

# Insurance and Indemnification of Directors and Officers: Avoiding Pitfalls 2011

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I. Introduction .....	198
II. The “Typical” Director and Officer Liability Policy .....	198
A. Insuring Agreements .....	198
1. Part A: Directors and Officers Liability..	199
2. Part B: Company Reimbursement Insurance .....	199
B. Claims, Notice, and Payments.....	200
1. Claims-Made Policies and the Notice-Prejudice Rule .....	200
2. D&O Policies are “Wasting” Policies .....	201
C. Indemnification and Retention .....	202
D. Exclusions.....	203
1. The “Insured v. Insured” Exclusion .....	203
a. Overview .....	203
b. Case Law .....	205
2. The Fraud Exclusion .....	206
3. The Personal Profit Exclusion .....	207
4. Bankruptcy Exclusions: Do They Work? .	208
5. Exclusion Triggers: “In Fact” Determinations versus “Final Adjudication” .....	210
E. Policy Rescission and Severability Clauses ..	212
F. Priority of Payment .....	215

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1. D&O Insurance as Property of the Bankruptcy Estate .....	215
2. Priority of Payments Clause .....	219
G. Policy Buy-Backs .....	220
H. Post-Policy Period Coverage .....	222
III. Part A Only Policies .....	222
IV. Indemnification and Advancement of Expenses .	225
A. Mandatory Indemnification .....	225
B. Individual Indemnification Agreement .....	226
C. Mandatory Advancement of Expenses .....	227
V. Conclusion .....	227

## ***I. INTRODUCTION***

This paper describes how a “typical” director and officer (“D&O”) insurance policy works and how D&O insurance interacts with the indemnification of D&Os by the companies they serve. With the intent of showing how best to protect D&Os and avoid common pitfalls, it highlights key policy sections, provisions, and definitions. Please bear in mind that while D&O policies generally share certain characteristics, they are not required to meet any standard or follow any norm. Each policy must be read carefully without assumptions regarding its definitions or coverage.

## ***II. THE “TYPICAL” DIRECTOR AND OFFICER LIABILITY POLICY***

### ***A. Insuring Agreements***

A company purchases D&O insurance for its directors and officers (the “D&O Insureds”) to protect them from personal liability for claims arising from their service to the company. The types of losses that a policy will typically cover include litigation defense costs, settlements, and adverse judgments arising from certain alleged “wrongful acts” by the directors or officers acting in such capacities. A D&O policy normally includes two “insuring agreements”—Part A (Directors and Officers Liability) and Part B (Company Reimbursement). Part B (or an additional insuring agreement, usually identified as Part C) may also provide coverage for “wrongful acts” of the company. In public companies, this additional entity coverage is often limited to securities claims.

### **1. Part A: Directors and Officers Liability**

Part A (also known as “Side A” or “Coverage A”) of a D&O policy provides direct liability insurance coverage for the D&O Insureds, to the extent that the company has not indemnified them. A typical Part A insuring agreement states:

This policy shall pay the Loss of each and every Director or Officer of the Company arising from a Claim first made against such Insureds during the Policy Period for any actual or alleged Wrongful Act in their respective capacities as Directors or Officers of the Company *except when and to the extent that the Company has indemnified such insureds*. The insurer shall advance Defense Costs of such Claims.<sup>1</sup>

### **2. Part B: Company Reimbursement Insurance**

In Part B, the insurer agrees to reimburse the company for amounts that the company has paid to indemnify the D&O Insureds. In the example below, part B(i) also provides direct coverage to the company for its wrongful acts:

This policy shall pay the Loss of the Company arising from a (i) claim first made against the Company, or (ii) claim first made against an Individual Insured, during the Policy Period for any actual or alleged Wrongful Act, but, in the case of (ii) above, only when and to the extent that the Company has indemnified the Individual Insured for such Loss pursuant to law, common or statutory, or contract, or the Charter or By-laws of the Company duly effective under such law which determines and defines such rights of Indemnity. The insurer shall advance Defense Costs for such Claims.<sup>2</sup>

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1. See, e.g., *In re Allied Digital Technologies, Inc.*, 306 B.R. 505, 510 (Bankr. D. Del. 2004).

2. *Id.*

## **B. Claims, Notice, and Payments**

### **1. Claims-Made Policies and the Notice-Prejudice Rule**

D&O policies are typically “claims-made” policies rather than “occurrence” policies. A claims-made policy provides coverage only for those claims made against the insured during the policy period or the extended reporting period, if any. An occurrence policy, on the other hand, provides coverage for claims arising from an occurrence that took place during the policy period, even if the claim does not arise until after the policy period.

Whether claims-made or occurrence, policies always require that the insured give the insurer notice of a claim within a certain period of time or within a qualitatively described time frame such as “promptly” or “as soon as practicable.” For occurrence policies, Texas and the majority of other states follow the “notice-prejudice rule” according to which an insurer may only deny coverage because of late notice if the insurer can show that it was adversely affected by the late notice.<sup>3</sup> Until recently, the notice-prejudice rule was, without qualification, held not to apply to claims-made policies under Texas law because, as one court stated, “[t]o require a showing of prejudice for late notice would defeat the purpose of ‘claims-made’ policies, and in effect, change such a policy into an ‘occurrence’ policy.”<sup>4</sup>

In recent years, the rules have changed significantly with regard to claims-made policies, at least in Texas. The Texas Supreme Court held in 2009 that when notice of a claim was given within the policy period, even if not within the policy’s qualitatively described time frame, the insurer had to show prejudice in order to deny coverage.<sup>5</sup> Specifically the court held, “In a claims-made policy, when an insured notifies its insurer of a claim within the policy term or other reporting period that the policy specifies, the insured’s failure to provide notice ‘as soon as practicable’ will not defeat coverage in the absence of prejudice to the insurer.”<sup>6</sup> In so ruling, the Texas Supreme

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3. See *PAJ, Inc. v. Hanover Ins. Co.*, 243 S.W.3d 630, 631 (Tex. 2008).

4. *Hirsch v. Tex. Lawyers’ Ins. Exch.*, 808 S.W.2d 561, 565 (Tex. App.—El Paso 1991, writ denied); see also *Fed. Ins. Co. v. CompUSA, Inc.*, 319 F.3d 746, 754 (5th Cir. 2003) (applying “well-settled” Texas law).

5. E.g., *Prodigy Commc’ns Corp. v. Agric. Excess & Surplus Ins. Co.*, 288 S.W. 3d 374, 382–83 (Tex. 2009), *reh’g withdrawn* (Aug. 21, 2009); *Fin. Indus. Corp. v. XL Specialty Ins. Co.*, 285 S.W.3d 877, 879 (Tex. 2009).

6. *Prodigy*, 288 S.W.3d at 382.

Court followed Massachusetts' highest court, and thus far, at least one federal district court in another state has followed the same rule.<sup>7</sup> The United States District Court for the Northern District of Texas similarly held that notice after the policy period did not preclude coverage, where the policy's only requirement was that notice be made "as soon as practicable."<sup>8</sup> Pennsylvania courts, on the other hand, continue strict adherence to the traditional rule, and have held that timely notice is a condition precedent to coverage under a claims-made policy, whether or not the insurer is prejudiced.<sup>9</sup> Particularly in light of the split among jurisdictions on this issue, prompt notice of claims is generally the prudent course of action.

The Fifth Circuit took the Texas Supreme Court's decisions a step further with regard to policies containing multiple notice provisions.<sup>10</sup> Noting that *Prodigy* and *XL Specialty* did not address the issue, the court held the prejudice analysis applied to each of two separate notices: a notice of claim and a notice of lawsuit.<sup>11</sup> An insurer therefore achieves no strategic advantage by relying upon one notice provision or another.

