When You Need it Most:
Directors and Officers Insurance in Bankruptcy

"What Could Be Worse than Your Company Spiraling Into Chapter 11?

Watching Your D & O Coverage Go With It."

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"Many companies continue to face serious financial challenges. Directors and officers of these companies face mounting pressure to fix their solvency crises quickly by selling assets, restructuring debt, instituting radically new corporate strategies, or by other means. However, one must proceed very carefully when making these corporate decisions, because they can serve as the basis of lawsuits claiming breach of fiduciary duties, or of other claims based upon laws relating to fraudulent conveyances or illegal dividends. **Those in charge of a financially troubled company may have their actions questioned by courts, creditors, bankruptcy trustees, and shareholders who have the benefit of twenty-twenty hindsight**."

Richard M. Cieri and Michael J. Riela, "Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions," 2 DePaul Business & Commercial L.J. 295, 296 (2004)

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F. Jurisdictional Issues

I. General Overview of Corporate Governance and Directors' Duties

A. The rights and powers of a corporation are generally governed by the laws of the state of its incorporation. *E.g.*, *Rogers v. Guaranty Trust Co. of New York*, 288 U.S. 123 (1933); *In re Gen-Air Plumbing & Remodeling, Inc.,* 208 B.R. 426, 429 (Bankr. N.D. Ill. 1997); *In re Stavola/Manson Electric Co., Inc.*, 94 B.R. 21, 24 (Bankr. D. Conn. 1988).

B. The specific sources of a corporation's power are the various states' statutory provisions and the corporation's governing documents (i.e., the certificate or articles of incorporation and the by-laws). *E.g., In re American Globus Corp.*, 195 B.R. 263, 265 (Bankr. S.D.N.Y. 1996).

C. Each state, and each corporation, will inevitably have provisions unique to itself. Nonetheless, the general rule in all jurisdictions seems to be that a corporation's board of directors has control over its policies.

D. The last few decades have seen a proliferation of statutes authorizing the use of business entities different both from the traditional corporation and from limited and general partnerships, such as Limited Liability Corporations. These entities are also creatures of statute.

E. Fiduciary Duties of Corporate Directors

1. The fiduciary duties of a director are also determined by the law of the state of its incorporation. *Slattery v. Bower*, 924 F.2d 6, 9 (1st Cir. 1991).

2. Generally, board members and officers, in carrying out their managerial duties, owe a fiduciary duty only to the corporation and its shareholders. *E.g.*, *United States v. Jolly*, 102 F.3d 46, 48 (2d Cir. 1996).

3. The Revised Model Business Corporation Act of 1984 ("RMBCA") attemped to codify the traditional standard of conduct for directors and has been enacted into law in many states. With some variations, for example, Georgia's O.C.G.A. §14-2-830, Alabama Code §10A-2-8.30, Tennessee Code §48-18-301, Florida Statutes, §607.0830, and Delaware Code, Title 8, §172 all contain provisions mirroring the RMBCA. The Florida version provides:

> (1) A director shall discharge his or her duties as a director, including his or her duties as a member of a committee:
>
> (a) **In good faith**;
>
> (b) With the care an **ordinarily prudent person** in a like position would exercise under similar circumstances; and

(c) In a manner he or she reasonably believes to be in the **best interests of the corporation**.

(2) In discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(a) One or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(b) Legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

(c) A committee of the board of directors of which he or she is not a member if the director reasonably believes the committee merits confidence.

(3) **In discharging his or her duties, a director may consider such factors as the director deems relevant, including the long-term prospects and interests of the corporation and its shareholders, and the social, economic, legal, or other effects of any action on the employees, suppliers, customers of the corporation or its subsidiaries, the communities and society in which the corporation or its subsidiaries operate, and the economy of the state and the nation.**

(4) A director is not acting in good faith if he or she has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (2) unwarranted.

(5) **A director is not liable for any action taken as a director, or any failure to take any action, if he or she performed the duties of his or her office in compliance with this section.**

4. Generally, creditors are not owed similar duties because satisfaction of creditors' claims requires only compliance with the contracts that create the claim. *United States v. Jolly*, 102 F.3d 46, 48 (2d cir. 1996)("[A] firm's obligations to creditors are generally regarded solely as contractual"); *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004)("It is presumed that creditors are capable of protecting themselves through contractual agreements").

5. In many states, however, when a debtor is insolvent[1] officers and directors may also owe a duty to creditors. *Unsecured Creditors Comm. of STN Enterprises, Inc. v. Noyes*, 779 F.2d 901, 904 (2d Cir. 1985); *Connoly v. Agostino's Ristorante, Inc.*, 775 So. 2d 387, 388 (Fla. 2d DCA 2000) (*citing Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del.Ch.1992); *In re McCook Metals, LLC*, 319 B.R. 570, 594 (Bankr. N.D.Ill. 2005).

6. Case law also suggests that fiduciary duties arise not only when actual insolvency is apparent, but even when a corporation is in the "vicinity of insolvency" or "zone of insolvency." *See Peroira v. Cogan*, 294 B.R. 449, 519-520 (S.D.N.Y. 2003); *Credit Lyonnais Bank Nederland, N.V. v Pathe Comm. Corp.,* 1991 WL 277613 at *1155 (Del.Ch. Dec. 30, 1991)("Where a corporation is operating in the vicinity of insolvency, a board of directors is not merely an agent of the residual risk bearers [the stockholders] but owes a duty to the corporate enterprise."

F. Duty of Care.

1. The duty of care requires directors and officers to exercise the **same care that a reasonable and prudent person in a similar position would exercise under similar circumstances**. *E.g. Meyers v. Moody*, 693 F.2d 1196 (5th Cir. 1982); D. J. Block, et al., *The Business Judgment Rule, Fiduciary Duties of Corporate Directors*, 109 n.9 (Aspen Law & Business, 5th Ed. 1998).

2. The duty of care requires the director to exercise oversight capacity and in the process be informed of relevant and material information reasonably available to the fiduciary. *See e.g., Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981) (director found liable for not noticing and trying to prevent misappropriation of corporate funds).

