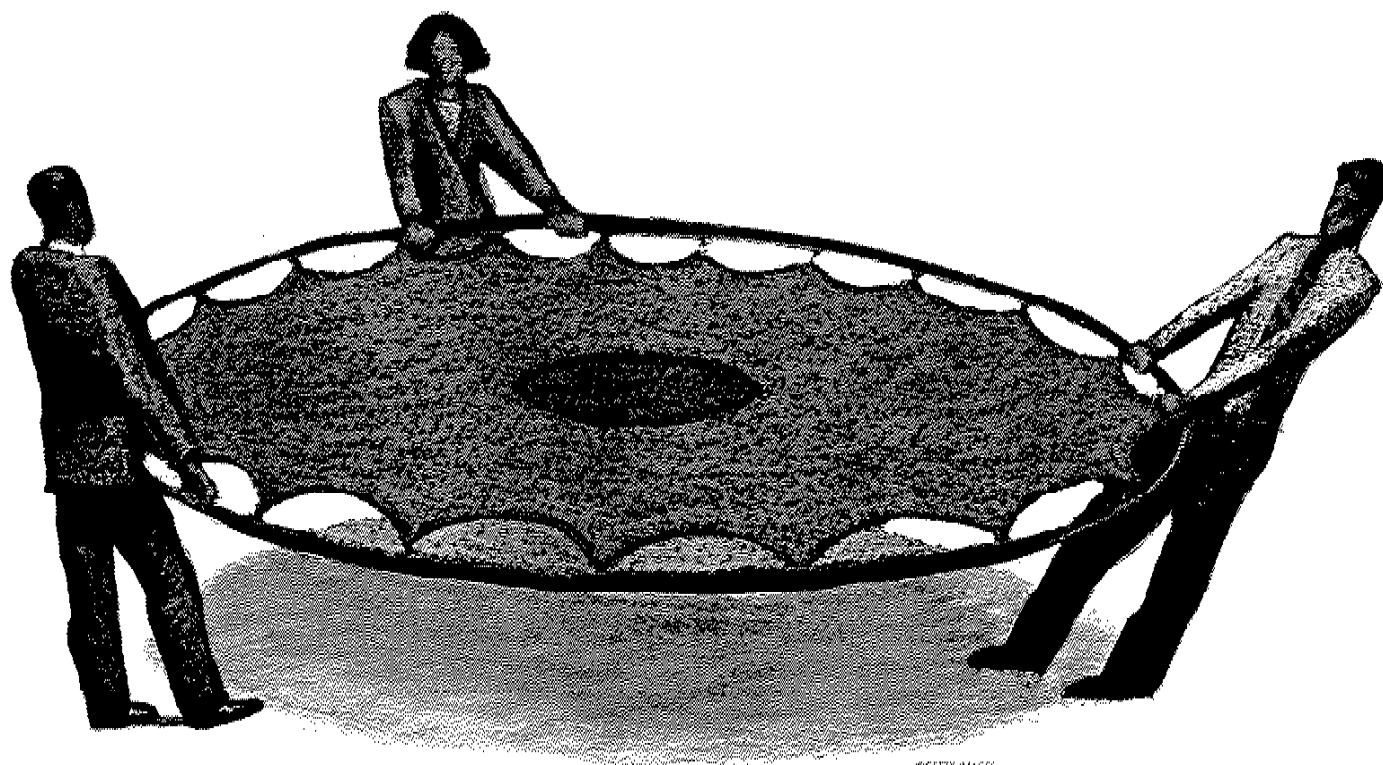


D&O INSURANCE POLICIES IN BANKRUPTCY

The Impact of Entity Coverage and the Entitlement to Proceeds

by Mark J. Politan

Corporations have traditionally provided liability coverage for their directors and officers under a directors and officers (D&O) insurance policy. Typically, the coverage provided under a D&O policy indemnifies the directors and officers for errors and omissions that may occur in the performance of their duties to, or on behalf of, the corporation.



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D&O policies serve an important and necessary function in the corporate world. By protecting directors and officers against the risks of lawsuits and the associated costs, D&O policies encourage individuals to serve on boards of directors and as senior management in corporations.