## 2. D&O Policies are "Wasting" Policies

While many types of insurance have "per occurrence" liability limits that do not include amounts paid by the insurer to defend the claim, D&O policies are typically single-limit policies, meaning that a payout of proceeds for any reason (including defense costs) or to any claimant will diminish the amount available to pay any other claims. For example, payment of defense costs on one claim will leave less money available to pay a settlement or judgment on that claim or another claim. For this

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7. *Chas. T. Main, Inc. v. Fireman's Fund Ins. Co.*, 551 N.E.2d 28, 30 (Mass. 1990); *see also* *T.H.E. Ins. Co. v. P.T.P. Inc.*, 628 A.2d 223, 228 (Md. 1993) (stating in dicta that it would follow the rule later adopted by Texas); *Fulton Bellows, LLC v. Fed. Ins. Co.*, No. 08-107, 2009 WL 3065056, at \*16-17 (E.D. Tenn. Sept. 21, 2009).
  8. *Evanston Ins. Co. v. Keeway Am., LLC*, 2010 WL 2652330 (N.D. Tex. June 29, 2010) (dismissing insurer's complaint for failure to plead facts showing it was prejudiced by allegedly late notice).
  9. *See ACE Am. Ins. Co. v. Underwriters at Lloyds & Cos.*, 939 A.2d 935, 940 (Pa. Super. 2007), *aff'd per curiam*, 971 A.2d 1121 (Pa. 2009).
  10. *E. Tex. Med. Ctr. Reg'l Healthcare Sys. v. Lexington Ins. Co.*, 575 F.3d 520, 529-30 (5th Cir. 2009).
  11. *Id.* at 528-30.

reason, D&O policies are sometimes referred to as “wasting” policies.<sup>12</sup>

### ***C. Indemnification and Retention***

States commonly proscribe rules for mandatory and permissive indemnification of D&Os in their corporation laws.<sup>13</sup> A typical state indemnification statute will *require* that companies indemnify D&Os for attorneys’ fees and costs incurred in successfully defending suits brought against them and will *permit* indemnification of D&Os, no matter what the outcome of a suit, as long as the director or officer acted in good faith and in a manner reasonably believed to be in the best interests of the company. A D&O policy will generally require that either the company or the D&O Insureds pay a specified amount, or “retention,” toward indemnifiable costs before the insurer will pay on the policy. Retention amounts can be significant, often ranging from \$250,000 to \$1 million or more.

Retention clauses can be a trap for the unwary D&O. If state law requires or permits a company to indemnify a D&O, but the company does not or cannot comply, satisfaction of the retention will fall to the D&O Insured. A D&O Insured must protect himself or herself against the situation in which indemnification is required or permitted under state law but is not provided by the company. A D&O Insured can in part protect against this risk by ensuring that the company is obligated—by its articles of incorporation, its bylaws, or contractual agreement—to indemnify the D&O Insured to the fullest extent permitted by law.

D&O Insureds may also bear the risk of having to pay the retention if a company is unable to perform on its indemnification obligations as a result of bankruptcy or other financial impairment. A D&O Insured can try to protect against this risk by negotiating for a provision stating that, in such a situation, losses, including defense costs, will be paid under Part A with no retention. Some insurers may resist the inclusion of such a provision within the policy, but may nevertheless be willing to

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12. *In re Allied Digital Technologies, Inc.*, 306 B.R. 505, 508 (Bankr. D. Del. 2004); *In re Metro. Mortg. & Secs. Co., Inc.*, 325 B.R. 851, 853 (Bankr. E.D. Wash. 2005); *In re Petters Co., Inc.*, 419 B.R. 369, 377 (Bankr. D. Minn. 2009).

13. Texas law, for example, includes indemnification provisions in BUSINESS ORGANIZATIONS CODE § 8.001 *et seq.*

issue a letter to the same effect. The following shows how the pertinent part of such a letter might read:

If the Company goes bankrupt and in a filing for bankruptcy protection (voluntary or involuntary) the court prohibits indemnification by the Company of Loss of the Insured Persons because of higher bankruptcy law priorities, then, generally, the Insurer would not consider indemnification of the Insured Persons for such Loss by the Company to be “permitted or required.” The result of this is that, as respects such Loss of the Insured Persons under Coverage A of the Policy, the presumptive indemnification language found in the definition of Indemnifiable Loss would not apply and the Insurer would apply a zero retention to such Loss.

Retention obligations are cumulative. Therefore, if in a suit against D&Os, a company is also a defendant, the company may satisfy the retention amount in defending itself, even if it has not paid it on behalf of the D&Os. This would allow D&Os to tap into the policy without coming out of pocket on the retention.

## ***D. Exclusions***

Policy exclusions—which carve out areas for which there is no coverage—are ubiquitous and crucial. While a D&O policy may have numerous exclusions, the three most common include: (1) the so-called “insured v. insured” exclusion; (2) the fraud exclusion; and (3) the personal profit exclusion. Each is discussed below, as well as the “bankruptcy exclusion”—an unusual exclusion that was recently litigated and may become more common.

### ***1. The “Insured v. Insured” Exclusion***

#### ***a. Overview***

The “insured v. insured” exclusion prohibits one insured from suing another insured. The primary purpose is to exclude coverage for collusive or “friendly” suits in which a company may seek to recover ordinary business losses by making claims against the D&O Insureds, who were involved in the transaction that gave rise to the losses. D&O policies will generally make an exception to the exclusion for shareholder derivative suits, as long as such suits are brought without the involvement

of any insured. A typical introductory clause for an insured v. insured exclusion might read as follows:

The Insurer shall not be liable for Loss on account of a Claim which is brought by any Insured or by the Company; or which is brought by any security holder of the Company, whether directly or derivatively, unless such security holder's Claim is instigated and continued totally independent of, and totally without the solicitation of, or assistance of, or active participation of, or intervention of, any Insured.

The need for the insured v. insured exclusion is understandable, but it may have unanticipated consequences if a company files for bankruptcy, in which case D&Os are more likely than ever to need the insurance protection. Not infrequently, after a bankruptcy filing, the bankruptcy trustee, examiner, debtor-in-possession, or a successor of the filing entity will sue D&Os of the debtor company for breach of fiduciary duty, a claim that the Bankruptcy Code expressly vests in the bankruptcy estate.<sup>14</sup> Insurers have sometimes taken the position that coverage is barred in such situations, either because the debtor company (i) is also an insured and/or (ii) is in effect itself bringing the claim.

D&O policies will sometimes address the question of how an insured v. insured exclusion will function in bankruptcy by providing a specific exception relating to insolvency. A typical exception might read: "This exclusion shall not apply to any Claim brought by any bankruptcy or insolvency trustee, receiver, examiner, or similar officer for the Company." In addition to an insolvency exception, the following exceptions to the insured v. insured exclusion should always be included to protect D&O Insureds in circumstances where the exclusion might otherwise bar coverage: (1) allowing one insured to bring claims against another for contribution or indemnity; (2) in employment matters; and (3) involving whistleblower matters under Sarbanes-Oxley or any similar whistleblower provisions.

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14. 11 U.S.C. § 541(a)(1) (2006); *see e.g. In re County Seat Stores, Inc.*, 280 B.R. 319, 325-26 (Bankr. S.D.N.Y. 2002).

