AMERICAN BANKRUPTCY INSTITUTE

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Commercial Track

Officer and Director Issues in Bankruptcy Cases

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CONCURRENT SESSION

2017

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Preservation of Claims and Rights

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Officer and Director Issues in Bankruptcy Cases

Preservation of Claims and Rights

A. Preserve claims for the benefit of the estate.

a. "[A] plan may...provide for...the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any...claim or interest." 11 U.S.C. §1123(b)(3)(B).

i. *Browning v. Levy*, 283 F.3d 761 (6th Cir. 2002) - A general reservation of rights does not suffice to avoid res judicata. The *Browning* court made clear that it was necessary to identify both the defendant, and the factual basis for the claim in the Chapter 11 plan in order to survive a *res judicata* challenge.

ii. Other courts hold that a sweeping, boilerplate reservation of claims is sufficient to escape res judicata. *See*, *e.g.*, *JP Morgan Trust Co. v. Mid-America Pipeline Co*., 413 F.Supp.2d 1244 (D. Kan. 2006); *Fleet Nat'l Bank v. Gray* (*In re Bankvest Capital Corp.*), 375 F.3d 51 (1st Cir. 2004).

b. Notice.

i. Claims made policy – covers **claims** that are made under the policy during the policy period.

1. A claims made policy does not provide coverage for claims made after the policy period expires, unless notice of a potential claim was provided prior to the lapse date, and the policy provides that notice will preserve the insured's coverage for claims that may later ensue.

ii. Occurrence – insures covered claims that arise from **occurrences** that happen during the policy period.

iii. D&O policies typically require that the policyholder must give written notice to the insurer of a claim as soon as practicable, and sometimes no later than a specified date.

iv. Courts strictly construe compliance with the notice requirement. *See, e.g.*, *Federal Insurance Co. v. CompUSA, Inc.*, 319 F.3d 746 (5th Cir. 2003) ("the notice provision must be enforced as written. The court therefore rejects defendants' reliance on actual notice not given in the manner the Policy required")

B. Property of the estate issues.

a. It is well-settled that the D&O insurance *policies* are property of the estate. Less clear is whether the *proceeds* are also property of the estate. *Allied Digital Techs. Corp.*, 306 B.R. 505, 509 (Bankr. D. Del. 2004) ("Generally a debtor's liability insurance policy is property of the bankruptcy estate. . . However, the courts are in disagreement over whether the proceeds of a liability insurance policy are property of the estate").

i. Whether the proceeds are 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).

b. Individual liability coverage for directors and officers.

i. "Although a debtor's liability insurance is considered property of the estate. . . when a policy covers the directors and officers exclusively, 'courts have generally held that the proceeds are not property of the estate.'" *Deangelis v. Corzine*, 151 F.Supp.3d 356 (S.D. N.Y. 2015).

c. Indemnity coverage for the corporation itself.

i. "When an insurance policy only provides direct coverage to a debtor, courts generally rule that the proceeds are property of the estate." *In re MF Global Holdings Ltd*., 469 B.R. 177 (S.D. N.Y. 2012)

d. "In cases where liability insurance policies provide direct coverage to both directors and officers and debtors, courts have held that '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." *In re MF Global Holdings Ltd.*, 469 B.R. 177 (S.D. N.Y. 2012).

i. The First Circuit has held that, broadly, proceeds are also property of the estate. *In re Allied Digital Techs. Corp.*, 306 B.R. 505 (Bankr. D. Del. 2004) ("This Court adopts the logic of the cases holding that D&O insurance proceeds are property of the estate.")

C. Motions for Relief from Stay.

a. Even when proceeds are considered part of the estate, and thus subject to the automatic stay, stay relief is routinely granted for the purpose of funding individual defense costs.

i. The First, Second, Third, and Seventh Circuits have all explicitly discussed this issue and used similar language in allowing stay relief to fund a defense.

1. "[The Directors/Officers] may suffer substantial and irreparable harm if prevented from exercising their rights to defense payments. . . . [They] are in need now of their contractual right to payment of defense costs and may be harmed if disbursements are not presently made. . . . the harm to the Debtor if relief from stay is granted is speculative." *In re CyberMedica Inc*., 280 B.R. 12 (D. Mass. 2002).

2. "The underlying issue in this case is whether MFG Assurance and U.S. Specialty may currently reimburse or advance defense costs for the Individual Insureds. . . Courts in this Circuit and other jurisdictions have permitted the advancement of defense costs to a debtor's directors or officers even though the insurance policies provided direct coverage to the debtor. . . At this time, the Individual Insureds' need far outweighs the Debtors' hypothetical or speculative need for coverage. . . failure to do so would significantly injure the Individual Insureds, whose defense costs are covered by the Specialty Policies." *In re MF Global Holdings, Ltd.*, 469 B.R. 177 (S.D. Ny. 2012).

D. Payment of defense costs from a wasting policy.

   a. Courts may fashion conditions to the stay relief when funding defense costs from a wasting policy.

      i. *In re Licking River Mining*, Case No. 14-10201 (E.D. Ky. Bankr., June 6, 2016) *("*"At this time and given the limited relief granted, the Court will not allow the Trustee, who is the plaintiff, to review the Movants' defense costs but will require Movants to file reports of the amount and date of disbursements.").

      ii. *In re Arter & Hadden, L.L.P.*, 335 B.R. 666 (Bankr. N.D. Oh. 2005) ("The Court finds that the payment of attorney's fees is subject to approval of an application for compensation or reimbursement, as provided by Federal Rule of Bankruptcy Procedure 2016").

	Are D&O insurance policies property of the estate?	Motions to terminate the automatic stay for payment of defense costs from a wasting policy
1st Circuit	***In re CyberMedica, Inc.,* 280 B.R. 12 (D.Mass.2002)** ("This Court adopts the logic of the cases holding that D & O insurance proceeds are property of the estate. There is a fundamental test that has been used in determining whether or not property belongs to the estate and that test is whether 'the debtor's estate is worth more with them then without them' . . . This Court finds that the D & O Policy is of benefit to the estate since the estate is worth more with it than without it. . . .and is therefore part of the bankruptcy estate.")	***In re CyberMedica Inc.* , 280 B.R. 12 (D. Mass. 2002)** ("This Court further finds that there is cause to lift the automatic stay because Dr. Hotchkiss and Mr. Vilar may suffer substantial and irreparable harm if prevented from exercising their rights to defense payments. Dr. Hotchkiss and Mr. Vilar are in need now of their contractual right to payment of defense costs and may be harmed if disbursements are not presently made to fund their defense of the Trustee's Complaint. Additionally, the harm to the Debtor if relief from stay is granted is speculative given the fact that there are presently no claims for indemnification nor entity coverage, therefore, there does not appear to be an immediate risk of the D & O Policy's two million dollars being depleted. . . Although the Trustee argues that there will be indemnification claims, the Debtor will not be harmed because the claims now being paid for defense costs are among the claims for which the Debtor is ultimately obligated to indemnify the directors and officers.")
2nd Circuit	***In re MF Global Holdings Ltd.* , 469 B.R. 177 (S.D.Ny.2012)** ("First, it is well-settled that a debtor's liability insurance is considered property of the estate. 'However, the courts are in disagreement over whether the proceeds of a liability insurance policy are property of the estate.' . . . When an insurance policy only provides direct coverage to a debtor, courts generally rule that the proceeds are property of the estate. . . However, when an insurance policy provides exclusive coverage to directors and officers, courts have generally held that the proceeds are not property of the estate. . . Here, the issue is more complicated. . . In cases where liability insurance policies provide direct coverage to both directors and officers and debtors, courts have held that '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.'"); ***Deangelis v. Corzine*** , 151 F.Supp.3d 356 (S.D.Ny.2015) ("Although a debtor's liability insurance is considered property of the estate. . . when a policy covers the directors and officers exclusively, 'courts have generally held that the proceeds are not property of the estate.'").	***In re MF Global Holdings, Ltd.* , 469 B.R. 177 (S.D. Ny. 2012)** ("The underlying issue in this case is whether MFG Assurance and U.S. Specialty may currently reimburse or advance defense costs for the Individual Insureds. . . if the policy proceeds are property of the Debtors' estates, then the Court must decide whether to lift the automatic stay. . . Courts in this Circuit and other jurisdictions have permitted the advancement of defense costs to a debtor's directors or officers even though the insurance policies provided direct coverage to the debtor. . . the Specialty Policies provide coverage to the Individual Insureds who have a present need for payment of their defense costs. At this time, the Individual Insureds' need far outweighs the Debtors' hypothetical or speculative need for coverage. . . failure to do so would significantly injure the Individual Insureds, whose defense costs are covered by the Specialty Policies.")
3rd Circuit	**In re World Health Alternatives, Inc., 369 B.R. 805 (D.Del.2007)** ("When insurance policy purchased by debtor provides coverage only to its directors and officers, courts will generally rule that policy proceeds, as opposed to policy itself, are not included in "property of the estate"); **In re Uni-Marts, LLC, 405 B.R. 113 (D.Del.2009)** ("The proceeds of said policy may not actually be part of the estate. . . 'the question of whether the proceeds are property of the estate must be analyzed in light of the facts of each case.'. . . Given the relatively modest size of the potential recovery in this adversary proceeding in relation to the limits on the Debtor's D & O policy. . . it is difficult to see how the Debtor would sustain any loss, much less one that would materially impair its reorganization").	***In re Downey Financial Corp.* , 428 B.R. 595 (D. Del. 2010)** ("Even if the Policy proceeds were property of the estate cause exists to lift the automatic stay to allow the Insureds to access the Policy proceeds . . . As discussed above, lifting the stay would likely not cause any hardship to the Debtor. By contrast, the Insureds would suffer a very real—and easily identifiable—hardship if the stay is not lifted"); ***In re Allied Digital Technologies Corp.* , 306 B.R. 505 (D. Del. 2004)** ("Without funding, the Individual Defendants will be prevented from conducting a meaningful defense to the Trustee's claims and may suffer substantial and irreparable harm. The directors and officers bargained for this coverage. . . Even if they were property of the estate, the Individual Defendants have shown cause for stay relief").
4th Circuit	-	-
5th Circuit	***In re Equinox Oil Co., Inc.,* 300 F.3d 614 (5th Cir. 2002)** ("An insurance policy owned by the debtor is generally considered property of the estate. *In re: Edgeworth* , 993 F.2d 51, 55 & n. 13. But, whether the proceeds of a particular insurance policy is property of the estate depends on the nature of the policy"); ***Matter of Edgeworth* , 993 F.2d 51 (5th Cir. 1993)** ("Insurance policies are property of the estate because, regardless of who the insured is, the debtor retains certain contract rights under the policy itself. Any rights the debtor has against the insurer, whether contractual or otherwise, become property of the estate"); **In re Louisiana, 832 F.2d 1391 (5th Cir. 1987)** ("On the merits, we hold that it was not error to dismiss the complaint because the proceeds of the liability coverage afforded the LWE directors and officers are not property of the LWE bankruptcy estate";	-
6th Circuit	-	***In re Arter & Hadden, L.L.P.* , 335 B.R. 666 (Bankr. N.D. Oh. 2005)** ("The Court finds that the payment of attorney's fees is subject to approval of an application for compensation or reimbursement, as provided by Federal Rule of Bankruptcy Procedure 2016").

