Cracking the D&O Code: The Keys to Insurance Recovery and Injunctive Orders in Bankruptcy Court

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Traditional Corporate Governance Fiduciary Duties

- Care
- Loyalty
- Good Faith

The Duty of Care

- The duty of care requires that directors inform themselves of "all material information reasonably available to them," prior to making a business decision. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

- Directors must "act in an informed and deliberate manner" prior to making a business decision. *Id.* at 873

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The Duty of Loyalty

- Directors must "protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage . . . ." *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

- A fiduciary should act in the best interests of the corporation, rather than for any other reason.

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Examples Where Loyalty is Implicated

- The duty of loyalty is potentially implicated when fiduciaries stand on both sides of a transaction or receive a personal benefit not shared with all stockholders (an "interested" director).
- Duty of loyalty is also potentially implicated when fiduciaries are beholden to an interested party, such as an investor group or investment fund.

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The Duty of Good Faith

Delaware courts consider the duty to act in good faith to be a subset of the duty of loyalty. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

- "To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation." *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 755 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).
- Three primary examples of a lack of good faith:
  - "consciously and intentionally disregarding their responsibilities" by adopting a "we don't care about the risks" attitude concerning a material corporate decision.
  - "intentionally act[ing] with a purpose other than that of advancing the best interest of the corporation."
  - "acts with the intent to violate . . . law."

  In re Walt Disney Co. Derivative Litigation, 906 A.2d 27, 67 (Del. 2006).

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Other Duties

- Candor—Directors have a duty to disclose to the board material information in their possession bearing upon a board decision. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1283 (Del. 1989).
- Disclosure—Directors are obligated to disclose material information accurately and completely when seeking shareholder action. *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998); *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992).
- Oversight—Directors have a duty "to assure [that] a reasonable information and reporting system exists." *In re Caremark International Derivative Litigation*, 698 A.2d 959, 971 (Del. Ch. 1996).
- Transaction-based
  - Sale or Change of Control—Directors must secure the transaction offering the best value reasonably available, and exercise duties to that end. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Paramount v. QVC*, 637 A.2d 34 (Del. 1994).
  - Threat of takeover—Directors' actions have an enhanced level of scrutiny where they adopt defensive measures in response to a threat of takeover. *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

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To Whom Do D&Os Owe Fiduciary Duties, Generally?

Solvent Corporations:

- Directors owe fiduciary duties to the corporation and its stockholders.

Insolvent Corporations:

- When a corporation is insolvent in fact, its creditors become the corporation's residual beneficiaries.
- Consequently, the constituencies that the directors and officers should consider in the proper exercise of their fiduciary duties expand to include the corporation's creditors in addition to its stockholders.

"Zone of Insolvency" is no longer. *N. Am.Catholic Educ. Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

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Who Can Sue?

- Corporation (including by a receiver or trustee)
- Stockholders in a derivative capacity on behalf of the corporation. Typically, the stockholder must have held the corporation's stock at the time of the breach and remain a stockholder during the suit. *See* 8 *Del. C.* § 327; *Lambrecht v. O'Neal*, 3 A.3d 277 (Del. 2010).
- Creditors, if the corporation is insolvent, in a derivative capacity on behalf of the corporation. *N. Am. Catholic Programming Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007). There is no direct fiduciary duty claim. *Id*.

Limited Liability Company:

- Only members and assignees of limited liability company interests have standing to bring a derivative claim against a limited liability company, and such members or assignees must have been such at the time of the breach. 6 *Del. C.* § 18-1002; *CML V, LLC v. Bax*, 28 A.3d 1037 (Del. 2011).

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To Whom Do Directors of a Wholly-Owned Subsidiary Owe Fiduciary Duties?

Solvent Wholly-Owned Corporation:

- **Directors of a solvent wholly-owned corporation owe fiduciary duties to the corporation's parent company and its shareholders. *See Trenwick Am. Litig. Trust v. Ernst & Young*, 906 A.2d 168, 200 (Del. Ch. 2006).**

Insolvent Wholly-Owned Corporation:

- **When a wholly-owned Delaware corporation is *insolvent*, the Board should focus on maximizing the value of the corporation. *Shandler v. DLJ Merch. Banking, Inc.*, 2010 Del. Ch. LEXIS 154, at *55 (Del. Ch. Jul. 26, 2010).**
  - **Potential loyalty issue where directors sit on both parent and sub**