### *b. Case Law*

If a policy does not include an insolvency exception or if suit is brought by a party not specified in the insolvency clause—such as a debtor-in-possession, successor or assignee—then the existence or lack of coverage will likely depend on the identity of the plaintiff. In cases in which the policy does not include an insolvency exception and the plaintiff bringing suit against the D&Os is a bankruptcy trustee, case law supports coverage. A majority of courts have held that the insured v. insured exclusion does not bar coverage in a suit brought by a trustee against the D&Os for one or both of the following reasons: (1) the risk of collusion is far lower because a trustee does not represent the debtor, does not owe any duties to the debtor, and is in fact often adverse to the debtor; or (2) the language of the exclusion (typically stating that claims brought “on behalf of” an insured are not covered) was ambiguous and state law therefore required that it be construed in favor of coverage.<sup>15</sup> A minority of courts have held that any differences between a bankruptcy trustee or similar official and the pre-petition debtor are immaterial as far as the insured v. insured exclusions is concerned.<sup>16</sup>

While the majority position for suits brought by trustees is clear, a recent opinion from the Ninth Circuit, *Biltmore Assocs., LLC v. Twin City Fire Ins. Co.*, addressed the less often discussed question of whether the exclusion should bar coverage for a suit brought by a debtor-in-possession.<sup>17</sup> Previous cases in federal district and bankruptcy courts were split on the issue.<sup>18</sup>

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15. *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1116-17 (9th Cir. 2006); *Grafenauer v. Mukamal (In re Laminate Kingdom, LLC)*, Nos. 07-10279, 07-01792, 2008 WL 704396, at \*3-4 (Bankr. S.D. Fla. Mar. 13, 2008); *Cohen v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. (In re County Seat Stores, Inc.)*, 280 B.R. 319, 324-27 (Bankr. S.D.N.Y. 2002); *Gray v. Executive Risk Indem., Inc. (In re Molten Metal Tech., Inc.)*, 271 B.R. 711, 728-31 (Bankr. D. Mass. 2002); *Reiser v. Baudendistel (In re Buckeye Countrymark, Inc.)*, 251 B.R. 835, 840-41 (Bankr. S.D. Ohio 2000); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376, 404 (D. Del. 2002).
  16. *Nat'l Union Fire v. Olympia Holding*, No. 94-2081, 1996 WL 33415761, at \*6-7 (N.D. Ga. June 4, 1996); *see also Reliance Ins. Co. of Ill. v. Weis*, 148 B.R. 575 (E.D. Mo. 1992) *aff'd in part*, 5 F.2d 532 (8th Cir. 1993) (plaintiff in the D&O suit was the representative of the Plan Committee in a Chapter 11 liquidation).
  17. 572 F.3d 663 (9th Cir. 2009).
  18. *Compare Terry v. Federal Ins. Co. (In re R.J. Reynolds-Patrick County Mem'l Hosp., Inc.)*, 315 B.R. 674, 678-82 (W.D. Va. 2003) (litigation trustee, as assignee of debtor-in-possession, was the same entity as

*Biltmore* is the first appellate opinion on the subject. The *Biltmore* court held that the debtor-in-possession was the same entity as the pre-filing company for purposes of the insured v. insured exclusion, overruling decisions in two lower courts.<sup>19</sup> In explaining its decision, the court noted that the Bankruptcy Code defines a Chapter 11 debtor-in-possession as “the debtor” and defines the debtor, in turn, as “the person or municipality concerning which a case under this title has been commenced.”<sup>20</sup> Therefore, the debtor-in-possession was the same entity as the pre-bankruptcy corporation and coverage was barred by the insured v. insured exclusion.

## 2. *The Fraud Exclusion*

D&O policies generally exclude from coverage claims that arise from a D&O’s dishonest or fraudulent acts. Two important provisions to the fraud exclusion should be insisted upon by a D&O. First, the policy should require a final adjudication of fraud by the insured in order for the exclusion to apply. Otherwise an insurer will argue that the mere allegation of fraud in a complaint activates the exclusion and allows the insurer to refuse coverage, including the advancement of defense costs. Second, the fraud exclusion should make clear that a finding of fraud as to one insured will neither affect the coverage of nor be

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debtor), *with* HA 2003, Inc. v. FDIC (*In re* HA 2003, Inc.), 310 B.R. 710, 717-19 (Bankr. N.D. Ill. 2004) (debtor-in-possession not same entity as pre-bankruptcy debtor for purposes of the exclusion and its insolvency exception); *Pintlar Corp. v. Fid. & Cas. Co. of N.Y.* (*In re* *Pintlar Corp.*), 205 B.R. 945, 947-48 (Bankr. D. Idaho 1997) (litigation trustee, as assignee of debtor-in-possession, not same entity as debtor under terms of trust precluding debtor’s successor entities from receiving any benefit from the prosecution of claims) *overruled by* *Biltmore Associates, LLC v. Twin City Fire Ins. Co.*, 572 F.3d 663 (9th Cir. 2009), *and* *Cirka v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa.*, No 20250-NC, 2004 WL 1813283 (Del. Ch. Aug. 6, 2004) (plaintiff in the D&O suit was the unsecured creditors committee); *see also* *Fed. Ins. Co. v. Cont’l Cas. Co.*, No. 2:05-cv-305, 2006 WL 3386625 (W.D. Pa. Nov. 22, 2006) (debtor-in-possession not the same entity as debtor, claims brought originally brought by unsecured creditor’s committee by leave of the district court, then assigned to litigation trust on behalf of creditors, not debtor-in-possession).

19. *Biltmore*, 572 F.3d at 671, 671 n.17, overruling *Pintlar Corp. v. Fid. & Cas. Co. of N.Y.* (*In re* *Pintlar*), 205 B.R. 945, 947-48 (Bankr. D. Idaho 1997), *aff’d sub nom.* *CIGNA Ins. Co. v. Gulf USA Corp.*, No. 97-250, 1997 WL 1878757, at \*3-5 (D. Idaho Sept. 11, 1997).

20. 11 U.S.C. §§ 101(13), 1101(1) (2006).

imputed to any other insured. (See Section E below, on Policy Rescission and Severability Clauses.)

Courts will generally enforce language that requires a final adjudication of fraud or dishonesty by the insured before the exclusion becomes applicable.<sup>21</sup> Significantly, these cases also require the insurer to advance defense costs until such a final adjudication. For more on the importance of “final adjudication” language, see below, Section II.D.5.

### **3. *The Personal Profit Exclusion***

Most D&O policies will exclude coverage for claims arising from an insured’s receipt of personal profits to which he was not legally entitled. Here again, as with the fraud exclusion, D&O Insureds should insist that final adjudication language be included. D&Os should also insist on a provision clearly stating that a finding of illegally gained personal profit as to one insured will not be imputed to other insureds. (See Section II.E. below.)

A Fifth Circuit opinion addressing the personal profit exclusion shows the importance of an effective severability or non-imputation clause and also highlights the attention to detail that should go into drafting a policy. In *TIG Specialty*, the jury in a state court securities fraud suit found that one of PinkMonkey’s former officers had improperly benefited from a false misrepresentation or promise he had made.<sup>22</sup> On the basis of that finding, the insurer denied coverage not only to that officer, but also to the company, the other officer on trial, and two other officers and directors who had settled prior to trial. The insurer denied coverage because of the policy’s personal profit exclusion, which excluded from coverage “any Claim [against any insured] based upon, arising from, or in consequence of an Insured having gained in fact any personal profit, remuneration, or advantage to which such Insured was not legally entitled.”<sup>23</sup> In the coverage dispute that followed, the Fifth Circuit upheld the insurer’s position, explaining:

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21. See, e.g., *In re Enron Corp. Secs., Derivative & ERISA Litig.*, 391 F. Supp. 2d 541, 573–74 (S.D. Tex. 2005) (collecting cases where court held that final adjudication was required before the exclusion would apply).

22. *TIG Specialty Ins. Co. v. PinkMonkey.com, Inc.*, 375 F.3d 365, 369 (5th Cir. 2004).

23. *Id.* at 368.