	Are D&O insurance policies property of the estate?	Motions to terminate the automatic stay for payment of defense costs from a wasting policy
7th Circuit	***In re Pasquinelli Homebuilding, LLC* , 463 B.R. 468 (N.D.Il.2012)** ("Turning to the D & O Policy herein, the language indicates that direct coverage is provided to Pasquinelli in addition to the Individual Insureds. . . The D & O Policy at issue herein, however, contains no such explicit language affording priority. Rather, the Order of Payment provision provides that in the event of a Loss from any claim covered under the Policy where the loss in the aggregate exceeds the remaining available Limit of Liability of this policy, the Insurer must first pay for coverage provided under Coverage A of the Policy, which in this case, would be for the Pasquinelli Insureds. . . Any remaining amount of the Limit of Liability available after the payment of a loss respecting the Directors and Officers, the Insurer would pay for any Loss for which coverage is provided by Coverage B of the D & O Policy, the source of the Debtor's coverage. . . Accordingly, the Court finds that the Debtor's interest is sufficient to bring the D & O Policy proceeds into the Estate").	***In re CHS Electronics, Inc.* , 261 B.R. 538 (S.D. Fl. 2001)** ("In conclusion, the Proceeds which Cooper seeks to protect to satisfy his claims if he obtains a judgment against the officers and directors are not property of the estate. To the extent that a relatively small portion of those Proceeds subject to the indemnification claims are property of the estate, the Court, for cause, grants stay relief to the Lead Plaintiffs. The Lead Plaintiffs may proceed with their efforts to obtain approval of the Settlement and the funding of the Settlement from the Proceeds").
8th Circuit	***In re Petters Co., Inc.* , 419 B.R. 369 (D.Minn.2009)** ("The status as property of the bankruptcy estates of the funds to be paid on account of claims made under the D & O policies is determined by two factors: the identity of the claimant-recipient, and the status under which the claimant-recipient will assert a claim under the policies: (a) As to any director, officer, or other Insured Person, including Tom Petters, any funds to be advanced to them on account of claims made for a covered Loss personal to them, including their own Defense Expenses, is not property of the bankruptcy estates of PCI or PGW; and (b) As to PCI or PGW as claimants, any funds to be advanced to them on account of claims made for their own covered Losses, including their own Defense Expenses, and any funds to be advanced to them as reimbursement for any expenditure they make in indemnifying any of their own Insured Persons against any covered Loss, are and will be property of their respective bankruptcy estates, upon the fixing of their rights to actually receive such payment(s). . . 'When [a D & O] insurance policy provides coverage only to the debtor, courts will generally rule that proceeds are property of the estate.... On the other hand, when a policy provides coverage only to directors and officers, courts will generally rule that the proceeds are not property of the estate.' (citing *In re World Health ALternatives, Inc.* , 369 B.R. 805 (Bankr.D.Del.2007).	-
11th Circuit	***In re Laminate Kingdom, LLC*, 21 Fla. L. Weekly Fed. B. 262 (S.D.Fl.2008)** ("Typically, the proceeds of a directors and officers liability insurance policy are not considered property of a bankruptcy estate. . . However, the foregoing cases are distinguishable from the instant case because in all of the cases cited, the Debtor did not have any interest in the policy proceeds; in none of those cases was there a direct claim by the debtor to the policy proceeds, as is the case here. 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").	-

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THE IMPACT OF BANKRUPTCY ISSUES ON D&O CLAIMS, INSURANCE AND INDEMNIFICATION

The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

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I. INTRODUCTION

Federal bankruptcy laws change the way insurance policies are applied and enforced. When an insured files a bankruptcy petition, all of the debtor's property, including potentially the debtor's D&O policy, falls under the jurisdiction of the bankruptcy court and an additional layer of defense and coverage issues must be considered. The following outline addresses: (1) the impact of bankruptcy on claims against directors and officers; (2) whether directors and officers are entitled to indemnification from a corporate debtor; and (3) the impact of bankruptcy on the D&O insurance policy and its proceeds.

II. IMPACT OF BANKRUPTCY ON D&O CLAIMS

The first issue which typically arises under a D&O insurance policy when the insured corporation enters a bankruptcy proceeding is whether the bankruptcy proceeding will reduce or eliminate D&O loss. Most frequently, this inquiry raises two questions: (i) is the claim against the D&Os stayed or enjoined by virtue of the corporate bankruptcy proceeding; and (ii) may claims by third parties be released pursuant to the corporation's plan of reorganization or otherwise?

A. Automatic Stay/Injunctions

1. Automatic Stay.

Section 362(a) of the Bankruptcy Code automatically stays all litigation, outside bankruptcy court, against the debtor and its property. The automatic stay becomes effective upon the filing of a petition commencing a bankruptcy proceeding under the Bankruptcy Code, and remains in effect until the proceeding is closed or dismissed or until the debtor's property is no longer property of the bankruptcy estate (generally, upon confirmation of a Chapter 11 plan, all property of the bankruptcy estate revests in the debtor).

Section 362(a) stays eight major types of acts against the debtor, only two of which are relevant here. A petition filed under the Bankruptcy Code operates as a stay of:

> (1) the commencement or continuation...of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the bankruptcy case or to recover a claim against the debtor that arose before the commencement of the bankruptcy case;...
>
> (2) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;....

See 11 U.S.C. § 362(a)(1) and (3).

a. Section 362(a)(1). Section 362(a)(1) is generally said to be available only to the debtor, not third-party defendants or codefendants, such as directors and officers. Actions against a debtor's directors and officers generally are not stayed in Chapter 11 (reorganization) or Chapter 7 (liquidation) cases under section 362(a)(1). *In re First Central Financial Corp.*, 238 B.R. 9, 18 (Bankr. E.D.N.Y. 1999) (explaining that lawsuits instituted against officers and directors of a corporate debtor are usually not stayed); *Bedel v. Thompson*, 103 F.R.D. 78, 81-83 (S.D. Ohio 1984) (action against former directors for violations of securities laws not stayed; debtor was not deemed an indispensable party and no directors or officers were involved in the debtor's reorganization); *Credit Alliance Corp. v. Williams*, 851 F.2d 119 (4th Cir. 1988) (the plain language of section 362(a) does not apply to non-debtors and will not be applied absent "unusual circumstances); *McCartney v. Integra National Bank North*, 106 F.3d 506, 510 (3rd Cir. 1997) (holding that although the scope of the automatic stay is broad, it does not extend to claims against solvent co-defendants); *Fidelity National Title Insurance Co. of New York v. Bozzuto*, 227 B.R. 466, 470-71 (Bankr. E.D. Va. 1998) (recognizing that § 362 does not generally apply to related suits against non-bankrupt third parties absent "unusual circumstances"); *Otoe County Nat'l Bank v. W & P Trucking, Inc.*, 754 F.2d 881 (10th Cir. 1985) (action against guarantor not stayed under section 362(a)); *Nevada Nat'l Bank v. Casgul of Nevada, Inc. (In re Casgul of Nevada, Inc.)*, 22 B.R. 65 (9th Cir. 1982) (in reversing order staying foreclosure against property of debtor's officers, the court noted: "We are unable to find any provision in section 362 that creates a stay in favor of any entity other than the debtor."); *see also In re Reliance Acceptance Group, Inc.*, 235 B.R. 548, 556-562 (Del. June 2, 1999) (denying debtors' attempt to obtain automatic stay of pending shareholder litigation against directors and officers because the nature and amount of coverage are issues properly left to insurer and insured to resolve); In re Enivid, 364 B.R. 139 (Bankr. D. Mass. 2007).

(1) Where the debtor is a codefendant with its directors and officers in an action pending on the petition date, the action ordinarily is stayed only as against the debtor. *JSO Assocs., Inc. v. Awrey Bakeries*, 2014 U.S. Dist. LEXIS 87429 (E.D.N.Y. June 25, 2014); *In re McCoy*, No. 97-31895, 1999 Bankr. Lexis 1461, at *2 (Bankr. E.D. Pa. Nov. 29, 1999); *In re First Central Financial Corp.*, 238 B.R. 9, 18 (Bankr. E.D. N.Y. 1999); *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 544 (5th Cir. 1983) (Chapter 11 debtor may be severed from state court action and action continued against other named defendants to

avoid stay violation); *Lynch v. Johns-Manville Sales Corp.*, 710 F.2d 1194 (6th Cir. 1983) (court refused to invoke automatic stay to protect solvent co-defendants); *Cornick v. Hi Grade Cleaners, Inc.*, 595 F. Supp. 718, 720-21 (N.D. Ill. 1984) (automatic stay does not apply to the claims against the debtor's nonbankrupt codefendants); *Duval v. Gleason*, No. C-90-0242-DLJ, U.S. Dist. LEXIS 18398 (N.D. Cal. 1990, Oct. 19, 1990) (where a non-debtor codefendant may be held liable independent of the debtor, there is no compelling basis on which a court may extend the automatic stay provisions to the non-debtor codefendants).

(2) Only under "unusual circumstances" may a court stay claims against non-debtor parties affiliated with the debtor under section 362(a)(1). *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1002-1003 (4th Cir. 1986), cert. denied, 479 U.S. 876 (1986). The A.H. Robins court explained:

> This "unusual situation," it would seem, arises when there is such an identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor.

Id. at 999. *See also In re Siskin*, 231 B.R. 514, 519 (Bankr. E.D. N.Y. 1999) ("Such [unusual] circumstances may exist when there is such identity between a debtor and a third party that judgment against a non-debtor would be binding upon a debtor."); *General Dynamics Corp. v. Veliotis (In re Veliotis)*, 79 B.R. 846, 848 (Bankr. E.D. Mo. 1987); *FTL, Inc. v. Crestar Bank (In re FTL, Inc.)*, 152 B.R. 61 (Bankr. E.D. Va. 1993); *In re Gray*, 230 B.R. 239, 242-43 (Bankr. S.D. N.Y. 1999).

An example of such an unusual situation may be an action against a director or officer who is entitled to absolute indemnity from the debtor. *In re Nat'l Heritage Foundation, Inc.*, 478 B.R. 216 (Bankr. E.D. Va. 2012), aff'd 2013 U.S. Dist. LEXIS 49081 (E.D. Va. Apr. 3, 2013); *In re Ionosphere Clubs, Inc.*, 111 B.R. 423, 435 (Bankr. S.D.N.Y. 1990); *Maxicare Health Plans, Inc. v. Centinela Mammoth Hosp. (In re Family Health Servs., Inc.)*, 105 B.R. 937 (Bankr. C.D. Cal. 1989).

