Hot Bankruptcy Topics Involving D&O and E&O Policies

Scott A. Wolfson, Moderator
Wolfson Bolton PLLC; Troy, Mich.

Marc J. Carmel
Paul Hastings LLP; Chicago

John C. Hoard
Rubin & Levin, P.C.; Indianapolis

Jason D. Horwitz
JLT Specialty Insurance Services Inc; Chicago

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Scott A. Wolfson, Wolfson Bolton PLLC

D&O Fiduciary Duties by Marc J. Carmel and Mike Lin

Marc Carmel is of counsel in the Chicago office of Paul Hastings LLP in the Corporate group with a focus in Restructuring and Bankruptcy law. Marc can be reached at marcarmel@paulhastings.com or (312) 499-6040. Mike Lin is an associate in the Palo Alto office of Paul Hastings LLP in the Corporate group. Additional information about the authors is available at www.paulhastings.com.

Introduction to Fiduciary Duties

- Directors and officers of a company owe obligations to the company as a result of their positions
- Specific obligations depend on state law and form of entity
- Generally
  - Duty of Care
  - Duty of Loyalty

Duty of Care and Duty of Loyalty

- Duty of Care - Obligation to:
  - Exercise the same degree of care that an ordinarily careful and prudent person would use in the same or similar circumstances,
  - While acting rationally,
  - After pursuing a deliberate investigation of all material information that is reasonably available at the time, and
  - Carefully considering the information and reasonable alternatives available at the time
- Duty of Loyalty - Obligation to:
  - Act in the best interests of the company without engaging in self-dealing and not acting for personal benefit

Other Duties

- Other duties are sometimes recognized, but they typically are incorporated into the Duty of Care or Duty of Loyalty
  - Duty of good faith
  - Duty to obey the law
  - Duty of oversight
  - Duty of disclosure
  - Others

Fiduciary Duties with Insolvent Corporation

- Generally, nature of fiduciary duties does not change as corporation approaches insolvency or becomes insolvent
  - At least in Delaware, but check state of organization for corporate entity because that is the relevant state law
  - Solvency/insolvency may, however, change which parties can sue for breaches of fiduciary duties
  - Note: fiduciary duty law continues to develop—inquiries are fact-intensive—and new cases continue to test boundaries

Parties Who Can Enforce Breaches of Fiduciary Duties

- Depends on if the corporation is solvent or insolvent
- If corporation solvent:
  - Corporation
  - Equity holders may seek derivative standing to sue directors and officers on behalf of corporation
- If corporation insolvent:
  - Corporation
  - Creditors may be able to seek derivative standing to sue directors and officers on behalf of corporation
- "Zone of Insolvency" - concept that fiduciary duties are affected as corporation approaches insolvency has mostly been abandoned by courts (at least in Delaware)

Tests to Determine if Corporation is Insolvent

- Generally, under Delaware law, a corporation is only solvent i it satisfies both of two tests:
  - "balance sheet" test and
  - "cash flow" test

Balance Sheet Test

- Corporation is solvent if the aggregate value of assets exceeds aggregate value of liabilities
  - Courts consider fair market value of assets, including the cost of liquidating assets
  - Liabilities calculated based on amount necessary to satisfy all liabilities, whether on- or off-balance sheet and whether matured, contingent, or unliquidated
    - Courts differ on how they account for contingent liabilities:
      - Some consider total potential exposure
      - Some calculate expected potential exposure factoring in probability of liability

Cash Flow Test

- Corporation is solvent if it is able to pay its debts as they come due
  - Courts consider proceeds generated from operations and the sale of assets, as well as potential capital raises
  - Courts are not consistent on the time frame the corporation has to have sufficient capital to satisfy test

Ways for D&Os to Limit Liability Based on Breaches of Fiduciary Duties

- Act in a manner that reduces likelihood that breaches of fiduciary duties occur
- Get the benefit of "business judgment rule"
- Ensure corporate formation documents have certain provisions (i.e., exculpation)
- Contract with other parties to satisfy claims for breaches of fiduciary duties (i.e., indemnification or D&O insurance)
- Negotiate for releases and injunctions

Act in a Manner that Reduces Breaches of Fiduciary Duties

- Request and review financial and legal information
- Consider all reasonably available alternatives
- Ask questions of management and advisors
- Avoid actual or constructive fraudulent transfers
- Disclose actual and potential conflicts to the Board and recus when appropriate
- Deliberate and be prepared to satisfy the "entire fairness" standard for transactions with insiders
- Maintain appropriate minutes of all meetings
- Seek advice from experienced advisors
- Communicate with constituencies

Business Judgment Rule

- Protects D&Os in decision-making process
- When the "business judgment rule" applies, a court will not second-guess actions of the board that are rational, as long as the directors:
  - Acted on an informed basis
  - Acted in the honest belief that the actions were taken in the best interest of the corporation
  - Did not have a personal interest in the transaction
- When the business judgment rule does not apply, must demonstrate "entire fairness" of action; fair process and fair result