The exclusion does not require that the claim be based upon *the Insured*, *that Insured*, or *such Insured* having gained a personal profit or gain, but based upon *an Insured* having gained a personal profit. Although the terms “the Insured,” “that Insured” or “such Insured” preceding personal profit would indicate the same insured as the claim is brought against, the Personal Profit Exclusion uses the more general term “an Insured.” This indicates that coverage is excluded for all Insureds, not merely the Insured who profited.<sup>24</sup>

#### **4. Bankruptcy Exclusions: Do They Work?**

While some D&O policies make an exception to the insured v. insured exclusion to allow coverage for suits brought by a bankruptcy trustee, and while courts will often find such an exception where it is not affirmatively written into the policy, in at least one case, *Tex. Attorney Gen. v. Brown*, the D&O policy specifically excluded coverage for such cases.<sup>25</sup> The “bankruptcy exclusion” in that case read as follows:

- (1) In the event that a bankruptcy or equivalent proceeding is commenced by or against the INSURED ENTITY, no coverage will be available under this Policy for any CLAIM brought by or on behalf of:
  - (a) the bankruptcy estate or the INSURED ENTITY in the capacity as DEBTOR IN POSSESSION; or
  - (b) any trustee, examiner, receiver, liquidator, rehabilitator, conservator or similar official appointed to take control of, supervise, manage or liquidate the INSURED ENTITY, or any assignee of any such official (including, but not limited to, any committee of creditors or committee of equity security holders).<sup>26</sup>

When the bankruptcy trustee sued the D&O Insureds, hoping to have any award covered by the D&O policy, the question before the court was whether the bankruptcy exclusion was an

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24. *Id.* at 371 (emphasis in original).

25. *Tex. Attorney Gen. v. Brown (In re Fort Worth Osteopathic Hosp., Inc.)*, 387 B.R. 706, 710 (Bankr. N.D. Tex. 2008).

26. *Id.* at 710 (emphasis in original).

unenforceable *ipso facto* clause.<sup>27</sup> As stated by the court, “[a]n *ipso facto* clause is a contractual or other provision that results in a loss of property rights or the elimination or limitation of obligations that existed prior to the commencement of a bankruptcy case, which loss, elimination or limitation occurs by reason of the debtor’s bankruptcy.”<sup>28</sup>

The court analyzed whether Section 541(c)(1) of the Bankruptcy Code—which renders ineffective certain *ipso facto* clauses that purport to preclude certain property of the debtor or property interests from transferring to the bankruptcy estate when they otherwise would automatically become property of the estate upon filing of the bankruptcy—applied to the bankruptcy exclusion.<sup>29</sup> The court noted that Section 541(c)(1) is not a blanket invalidation of *ipso facto* clauses; rather, it invalidates only those *ipso facto* clauses purporting to counteract certain specified provisions of the Bankruptcy Code.<sup>30</sup> It does not invalidate *ipso facto* clauses that prohibit property from transferring to the bankruptcy estate under Section 541(a)(6), which pulls into the estate “[p]roceeds, product, offspring, rents, or profits of or from property of the estate. . . .”<sup>31</sup> Thus, in the court’s analysis, the question of whether the policy’s bankruptcy exclusion was enforceable turned on whether the proceeds of the policies, as opposed to the policy itself, belonged to the debtor at the time of the bankruptcy filing.<sup>32</sup>

According to the court, while the bankruptcy estate owned the D&O policy, the estate’s right to proceeds from the policy arose only from Section 541(a)(6) and thus was not protected by Section 541(c)(1)’s prohibition of *ipso facto* clauses.<sup>33</sup> The bankruptcy exclusion was, in this case, enforceable.<sup>34</sup> The court, however, left the door open for a different result, stating that it did not “address the question of whether [the bankruptcy exclusion] is valid to limit claims by the D&O Insureds” and that certain other issues “would have to be addressed to determine what rights, if any, the D&O Insureds have under the policies

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27. *Id.* at 711.

28. *Id.*

29. *Id.* at 713–15.

30. *Id.* at 712–13.

31. 11 U.S.C. § 541(a)(6) (2006).

32. *Brown*, 387 B.R. at 714.

33. *Id.* at 715.

34. *Id.*

in connection with claims made against them” in the trustee’s suit or other suits.<sup>35</sup>

While *Brown* is probably not the last word on judicial treatment of bankruptcy exclusions, it draws attention to the existence of such exclusions and serves as a strong warning to D&O Insureds to carefully analyze whether such an exclusion should be included in the D&O policy.

### **5. Exclusion Triggers: “In Fact” Determinations versus “Final Adjudication”**

Exclusions based on wrongful conduct by the insured, such as the fraud exclusion, will often require that the wrongful conduct be proved by a final adjudication before the insurer may deny coverage and will require the insurer to advance defense costs until such final adjudication has been made.<sup>36</sup> Sometimes, however, an exclusion may be worded so that it bars coverage when the relevant wrongful conduct has “in fact” occurred.<sup>37</sup> As the recent Fifth Circuit opinion *Pendergest-Holt* shows, the difference can be crucial.<sup>38</sup> The case arose from the ongoing lawsuits surrounding the Stanford Financial scandal, which involved \$100 million in D&O coverage.<sup>39</sup> The primary policy contained a fraud exclusion that disclaimed coverage for loss:

[R]esulting from any Claim . . . brought about or contributed to in fact by any dishonest, fraudulent or criminal act or omission by the Directors or Officers or the Company . . . as determined by a final adjudication.<sup>40</sup>

The policy also contained a money laundering exclusion that would bar coverage for any claim “arising directly or indirectly as a result of or in connection with any act or acts (or alleged act or acts) of Money Laundering.”<sup>41</sup> The money laundering exclusion was qualified as follows:

Notwithstanding the foregoing Exclusion, Underwriters shall pay Costs, Charges and Expenses in the event

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35. *Id.*

36. *Pendergest-Holt v. Certain Underwriters at Lloyd’s of London*, 600 F.3d 562, 572 (5th Cir. 2010).

37. *Id.* at 573.

38. *Id.*

39. *Id.* at 566.

40. *Id.* at 566–67.

41. *Id.* at 567.

of an alleged act or alleged acts *until such time that it is determined that the alleged act or alleged acts did in fact occur*. In such event the Directors and Officers and the Company will reimburse Underwriters for such Costs, Charges and Expenses paid on their behalf.<sup>42</sup>

At the time of this writing, the trials in which fraud claims will be adjudicated have not yet occurred, but the insurers have successfully denied coverage based on the money laundering exclusion and thus ended their obligation to advance defense costs.<sup>43</sup>

When the insurers first attempted to deny coverage, the D&O Insureds sought and obtained a preliminary injunction requiring continued coverage of defense costs, which the insurer appealed to the Fifth Circuit.<sup>44</sup> As the Fifth Circuit noted, the policy does not state who must make the “in fact” determination of whether money laundering occurred.<sup>45</sup> The court pointed out that the insurer could have retained the right to determine coverage in its sole discretion, but had not done so—a fact that weighed in favor of requiring coverage until a final adjudication.<sup>46</sup> However, the court found even more compelling the contrast between the fraud and the money laundering exclusions.<sup>47</sup> While the language of the fraud exclusion clearly required a final adjudication, the wording of the money laundering exclusion indicated a conscious decision not to do so.<sup>48</sup> The need to give meaning to the difference in the language of the two exclusions, combined with the weight of case law construing “in fact” provisions, led the court to conclude that the “in fact” determination would have to be a judicial act resulting from a separate coverage proceeding.<sup>49</sup>

On remand, the case was assigned to a different district court to handle the coverage proceeding.<sup>50</sup> The new court announced that the “in fact” determination would be made at a

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42. *Id.* (emphasis added by the court).

43. *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, 751 F. Supp. 2d 876, 901 (S.D. Tex. 2010).

44. *Pendergest-Holt*, 600 F.3d at 568.

45. *Id.* at 570.

46. *Id.* at 571.

47. *Id.*

48. *Id.* at 571–72.

49. *Id.* at 574.

50. *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, No. H-09-3712, 2010 WL 3199355, at \*2 (S.D. Tex. Aug. 11, 2010).

