Alliant

Management Professional Solutions

D&O Insurance During Turbulent Times

On March 11, 2020, the World Health Organization declared that COVID-19 is a pandemic having spread to more than 110 countries and territories across the world. Over the following week, U.S. authorities declared a national emergency, announced a travel ban from Europe, and instituted mandatory shut-down orders affecting many businesses and school districts. The resulting loss in demand combined with the Saudi Arabia-Russia price war sent oil prices plummeting below $30/bbl on March 16 and eventually to a record low of negative $37.63/bbl on April 20. Although the outlook for energy prices has started to improve, the International Energy Agency (IEA) noted on May 14 that "major uncertainties" remain, including whether governments across the western world can ease lockdown measures without sparking a resurgence of COVID-19 outbreaks and whether OPEC+ will comply with their stated output cuts of 9.7 million barrels per day through June.

With U.S. employment at 13.3% in May, the presumed "v-shaped" recovery has morphed in to a "u" or "w" shaped recovery as expectations have tempered. As of early June, NYMEX oil futures suggest that West Texas Intermediate (WTI) crude prices are expected to stay below $38/bbl through December and below $40/bbl throughout 2021. At these price levels, only the most efficient producers with strong balance sheets will avoid restructuring. The energy sector has already started to experience an increase in bankruptcies with recent filings by Whiting Petroleum, Yuma Energy, Diamond Offshore Drilling, Ultra Petroleum, and Chesapeake Energy since April 1st. With an estimated $200B of energy-related debt maturing over the next four years, including more than $40B this year, the energy sector can expect additional filings over the coming months.

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Bankruptcy-Fit D&O Insurance

During turbulent times, it is critically important that all companies review their Director & Officer Liability insurance ("D&O insurance") to ensure that it provides the required protection for directors and officers ("D&Os") with no hidden surprises. The following are best practices for all companies, but especially those experiencing financial distress:

(1) Financially Strong and Reputable D&O Insurer(s) - Many smaller D&O insurers offer below-market premiums when times are good, but these are the very same players who tend to "run for the hills" when conditions deteriorate. Alliant strongly recommends placing your D&O insurance with quality insurers who are committed to the energy sector and have the financial strength to stand by your side through the ups and downs.

(2) Ensure Adequate Excess Side A Limits - Side A coverage for non-indemnifiable loss is of paramount importance during periods of financial distress because it provides broad coverage for individual D&Os which cannot be eroded by claims against the company or considered part of the debtor's bankruptcy estate.

(3) Pre-approved Defense Counsel - Establish a relationship with experienced defense counsel in advance of a claim and obtain pre-approval from the primary D&O insurer to avoid coverage disputes later on.

(4) No Bankruptcy "Run-Off" Trigger - Some D&O policies automatically enter "run-off" when the company files for bankruptcy, which means that there will be no coverage for conduct occurring during the bankruptcy proceeding. Amend these policies so coverage continues unabated for the duration of the bankruptcy proceeding.

(5) Priority of Payments Clause - Most D&O policies (other than Side A only) share aggregate limits across Insuring Agreements A, B, and C, with Insuring agreement A protecting the D&Os' personal assets and Insuring agreements B and C protecting the company's assets. A "Priority of Payments" clause states the insurer must prioritize the payment of covered loss under Side A before paying any loss under Sides B and C, thereby prioritizing the individual D&Os. When a company files for bankruptcy, this clause may also help D&Os gain access to the policy limit more quickly if the U.S. trustee tries to prevent access on the basis that the policy is subject to the automatic stay.

(6) Waiver of Automatic Stay Clause - This clause expressly states that the insured company waives the automatic stay to the extent it applies to the policy and will not oppose any efforts by its D&Os to obtain a release from such automatic stay. It is a standard provision within modern policies, but some older policy forms may not include it.

(7) Outside Capacity Exclusion - In some formulations, this exclusion can bar coverage for directors who are also directors or officers of a shareholder (e.g., private equity firm) when the underlying claim alleges misconduct in both capacities. The exclusion should be narrowly constructed so that coverage is preserved for directors and officers in their insured capacity.

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(8) Insured versus Insured Exclusion - The Insured versus Insured exclusion can vary significantly between policy forms, but should always include exceptions for claims brought by the creditors' committee, bankruptcy trustee, examiner, receiver, liquidator, rehabilitator, or any similar official. Otherwise, the insurer may be able to argue that such claims are "on behalf of the Insured" and therefore excluded from coverage. Some insurers are also willing to include an exception to the exclusion for claims brought by the Debtor in Possession against its own current or former D&Os.

(9) Contractual Liability Exclusion - The contractual liability exclusion found in private-company D&O policies often sweeps too broadly and may preclude coverage for some creditor claims (e.g., fraudulent misrepresentation or breach of fiduciary duty claims) that should be covered. This exclusion should only apply to: (i) claims against the company (i.e., not individual D&Os) and (ii) breach of contract claims, without excluding all claims arising out of a breach of contract.

