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D&O Policy Coverage: Specificity Matters in Bankruptcy Context

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A recent decision by the United States Bankruptcy Court for the Southern District of Texas in *In re Walker County Hospital Corporation* serves as an important reminder to clients that are purchasing or renewing directors and officers ("D&O") insurance coverage that the "Insured versus Insured" exclusion must contain the broadest possible exceptions for claims brought against directors and officers following a bankruptcy filing. Without the specific policy language, current and former directors and officers may be exposed to personal liability.

After Walker County Hospital (the "Hospital") filed for bankruptcy, in its capacity as debtor-in-possession, the Hospital sued its former chief executive officer (the "CEO") for breach of fiduciary duty claims. The CEO tendered the claims to the Hospital's D&O insurer and demanded that the insurer provide a defense against the claims. The insurer denied coverage, relying on the "Insured versus Insured" exclusion ("IvI Exclusion") — a standard D&O coverage exclusion which, subject to certain specified exceptions, bars insurance coverage for claims asserted by one insured party against another insured party.

The bankruptcy court began by noting that because both the Hospital (in its capacity as a debtor-in-possession) and its former CEO were "Insureds" under the policy, the IvI Exclusion would bar coverage ***unless*** an applicable exception to the exclusion applied. Closely reading the text of the policy, the court observed that the IvI Exclusion contained an exception for "any Claim brought or maintained by or on behalf of a bankruptcy or insolvency trustee, examiner, receiver or similar official for the Company." The court further explained that relevant provisions of the Bankruptcy Code confer upon a Chapter 11 debtor-in-possession "all the powers, functions, and duties of a bankruptcy trustee" and reasoned that, because a debtor-in-possession has substantially the same authority as a bankruptcy trustee, it qualifies as a "similar official" to a bankruptcy trustee, triggering the exception to the IvI Exclusion. Thus, the court held that the IvI Exclusion did not apply and the former CEO was entitled to coverage for the costs of defending the claims asserted against him by the Hospital (acting in its capacity as a debtor-in-possession).

Although the case was decided favorably for the former CEO, the dispute in *Walker County Hospital* highlights the material risk for directors and officers when their company's D&O policies fail to provide adequate coverage following a bankruptcy filing. When a company files for bankruptcy, the directors and officers can no longer rely on the company's indemnification for claims that arose before the bankruptcy case and must instead rely on available insurance protection. If the company's D&O policy excludes claims brought during the bankruptcy case — due to an overly broad IvI Exclusion — current and former directors and officers may be exposed to personal liability.

Ensuring that the IvI Exclusion in a D&O policy has a broadly drafted "bankruptcy exception" is critically important, as the market exceptions can vary considerably. For example, while the Court in *Walker County Hospital* noted that there was ambiguity as to whether claims asserted by the Hospital as a debtor-in-possession fell within the policy's exception to the IvI Exclusion (and construed that ambiguity against the insurer), many other policies available in the market do not have such ambiguity as they either explicitly state that claims brought by a debtor-in-possession fall within an exception to the exclusion (or, alternatively, that they do not). Specificity is critical.

Another way that directors and officers can help ensure that they have adequate protection for suits in a bankruptcy context is to insist that their company purchase “Side A” policies, which provide coverage to individuals for non-indemnified loss and typically do not contain any IvI Exclusion and very limited, other exclusions. D&O insurance exists to protect directors and officers, and bankruptcy is a setting where the need for protection is highest. *Walker County Hospital* is an important reminder of the importance of ensuring that coverage doesn’t fail when it is needed the most.

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