Exculpation

- Prospectively limits the ability of parties to bring claims for breaches of fiduciary duties
- Exonerates or excuses, in advance, directors from civil liability for certain breaches of the duty of care
  - Note: Under Delaware law, exculpatory clause may not apply to officers
- While state law varies, an exculpatory clause generally does not offer protection against:
  - Claims for breaches of the duty of loyalty
  - Intentional misconduct
  - Knowing violations of law
  - Actions not taken in good faith
- See Appendix – Sample language for a Delaware Certificate of Incorporation

Contract with Others to Satisfy Claims for Breaches of Fiduciary Duties

- Indemnification by Corporation
  - Delaware law requires corporation to indemnify D&Os for expenses if D&O successful in defense
  - Delaware law permits corporation to indemnify D&Os for losses incurred as a result of position
  - Generally not apply if D&O failed to act in good faith or in manner in best interest of corporation
- Advancement of Defense Costs – incurred in connection with legal proceedings
- See Appendix – Sample language for a Delaware Certificate of Incorporation

Considerations for LLCs

- In Delaware and many other jurisdictions, fiduciary duties of members, managers, and officers of LLCs can be modified or waived to a much greater extent than for corporations
  - An LLC agreement may modify or even eliminate fiduciary duties (except for the duty to act in good faith)
  - See Appendix – Delaware Statute § 18-1101
- Special care should be taken when crafting such provisions, as they must be clear and unambiguous to be respected by a court
  - Important to seek advice from experienced counsel
  - Modifications of the fiduciary duties can take several different forms
  - See Appendix – Sample language for Delaware LLC Agreements
- As a general matter, in the absence of provisions to the contrary in LLC agreement, managers and officers likely owe duties to the LLC
  - Note: Delaware Supreme Court has not clearly spoken on this issue

Appendix

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Sample language for Delaware Certificate of Incorporation

Waiver of Liability. To the fullest extent permitted by the General Corporation Law of the State of Delaware, as the same exists or as may hereafter be amended, a director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director. No amendment to, modification of or repeal of this section shall apply to or have any effect on the liability or alleged liability of any director of the Corporation for or with respect to any acts or omissions of such director occurring prior to such amendment.

Indemnification. The Corporation shall indemnify to the fullest extent permitted by applicable law as it presently exists or may hereafter be amended, any person made or threatened to be made a party to an action or proceeding, whether criminal, civil, administrative or investigative, by reason of the fact that he or she or his or her testator or intestate was a director or officer of the Corporation or any predecessor of the Corporation, or serves or served at any other enterprise as a director or officer at the request of the Corporation or any predecessor to the Corporation, against all liability and loss suffered and expenses (including attorneys' fees) reasonably incurred by such person.

Delaware LLC Fiduciary Duty Statute

Under these Delaware state law provisions, the fiduciary duties of members, managers, and officers of LLCs can be modified or waived to a much greater extent than for corporations

§ 18-1101 Construction and application of chapter and limited liability company agreement.

(c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

Sample language for Delaware LLC Agreement

"Affiliate" of any particular Person means any other Person controlling, controlled by or under common control with such particular Person, where "control" means the possession, directly or indirectly, of the power to direct the management and policies of a Person whether through the ownership of voting securities, by contract or otherwise.

"Agreement" means this Limited Liability Company Agreement, as executed and as it may be amended, modified, supplemented or restated from time to time, as provided herein.

"Board" means the Board of Managers of the Company, which shall have the power and authority described in this Agreement.

"Covered Person" shall mean (i) each Member; (ii) each officer, director, stockholder, partner, member, Affiliate, employee, agent or representative of each Member, and each of their Affiliates; and (iii) each Officer, employee, agent or representative of the Company.

"Delaware Act" means the Delaware Limited Liability Company Act, 6 Del. L. § 18-101, et seq., as it may be amended from time to time, and any successor thereto.

"Member" means (a) [the members of the Company] and (b) each Person who is hereafter admitted as a Member in accordance with the terms of this Agreement and the Delaware Act. The Members shall constitute the "members" (as defined in the Delaware Act) of the Company.

"Manager" means a current member of the Board, who, for purposes of the Delaware Act, will be deemed a "manager" (as defined in the Delaware Act), but will be subject to the rights, obligations and limitations set forth in this Agreement.

"Officers" means each person designated as an officer of the Company to whom authority and duties have been delegated by the Board in accordance with this Agreement.

"Person" means an individual, a partnership, a corporation, a limited liability company, an association, a joint stock company, a trust, a joint venture, an unincorporated organization, association or other entity or a governmental entity.