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Breach of Duty of Loyalty in Transactions Benefiting the Parent Company

Courts have found the following actions may establish claims that directors breached their ***duty of loyalty*** by ***self-dealing*** when authorizing a transaction benefitting the parent company:

- Permitting an insolvent subsidiary to be plundered with impunity for the benefit of its parent corporation. *In re Direct Response*, 466 B.R. 626, 649 (Bankr. D. Del. 2012) (*citing In re RSL COM Primecall, Inc.,* 2003 Bankr. LEXIS 1635 at *13)).
- Causing a subsidiary to guarantee its parent's debt without fair consideration. *In re RSL COM Primecall, Inc.,* 2003 Bankr. LEXIS 1635 at *38-39 (Bankr. S.D.N.Y. Dec. 11, 2003).
- Depleting an insolvent subsidiary's asset base such as to render the subsidiary insolvent. *In re Direct Response*, 466 B.R. at 649-50.
- Raising the structural payout priority of the corporation's debts to directors to the injury of the corporation and its creditors. *In re Autobacs*, 473 B.R. 525, 564 (Bankr. D. Del. 2012).
- Permitting the insolvent subsidiary to accrue debt without consideration or reasonably equivalent value. *In re Direct Response*, 466 B.R. at 653.
- Failing to fund certain costs and expenses of the insolvent subsidiary after promising to do so. *Id*.

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Officer Considerations

- 34 states have statutory provisions, not Delaware.
- Officers are agents and owe fiduciary duties under agency and corporate law.
- Sec. 8.42 of Model Business Corporation Act
  - (a) An officer with discretionary authority shall discharge his or her duties under that authority:
    - (1) in good faith;
    - (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
    - (3) in a manner the officer reasonably believes to be in the best interests of the corporation and its members, if any.
- *Gantler v. Stephens*, 965 A.2d 695, 708-09 & n.37 (Del. 2009) (emphasis added).
  - "The Court of Chancery has held, and the parties do not dispute, that corporate officers owe fiduciary duties that are identical to those owed by corporate directors. That issue-whether or not officers owe fiduciary duties identical to those of directors-has been characterized as a matter of first impression for this Court. In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold."

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Standards of Judicial Review of Directors' Actions

Under Delaware law, there are three tiers of judicial review for evaluating the conduct of a director of a corporation:

- **Business Judgment Rule (default standard)**
- **Enhanced Scrutiny (intermediate standard)**
- **Entire Fairness (strictest standard)**

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The Business Judgment Rule

- **Rebuttable presumption that when making a decision, the directors of a corporation acted**
  - **on an informed basis,**
  - **in good faith, and**
  - **in the honest belief that the decision taken was in the best interests of the corporation.**
- **Does not apply to interested directors or claims for breach of loyalty or good faith.**
- **If rebutted, director or officer must demonstrate entire fairness of transaction.**

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Entire Fairness

The strict "*Entire Fairness*" standard applies instead of the *Business Judgment Rule* where:

- an actual conflict of interest affects a majority of the directors making a decision,
- interested persons control or dominate the directors(s) making a decision,
- a decision involves a controlling owner, *or*
- a plaintiff shows that the directors(s) committed a breach of the duty of care or duty of loyalty.

To prove a transaction was "entirely fair," directors must show:

- Fair dealing: Courts focus on process; AND
- Fair price: Courts focus on all relevant factors related to the economic and financial considerations of the proposed transaction

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Exculpatory Provisions

- 8 Del. Code § 102(b)(7)
  - Section 102(b)(7) only permits exculpation of liability of directors for certain breaches of duty:
    - A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective.
  - No monetary damages for duty of care breach.
  - Does not protect officers, only directors.
  - Does not prevent injunctive relief to enjoin acts resulting from breach of duties, including care.

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Traditional D&O Insurance

- **D&O policies are almost uniformly claims-made policies**
  - Claims made policy: The making of the claim is the peril insured against, regardless of when the occurrence (or harm) took place.
  - Occurrence policy: Provides coverage when the triggering event occurs during the policy period, regardless of when the claim is made.
- **…and carry "wasting limits"**
  - Every dollar spent in defense reduces the available insurance.