3. The duty of care also encompasses a duty to make decisions with a reasonable amount of attention and skill. *See, Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

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[1] Insolvency is typically determined by one of two tests – the balance sheet test and the equitable test. A rebuttable presumption of equitable insolvency has been created by statute in Florida. "A debtor who is generally not paying his or her debts as they become due is presumed to be insolvent." Fla. Stat. §726.103(2). Case authority articulates the rule in a similar fashion, noting that a corporation is not only considered insolvent when liabilities exceed assets but also when the corporation "has a general inability to answer in the course of business the liabilities existing and capable of being enforced." *James Talcott, Inc. v. Crown Industries, Inc.*, 23 So.2d 311 (Fla.App. 1975).

4. **The business judgment rule protects decisions that which can be attributed to a rational business purpose.** *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971). The business judgment rule applies if disinterested and independent directors, on an informed basis, make the decision in good faith. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). It creates a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interest of the company.

5. The business judgment rule protects officers and directors from personal liability when performing their fiduciary duties provided they have not acted "fraudulently, illegally, or oppressively, or in bad faith." *In re Toy King Distributors, Inc.* 256 B.R. 1, 168 (Bankr. M.D. Fla. 2000)(internal citations omitted). Courts recognize that directors are generally more qualified to make business decisions than judges and will not look in hindsight to second guess a fiduciary's business decisions. *Id*. "Florida Statute §607.0831 … will not permit liability for violation of the duties under the standard of care, unless the breach constitutes among other things, a violation of criminal law, a transaction which amounts to self-dealing, or recklessness, conscious disregard for the best interest of the corporation or willful misconduct." *Id*.

6. Many states have enacted "director shield" or "charter option" statutes that permit a corporation to include provisions in its charter to effectively eliminate liability for a breach of the duty of care in the absence of improper personal benefit or fraud. *See, e.g.,* Del. Code Title 8, §102(b)(7); *See also*, Fla. Stat., §607.0831 (which begins with the words, "A director is not personally liable for monetary damages. . .). Fla. Stat., §607.0831 automatically applies to all corporations, although it has not been given as broad a construction as some of the charter option statutes.

G. Duty of Loyalty.

1. Corporate fiduciaries should not use their position in the corporation to obtain personal advantage. *See, e.g., FDIC v. Sea Pines Co*., 692 F.2d 973, 976 (4th Cir. 1982), *cert. denied*, 461 U.S. 928 (1983).

2. The duty of loyalty prohibits self-dealing and usurpation of corporate opportunity by directors. *See, e.g., Pepper v. Litton*, 308 U.S. 295, 306-07 (1939); *Guth v. Loft*, 5 A.2d 503 (Del. 1939) (explaining the concept of usurpation of corporate opportunity).

3. When analyzing a decision in the context of the duty of loyalty, the test is whether the transaction is objectively fair. *See, e.g., Miramar Resources, Inc. v. Schultz (In re Schultz)*, 208 B.R. 723, 730 (Bankr. M.D. Fla. 1997); *Committee of the Creditors of Xonics Med. Sys., Inc. v. Haverty (In re*

Xonics, Inc.), 99 B.R. 870, 876 (Bankr. N.D. Ill. 1989).

4. Court decisions dealing with breaches of fiduciary duty to creditors may find a breach of duty when there are insider preferences and fraudulent transfers for the benefit of directors and stockholders.

II. Indemnification of Corporate Directors

A. As a general rule, corporations may indemnify their officers, employees, and agents for acts if to do so would not be in violation of public policy. Many states have enacted statutes codifying this rule.

B. O.C.G.A. §14-2-851 provides:

(a) Except as otherwise provided in this Code section, **a corporation may indemnify an individual who is a party to a proceeding because he or she is or was a director against liability** incurred in the proceeding **if**:

(1) **Such individual conducted himself or herself in good faith**; **and**

(2) **Such individual reasonably believed**:

(A) **In the case of conduct in his or her official capacity, that such conduct was in the best interests of the corporation**;

(B) **In all other cases, that such conduct was at least not opposed to the best interests of the corporation**; and

(C) In the case of any criminal proceeding, that the individual had no reasonable cause to believe such conduct was unlawful.

* * * *

(d) **A corporation may not indemnify a director** under this Code section:

(1) **In connection with a proceeding by or in the right of the corporation, except for reasonable expenses incurred in connection with the proceeding if it is determined that the director has met the relevant standard of conduct under this Code section**; or

(2) In connection with any proceeding with respect to conduct for which he or she was adjudged liable on the basis that **personal benefit was improperly received by him or her**, whether or not involving action in his or her official capacity.

C. O.C.G.A. §14-2-857 provides:

1. A corporation may indemnify and advance expenses under this part to an officer of the corporation who is a party to a proceeding because he or she is an officer of the corporation:

(1) To the same extent as a director; and

(2) If he or she is not a director, to such further extent as may be provided by the articles of incorporation, the bylaws, a resolution of the board of directors, or contract except for liability arising out of conduct that constitutes:

(A) Appropriation, in violation of his or her duties, of any business opportunity of the corporation;

(B) Acts or omissions which involve intentional misconduct or a knowing violation of law;

(C) The types of liability set forth in Code Section 14-2-832; or

(D) Receipt of an improper personal benefit.

(b) The provisions of paragraph (2) of subsection (a) of this Code section shall apply to an officer who is also a director if the sole basis on which he or she is made a party to the proceeding is an act or omission solely as an officer.

(c) An officer of a corporation who is not a director is entitled to mandatory indemnification under Code Section 14-2-852, and may apply to a court under Code Section 14-2-854 for indemnification or advances for expenses, in each case to the same extent to which a director may be entitled to indemnification or advances for expenses under those provisions.

(d) A corporation may also indemnify and advance expenses to an employee or agent who is not a director to the extent, consistent with public policy, that may be provided by its articles of incorporation, bylaws, general or specific action of its board of directors, or contract.