Sample language for Delaware LLC Agreement

"Subsidiary" means, with respect to any Person, any corporation, limited liability company, partnership, association or business entity of which (i) if a corporation, a majority of the total voting power of shares of stock entitled (without regard to the occurrence of any contingency) to vote in the election of directors, managers or trustees thereof is at the time owned or controlled, directly or indirectly, by that Person or one or more of the other Subsidiaries of that Person or a combination thereof, or (ii) if a limited liability company, partnership, association or other business entity (other than a corporation), a majority of partnership or other similar ownership interests thereof is at the time owned or controlled, directly or indirectly, by any Person or one or more Subsidiaries of that Person or a combination thereof. For purposes hereof and without limitation, a Person or Persons shall be deemed to have a majority ownership interest in a limited liability company, partnership, association or other business entity (other than a corporation) if such Person or Persons shall be allocated a majority of limited liability company, partnership, association or other business entity gains or losses or shall be or control the manager, managing member, managing director (or a board comprised of any of the foregoing) or general partner of such limited liability company, partnership, association or other business entity. For purposes hereof, references to a "Subsidiary" of any Person shall be given effect only at such times that such Person has one or more Subsidiaries, and, unless otherwise indicated, the term "Subsidiary" refers to a Subsidiary of the Company.

Sample language for Delaware LLC Agreement

(1) No Duties. To the extent that, at law or in equity, a Member, Manager, or Officer in each case, in their capacity as such, has any duty (including any fiduciary duty) to the Company, a Member or any other Person that is party to or otherwise bound by this Agreement, all such duties are hereby eliminated, and each of the Company, Members and such other Persons hereby waives such duties (including any fiduciary duties), to the fullest extent permitted by the Delaware Act and all other applicable law. In addition, each of the Members and any other Person that is party to or otherwise bound by this Agreement acknowledges and agrees that (a) it shall not (and shall not assist any Person attempting to), directly or indirectly, derivatively or otherwise, make any claim with respect to or seek to enforce any duty (including any fiduciary duty) which any Person may have to any Subsidiary of the Company in their capacity as a director, manager, officer or equity holder of such Subsidiary and (b) the Company, acting directly or indirectly through its control of any Subsidiary, shall have the sole and exclusive right to make any such claim or seek any such enforcement.

(2) Waiver of Liability. No present or former Member, Manager or Officer or any of their respective Affiliates or any equity holder, partner, director, manager, officer, employees, agents or representatives of any of the foregoing shall be liable to the Company or any of its Subsidiaries or to any Member for any act or omission performed or omitted by such Member, Manager or Officer in their capacity as such; provided that (a) such limitation of liability shall not apply to the extent the act or omission was attributable to such Person's fraud, bad faith or knowing violation of law (in each case, as determined by a final judgment, order or decree of an arbitrator or a court of competent jurisdiction (which is not appealable or with respect to which the time for appeal therefrom has expired and no appeal has been perfected)) and (b) for the avoidance of doubt, such limitation of liability shall not apply with respect to any breaches of any representations, warranties or covenants by any such Person contained herein or in any other agreement with the Company or any of its Subsidiaries. With respect to any action taken or decision or determination made by any Manager, the Board or any Officer in their capacity as such, it shall be presumed that such Manager, the Board or such Officer acted in good faith and in compliance with this Agreement and the Delaware Act, and any Person bringing, pleading or prosecuting any claim with respect to any action taken or decision or determination made by any Manager, the Board or any Officer in their capacity as such shall have the burden of overcoming such presumption by clear and convincing evidence; provided that, for the avoidance of doubt, this sentence shall not be deemed to increase or place any duty (including any fiduciary duty) on any Manager, the Board or any Officer.

Sample language for Delaware LLC Agreement

(3) Indemnification. The Company hereby agrees to indemnify and hold harmless any Person (each an "Indemnified Person") to the fullest extent permitted under the Delaware Act, as the same now exists or may hereafter be amended, substituted or replaced (but, in the case of any such amendment, substitution or replacement only to the extent that such amendment, substitution or replacement permits the Company to provide broader indemnification rights than the Company is providing immediately prior to such amendment, substitution or replacement), against all proceedings, claims, actions, liabilities, losses, damages, costs or expenses (including reasonable attorney fees and expenses, judgments, fines, excise taxes or penalties) incurred or suffered by such Person by reason of the fact that such Person is or was a Member or is or was serving as a Manager or Officer of the Company or is or was serving at the request of the Company as a managing member, manager, officer, director, principal, member, employee, agent or representative of another Person; provided that no Indemnified Person shall be indemnified (a) with respect to proceedings, claims or actions (i) initiated or brought voluntarily by or on behalf of such Indemnified Person and not by way of defense or (ii) brought against such Indemnified Person in response to a proceeding, claim or action initiated or brought voluntarily by or on behalf of such Indemnified Person against the Company or any of its Subsidiaries, (b) for any amounts paid in settlement of an action effected without the prior written consent of the Company to such settlement, (c) to the extent such proceedings, claims, actions, liabilities, losses, damages, costs or expenses arise from such Person's fraud, bad faith or knowing violation of law as determined by a final judgment, order or decree of an arbitrator or a court of competent jurisdiction (which is not appealable or with respect to which the time for appeal therefrom has expired and no appeal has been perfected) or (d) for the avoidance of doubt, with respect to any present or former breaches of any representations, warranties or covenants by any such Person contained herein or in any other Contract with the Company or any of its Subsidiaries. Expenses, including reasonable attorneys' fees and expenses, incurred by any such Indemnified Person in defending a proceeding may be paid by the Company in advance of the final disposition of such proceeding, including any appeal therefrom, upon approval of the Board and receipt of an undertaking by or on behalf of such Indemnified Person (in form and substance acceptable to the Board) to repay such amount if it shall ultimately be determined that such Indemnified Person is not entitled to be indemnified by the Company. If this section or any portion hereof shall be invalidated on any ground by any court of competent jurisdiction, then the Company shall nevertheless indemnify and hold harmless each Indemnified Person pursuant to this section to the fullest extent permitted by any applicable portion of this section that shall not have been invalidated.

