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InSights

Corporate Defaults, Bankruptcies and D&O Claims

Our depressed economy continues to monopolize the news and generate considerable attention – from conversations at the local coffee shop to discussions on stimulus packages within the halls of the Capitol Building. Businesses, large and small, are being directly affected, and companies are closely watching their cash flow.

This article takes a look at the conditions that could contribute to an increase in corporate bankruptcies, the likelihood that more bankruptcies could translate to increased litigation, and the D&O insurance issues that bankruptcy litigation could present.

A March 26, 2009 *Reuters* article entitled "U.S. Economy Shrinks, Profits Plunge in Q4," states, "U.S. corporate profits plunged a record $120.1 billion in the fourth quarter as the economy shrank at its fastest pace since 1982, depressed by a slump in consumer spending and exports." Whether we have reached the trough is being debated by economists, but what is certain is that any reversal in our economy will take time. Unfortunately, time is a valuable commodity that much of Corporate America does not have the luxury or resources to wait upon.

Deteriorating economic conditions threaten a massive wave of corporate defaults. Corporate borrowers' inability to fulfill debt obligations could not only prompt a bankruptcy filing surge, but could also result in a flood of lawsuits and claims as creditors and shareholders seek to recoup their losses. These claims could present a host of challenging D&O coverage issues.

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The Financial Challenges

According to a February 13, 2009 *Wall Street Journal* article entitled, "Wave of Bad Debt Swamps Companies," the U.S. is entering a period likely to feature, "the most corporate-debt defaults, by dollar amount, in history." The article reports estimates that "U.S. companies are poised to default on $450 billion to $500 billion in corporate bonds and bank loans over the next two years."

In percentage terms, the default rate could "approach levels last seen in 1933," when high yield default rates peaked around 15%. The *Journal* cites S&P estimates that default rates will hit 13.9% this year "but could go as high as 18.5% if the downturn is worse than expected."

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The "growing wave of souring debt" has already resulted in a rising number of bankruptcies, including, just in recent days, Muzak Holdings LLC; BearingPoint; Midway Games; Ritz Camera; Philadelphia Newspapers LLC; and Spansion.

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However, as the *Journal* article observes, corporate defaults do not always result in Chapter 11 filings. Borrowers are sometimes able to restructure their debt outside of bankruptcy, and sometimes give creditors ownership stakes in exchange for reducing or eliminating debt.

At the same time, however, many companies may find in the course of their year-end audits that their auditors are questioning whether the companies can continue as going concerns. To choose the most prominent recent example, General Motors recently received a going concern opinion from its auditors. Many other companies could similarly face going concern audit opinions.

A March 5, 2009 *CFO.com* article entitled "The Growing Concern over 'Going Concern'" quoted the CEO of one of the Big Four accounting firms as saying that, in the months ahead, "we'll see an unprecedented number of going-concern footnote disclosures and clarifications from the auditors."

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The problem with going concern opinions is that they can become self-fulfilling prophecies. As the *CFO.com* article notes, "the revised status can further hinder a company on the brink of filing Chapter 11 from avoiding bankruptcy court," because the qualification can spook "investors, lenders and suppliers."

The Risk of Increased Claims

In addition to the possibility of a growing number of bankruptcies, the prospect of surging corporate defaults and the rising number of companies with going concern audit opinions also raise the possibility of an increase in litigation against the directors and officers of the struggling or bankrupt companies.

Among other things, the mere question of whether a company can continue as a going concern can become an allegation in a shareholders' class action complaint. For example, the complaint in the recent securities suit against NextWave Wireless alleges that the company had concealed questions surrounding its ability to continue as a going concern.

Litigation may arise even when companies attempt to avoid bankruptcy. These claims can come from shareholders, who may contend that the so-called workout resulted in a dilution of their interests, or it can even come from bondholders, who may claim that their interests have been harmed or improperly subordinated, as demonstrated in a recent claim filed by bondholders against Station Casinos and several of its directors and officers.

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A bankruptcy filing is particularly likely to be followed by claims against the bankrupt company's directors and officers. In its recent report analyzing the 2008 securities lawsuits, the information database firm Advisen noted that the rising number of bankruptcies, "almost certainly will be accompanied by an increase in securities lawsuits."

The Advisen Report notes that since 1995, roughly 35 percent of large public companies (defined as having more than $250 million in assets, measured in 2008 dollars) that filed for bankruptcy were also named in securities class action lawsuits. During 2007 and 2008, that percentage increased to 77 percent.

These claims can come in the form of securities lawsuits brought against the individuals by the bankrupt company's shareholders, as reflected for example in the recent cases filed against Pilgrim Pride's corporate officials; against Britannia Bulk's senior officers; and against the directors and officers of Charys Holding Company.

