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Insurance Issues

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A Look at D&O Insurance in Bankruptcy Proceedings

Through the first three quarters of 2020, U.S. commercial bankruptcies already topped chapter 11 filings for all of 2019.[1] Despite entering 2021 with the promise of new vaccines and additional federal bailouts, there remains no immediate relief in sight from either the coronavirus or the economic wreckage left in its wake. Most industry observers expect chapter 11 filings to continue climbing.

At some point in almost every chapter 11 case, the creditors' committee will consider pursuing a litigation strategy against the company's directors and officers (D&Os) to access the insurance the company has in place to protect them. In a 2021 outlook for D&O insurance, it was noted that the "2019 median cash settlement of $13.6 million was well above the 10-year average of $8.3 million."[2] While the rise in bankruptcy filings might have little impact on the median cash-settlement figure, the number of overall settlements is expected to increase. In this climate, it is important for trustees, creditors and debtors (including its D&Os) to understand the role that D&O insurance plays in insolvency matters today. Simply put, within the context of chapter 11 proceedings, D&O insurance represents an untapped — and potentially significant — source of funds that can be used to help settle creditors' claims. This article explores the role of D&O insurance from the perspectives of both the debtor and creditor, while offering a few best practices for each to consider.

Some Background

D&O insurance arose from the enactment of the Securities Acts of 1933 and 1934. Initially designed to protect the personal assets of independent corporate directors from potential securities liability, D&O insurance policies have evolved beyond that original purpose and now provide coverage not just for the individual D&Os, but for the entity or organization itself. While D&O insurance policies are neither standard nor uniform, they typically provide three areas of coverage commonly known as the three sides (A, B and C) of D&O insurance.

Side A coverage reimburses individual D&Os for losses that they personally incur arising from a wrongful act that is not indemnified by the company.[3] Side B coverage reimburses the company for its indemnification of losses incurred by its D&Os.[4] Side C coverage (a.k.a. entity coverage) indemnifies the company for losses related to defending certain claims against it.[5]

Fitting a Claim Within D&O Coverage

As previously mentioned, asserting claims that are covered by D&O insurance in an insolvency scenario has become *de rigueur*. In many instances, the unsecured creditors' committee might obtain authority in connection with a debtor's plan to pursue claims on behalf of the debtor against former management or its directors. This approach is often negotiated by the unsecured creditors' committee as part of the package of consideration provided to unsecured creditors under a liquidation plan. The typical vehicle used is a liquidating or litigating trust, the main purpose of which is to undertake the pursuit of D&O insurance and other claims under chapter 5 of the Bankruptcy Code.

1 "Bankruptcy Statistics," ABI, *available at* abi.org/newsroom/bankruptcy-statistics (unless otherwise specified, all links in this article were last visited on Dec. 22, 2020).
2 Priya Cherian Huskins, "2021 D&O Insurance Trends: A Looking Ahead Guide," Woodruff Sawyer (Sept. 22, 2020), *available at* woodruffsawyer.com/do-notebook/do-looking-ahead-guide-2021.
3 Mark M. Bell & Richard W. Westling, "Directors' and Officers' Insurance and Its Role in Government Investigations," *New Appleman on Insurance: Current Critical Issues in Insurance Law* (Spring 2013).
4 *Id.*
5 *Id.*

For parties setting up these trusts, a review of applicable D&O policies should guide whether there might be an "insured vs. insured" issue (and whether the claims can only be brought by the debtors), in which case any liquidating trustee should also be given the powers of the debtors and their representatives. In other instances, secured creditors might have had claims against D&Os pledged as part of its collateral, and a secured creditor may pursue such claims. It is important, if representing the party seeking to hold the D&Os liable, to make sure that the terms of any plan provide the requisite standing and authorization for any third party (including committees or creditors) that may wish to pursue such claims.

Among the theories often pursued in D&O litigation are that (1) the directors and/or officers breached their fiduciary duties by allowing company management to operate relatively unsupervised; or (2) directors and/or officers should have acted more promptly to pursue a bankruptcy case before the company became hopelessly insolvent. Most D&O policies contain an insured-vs.-insured exclusion that may arise in the bankruptcy context. This exclusion provides that there is no coverage for claims made by one insured individual (whether the company or an individual director) against another insured individual. The purpose behind the insured-vs.-insured exclusion is to prevent the company or individual directors from profiting from a claim brought against an individual director and to prevent collusion by the insureds. Prior to bankruptcy, if the company were to sue its individual directors, then the insured-vs.-insured exclusion would likely prevent coverage. After filing for bankruptcy, however, the issue becomes more muddled.

In the bankruptcy context, disputes often arise concerning the scope of the insured-vs.-insured exclusion and whether it applies to a trustee, a debtor in possession (DIP), a liquidation trustee or a creditors' committee. Many D&O policies have exceptions to the insured-vs.-insured exclusion. For example, many policies (although certainly not all) contain exceptions for claims brought or maintained by a bankruptcy trustee, receiver, examiner or liquidator. For these policies, disputes can and do arise concerning whether a creditors' committee falls within the exception.