Types of D&O Coverage

- **Side A – Insured Person Coverage**
  - Directly covers directors and officers against personal liability in the absence of indemnification by the entity
- **Side B – Indemnification Coverage**
  - Reimburses the entity when it indemnifies its directors and officers
- **Side C – Entity Coverage**
  - Directly covers the entity for its own exposure, but frequently to the limited extent of securities claims

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Timeliness of the Trustee's Claim

- **A newly-appointed Trustee must immediately assess the operative policy period and assert a claim within that window.**
- **But, there are other avenues to coverage even if this is not possible:**
  - (1) Tail coverage or extended reporting periods: Lengthens the period of time to assert a claim *after* the policy period has expired
  - (2) Relation back provisions: Provide that multiple claims involving related wrongful acts constitute a single claim

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Deductible and SIR Obligations

- **Bankruptcy does not absolve a D&O insurer from its contractual duties**
  - **Policy Basis:** "Bankruptcy or insolvency of any Organization or any Insured Person shall not relieve the Insurer of any of its contractual obligations under this Policy."
  - **Common Law Basis:** "[W]here . . . an insured debtor has paid the policy premium in full, the insurance policy is not an executory contract for purposes of § 365 of the Bankruptcy Code, even where the debtor has continuing obligations, such as the payment of a self-insured retention, a deductible, or a premium. Failure of the debtor to perform these continuing obligations does not excuse the insurer from performance under the contract, but gives rise to an unsecured claim by the insurer for any damages incurred by reason of the debtor's breach of the policy."
    - *Am. Safety Indem. Co. v. Vanderveer Estates Holdings, LLC* (*In re Vanderveer Estates Holding, LLC*), 328 B.R. 18, 25 (Bankr. E.D.N.Y. 2005).

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Order of Payments & Protecting the Policy Proceeds

- **Order of Payments**
  - This provision defines how proceeds are paid if multiple insuring agreements are implicated by one or more claims.
  - The policy proceeds are typically paid in the following order:
    - **First**, on behalf of the individual insureds under Side A
    - **Second**, to reimburse the entity for amounts advanced on behalf of the individual insureds under Side B
    - **Third**, to cover claims directly against the entity under Side C

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Order of Payments & Protecting the Policy Proceeds (ctd)

- **Trustees can protect the asset they're seeking to monetize for the estate's benefit**
  - Where Trustees or third parties sue the directors and officers, the payment of defense costs will "waste" or "burn" the policy proceeds.
  - Because the policy is property of the estate where the debtor is the named insured, carriers frequently seek relief from the automatic stay to advance defense costs.
  - Trustees should seek an agreed order that provides this relief with certain protections for the estate:
    - Consider, *e.g.*, the advancement of defense costs in limited tranches and periodic updates on defense costs incurred

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Frequently-Raised D&O Insurance Exclusions

- **Insured v. Insured Exclusion**
  - **Intended to prevent collusion and claims by companies against their directors and officers for imprudent business decisions. But, many policies expressly exempt bankruptcy trustees from this exclusion. For example:**
    - "The Insurer shall not be liable for Loss arising out of, based upon, or attributable to any Claim which is brought by or on behalf of any . . . Company. This exclusion shall not apply to . . . any Claim against any Insured Person . . . pursued by an insolvency administrator, receiver, trustee or liquidator of any Company or Outside Entity either directly or derivatively on behalf of a Company or Outside Entity."
  - **Some policies also contain exceptions to this exclusion when a claim is asserted by a debtor-in-possession. For example:**
    - "This exclusion shall not apply to any Claim brought by the Organization as a debtor-in-possession against an Insured Person that is no longer acting in his or her capacity as an Insured Person at the time that such Claim is brought . . ."

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Frequently-Raised D&O Insurance Exclusions (ctd)

- **Insured v. Insured Exclusion (ctd)**
  - **Where the policy does not contain an express debtor-in-possession carve out, there is conflicting law as to the exclusion's applicability.**
    - *See, e.g.*, *Fed. Ins. Co. v. Cont'l Cas. Co.*, No. 2:05-cv-305, 2006 WL 3386625 (W.D. Pa. Nov. 22, 2006) (finding insured v. insured exclusion inapplicable to debtor-in-possession); *In re HA 2003, Inc.*, 310 B.R. 710 (Bankr. N.D. Ill. 2004) (same); *In re Savino Oil & Heating Co., Inc.*, 99 B.R. 518 (E.D.N.Y. 1989) (discussing how a debtor-in-possession is distinct from the prepetition debtor and analogous to bankruptcy trustee); *but see, e.g.*, *Biltmore Assocs., LLC v. Twin City Fire Ins. Co.*, 572 F.3d 663 (9th Cir. 2009) (finding insured v. insured exclusion applicable to debtor-in-possession based on conclusion that prepetition debtor and company as debtor-in-possession are the same entity).