Sample language for Delaware LLC Agreement

(4) Exculpation of Covered Persons. No Covered Person shall be liable to the Company or any other Covered Person for any loss, damage or claim incurred by reason of any action taken or omitted to be taken by such Covered Person in good faith reliance on the provisions of this Agreement, so long as such action or omission does not constitute fraud, gross negligence, willful misconduct or a material breach of this Agreement by such Covered Person or is not made in knowing violation of the provisions of this Agreement. A Covered Person shall be fully protected in relying in good faith upon the records of the Company and upon such information, opinions, reports or statements of the following Persons or groups: (i) another Member; (ii) one or more Officers or employees of the Company; (iii) any attorney, independent accountant, appraiser or other expert or professional employed or engaged by or on behalf of the Company; or (iv) any other Person selected in good faith by or on behalf of the Company, in each case as to matters that such relying Person reasonably believes to be within such other Person's professional or expert competence. The preceding sentence shall in no way limit any Person's right to rely on information to the extent provided in § 18-406 of the Delaware Act.

D&O and E&O Overview

By Jason D. Horwitz, JLT Specialty Insurance Services, Inc.

D&O and E&O Overview

- Directors' & Officers' insurance protects directors, officers and the company against securities law violations, breach of fiduciary duty, fraud and similar claims
- Errors & Omissions insurance protects against claims arising out of allegations of negligent acts and errors or omissions in providing professional services to others.

D&O Program Construction

- Traditional D&O policies provide Side A, B & C coverage subject to an aggregate limit; i.e., limits are shared between the individual insureds and the company.
  - Side A provides personal asset protection by covering individual insureds when indemnification is not available or provided by the company.
  - Side B provides balance sheet protection by reimbursing the company for indemnification provided to the individual insureds.
  - Side C also provides balance sheet protection by covering a public company for securities claims. Side C coverage for private companies applies to all claims not expressly excluded.
  - Dedicated Side A limits are not shared with the company and cannot be eroded/exhausted by Side B and/or C claims.
  - Side A Difference in Condition (DIC) policies can "drop down" when the underlying Side A coverage is more restrictive or the underlying Side A insurer does not pay the loss.

D&O Coverage Overview

- "Claim" is broadly defined and generally includes any written demand for monetary or non-monetary damages.
- Claims generally include allegations of:
  - Breach of fiduciary duty
  - Fraud
  - Illegal personal profit
  - Improper disclosures
  - Securities law violations
- Who is covered?
  - Directors and officers
  - For a public company, employees in a securities claim and/or as a co-defendant with a director or officer; for a private company, employees for all covered claims
  - The company, including subsidiaries (>50% owned)
  - Other individuals or entities scheduled via endorsement

Typical D&O Exclusions

- Finally adjudicated fraud or illegal personal profit.
- Matters noticed to prior D&O insurance programs.
- Claims not noticed in accordance with the program's reporting requirements.
- Matters covered under other types of insurance (e.g. pollution, property damage, bodily injury, etc.).

D&O Claims Reporting

- Policies are generally written on a claims made and reported basis, meaning that all claims must be noticed during the policy term in which they are first received by the company.
- The program in place at the time the claim is made provides coverage; even if the alleged wrongful act predated the program inception date.

Considerations for D&O Policies Pre-Bankruptcy Filing

- The primary purpose of D&O policies is to protect the personal assets of the company's directors and officers.
- Because of the automatic stay, the directors and officers often become prime targets for unhappy shareholders and creditors.
- D&O insurance policies are not standardized from a language perspective. Significant amendments are needed to shift contractual leverage from the insurer to the insured and to allow the insurance to respond as intended in a claim scenario.
- Distressed situations and bankruptcy put additional stress on D&O insurance coverage and increase the personal asset exposure because:
  - Uncertainty around the company's ability to provide indemnification to individuals,
  - Unique claim scenarios that may not be contemplated by an "off the shelf" policy, and
  - Additional bankruptcy-specific parties, such as trustees, receivers and official committees.