III. The D & O Policy

A. Generally

1. In the absence of D&O insurance, directors must rely upon their indemnification agreements with the company to protect their personal

assets and pay costs of defense if they are sued for breach of fiduciary duty. If the company is friendly and solvent, this might well be adequate protection for the directors, but problems arise as bankruptcy looms.

2. In bankruptcy the indemnification claims of directors are likely merely unsecured claims that are not payable out of assets of the estate in preference to other unsecured claims. *See In re Baldwin-United Corp.,* 43 B.R. 443 (S.D. Ohio 1984) (§503(b)(1)(A) did not require a corporate debtor to advance defense fees to former D&Os to defend allegations of misconduct in connection with prepetition service because the debtor's obligation to indemnify its D&Os had fully matured prior to the filing of the bankruptcy petition); *In re Amfesco Industries, Inc.*, 81 B.R. 777 (Bankr. E.D.N.Y. 1988) (legal expenses incurred by former management were incurred in response to threats of litigation against them, unmatured, contingent rights to payment and, as such, fell within the Bankruptcy Code's definition of a claim; no administrative priority claims under §503(b)(1)(A) because the claims for expenses filed by the directors and officers arose out of prepetition services rendered to the corporation rather than post-petition services to the debtor). *In re Heck's Properties, Inc.*, 151 B.R. 739 (S.D.W.Va. 1992)(directors and officers were entitled to indemnification and administrative cost priority for claims asserted for post-petition breaches of fiduciary duty).

3. In an insolvency setting, therefore, a director's only real protection may come from a D&O policy.

4. There are fewer reported cases involving D&O policies than involving other types of insurance, mainly because there are fewer policies issued and most of those contain arbitration clauses.

B. Some Generalizations as to D&O Policies:

1. Absent statutory requirements, D&O insurance coverage is a matter of contract, and the scope of coverage will be defined by the terms of the policy. There is little state regulation of D&O policies, unlike some other types of coverage such as homeowners, automobile insurance, workers' compensation, and health insurance policies. Moreover, there have not been "standardized" D&O policy skeletons issued by the Insurance Services Office. This results in a wide divergence of policy language and provisions. "Off-the shelf" policies may have coverage holes that can be changed through negotiation prior to placement.

2. D&O policies are typically "wasting" policies. Thus, costs of defense reduce the amounts available to pay damages. The policy limit will thus be an aggregate amount for all legal defense costs and claims paid. *See, In re GunnAllen Financial, Inc.*, 443 B.R. 908, 912 (Bankr. M.D.Fla. 2011)

("[E]ach dollar spent on defense costs reduces the amount available to pay claims"); *Boles v. Turner (In re Enivid, Inc.)*, 364 B.R. 139, 143-144 (Bankr. D.Mass. 2007).

3. They are "claims made" policies. In other words, regardless of when the wrongful act occurred, the claim must be made during the policy term. *See*, *Cox Communications, Inc. v. Nat. Union Fire Ins. Co.*, 708 F.Supp. 2d 1322, 1326 (N.D.Ga. 2010)(interpreting "claims made" provision in D&O policy); *In re GunnAllen*, 443 B.R. at 912.

4. D&O policies generally do not cover intentional wrongdoing, dishonest conduct, or risks arising from moral turpitude or want of integrity. Coverage for these risks may be provided by fidelity coverage. *See, e.g., Elgin National Bank v. Home Idem. Co.*, 583 F.2d 1281, 1283 (5th Cir. 1978)("Every loss covered by [a] banker's blanket bond is by definition [e]xcluded from coverage by the liability policy"); *First Nat. Bank Holding Co. v. Fidelity & Deposit Ins. Co. of Maryland*, 885 F.Supp. 1533 (N.D. Fla. 1995)(no coverage for losses incurred from loans made by bank president, who was later convicted, to fictitious entities to avoid lending limits).

5. The insurer's obligation is generally one of reimbursement or indemnification, not direct payment. Some policies, however, allow directors to collect directly when the company is barred by law or contract from indemnifying the directors. *See In re Downey Fin. Corp.*, 428 B.R. 595 (Bankr. D.Del. 2010).

6. Where a single lawsuit contains both covered (negligence) and non-covered (intentional tort) claims, the insurer may be responsible for the costs of defending only the covered claims, requiring an allocation of defense costs.

7. There is often a deductible or self-insured retention amount that must first be paid before the insurer's obligation to indemnify the D&Os kicks in.

C. Side A, Side B, and Side C coverages

1. **Side A Coverage (or Insuring Clause 1) covers only the officers and directors, not the company,** and generally provides coverage when the company does not indemnify the D&Os. This was the original coverage when Lloyds of London initiated this type of coverage in the late 1930s –a time when many states did not permit indemnification of directors.

2. **Side B Coverage (Insuring Clause 2) covers the company's costs incurred when it lawfully indemnifies its officers and directors**. This obviously reduces the company's risk of paying large amounts on claims

against its directors and is designed to protect the company's balance sheet.

3. **Side C Coverage (Insuring Clause 3) protects the Company for its own wrongful acts**. This most frequently protects public companies for alleged violations of laws regulating to the issuance of securities to the public.

4. There is generally an aggregate policy limit for all coverages: Side A, Side B, and Side C, and traditionally there was no order of priority in payments.

5. Sometimes there is Side D Coverage (Insuring Clause 4) may cover investigative costs related to shareholder derivative demands.

D. "Drop-down" Coverage and Executive Liability Policies

1. "Drop-down" coverage generically refers to additional separate policies or additional insuring clauses providing coverage that sits on top of a traditional D&O insurance program and covers only the officers and directors, or perhaps the independent directors (but not the company) for claims with respect to which the company will not or cannot indemnify them. A separate policy probably presents the least risk if a bankruptcy is filed.

2. Drop-down coverage may include a Side A-DIC ("Difference in Conditions") policy providing excess Side A Coverage and plugging coverage holes in coverage in the event, for example, of bankruptcy.

3. Executive liability policies may provide broader coverage directly to executives and may include employment practices liability insurance, kidnap/ransom/extortion insurance, ERISA liability insurance, and breach of duty claims.