In addition, the trustee in bankruptcy may also assert claims against the company's directors and officers, as evidenced in the now infamous Just for Feet claim. In that case, the bankruptcy trustee asserted breach of fiduciary duty claims against certain of Just for Feet's directors, after the company's D&O insurance policy had been exhausted in a settlement of a related securities lawsuits. As highlighted in a previous InSights, (Vol. II Issue Four May 2007 "Outside Director Exposure and the Need for IDL Insurance Protection") the *Just for Feet* case also demonstrates the devastating potential for multiple bankruptcy claims to deplete all available insurance.

The Potential Coverage Issues

Post-bankruptcy claims present a number of challenges in the context of any potentially applicable directors and officers' liability insurance. Some of these challenges are a reflection of the size and structure of the insurance program; other challenges arise from the nature and extent of the coverage afforded.

With respect to the overall program, one critically important issue may simply be the amount of insurance available. The prospect for multiple simultaneous claims is increased

dramatically when a company files for bankruptcy. The simultaneous prosecution of multiple claims presents the very real possibility that the insurance could be entirely exhausted. Indeed, as actually happened in connection with the claims surrounding the recent Collins & Aikman bankruptcy, defense costs alone could potentially deplete the available limits.

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And as happened in connection with the multiple post-bankruptcy claims filed against the directors and officers of Just for Feet, the proceeds of a traditional D&O insurance program alone may be insufficient to resolve all claims that can arise in the bankruptcy context. Both the Collins & Aikman and the Just for Feet examples have important implications for policy structure, as discussed below.

The interplay between the provisions of the Bankruptcy Code and the terms and conditions of the D&O policy may present certain specific challenges. One recurring issue – since so-called 'entity coverage' has become a standard part of the D&O policy – has been whether or not the D&O policy proceeds are property of the bankrupt estate under Bankruptcy Code Section 541(a) and subject to the automatic stay in bankruptcy under Bankruptcy Code Section 362.

Another frequently recurring D&O insurance coverage issue arising in the bankruptcy context is whether claims asserted by the trustee or other receivers or liquidators against the company's directors or officers run afoul of the policy's exclusion for claims brought by one insured against another insured. The 'insured vs. insured' question arises because of the concern that the Trustee or other claimant is standing in the shoes of a policy insured, the company itself.

Another issue arising in the bankruptcy context is whether claims asserted by the trustee against the company's directors or officers run afoul of the policy's exclusion for claims brought by one insured against another insured.

Addressing the Insurance Concerns

A number of policy solutions to these recurring bankruptcy issues have arisen in recent years. For example, a coverage carve-back to the insured vs. insured exclusion, now a standard provision in most policies, has continued to evolve over the years to address concerns about coverage for claims brought by Trustees and others.
In addition, many policies now contain 'priority of payments' provisions as a way to try to address questions surrounding the availability of the D&O policy's proceeds for the payment of defense expense or the resolution of claims notwithstanding the bankruptcy stay.

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Perhaps even more importantly, to address concerns about the susceptibility of the policy proceeds to depletion or exhaustion from multiple simultaneous claims (particularly in the bankruptcy context) the D&O industry has developed a number of structural solutions designed to ensure that whatever may happen, a fund of money will remain available for specified individuals so they can defend and resolve claims against them. These structures might take any one of a number of forms, including a so-called A-Side DIC policy, or even an individual director liability (IDL) policy.

Conclusion

The complexity of these coverage and structural issues underscores the need to involve a skilled insurance professional in the D&O insurance acquisition process. Financially troubled companies in particular require the contributions of an informed and experienced advocate in structuring their coverage. The structure and the terms and conditions of a company's insurance program could determine whether or not insurance coverage is available for individual directors and officers in the event of bankruptcy and related claims.

Further, it is worth noting that the current deteriorating economic conditions not only present challenges for insurance buyers, they also present serious concerns for D&O underwriters. As the *Journal* article cited above notes, the defaults, "will likely spread across many industries." Among the industries the article specifically mentions are, "media, entertainment, casino and hotel companies, car makers and retailers."

Up to this point, the most significant consequences of the credit crisis have been concentrated in the financial sector. D&O underwriters have had the ability to segment risk arising from the credit crisis according to whether or not companies were in the financial industry. However, with the growing threat of corporate defaults across many industry sectors, risk segmentation will be much more challenging. At a minimum, it will no longer be sufficient for underwriters to presume that risk is limited to the financial sector alone. These factors suggest that turbulent times could be ahead for both buyers and sellers in the D&O marketplace.

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A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can acces the blog via our website at www.oakbridgeins.com. To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to The D&O Diary regularly.

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