Common Issues for an Improperly Drafted D&O Policy

- Poor Representations and/or Severability language
- Overly broad exclusions (Conduct, Insured v. Insured, Prior Notice, Prior Acts, E&O, etc.)
- Policy not tailored to company (organizational structure, interim management, etc.)
- Not follow-form excess policy language

D&O Options Pre-Bankruptcy Filing

- Contact a broker who understands bankruptcy and can work with restructuring counsel to fix coverage deficiencies and eliminate distressed-specific issues.
- Extend the policy through the bankruptcy case.
- Purchase a tail (also known as run-off or extended reporting period).
- Additional options depending on the company and its risk profile:
  - Convert Side B & C limits to Side A
  - Add a dedicated Side A policy with a DIC feature

D&O Tail

- The tail extends the reporting period for claims occurring during the term of the underlying D&O policy.
- A tail can generally be purchased for any length of time, but a 6-year tail covers all applicable statutes of limitations.
- Tails are non-cancellable.

D&O Options During the Bankruptcy Case

- The D&O policy will continue until its expiration date (assuming premiums are paid).
- If the policy expires during the bankruptcy case, a debtor can renew.
  - The debtor may need Bankruptcy Court approval to renew, and often will file a first day motion seeking authority to renew insurance policies in the ordinary course of business
- A debtor can purchase a tail postpetition, but will likely need Bankruptcy Court approval.

Insurance Options Post-Effective Date

- A Debtor can purchase a tail as of the Effective Date without Bankruptcy Court approval if the confirmed plan authorizes it.
- If a liquidating, litigation or distribution trust is created or a plan administrator is appointed (or in the event of a chapter 7 or 11 trustee), an E&O policy can be placed to protect the trustee during the term of the engagement and a tail can be added to cover any statute of limitations period.

D&O Claims Trends

- Recently there have been massive shareholder derivative settlements.
  - Historically, settlements typically included governance reforms and the payment of plaintiffs' attorneys' fees.
  - In 2013, News Corp. settled for $139M.
  - In 2014, Activision Blizzard, Inc. settled for $275M and Freeport-McMoRan, Inc. settled for $137.5M, much of it purportedly paid by D&O insurance carriers.
- Securities class action filings rose slightly in 2014, with 170 new federal actions compared to 166 in 2013.
  - The number of filings in 2014 remains below the annual average of 177 recorded between 2004 and 2014, and substantially below the average of 189 recorded between 1997 and 2013.

D&O Claims Trends, Cont.

- Cyber security generates a unique and growing D&O exposure.
  - The allegation could be that the board and executives "knew or should have known that the company had failed to meet industry standards with its security systems and left its technologies unreasonably vulnerable rendering its customers a target of attacks by nefarious third parties."
  - A D&O program, if properly negotiated, should protect individuals for derivative litigation arising out of a cyber breach.
- The increase in U.S. IPO activity is likely to draw an increase in IPO-related securities litigation.
  - IPO companies tend to be attractive targets by the plaintiffs' bar given the lower standard of liability under Section 11 (no showing of reliance is needed), a lack of experience complying with reporting requirements and their short trading history typically feeds volatility in reaction to news.

Chapter 7: Trustee's Rights Against Directors & Officers

By:
John C. Hoard, Rubin & Levin, PC
Elizabeth M. Lally, Rubin & Levin, PC

The Treatment of D&O Insurance in Bankruptcy

- D&O Insurance protects directors, individually, and the corporation against losses for claims arising out of the directors' corporate duties, including claims for breach of fiduciary duties and other derivate claims brought on behalf of the corporation in order to redress damage to the enterprise as a whole, or by a shareholder directly.
- The treatment of a D&O policy within the context of bankruptcy depends on many factors, including:
  - the type of policy at issue, and
  - the jurisdiction in which the case is filed.

D&O Insurance in Bankruptcy "Property of the Estate?"

- Is the D&O Insurance "Property of the Estate?"
  - The bankruptcy estate is broadly defined as including "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a).
  - "Numerous courts have determined that a debtor's insurance policies are property of the estate, subject to the bankruptcy court's jurisdiction." *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 92 (2d Cir. 1988), *cert. denied*, 488 U.S. 868 (1988).

D&O Insurance in Bankruptcy "Property of the Estate?"

- Is the D&O Insurance "Property of the Estate?"
  - An insurance contract may contain a provision that purports to terminate the policy if the insured becomes subject to a reorganization proceeding.
  - These provisions are void under § 541(c)(1)(B) of the Bankruptcy Code, which provides, in part:

    (c) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—

    (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

D&O Insurance in Bankruptcy "Property of the Estate?"