Although the D&O's indemnification rights against the debtor corporation arguably create this "identity of interest," some courts have rejected this argument. *United States v. Huckabee Auto Co.*, 783 F.2d 1546 (11th Cir. 1986) (officer's indemnification right does not give bankruptcy court jurisdiction to stay action against officer).

b. Section 362(a)(3). *See* Section IV(A) below.

c. Relief from Automatic Stay. Even if the automatic stay applies to D&O claims, the bankruptcy court may, after notice and a hearing, grant relief from the automatic stay. 11 U.S.C. § 362(d). The court can terminate, annul, modify or condition the stay for cause, including the lack of adequate protection of an interest in property of such party-in-interest, or with respect to a stay of an act against property, if the debtor does not have an equity in such property and the property is not necessary to an effective reorganization.

2. Injunction. Section 105(a) of the Bankruptcy Code, which confers general equitable powers on the bankruptcy court, provides a basis for a bankruptcy court to enjoin actions not covered by the automatic stay imposed by section 362(a). *A.H. Robins Co.*, 788 F.2d 994; *Madison Management Group, Inc. v. Zell*, No. 93 CV 04777, 1999 U.S. Dist. Lexis 3330, at *26 (N.D. Ill. Mar. 10, 1999) (explaining that § 105 complements the automatic stay provision of § 362). Under this section, the bankruptcy court can issue an injunction to preserve the orderly conduct and integrity of liquidation or reorganization proceedings. *In re Baldwin-United Corp. Litig.*, 765 F.2d 343, 348 (2d Cir. 1985); *In re Third Eighty-Ninth Assocs.*, 138 B.R. 144 (S.D.N.Y. 1992); *All Seasons Resorts, Inc. v. Milner (In re All Seasons Resorts, Inc.)*, 79 B.R. 901, 903-04 (Bankr. C.D. Cal. 1987); *Johns-Manville Corp. v. The Asbestos Litig. Group* (*In re Johns-Manville Corp.*), 40 B.R. 219 (S.D.N.Y. 1984).

a. A director or officer seeking to enjoin the prosecution of a D&O claim under section 105(a) must show, like any injunction: (i) irreparable harm to the debtor; (ii) reasonable likelihood of success; (iii) that injury to the moving party outweighs any harm to the party to be enjoined; and (iv) that the public interest will not be adversely affected. *In re BORA BORA Inc.*, 424 B.R. 17, 20 (Bankr. D.P.R. 2010); *Lane v. Phila. Newspapers LLC*, 423 B.R. 98 (Bankr. E.D Pa. 2010); *Zenith Lab., Inc. v. Sinay* (*In re Zenith Lab., Inc.*), 104 B.R. 659, 665 (D.N.J. 1989); *In re Reliance Acceptance Group, Inc.*, 235 B.R. at 556. *See also In re FTL*, 152 B.R. 61, 63.

b. Where third-party actions against a debtor's former, present or future directors and officers would interfere with, deplete or

adversely affect the property of the estate or would diminish the debtor's ability to formulate a plan of reorganization, a bankruptcy court may stay and enjoin all such proceedings by virtue of section 105(a) of the Bankruptcy Code. *Johns-Manville Corp. v. The Asbestos Litig. Group* (*In re Johns-Manville Corp.*), 33 B.R. 254, 263 (Bankr. S.D.N.Y. 1983); *A.H. Robins Co.*, 788 F.2d at 1008 (court stayed actions because continuation would frustrate, if not thwart, reorganization effort); *Lazarus Burman Assocs. v. National Westminster Bank* (*In re Lazarus Burman Assocs.*), 1993 Bankr. LEXIS 1910 (Bankr. E.D.N.Y. Dec. 20, 1993) (state court action, if allowed to proceed, would substantially divert the attention of the principals away from the reorganization; non-debtor's financial contribution to reorganization alone could provide a basis for an injunction); *In re Zenith Lab., Inc.*, 104 B.R. at 665 (court stayed shareholder actions because they would cause debtor's employees to be involved in time-consuming depositions and burdensome document requests which would distract key personnel from reorganization effort); *In re Ionosphere Clubs, Inc.*, 111 B.R. at 435.

B. Release of D&O Claims

Whether or not a D&O claim is stayed or enjoined, it remains a potential liability of the defendant D&O unless released as part of the bankruptcy proceeding. Such a release could be provided in the corporation's plan of reorganization. Generally, non-consensual release provisions, which provide for the discharge of non-debtor third-parties such as a debtor's directors and officers, are not enforceable. But, plan provisions that provide creditors with the option of releasing non-debtor third-parties have been upheld.

1. Non-Consensual Plan Release

Section 524(e) of the Bankruptcy Code provides that the discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt. This statutory provision prohibits a bankruptcy court from discharging claims against a non-debtor as part of a debtor's reorganization plan. *Underhill v. Royal*, 769 F.2d 1426 (9th Cir. 1985); *In re Columbia Gas Transmission Corp.*, 219 B.R. 716, 720 (Bankr. S.D. W. Va. 1998) (explaining that many courts, relying on § 524(e), have allowed actions to establish the debtor's liability in order to collect from the debtor's insurer). In Underhill, creditors approved a plan which released the debtor's principal shareholder from personal liability, although the validity of the release was to be decided by the district court in which a securities fraud action was pending against the owner. Although the owner maintained that the confirmed reorganization plan barred any claims against him, the court held that the release was

ineffective because the bankruptcy court did not have the power to discharge a non-debtor.

a. The Seventh Circuit Court of Appeals similarly held in *Union Carbide Corp. v. Newboles*, 686 F.2d 593 (7th Cir. 1982):

> A creditor's approval of the plan cannot be deemed an act of assent having significance beyond the confines of the bankruptcy proceedings, simply because the gamesmanship imported from state contract law into the bankruptcy proceedings would be intolerable.... [T]he mechanics of administering the federal bankruptcy laws, no matter how suggestive, do not operate as a private contract to relieve co-debtors of the bankrupt of their liabilities.

Id. at 595. *See also Houston v. Edgeworth* (*Matter of Edgeworth*), 993 F.2d 51 (5th Cir. 1993); *In re Future Energy Corp.*, 83 B.R. 470 (S.D. Ohio 1988).

b. Because a non-consensual D&O release provision in a plan of reorganization is violative of section 524(e) of the Bankruptcy Code, most courts have refused to confirm a reorganization plan that releases a debtor's directors and officers. *In re Nat'l Heritage Foundation, Inc.*, 478 B.R. 216 (Bankr. E.D. Va. 2012), aff'd 2013 U.S. Dist. LEXIS 49081 (E.D. Va. Apr. 3, 2013); *In re Quincy Medical Center, Inc.*, 2011 Bankr. LEXIS 4405 (Bankr. D. Mass. Nov. 16, 2011); *In re SL Liquidating, Inc.*, 428 B.R. 799 (Bankr. S.D. Ohio 2010); *In re Elsinore Shore Assoc.*, 91 B.R. 238 (Bankr. D.N.J. 1988); *see also In re Bennett Paper Corp.*, 68 B.R. 518 (Bankr. E.D. Mo. 1986).

c. Although in the minority, some courts have upheld a D&O release provision in a plan of reorganization. For example, in *In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir. 1989), cert. denied, 493 U.S. 959 (1989), the Fourth Circuit affirmed an order confirming a reorganization plan that released the debtor's directors and officers, and permanently enjoined all actions against them. The court reasoned that no harm could be suffered by any potential plaintiff since all creditors would be paid in full under the reorganization plan:

> In this situation where the Plan was overwhelmingly approved, where the Plan in conjunction with insurance policies provided as part of a plan of reorganization gives a second chance for even late claimants to recover, where,

> nevertheless, some have chosen not to take part in the settlement in order to sue certain other parties [Robin's personal injury insurer and certain health care providers], and where the entire reorganization effort hinges on the debtor being free from indirect claims such as suits against parties who would have indemnity or contribution claims against the debtor, we do not construe § 524(e) so that it limits the equitable power of the bankruptcy court to enjoin the questioned suits.

Id. at 702.

d. *In Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1050 (5th Cir. 1987), the Fifth Circuit upheld, on res judicata grounds, a non-consensual release provision that was collaterally attacked in a separate proceeding after confirmation of a Chapter 11 plan. The court stated that section 524 does not by its specific terms preclude discharge of a non-debtor when a release is accepted and confirmed as an integral part of reorganization. *See also In re Mercedes Homes, Inc.*, 431 B.R. 869 (Bankr. S.D. Fla. 2009); *In re National Gypsum Co.*, No. 3:97-CV-2613-G, 1998 U.S. Dist. Lexis 13860, at *13 (N.D. Tex. Aug. 27, 1998).

2. Consensual Plan Release

Notwithstanding section 524(e), consensual D&O releases by the claimants are enforceable. Several courts recognize that a reorganization plan that releases a non-debtor does not violate section 524(e) of the Bankruptcy Code if the plan merely affords creditors the option of providing a voluntary release to the non-debtor. *In re Monroe Well Service*, 80 B.R. 324 (Bankr. E.D. Pa. 1987) (plan could be confirmed where individual creditors allowed to voluntarily surrender claims against non-debtors in exchange for payments from non-debtors under plan); *see also In re AOV Indus., Inc.*, 792 F.2d 1140 (D.C. Cir. 1986) (upholding reorganization plan that provided for release of non-debtors to extent release was voluntarily entered into for valuable consideration, and noting that the releases could not have been expected to commit millions of dollars to a reorganization plan and still remain liable to individual creditors for the full amount of their claims).

3. Rule 9019 Settlements

Directors and officers of a debtor also may be able to obtain a release from liability in connection with a bankruptcy proceeding through a bankruptcy court-approved settlement among all parties. Federal Rule of Bankruptcy Procedure 9019 authorizes a bankruptcy court to approve compromises

and settlements if they are in the best interest of the estate. *In re Energy Cooperative, Inc.*, 886 F.2d 921 (7th Cir. 1989). Court approval first requires notice and a hearing.

a. A Rule 9019 settlement can bar claims against D&Os by all members in an identified class if the bankruptcy court approves the settlement as fair to the class after notice to all class members and a hearing.

b. Once approved by the court, a compromise takes the form of a court order and has the effect of a final judgment. *In re Joint Eastern & Southern Asbestos Litigation* (*In re Johns-Manville Corp.*), 129 B.R. 710, 861 (E.D.N.Y. & S.D.N.Y. 1991), vacated on other grounds, 982 F.2d 721 (2nd Cir. 1992). A settlement that provides releases to and injunctions concerning non-debtors is permissible where a material benefit results to the debtor's estate and advances the consummation of a plan. *SEC v. Drexel Burnham Lambert Group, Inc.* (*In re Drexel Burnham Lambert Group, Inc.*), 130 B.R. 910, 928 (S.D.N.Y. 1991), aff'd 960 F.2d 285 (2nd Cir. 1992).

c. A Rule 9019 order, to be effective, should provide for an injunction which permanently enjoins all present claimants in the bankruptcy proceeding and all present and future claimants properly designated in a class under Federal Rule 23 from taking any action directly or indirectly, for the purpose of collecting, recovering or receiving payment of a D&O liability claim against the defendant directors and officers and any D&O insurer. Some courts, though, have refused to approve a settlement conditioned on the court's entry of such a bar order. *In re GunnAllen Fin., Inc.*, 443 B.R. 908 (Bankr. M.D. Fla. 2011).

