointment or designation power to select a majority of the board of directors of the insured company.

However, the definition of "change in control" is meant to be applied to a wide variety of circumstances, including nondistressed mergers and sales, so an adviser can be a helpful liaison between the insured and the insurer to determine when a restructuring event constitutes a "change in control" from the underwriter's perspective.

"Change in Control" in Common Restructuring Scenarios

A change in control under a D&O insurance policy can be triggered in a variety of ways in an in-court or out-of-court restructuring, and the examples that follow are the most commonly encountered scenarios in a bankruptcy context.

Chapter 11

A company that has sought protection under Chapter 11 of Title 11 of the United States Code (the Bankruptcy Code) typically seeks to restructure by implementing a plan of reorganization. Often, such a plan will provide for a change in ownership of the equity of the debtor company, but until such time, the majority of equity is likely to remain in the same hands as on the day prior to the petition.

Accordingly, in Chapter 11, the change in control frequently occurs on the date the plan is implemented, often referred to as the "effective date" of the plan.[1]

Although a debtor usually remains in possession of its assets and operations during a Chapter 11 case, it is possible that a trustee may be appointed to supplant the debtor's directors and officers.[2] In spite of the fact that day-to-day operations are being managed by a different person, a D&O insurer will likely view this situation as a change in management and not a change in control, because ownership of the debtor remains unchanged.

There have also been recent Chapter 11 cases that have been dismissed in a structured manner, in which the debtor has not confirmed and implemented a plan.[3] In the dismissal scenario, a change in control is unlikely to occur solely because a Chapter 11 case has been dismissed.

Chapter 7

Under chapter 7 of the Bankruptcy Code, a debtor seeks to liquidate its assets and distribute the proceeds therefrom to its creditors. A trustee is always elected to supplant the debtor's directors and officers.[4] Given that such trustee will take over the management of the debtor and the disposition of its assets, such appointment is likely to constitute a change in control under the relevant D&O policy.

363 Sale

Section 363 of the Bankruptcy Code allows a Chapter 7 trustee or Chapter 11 debtor to sell its assets outside of the ordinary course of business, after providing appropriate notice and a hearing. Increasingly — and at times controversially — this statutory authority has been employed by debtors to effect a sale of substantially all of their assets.[5]

Depending on how "change in control" is defined in a D&O policy, the change-in-control provision may be triggered upon a sale. In a Chapter 11 proceeding, this may create an undesired coverage "gap" for ongoing management activity.

Most insurers are willing to waive this trigger by endorsement and allow the coverage to continue after the sale of assets through the implementation of the debtor's plan, which may include transferring residual assets to a liquidation trust, and perhaps even beyond to liquidation or dissolution of such debtor.

Dissolution

Dissolution of an entity may follow the various restructuring paths set forth above. For instance, after a Chapter 11 debtor has sold substantially all of its assets in a 363 sale and closed its case, it may dissolve the resultant shell entity.[6] After a Chapter 7 liquidation, the shell entity is often dissolved under applicable corporate law. Upon dissolution, if a change in control has not already been triggered, it will likely be triggered at that point.

Upon reorganization of a debtor or acquisition of a debtor's assets by a newly formed entity, a "newco" arises that will have the same need to fashion a regime to protect its leadership from liability. The mechanisms of that protection will often include the same components that were in place for a troubled entity.

However, there will be the added consideration of determining how the newco's protections will dovetail with those that may be in place, or have been in place, for the debtor's directors and officers, particularly if those same individuals will be employed by newco.

As illustrated above, when a change in control under a D&O policy will occur depends on the particular reorganization strategy. The timing of such occurrence will dictate when and what measures must be taken to ensure the continuation of the current insurance throughout the restructuring process and thereafter, as well as when newco D&O coverage will commence in order to avoid "gaps" between management insurance for the once financially distressed companies and the post-restructuring companies.

Accordingly, best practices dictate that several important preparatory steps be taken prior to filing, even if the ultimate restructuring mechanism is unknown at the outset.

Run-Off Coverage

D&O insurance affords coverage for claims made against the insureds and noticed to the insurer during the policy period; the underlying conduct, however, need not occur during that policy period.

Once a change in control occurs under a policy, management no longer enjoys insurance coverage for conduct taking place post-change in control; while management may continue to be employed or govern new or reorganized legal entities with little apparent change in day-to-day operations, from the insurer's perspective it is an altogether new and distinct insurable risk.

Statutes of limitations, however, allow plaintiffs to assert claims that are typically lodged against directors and officers for up to six years from the date of the alleged misconduct.[7]

Therefore, management must preserve its ability, for a period of time, to notice claims to the applicable D&O insurance policy made post-change in control based upon pre-change in control conduct. This extended noticing period is commonly referred to as "run-off" or "tail" coverage.

