Proskauer

Private Credit Lenders: D&O Insurance in Times of Distress

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It seems inevitable there will be an uptick in private credit defaults as economic conditions further deteriorate. What steps are you taking in terms of portfolio management to prepare for the next cycle with respect to directors and officers ("D&O") insurance? In this post, we offer some practical tips in connection with change of control transactions and in those instances where lenders appoint a director to the borrower's board.

1. **Change of Control Transactions**

In the next cycle, we expect to see an increase in change of control transactions through debt for equity transactions, including "key tossing" transactions,[1] Article 9 foreclosures, and chapter 11 credit bid sales or debt-for-equity conversion plans. When lenders acquire ownership of a borrower's equity, the borrower's D&O insurance goes into "run-off" and no longer covers claims for wrongful acts occurring after the change of control transaction. In this scenario, private credit lenders should be mindful of at least two significant issues.

First, in our experience, the existing directors will typically insist on the purchase of tail coverage (usually for a six-year period) to cover their exposure for claims for acts, errors, or omissions occurring before the change of control which have not yet been asserted. The pricing for tail coverage has increased significantly over the last few years and is typically 1.5x to 2.5x the existing premium, all paid up-front and on a non-refundable basis. While there is no one-size-fits-all approach to the cost of tail coverage, it can be a significant – sometimes multi-million dollar – expense, depending on the company, the existing policy and the amount of tail coverage being purchased. This cost is often overlooked and must be factored into the budgeting process for any consensual change of control transaction.

Second, the acquiring company (often an acquisition vehicle formed by the lenders, "NewCo") must also buy new D&O coverage to protect NewCo and its new board on a go-forward basis. The key here is to ensure that strong coverage is negotiated, rather than simply defaulting to whatever (sometimes poor) coverage the borrower previously had in place. It also is important to confirm that NewCo's coverage is coordinated with the acquiring lenders' (now, the new equity holders') own insurance policies to ensure NewCo's coverage applies on a primary basis for claims against directors serving on the NewCo board.

2. **Lender Appointed Directors**

There also are a number of restructuring scenarios – consensual or otherwise – that involve the lenders appointing directors to the borrower's board. This often occurs consensually in connection with a forbearance agreement or amendment. Other times it occurs non-consensually in connection with the exercise of remedies. In either scenario, D&O insurance is critically important. We offer three important tips.

First, it is important to determine whether the board appointment constitutes a change of control transaction under the policy. Many clients are surprised to learn that a change of control transaction is not always limited to a change of equity control. In our experience, some policies will broadly define "change of control" to include a change in control over the board's composition. For those policies where a "change of control" broadly incudes a change of board composition, then the same considerations regarding tail coverage and new go-forward coverage discussed above apply.

Second, a newly appointed director in a distressed situation will focus on the adequacy of the borrower's D&O insurance. It is important, therefore, to review the policy, including for problematic exclusions to help alleviate that concern. At this stage, it also is important to focus on policy renewals because insurers often use the insured's financial condition as an opportunity to increase premiums and add exclusions that significantly limit coverage for directors, such as insolvency exclusions or sponsor exclusions.

Finally, private credit lenders should consider their own insurance coverage in connection with protecting a lender-designated director on a borrower's board. Asset managers commonly purchase their own D&O insurance as part of a combined insurance program that also includes professional liability (also called errors and omissions, or "E&O") insurance. The E&O coverage is typically broad and there are usually opportunities to negotiate significant enhancements to such coverage, including coverage for SEC and other government investigations, narrowing policy exclusions, and making provisions related to the claim process (such as consent and cooperation provisions and provisions related to counsel rates) more favorable for the policyholder. This insurance also can play an important role in protecting individuals that private credit lenders appoint to boards, whether as part of change of control transactions or in other restructuring scenarios.

Asset managers' policies commonly include "outside capacity" coverage, which generally provides coverage to individuals the asset manager has appointed to the board of a portfolio company if indemnification and insurance at the portfolio company level are unavailable. This coverage serves as an important backstop to protect the private credit lender. The language of this coverage can vary considerably, however, in terms of which board appointees are covered and under what circumstances. This outside capacity coverage should, thus, be carefully reviewed and also coordinated to function seamlessly with portfolio company insurance.

In sum, D&O coverage is an important asset that must be carefully evaluated in times of distress. Proskauer's Private Credit, Private Credit Restructuring and Insurance Groups constantly communicate and collaborate with our private credit clients and their insurance brokers to address D&O considerations in connection with restructuring and other distress scenarios.

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[1] For more information about "key tossing" transactions, see our prior client alert published in Bloomberg - Taking the Keys: Restructuring Tips for Private Credit Lenders (bloomberglaw.com)

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