III. INDEMNIFICATION

A director or officer may be entitled to indemnification from the corporation for defense costs, settlements or judgments if the director or officer was sued in his or her capacity as a director or officer. The corporation's indemnification obligation may arise under its by-laws, an indemnity or employment agreement or pursuant to a state indemnification statute.

Two issues typically arise concerning indemnification claims in the bankruptcy context: (i) is the indemnification claim an allowable claim; (ii) if allowed, what priority is the claim given?

A. Allowable Claim

1. Under section 502(e)(2) of the Bankruptcy Code, a claim for reimbursement or contribution that is fixed after the commencement of the bankruptcy case shall be determined and either allowed or disallowed as if

the claim had become fixed pre-petition. *See In re Pettibone Corp.*, 110 B.R. 837 (Bankr. N.D. Ill. 1990) (a claim for reimbursement that becomes fixed post-petition is deemed a pre-petition claim for purposes of allowance).

2. Section 502(e)(1)(B) of the Bankruptcy Code commands disallowance of claims for reimbursement or contribution against the estate if the claimant is "liable with the debtor," and the claim is contingent at the time the court determines the allowance or disallowance of claims.

3. Disallowance under section 502(e)(1)(B) requires that three elements be established: (1) the claim must be one for reimbursement or contribution; (2) the claimant must be liable with the debtor on the underlying claim; and (3) the claim must be contingent at the time of its allowance or disallowance. *In re Pinnacle Brands, Inc.*, 259 B.R. 46 (Bankr. D. Del. 2001); *In re Drexel Burnham Lambert Group, Inc.*, 146 B.R. 98 (Bankr. S.D.N.Y. 1992); *In re Wedtech Corp.*, 85 B.R. 285, 289 (Bankr. S.D.N.Y. 1988); *In re Provincetown-Boston Airlines, Inc.*, 72 B.R. 307 (Bankr. M.D. Fla. 1987).

   a. The concept of reimbursement includes claims for indemnification by directors and officers. *In re Drexel Burnham Lambert Group, Inc.*, 1992 U.S. Dist. LEXIS 16027 (S.D.N.Y., Oct. 19, 1992); *In re Wedtech Corp.*, 85 B.R. at 289.

   b. The co-liability factor is determined by reference to the underlying third-party action. If the underlying lawsuit asserts claims that, if proven, would give rise to liability against the debtor but for the automatic stay, then the co-liability factor is present. *In re Wedtech Corp.*, 85 B.R. at 290.

   c. Claims are contingent if they are undetermined at the time the court rules on their allowance. *In re Wedtech Corp.*, 85 B.R. at 289.

4. In a fairly typical case, a director or officer may be sued with the debtor in an action alleging violations of federal securities laws. If the director or officer may be entitled to indemnification for his or her defense costs, judgments or settlement payments incurred in connection with the lawsuit, the director or officer must file a proof of claim with the bankruptcy court.

   a. Often, the director's or officer's indemnification rights are contingent and unliquidated at the time of filing the proof of claim because the third-party litigation has not yet been resolved and not all defense costs have been incurred. In that situation, a director or officer should attempt to delay a determination of the allowance or disallowance of the claim as long as possible to allow a greater

portion of the claim to become fixed and noncontingent (e.g., defense costs incurred, settlements made). The director or officer should continue to amend the proof of claim to identify that portion of the claim that is no longer contingent.

b. Directors and officers should be mindful that by filing a proof of claim they submit to the jurisdiction of the bankruptcy court and waive their right to a jury trial. *Riley v. Wolverine, Proctor & Schwartz Ltd. (In re: Wolverine, Proctor & Schwartz, LLC)*, 404 B.R. 1 (D. Mass. 2009); *Cage v. Hardy Rawls Enters LLC (In re Moye)*, 2009 Bankr. LEXIS 4033 (Bankr. D. Tex. Dec. 9, 2009); *Arecibo Cmty. Health Care, Inc. v. P.R.*, 270 F.3d 17 (1st Cir. 2001); *AEC One Stop Group v. Bain Capital Fund IV*, 2001 U.S. App. LEXIS 8867 (2nd Cir. May 9, 2001); *Langenkamp v. Culp*, 498 U.S. 42 (1990); *Superior Precast, Inc. v. Buckley & Co.*, No. 97-218, 1998 U.S. Dist. Lexis 1739, at *6 (E.D. Pa. Feb. 18, 1998); *In re Kraeger Co., Inc.*, No. 97-10884, 1999 Bankr. Lexis 615, at *23 (Bankr. E.D. Pa. May 24, 1999); *In re Stansbury Poplar Place*, No. 93-1363, 1993 U.S. App. LEXIS 33656 (4th Cir. Dec. 27, 1993). But see, *Great Am. Ins. Co. v. Bally Total Fitness Holding Corp. (In re: Bally Total Fitness of Greater NY, Inc.)*, 2009 Bankr. Lexis 728 (Bankr. S.D.N.Y. March 27, 2009) (The assertion of an affirmative defense for indemnification does not constitute a waiver of the right to a jury trial); *William v. Condrey P.C. v. Endeavour Highrise L.P. (In re Endeavour Highrise L.P.)*, 425 B.R. 402, 407 (Bankr. D. Tex. 2010); *Mattingly v. Piccinini (In re Piccinini)*, 424 B.R. 767, 769 (Bankr. D. Mich. 2010).

B. Claim Priority

Generally, an allowed D&O claim for indemnification is treated as a general unsecured claim. *See generally Woburn Assocs. v. Kahn (In re Hemingway Transport)*, 954 F.2d 1 (1st Cir. 1992); *In re Wilbur*, 237 B.R. 203, 206-07 (M.D. Fla. 1999). However, if a debtor's indemnification obligations arise post-petition, the directors or officers may be entitled to first priority administrative expense treatment.

1. Under section 503 of the Bankruptcy Code, administrative expenses are allowed for the "actual, necessary costs and expenses of preserving the estate." Under section 507(a)(1), administrative expenses are entitled to first payment priority. Most courts generally allow administrative priority when the claim: (a) arises from a transaction with a debtor-in-possession or trustee, as distinct from the pre-petition debtor; and (b) the debtor-in-possession received a benefit in the operation of the business of the estate. *In re Jartran, Inc.*, 732 F.2d 584 (7th Cir. 1984); *In re Entertainment, Inc.*, 223 B.R. 141, 154 (Bankr. N.D. Ill. 1998). In the context of D&O indemnification claims, it is rare that administrative expense treatment is

allowed. *In re Amfesco Indus., Inc.*, 81 B.R. 777 (Bankr. E.D.N.Y. 1988) (court found that priority should only be granted under extraordinary circumstances when a director's or officer's services are actual and necessary to preserve the estate); *In re Mid-American Waste Systems, Inc.*, 228 B.R. 816, 821 (Bankr. Del. 1999).

2. To qualify as an administrative expense, the D&O indemnification claim typically must arise from post-petition conduct which benefited the estate. *In re Heck's Properties Inc.*, 151 B.R. 739, 766-68 (S.D.W. Va. 1992) (because claim against directors and officers related solely to post-petition conduct, directors and officers entitled to indemnification and administrative cost priority); *In re Mid-American Waste Systems, Inc.*, 228 B.R. at 821; (emphasizing that in order to establish administrative priority under § 503, director or officer must demonstrate that claimed expense: (1) arose out of a post-petition transaction with the debtor-in-possession, and (2) directly and substantially benefited the estate); *In re BH S&B Holdings LLC*, 426 B.R. 478 (Bankr. D.N.Y. 2010).

3. If the indemnification arises from pre-petition conduct, administrative expense priority is generally not available, even if the indemnification claim arises post-petition. *Id*; *In re Consolidated Oil & Gas, Inc.*, 110 B.R. 535 (Bankr. D. Colo. 1990) ("[T]here is...an evident duty to indemnify these Claimants, and while that duty arose post-petition, the services were pre-petition. Therefore...these Claimants are not entitled to administrative expense priority."); *In re Amfesco Indus., Inc.*, 81 B.R. 777, 784 (Bankr. E.D.N.Y. 1988) ("All of the operative facts, legal relationships, and conduct of the Applicants upon which is based the threatened litigation occurred pre-petition. The indemnification agreement...occurred pre-petition. Any duty to indemnify the Applicants arises from services provided to the pre-petition Corporation not for services rendered post-petition...as such, the Applicants' legal fees claim arises from their pre-petition services rather than any pos-petition services."); *Christian Life Center v. Silva (In re Christian Life Center)*, 821 F.2d 1370 (9th Cir. 1987) (claims for legal fees of attorney who represented officer post-petition not entitled to administrative priority because they arose from debtor's duty to indemnify officer based on officer's pre-petition services and conduct).

   a. But *see*, *In re Sahlen & Assoc., Inc.*, 113 B.R. 152 (Bankr. S.D.N.Y. 1990) (Directors or officers of a debtor entitled to administrative expense treatment of their indemnification claims even though claims relate to pre-petition actions if the directors or officers can establish that their services benefited the estate).

4. Administrative expense treatment may be denied even for post-petition conduct if the indemnification claims are asserted by former officers and directors. *In re Baldwin-United Corp.*, 43 B.R. 443 (S.D. Ohio 1984).

a. In Baldwin-United, the court refused to permit a debtor to advance defense costs to former directors of the debtor because the expenditures did not constitute "actual and necessary costs" of preserving the estate for the benefit of its creditors.

b. The court also refused to grant administrative priority to the defense costs of the debtor's present directors because it found that the corporate by-laws (which contained the mandatory indemnification provision) did not constitute an executory contract subject to assumption. The court further held that administrative priority is not available where the debtor became bound to honor an obligation pre-petition, regardless of when the amount owed comes due.

5. In order to maximize the financial protection of directors and officers in light of these claim priority rules, at least one D&O policy form contains the following provision:

> In the event the Company becomes a debtor in possession under the United States Bankruptcy Code or an equivalent status under the law of any other country and the aggregate Loss due under this Policy exceeds the remaining available Limit of Liability, the Insurer shall:
>
> (a) first pay such Loss allocable to Wrongful Acts that are actually or allegedly caused, committed, or attempted prior to the Company becoming a debtor in possession, then
>
> (b) with respect to whatever remaining amount of the Limit of Liability is available after payment under (a) above, pay such Loss allocable to Wrongful Acts that are actually or allegedly caused, committed, or attempted after the Company became a debtor in possession.
>
> If the D&O insurance proceed will be inadequate to pay all loss arising from pre-petition and post-petition wrongdoing, this provision applies the insurance proceeds first to the pre-petition wrongdoing based on the assumption that the post-petition wrongdoing will likely be indemnified by the debtor's estate.