“trial” in the context of a non-jury preliminary injunction hearing.<sup>51</sup> After a full evidentiary hearing, the court concluded the insurers had proven a substantial likelihood that acts of money laundering had “in fact” occurred, triggering the money laundering exclusion.<sup>52</sup> The policy, therefore, no longer required the insurers to cover defense costs, and the court vacated the preliminary injunction that had until then required the insurer to pay.<sup>53</sup>

### ***E. Policy Rescission and Severability Clauses***

Another frequently litigated issue is whether the insurer may rescind a D&O policy because it was issued on the basis of fraudulent or deceptive information contained in the application or in materials incorporated in or referred to in the application. The issue often arises when a company has had to restate its financial statements or has filed for bankruptcy, which results in lawsuits against the company and the D&O Insureds, and corresponding insurance claims. Typically, the insurance application will require extensive information involving the company’s history, litigation experience, contingent liabilities, and financial information. For public companies, the application will normally incorporate by reference SEC filings. The signatory on the application, of course, represents that all of the information contained therein is true. If the company thereafter draws claims against itself or its D&O Insureds (particularly if financial or securities disclosure are at the heart of the dispute), an insurer may try to rescind the policy on the ground that the

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51. *Id.*

52. *Pendergest-Holt v. Certain Underwriters at Lloyd’s of London*, 751 F. Supp. 2d 876, 901 (S.D. Tex. 2010).

53. *Id.* Unfortunately for the D&O Insureds’ attorneys, the same court also denied coverage for the period between the “trial” and the order vacating the preliminary injunction. The court noted the preliminary injunction, as modified by the Fifth Circuit, enjoined the insurers “from ‘refusing to advance defense costs *as provided in the D&O policy*’ until such time as a court determined that an exclusion in the Policy applied.” *Pendergest-Holt v. Certain Underwriters at Lloyd’s of London*, No. H-09-3712, 2011 WL 675273, at \*1 (S.D. Tex. Feb. 11, 2011) (emphasis added). The policy required payment once every 60 days, but the next payment did not come due until after the court’s order. *Id.* The express terms of the policy thus relieved the insurers of any obligation to provide coverage for that period. *Id.*

insurer, in issuing the application, relied on misrepresentations or omissions in the application.<sup>54</sup>

If the insurer rescinds the D&O policy because of problems in the application, careful drafting can protect D&Os who were not involved in the application process and who had no knowledge of the facts allegedly misrepresented (the “innocent directors”) and allow coverage to remain in place for these insureds.<sup>55</sup> To minimize the risk to innocent directors, the policy should include a severability or non-imputation provision that prevents the imputation of any knowledge to them. As with D&O policies generally, precise drafting is essential. The following cases illustrate the potential problems of inartfully worded rescission and severability clauses.

In *Cutter & Buck*, an accounting scandal caused the company to restate its financial statements for the preceding four years, prompting several shareholder lawsuits.<sup>56</sup> Cutter & Buck’s D&O insurer sent a notice of rescission to the company based on material misrepresentations of fact in the application materials, which included some of the financial statements that Cutter & Buck later restated.<sup>57</sup> The court found that the Cutter & Buck CFO, who signed the application, knew of the misrepresentations and, on the basis of the CFO’s knowledge, allowed complete rescission of the policy as to all insureds, including the company.<sup>58</sup> The policy contained the following severability provision:

[I]n the event that the Application, including materials submitted therewith, contains misrepresentations made with the actual intent to deceive, or contains misrepresentations which materially affect either the acceptance of the risk or the hazard assumed by the Insurer under this Policy, this Policy in its entirety

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54. Policy terms and applicable state law will affect the circumstances that will justify rescission in a given case. For example, some states require a showing of intent to deceive, while others will allow rescission even for innocent misrepresentations. *Compare* *Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F. Supp. 2d 988, 997 (W.D. Wash. 2004), *aff’d*, 144 Fed. Appx. 600 (9th Cir. 2005), *with* *TIG Ins. Co. of Mich. v. Homestore, Inc.*, 40 Cal. Rptr. 3d 528, 532 (Cal. Ct. App. 2006).

55. *Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F. Supp. 2d 988, 992 (W.D. Wash. 2004), *aff’d*, 144 Fed. Appx. 600 (9th Cir. 2005).

56. *Id.* at 995–96.

57. *Id.* at 996.

58. *Id.* at 1014.

shall be void and of no effect whatsoever; and provided, however, that no knowledge possessed by any director or officer shall be imputed to any other director or officer *except for material information known to the person or persons who signed the Application*. In the event that any of the particulars or statements in the Application is untrue, this Policy will be voided with respect to any director or officer who knew of such untruth.<sup>59</sup>

The court interpreted this provision to mean that “when the signor knows that there are misrepresentations in the application materials, that knowledge is imputed to all other directors or officers . . . in which case even innocent directors and officers lose coverage.”<sup>60</sup> On the basis of a similarly worded policy, a California state court and the Ninth Circuit allowed rescission of an entire D&O policy and the associated excess policy as to all insureds, including the company, its officers, and its directors.<sup>61</sup>

In *In re HealthSouth Corp. Ins. Litig.*, an Alabama district court reached a different result based on more thoughtful imputation language.<sup>62</sup> There, a number of officers and employees had pleaded guilty to fraud charges brought by the SEC and numerous other securities fraud actions against the company and its officers and directors were pending.<sup>63</sup> HealthSouth’s D&O insurers brought an action to rescind the policies or, alternatively, for a declaration of no coverage.<sup>64</sup> The severability provision in HealthSouth’s D&O policy provided that the insurer had relied on the application and related material in issuing the policy, but included non-imputation language that differed dramatically from the language in *Cutter & Buck*.<sup>65</sup> In pertinent part the non-imputation provisions stated:

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59. *Id.* at 1011 (emphasis added).

60. *Id.* at 1012.

61. *Fed. Ins. Co. v. Homestore, Inc.*, 144 Fed. Appx. 641, 648 (9th Cir. 2005) (unpublished decision); *TIG Ins. Co. of Mich. v. Homestore, Inc.*, 40 Cal. Rptr. 3d 528, 533 (Cal. Ct. App. 2006).

62. *In re HealthSouth Corp. Ins. Litig.*, 308 F. Supp. 2d 1253 (N.D. Ala. 2004).

63. *Id.* at 1257–58.

64. *Id.* at 1256.

65. *Compare Cutter & Buck*, 306 F. Supp. 2d 988, with *HealthSouth*, 308 F. Supp. 2d 1253.

Such written application(s) for coverage shall be construed as a separate application for coverage by each of the Insured Persons. With respect to the declarations and statements contained in such application(s) for coverage, no statement in the application or knowledge possessed by any Insured Person shall be imputed to any other Insured Person for the purpose of determining if coverage is available.<sup>66</sup>

The court concluded that the clause “[p]recludes rescission as to all insured persons without proof of knowing misrepresentation specifically made by the insured person in a document referenced in the representations clause to the policy sought to be rescinded.”<sup>67</sup> In other words, for each D&O Insured with respect to whom the insurer sought to rescind the policy, the insurer had to show that person made knowing misrepresentations in the policy application.

There are innumerable variations of such representation and severability clauses, which are often heavily negotiated. It is important to ensure that the non-imputation language is clear and not internally self-contradictory. Insurers, while usually flexible on the “innocent director” issue, often insist on broad imputation of knowledge possessed by senior officers or other insureds for the purpose of determining coverage for claims against the company, as distinguished from claims against the D&O Insureds.<sup>68</sup>

## ***F. Priority of Payment***

### ***1. D&O Insurance as Property of the Bankruptcy Estate***

Bankruptcy often gives rise to disputes over D&O insurance. One frequently litigated issue is whether the policy proceeds belong to the bankruptcy estate. It is now fairly well settled that D&O *policies*, which are typically paid for and owned by the company, become property of the bankruptcy estate pursuant to 11 U.S.C. § 541(a)(1).<sup>69</sup> Less clear, however, is whether the policy *proceeds* belong to the bankruptcy estate.

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66. *HealthSouth*, 308 F. Supp. 2d at 1261.