4. Separate policies may also cover independent directors – excluding officers and inside directors.

5. It is common now for larger corporations to layer coverage to include all of those types of coverage.

E. Policy Terms, Exclusions, and Definitional Issues

1. Covered claims may exclude claims arising from "known but undisclosed facts and circumstances."

- This exclusion presents risks for outside directors where management, but not the directors, knew of wrongdoing.

- This bears some relation to an insurer's efforts to rescind a policy for fraud or misrepresentation in the application process, as failure to honestly disclose relevant facts as required by an application may lead to a rescission action.

2. Termination of a policy upon change of control – is a chapter 11 filing a "change of control" terminating post-filing coverage?

3. Who is an "officer" covered by the policy? *See, e.g., Sphinx v. Nat. Union Fire Ins. Co.*, 412 F.3d 1224 (11th Cir. 2005). Does it include only board-appointed officers?

4. Is there an "Insured v. Insured" exclusion? This exclusion is designed to avoid collusive disputes between a corporation and former directors or officers. *See Biltmore Assoc., LLC v. Twin City Fire Ins. Co.*, 572 F.3d 663 (9th Cir. 2009), discussed in depth in Section V *infra*.

   - If there is this exclusion, is there a "carve back" clause providing coverage in the event of suit by a bankruptcy trustee, creditors' committee, or representative of the estate?

5. Policies always provide for the prompt notification of claims (generally 30 days) and they normally exclude from coverage claims not reported to the insurer within this time. Some policies may permit the company to purchase an extended reporting or "discovery period" following the expiration date of the policy period.

6. Clauses permitting the insurer to rescind the policy based upon fraud in the application process. *See, e.g., Scottsdale Ins. Co. v. Wave Technologies Communications, Inc.*, 341 Fed. Appx. 569, 2009 WL 2448259 (11th Cir. 2009); *National Union Fire Insur. Co. v. Sahlen*, 999 F.2d 1532 (11th Cir. 1993)(permitting rescission because audited financial statements provided to insurer were incorrect due to employees' creation of fictitious invoices). The grounds for rescission may be set forth by state statute. *E.g., Fla. Stat.*, 627.409 (2011).

   - If there is such a provision, does it permit rescission of the entire policy affecting directors an offices who did not know of or participate in the fraudulent misrepresentation? This is sometimes referred to as an "application severability provision."

   - Is there a provision stating that the knowledge of one insured will not be imputed to another insured?

- Does the application incorporate by reference financial statements?

- Are there representations and warranties as to their accuracy?

7. No coverage is provided for claims involving intentional misconduct, dishonesty, and self-dealing (i.e., transactions involving personal profit).

   - Again, of particular importance is whether the insurer can refuse coverage of innocent directors where one officer or director engaged in the intentional misconduct. Is there a severability clause?

8. Terms permitting cancellation of the policy without cause.

   - This presents risks, given that the policy only covers claims made during the term of the policy. Thus, an important question is whether the policy permits termination only for non-payment of premiums.

9. Provisions requiring insurance company consent to a settlement.

10. Definition of "claim:" does it include coverage for administrative, regulatory, civil and/or criminal proceedings? *See, e.g., Office Depot, Inc. v. Nat. Union Fire Ins. Co.*, Case No. 11-10814 (11th Cir. 2011)(slip opinion dated October 13, 2011)(denying coverage for expenses in responding to inquiries from the S.E.C.).

11. Arbitration requirement for dispute resolution.

12. Allocation of loss provisions. See ¶ III. G.3 below

13. Existence of an option giving the insured the ability to buy "tail coverage" at the expiration of a policy for a fixed amount and stated term.

14. Provisions related to the reimbursement of legal fees and costs.

F. Defense Costs

G. Allocation of proceeds between covered and non-covered claims asserted in a single action or between the insured officers and directors and the insured corporation.

   1. A damages award may be subject to allocation between counts alleging covered (negligent) misconduct and those alleging intentional, non-

covered conduct.

2. Allocation may also become an issue when responsibility may be shared among insured and non-insured parties.

3. Allocation between Side A and Side B coverages becomes particularly important when the interests of the corporation and its officers and directors diverge. A bankruptcy trustee may contend that exhaustion of a policy to pay Side A coverage may deplete Side B coverages that is property of the estate. Under Side A Coverage, the insurer may contend that liability be apportioned between the parties. *See In re National Century Fin. Enter., Inc.*, Bankr. No. 02-65236, 2005 WL 6242169 (Bankr. S.D. Ohio, Jan. 10, 2005) (allocating even in the absence of an allocation clause 70% of a $5 million policy to the D&Os and 30% to the entity in the face of $2.6 billion in claims).

4. Some policies include an "order of payment" provision requiring that policy limits should first be applied to Side A Coverage.

   - Examples of "Order of Payment" clauses can be found in *In re Locateplus Holdings Corp.*, Case No. 11-15791-JNF (Bank. D.Mass. Oct. 31, 2011)("[t]he insurer shall in all events first pay Loss for which coverage is provided under Coverage A. . . . The bankruptcy or insolvency of any Organization or any Insured Person shall not relieve the Insurer of its obligations to prioritize payment of covered Loss under this policy. . . .") and *In re Downey Fin. Corp.*, 428 B.R. 595 (Bankr. D.Del. 2010).

IV. Summary of Non-Bankruptcy Risks that D&O Coverage Will be Denied.

A. The company committed fraud or failed to make full disclosure in the insurance application, which may be an application never seen by an outside director.

What to look for:

- language in the policy that it is not rescindable;
- language in the policy limiting rescission to those participating in the fraud (severability clauses);
- language in the policy regarding incorporation of and reliance upon papers other than the policy application (particularly financial reports and SEC filings, which are generally reviewed only at a high level by outside directors).

