BANKRUPTCY ISSUES AFFECTING D & O COVERAGE

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Introduction

When a company files for bankruptcy, numerous and various issues can arise for the company's insurers. In many instances, the mismanagement of the company by the directors and officers caused the insolvency of the company. Additionally, regardless of fault, the Directors and Officers liability policy is viewed as a potential source of money, ripe for recovery by creditors, especially in cases where all other assets are encumbered. It is important for an insurance company to understand the implications of bankruptcy on its insured, and on the policy itself. The panel will discuss the general duties and obligations of Directors and Officers, the bankruptcy process generally and discuss the multiple entities involved in a typical bankruptcy proceeding, the standing of each and types of claims that can be brought. The panel will then address specific policy provisions and discuss how courts have evaluated those provisions.

General

Directors are fiduciaries of the company and hold a position of trust and confidence and are expected to meet their duties of care and loyalty to the company (described as the standard of conduct). The standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the company for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value. For a solvent company this means the directors are charged with the fiduciary duty to manage the company's affairs on behalf of the shareholders.

Duty of Care: Directors and officers are expected to exercise ordinary care in the discharge of their duties. Directors must exercise the degree of care that a reasonable careful and prudent person would exercise in similar circumstances. The duty of care requires them to perform their duties in an informed businesslike manner.

Duty of Loyalty: Directors must act in good faith and with the reasonable belief that the action taken is in the best interests of the company. The duty of loyalty contemplates the fiduciary duty owed is the subordination of a director's self-interest to the company.

Business Judgment Rule: The business judgment rule shields directors and officers from liability for honest mistakes and prevents the use of hindsight to impose alternative decisions on the company. Typically there is a reluctance by courts to interfere in the internal affairs of a company and to substitute their judgment for that of the officers and directors.

How are the duties of Directors Affected by the Solvency of the Company?

Solvent Company: The directors of a solvent company owe fiduciary duties to the company and to its shareholders by exercising their business judgment in the best interests of the company for the benefit of the residual claimants. For a solvent company, the residual claimants are the shareholder owners.

Standing: When a company is solvent, the fiduciary duties that the directors owe the company may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the company because they are the ultimate beneficiaries of the company's growth and increased value. Creditors do not have standing to bring a direct or a derivative action against the company.

Insolvency: Once a company becomes insolvent, the creditors become the residual beneficiaries of the company, rather than the shareholders. As residual beneficiaries, the creditors now have standing to assert derivative claims against directors on behalf of the company for breaches of fiduciary duties.

Standing: While creditors have standing to bring a claim against the company for breaches of fiduciary duty, the claim is a derivative claim made for the harm done to the company as an economic entity. It is not for any direct harm to the individual creditor.

Zone of Insolvency: A line of cases held that when a company was in the zone of insolvency the fiduciary duties of the directors shifted from the shareholders to the creditors of the company. Some courts allowed creditors to bring direct claims for breach of fiduciary duty against the directors.

Test for Insolvency: When a company becomes insolvent can sometimes be difficult to determine. There are two tests used to determine whether a company is insolvent: the balance sheet test and the ability to operate test.

Current Trend: Expanding the fiduciary duties of directors of a company arguably could create a conflict by forcing the directors to choose between opportunities to maximize the firm's profit and the need to preserve assets of the company that presumably would be used to pay creditors upon insolvency. This duty may result in risk averse behavior and avoidance of opportunities that could otherwise maximize the value of the company.

Protections for Creditors: Courts reason that there is no need to provide creditors with direct fiduciary protection as creditors are protected through their contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law and general commercial law.

Types of Coverage

D&O policies contain one or more of these three basic types of coverage. The first type of coverage is direct coverage for the individual directors and officers. The second type of coverage is indemnity coverage which reimburses the company. The third coverage is entity coverage for the company itself.

D&O Policy Provisions Affected by the Filing of Bankruptcy by the Company

It is often corporate mismanagement that caused some or all of the company's problems which necessitated the filing of bankruptcy. As a result, a variety of entities may initiate litigation against the officers and directors of the debtor company. The entities are competing to improve their own recoveries and pursue payment from the insurance proceeds. In the insolvency/bankruptcy context, this is often the only source of recovery.

Property of the Bankruptcy Estate and Issues Related to Payment of Defense Fees

When the company files bankruptcy, a frequently litigated issue is whether or not the proceeds to a D & O policy are payable for defense fees, or whether payment is stayed by the section 362 automatic stay. The type of policy can affect whether or not the policy and the proceeds are considered property of the bankruptcy estate. In situations where the stay applies, the directors and officers may not have direct access to the proceeds for payment of defense fees.

Insured versus Insured Exclusions in Bankruptcy

After a bankruptcy case is filed, it is not uncommon for interested parties to assert claims against the bankrupt entity's directors and officers. In some instances, the party asserting the claim is the entity itself, which is known as the "Debtor-in-Possession" following the commencement of the bankruptcy. Claims may also be asserted by a "Creditors Committee" – a representative group of all creditors of the Debtor-Insured, or an entity created to implement the Debtor-Insured's bankruptcy plan (usually a "Liquidating Trust" or a "Litigation Trust"). In a chapter 7 liquidation case, claims may also be asserted by a Trustee.

Priority of Payments/Order of Payments Provisions

In bankruptcy, there is often a tension between the directors and officers' desire to have proceeds available for claims against them, and the Bankruptcy Estate's interest in marshalling all assets that it can possibly reach. The inclusion of a priority of payments or order of payments provision assists with ensuring that Side A coverage is unaffected by the bankruptcy.

Notice of Circumstances

In the run-up to bankruptcy, Insureds often provide vague and non-specific information to their Insurers which purport to satisfy the Notice of Circumstances/Notice of Potential Claim provisions of claims-made policies. Although policies usually require a particular degree of specificity, policies frequently require the Insurer take the affirmative step of notifying the Insured that the purported Notice of Circumstances was insufficient.

Misrepresentations in Applications and the Affect on Innocent Directors and Officers

If an insured makes a material misrepresentation in an insurance application, the carrier may be entitled to rescind the policy in its entirety, arguing that the policy is void ab initio. Some policies contain a severability clause that protects innocent insureds. Other applicable provisions include the fraud exclusion, and the prior knowledge exclusion. Some D&O policies have added a provision that states the policy may not be rescinded for any reason.

Drop Down Issues

Claimants may argue that an excess carrier is required to drop down and provide coverage when an underlying carrier is insolvent. The drop down issue is complicated when the underlying coverage is a self insured retention and the insured is insolvent, or if the excess policy is a Side A DIC DOC policy.

Trustee as Plaintiff

Often it is the trustee for the debtor that asserts claims against the directors. In an attempt to preserve the proceeds for any potential judgment that the trustee may obtain, he may argue that the proceeds are property of the bankruptcy estate thereby preventing other claimants from accessing the proceeds. The fact that the trustee is a plaintiff should not affect the determination of whether or not the proceeds of the policy are property of the estate.

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