67. *Id.* at 1291.

68. *Cutter & Buck*, 306 F. Supp. 2d at 992.

69. *See, e.g.*, Steven Plitt, *Directors and Officers Entitlement to D&O Policy Benefits When the Corporation They Served Files Bankruptcy*, 29 INS. LITIG. REP. 785 (2007); *In re Louisiana World Exposition, Inc.* 832 F.2d

The question is important because, if the proceeds are determined to be part of the estate, they may be subject to the automatic stay and unavailable to the D&O Insureds. Cases are often fact-sensitive and outcomes can vary from one jurisdiction to the next.

Some courts have determined that even though a D&O policy belonged to the bankruptcy estate, the proceeds of the policy did not. These decisions often turn on the particular circumstances of the case, the nature of the claims against the D&O Insureds, and the language of the policy. For example, *Louisiana World Exposition* involved an action by a creditors' committee against various D&Os.<sup>70</sup> The creditors' committee sought to enforce the automatic stay by enjoining the payment of D&O policy proceeds, to which the D&Os were otherwise entitled.<sup>71</sup> The court agreed with the creditors' committee that the D&O policies belonged to the bankruptcy estate, but determined that the proceeds from those policies belonged only to the D&Os and thus were not part of the estate.<sup>72</sup>

Looking to earlier D&O opinions for guidance, the court distinguished cases in which policies (unlike the policies at issue) included coverage for claims against the bankrupt entity itself, noting that in such cases the estate "owns not only the policies, but also the proceeds designated to cover corporate losses."<sup>73</sup> The court also distinguished the instant action against the D&O Insureds, brought by a creditors' committee, from actions brought by third parties against D&O Insureds.<sup>74</sup> The payment of proceeds in such third party suits would deplete the debtor's estate rather than enlarge it.<sup>75</sup> The court also thought it significant that liability payments made directly to the D&O Insureds under Part A relieved the debtor of the need to indemnify the D&O Insureds, as the debtor would have had to do if the Part A coverage were not available to the D&O Insureds.<sup>76</sup> The court concluded that the "proceeds concept" of Section 541(a)(6) of the Bankruptcy Code, which provides that proceeds of estate property are also estate property, "does not

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1391, 1399 (5th Cir. 1987) (citing numerous cases holding that liability insurance policies belong to the bankruptcy estate).

70. 832 F.2d at 1394.

71. *Id.*

72. *Id.* at 1400-01.

73. *Id.* at 1400.

74. *Id.*

75. *Id.*

76. *Id.*

give the bankrupt's estate property the debtor would not own if it were solvent," *i.e.*, the policy's proceeds.<sup>77</sup>

A bankruptcy court reached a similar conclusion in *In re Allied Digital Technologies, Inc.*, but under somewhat different circumstances.<sup>78</sup> In that case, the bankruptcy trustee sued several D&Os, who then sought reimbursement of their defense costs.<sup>79</sup> The policy provided direct coverage for the D&Os, indemnity coverage for the debtor, and (unlike the policy in *Louisiana World Exposition*) direct coverage of the debtor for securities claims.<sup>80</sup> The court determined that the rules governing rights to proceeds depended on what types of coverage the policy provided:

[W]hen a debtor's liability insurance policy provides direct coverage to the debtor the proceeds are property of the estate, because the proceeds are payable to the debtor. Further, when the liability insurance policy only provides direct coverage to the directors and officers the proceeds are not property of the estate. However, when there is coverage for the directors and officers and the debtor, the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution.<sup>81</sup>

While the policy before the court did provide direct coverage to the debtor for securities claims, all securities claims had either already been adjudicated or were time-barred, meaning that direct coverage of the debtor was no longer a possibility.<sup>82</sup> Second, while the D&O policy did provide direct coverage to the

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77. *Id.* at 1406.

78. *See In re Allied Digital Techs., Inc.*, 306 B.R. 505 (Bankr. D. Del. 2004).

79. *Id.* at 507–08.

80. *Id.* at 510.

81. *Id.* at 512. *See also In re Downey Fin. Corp.*, 428 B.R. 595 (Bankr. D. Del. 2010) (holding the policy proceeds were not property of the estate because the policy's entity coverage and indemnification coverage were no longer protecting the estate's other assets from diminution, and further, treating the policy proceeds as property of the estate would improperly expand the trustee's rights in the proceeds due to debtor's bankruptcy filing).

82. *Id.* at 511.

debtor for indemnification costs, no indemnification had occurred.<sup>83</sup> On this latter point the court concluded:

[W]hen the liability policy provides the debtor with indemnification coverage [Part B Company Reimbursement Coverage] but indemnification either has not occurred, is hypothetical or speculative, the proceeds are not property of the bankruptcy estate.<sup>84</sup>

As in *Louisiana World Exposition*, the trustee's claim against D&Os in *Allied Digital* was for the benefit of the estate.<sup>85</sup> The court concluded that the trustee's concern that payment of defense costs to D&Os would deplete the policy and lessen the estate's recovery was no different than any third-party plaintiff suing defendants covered by a "wasting" D&O policy.<sup>86</sup> In holding that the policy proceeds could be used to pay the D&Os' defense costs, the court stated:

The bottom line is that the Trustee seeks to protect the amount he may receive in his suit against the directors and officers while limiting coverage for the defense costs of the directors and officers. This is not what the directors and officers bargained for.<sup>87</sup>

Cases involving multiple third party claims against D&O Insureds, as contrasted with claims brought by the debtor estate against D&O Insureds for the benefit of the estate, have reached different results. In these third-party claim situations, some courts have concluded that the third-party actions should be enjoined under the automatic stay so as to preserve policy proceeds and prevent diminishment of an estate asset, namely, the D&O policy.<sup>88</sup>

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83. *Id.*

84. *Id.* at 512.

85. *Id.* at 513.

86. *Id.*

87. *Id.*

88. *In re Metro. Mortgage & Sec. Co., Inc.*, 325 B.R. 851, 857 (Bankr. E.D. Wash. 2005); *In re Circle K Corp.*, 121 B.R. 257, 262 (Bankr. D. Ariz. 1990). *See also In re Adelpia Commc'ns Corp.*, 285 B.R. 580, 593 (Bankr. S.D.N.Y. 2002) (holding proceeds were property of the estate and capping insurers' payouts for defense costs at \$300,000 per insured), *vacated*, 298 B.R. 49, 53-54 (S.D.N.Y. 2003) (holding that proceeds were not property of the estate), *remanded to* 302 B.R. 439, 445 (Bankr. S.D.N.Y. 2003) (stating the policies were property of the estate,

One bankruptcy court recently tried to harmonize the different treatments of proceeds in a single framework.<sup>89</sup> The court began by rejecting broad, bright-line rules classifying all proceeds as in or out of the bankruptcy estate, because they tend to defeat both the orderly administration sought in bankruptcy and the legitimate expectations of the insureds under the policy.<sup>90</sup> The court then reasoned that while the company and the D&Os each hold a contractual right to payment of the proceeds, their rights are contingent until an event occurs creating an entitlement to proceeds.<sup>91</sup> Therefore, to serve the interests of substantive bankruptcy and insurance law, and address the contingent nature of the insureds' contractual rights, proceeds can only be classified to the extent an insured has accrued a claim against them.<sup>92</sup> For example, if a debtor company has accrued claims of \$400,000 under a \$1,000,000 policy, only \$400,000 is property of the estate.