A run-off extension merely extends the term to notice claims; policy limits (impaired or not), terms, conditions and exclusions remain unchanged for the most part. Post-change in control management must secure new, separate, "go-forward" D&O coverage.

While many plans of reorganization provide for releases of claims that could be asserted derivatively and directly by creditors, directors and officers in such restructurings generally still desire coverage in order to shield themselves from having to shoulder the significant defense costs that could be expended in a nuisance suit or an action that is subject to dismissal based on the releases.

Pre-Filing Best Practices: Run-Off

The commencement of a formal restructuring process may complicate a company's ability to expend funds on D&O insurance, including the necessary run-off extensions. Moreover, management will be keenly focused on having these issues resolved and funded in advance, so addressing these matters will remove a potential distraction from the restructuring landscape.

A run-off extension must “attach” to a D&O policy in effect at the time of the policy’s change in control. Before filing, therefore, the company must determine whether the current D&O policy will expire prior to the policy’s change in control trigger and, if so, implement the renewal or extension process.

Many companies decide to extend the existing policy term rather than undergo the annual renewal process. An extension has several potential benefits.

First, an extension is less time-consuming for management compared to the annual renewal process. Given the uncertainty of the company’s overall outlook, management is often unable to provide the insurer’s underwriters with the normal renewal due diligence.

Second, insurers are often reluctant to issue new limits to a company in financial distress, particularly when the risk of management-based claims may be heightened. A drawback to extending, however, is the potential “dilution” of existing limits over a longer policy term. Regardless, funding the D&O insurance modifications prior to filing ensures that management will remain insured throughout the process.

While annual D&O insurance renewals should be considered ordinary-course-of-business expenditures by a debtor — though debtors often request court approval to continue their insurance programs at the outset of a case in an abundance of caution — obtaining a D&O insurance run-off extension may require bankruptcy court approval. Stakeholders may oppose such a purchase or a court may determine not to approve it.[8]

Having a D&O policy expire, and the run-off extension incept, in the middle of a reorganization process is an undesirable result and may create insurance “gaps” if another policy extension cannot be secured.

Run-off extension premiums are often issued on a nonrefundable, noncancellable basis. This prohibits third parties from attempting to challenge or avoid this expenditure and strip management of its insurance protection, often at times when effective corporate indemnification is unavailable due to the bankruptcy process.

Often, prior to filing, formal discussions have ensued with the lenders, possibly culminating in a restructuring support agreement or plan support agreement regarding the proposed framework of the reorganization. Such agreement may give the lenders tighter operational and budgetary controls than debt instruments typically provide. If a support agreement is being negotiated, a company should consider advocating for express approval for the purchase of run-off coverage.

However, if the discussions are contentious, the debtor could also consider moving quickly to purchase noncancellable run-off prior to the imposition of restraints that will contractually limit the company’s ability to do so.

Certain distressed companies simply may not have adequate liquidity to fund the purchase, requiring the company to wait until a filing and the advancement of debtor-in-possession financing before it purchases run-off coverage. A debtor in that situation should ensure that the price of run-off coverage is included in any debtor in possession financing or cash collateral budgets.

Insurance Coverage Should be Continually Assessed During a Reorganization

Once run-off coverage has been obtained, it is not sufficient for the company to place the policy in a drawer and await the finalization of the reorganization proceedings. Given that reorganizations often flush out claims, whether meritorious or not, it is imperative that the company, with the assistance of its advisers, continually assess its noticing obligations under the policy.

While determining whether a claim should be noticed is often a matter of art, the consequences of failing to properly notice a claim are sufficiently dire that claims noticing needs to be at the forefront of a company's risk management considerations.

Additionally, settlements that are entered into in a reorganization context must be carefully negotiated and documented to avoid the scenario in which an insurer is able to deny coverage because the insured has not suffered a "loss."[9]

Aligning Post-Restructuring Protection to Optimize Outcome for Directors & Officers

Lenders that are slated to be stakeholders in the restructured entity may agree to indemnify the management of the pre-reorganization entity, or "oldco," for oldco-based claims, particularly if they want to induce management to continue in their managerial positions.

Other lenders propose a one-or-the-other option: fund the run-off extension or agree to open-ended indemnification of oldco directors and officers. Oldco directors and officers may demand both.

A better option for all parties is for the lenders to agree to purchase run-off coverage and provide indemnification in excess of the run-off limits, if necessary, or in the event the run-off coverage does not respond to the claims.

The effect is to align the hierarchy of run-off coverage and newco's indemnity, avoiding concurrent obligations between the two that may frustrate a determination of who pays and in what sequence.