IV. POLICY AS ASSET OF ESTATE

D&O insurance policies typically have one or more of three basic insuring agreements. First, all D&O policies will have an insuring agreement which covers Loss incurred by directors and officers resulting from Claims against the directors and officers for which the Company does not indemnify the directors and officers. This insuring agreement is frequently referred to as

"Clause A" or "Side A" coverage. Second, most D&O policies also cover the Company to the extent the Company indemnifies directors and officers for Loss incurred by directors and officers resulting from Claims against the directors and officers. This is frequently referred to as "corporate reimbursement" coverage. Third, beginning in the mid-1990s, many D&O policies added a third insuring agreement which covers Loss incurred by the Company resulting from Securities Claims against the Company. This "entity coverage" was intended to eliminate the need for a difficult and frequently contentious allocation under a standard D&O policy between Loss allocable to Securities Claims against directors and officers (which traditionally is covered) and Loss allocable to Securities Claims against the Company (which traditionally is not covered). As explained below, the addition of this "entity coverage" potentially impairs the coverage available for directors and officers if the Company files bankruptcy.

When an entity files a bankruptcy petition, an "estate" is created which is comprised of all legal or equitable interests of the debtor in property owned at the time of the commencement of the case or acquired thereafter. 11 U.S.C. § 541(a). If a D&O insurance policy and its proceeds are assets of the bankruptcy estate, the policy and its proceeds will be subject to the automatic stay, thereby preventing the insurer from making any payments under the policy for the benefit of the insured D&Os while the stay remains in effect.

Insurance Policies Generally. Generally, a corporation's insurance policies are property of the bankruptcy estate because the corporation pays for and owns the insurance policies. *A.H. Robins Co., Inc.*, 788 F.2d at 1001 ("Under the weight of authority, insurance contracts have been said to be embraced in this statutory definition of 'property'"); *In re First Central Financial Corp.*, 238 B.R. 9, 15-16 (Bankr. E.D. N.Y. 1999), aff'd 2002 U.S. Dist. LEXIS 22005 (E.D.N.Y. 2000); *In re Davis*, 730 F.2d 176 (5th Cir. 1984); *Celotex Corp. v. AIU Ins. Co. (Matter of Celotex Corp.)*, 152 B.R. 667, 675 (Bankr. M.D. Fla. 1993); *In re Equinox Oil Company*, 2002 U.S. App. LEXIS 16170 (5th Cir., Aug. 12, 2002). One court has ruled that an insurance policy paid for by the debtor is not ipso facto an asset of the debtor's estate. *Zenith Labs., Inc. v. Sinay (In re Zenith Labs., Inc.)*, 104 B.R. 659 (D.N.J. 1989). Rather, an insurance policy purchased by the debtor is only an estate asset to the extent that it increases the debtor's worth or diminishes its liabilities.

D&O Policy. Courts have consistently held that D&O liability policies constitute property of the estate. *In re Youngstown Osteopathic Hosp. Ass'n*, 271 B.R. 544 (Bankr. N.D. Oh. 2002); *In re Chiles Power Supply Co.*, 264 B.R. 533 (Bankr. W.D. Mo. 2001); *In re First Central Financial Corp.*, 238 B.R. at 16; *Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Re: Insurance Corp. (In re Minoco Group of Cos., Ltd.)*, 799 F.2d 517 (9th Cir. 1986) ("we see no significant distinction between a liability policy that insures the debtor against claims by consumers and one that insures the debtor against claims by officers and directors") (emphasis in original)); *Louisiana World Exposition, Inc. v. Federal Ins. Co. (In re Louisiana World Exposition, Inc.)*, 832 F.2d 1391, 1399 (5th Cir. 1987); *Duval v. Gleason*, 1990 U.S. Dist. LEXIS 18398 (N.D. Cal. Oct. 19, 1990); *In re Florian*, 233 B.R. 25, 27 (Bankr. Conn. 1999); *Houston v. Edgeworth (Matter of Edgeworth)*, 993 F.2d 51, 55 (5th Cir. 1993) ("Insurance policies are property of the estate because, regardless of who the insured is, the debtor retains certain contract rights under the policy itself."). *But see, In re First Central Financial Corp.*, 238 B.R. at 16-17 (ruling that because no covered entity claims had yet been filed during the first

eighteen months of the bankruptcy proceeding, the company did not need the entity coverage and therefore the D&O policy (with entity coverage) was not an asset of the bankruptcy estate).

D&O Policy Proceeds. Although the D&O policy is generally considered an asset of the bankruptcy estate, some courts have held that the proceeds of certain D&O policies are not assets of the estate, but instead belong to the directors and officers as beneficiary of the policies. *In re First Central Financial Corp.*, 238 B.R. at 16 ("While a majority of courts consider a D&O policy estate property [citations omitted], there is an increasing view that a distinction should be drawn when considering treatment of proceeds arising under such policies."). The directors and officers normally are deemed the owners of the policy's proceeds under the "Side-A" coverage; while the corporation is deemed the owner of the policy's proceeds under the "corporate reimbursement" coverage.

The seminal case discussing the ownership of the proceeds of a D&O policy is *Louisiana World Exposition v. Federal Ins. Co. (In re: Louisiana World Exposition, Inc.)*, 832 F.2d 1391 (5th Cir. 1987). There, a creditors' committee sought to invoke the automatic stay and halt the payment of defense costs under the debtor's D&O insurance policies. The Fifth Circuit held that, while the policies themselves were deemed part of the debtor's estate, the debtor had no ownership interest in the proceeds of the policies since those policies only provided liability coverage for its directors and officers, not reimbursement coverage for the corporation. Therefore, because the policy proceeds were not found to be property of the estate, the automatic stay could not be invoked to prevent dissipation of the policy proceeds. The Fifth Circuit expressly distinguished between a policy reimbursing directors only (i.e., a Side-A only policy) and a policy reimbursing both the corporation and its directors. With respect to policies providing coverage to the debtor itself, "the estate owns not only the policies, but also the proceeds designated to cover corporate losses or liability." *Id.* at 1400; *see generally In re First Central Financial Corp.*, 238 B.R. at 16-17.

Some subsequent cases have adopted this "policy/proceeds" distinction even with respect to D&O policies that afford corporate reimbursement coverage. *See, e.g. In re Youngstown Osteopathic Hospital Assoc.*, 271 B.R. 544 (N.D. Ohio 2002) (D&O policy with corporate reimbursement but not entity coverage was property of bankruptcy estate, but proceeds were not); *Duval v. Gleason*, No. C-90-0242-DLJ, 1990 U.S. Dist. LEXIS 18398 (N.D. Cal. Oct. 19, 1990) (D&O policy was property of the estate, but court was "not persuaded that the insurance policy proceeds...necessarily constitute 'property' of the debtor policy-owner within the meaning of § 541(a)(1) such that the present proceedings [against non-debtor codefendants] should be stayed"); *In re Daisy Sys. Sec. Litig.*, 132 B.R. 752 (N.D. Cal. 1991) (proceeds of D&O policies were not assets of estate to be divided among creditors because the directors and officers were the primary beneficiaries of the policies); *In re Edgeworth*, 993 F.2d 51, 55-56 (5th Cir. 1993) (same); *In re Florian*, 233 B.R. 25, 26-27 (Bankr. Conn. 1999) (reasoning that when the debtor had no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate); *In re Pelullo*, No. 98-6181, 1999 U.S. Dist. Lexis 14920, at *6-7 (Bankr. E.D. Pa. Sept. 29, 1999); *Brook v. Educ. P'ship, Inc.*, 2010 R.I. Super. LEXIS 63 (R.I. Super. Ct. Apr. 8, 2010); *Brothers v. Neblett*, 2015 Bankr. LEXIS 4296 (Bankr. M.D. Pa. Dec. 21, 2015).

Other courts, though, appear to eschew the "policy/proceeds" distinction, focusing instead on whether payment of a particular loss erodes policy proceeds that would otherwise be

available to the debtor for other claims. *See In re Leslie Fay Companies, Inc.*, 207 B.R. 764 (Bankr. S.D.N.Y. 1997); *In re Circle K*, 121 B.R. 257, 259-60 (Bankr. D. Ariz. 1990); *A. H. Robbins Co., Inc.*, 788 F.2d at 1001; *In re Johns-Manville Corp.*, 40 B.R. 219, 230-31 (D.C.N.Y. 1984); *In re Minoco Group*, 799 F.2d 517, 519 (9th Cir. 1986). Under these cases, the proceeds of a D&O policy containing corporate reimbursement coverage will likely be an asset of the bankruptcy estate, but proceeds of a policy containing only direct D&O coverage will likely not be an asset.

If the policy affords only direct D&O liability coverage and not corporate reimbursement coverage or if the dispute involves only the direct liability coverage, the policy may not be an asset of the estate. *In re MF Global Holdings, Ltd.*, 469 B.R. 177 (Bankr. S.D.N.Y. 2012); *In re Vitek, Inc.*, 51 F.3d 530, 535 (5th Cir. 1995); *Pintlar Corporation v. The Fidelity and Casualty Company of New York*, 124 F.3d 1310 (9th Cir. 1997); *SEC v. Narayan*, 2017 U.S. Dist. LEXIS 14424 (N.D. Tex. Feb. 2, 2017).

D&O Policy with Entity Coverage. If a D&O policy provides coverage for claims against the entity (usually applicable only to securities claims), the policy proceeds are more likely to be assets of the bankruptcy estate. Examples of cases which have ruled that the automatic stay applies to the proceeds of a D&O policy which covers claims against the insured company include the following: *In re Adelphia Communications Corp.*, 285 B.R. 580 (Bankr. S.D.N.Y. 2002); *In re Republic Technologies International, LLC*, 275 B.R. 508 (Bankr. N.D. Oh. 2002); *In re Sacred Heart Hospital of Norristown*, 182 B.R. 413 (Bankr. E.D. Pa. 1995); *In re CyberMedica*, 280 B.R. 12 (Bankr. D. Mass. 2002); *Davis v. Connolly*, 2011 U.S. Dist. LEXIS 39619 (N.D. Ill. Apr. 12, 2011); *In re Beach First Nat'l Bancshares, Inc.*, 451 B.R. 406 (Bankr. D.S.C. 2011); *In re Pasquinelli Homebuilding, LLC* 463 B.R. 468 (Bankr. N.D. Ill. 2012); *Fed. Ins. Co. v. DBSI, Inc.*, 2012 Bankr. LEXIS 2937 (Bankr. D. Del. 2012). These cases generally are decided under the premise that the bankruptcy estate is worth more with the D&O policy than without it by reason of the entity coverage.