While theoretically intriguing, the court's analysis does not resolve the dilemma that the insurers and insureds face when a policy is caught in bankruptcy. Most often, both the company and the D&Os have accrued claims against the policy, dispute the value of the claims, and the insurer is unsure whether it has the power to process, let alone pay, these competing claims without violating the stay. In applying its accrual-based theory, the court implicitly recognized this flaw by treating all of the proceeds at issue as stayed (even though they were not technically property of the estate) and lifted the stay as to 25% of the proceeds to allow the insurer to process claims already made by the insureds.<sup>93</sup>

## ***2. Priority of Payments Clause***

Given the uncertainties in the case law, an important tool to effect coverage for D&Os in a bankruptcy setting is a priority of payments provision. This type of endorsement provides that, if an entity and the D&O Insureds are competing for policy proceeds, all D&O claims—including claims for defense costs, settlements, or adverse judgments—must be paid in full under

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even if the proceeds were not, and restricting access to proceeds was necessary to protect the policies).

89. *In re Petters Co., Inc.*, 419 B.R. 369, 375–80 (Bankr. D. Minn. 2009).

90. *Id.* at 377–78.

91. *Id.* at 378–79.

92. *Id.*

93. *Id.* at 380.

Part A before any payments will be made to the company, whether those other claims are for indemnity reimbursement or for direct entity coverage. A sample priority of payments endorsement is given below:

#### Payment of Loss

In the event of Loss arising from a covered Claim for which payment is due under the provisions of this policy, then the insurer shall in all events:

- (a) first, pay Loss for which coverage is provided under Part A (Directors and Officers Liability) of this policy; then
- (b) only after payment of Loss has been made pursuant to Subsection (a) above, with respect to whatever remaining amount of the Limit of Liability is available after such payment, pay such other Loss for which coverage is provided under Insuring Clause B (Company Reimbursement Insurance) of this policy; and then
- (c) only after payment of Loss has been made pursuant to Subsections (a) and (b) above, with respect to whatever remaining amount of the Limit of Liability is available after such payment, pay such other Loss for which coverage is provided under this policy.

The bankruptcy or insolvency of any Insureds shall not relieve the insurer of any of its obligations to prioritize payment of covered Loss under this policy pursuant to this Clause.

### **G. Policy Buy-Backs**

Another frequent bankruptcy situation that can deprive D&O Insureds of coverage arises when a company negotiates a *buy-back* of its insurance policies. In a buy-back, the company receives a payment from the insurer (generally less than policy limits, but avoiding coverage litigation). In return, the company absolves the insurer from further obligations under the policies. The outcome of these situations may turn on whether the D&O policy provides only Part A coverage of the individual D&O Insureds, or provides coverage to the company under Part B and/or Part C, or both.

A leading case, *In re Adelpia Communications Corp.*, involved a D&O policy covering both the company and its D&Os, who had been sued for securities violations.<sup>94</sup> The company claimed covered losses exceeding the remaining policy limits. The D&Os also asserted claims against the policy for defense and indemnification. The company negotiated a settlement with its insurers that included a buy-back of the D&O policies, contingent on entry of a “channeling injunction” that would “prohibit . . . directors and officers from proceeding directly against the insurers to pursue claimed entitlements under the policies.”<sup>95</sup> Adelpia sought judicial approval of the agreement, and the D&Os objected.<sup>96</sup> The court refused to approve the settlement with the injunction, holding that although the D&Os “do not have an ownership interest in the policies themselves . . . [they] have *contractual rights* under the policies” that could not be eliminated without their consent.<sup>97</sup> The court, therefore, refused to bar the D&O Insureds from pursuing their rights under the policies, and held the proceeds would be paid “first-come, first-served.”<sup>98</sup>

The Fifth Circuit has not addressed the co-insured problem presented in *Adelpia*.<sup>99</sup> The bankruptcy court in Dallas, however, has addressed the issue of co-insureds under the same D&O policy.<sup>100</sup> That court decided that, although the process would be procedurally and substantively complex, “an allocation of proceeds among the various co-insureds, makes the most sense.”<sup>101</sup>

A second concern for D&Os arising from a buy-back of a primary policy is whether it will trigger coverage under excess “Part A only” policies.<sup>102</sup> Generally, a primary policy must be exhausted before an insured can reach an excess policy.<sup>103</sup> Neither the Fifth Circuit nor Texas courts have determined

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94. *In re Adelpia Communications Corp.*, 364 B.R. 518 (Bankr. S.D.N.Y. 2007).

95. *Id.* at 520.

96. *Id.*

97. *Id.* at 525.

98. *Id.* at 525 (emphasis in original).

99. *See In re Vitek*, 51 F.3d 530, 535 (5th Cir. 1995).

100. *See CBI Eastchase, L.P. v. Farris (In re e2 Communs., Inc.)*, 2005 Bankr. LEXIS 3250, \*32–42 (Bankr. N.D. Tex. Mar. 24, 2005).

101. *Id.*

102. Part A only policies are discussed below in Section III.

103. *See Emscor Mfg., Inc. v. Alliance Ins. Group*, 879 S.W.2d 894, 903 (Tex. App.—Houston [14th Dist.] 1994, writ denied).

whether a buy-back of a primary policy satisfies the exhaustion requirement for excess coverage. Other jurisdictions have reached conflicting results on this issue.<sup>104</sup>

### ***H. Post-Policy Period Coverage***

Companies can purchase *run-off* insurance that will cover D&O Insureds for their acts as D&Os even after they no longer serve. Run-off coverage should last as long as any applicable statutes of limitation. Six years is typical.

Similarly, a *discovery clause* can provide protection for claims that arise during the policy period, but are not made against a D&O until after the policy period has expired. Most D&O policies have discovery clauses providing that, if the insurer or the company refuses to renew the policy, the company can purchase a Discovery Period policy for a pre-negotiated additional premium and length of time. The right to purchase a Discovery Period policy should be extended to the individual D&Os. The ability to purchase such a policy can protect D&O Insureds in situations where the company does not wish to purchase additional insurance, perhaps because it is going out of business or is insolvent, but the D&O would nonetheless want the additional protection. Insurers will usually allow such an amendment.

## ***III. PART A ONLY POLICIES***

As shown by the issues and cases discussed above, even a well-worded D&O policy that is designed to be watertight cannot guarantee that coverage will be available when it is needed. In response to D&O concerns that traditional policies leave them at risk, the insurance industry has developed a product

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104. See, e.g., *Aerojet-General Corp. v. Transcontinental Ins. Co.*, 2002 Cal. App. LEXIS 1965, at \*38–44 (Cal. Ct. App. June 7, 2002) (duties of excess carriers not triggered after buy-back because primary policies not exhausted); *Comerica, Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp. 2d 1019, 1032 (E.D. Mich. 2007) (exhaustion requirement satisfied only by “actual payment”); *but see* *HLTH Corp. v. Agric. Excess & Surplus Ins. Co.*, 2008 Del. Super. LEXIS 280, at \*46–47 (Del. Sup. Ct. July 31, 2008) (settlements with underlying insurers exhausted policies in light of public policy encouraging settlement and avoiding unfairness); *Zeig v. Mass. Bonding & Ins. Co.*, 23 F.2d 665, 666 (2d Cir. 1928) (interpreting exhaustion clause to require insured to collect full amount of primary policy was “unnecessarily stringent” and would “involve delay, promote litigation, and prevent an adjustment of disputes which is both convenient and commendable”).

called the Part A Only Policy. A Part A Only Policy directly insures the directors and officers, and *only* the directors and officers. It is designed to provide coverage, including for defense costs, in the event the standard policy fails to do so. An example of a Part A Only insuring agreement follows:

#### INSURING CLAUSE

The Insurer shall pay on behalf of the Insureds or any of them, any and all Loss that the Insureds shall become legally obligated to pay by reason of any Claim or Claims first made against the Insureds or any of them during the Policy Period, for any Wrongful Acts that are actually or allegedly caused, committed, or attempted prior to the end of the Policy Period by the Insureds, in excess of the amounts payable under, or for which no amounts are payable with respect to such Loss under, or for which the insurer(s) wrongfully refuses or is financially unable to pay under, the Underlying Insurance, and not exceeding the Limit of Liability.