- Is the D&O Insurance "Property of the Estate?"
  - Whether insurance proceeds constitute estate property turns on (1) the language and scope of the specific policies at issue, and (2) the particular facts of each case.
    - "In making its determination, the court must analyze the facts of each particular case, focusing primarily upon the terms of the actual policy itself." *In re Medex Reg'l Labs., LLC*, 314 B.R. 716, 720 (Bankr. E.D. Tenn. 2004)
    - "Whether the proceeds of a D & O liability insurance policy is property of the estate must be analyzed in light of the facts of each case." *In re CyberMedica, Inc*., 280 B.R. 12, 16 (Bankr. D. Mass. 2002)

D&O Insurance in Bankruptcy Access to Coverage

- If proceeds from D&O Insurance are considered property of the estate, **Section 362(a)'s automatic stay will prevent a director or officer from accessing coverage** or receiving indemnification outside of the general bankruptcy claims allowance process.
- Many jurisdictions have adopted a three-prong test to determine whether to grant relief from the stay pursuant to 11 U.S.C. § 362(d):
  - whether any great prejudice to either the bankrupt estate or the debtor will result from a lifting of the stay;
  - whether the hardship to the non-bankrupt party by maintenance of the stay considerably outweighs the hardship to the debtor; and
  - the probability of the creditor prevailing on the merits.

  In re Downey Fin. Corp., 428 B.R. 595, 609 (Bankr. D. Del. 2010)

D&O Insurance in Bankruptcy Access to Coverage

- *In Downey Financial* two proceedings were initiated against the debtor prior to its bankruptcy.
  - The first case was a consolidated securities class action filed against the debtor and certain directors and officers.
  - The second case was a consolidated shareholder derivative action filed against the directors and officers (with the debtor as a nominal defendant).
- Due to the overlap between the two actions, the parties agreed to stay the derivative action until motions to dismiss in the securities action could be decided.
- The debtor then filed for Chapter 7 protection, and the Chapter 7 Trustee was substituted for the debtor in the derivative action.

D&O Insurance in Bankruptcy Access to Coverage

- *In re Downey Financial:*
  - Eleven (11) former officers and directors of the debtor sought permission from the bankruptcy court to access proceeds from the debtor's D&O Insurance policy to fund their defense of both the securities action and the derivative action.
  - In May 2010, the bankruptcy court entered its decision in favor of the directors and officers, **holding that the proceeds of the Policy were not property of the estate, were not subject to the automatic stay and thus, were available to the directors and officers**.

D&O Insurance in Bankruptcy Access to Coverage

- *In re Downey Financial:*
  - The court considered:
    - the specific language of the Policy,
    - the anticipated coverage profile of the debtor,
    - how its determination regarding the status of the proceeds would impact the bankruptcy estate, and
    - the potential harm to the officers and directors.

D&O Insurance in Bankruptcy Access to Coverage

- The specific language of the D&O policy & the anticipated coverage profile of the debtor
  - In deciding whether the D&O policy proceeds are subject to the stay, courts look to whether the policy only provides coverage to directors and officers (Side A coverage), or
  - Whether it also provides coverage to the debtor corporation (Side B coverage or Side C coverage).
    - If Side A coverage, the proceeds are not considered property of the estate.
    - If Side B or Side C coverage, the result can turn on the specific facts unique to the case.
      - *See In re Mila*, 423 B.R. 537, 543 (9th Cir. BAP 2010).

Chapter 7: Trustee's Rights Against Directors & Officers

- From 2007 through 2011, four hundred twelve (412) United States banking institutions failed.
- The FDIC authorized suits in connection with thirty-seven (37) of those failed institutions against 340 individuals for D&O liability.
- Of those suits, sixteen (16) D&O lawsuits were filed by the FDIC, naming 124 former directors and officers.

Case Study: Irwin Financial Corporation

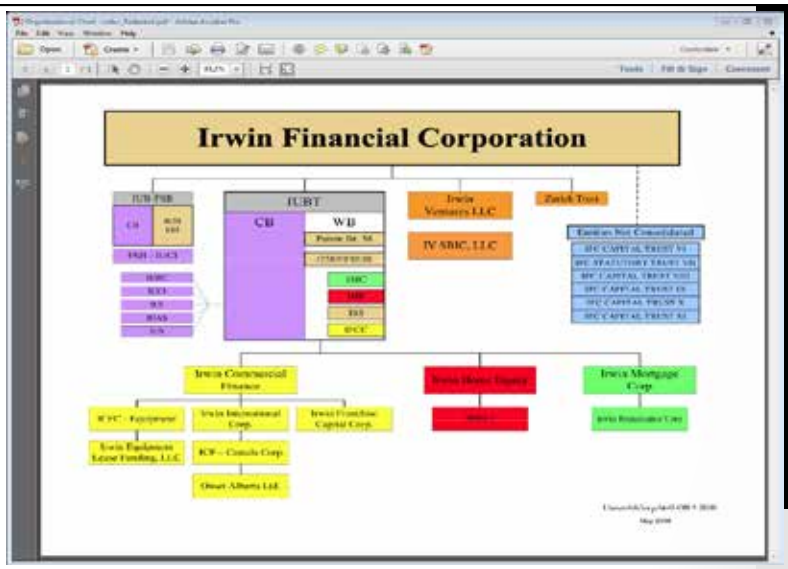
- Until its demise in September 2009, Irwin Financial Corporation ("IFC") was a public company, organized under the laws of the State of Indiana, that, among other things, functioned as a holding company for two banks: Irwin Union Bank and Trust Company, and Irwin Union Federal Savings Bank (the "Banks").