B. One or more officers committed an intentional and/or self-serving wrongful act.

What to look for:

- a severance clause that would preserve defenses for innocent directors;

- in the case of Side B indemnification policies, state statutes and case law determining the conditions under which a company is permitted or required to indemnify directors

C. The near certainty that policy limits will be eroded by defense costs.

D. The risk that the company had notice of a claim and did not timely report it. Many states hold that notice provisions will be strictly enforced. Issues include:

- Has the policy been triggered by a written, pre-suit demand for payment? If so, was notice given? *Compare*, *Westree Marina Mgmt. Inc. v. Arrowood Indemnity Co.*, 163 Cal. App. 4th 1387 (Cal. Ct. App. 2008)(letter from former employee's counsel after right-to-sue letter was a claim; no coverage), with *In re Ancillary Receivership of Reliance Ins. Co.*, 863 N.Y.S. 2d 415 (Sup. Ct. N.Y. 2008)(letter from lawyer for former employees fell "far short" of a demand for money; notice was therefore timely).

- Has there been activity involving a regulatory agency regarding compliance issues? If so, was notice of a claim required and given? *Compare*, *F.D.I.C. v. Booth*, 82 F.3d 670 (5th Cir. 1996)(letter from F.D.I.C. to directors following examination reminding directors of their duties and stating that failure to take remedial action might result in civil money penalties was not a claim) and *Resolution Trust Corp. v. Artley*, 24 F.3d 1363 (11th Cir. 1994)(regulatory agency's request for compliance without a monetary demand not a claim) *with* Mt. *Hawley Ins. Co. v. Federal Savings & Loan Ins. Corp.*, 695 F.Supp. 469 (C.D. Cal. 1987)(similar letters from bank regulators did constitute a claim).

E. Is a policy (or tail coverage) about to expire prior to the filing of any suit or the receipt of a demand letter?

- Can the company or the directors "self-report" by presenting the insurer with facts or circumstances that might give rise to a suit or demand? *Compare*, *Continental Insurance Co. v. Metro-Goldwyn-Mayer*, 107 F.3d 1344 (9th Cir. 1997)(A "laundry list" provided by the insured, notifying the insurer of related lawsuits and the potential for additional claims arising from a specific merger transaction, constituted sufficient notice under the policy; in addition to the laundry list, the insured tendered several documents and pleadings that provided all the information

necessary to satisfy the notice provisions of the insurance contract, _*with*_ *Federal Deposit Insurance Corp. v. Caplan*, 838 F.Supp. 1125 (W.D.La. 1993)(Under Louisiana law, a letter from the insured that purported to notify the insurer of potential claims by the FDIC but that did not describe the "wrongful acts" involved, did not constitute sufficient notice under the policy).

V. Bankruptcy Issues Related to D&O Policies

A. Is the policy "property of the estate" under §541 and the subject to the automatic stay under §362(a)(3)?

1. Courts have reached different conclusions as to whether coverage under a D&O policy is property of the estate. Typically, the corporate debtor has obtained, paid for, and owns the policy. Most courts have adopted the approach that the proceeds payable under the policy are different from ownership of the policy. *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3rd 203, 216 (3rd Cir. 2000)(proceeds from an insurance policy should be evaluated separately from the debtor's interest in the policy itself); *In re Beach First Nat. Bacshares, Inc.*, 451 B.R. 406 (Bankr. D.S.C. 2011); *In re CHS Electronics, Inc.*, 261 B.R. 538, 542 (Bankr. S.D.Fla. 2001); *In re Goodenow*, 157 B.R. 724 (Bankr. D.Me. 1993). The question of whether proceeds of policy are property of the estate may be fact intensive. *In re First Central Financial Corp.*, 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999) with the major factual inquiries being the language of the policy and the number and amount of the claims against the policy.

2. In *Louisiana World Exploration, Inc. v. Federal Ins. Co. (Louisiana World Exposition, Inc.)*, 832 F.2d 1391 (5th Cir. 1987), the Fifth Circuit decided that the proceeds of a policy providing Side A coverage to officers and directors and Side B coverage to the company were not property of the estate. The court found that an unadjudicated claim from an estate does not give the debtor a property interest in the policy. *Accord, In re Daisy Sys. Sec. Litigation*, 132 B.R. 752, 755 (Bankr. N.D.Cal.)(proceeds from D&A policy not property of the estate).

3. In *CHS Electronics,* a case involving Side A and Side B coverage, the court found that the proceeds under the Side A coverage were not property of the estate where the policy limits were sufficient to cover any claim the debtor might make under Side B coverage. *In re CHS Electronics, Inc.*, *supra*, at 543; *accord, In re Youngstown Osteopathic Hospital Association*, 271 B.R. 544 (Bankr. N.D.Ohio 2002).

Other cases include:

- *In re Pintlar Corp.*, 124 F.3d 1310 (9th Cir. 1997) (debtor sued former management; the court held that direct Side A coverage was not property of the estate; automatic stay did not preclude declaratory action brought by insurer against former management to determine that no coverage existed); *In re Spaulding Composites Co., Inc.*, 207 B.R. 899 (Bankr. 9th Cir. 1997)(Side A coverage not property of the estate; declaratory action by insurer to determine existence of coverage allowed to proceed).

- *In re Sacred Heart Hosp.*, 182 B.R. 413 (E.D.Pa. 1995) (policy with Side A and Side B coverage was property of the estate).

4. Where the policy includes Side C coverage (direct coverage to the debtor for losses), courts typically conclude that the policy is property of the estate and the directors and officers must obtain relief from the automatic stay to make a claim for defense costs. *In re Cybermedia, Inc.*, 280 B.R. 12 (Bankr. D.Ma. 2002)(suit brought by chapter 7 trustee against two former directors and officers on several counts, including breach of fiduciary duty; "The majority view is that insurance policies are property of the estate and protected by the automatic stay provisions of Section 362(a)(3) of the Code"). The court did not lift the stay to allow the payment of defense costs after considering the balance of harm as between the estate and the former officers and directors. *See also, In re Boston Regional Medical Center, Inc.*, 285 B.R. 87 (Bankr. D.Ma. 2002); *In re Enron Corp.*, 2002 WL 1008240 (Bankr. S.D.N.Y. May 17, 2002).

