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The Bankruptcy Corner: Is Your D&O/Lender Liability Coverage High Danger Proof?

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When Baker Donelson's Advocacy Department invites the Corporate Restructuring & Bankruptcy (CRaB) practice group to submit an article for the Trial Spotlight Newsletter it creates the editorial equivalent of hockey's "high-danger chance." Because the bankruptcy process is marginally-managed chaos (again, much like this author's favorite sport), the Firm's other practice groups are often wary of extending invitations to CRaB (admittedly, this usually applies to dinner parties and happy hours), mostly because the pressure-intensive nature of bankruptcy practice makes bankruptcy lawyers edgy, irritable and ready to "drop the gloves" at even the slightest provocation. Arguably, this makes us better litigators because we have to be prepared to contend with multiple, competing threats from any number of different constituencies – aggressive trustees, overly litigious creditors' committees, paranoid secured lenders, and former equity holders located somewhere near the middle of Kubler-Ross' five stages of grief index. Basically, if you hang out with the bankruptcy lawyers, you better "keep your head on a swivel," or you'll get checked hard into the boards.

Remaining vigilant to avoid long-term pain is also part of corporate governance. Certainly, avoiding collisions at the intersection of the boardroom and the courtroom is highly advisable. Unfortunately, even in 2021, there is no app for that. There is, however, insurance for directors and officers (D&O), and as the world emerges from the COVID-19 pandemic, now is the right time for financial institutions to evaluate their coverages in an environment where sophisticated lenders have liened up substantially all corporate assets, leaving other paying customers (subordinated lenders, unsecured trade creditors, and equity) to hunt for other targets and avenues of recovery in the context of restructurings and liquidations.

Chasing pucks is all about angles, so readers may wonder about the trial angle in the D&O area. Here, the game is more centered on litigation avoidance than direct impact. And in the world of D&O liability, most insolvency-related battles are fought over discreet issues involving coverage, and specifically the bankruptcy-related exclusions insurers may have baked into policies (including Lender Liability Endorsements) that may allow an insurer to deny coverage in the face of litigation brought by one of the many players in the bankruptcy process.

Two decisions (one fairly recent) underscore and illustrate the parameters of the battle – both involved significant litigation at the trial court and appellate levels over D&O coverage issues. In *Yessenow v. Executive Risk Indemnity Inc.*, 953 N.E.2d 433 (Ill.App.Ct.2011), former directors of a bankrupt entity asserted that they were entitled to coverage for claims brought by the bankruptcy trustee. Relying on bankruptcy exclusion provisions in the policy, the insurer denied coverage. The lower court disagreed, finding that coverage existed, and the appellate court affirmed – on grounds that the policy was property of the bankruptcy estate and that the exclusion itself violated the statutory provisions (section 541) of the Bankruptcy Code.

In *CMH Liquidating Trust v. National Union Fire Insurance Company of Pittsburgh, PA* (In re Community Memorial Hospital), Case No. 12-20666 (Bankr.E.D.Mich.2019), the Bankruptcy Court held (and the District Court concurred in adopting its Report and Recommendation) that the D&O policy itself was an executory contract that carried with it an embedded prohibition against ipso facto clauses (section 365(e)) that allow a counter-party to escape performance simply because the insured has filed for relief under the Bankruptcy Code. Here, both courts concluded that the bankruptcy exclusion did not apply, and there was coverage for claims that the former officers and directors committed wrongful acts that led the company to seek bankruptcy relief. Again, the real battle in these cases is over coverage – once coverage is established, the cases typically move to a more predictable (expensive) and often negotiated outcome.

Why does this matter? To be clear, it's not just the debtor's former management who is at risk. If you watch a hockey game, it's hard not to find the player with the bullseye on their back – it's the person skating with the puck. When an enterprise fails, the last player possessing the "puck" often is the financial institution that served as the company's primary lender. While that position may provide a lender with the ability to erect guardrails around a financial free-fall, the reality is that the impact with the ground usually hurts (sometimes a lot). The first lienholder may stand to benefit the most from an expeditious, controlled liquidation of a borrower's collateral, but oftentimes it is the primary lender that ends up holding the largest unsecured claim in the form of a deficiency.

To add insult to injury, borrowers and other third parties may decide to assert liability claims against the lender based on allegations of wrongdoing. These claims may take the form of improper management of the credit itself, self-dealing and overreaching in exerting control of the enterprise during the slide into insolvency, failure to adhere to appropriate regulatory requirements, tortious interference with other contractual relationships, and generally bad behavior. It's worth keeping in mind, though, that D&O claims are often out of pattern, and only limited by the creativity of the attorney looking for a cause of action. Like they say at the rink, you miss 100 percent of the shots you don't take.

While you're flipping through that existing D&O policy (and that Lender Liability Endorsement) to evaluate your coverage, here are a few things to keep in mind in the spirit of risk management:

- Seriously, pull out your D&O policy and read it. Be familiar with coverage limits and exclusions – especially the insolvency and bankruptcy exclusions.
- Do not take an active role in the day-to-day operations of the borrower, including management of accounts payable.
- Do not put an employee of the lender on-site at the borrower's principal place of business for an extended period.
- Do not assist the borrower with its decision-making process.
- If a workout is in play, ALWAYS use it as an opportunity to engineer a full release in the forbearance agreement or loan modification.
- Thoroughly document discussions with the borrower and DO NOT make promises that fall outside the loan documents.
- Understand claims that may trigger coverage and ACT in a timely manner in to report them to the carrier.
- Resist ALL temptation to put a lender representative on the borrower's Board of Directors.
- Remain vigilant and use professionals (attorneys, financial advisors, and turnaround management teams) to evaluate the potential source of any threats.
- Offense sells tickets. Defense wins championships.

If you have any questions on this topic, or another CRaB-related subject, please contact John Rowland.