However, a few courts have ruled that even the proceeds of a D&O policy containing entity coverage are not an asset of the bankruptcy estate under the unique facts of that case. For example, in *In re First Central Financial Corp.*, 238 B.R. at 17, the court recognized that although proceeds of a D&O policy with entity coverage may be considered property of the estate under certain circumstances, such a conclusion is not necessary in all cases. According to the court, "[t]he appendage of an inchoate entity coverage endorsement, without more, is not a license for a trustee to obtain first crack at the proceeds of a D&O policy." *Id.* at 21. In *First Central*, no securities claims were filed against the Debtor during the first 18 months of the bankruptcy proceeding. Therefore, the estate was not in need of the entity insurance protection under the D&O policy and thus the policy proceeds were not an asset of the estate. According to the court, "[i]f entity coverage is hypothetical and fails to provide some palpable benefit to the estate, it cannot be used by a trustee to lever himself into a position of first entitlement to policy proceeds." *Id.* at 19. See, also, *In re CHS Electronics, Inc.*, 261 B.R. 538 (Bankr. S.D. Fla., April 9, 2001) (all claims against the debtor were discharged and therefore the entity coverage was meaningless. As a result, proceeds of D&O policy were not asset of the bankruptcy estate); *In re marchFIRST, Inc.*, 288 B.R. 526 (Bankr. N.D. Ill., Dec. 16, 2002) (proceeds of D&O policy with entity coverage not property of the bankruptcy estate unless there is a judgment requiring the insurer to pay under the Policy); In re World Health Alternatives, Inc., 2007 Bankr. LEXIS 1927

(Bankr. D. Del. June 8, 2007) (proceeds of D&O policy with entity coverage not property of bankruptcy estate because of priority-of-payment provision in policy); In re Laminate Kingdom, 2008 Bankr. LEXIS 1594 (Bankr. S. D. Fla. Mar. 13, 2008).

Practice Pointer: The most effective way to reduce the risk of this undesirable result for D&Os is not to include within the D&O insurance policy coverage for the company. The safest approach is to purchase a policy affording only Side-A coverage. However, because this approach eliminates the valuable corporate reimbursement coverage, the next preferred approach is to include corporate reimbursement coverage and eliminate the entity securities coverage. The Insureds could rely on the policy/proceeds distinction to argue the policy proceeds are available to defendant directors and officers under such a policy even if the company files bankruptcy. In order to address the allocation issue (which originally was why entity securities coverage was added to the D&O policy), the policy would include a provision which predetermines the percentage allocation that will apply to securities claims in which an allocation is required. A sample predetermined allocation provision is as follows:

> If in any Securities Claim the Insureds incur both Loss that is covered under this Policy and loss that is not covered under this Policy, the Insureds and the Insurer shall allocate such amount between covered Loss and non-covered loss as follows:
>
> (A) Loss consisting of Defense Costs shall be allocated to covered Loss as specified in Item 5(A) of the Declarations for this Policy; and
>
> (B) Loss not consisting of Defense Costs shall be allocated to covered Loss as specified in Item 5(B) of the Declarations for this Policy.

Practice Pointer: If entity coverage is desired in the D&O policy notwithstanding the bankruptcy issues, a method to potentially minimize the adverse consequences to directors and officers from this entity coverage in the event of a bankruptcy is to include a provision in the D&O policy which states that the Insured Organization agrees to waive the automatic stay with respect to the D&O policy in the event a bankruptcy petition is subsequently filed. The following paragraph sets forth such a sample provision:

> If a liquidation or reorganization proceeding is commenced by or against an Insured Organization pursuant to the United States Bankruptcy Code, as amended, or any similar state or local law, the Insureds hereby (i) waive and release any automatic stay or injunction which may apply in such proceedings to this Policy or its proceeds under such Bankruptcy Code or law, and (ii) agree not to oppose or object to any efforts by the Insurer or any Insured to obtain relief from any such stay or injunction.

The enforceability of such a pre-petition waiver of the automatic stay has been considered by several bankruptcy courts in other contexts. The emerging decisional law upholds and enforces pre-bankruptcy waivers of the automatic stay. *See In re Excelsior Henderson Motorcycle Mfg. Co., Inc.*, 273 B.R. 920 (Bankr. S.D. Fla. 2002) (pre-petition agreements

entered into as part of a former plan of reorganization and confirmed by the court are enforceable); *In re Shady Grove Tech Center Assocs. Ltd. Partnership*, 216 B.R. 386 (Bankr. D. Md. 1998) (...waiver is a factor in the decision as to whether cause exists to modify the stay...."); *Merridale Gardens Ltd. Partnership v. ALI, Inc. (In re Merridale Gardens Ltd. Partnership)*, 1996 U.S. Dist. LEXIS 22042 (D. Md. Feb. 28, 1996) ("The Court fails to discern any public policy that bars the waiver of § 362 protection."); *In re Darrell Creek Assocs., L.P.*, 187 B.R. 908, 913 (Bankr. D.S.C. 1995) ("Pre-petition agreements, such as the waiver of stay agreement in this case, are enforceable in bankruptcy."); *In re Powers*, 170 B.R. 480 (Bankr. D. Mass. 1994) (pre-petition agreements waiving opposition to relief from the automatic stay may be enforceable in appropriate cases); *In re Cheeks*, 167 B.R. 817 (Bankr. D.S.C. 1994) (upheld the enforcement of the pre-petition waiver agreement). *In re Club Towers, L.P.*, 138 B.R. 307, 311 (Bankr. N.D. Ga. 1991) ("Pre-petition agreements regarding relief from stay are enforceable in bankruptcy."); *In re Citadel Properties, Inc.*, 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988) ("[T]he terms of the prepetition stipulation are binding upon the parties and that sufficient cause exist to lift the automatic stay pursuant to section 362(d)(1)."); *In re Orange Park South Partnership*, 79 B.R. 79 (Bankr. M.D. Fla. 1987).

However, some courts have refused to enforce a waiver of the automatic stay. *See In re Trans World Airlines, Inc.*, 261 B.R. 103 (Bankr. D. Del. 2001) (pre-petition agreement where debtor agrees to waive its debtor-in-possession authority to assume or reject an executory contract should bankruptcy occur is unenforceable); *In re Pease*, 195 B.R. 431 (Bankr. D. Neb. 1996) (a pre-bankruptcy waiver of the automatic stay is unenforceable per se); *In re Jenkins Court Assocs. Ltd. Partnership*, 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995) ("[T]he court believes that enforcement of the pre-petition waiver of the automatic stay...too closely approximates the more reviled prohibition against filing for bankruptcy protection."); *Farm Credit for Cent. Fla., ACA v. Polk*, 160 B.R. 870 (M.D. Fla. 1993) (pre-petition agreements waiving the automatic stay are not per se binding on the debtor for public policy reasons); *In re Sky Group Int'l, Inc.*, 108 B.R. 86 (Bankr. W.D. Pa. 1989) (refusing to enforce a pre-petition waiver agreement).

Lifting Automatic Stay. If the proceeds of the D&O insurance policy are considered an asset of the bankruptcy estate, the next question is whether the bankruptcy court should lift that automatic stay to allow insured directors and officers access to the policy proceeds. Courts generally have granted relief from the automatic stay when requested since D&O insurance policies are obtained primarily for the protection of individual directors and officers. *In re Enron Corp.*, 2002 Bankr. LEXIS 544 (Bankr. S.D.N.Y., May 17, 2002); *In re Adelphia Communications Corp.*, 285 B.R. 580 (Bankr. S.D.N.Y. Nov. 15, 2002) ("in essence and at its core, a D&O policy remains a safeguard of officer and director interest and not a vehicle for corporate protection..., bankruptcy court should be wary of impairing the contractual rights of directors and officers even in cases where the policies provide entity coverage as well."); *In re CyberMedica, Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002) (harm from withholding policy proceeds from two directors outweighs the risk that there will be nothing left under the policy to pay any judgment the trustee may win against the directors); *In re Sacred Heart Hospital of Norristown*, 182 B.R. 413 (Bankr. E.D. Pa. 1995); *In re Locateplus Holdings Corp.*, 2011 Bankr. LEXIS 4206 (Bankr. D. Mass., October 31, 2011); *In re MF Global Holdings, Ltd.*, 469 B.R. 177 (Bankr. S.D.N.Y. 2012); *In re Hoku Corp.*, 2014 Bankr. LEXIS 1167 (Bankr. D. Idaho, March 25, 2014); In re GB Holdings, Inc., 2006 Bankr. LEXIS 4131 (Bankr. D. N.J. Sept. 21, 2006); *In re RC*

Liquidating Co., 2007 Bankr. LEXIS 401 (Bankr. M.D.N.C. Jan. 31, 2007); *In re Beach First National Bancshares, Inc.*, 2011 Bankr. LEXIS 1622 (Bankr. D.S.C. April 29, 2011).

Where the interest of the debtor is particularly compelling, a few courts have lifted the automatic stay only to a limited extent, thereby assuring that significant insurance proceeds will remain available for the benefit of the estate. *In re Adelphia Communications Corp.*, 285 B.R. 580 (Bankr. S.D.N.Y. Nov. 15, 2002) (in order to induce non-defendant outside directors to continue to serve on the Debtor's board of directors, the automatic stay was lifted to allow the insurer to pay only up to $300,000 per insured defendant director and officer for defense costs); *In re Boston Regional Medical Center, Inc.*, 285 B.R. 87 (Bankr. D. Mass. Apr. 2, 2002) (automatic stay lifted to authorize the payment of $600,000 under the D&O policy for expert costs, thereby preserving most of the policy's limits of liability for two competing plaintiffs); *In re Licking River Mining, LLC*, 2016 Bankr. LEXIS 2211 (Bankr. E.D. Ky. June 6, 2016).

Practice Pointer: In order to minimize the risk that coverage for directors and officers is not unreasonably diluted by the entity coverage and in order to maximize the chance a bankruptcy court will lift any applicable stay, many D&O policy forms now include a "priority of payments" provision. An example follows:

> In the event of Loss arising from a Claim or Claims for which payment is due under the provisions of this policy but which Loss in the aggregate exceeds the remaining available Limit of Liability of this policy, the Underwriter shall:
>
> 1. first pay such Loss for which coverage is provided under Insuring Clause A of this policy [i.e., coverage for Loss not indemnified by Company], then
>
> 2. with respect to whatever remaining amount of the Limit of Liability is available after payment under (1) above, pay such Loss for which coverage is provided under any other Insuring Clause of this policy.
>
> Such a provision arguably renders the debtor's interest in the policy minimal, thus reducing the risk that a bankruptcy court will impair the debtor's estate if the court lifts the stay.