When a corporation files for bankruptcy protection, however, the primary purpose of a D&O policy can often be disregarded and abused. Various parties in interest will compete to recover their share of the proceeds, including the debtor-corporation or its trustee. Lawsuits seeking to recover directly from the directors and officers covered under a D&O policy invariably conflict with the debtor-corporation's interests in the D&O policy. The proceeds available under a D&O policy are often the only or best source of recovery on claims brought against a corporation's insiders.

Further complicating the landscape of entitlement to proceeds, D&O policies may also include direct coverage for the corporation itself, known as entity coverage. As a result, during a debtor corporation's bankruptcy case, a D&O policy may often be treated as simply another asset of the debtor's estate, to the detriment of a debtor's directors and officers.

The D&O Policy and Bankruptcy

D&O policies generally provide three types of coverage: 1) individual liability coverage for a corporation's directors and officers; 2) indemnification coverage, which insures a corporation's obligation to indemnify its directors and officers; and 3) entity coverage, which provides coverage for direct claims made against the corporation. Under the terms of a D&O policy, liability coverage generally is provided and payable directly to the directors and officers for claims arising out of their wrongful acts

or indirectly through indemnification by the corporation. In addition, indemnification coverage generally is provided to the corporation as reimbursement for indemnification provided to directors and officers for claims made against them.

The language of a D&O policy specifies and describes the coverage provided, and defines the types of loss that are covered. Intertwined with the issue of coverage for claims against the directors

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and officers is the timing and advancement of defense costs to directors and officers who are defendants in lawsuits initiated by various plaintiffs. D&O policies that include language providing for the advancement of defense costs will detail the circumstances under which the advancement of costs may be made.

With the inclusion in recent years of entity coverage in D&O policies, the rights to proceeds of such policies have been altered. In general, the courts have not taken a consistent approach to the competing demands for D&O policy proceeds among the debtor's estate, its creditors, the covered entities under a D&O policy and the plaintiffs bringing suit. The main question the courts have confronted is whether D&O policies and their proceeds are "property of the estate" under the Bankruptcy Code and,

if so, whether cause exists to lift the automatic stay.¹

These issues are crystallized with D&O policies, since these policies are considered to be eroding assets, *i.e.*, the amounts advanced by the insurer, as payments for defense costs, indemnification or settlements, erode the limits available to indemnify all of the insureds regarding other losses. D&O policies usually have one fixed policy limit, thereby creating a pot of proceeds available to satisfy all claims made against insureds, including the advancement of defense costs to directors and officers. D&O policies also rarely segregate the available proceeds by type of claim or insured.

In the bankruptcy context, the combination of an eroding asset, competing claimants (including the debtor itself), and issues of coverage, can make the issue of entitlement to proceeds more complicated. This is particularly true where a small amount of proceeds is available to satisfy several claims. While courts have struggled with developing a consistent strategy to approach these types of disputes, several leading bankruptcy cases have provided guidance when considering the impact of entity coverage for debtors under a D&O policy.

Property of Estate: Policy v. Proceeds Distinction

The Bankruptcy Code provides that a debtor's estate is comprised of all legal and equitable interests of the debtor in property as of the commencement of the case.² The United States Supreme Court has determined that the scope of what is considered "property of the estate" is to be interpreted very broadly.³ Given the breadth of the definition, it is clear that the determination of whether a D&O policy and its proceeds are property of the estate is a significant issue, and will form the basis of whether a court will allow the proceeds to be

invaded while a debtor-corporation's bankruptcy case is pending.

Designation as property of the estate means, among other things, that the D&O policy and its proceeds are protected by the automatic stay provisions of the Bankruptcy Code.⁴ The automatic stay's primary purpose is to preserve the *status quo* as of the commencement of the bankruptcy case, and to maintain the debtor's assets that may be utilized to satisfy the estate's creditors.⁵ The automatic stay protects the debtor's estate from dismemberment by creditors, and thereby promotes the goal of an equitable and orderly distribution of

will also enjoy such a designation. Many courts have examined the issue of whether the proceeds of a D&O policy are property of a corporate debtor's estate, where the policy includes entity coverage, with a varying degree of results. Some courts have reasoned that where entity coverage is implicated by virtue of direct claims, or there is a strong likelihood that coverage will become necessary, the corporate debtor's interest in the proceeds is paramount and must be protected.¹¹ Other courts have held that the proceeds of a D&O insurance policy providing only indemnification coverage constituted

policy were property of the estate.