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Frequently-Raised D&O Insurance Exclusions (ctd)

- **Conduct Exclusions**
  - **Intended to preclude coverage for improper personal profits or criminal/fraudulent acts. For example:**
  - "The Insurer shall not be liable to make payment for Loss . . . in connection with any Claim made against an Insured arising out of, based upon or attributable to any:
    - (a) remuneration, profit or other advantage to which the Insured was not legally entitled; or
    - (b) deliberate criminal or deliberate fraudulent act by the Insured;
    - *if established by any final, non-appealable adjudication* in any action or proceeding other than an action or proceeding initiated by the Insurer to determine coverage under the policy."
  - **These should not be characterized as "intentional acts" exclusions**

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Frequently-Raised D&O Insurance Exclusions (ctd)

- **Conduct Exclusions (ctd)**
  - **Two critical elements to preserving coverage despite the Conduct Exclusions:**
  - **(1) The requirement of a "final, non-appealable adjudication" that the conduct occurred**
    - It is improper for an insurer to deny coverage on these grounds prior to obtaining a final adjudication. *See, e.g.*, *Philadelphia Indem. Ins. Co. v. Hamic,* No. 8:12-cv-829-T-26EAJ, 2012 WL 3835088 (M.D. Fla. Sept. 4, 2012).
  - **(2) Severability Clause**
    - Ensures that one insured's misconduct does not destroy coverage for all. For example:
    - "In determining whether any of the following Exclusions apply, the Wrongful Acts of any Insured Person shall not be imputed to any other Insured . . . [O]nly the Wrongful Acts of any chief executive officer, chief financial officer or general counsel (or equivalent position) of an Organization shall be imputed to such Organization."

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Dealing with Competing Claimants against the Policy

- Trustees frequently encounter situations where she and other third parties are pursuing the same policy limits, which are insufficient to settle all pending claims.

- Several approaches can assist the Trustee in securing the lion's share of the proceeds:
  - **(1) <u>Injunction</u>:** Where the prosecution of third-party actions against directors and officers stands to deplete the policy proceeds before the trustee has had an opportunity to complete her investigation and initiate suit, it may be possible to obtain an injunction.
    - *See Leibowitz v. First Chicago Bank & Trust* (*In re* IFC Credit Corp.), 422 B.R. 659 (Bankr. N.D. Ill. 2010).
    - *But see In re CHS Electronics, Inc.*, 261 B.R. 538 (2001) (a trustee in bankruptcy does not have "super-plaintiff powers in causes of actions between third parties.").

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Dealing with Competing Claimants against the Policy (ctd)

- **(2) <u>The Threat of Substantial Bad Faith Liability</u>:** Depending on the law in the governing jurisdiction, the trustee may be capable of consummating a policy limits settlement in her favor where the estate's claims present the greatest exposure to the insureds.
  - In Florida, for example, an insurer must fully investigate the pending claims and minimize the magnitude of possible excess judgments against the insureds by reasonable claim settlement. The carrier's failure to do so can result in extra-contractual liability.
  - *See, e.g.*, *Farinas v. Florida Farm Bureau Gen. Ins. Co.*, 850 So. 2d 555, 560-61 (Fla. 4th DCA 2003); *Gen. Sec. Nat'l Ins. Co. v. Marsh*, 303 F. Supp. 2d 1321, 1325-26 (M.D. Fla. 2004); *Valle v. State Farm Mut. Auto. Ins. Co.*, No. 1:08-cv-22117-JLK, 2010 WL 3310616 (11th Cir. Aug. 24, 2010).

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Dealing with Competing Claimants against the Policy (ctd)

- **(3) <u>A Bar Order:</u>** The trustee wields the unique ability to preclude further third-party litigation by securing a bar order.
  - The benefit of finality can be strategically leveraged in negotiations with insurance carriers.
  - This translates to a greater recovery from the policy than what might have been accomplished absent this option.

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Whose *Policy* Is It Anyway?