The Part A Only policy may set forth the specific circumstances under which it will be liable. Such a policy might state, for example, that the insurer is not liable for any portion of the Loss unless:

- (1) the insurer(s) of the Underlying Insurance (a) wrongfully refuses to indemnify the Insureds as required under the terms of the Underlying Insurance; or (b) is financially unable to indemnify the Insureds; or (c) rescinds the Underlying Insurance; or
- (2) according to the terms and conditions of the Underlying Insurance, the insurer(s) of the Underlying Insurance are not liable for such portion of the Loss; or
- (3) the limit(s) of liability of the Underlying Insurance has been exhausted or reduced by reason of Losses paid thereunder;
- (4) a liquidation or reorganization proceeding is commenced by or against the Company pursuant to the U.S. Bankruptcy Code, as amended (“Code”) and as a result of such proceeding the proceeds of any Underlying Insurance cannot legally be paid by the Insurer thereof solely because such proceeds are

subject to the automatic stay under the Code; provided that as a condition precedent to the Insurer being liable pursuant to this subparagraph (4), the Insureds or the Company shall request, or arrange for the insurer of the Underlying Insurance to request, relief from the automatic stay with respect to such proceeds.

Parts (1) and (2) in the above example provide coverage in case the underlying insurer does not respond because of the underlying insurer's wrongful refusal, financial inability, rescission of the policy, or because of the application of an exclusion. Part (3) provides coverage in the event the underlying insurance has been exhausted, while part (4) provides coverage when the underlying insurance has been frozen by an automatic stay. In addition, there is typically no retention to satisfy in a Part A Only Policy and typically no provision imputing the knowledge or misrepresentations of one insured to any other. Finally, a Part A Only Policy often provides that it cannot be rescinded.

While some Part A Only policies may, as in the above example, limit coverage to those situations specifically described in the policy, others use a different approach, stating that the insurer *will* pay for Loss *unless* such Loss is paid as indemnification by the company or by any other insurance. Such policies will generally state that the company's acceptance of the policy is an agreement to indemnify to the fullest extent allowed by law. They will also usually require D&O Insureds to subrogate their indemnification claims to the insurer if the company does not indemnify when and as it should. A sample provision from this type of policy follows.

In consideration of the premium charged, it is agreed that:

- (1) The insurer shall pay, on behalf of each of the Insured Persons, Loss which the Insured Person becomes legally obligated to pay on account of any Claim first made against the Insured Person during the Policy Period or, if exercised, during the Extended Reporting Period, for a Wrongful Act committed, attempted, or allegedly committed or attempted by such Insured Person before or during the Policy Period, except to the extent that such Loss is paid by any other insurance or is paid as

indemnification by the Company or any other source.

- (2) By acceptance of this Policy the Company agrees to indemnify for Loss, or advance Defense Costs on behalf of, the Insured Persons to the fullest extent permitted or required by law. If the Company fails or refuses to indemnify for Loss, or advance Defense Costs on behalf of, the Insured Persons to the fullest extent permitted or required by law (for reasons other than Financial Impairment), any coverage for such Insured Persons under this Policy shall be subject to the Insured Persons complying with the Section of this policy dealing with Subrogation. By paying Loss under this Policy the insurer does not waive, compromise or release its right to recover such Loss from the issuers of any other insurance under which coverage may be owed or from the Company or other entity from which (or any person from whom) an Insured Person is entitled to indemnification.

Features that a Part A Only Policy will normally have in common with a standard D&O policy are the insured v. insured exclusion, the fraud exclusion, and the personal profit exclusion. The matters discussed above regarding such exclusions in relation to a standard D&O policy should also be considered when analyzing whether a Part A Only Policy is appropriate.

#### ***IV. INDEMNIFICATION AND ADVANCEMENT OF EXPENSES***

The advancement of expenses to D&Os and the indemnification of D&Os by the company for wrongful acts are separate legal concepts. A company's charter or bylaws will usually require it to advance litigation expenses to D&Os for actions arising from their service as these expenses are incurred, even before a wrongful act is determined to have occurred, and before a decision is made as to whether the acts in question are subject to indemnification.

##### ***A. Mandatory Indemnification***

The bylaws or the articles of incorporation of the company should make mandatory (not permissive) the indemnification of D&Os to the fullest extent allowed by law. The articles of incor-

poration should also include the standard exculpation provisions, allowed by most state corporate law statutes, which relieve D&Os from monetary liability for their breach of the duty of care. With such an exculpation provision in place, individual monetary liability will attach only if there is a breach of loyalty or if the individual acts in bad faith.

It is important to note that under most states' corporate statutes, even mandatory indemnification (as distinguished from mandatory advancement of expenses) can be granted only if disinterested directors, or independent legal counsel, or a majority of shareholders, determine that the person seeking indemnity has met the applicable standards of conduct set out in the statute; i.e., that the person seeking indemnity acted in good faith and in a manner he or she believed to be in the best interest of the corporation.

### ***B. Individual Indemnification Agreement***

A D&O Insured should also consider having a separate indemnification agreement with the company. Such an agreement can strengthen the D&O's indemnity rights and reduce the likelihood that indemnification will be unfairly denied by the company. An indemnity agreement can improve an individual's chance of being indemnified by addressing certain matters concerning claims for indemnification, such as:

- If a change in control of the company has occurred, the indemnity agreement can require that only independent counsel can make the indemnification determination—in light of the concern that new directors with whom D&Os likely have not worked might be inclined to avoid the expense of indemnity.
- An indemnity agreement can provide for a short, but reasonable, time within which the company must make its determination of indemnification and pay the claim, *e.g.*, 60 days.
- An indemnity agreement can place on the company the burden of proving that the D&O has no right to indemnity by “clear and convincing evidence” rather than the lower, more typical, civil court standard of proof by a preponderance of the evidence. Placing this higher burden of proof on the company can be crucial, especially if a “no indemnity” decision is made and then a subsequent review of that decision by a court follows.

- The indemnity agreement can provide that any expenses a D&O incurs in seeking indemnification are paid by the company.
- The agreement can provide that a D&O can challenge a negative determination in court or by arbitration and, if the D&O wins, his or her attorney's fees and expenses are paid by the company.
- Some agreements provide for the creation of a trust to be funded in an amount determined by independent counsel to fund litigation costs if there has been a change of control.
- Some agreements also require the company to maintain D&O insurance in the same amount and under the same terms for the party to the indemnification agreement as is maintained for any other D&O.
- Such agreements can require the company to maintain *run-off* insurance, described above, to cover D&Os after they have left the board for acts that occurred during their board membership. This run-off insurance should be for as long as any applicable statutes of limitation. Six years seems to be the standard.

### ***C. Mandatory Advancement of Expenses***

The bylaws or articles of incorporation of the company should also require the mandatory periodic advancement of expenses during the pendency of a claim, with no conditions other than an obligation of the D&O to repay the company if it is ultimately determined that the claim is not subject to indemnity. (This repayment obligation is required by corporate law.) If the advancement of expenses is required by the articles of incorporation or bylaws, expenses must be mandatorily advanced until it is determined that the acts in question are not indemnifiable, which determination is often not made until after a final adjudication. The governing documents should make explicit that the company cannot require collateral to secure the advancement of expenses to a D&O.

## **V. CONCLUSION**

Because a D&O policy can have such important ramifications for companies and their D&O Insureds, it should be critically examined and seriously negotiated. The specimen form and accompanying standard endorsements provided by the in-

surer at the outset of the insuring process should not simply be accepted as written. This paper has attempted to point out key areas where problems are most likely to arise and to shed some light on how such problems might be addressed.

A primary purpose of D&O insurance, in the authors' view, is to ensure the advancement of expenses to a D&O during litigation. Without that protection, the costs of litigation can be crushing. The great majority of cases involving D&Os will end in a settlement of some kind, funded by the insured company, the insurer, or some combination of the two. Surviving financially to that point is crucial to the individual officers and directors.