(10) No Bankruptcy or Creditors Exclusions - Some companies that are in financial distress and have not been adequately represented in the insurance market may find a bankruptcy or creditor exclusion lurking within their D&O policy. Such exclusions are clearly unacceptable and should be removed or mitigated with additional excess limits as soon as possible.

D&O Claims in Bankruptcy

The risk of D&O litigation increases substantially as companies enter bankruptcy. Shareholders may sue directors and officers under federal securities laws alleging the company misled investors with respect to break-even prices, well productivity, prior acquisitions, or other material aspects of the business. Shareholders may allege that the company's directors breached their fiduciary duties of care and/or loyalty by mismanaging the business, entering into underperforming or related-party transactions, imprudently repurchasing stock, and/or approving excessive compensation levels.

Delaware law no longer recognizes a "zone of insolvency" during which fiduciary duties start to be owed to creditors. Therefore, creditors of Delaware corporations generally lack standing to bring lawsuits based on transactions that occur before the company enters insolvency. However, that is not true in all jurisdictions as some other states continue to recognize a "zone of insolvency" which would confer standing to sue. In general, creditors are most likely to file claims against D&Os alleging breach of fiduciary duty or fraudulent conveyance in connection with a stock repurchase, dividend, or executive bonus payment that occurs prior to the bankruptcy filing. Creditors may also sue executives for alleged breach of fiduciary duty, negligence, misrepresentations, and/or fraudulent concealment in connection with the Debtor-in-Possession (DIP) financing and any other material transactions occurring during the bankruptcy proceeding. In some instances, the bankruptcy court may even authorize the formation of a litigation trust and the appointment of a litigation trustee to pursue claims against potentially-liable third parties, such as the current or former D&Os. Finally, the trustee in a Chapter 7 (liquidation) case and, in rare instances, during a Chapter 11 (reorganization) case has the power to investigate suspected wrongdoing and bring legal claims against the company's former D&Os. Bankruptcy trustee claims are rare in Chapter 11 because the debtor typically remains in control of the business with a trustee only being appointed for cause such as fraud, dishonesty, gross mismanagement, or as otherwise provided in Section 1104(a) of the Bankruptcy code.

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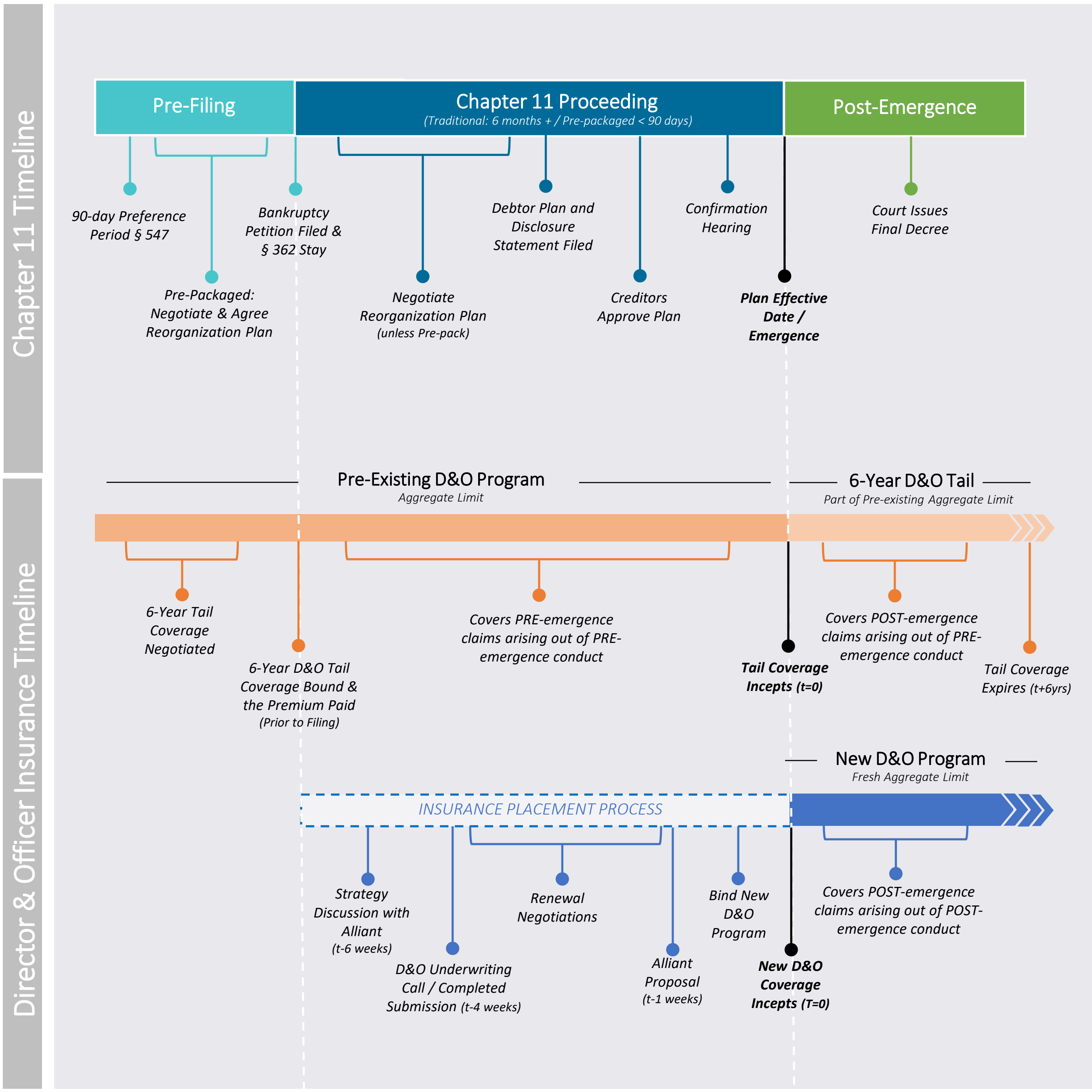
D&O Insurance and the Chapter 11 Process