- **The Bankruptcy estate is broadly defined to include "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a).**
- **Once the bankruptcy petition is filed, the debtor's insurance policies become property of the bankruptcy estate and subject to the jurisdiction of the bankruptcy court.**
- **Property of the estate (including insurance policies) are nevertheless subject to non-bankruptcy law limitations (e.g. state law limits on assignability, etc.).**

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Whose *Proceeds* are They?

Whether policy proceeds are property of the bankruptcy case is decided on a case-by-case and policy-by-policy basis. Mixed use policies are focal point.

- ***In re Edgeworth,* 993 F. 2d 51, 55-56 (5th Cir. 1993) ("The overriding question when determining whether insurance proceeds are property of the estate is whether the debtor would have a right to receive and keep those proceeds when the insurer paid on a claim.").**

- ***In re Allied Digital Techs. Corp.*, 306 B.R. 505 (Bankr. D. Del. 2004) (concluding that "when there is coverage for the directors and officers of the debtor, the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution.").**

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Policy-by-Policy Test

- ***In re Laminate Kingdom, LLC,* Case No. 07-10279-BKC-AJC; 2008 WL 1766637 (Bankr. S.D. Fla. March 13, 2008) ("In this case, the Policy provides coverage for the directors and officers *and* the debtor. In such circumstances, the proceeds *may be* property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution.") (emphasis in original).**

- ***But see, In re Downey, Fin. Corp.*, 428 B.R. 595 (Bankr. D. Del. 2010) (holding that "there was no means by which the Debtors' interests in Coverages B(i) and B (ii) could become superior to, or even equal to, the [individual] insured's interest in Coverage A.").**

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Insurance Protocol/Comfort Orders

- ***Relief from the automatic stay in bankruptcy may be necessary to access policy proceeds to fund D&O defense costs and/or provide "soft caps." In re Downey, 428 B.R. 595 (Bankr. D. Del. 2010).***

- ***In re Adelphia Comm. Corp.*, 285 B.R. 580 (Bankr. S.D.N.Y. 2002) (exercised discretion and limited D&O defense costs to $300K each, with Court retaining control over future expenditures of policy proceeds).**

- ***In re MF Global Holdings, Ltd.*, 469 B.R. 177 (Bankr. S.D.N.Y. 2012) (imposing an initial cap on defense costs and reporting requirements).**

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Bar Order Overview

- Non-debtor releases of interrelated claims typically sought by debtors or trustees in connection with 9019 motions/plan provisions with D&Os to eliminate future, third-party actions against D&Os and insurers
- Courts rely on Section 105(a) of the Bankruptcy Code for authority enter the bar orders/injunctions/releases for non-debtors
- shields third parties who share an identity of interest with the debtor, usually corporate officers and directors in a Chapter 11 proceeding, from any claim, obligation, cause of action, or liability to any party in interest who has filed a claim or been given notice of the debtor's bankruptcy
- Help facilitate settlements with D&Os and insurers by providing financial certainty with respect to third-party claims, which often times results in higher settlement amount for the estate
- Validity and standard for approval varies between Circuits

Authority

Court's authorizing the approval of non-debtor, non-consensual releases typically rely on 11 U.S.C. § 105(a):

- "The Court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

- The Supreme Court also recognized the authority of bankruptcy courts to enter injunctive relief when necessary to prevent a party from defeating its jurisdiction (*Cont'l Ill. Nat'l Bank & Trust Co. of Chicago v. Chicago, R.I. & P. Ry. Co.*, 294 U.S. 648, 675 (1935))

Circuit Split

Majority View – Allowance of non-debtor releases

- First, Second, Third, Fourth, Sixth, Seventh, Eleventh, and D.C. Circuit

Minority View – Disallowance of Non-Debtor Releases

- Fifth, Ninth, and Tenth Circuits

Majority View

- Rely upon the bankruptcy court's equitable powers in Section 105 for support of non-debtor releases/bar orders/injunctions
- Allow releases under the appropriate circumstances and find that Section 524(e) does not forbid non-debtor releases, as it only speaks to the effect of the debtor's discharge
- Despite allowance, generally difficult to receive, as they are reserved for "rare" and "unusual" circumstances

Majority View Cases

- *In re Specialty Equip. Co.*, 3 F.3d 1043, 1047 (7th Cir. 1993) ("[The language of Section 524(e)] does not purport to limit or restrict the power of the bankruptcy court to otherwise grant a release to a third party.")
- *In re Dow Corning Corp.*, 280 F.3d 648, 657-58 (6th Cir. 2002) (approving seven-factor test for approval of non-debtor releases)
- *In re Continental Airlines*, 203 F.3d 203, 214 (3d Cir. 2000) (setting forth the broad standards for approving non-consensual third party releases, including consideration of three factor test)
- In re Metromedia Fiber Network, 416 F.3d 136, 141 (2d Cir. 2005) ("[I]t is clear that such a release is proper only in rare cases.")