Given the range of decisions and the highly factual nature of the courts' inquiry, the following attempts to highlight some the leading and most recent decisions addressing this significant issue.

*Ochs v. Lipson (In re First Central Financial Corp.)*¹¹

In *Ochs*, the entity coverage provision was found in a rider to the D&O policy that otherwise provided only the traditional coverages for directors and officers liability and indemnification liability of the entity.¹⁴ The entity coverage provision provided the debtor "with a limited

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estate assets.⁶ The automatic stay also serves to prevent a creditor's race for the assets of the estate.⁷

D&O Policy as Property of the Estate

Because corporations pay for and own insurance policies, several courts have concluded that insurance policies are property of the estate under the Bankruptcy Code.⁸ Thus, when a corporation becomes a debtor, its insurance policies generally become property of the estate.⁹ Additionally, several courts have reasoned that D&O policies are property of a corporate debtor's estate when the estate is worth more with the policy than without it.¹⁰

Proceeds of D&O Policy as Property of the Estate

While D&O policies maintained by corporate debtors will almost always be held to be property of the estate, it is a more fact-intensive question regarding whether the proceeds of such policies

estate property even in the absence of entity coverage.¹²

In the most recent cases, the key inquiry has focused on whether the debtor has a "direct interest" in the proceeds of the D&O policy. Where the debtor has a direct interest in the proceeds, most courts have held the proceeds to be property of the bankruptcy estate, and protected from dissipation by the automatic stay. These courts primarily reason that payments made from the D&O policy for defense costs or settlements deplete the policy limits, thereby increasing the debtor's exposure to indemnification claims in other litigation or direct claims. Several courts also reason that the addition of entity coverage for the debtor corporation transforms the policy into a vehicle for both individual and corporate protection. However, other courts have determined that the mere existence of entity coverage was not sufficient on its own to conclude that the proceeds of the D&O

sphere of liability protection in the event the corporate entity is sued for violations of securities laws."¹⁵ Based on those facts, the United States Bankruptcy Court for the Eastern District of New York held that "the mere appendage of entity coverage to this [p]olicy by way of a rider, providing the [d]ebtor with protection from securities claims, does not provide sufficient predicate, *per se*, to metamorphose the proceeds into estate property."¹⁶

The court reasoned that policy proceeds are properly deemed estate property where many large entity coverage claims threaten to become a "free-for-all" that might exhaust the insurance proceeds and thereby jeopardize estate assets over and above the limits of the policy. In such situations, the debtor's entity coverage competes for proceeds with the director and officer liability portion of the insurance policy.

The court supported its holding by noting that in the 18 months the bankruptcy case was pending: 1) there had

been no claims filed against the debtor that would implicate the narrow scope of the D&O policy's entity coverage, 2) there had been no expressions of interest in suing the debtor for violations of securities laws, and 3) the trustee had indicated that no actions were likely or imminent.¹⁷

*In re Sacred Heart Hospital*¹⁸

In *Sacred Heart*, the policy at issue provided direct entity coverage to the debtor, as well as coverage for claims against its officers and directors. To determine the merits of an objection interposed by a creditor seeking to block confirmation of the debtor's plan of

court in *Louisiana World Exposition* did not provide liability coverage for direct claims against the debtor.²² As the court in *Sacred Heart* recognized, the better practice is to limit the holding of *Louisiana World Exposition* to cases in which the policy does not provide entity coverage to the debtor.²³

*In re Adelpia Communications Corp.*²⁴

In *Adelpia*, the D&O policy at issue provided both directors and officers coverage, and direct entity coverage to the debtors. The United States District Court for the Southern District of New York reversed the bankruptcy court's

yet.²⁸ However, the question that remains and constitutes the flaw in the district court opinion, lies in the district court's failure to apply the proper test for determining "property of the estate."