Here, the best practice is to confirm coverage for this arrangement with the insurers, including adding newco as an "insured" under the run-off to ensure coverage for newco's assumed indemnity; confirm that despite the presence of contractual indemnification, no retention applies; and obtain a waiver of the "insured versus insured" exclusion, ensuring coverage for claims by newco, now an elected insured under the run-off, against oldco directors and officers.

While all of these options may not be achievable, they should be considered and pursued.

Conclusion

Ensuring that appropriate insurance protection is available — and accessible — for directors and officers throughout and after a reorganization process should be of paramount concern to company-side restructuring advisers.

Optimal results for the company's leadership will require assessment of appropriate coverage for directors and officers both throughout and after the process, ensuring that there is sufficient (financial and political) capital to obtain run-off coverage.

At times, disputes with interested parties regarding the propriety of the protection package may have to be resolved. Accordingly, insurance and restructuring advisers should coordinate early in the process to implement a solid approach to providing protection for a debtor's leadership.

--By Shaunna D. Jones and Jeffrey B. Clancy, Willkie Farr & Gallagher LLP

Shaunna Jones is a partner in the Willkie Farr's business reorganization and restructuring department in the firm's New York office. Jeffrey Clancy is a senior associate in the firm's insurance department in New York.

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[1] Notably, it is typical for a Chapter 11 case to remain open and pending after the effective date of the plan to continue the implementation of transactions contemplated by the plan, including the administration of distributions and the claims reconciliation process.

[2] See 11 U.S.C. § 1104(a) (authorizing appointment of a trustee in a chapter 11 case).

[3] See, e.g., In re TLG Liquidation LLC, Case No. 10-10206 (MFW) (Bankr. D. Del. Oct. 29, 2010); In re KB Toys, Inc., Case No. 08-13269 (KJC) (Bankr. D. Del. Dec. 1, 2009); In re Levitz Home Furnishings, Inc., Case No. 05-45189 (BRL) (Bankr. S.D.N.Y. March 28, 2008).

[4] See 11 U.S.C. § 701.

[5] See, e.g., In re General Motors Corp., Case No. 09-50026 (REG) (Bankr. S.D.N.Y. July 5, 2009); In re Old Carco LLC (f/k/a Chrysler LLC), Case No. 09-50002 (SMB) (Bankr. S.D.N.Y. May 31, 2009).

[6] A debtor corporation may be authorized by state statute to dissolve itself, without further action by its directors or stockholders, as part of a bankruptcy proceeding. See, e.g., 8 Del. C. § 303.

[7] See, e.g., N.Y. C.P.L.R. § 213(8); Spitzer v. Schussel, 7 Misc. 3d 171 (N.Y. Sup. Ct. 2005) (holding that a six-year limitation period applies where the relief sought for breach of fiduciary duties is a mix of both equitable and monetary remedies); See Pub. L. No. 107-204, 116 Stat. 745, Title VIII, § 804(a) (2002) (providing for a statute of limitations for bringing claims of federal securities fraud under Section 10(b) of the Securities Exchange Act to the earlier of two years after the discovery of the facts constituting the violation or five years after such violation).

[8] In certain instances, even the tapping of coverage by insured directors and officers can be controversial. Recently, in the chapter 11 cases of MF Global Holdings, Ltd. and its affiliated debtors pending in the United States Bankruptcy Court for the Southern District of New York, parties in interest objected to the chapter 11 trustee's request for an order authorizing the debtor's insurer to make certain payments that would reduce the aggregate coverage available under the applicable policies. See, e.g., Certain Interested Parties' Objection to Proposed Stipulation and Order Between the Chapter 11 Trustee and MFG Assurance Company Limited Regarding Payment of Loss and Reimbursement of Covered Costs and Expenses, Case No. 11-15059 (MG) (Bankr. S.D.N.Y. Feb. 7, 2012) (stating "the MFGI commodities customers believe that the coverage is a valuable asset which should be protected and preserved by this Court for the benefit of MFGI's innocent victims, MFGI's unfortunate commodities customers"); In re Adelphia Communications Corp., 298 B.R. 49 (S.D.N.Y. 2003) (responding to the Adelphia estates' attempt to block direct D&O insurance payments to individual directors and officers and holding that the estate did not have a current property interest in insurance proceeds because the debtors had not yet incurred any actual insurable loss, characterizing the estate's purported property interest claim in the insurance proceeds as "akin to a car owner with collision coverage claiming he has the right to proceeds from his policy simply because there is a prospective possibility that his car will collide with another tomorrow").

[9] See, e.g., United States Bank Nat'l Ass'n v. Fed. Ins. Co., Case No. 10-3472 (8th Cir. Dec. 13, 2011) (holding that a D&O insurer did not have to satisfy the claims of a creditor's trust against a director because, as part of a settlement between the trust and the director, the trust had expressly agreed not to pursue recovery against the director's personal assets and therefore there was no "insurable" loss).

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