Majority View Cases

- *In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir. 1989) (affirming on appeal confirmation of a plan that included an injunction of suits brought against certain non-debtor entities)
- *Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973 (1st Cir. 1995) (involving a confirmed plan that included a settlement by creditors of the debtor who, in consideration of their agreement to release claims and contribute to the plan, wanted a permanent injunction to protect them from future lawsuits arising from such settled claims)
- *In re Munford, Inc.*, 97 F.3d 449, 455 (11th Cir. 1996) (holding that Section 105(a) and the Fed. R. Civ. P. 16 "authorize bankruptcy courts to enter bar orders where such orders are integral to settlement in an adversary proceeding.")
- *In re AOV Indus.*, 792 F.2d 1140 (D.C. Cir. 1986) (stating that the bankruptcy court had jurisdiction to approve a plan even if contained a third party release, which was included as a result of a settlement.")

Minority View

- These courts take a strict construction approach and state that a bankruptcy court lacks the power to discharge any claims against non-debtors
- Rely on Section 524(e) which provides that "the discharge of the debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."
- Section 105(a) cannot be used by bankruptcy courts to discharge the liabilities of non-debtors because such relief would be inconsistent with the specific provisions of §524(e)
- As a general rule, the equitable powers under Section 105(a) cannot be used by the courts to authorize relief inconsistent with a more specific provision of the Code. *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988)

Minority View Cases

- *In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995) (finding that since a permanent injunction improperly discharged a potential debt of a non-debtor, the bankruptcy court exceeded its powers under Section 105)
- *In re Pac. Lumber Co.*, 584 F.3d 229 (5th Cir. 2009) (finding that the exculpation clauses contained in the debtor's plan of reorganization that released the non-debtor plan proponents for acts taken during the course of the bankruptcy proceeding were inappropriate)

Minority View Cases

- *In re Lowenschuss*, 67 F.3d 1394, 1401 (9th Cir. 1995) (affirming the district court's decision to vacate a release provision, finding that the bankruptcy court lacked the power to approve a provision which released claims against non-debtors)
- *In re W. Real Estate Fund*, 922 F.2d 592, 600 (10th Cir. 1990) (finding that a permanent injunction that relieved a non-debtor from its liability to a creditor was inappropriate)

Standard for Approval

- No consensus among the Circuits as to a specific test to apply for approval, but various tests have evolved, *Dow Corning, Continental Airlines*, *Master Mortgage*, and *Munford*.
- Generally, the courts agree that at a minimum third party releases must be important, necessary, and the third party must provide some form of consideration
- The releases should be only used when they are essential, fair, and equitable

In re Dow Corning Corp., 280 F.3d 648, 657-58 (6th Cir. 2002) (approved of by the Eleventh Circuit in *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070 (11th Cir. 2015))

1. *there is an identity of interests between the debtor and the third party;*
2. *the nondebtor has contributed substantial assets to the reorganization;*
3. *the injunction is essential to reorganization;*
4. *the impacted class, or classes, has overwhelmingly voted to accept the plan;*
5. *the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction;*
6. *the plan provides an opportunity for those claimants who choose not to settle to recover in full; and*
7. *the bankruptcy court made specific factual findings*

In re Master Mortgage Invest. Fund, Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994)

1. the identity of interests between the debtor and the third party, including any indemnity relationship;
2. any value (monetary or otherwise) contributed by the third party to the chapter 11 case or plan;
3. the need for the proposed release in terms of facilitating the plan or the debtor's reorganization efforts;
4. the level of creditor support for the plan; and
5. the payments and protections otherwise available to creditors affected by the release.

In re Continental Airlines, 203 F.3d 203, 214 (3d Cir. 2000)

1. the releases must be fair, which would require sufficient compensation to the party granting the release;
2. the releases must be necessary to the reorganization; and
3. the bankruptcy court must make specific factual findings to support these conclusions.