The Bankruptcy Code, by its clear language, requires the determination of whether an asset is or is not estate property to be made "as of the commencement of the case."²⁹ The future event on which the district court in *Adelpia* premised its assessment of the estates' interest in the policy proceeds, should have had no bearing on the court's evaluation of whether the proceeds were estate property. That determination should have been

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reorganization, the court in *Sacred Heart* was required to determine whether the proceeds of the subject policy were property of the debtor's estate. Specifically, the court noted that the "proceeds available for the [d]ebtor's liability exposure are not segregated from [p]roceeds available to the directors and officers."¹⁹ Because the debtor, in addition to its directors and officers, was an insured under the subject policy, the court held the estate had a "sufficient interest in the [p]roceeds as a whole to bring them into the estate" pursuant to Section 541(a) of the Bankruptcy Code.²⁰

Importantly, the court in *Sacred Heart* distinguished the Fifth Circuit's seminal decision in *In re Louisiana World Exposition*, where the policy at issue provided liability coverage for the directors and officers and reimbursement to the debtor to the extent it was obligated to indemnify the directors and officers.²¹ Unlike the policies at issue in *Sacred Heart*, however, the policy before the

holdings that: 1) the policy proceeds were estate property, and 2) relief from the automatic stay to allow defense costs to officers and directors was inappropriate.²⁵ At the heart of the district court's decision was its observation that "none of the Debtors [have] made or committed themselves to payments using their entity coverage."²⁶ Continuing with that reasoning, the court analogized the debtors' argument in support of its entitlement to the proceeds to a car owner claiming a property interest in car insurance proceeds based on the possibility that an automobile accident might occur, and the beneficiaries of a death benefit claiming a property interest in the policy proceeds while the insured is alive.²⁷

The reasoning of the district court in *Adelpia* was premised upon the remoteness of the debtors' potential entity coverage claims. The court determined that the debtors had no "property interest in the proceeds of the insurance policies

made as of the commitment of the case. For that reason alone, the *Adelpia* rationale may be questioned.

*In re Allied Digital Tech. Corp.*³⁰

A more reasoned analysis is provided in *Allied*. In that case, the United States Bankruptcy Court for the District of Delaware wrestled with the question of whether proceeds from a directors and officers liability policy, which provided both direct entity coverage and indemnification coverage, constituted property of the estate subject to the automatic stay. The bankruptcy court analyzed relevant case law and determined that when there is coverage for the directors and officers and the debtor, 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.³¹

Based on the facts of the case, however, the bankruptcy court in *Allied*

determined that the policy proceeds were not estate property.³² In *Allied*, the entity coverage provisions of the subject policy limited the debtor to recovering for indemnification coverage and coverage based only on securities law claims against the debtor.³³ The individual defendants argued that any securities law claims against the debtor would be time barred, and the Chapter 7 trustee "provide[d] no basis for disputing [that] position."³⁴

The fact that it appeared there could be no direct securities law claim against the debtor greatly influenced the bankruptcy court's decision that the proceeds of the subject policy were not estate property.³⁵ The court reasoned that direct coverage no longer applied, "because all securities claims have already been adjudicated and/or barred by the applicable statute of limitation."³⁶

*In re Medex Regional Labs., LLC*³⁷

Similarly, the United States Bankruptcy Court for the Eastern District of Tennessee, following the *Allied* reasoning, recently held that a debtor had no interest in the proceeds of a D&O policy that provided entity coverage, because the policy and discovery periods had expired without the insurer receiving any notice of a claim or demand against the debtor regarding a securities claim.

In *Medex*, the D&O policy provided entity coverage to the debtor specifically for securities claims.³⁸ After the debtor filed its Chapter 11 case, a committee of unsecured creditors filed a complaint against the directors and officers of the company, alleging various causes of action. After the insurer agreed to indemnify the directors and officers for their defense costs, a motion was filed seeking a determination that the D&O policy proceeds were not property of the estate. The directors and officers also asserted that the D&O policy proceeds were excluded from the automatic stay of the Bankruptcy Code, and therefore

could be paid to them by the insurer.