5. In *In re Medex Regional Laboratories, LLC*, 314 B.R. 716 (Bankr. E.D.Tenn 2004) the debtor corporation had obtained a policy with Side A, Side B, and Side C coverage. The creditors' committee filed suit against officers and directors for breach of fiduciary duty, breach of the duty of care and loyalty, abdication of responsibilities, breach of contract, negligent supervision, negligent promotion, negligent hiring, conversion, and ordinary negligence. The directors filed a motion seeking a determination that the automatic stay did not apply or, alternatively, for relief from stay. The parties stipulated that no claims under the Side C coverage had been made and that any such future claims would be time barred. The debtor had not actually indemnified any officers or directors. The Court held:

   > Because the Debtor had not provided any indemnification to the Movants and because such indemnification is hypothetical and/or speculative, the court finds that the Policy Proceeds are not property of the Debtor's bankruptcy estate. . . .

Id. at 722-723.

B. If the proceeds of a D&O Policy are property of the estate protected by the automatic stay, when should the stay be lifted to allow the insurer to pay claims or defense costs of directors?

1. The ground for stay relief would be "cause" under §362(d)(1).

2. Summarizing the law, one recent case stated:

> The Court finds cause exists to grant relief from stay. Courts faced with similar situations have commonly granted relief from stay to allow directors and officers to receive payment for their defense costs. . . . Debtor purchased the Policy for the purpose, in large part, of insulating its directors and officers from personal liability for the costs they incurred in defending actions. "D&O policies are obtained for the protection of individual directors and officers. . . . in essence and at its core, a D & O policy remains a safeguard of officer and director interests and not a vehicle for corporate protection." Movants cannot now be prevented from using the Policy for its intended purpose simply because Debtor wishes to save the policy limit for any potential claims of its own.

In Beach First Nat. Bancshares, Inc., 451 B.R. 406, 410-411 (Bankr. D.S.C. 2011)(internal citations omitted).

3. Other cases include:

- *In re Arter & Hadden, LLP*, 335 B.R. 666 (Bankr. N.D.Ohio 2005) (policy was property of the estate, but the court granted stay relief to directors and officers to receive defense costs based upon the "substantial and irreparable" harm to them and the fact there were no identified indemnification or entity claims).

- *In re Petters Co.*, 419 B.R. 369 (Bankr. D.Minn. 2009)(holding that, when an entity and its directors and officers are both potential beneficiaries under a policy, they hold equal rights to make a claim on proceeds under the policy and the policy is property of the estate, but lifting the automatic stay for a portion of the proceeds in order to fund the criminal defense of a director or officer. The remainder of the proceeds remained subject to the automatic stay for the benefit of the bankruptcy estate).

- *In re Adelphia Communications Corp.,* 298 B.R. 49 (S.D.N.Y. 2003)(remanding order modifying the automatic stay to allow defense payments and restricting all insurance-related litigation – including litigation to draw down from the policies if the insurer refused to pay the directors' and officers' claims – until after the conclusion of criminal proceedings against the directors and officers. The district court noted that the debtors did not yet have any property interest in the proceeds of the policies, because they had made no indemnification payments to the directors and officers).

C. May the Bankruptcy Court under §105 to enjoin third parties from pursuing proceeds of those D&O policies and enjoining insurers from settling?

1. Where the third parties are creditors pursuing essentially derivative breach of duty claims against officers that are also being asserted by the debtor, a trustee, or a liquidating trust, some cases have enjoined the creditor action. *Fisher v. Apostolov*, 155 F.3rd 876 (7th Cir. 1998)(Although no D&O policy existed, the ruling in *Fisher* was extended by other 7th Circuit Courts to shareholder suits against D&O insurers); *Megliola v. Maxwell*, 293 B.R. 443 (N.W.Ill. 2003). *See also A.H. Robins Co. v. Piccinin*, 788 F.2d 994 (4th Cir. 1986), *cert denied* 479 U.S. 876 (1986)(automatic stay extended to preclude action against officers and directors based upon their right of "absolute indemnity" from the debtor); *In re Johns-Manville Corp.*, 26 B.R. 420 (Bankr. S.D.N.Y. 1983).

2. Most decisions hold that no injunction will lie, commenting in Judge Robert Mark's words that no provisions in the Bankruptcy Code or case law "give a bankruptcy trustee any different status than a non-bankruptcy plaintiff with an unliquidated claim against third parties which may be covered by insurance proceeds about to be used to settle or satisfy a judgment entered in favor of other plaintiffs." *In re CHS Elec., Inc.*, 261 B.R. 538 (Bankr. S.D.Fla. 2001). See also *In re GunnAllen Financial, Inc.*, 443 B.R. 908, 912 (Bankr. M.D.Fla. 2011) (holding that no bar order would be entered to protect third parties as part of a settlement with a liquidating trustee); *Miller v. McDonald (In re World Health Alternatives, Inc.)*, 369 B.R. 805 (Bankr. D. Del. 2007) (no injunction in favor of a chapter 7 trustee who was also asserting claims against directors and officers to prevent use of Side A funds to defend the directors and officers in other actions).

3. Other cases declining to issue a §105 injunction include:

   - *In re Reliance Acceptance Group, Inc.*, 235 B.R. 548 (D.Del. 1999);

- *In re Uni-Marts, LLC*, 404 B.R. 767 (Bankr. D.Del. 2009)(no protection from president covered by D&O policy from suit filed in bankruptcy court seeking damages against him);

- *In re Enivid, Inc.*, 364 B.R. 139 (Bankr. D.Mass. 2007).

D. Does a chapter 11 filing stay an insurer's contractual entitlement to cancel the policy?

1. Like most insurance policies, D&O policies often have provisions providing for cancellation for non-payment of premiums. Some policies permit at-will termination by either party.

2. In *Nicholls v. Zurich Am. Ins. Co*., 244 F. Supp. 2d 1144 (D. Colo. 2003), a smoothie company and its subsidiary filed chapter 11 petitions "after its corporate directors and officers slurped up all of the business' assets." The D&O insurer cancelled its policy about a month later for failure to pay premiums. The court held that the post-petition termination did not violate the automatic stay because the stay did not permit the court to "rewrite the insurance policy to prevent the termination of a contract by its own terms."