Case Study: Background

- IFC was formed as a bank holding company in 1972, at which time IUBT became a wholly-owned subsidiary of IFC
- IUBT was an Indiana state-chartered bank that was formed in 1871.
  - In 1997, IUBT became a state member bank of the Federal Reserve System.
  - At the time it became a state member bank, IUBT was operating as a community bank conducting commercial lending activities in three states.

Case Study: Background

- In the 1990s, IFC and its direct and indirect subsidiaries began the transition from a community banking operation to a large complex, nationwide banking enterprise.
- In 2000, IUB FSB was formed as a wholly-owned subsidiary of IFC to expand IUBT's existing commercial banking activities.
- During 2001 and 2002, the IFC Enterprise underwent a corporate reorganization.
  - IUBT acquired subsidiaries headquartered and conducting lending business in California, Washington, New York, Indiana, and Canada, which became indirect subsidiaries of IFC.



Case Study:
Background

- In connection with its corporate reorganization, the IFC Enterprise pursued an aggressive growth strategy that involved originating a large volume of real estate loans.

Case Study: Bankruptcy

- On September 18, 2009
  - IUBFSB was closed by the Office of Thrift Supervision and the Federal Deposit Insurance Corporation was appointed Receiver for IUBFSB.
  - IUBT was closed by the Indiana Department of Financial Institutions, and the FDIC was appointed Receiver of IUBT also.
  - IFC, filed for Chapter 7 protection
    - Trustee was appointed, and, thereafter, gave notice to insurance carriers of potential claims

Case Study: Debtor's Directors and Officers Liability

- On November 24, 2009, the Trustee put the Debtor's insurance carrier on notice of potential claims against the Debtor's former managers, officers and directors, pursuant to the Debtor's D&O Liability Policy.

Case Study:
Debtor's Directors and Officers Liability

- Specifically, the Trustee demanded payment for damages caused by breaches of fiduciary duties of care and loyalty to IFC, pursuant to:
  - Indiana Code sections 23-1-35-1(a) and 23-1-35-2; and
  - Section 10(b)(5) and 20(a) of the Securities and Exchange Act of 1934.

Irwin Financial Corporation
D&O Complaint

- In September 2011, the Trustee filed his Complaint against Defendants, William I. Miller, Gregory F. Ehlinger, and Thomas D. Washburn in the Untied States District Court for the Southern District of Indiana, Indianapolis Division, Case No. 1:11-CV-1264.

Case Study:
Debtor's Directors and Officers Liability

- The Complaint alleged seven Counts against IFC's former Officers:
  - Count I: Breach of their duty of care & loyalty, via a failure to cause IFC to implement and maintain an effective, integrated enterprise-wide risk management system;
  - Count II: Breach of their duty of care & loyalty, via a failure to Develop Non-Volatile Sources of Liquidity to Sustain the Enterprise in the Event of an Interruption of Demand in the Secondary Market for Real Estate Loan;
  - Count III: Breach of their duty of care, via a failure to timely implement effective internal controls and to keep the Board adequately informed;
  - Count IV: Breach of their duty of care, via a failure to keep the Board adequately informed regarding market risk associated with IHE's mortgage servicing rights.

Case Study:
Debtor's Directors and Officers Liability

- The Complaint alleged seven Counts against IFC's former Officers:
  - Count V: Breach of their duty of care & loyalty, via the failure to protect and preserve the value of IFC's interests in its subsidiaries;
  - Count VI: Breach of duty of care, via the incurrence of unnecessary expenses; and
  - Count VII: Breach of duty of loyalty, via the dissipation of IFC's cash.
  - In addition to the other damages, these failures caused IFC to lose more than $572 million dollars.

Case Study:
Motion to Dismiss Trustee's D&O Complaint
District Court

- On December 7, 2011, the Defendants filed their Motion to Dismiss the Trustee's Complaint and Memorandum in Support of their Motion to Dismiss pursuant to Fed. R. Civ. P. 12(b)(6).

Case Study:
Motion to Dismiss Trustee's D&O Complaint
District Court

- Defendants argued, in part, that the Trustee's claims were subject to dismissal for the following reasons:
  - The Trustee lacked standing to bring derivative claims related to the Banks.
  - Pursuant to the Financial Institutions Reform, Recovery, and Enforcement Act (12 U.S.C. §1821) ("FIRREA"), those claims belonged exclusively to the FDIC and are therefore subject to dismissal.

Case Study:
Motion to Dismiss Trustee's D&O Complaint
District Court

- Defendants argued, in part, that the Trustee's claims were subject to dismissal for the following reasons:
  - The Trustee failed to demonstrate a plausible right to relief in any of the Counts in the Complaint under the pleading standards set forth in Bell Atl. Corp. v. Twombly, 127 S. Ct. 1955, 1964-65 (2007), and Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949-50 (2009).