- *In re Munford, Inc.*, 97 F.3d 449, 455 (11th Cir. 1996)
  - Bankruptcy court must make a determination as to whether the bar order is "fair and equitable" and should consider the following:
    1. The interrelatedness of the claims that the bar order precludes;
    2. The likelihood of nonsettling defendants to prevail on the barred claim;
    3. The complexity of the litigation; and
    4. The likelihood of depletion of the resources of the settling defendants

D&O/Insurance Bar Order Cases

- *In re Jiangbo Pharmaceuticals, Inc.*, 520 B.R. 316 (Bankr. S.D. Fla. 2014) affirmed by *Lewis v. Salkin*, No. 14-62780-JIC (S.D. Fla. Sept. 24, 2015)
  - Chapter 7 Trustee sought approval of settlement agreement with former officer of debtor
  - Terms of the settlement agreement included a bar order which would enjoin, *inter alia*, an interrelated securities class action lawsuit against the debtor and the officer
  - The court approved the bar order finding that it met the requirements of *Munford*
  - Settlement funded wholly by a wasting D&O policy

- ** Bar order entered at In re Jiangbo Pharmaceuticals, Inc.*, No. 13-15624-BKC-RBR (Bankr. S.D. Fla. December 8, 2014)

D&O/Insurance Bar Order Cases

- *In re Cordia Comm's Corp.*, Case No. 6-06493-BKC-KSJ (Bankr. M.D. Fla. Dec. 3, 2013)
  - Chapter 7 Trustee sought approval of settlement agreement with former directors and officers and insurance company
  - Terms of the settlement agreement included a bar order
  - The court approved the bar order and found that it was "fair and equitable" under the *Munford* test
  - Settlement funded wholly by a wasting D&O policy

D&O/Insurance Bar Order Cases

- *In re Comprehensive Clinical Dev., Inc.*, No. 13-17273-BKC-JKO (Bankr. S.D. Fla. Apr. 15, 2016)
  - Chapter 7 Trustee sought approval of settlement agreement with independent accounting and advisory firm
  - The terms of the settlement agreement included a bar order
  - The court approved the bar order, overruling objections of the debtor's former officers and directors, and found that it was "fair and equitable" under the *Munford* test

D&O/Insurance Bar Order Cases

- *In re Internal Fixation Sys., Inc.*, No. 12-39145-BKC-RAM (Bank. S.D. Fla. Dec. 12, 2014)
  - Chapter 7 Trustee sought approval of a settlement agreement with former directors and officers of the debtor and investors in the debtor who had a pending district court action at the time the bankruptcy case was filed
  - The terms of the settlement agreement included a bar order
  - The court approved the bar order and found that the bar order was "fair and equitable" under the *Munford* test
  - The court initially expressed concern over the scope of the bar order which would have barred claims of the debtor's investors not a party to the bankruptcy case or the district court case; however, the benefits of the settlement outweighed the fact those investors' claims would be barred, especially in light of the running of the statute of limitations on most claims and their lack of participation in either case
  - Settlement funded wholly by a wasting D&O policy

D&O/Insurance Bar Order Cases

- *In re GunnAllen Fin., Inc.*, 443 B.R. 908 (Bankr. M.D. Fla. 2011)
  - Liquidating agent sought approval of a settlement with one of the debtor's pre-petition liability insurers
  - Terms of the settlement agreement included a bar order that would permanently enjoin securities claimants from continuing their pending arbitration and litigation cases against the debtor's former registered representatives, officers, and directors
  - The court did not approve the settlement agreement because it was not "fair and equitable" since the harm imposed upon the securities claimants as a result of the bar order outweighed any benefit the settlement provided with respect to the proposed disposition of policy proceeds.

Challenges to Non-Debtor Releases/Bar Orders

- 11 U.S.C. 524(e)
- Jurisdictional issues
- Notice and due process
- Binding effect on individuals and entities not a party to the bankruptcy proceedings
- What circumstances constitute "rare" and "unusual"?
- What is "fair and equitable"?

Strategies for Settling with D&Os and Insurers

- Determine whether the insurance policy is a wasting policy, which they typically are, and policy limits
- Evaluating claims based on the merits, as opposed to policy limits
- Drafting a solid complaint and determining appropriate claims to include if seeking payment of a settlement from insurance proceeds
- Determining if pre-suit settlement is a possibility
- Effect of solvency of defendants
- Assignment of bad faith claims
- Properly presenting the settlement agreement to the court for approval