The following chart provides an overview of the how D&O insurance fits into a typical Chapter 11 bankruptcy process.



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Under Chapter 11 of the United States Bankruptcy Code, all debtors are entitled to a 120-day exclusivity period during which to file a Plan of Reorganization that will gain the support of at least one impaired class of creditors and be confirmed by the court. In an ideal world, the debtor will emerge from bankruptcy six to twelve months later with a new balance sheet and greatly-improved prospects. However, there are many potential hazards and roadblocks that can slow or stall the debtor's progress. For example, creditors may reject the debtor's plan and present a competing plan after the exclusivity period has ended; evolving economic and industry conditions may render a plan unworkable; and/or the court may appoint a case trustee to assume control of the business. In summary, the bankruptcy process is rife with uncertainty, and there are no guarantees that the debtor will successfully reorganize. Consequently, the vast majority of companies choose to bind and prepay their D&O insurance premium before filing for bankruptcy so that coverage is locked-in for the duration of the bankruptcy period and for six years thereafter (the "D&O tail").

Accordingly, the current policy period should be extended before filing so that it will not expire during the bankruptcy proceeding; otherwise, the debtor may be forced to negotiate an extension at a particularly inopportune time. The current D&O policy covers current and former D&Os for claims arising out of acts, errors, and/or omissions occurring before or during the bankruptcy proceeding, so it should not be allowed to lapse during the bankruptcy proceeding. In addition, a six-year D&O tail should be purchased before filing, which extends the current D&O policy to cover claims made during a six-year tail period starting at the end of the bankruptcy proceeding and arising out of acts, errors, and/or omissions occurring during or before the bankruptcy proceeding. Other important considerations include: (i) amending the D&O policies so that coverage is fully non-cancellable once the premium has been paid; (ii) pre-negotiating the additional premium for an extension if the bankruptcy proceeding lasts longer than expected; (iii) adding coverage for wind-down exposures in the event of liquidation; and (iv) purchasing additional excess limit if the current aggregate limit is too low or impaired by one or more claims. In the past, Alliant has successfully negotiated new limits for companies in or approaching bankruptcy at a very reasonable cost. Do not assume that additional coverage is unavailable or prohibitively expensive.

In today's market, D&O insurers frequently charge between two to three and a half times the annual premium for a prepaid six-year D&O tail depending upon the size and complexity of the bankruptcy filing, the likelihood of liquidation, whether it will be a prepackaged filing, the existence of any open claims and/or investigations, the expiring premium level, and any specific circumstances that led to insolvency. In theory, waiting to bind the D&O tail coverage towards the end of the bankruptcy proceeding may prove to be more cost effective, but very few companies seriously consider this approach given the inherent uncertainty regarding the debtor's ability and willingness to pay the premium at a later date.

Finally, if the debtor successfully emerges from bankruptcy, a go-forward D&O program covering the restructured company and its newly-constituted board will need to be purchased for conduct that occurs on or after the plan's "effective date." Alliant recommends soliciting quotes for the go-forward insurance program as soon as the restructuring plan is known and management are able to convey to underwriters the restructured company's asset profile, capital structure, pro-forma EBITDA, ownership, and board composition.

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Bankruptcy is often a new and stressful experience for directors and officers; therefore, it is critically important to hire an experienced and knowledgeable D&O insurance broker who will avoid the pitfalls and guide you through the process as smoothly as possible. Alliant has over 80 professionals across the U.S. with significant experience providing D&O insurance brokerage services to our clients (both operators and strategic investors) during periods of financial distress, including some of the largest and most complex bankruptcy filings within the energy sector.

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