V. TERMINATION OF POLICY

Insurer Cancellation. The right to cancel an insurance policy issued pre-petition to a debtor has uniformly been held to be stayed by section 362(a)(3) of the Bankruptcy Code. *A. H. Robins Co., Inc.*, 788 F.2d at 1001; *In re Minoco Group*, 799 F.2d 517, 519 (9th Cir. 1986); *In re First Central Financial Corp.*, 238 B.R. at 16; *Federal Ins. Co. v. Sheldon*, 150 B.R. 314, 319 (S.D.N.Y. 1993). In *Minoco*, the insurer sought to terminate certain D&O policies two months after the debtor commenced its Chapter 11 case by giving notice as required in the policy. The policy permitted either party to cancel the policies at any time on thirty days' notice. The court held that cancellation of the D&O policies was automatically stayed because the policies were property of the estate. An insurer's post-petition cancellation of an insurance policy for

nonpayment of pre-petition premiums also has been held to violate the automatic stay. *In re Augustino Enter., Inc.*, 13 B.R. 210 (Bankr. D. Mass. 1981).

Purported cancellations of insurance policies that violate the automatic stay provisions are void *ab initio*. *Scrima v. John Devries Agency, Inc.*, 103 B.R. 128 (W.D. Mich. 1989); *In re Rath Packing Co.*, 35 B.R. 615 (Bankr. N.D. Iowa 1983).

Similarly, language in the policy which purports to cancel or restrict coverage upon the insolvency or bankruptcy of the insured (i.e., ipso facto termination clauses) are generally rendered unenforceable by the "anti ipso facto" provisions of the Bankruptcy Code contained in 11 U.S.C. § 365(e)(2). *See In re Huntington Ltd.*, 654 F.2d 578 (9th Cir. 1981); *In re Texaco, Inc.*, 73 B.R. 960 (Bankr. S.D.N.Y. 1987). Thus, the rights and obligations of an insured debtor and its carrier under the policy are not altered because of the debtor's bankruptcy filing.

While a D&O insurer is precluded from canceling a D&O policy by the automatic stay, the Bankruptcy Code does not prevent such a policy from expiring according to the terms of the insurance contract. *Nationwide Life Ins. Co. v. American Medical Imaging Corp. (In re: American Medical Imaging Corp.)*, 133 B.R. 45 (Bankr. E.D. Pa. 1991); *Aetna Casualty & Sur. Co. v. Gamel*, 45 B.R. 345 (N.D.N.Y. 1984).

Debtor Cancellation. Although the insurer is generally prohibited from prematurely canceling the policy, the debtor may be able to cancel by rejecting the policy as an executory contract. Insurance contracts, if not terminated pre-petitioned, often are considered executory contracts which the debtor can either assume or reject. *Aetna Casualty & Sur. Co. v. Gamel*, 45 B.R. 345; *In re Wheeling-Pittsburgh Steel Corp.*, 67 B.R. 620 (W.D. Pa. 1986).

An executory contract is a contract under which the obligations of both the debtor and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other. Countryman, "Executory Contracts In Bankruptcy, Part I," 57 Minn. L.Rev 439, 460 (1973); *Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986); *See generally In re Bergt*, 241 B.R. 17, 26 (Bankr. Ala. Oct. 22, 1999). A debtor can reap the benefits of an insurance policy only if it chooses to fulfill its obligations under the policy (e.g., payment of premiums) and assumes it pursuant to section 365(b)(1) of the Bankruptcy Code. *In re American Medical Imaging Corp.*, 133 B.R. 45, 55 (Bankr. E.D. Pa. 1991).

Consensual Cancellation. A debtor and its D&O insurer may consensually agree to cancel coverage under mutually agreeable terms, as approved by the bankruptcy court. However, such a cancellation may not be binding on the insured directors and officers who have vested rights under the policy and who are not parties to the bankruptcy proceeding. *Helfand v. National Union Fire Ins. Co.*, 10 Cal. App. 4th 869, 13 Cal. Rptr. 2d 295 (1993).

VI. INSURED V. INSURED EXCLUSION

Most D&O policies contain an exclusion known as the "insured v. insured" exclusion. This exclusion typically provides that the insurer is not liable for payment of loss in connection with any claim made against a director or officer brought by or on behalf of the company or

another insured person. In the bankruptcy context, a dispute frequently arises as to whether this exclusion applies to claims by or on behalf of the debtor's estate.

If the claim is brought directly by the debtor, this exclusion will likely apply. *Reliance Ins. Co. of Illinois v. Weis*, 148 B.R. 575 (E.D. Mo. 1992), aff'd, 5 F.3d 532 (8th Cir. 1993) (excluding coverage for a suit brought by the bankruptcy Plan Committee against the company's officers and directors); *National Union Fire Ins. Co. v. Olympia Holdings Corp.*, Case No. 1:94-CV-2081-GET (9/18/1995), aff'd without opinion, 148 F.3d 1070 (Table) (11th Cir. 1998); *Youell v. Grimes*, Case No. 2:00-CV-02207-JWL (D. Kan. Aug. 19, 2002) (when representative of estate takes a lead role in suing the directors and officers, exclusion applies and duty of cooperation under policy is breached).

However, if the claim is brought by a representative of the debtor's estate under circumstances where creditors can be viewed as the true beneficiary of the claim, the exclusion may not apply. *In re County Seat Stores, Inc.*, 280 B.R. 319 (Bankr. S.D.N.Y. July 10, 2002) (bankruptcy trustee separate entity from Debtor; suit by trustee for benefit of creditors, not Debtor); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp.2d 376 (D. Del. 2002) (debtor's estate representative and the debtor are separate entities); *Narath v. Executive Risk Indem., Inc.*, 2002 U.S. Dist. LEXIS 8162 (D. Mass. March 14, 2002) ('insured v. insured' clause is inapplicable as to claims brought by trustee against insolvent partnership's board members); *Gray v. Executive Risk Indem. Inc.*, 2002 U.S. Dist. LEXIS 8155 (D. Mass. May 6, 2002); *In re Molton Metal Tech., Inc.*, 271 B.R. 711, 726 (Bankr. D. Mass. 2002) (the phrase "claim brought by" unambiguously focuses on "who is bringing the claim, not who it initially belonged to"); *Zurich American Ins. Co. v. Boyes*, 2001 U.S. Dist. LEXIS 15123 (N.D. Tex. July 31, 2001) ("on behalf of" language in the 'insured v insured" clause is ambiguous and should be strictly construed against the insurer); *In re Buckeye Countrymark, Inc.*, 251 B.R. 835, 840 (Bankr. S.D. Oh. 2000) (the underlying purpose behind an 'insured v insured' clause is to prevent collusive suits against the insurer by an insured corporation and its insured management. In the bankruptcy situation, there is no threat of collusion because the bankruptcy trustee is acting as a genuinely adverse party to the defendant officers and directors); *Yessenow v. Exec. Risk Indem., Inc.*, 2011 Ill. App. LEXIS 713 (June 30, 2011); *Fed. Ins. Co. v. DBSI, Inc.*, 2011 Bankr. LEXIS 2727 (Bankr. D. Del. July 22, 2011) (exclusion inapplicable to an action by a bankruptcy trustee); *In re* Cent. La. Grain Coop., Inc., 467 B.R. 390 (Bankr. W.D. La. 2012).

Other courts have applied the insured versus insured exclusion to claims by representatives of the bankruptcy estate if the claim originates from or is assigned by the debtor, including a debtor in possession. *Biltmore Ass'n v. Twin City Fire Ins. Co.*, Nos. 06-16417 & 07-16036, 2009 U.S. App. LEXIS 15322 (9th Cir. July 10, 2009) (the insured versus insured exclusion was not "gobbledygook" and "bars coverage for...claims [of the assignee of the debtor in possession], because a post-bankruptcy debtor in possession acts in the same capacity as the pre-bankruptcy debtor for the purpose of directors and officers liability insurance."); *Indian Harbor Ins. Co. v. Zucker*, 2017 U.S. App. LEXIS 10821 (U.S. Ct. App. 6th Cir. June 20, 2017) (claim by trustee of liquidation trust as an assignee of debtor in possession not covered by reason of insured versus insured exclusion); *Oliver v. Indian Harbor Ins. Co.*, 2008 U.S. Dist. LEXIS 15552 (N.D. Ill. Feb. 27, 2008); *Unified Western Grocers, Inc. v. Twin City Fire Ins. Co.*, 371 F. Supp. 2d 1234 (D. Haw. 2005).

Practice Pointer: Most policies contain exceptions to the exclusion (i.e., cover) certain types of claims that are sufficiently adversarial to justify coverage. For example, many D&O policy forms expressly except from the exclusion (i.e., cover) claims "brought or maintained by or on behalf of a bankruptcy or insolvency trustee, examiner, liquidator, rehabilitator, receiver, or creditors' committee for the Company or any assignee of such trustee, examiner, liquidator, rehabilitator, receiver, or creditors' committee."

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Frost Brown Todd LLC
ATTORNEYS

OFFICER & DIRECTOR ISSUES IN BANKRUPTCY

D&O COVERAGE ISSUES

2017 MIDWEST REGIONAL BANKRUPTCY SEMINAR

THURSDAY, AUGUST 24, 2017
11:00 a.m.-12:00 p.m.

Paige L. Ellerman
Frost Brown Todd LLC, Cincinnati

INDIAN HARBOR INSURANCE CO. V. ZUCKER

In *Indian Harbor Ins. Co. v. Zucker*, 860 F.3d 373 (6th Cir. 2017), the Court examined whether a D&O policy's "insured-versus-insured" exclusion precluded coverage for breach of fiduciary duty claims brought by a company's Liquidating Trust.

The debtor, Capitol Bancorp, filed for bankruptcy in 2012. Capital purchased a one-year management liability insurance policy from Indian Harbor in September 2011, a year prior to its bankruptcy filing. Indian Harbor twice extended the policy post-filing. Indian Harbor agreed to pay for:

> "Loss resulting from a Claim first made against the Insured Persons"—a group that included Capitol's directors, officers and employees--- "during the Policy period … for a Wrongful Act."

But, the Indian Harbor policy excluded from coverage (an "insured-versus-insured" exclusion):

> "any claim made against an Insured Person … *by, on behalf of, or in the same name or right of, the Company or any Insured Person*," except derivative suits by independent shareholders and employment claims.

This "insured-versus-insured" exclusion is akin to a homeowner's insurance policy that excludes coverage for a fire that a policyholder intentionally sets. This type of exclusion "limits the management-liability insurance to claims by outsiders, prohibiting coverage for claims by people within the insured company."

In 2014, a plan was confirmed that required Capital to assign each of its causes of action to a Liquidating Trust, which could pursue claims on behalf of creditors. The plan provided that the Reid family— the founder of Capital, his daughter, and his son-in-law, who held the CEO, president and general counsel positions at the debtor— had no liability for post-bankruptcy conduct and limited pre-bankruptcy liability to amounts recovered from Capital's liability insurance policy with Indian Harbor. The plan also required the Reids to sue Indian Harbor if it denied coverage under Capitol's management liability policy.