The court noted that although "the courts readily agree that directors' and officers' insurance policies themselves are property of a debtor's estate, there is more discord regarding the question of whether proceeds of such policies constitute estate property."³⁹ The court stated that the specific terms of the D&O policy would govern the determination of whether the proceeds of a policy are property of the estate. The court concluded that although the D&O policy afforded entity coverage for securities claims, the discovery period and the policy period had expired without any such claim being made.⁴⁰ As a result, the debtor no longer enjoyed any direct entity coverage under the D&O policy.

To the contrary, however, the directors and officers of the debtor were faced with significant defense costs by virtue of the pending adversary proceeding. Therefore, the court determined that the D&O policy proceeds were not property of the bankruptcy estate, and defense costs could be advanced without violating the automatic stay of the Bankruptcy Code.⁴¹

Lifting the Automatic Stay

As demonstrated in *Medex*, the current trend in decisions shows courts balancing the interests of the directors and officers with those of other stakeholders to the proceeds of a D&O policy in a corporate bankruptcy. Some recent decisions have gone beyond the property of the estate analysis and focused more specifically on whether lifting the automatic stay is appropriate to allow the advancement of defense costs to the individual directors and officers.⁴² Where directors and officers are entitled under the D&O policy to the advancement of defense costs, that entitlement is often challenged by other parties-in-interest, including trustees, creditors and other claimants ultimately seeking to recover under the D&O policy.

Relief from the automatic stay must be granted by the court in order to make any advances where the proceeds are determined to be estate property.⁴³ In these circumstances, a court must scrutinize the D&O policy language and provisions closely, and weigh the competing interests to the proceeds.

In *In re Cybermedica, Inc.*, where the policy included entity coverage, the court found that the policy proceeds were property of the estate.⁴⁴ Still, the court chose to lift the automatic stay so the directors and officers could pay for defense costs related to certain litigation that was brought directly against them. The court reasoned that directors and officers would suffer irreparable harm if they did not have access to the coverage. Any harm that would be caused to the debtor by lifting the automatic stay, the court determined, was speculative because there were no direct claims pending against the debtor.⁴⁵

Conclusion

Any analysis of the entitlement to proceeds under a D&O policy is a highly factual exercise, which will require a court to review the specific language and provisions of a D&O policy. Where a D&O policy provides entity coverage in addition to traditional coverage to directors and officers, the analysis becomes even more difficult, and often will result in a balancing of the competing interests of the several parties. The unsettled nature of the law with regard to the advancement of defense costs to directors and officers under such policies further complicates the determination of a parties' entitlement to proceeds under a D&O policy.

If a D&O policy provides coverage for claims against the debtor entity, the proceeds are more likely to be assets of the bankruptcy estate. Recent cases have ruled that the automatic stay, therefore, applies to the proceeds of a D&O policy. While lifting the automatic stay to allow

the advancement of defense costs to directors and officers may be a viable option, courts will be wary to invade the proceeds of a D&O policy that provides entity coverage to a debtor, and where there are pending or potential claims that may implicate coverage. Directors and officers who share coverage under such a D&O policy with the corporate entity should be guided accordingly. ☞