Other policies expressly include claims brought by a creditors' committee. For example, some policies except from the insured-vs.-insured exclusion claims brought or maintained by a bankruptcy trustee, receiver, examiner or liquidator or "creditors' committee for the Company, or any assignee thereof or the [DIP]." These exceptions provide much clearer access to potential policy proceeds by the creditors' committee or DIP.

Further complicating matters, some policies expressly purport to exclude claims brought by or on behalf of a bankruptcy estate or DIP. This is an emerging area, but at least two cases have held that such clauses are unenforceable *ipso facto* clauses because the bankruptcy exclusions are conditioned upon or triggered by a bankruptcy filing.[6]

Defending D&O Coverage

Anytime the plaintiff attempts to monetize D&O insurance coverage to repay creditors, the company and its D&Os are naturally concerned. Among the concerns that D&Os may have is whether the plaintiff may pursue directors and/or officers for liability that exceeds the policy limits. Another concern is that plaintiffs may allege conduct that is not typically covered by insurance, such as fraud. However, sophisticated plaintiffs often recognize that obtaining judgments against individuals that are not covered by insurance can be much more difficult to collect than judgments covered by an insurance policy.

D&O Best Practices for Companies, Directors and Officers

If your company has no D&O insurance or you are concerned that you are not getting the coverage needed in a specific situation, make an investment in expertise. Find a qualified agent and legal counsel who are already experienced with sophisticated D&O policies. You will want to work with someone who can help you customize your protection rather than simply settle for an insurance company's "off-the-shelf" policy. There can be vastly different language used by different insurers, and it is critically important to assess and negotiate policy language on the front end.

If your company is in distress, prebankruptcy planning should include considering whether it would be advantageous to have an independent director(s) or independent management join the company. D&O premiums for independent directors and managers are usually significantly less than covering incumbent managers and directors.

In addition to procuring sufficient D&O coverage, consider including exculpatory language in the company's operating agreement, such as incorporating the business-judgment rule as the standard for D&O conduct. The business-judgment rule is a legal defense to a claim that a director breached his/her fiduciary duty to the company.

In most states, directors owe two primary fiduciary duties: the duty of care and the duty of loyalty. The duty of care requires making thorough, informed decisions based on sufficient information. Think of it as a director doing his/her homework before voting up or down. The duty of loyalty requires acting (or abstaining in some instances) in the best interests of the company and its shareholders, over and above any personal interests of the director. Such personal interests must be subordinate to the interests of the company and its shareholders because independence and the avoidance of self-dealing are paramount.

Directors should actively consider their duties of care and loyalty throughout the decision-making process. The decisions of a director, however, might be protected if the director conducted himself/herself (1) in good faith, (2) with the care that a reasonably prudent person would use under the same or similar circumstances, and (3) with a reasonable belief that the director is acting in the best interests of the company. If these three elements are proven, then a presumption in favor of the director or the board may insulate them from liability. The company should consider including a limitation-of-liability section in its operating agreement that incorporates the business-judgment rule. For example, such language may include:

> No shareholder, director, or officer shall be liable to the Company or any shareholder for any loss suf-

6 *See Tessenow v. Executive Indem. Inc.*, 953 N.E.2d 433 (Ill. Ct. App. 2011); *In re Cmty. Mem'l Hosp.*, 67 Bankr. Ct. Dec. 131 (E.D. Mich. July 23, 2019).

> fered which arises out of an act or omission of such person if it was determined by such persons that such act or omission was made in good faith, with the care that a reasonably prudent person would use under the same or similar circumstances, and in the best interests of the Company.

The company may also want to consider adding similar language in the voting or actions sections of its operating agreement. For example, where an operating agreement discusses what percentage vote (*e.g.*, majority, super-majority, etc.) of its board of directors or shareholders is required for company actions, the company can include such language as:

> Where any action is taken by the Company in accordance with this Section, such action shall be deemed to have been taken in good faith, with the care that a reasonably prudent person would use under the same or similar circumstances, and in the best interests of the Company.

As an additional layer of protection for D&Os, the company should include similar language in the minutes of every meeting at which critical decisions are made. At the end of the minutes for any such meeting, the company should consider adding a catch-all statement such as:

> Each and every action taken by the Company as reflected in these Minutes shall be deemed to have been taken in good faith, with the care that a reasonably prudent person would use under the same or similar circumstances, and in the best interests of the Company.

With these best practices in place, D&Os should feel more comfortable in making decisions on the company's behalf. In the unfortunate circumstance that a claim for breach of fiduciary duty arises, the company, director and/or officer can point to the various provisions of the operating agreement and meeting minutes previously set forth as additional evidence that such duties were met. This evidence, alongside a good D&O insurance policy, should provide corporate D&Os with peace of mind in carrying out their responsibilities. abi

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