3. *In re Minoco Group of Cos., Ltd.*, 799 F.2d 517 (9th Cir. 1986) (cancellation of a prepaid D&O policy was automatically stayed pursuant to 11 U.S.C. §362(a)(3), even though the policies only benefitted the directors and officers). The court determined that the D&O policies were the property of the estate because the policies protected against diminution of the value of the estate and because the estate was worth more with the policies than without them.

4. *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1401 (5th Cir. 1987)("We agree that the [D&O policies] belong to the bankrupt estate; this empowers the bankruptcy court to prevent their cancellation").

E. Does an "insured v. insured" exclusion apply to terminate coverage if a suit against officers or directors is brought by:

- a debtor in possession;

- a representative of the bankruptcy estate, such as a post-confirmation liquidating trustee;

- a chapter 7 or chapter 11 trustee; or

- an official committee of unsecured creditors?

1. This, like most issues regarding D&O policies, will turn in the first instance on the language of the policy.

2. Several cases in the Eleventh Circuit have addressed the issue, coming to different conclusions based in part upon the language of the specific policy at issue:

   - In *Nat'l. Union Fire v. Olympia Holding*, Case No. 94-2081, 1996 WL 33415761, at *6-7 (N.D.Ga. June 4, 1996), *aff'd* 148 F.3d 1070 (11th Cir. 1998)(unpublished table disposition), the court held that a chapter 7 trustee stood in the shoes of the company in prosecuting claims against former directors and officers and was barred by the "insured versus insured" exclusion.

   - In *Certain Underwriters at Lloyd's of London v. Rigby*, 917 So.2d 192 (Fla.), *review dismissed as improvidently granted* 934 So.2d 1183 (Fla. 2006), the court held that a suit by a chapter 7 trustee against a former officer and director was a covered claim notwithstanding the "assured versus assured" exclusion, even though the trustee had himself been added as assured party (the court finding that he was not bringing the claim in that capacity but rather as a representative of the estate and creditors).

   - In *Grafenauer v. Mukamal (In re Laminate Kingdom, LLC*), Nos. 07-10279, 07-01792, 2008 WL 704396, at *3-4 (Bankr. S.D.Fla. March 13, 2008), the court, relying upon the *Rigby* decision, held that the Chapter 7 trustee was a distinct entity from the debtor.

   - In *Federal Ins. Co. v. Surujon*, No. 07-22819, 2008 WL 2949438, at *6 & n. 5 (S.D.Fla. July 29, 2008), the court held that the reorganized debtor was the same entity as the pre-bankruptcy debtor and that there was no coverage under the D&O policy for its suit against former directors and officers, relying in part upon the *Nat'l. Union Fire v. Olympia Holding* ruling.

   - Most recently, in *Cox Communications, Inc. v. Nat. Union Fire Ins. Co.*, 708 F.Supp. 2d 1322, 1326 (N.D.Ga. 2010), the court looked carefully at the policy language in concluding that an action against directors and officers by a bondholders' committee in a chapter 7 case was covered. The *Cox* court distinguished the *Biltmore* case, *infra*, finding that a bondholder's committee that sued the *Cox* directors was different from the DIP which first sued the directors in *Biltmore*. It found the reasoning in *Olympia, supra,* "unpersuasive." Id. at 1331-1332.

3. In a widely discussed decision, the Ninth Circuit Court of Appeals held in *Biltmore Assocs. LLC v. Twin City Fire Ins. Co.*, 572 F.3d 663 (9th Cir. 2009) that a chapter 11 debtor and its assignee (a litigation trust for the benefit of creditors) had no right of recovery against the proceeds of a D&O insurance policy containing an insured vs. insured exclusion.

- The D&O policies at issue in *Biltmore* contained insured vs. insured exclusions providing that "the Insurer shall not be liable to make any payment for Loss in connection with any Claim made against the Directors and Officers . . . brought or maintained by or on behalf of an Insured in any capacity." Coverage was provided for certain derivitive claims by shareholders that were "instigated and continued totally independent" of the Insured.

- Post-filing, the debtor sued some of its recently discharged officers and directors for breach of their fiduciary duties. The insurers refused coverage under the "insured vs. insured" exclusion, and the claims against the former directors and officers were then assigned by the debtor to a trust established for creditors, pursuant to a confirmed chapter 11 plan. The trustee settled with four of the former directors and officers for a confession of judgment in the amount of $175 million with a covenant not to execute and an assignment of whatever rights the former directors and officers had against the insurers for failure to cover and bad faith. Scott Bernstein, *Ninth Circuit Rules on the Application of the Insured-vs.-Insured Exclusion*, ABI Bankruptcy Litigation Committee News, Vol. 7, No. 8, (Oct. 2010) (hereafter "Bernstein").[2] The trustee then sued the insurance companies on the basis of these claims. The bankruptcy court dismissed the complaint.

- On appeal, the Ninth Circuit held that that the insured-vs.-insured exclusion applied and affirmed the dismissal of the complaint. In the Ninth Circuit's view, the "only question . . . on the language of the exclusion is whether the underlying suit was "brought or maintained on behalf of an insured in any capacity." The trustee contended that the claim was brought on behalf of creditors and not on behalf of the pre-bankruptcy corporation.