The Liquidation Trustee sued Capitol's officers, the Reids, for $18.8 million, alleging breach of fiduciary duty claims. Indian Harbor filed a lawsuit against the Liquidation Trustee and the Reids in response, seeking a declaratory judgment that the Liquidation Trustee's claims against Capital's officers were precluded by the "insured-versus-insured" exclusion in Capital's liability insurance policy. The district court held that the exclusion prevented the Trust from pursuing the claims on behalf of creditors.

On appeal, the Sixth Circuit held that coverage for the Trustee's claims against Capitol's former executives was precluded by the policy's "insured-versus-insured" exclusion, because "[a]s a voluntary assignee, the Trust stands in Capitol's shoes and possesses the same rights and is subject to the same defenses as Capitol. By bringing the lawsuit as the voluntary assignee of Capitol (an insured person), against Capital's officers (also insured persons), the claims are excluded.[1]

In rejecting the positions of both the Trustee and Reids, the Sixth Circuit observed the "insured-versus-insured" provision in the broader context of the Bankruptcy Code. It noted that the argument that the debtor-in-possession and Liquidation Trust are "new entities" to which the exclusion does not apply fails because Capitol could not have dodged the exclusion by transferring its claims against the Reids to a new company before bankruptcy, so the same conclusion applies after bankruptcy.

> "The relevant bankruptcy provisions do not support [the trustee] and the [executives'] contention that the debtor in possession and pre-bankruptcy company are necessarily distinct legal entities—at least for purposes of the insurance contract."

"'[T]he debtor in possession is the debtor, and the debtor is the person'"—pre-bankruptcy Capitol— "that filed for bankruptcy.'" Additional provisions of the insurance contract were examined by the Court, including the "Change in Control" clause that contemplated that the coverage would continue uninterrupted during bankruptcy, even after the company became a debtor in possession. In reaching its holding, the Court found that "[a]ny other interpretation would not make sense. If the company had a one-year policy from January 1 to December 31 and filed for Chapter 11 protection on July 1, the debtor in possession surely could seek coverage for insurable events during the second half of the year just as it could be denied coverage for excludable events during that period."

The Sixth Circuit's decision identifies a distinction between a court-appointed trustee and an assignee from a Chapter 11 debtor, but affirmed that it "makes no difference that the bankruptcy court approved the plan transferring the bankruptcy estate's causes of action from Capitol to the Liquidation Trust." The Court cited a practical and legal difference between an assignee and a court-appointed trustee, finding that the risk of collusion is higher when the insured parties— management and debtor— can negotiate and put conditions on a trustee's right to sue them. However, "because the exclusion also applies to claims 'in the …

[1] A company cannot hope to push the costs of mismanagement onto an insurance company just by suing (and perhaps collusively settling with) past officers who made bad business decisions. *See Biltmore Assocs., LLC v. Twin City Fire Ins. Co.*, 572 F.3d 663, 670 (9th Cir. 2009).

right of' Capitol, it's not even clear that a court-appointed trustee or creditor's committee could collect on the policy. *But today's decision does not resolve that distinct question*."

The Dissent (J. Bernice B. Donald):

The dissent concluded that the assigned trustee in this case should have the same right to be exempt from the "insured-versus-insured" exclusion as a court-appointed trustee and that the *Indian Harbor* decision makes it harder for companies to emerge from bankruptcy with a consensual plan of reorganization. The dissent identified a move towards an examination of the plain language of the "insured-versus-insured" exclusion, which some courts have similarly found should not extend to successors or assigns.[2] Yet, it stated that the plain meaning of the "insured-versus-insured" exclusion at issue does not include a debtor-in-possession or other estate representative. Therefore, the dissent concluded that if a Liquidating Trustee brings a suit on behalf of the debtor-in-possession, by the plain language of the insurance policy, it is not brought on behalf of the debtor company.

The dissent also highlighted that the Sixth Circuit has held, in different contexts, that a bankruptcy estate and a debtor are separate legal entities, a new entity is formed upon filing, and it is precisely the reason many companies file bankruptcy, and that same logic should apply to the Liquidating Trust that was created for the benefit of the creditors, not the debtor company, and is separate from the debtor company.

WHY *INDIAN HARBOR* MATTERS

A threshold question in pursuing breach of fiduciary duty insurance claims against D&Os following a bankruptcy filing is whether the plaintiff is considered the same person as the pre-petition debtor for purposes of the applicable insurance coverage. Following the Sixth Circuit's decision in *Indian Harbor*, the ability to pursue D&O insurance claims in bankruptcy is in question because they are often subject to an "insured-versus-insured" exclusion. A split remains among federal courts as to whether a lawsuit against a corporation's former D&Os brought by a trustee, creditors' committee or post-confirmation liquidating trustee triggers the "insured-versus-insured" exclusion, and *Indian Harbor* does not necessarily settle that issue in the Sixth Circuit because the decision is limited to consensual assignments. Cases cited by majority in *Indian Harbor* have held that court-

[2] *Alstrin v. St. Paul Mercury Insurance Co*., 179 F.Supp.2d 376 (D. Del. 2002); *In re Molten Metal Technology*, 271 B.R. 711 (Bankr. D. Mass. 2002); *Zurich American Insurance Co. v. Boyes*, 2001 U.S. Dist. LEXIS 15123 (N.D. Tex. 2001).

appointed trustees are exempt from the "insured-versus-insured" exclusion because there is no risk of collusion, but the *Indian Harbor* declined to decide that issue.[3]

> Post-*Indian Harbor*, what is the best strategy for preserving D&O insurance claims when an "insured-versus-insured" exclusion exists?

- Can D&O insurance claims subject to an "insured-versus-insured" exclusion ever be preserved through a plan confirmation process?

- Does the transfer of D&O insurance claims subject to an "insured-versus-insured" exclusion to a committee preserve the claims?

- Is obtaining a court-appointed trustee to pursue D&O insurance claims subject to an "insured-versus-insured" exclusion sufficient to preserve the claims? (A liquidating trustee is usually selected by and/or approved by the creditors.)

- What concern(s) and/or issue(s) does limiting coverage under a plan to insurance coverage and/or prohibiting collection from personal assets of defendants raise?

HYPOTHETICALS

1) Scenario 1- Preserving the D&O Insurance Policy

A debtor purchased a "management protection" policy from an insurer. The policy provided coverage for the debtor "company", its subsidiaries and "any such organization as a debtor-in-possession" as well as for "insured persons" that included the debtor's executives. The policy provided coverage for losses arising from "misleading statement[s]" and other "act[s and] omission[s]" by the insureds and to pay costs "arising out of" civil proceedings related to such acts. The policy also included an "insured-versus-insured" exclusion for losses arising from any "[c]laim brought or maintained by, on behalf of, or in the right of the company, in any respect."

During the relevant time, Robert Smith was an "insured person" under the policy. After the debtor's bankruptcy filing, it brought an adversary proceeding in bankruptcy court against several former executives and employees, including Smith. Acting as a debtor-in-possession, the debtor sought damages "on behalf of itself and as an assignee of its shareholders" alleging a fraudulent scheme to manipulate the company's stock prices. After the adversary proceeding was commenced, a chapter 11 trustee was appointed to pursue the debtor's claims in the adversary proceeding.

[3] *See, e.g.*, *Cohen v. National Union Fire Ins. Co. of Pittsburgh* (*In re County Seat Stores Inc.*), 280 B.R. 319 (Bankr. S.D.N.Y. 2002) (a chapter 11 trustee charged with statutory powers and duties is independent, separate and distinct from the debtor and pre-petition company).

Smith asked the insurer to provide his defense or otherwise cover his costs, the insurer denied coverage, and Smith sued the insurer. The insurer moved to dismiss the case filed by Smith, citing the "insured-versus-insured" provision.

- Is Smith entitled to coverage?
- Does it matter that the chapter 11 trustee was substituted for the debtor in the adversary proceeding?
- What could have been a different approach to who "brought" the action?

See Redmond v. ACE American Insurance Co., 614 Fed. Appx. 77 (3rd Cir. 2015).

2) Scenario 2- Insurance Proceeds as Property of the Estate

The debtor filed for chapter 11 protection and the case was converted to a chapter 7. The chapter 7 trustee filed an adversary proceeding against eight of the debtor's former directors and officers, seeking damages in excess of $62,000,000 relating to a leveraged buyout. Both the chapter 7 trustee and the defendant D&Os asserted rights under the debtor's Directors, Officers and Corporate Liability insurance policy. The policy had a $15,000,000 limit of liability and a $5,000 retention per director or officer for non-identifiable loss, subject to a maximum of $50,000 per loss. The policy provided coverage to the D&Os for liability and defense costs, indemnification coverage to the debtor, and coverage to the debtor for securities claims. The policy had a single limit for all three types of claims. The defendants D&Os filed a motion for relief from the automatic stay seeking reimbursement of their defense costs under the D&O policy, and the chapter 7 trustee objected.

- Are the insurance proceeds property of the debtor's estate?
- Does the indemnification coverage matter?
- Do the D&Os win their motion?

See In re Allied Digital Technologies, Corp., 306 B.R. 505 (Bankr. D. Del. 2004).

3) Scenario 3- Wasting Insurance Policies and Defense Costs

An involuntary chapter 11 was commenced against the debtor, the committee investigated and filed an adversary proceeding against certain former directors and officers of the debtor for breach of fiduciary duties arising from certain alleged conflicts of interest, the main case converted to chapter 7, and the chapter 7 trustee was substituted for the committee as the plaintiff in the adversary proceeding. The debtor was a "named entity" under a claims-made directors and officers insurance policy. The policy provided $15 million in "D&O coverage" with a $75,000 "retention/deductible," provided coverage to individual officers and directors for liability and defense costs (Coverage A), and provided coverage to the debtor for liability and indemnification (Coverage B). The policy was wasting and there was no dispute that the D&Os were "individual insureds" under the

policy. Additionally, the policy provided that Coverage A claims are to be paid ahead of Coverage B claims. Under the D&O coverage section, the term "insured" means "individual insured" or "company." The insurer agreed to pay a portion of the D&O's defense costs that it believed were covered by the claims alleged in the adversary proceeding complaint, but prior to payment of any defense costs, the insurer required the D&Os to obtain a "proposed comfort order" declaring that the payment of a loss, including their defense costs, by the insurer pursuant to the debtor's D&O coverage section (Coverage A) did not violate the automatic stay. The D&Os argued that the Coverage A policy proceeds were not property of the estate. Alternatively, the D&Os argued that cause existed to lift the stay to enforce their rights under the policy. Finally, the D&Os also asserted that the chapter 7 trustee was not entitled to review or regulate their defense costs. The D&Os did not request a specific amount of coverage for their defense costs.

- Is the chapter 7 trustee entitled to information related to or oversight of the D&O's defense costs?

- What impact do the order of payment provisions for Coverage A and Coverage B claims have on the D&O's motion?

- Should the court limit the D&O's defense costs if the motion is granted?

See In re Licking River Mining, LLC, 2016 WL 3251890 (Bankr. E.D.K.Y., June 6, 2016).