Endnotes

1. See 11 U.S.C. § 362(d).
2. See 11 U.S.C. § 541.
3. *United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983).
4. See 11 U.S.C. § 362(a).
5. 11 U.S.C. § 362(a)(3) provides, in pertinent part, that the filing of a bankruptcy petition operates as a stay of "any act to obtain possession of property of the estate or to exercise control over property of the estate."
6. See *Koolik v. Markowitz*, 40 F.3d 567 (2d Cir. 1994); *In re Financial News Network, Inc.*, 158 B.R. 570 (S.D.N.Y. 1993).
7. Additionally, since a debtor may not utilize the proceeds of its insurance policies outside the ordinary course of business without obtaining court approval under the Bankruptcy Code, there is even a greater protection against the wasting of a debtor's assets. See 11 U.S.C. § 363.
8. See *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1001 (4th Cir.), cert. denied, 479 U.S. 876 (1986); *In re Grogg*, 2003 WL 21380539, at *2, n.2 (Bankr. C.D. Ill. 2003) (construing the automatic stay's application to an insurance policy and finding that Section 541 is "broadly construed to include every conceivable interest of the debtor, whether future, nonpossessory, contingent, speculative or derivative.")
9. See *A.H. Robins Co.*, 788 F.2d at 1001; *In re Davis*, 730 F.2d 176, 184 (5th Cir. 1984); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 92 (2d Cir. 1988).
10. See *Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reinsurance Corp.*, 799 F.2d 517, 519 (9th Cir. 1986); *Zentith Laboratories, Inc. v. Sinay*, 104 B.R. 659, 665 (D.N.J. 1989); *In re Vitek, Inc.*, 51 F.3d 530, 533 (5th Cir. 1995).
11. See *In re Jasmine*, 258 B.R. 119, 129 (Bankr. D. N.J. 2000); *In re Circle K Corp.*, 121 B.R. 257 (Bankr. D. Ariz. 1990).
12. See, e.g., *In re The Leslie Fay Company, Inc.*, 207 B.R. 764 (Bankr. S.D.N.Y. 1997) (where a single coverage limit applied to both D&O and indemnification coverage "payment under either reduces the amount of coverage available under both, and therefore the Debtor has an independent right to the policy proceeds.")
13. *Ochs v. Lipson (In re First Central Financial Corp.)*, 238 B.R. 9 (Bankr. E.D.N.Y. 1999).
14. *Id.* at 14.
15. *Id.* at 14, n. 8.
16. *Id.* at 17.
17. *Id.* at 17.
18. *In re Sacred Heart Hospital*, 182 B.R. 413 (Bankr. E.D. Pa. 1995).
19. *Id.* at 420.
20. *Id.* (quoting *Vitek*, 51 F.3d at 534, n.17 ("Faced with the typical situation in which a debtor corporation's liability policies provide the debtor and thus the estate with direct coverage against third party claims, virtually every court to have considered the issue has concluded that the policies and clearly the proceeds of those policies are part of the debtor's bankruptcy estate, irrespective of whether those policies also provide liability coverage for the debtor's officers and directors."))
21. 832 F.2d 1391 (5th Cir. 1987).
22. *Id.* at 418 (citing *In re Louisiana World Exposition*, 832 F.2d at 1398.)
23. *Sacred Heart*, 182 B.R. at 419.
24. *In re Adelphia Communications Corp., et al.*, 298 B.R. 49 (S.D.N.Y. 2003).
25. *Id.*
26. *Id.* at 53.
27. *Id.* at 534.
28. *Id.* at 53.
29. See 11 U.S.C. § 541(a)(1).
30. *In re Allied Digital Tech. Corp.*, 306 B.R. 505 (Bankr. D. Del. 2004).
31. *Id.* at 512.
32. *Id.*
33. *Id.* at 508.
34. *Id.* at 511.
35. *Id.*
36. *Id.* at 509.
37. *In re Medex Regional Labs., LLC*, 314 B.R. 716 (Bankr. E.D. Tenn. 2004).
38. *Id.* at 719-20.
39. *Id.* at 720.
40. *Id.* at 722-23.
41. *Id.*
42. The language of Section 362(d)(2) of the Bankruptcy Code is in the conjunctive. Accordingly, both elements of Section 362(d)(2) must be satisfied before a court may grant relief from the automatic stay. Where the bankruptcy court finds either that the debtor has equity in the subject property or that the property is necessary to an effective reorganization, the court cannot grant relief under Section 362(d)(2). See *In re New Era Co.*, 125 B.R. 725, 728 (S.D.N.Y. 1991).
43. See 11 U.S.C. § 362(d).
44. *In re Cybermedica, Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002).
45. *Id.* at 18-19; see also *In re Boston Regional Medical Center*, 285 B.R. 87 (Bankr. D. Mass. 2002).

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