- The Ninth Circuit, noting that to rule otherwise would promote the "moral hazard" that the insured-vs.-insured exclusion was intended to avoid, rejected the trustee's argument, stating that:

  - o to hold for the trustee would create an incentive for principals of a failing business to "bet on a lawsuit that would bail them out with money from the D&O insurance

[2] http://www.abiworld.org/committees/newsletters/litigation/vol7num8/ninth.html, at n. 9.

policy if they won and protect them from personal liability if they lost;"

- o the underlying lawsuit for breach of statutory and fiduciary duties asserted a cause of action for mismanagement that belonged to the debtor and could only be brought derivatively on behalf of the corporation;
- o as none of the insurance companies had issued any policies to the trustee or the creditors, the creditors and the trustee had no contractual claim against the insurance companies;
- o the assignment of the claims by the DIP to the trust that was formed for the creditors' benefit did not change the result as the Trustee could not "jump into the insureds' shoes to bring the lawsuit, out of their shoes to claim not to be suing as though it were the insureds, and then back into their shoes to get compensatory and punitive damages for the insurers' failure to cover their liabilities;"

4. In deciding the last point, the *Biltmore* court rejected the argument (based in part upon the differences in fiduciary responsibilities of the DIP's management resulting from the bankruptcy) that the pre-petition debtor and the liquidating trustee were not "different entities" for purposes of the insured vs. insured exclusion decisions. Bernstein, at fn. 14.

5. In so ruling, the Ninth Circuit expressly overruled the court decisions in *Pintlar Corp. v. Fid. & Cas. Co. of N.Y.*, 205 B.R. 945 (Bankr. D.Idaho 1997).

6. The *Biltmore* decision appears to be in the minority. Other cases reaching the same result include: *Reliance Ins. Co. of Ill. v. Weis*, 1993 WL 369302, 5 F.3d 532 (8th Cir. 1993)(unpublished table disposition) (affirming "on the basis of the well-reasoned opinion of the district court."), *aff'g* 148 B.R. 575, 581-83 (E.D.Mo. 1992)(bankruptcy plan agent is assignee of debtor's claims, "no significant legal difference" between debtor and debtor's bankruptcy estate); *Stratton v. Nat'l. Union Fire Ins. Co. of Pittsburgh, PA*, No. 03-12018, 2004 WL 1950337, at *4-6 (D.Mass. Sept. 3, 2004)(reorganized post-bankruptcy company successor entity of pre-bankruptcy debtor); *Terry v. Federal Ins. Co.*, 315 B.R. 674 (W.D.Va. 2003).

7. The majority of cases find the plaintiff to be a "different entity." *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1116-17 (9th Cir. 2006)(bankruptcy trustee of subsidiary different entity than subsidiary itself); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F.Supp. 2d 376, 403-05 (D.Del. 2002)(Chapter 11 estate representative distinct entity from debtor); *Cohen v. Nat'l. Union Fire Ins. Co. of Pittsburgh, PA (In re County Seat Stores, Inc.)*, 280 B.R. 319, 324-26 (Bankr. S.D.N.Y. 2002)

(trustee legally distinct entity from debtor, distinguishing trustee from debtor in possession); *Gray v. Executive Risk Indem. Inc. (In re Molten Metal Tech, Inc.)*, 271 B.R. 711, 728-31 (Bankr. D.Mass. 2002) (Chapter 11 trustee not same entity as debtor, distinguishing debtor in possession); *aff'd.*, No. 02-10289, 2002 WL 923936 (D.Mass. May 6, 2002), *see also Narath v. Executive Risk Indem. Inc.*, No. 01-10122, 2002 WL 924231, at *2 (D.Mass. Mar. 14, 2002)(same, also arising from *Molten Metal's* insolvency); *Rieser v. Baudendistel (In re Buckeye Countrymark, Inc.*), 251 B.R. 835, 840-41 (Bankr. S.D.Ohio 2000)(Chapter 7 trustee not the same entity as debtor); *Yessenow v. Executive Risk Indemnity, Inc.*, Case No. 1-10-2920 (Ill.App., 1st Dist. June 30, 2011)(coverage existed for suit brought by chapter 11 debtor); *Cirka v. Nat'l. Union Fire Ins. Co. of Pittsburg, PA.*, No. 20250, 2004 WL 1813283, at *7-9 (Del.Ch. 2004)(creditor's committee not same entity or assignee of debtor in possession, which was specifically covered by the insured versus insured exclusion at issue).

E. Jurisdictional Issues

1. The determination of whether a D&O policy and its proceeds are property of the estate is a core matter. *E.g., In re Boston Medical Center, Inc.*, 285 B.R. 87 (Bankr. D.Mass. 2002).

2. A dispute over coverage under the policy may not be a core proceeding.

   · *Mt. McKinley Insurance Co. v. Corning, Inc.*, 399 F.3d 436 (2d Cir. 2005)(coverage dispute not a core proceeding; case remanded for a determination of whether the issues in the declaratory judgment action could be speedily resolved in state court, because (1) the case concerned insurance policies issued before the debtor declared bankruptcy; (2) the debtors were not involved in the lawsuit, and plaintiffs sought to adjudicate the rights of nondebtors only; and (3) the resolution of the affiliate insurer claims would have only a tangential and speculative effect on the bankruptcy proceeding)

3. Bar orders in settlements:

   · *In re Vitek, Inc.*, 51 F.3d 530 (5th Cir. 1995), the bankruptcy court approved a settlement between the bankruptcy trustee and the debtor's liability insurers, by which the insurers would receive injunctive protection from third-party suits in exchange for payment of the remainder of the policy limits to the estate. Two of the debtor's D&Os objected, arguing that the settlements left them exposed to suits while denying coverage due them as co-insured with the debtor. The bankruptcy court rejected this argument,

finding that the D&Os had no property interests in the policies. The district court reversed, holding that the D&Os had independent rights to the policy proceeds and ordered the bankruptcy court to extend its injunctive orders to cover the D&Os. The Fifth Circuit reversed and reinstated the bankruptcy court's order. The Fifth Circuit noted that it had never considered how to treat the proceeds of a liability policy in like circumstances involving co-insured and potential liability well in excess of the aggregate limits of available insurance. However, the court declined to rule on that issue, instead finding a lack of support for the district court's reliance o the principle that an insurance company may not favor the rights of one insured over another and noted that the aggrieved D&Os retained the right to sue the insurers for bad faith if they so chose.

· *In re GunnAllen Financial, Inc.*, 443 B.R. 908, 912 (Bankr. M.D.Fla. 2011)(court had jurisdiction to consider settlement and bar order but would not issue order protecting non-contributing non-debtor third parties)l