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Critical Insurance Considerations For Financially Distressed Companies

BY: LYNDA A. BENNETT, ESQ.

Companies experiencing financial distress often consider two potential avenues to ''right the ship'' – they pursue a restructuring in bankruptcy or they seek an infusion of cash from private equity investors. What most directors and officers do not know is that exercising either option implicates important insurance considerations that directly impact their ability to maintain D&O coverage during and after the reorganizing transaction takes place. This article focuses on two key insurance provisions that must be considered in any restructuring or investment deal, however, companies are best served to include an insurance specialist on their transaction team to ensure that all insurance issues undergo the appropriate due diligence.

CHANGE IN CONTROL: ''RUN OFF'' COVERAGE

The typical D&O policy contains a ''change in control'' (''CIC'') provision that, when triggered, reduces the scope of coverage provided under the policy. In most policies, the CIC provision is triggered when another entity or person acquires 50 percent or more of the voting control or the power to select a majority of the board of directors of the insured company. Thus, the CIC provision may immediately be triggered if a private equity investor makes its investment contingent on taking control of the board. Alternatively, the CIC provision may be triggered a few months after a deal is closed if the private equity's board seats accumulate with scheduled cash infusions.

The CIC provision can also be triggered upon the appointment of a receiver, liquidator, or trustee (though this language can and should be negotiated when the D&O policy is purchased) and/or where there is a sale of all, or substantially all, of the company's assets. Here, the restructuring team must be focused on the precise details of the transaction, *e.g.*, will a trustee be appointed and/or how and when the sale of assets will take place. In those instances where the restructuring will be accomplished through a ''pre-packaged'' plan, the CIC provision may not be triggered until the plan is formally adopted and becomes effective.

The impact of triggering the CIC provision differs from policy to policy. In the most extreme (but rare) instance, a change in control can result in **immediate termination** of the policy. In most instances, however, triggering the CIC provision will result in a ''cut off'' date for the wrongful acts that are covered by the policy. Specifically, most CIC provisions state that coverage will remain available for the remainder of the policy period; **however**, coverage will only apply to conduct or omissions that took place **before** the transaction closed. Thus, to the extent that the company will continue to operate after the change in control takes place, new D&O coverage will have to be secured and careful attention will have to be given to coordinating the ''old'' coverage with the ''new'' coverage.

Depending on the nature of the transaction, the current D&O insurer may be willing to waive the CIC provision. In that instance, the insurer likely will require additional underwriting information and may charge an additional premium if the nature of the risk has materially increased as a result of the transaction. Companies should allow at least ten (10) business days in advance of the closing or bankruptcy filing to discuss CIC provisions with their insurers.

TAIL COVERAGE

Once the transaction is complete, the insurance considerations do not end there. As noted above, the com-

Lynda Bennett is a partner at Lowenstein Sandler LLP and Chair of the firm's Insurance Coverage Practice. She regularly represents corporate policyholders in insurance coverage disputes.

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pany's current D&O policy likely will remain in effect through the end of the policy period and will provide coverage on a more limited basis. Post-transaction, directors and officers must remain focused on the insurance that will be available to them when the ''run off'' coverage expires and they remain exposed to future lawsuits.

In a private equity financing scenario, most directors and officers expect that the ''new'' D&O policy put in effect will cover them for future claims. However, the devil is in the details of that new policy. To ensure such coverage exists, directors and officers must confirm that: (a) full prior acts coverage has been purchased; (b) certain exclusions have been modified; and (c) no entity-specific exclusions have been placed on the new policy.

In a bankruptcy restructuring scenario, some directors and officers believe they do not have a need for insurance post-plan approval because they have negotiated for, and received, releases from the parties associated with the bankruptcy proceeding. Reliance on the release, however, is a dangerous course for directors and officers to chart because risks remain that the release may not be enforceable to extinguish any and all future claims made by any party.

To avoid the risks associated with the above scenarios, directors and officers should become familiar with the details and requirements associated with ''tail'' coverage. Most D&O policies offer a tail for purchase at specific price points depending on the length of the tail. A ''tail'' allows directors and officers additional time after the policy period has expired to receive notice of claims and to report those claims to the insurer. Importantly, the tail does not provide coverage for additional wrongful acts that the director or officer may have committed after the policy expired; rather, the tail simply keeps the window of opportunity to report new claims open for the period of time purchased for the tail. As such, as noted above, coordination between ''new'' and ''old'' coverage is critical when the company will continue operations post-transaction.

Distressed companies, and their boards, should be evaluating tail coverage early on in the restructuring process. The premiums for tails can run anywhere from 100-300% of the current D&O policy premium. Therefore, companies need to include the funding for that premium when they approach private equity investors, DIP lenders, and/or creditors involved in the restructuring process.

CONCLUSION

The process of restructuring and/or rehabilitating a distressed company is complicated and shot full of complex issues. Companies should not overlook the insurance issues that arise in that process. Careful diligence and early involvement of insurance specialists in the transaction will help avoid unexpected and unwelcome gaps in coverage.

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