D&O Considerations: Companies in Financial Distress

Even before the global impact of COVID-19, commercial bankruptcy filings were on the rise. Government stimulus programs temporarily helped companies stave off difficult financial decisions. Fast forward to 2023, most stimulus funds have expired and the overall economic outlook is in fluctuation. Central banks have aggressively hiked interest rates in an attempt to lower surging inflation.[1] But the higher rates have contributed to increased recessionary pressures and, more recently, the collapses of Silicon Valley Bank and other financial institutions.

Regardless of its financial situation, a company's board of directors and officers (D&Os) owe fiduciary duties to the corporation. However, when financial performance declines to the point where insolvency may be a consideration, D&O fiduciary duties to key stakeholders come to the forefront. Because of this heightened risk, the role of a director or officer at a company in financial distress can be daunting.

Financial Distress: Shifting of Fiduciary Duty Obligations?

Directors and officers owe fiduciary duties to the company, including the duty of care, loyalty and good faith. These obligations do not change during an insolvency event. Delaware courts have rejected the idea that fiduciary duties shift from stockholders to creditors for companies operating in the "zone of insolvency," but heightened risk does exist.[2] Delaware law establishes that duties of directors are fundamentally the same whether a corporation is solvent, insolvent or trending toward insolvency, with the goal of pursuing "value-maximizing strategies" for the benefit of the corporation and its residual stakeholders.[3]

A corporation's creditors are typically protected by their contracts and related laws. However, once a corporation becomes insolvent, creditors at risk of not being paid become the primary beneficiaries of any residual value of the corporation.[4] Upon insolvency, creditors have the right to pursue derivative claims on behalf of the corporation – *this right is derivative only.*[5] Delaware courts clarified that the "zone of insolvency" has no implications for fiduciary duty claims.[6] "The only transition point that affects fiduciary duty analysis is insolvency itself."[7] At the point of insolvency, creditors have derivative standing to enforce the fiduciary duties owed to the corporation, but they cannot bring direct claims for breach of fiduciary duty.[8] Because directors owe fiduciary duties to the corporation itself for the benefit of its residual claimants, when the corporation is insolvent the fiduciary duties shift and expand to include creditors on a derivative basis.[9]

Steps prior to Bankruptcy: Consider D&O Policy

There are several steps companies can take prior to the actual filing of bankruptcy, including pulling certain financial levers (e.g. common equity issuance, preferred equity issuance, increase bank lines of credit, selling of assets, selling/ refinancing debt or out-of-court settlements), but once bankruptcy enters the conversation, a company's tack and strategy must change.

The introduction of specialized legal counsel and financial advisors will create a whirlwind of activity at the board level, with senior officers of the company managing the day-to-day process. One item that is generally discussed early in the process is the quality and quantity of the company's Directors & Officers Liability insurance. This insurance is typically the final asset of a company that is able to fulfill its indemnity obligation to directors and officers.

Opinions will vary on both the quantity and quality, but the main thrust of the conversation is to shore up the insurance sooner than later to make sure there are no surprises once it is determined that some form of bankruptcy filing will be made. The most common bankruptcy filings in the United States are Chapters 7 and 11. In a Chapter 7 filing, a company closes its doors and a court designates a trustee to control and liquidate the company's assets for the creditors. In a Chapter 11 filing, the bankruptcy court allows a company to continue operations. The company's current management team often stays in place as the "debtor-in-possession," at least pending a recapitalization or other resolution under the oversight of a court. Depending on the industry and federal jurisdiction involved, a Chapter 11 bankruptcy has been successfully utilized as an expedient tool to satisfy debt holders and create a quick and orderly disposition of corporate assets. Both types of filings create challenges for D&O insurance, although most can be contemplated effectively ahead of any action with a court.

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D&O policies are written on a “claims-made” basis, meaning you only have coverage for claims made while a policy is in force. Due to the “long-tail” nature of D&O claims, it’s very hard to predict when a claim may be made for actions that took place in the past. Additionally, both Chapters 7 and 11 trigger a “change of control” at different points in the bankruptcy process. When a change of control occurs, it is highly recommended to enact a D&O policy’s “extended reporting period.” This extension of the policy will apply to claims made against Insureds during the extended reporting period (ERP) that are based on alleged wrongful acts occurring prior to the change of control. Not all coverages are created equal and there is typically an additional cost associated with purchasing the extended reporting period, so careful attention must be paid to this process.

An ERP can generally be purchased at any time during the life of a D&O policy. However, many companies have moved to a pre-payment setup whereby the ongoing insurance and ERP are purchased to encompass the estimated lifespan of the bankruptcy filing. This has increased in popularity over the past decade since most courts do not consider the arrangement as a preference payment. Courts are also generally agreeable to this insurance transaction because they understand the importance of having adequate insurance in place for the filing and subsequent change of control. *In many cases, this insurance is the only asset of the company available to indemnify directors and officers.*

There are other provisions within D&O policies that also should be considered, including:

- Coverage for individual directors and officers vs. coverage for the entity itself
- Amend the definition of Insured to include a debtor-in-possession
- Exclusionary language surrounding insolvency, bankruptcy or other financial distress
- Review the allocation provisions
- Limiting the breadth of “Insured vs. Insured Exclusions”
- Strengthening of “Order of Payments” provisions
- Checking language on stays that may be imposed by the court
- Ensuring adequate and quality standalone Excess Side-A coverage, which also should contemplate insolvency risk for individual directors and officers

Nearly all of these items can be managed well ahead of a bankruptcy filing, and most should be part of the regular renewal process. However, since this is not always the case, we highly recommend seeking quality advice from a D&O broker with experience in both terms and conditions negotiating and working with carriers and clients on managing claims that can emanate from this process.

Conclusion

By reaffirming a commitment to act in the corporation’s best interest, directors and officers stand the best chance of avoiding lawsuits for breaches of fiduciary duties. By ensuring appropriate D&O liability insurance coverage, and then employing strategies to mitigate the effect of an insurer's non-renewal of coverage, directors and officers stand the best chance of preserving insurance coverage for claims made during financial distress.

[1] https://www.fdic.gov/news/speeches/2023/spmar0623.html
[2] https://www.gibsondunn.com/delaware-court-of-chancery-__decision-rejecting-continuous-insolvency-requirement-for-creditor-derivative-claims-summarizes-current-law-on-derivative-standing-for-creditors/
[3] https://www.courtlistener.com/opinion/2360388/trenwick-america-lit-v-ernst-young/
[4] https://courts.delaware.gov/opinions/download.aspx?ID=223230
[5] https://www.courtlistener.com/opinion/2330424/nacepf-v-gheewalla/
[6] https://www.americanbar.org/content/dam/aba/publications/blt/2010/09/inside-buslaw-insolvency-201009.authcheckdam.pdf
[7] Quadrant Structured Products Co. v. Vertin, 115 A.3d 535, 546 (Del. Ch. 2015).
[8] N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007)
[9] https://www.icemiller.com/ice-on-fire-insights/publications/fiduciary-duty-to-insolvent-near-insolvent-corpo/

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