Case Study:
Motion to Dismiss Trustee's D&O Complaint
District Court

- Specifically, the Trustee failed, pursuant to Twombly & Iqbal:
  - To allege sufficient facts to support his claims that the IFC board was uninformed or misinformed;
  - To establish a plausible claim for relief on his theory that the IFC business model created an actionable wrong;
  - To establish a plausible claim for relief that the hiring of "expert" was an actionable wrong; and
  - To establish a plausible claim for relief that Defendants' activities aimed at keeping the IFC subsidiaries solvent was an actionable wrong.

Case Study:
Motion to Dismiss Trustee's D&O Complaint
District Court

- Finally, the Defendants argued that the Trustee's assertion that the Defendants did not act timely in implementing an enterprise-wide risk management system was barred by the statute of limitations.

Case Study:
Motion to Dismiss Trustee's D&O Complaint
District Court

- In February 2012, the Trustee filed his Amended Response in Opposition to the Defendants' Motion to Dismiss.
  - The Trustee argued, in part, that:
    - The claims asserted against the Defendant were direct, and not derivative;

Case Study:
Motion to Dismiss Trustee's D&O Complaint
District Court

- The Trustee's claims were quintessential direct claims on behalf of a corporation against that corporation's former officers for breach of their fiduciary duties:
  - When IFC became a debtor in Chapter 7, these direct claims became property of IFC's estate.
  - Pursuant to 11 U.S.C. § 541(a)(1), property of a debtor's estate includes all legal or equitable interests of the debtor in property as of the commencement of the bankruptcy case.
  - The legal and equitable interests of the debtor that become property of the estate under Section 541(a)(1) of the Bankruptcy Code include causes of action. *Official Comm. Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 356 (3d Cir. 2001).
  - The Trustee's claims are not derivative claims that belong to the FDIC under FIRREA (12 U.S.C. § 1821(d)(2)(A)(i)) "where the Trustee is suing to vindicate the rights of the Holding Company against its own officers, FIRREA is not invoked." *Lubin v. Skow*, 382 F. App'x 866, 872 n.9 (11th Cir. 2010) (emphasis added).

Case Study:
Motion to Dismiss Trustee's D&O Complaint
District Court

- On September 27, 2012, the District Court issued an Order granting the motions to dismiss filed by the Defendants and the FDIC-R and dismissing the Complaint filed by the Trustee with prejudice pursuant to a judgment entered in favor of the Defendants and against the Trustee.
- On October 26, 2012, the Trustee filed his Notice of Appeal from the Judgment and the Order

Case Study:
7th Circuit Court of Appeals

- The issues on appeal before the Seventh Circuit Court of Appeals were:
  - Whether the Trustee had standing to assert claims against IFC's former officers for injuries suffered solely by the holding company as a result of breaches by its former officers of fiduciary duties owed directly to the holding company; and
  - Whether the Trustee had standing to assert breach of fiduciary duty claims directly against IFC's former officers for their failures to protect and preserve the holding company's interests in its subsidiaries.

Irwin Financial Corporation
7th Circuit Court of Appeals

- On August 14, 2014, the Seventh Circuit Court of Appeals issued its Decision and Final Judgement:
  - The Court of Appeals affirmed the District Court with respect to Counts I, II, IV, and V of the Trustee's Complaint, which alleged that the Officers violated their fiduciary duties to IFC by not implementing additional financial controls that would have protected IFC from the Officers' errors in their roles as directors and managers of the Banks.

Irwin Financial Corporation
7th Circuit Court of Appeals

- On August 14, 2014, the Seventh Circuit Court of Appeals issued its Decision and Final Judgement:
  - The Court of Appeals vacated the District Court with respect to Count III and VII of the Complaint, which counts alleged that:
    - The Officers allowed IFC to pay dividends (or, equivalently, repurchase stock) in amounts that left it short of capital when the financial crunch arrived;
    - Two of the Managers breached their duties of care and loyalty when in the first half of 2009 they "capitulated" to the FDIC and caused IFC to contribute millions of dollars in new capital to the Banks.

Irwin Financial Corporation
7th Circuit Court of Appeals

COUNT	ALLEGATION	DISPOSITION
I	Failure to cause IFC to implement and maintain an enterprise-wide risk management system	Derivative claim, dismissed
II	Failure to Develop Non-Volatile Sources of Liquidity to Sustain the Enterprise	Derivative claim, dismissed
III	Failure to timely implement effective internal controls and to keep the Board adequately informed	Direct claim, reinstated
IV	Failure to keep the Board adequately informed regarding market risk associated IHE's mortgage servicing rights	Derivative claim, dismissed
V	Failure to protect and preserve the value of IFC's interests in its subsidiaries	Derivative claim, dismissed
VI	The incurrence of unnecessary expenses	Derivative claim, dismissed
VII	The dissipation of IFC's cash	Direct claim, reinstated