DIRECTORS & OFFICERS INSURANCE

THIRTY-FIRST ANNUAL SOUTHEASTERN
BANKRUPTCY LAW INSTITUTE, ATLANTA, GEORGIA
April 14-16, 2005

James H.M. Sprayregen
Jonathan P. Friedland
Marjon Ghasemi†
Kirkland & Ellis LLP
200 E. Randolph Drive
Chicago, Illinois 60601
312-861-2000

† Messrs. Sprayregen and Friedland are partners, and Ms. Ghasemi is an associate, with Kirkland & Ellis LLP.

DIRECTORS & OFFICERS INSURANCE

I. Introduction

A. The law regarding fiduciary duties of officers and directors to a corporation and its constituents is constantly evolving. In recent years, in light of Sarbanes-Oxley, Enron, Global Crossing and WorldCom, courts seem more inclined to scrutinize the acts of officers and directors.[1] These developments highlight the importance of adequate director and officer liability policies ("D&O Policies").

B. Bankruptcy implicates a number of issues with respect to D&O Policies. Key among these are continuation of coverage and adequacy of coverage. Section II discuses D&O Policies and the implications of such policies in a bankruptcy proceeding.

C. The remaining sections provide a necessary background for Section II of this paper. In particular, Section III provides a general overview of officer and director fiduciary duties, and Section IV discusses fiduciary obligations in the context of a company that is in the zone of insolvency.

II. Director and Officer Liability Policies

A. **Types of Coverage.** D&O Policies generally contain one or more of three basic types of coverage:

1. Direct coverage of officers and directors (also known as "Side A" coverage), which covers the losses of directors and officers when the corporation has not indemnified them. Proceeds from such a policy are paid directly to the directors and officers. "Side A excess coverage" policies provide additional coverage for directors and officers above the limits of the primary "Side A" coverage.

2. Coverage of indemnification payments that the corporation is permitted or required to make to directors and officers (also known as "Side B" coverage). With indemnification coverage, the corporation itself has the right to receive the proceeds of the policy to the degree necessary to reimburse the corporation for its indemnification payments to officers and directors. Given the benefits to the corporate entity of maintaining

---

1 In particular and relatively recently, the tort claim of deepening insolvency has developed as an avenue to provide damages to injured creditors against solvent third parties whose control and decision-making added to a company's insolvency.

indemnification coverage, corporate charters and bylaws tend to require it for certain circumstances.[2]

3. Entity coverage (also known as "Side C" coverage), insures the corporation itself for any claims brought against it directly. Without entity coverage, D&O insurance policies would not insure the corporation itself for securities or other claims brought against the company.

B. **Who Owns the Policy?**

1. Under Bankruptcy Code § 541(a), estate property is broadly construed.[3] Bankruptcy Courts have consistently held that D&O Policies are property of the estate, because the corporation pays for and owns the policy.[4]

2. D&O Policies are generally "single limit" policies, which contain one policy limit for all types of coverage. This means that every dollar paid out for "Side A" coverage, will reduce the available "Side B" or "Side C" coverage. Determining the right to coverage is a critical issue because the total available policy proceeds are limited and are shared between the directors and officers and the corporate entity.

C. **Who Owns the Proceeds?**

1. The issue of whether policy proceeds are estate property is far more controversial than whether the policy is estate property, and revolves around the type of coverage and/or the beneficiary of the policy. As a general rule, if the insurance proceeds are payable to the debtor, it is more likely that the proceeds are considered estate property; if the insurance proceeds are payable to individual claimants, it is more likely that the proceeds are not considered estate property.

2. In particular, case law has identified four scenarios, all centered on the named insured and the recipient of the proceeds:

   - When a debtor's D&O Policy provides direct ("Side C") coverage to the debtor, the proceeds are estate property because the proceeds are payable to the debtor.

---

2 See N. R. Eitel, Now You Have It, Now You Don't: Directors' and Officers' Insurance After a Corporate Bankruptcy, 46 Loy. L. Rev. 585, 588 (2000).

3 11 U.S.C. § 541(a).

4 See generally, A.H. Robins Co., Inc. 788 F.2d 999, 1001 (stating that, [u]nder the weight of authority, insurance contracts have been said to be embraced in this statutory definition of 'property'").

- When the D&O Policy provides only direct coverage to the directors and officers ("Side A coverage"), the proceeds are not estate property.

- When there is coverage for the directors and officers and for the debtor, the proceeds will be estate property 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.

- When the policy provides the debtor with indemnification coverage, but indemnification is hypothetical or speculative, the proceeds are not estate property.[5]

3. The Bankruptcy Court for the District of Tennessee discussed the issue in In re Medex.[6] In Medex, the creditors' committee filed an adversary proceeding against the debtor's principals alleging breach of fiduciary duties. In turn, the debtor's principals asserted a right to indemnification by the debtor. The adversary proceeding initiated by the committee constituted a "claim" under the D&O policy and the insurance carrier agreed to pay the reasonable and necessary defense costs, subject to a Court order either stating that the proceeds were not property of the estate or that relief from stay would be granted with regard to such proceeds.[7] The Court decided that, to the extent proceeds under a D&O Policy are paid directly to non-debtors, such proceeds are clearly not considered property of the estate. Conversely, to the extent that such proceeds are paid directly to the debtor, the proceeds clearly are estate property.[8] The D&O Policy did provide direct coverage for officers and directors as well for the corporation. The "Side C" coverage, however, had lapsed and, while the indemnification coverage was still valid, the debtor had not actually made any payments to the officers and directors or committed to provide any such indemnification payments. Accordingly, the Court concluded that the indemnification coverage was "hypothetical and/or speculative" and that the only proceeds at issue were those payable to the

5 See In re Medex, 314 B.R. 716 (Bankr. E.D. Tenn. 2004); Allied Digital Tech. Corp, 306 B.R. 505 (Bankr. D. Del. 2004).

6 In re Medex, 314 B.R. 716 (Bankr. E.D. Tenn. 2004).

7 Id. at 722.

8 Id. at 720-21.

officers and directors. As these proceeds were not property of the estate, the stay did not apply.[9]

4. Another key case on D&O Policy proceeds is Louisiana World Exposition v. Federal Ins. Co.[10] In that case, the Fifth Circuit held that a debtor had no right to policy proceeds where a creditors committee sought to enforce the automatic stay and halt payment of defense costs under the D&O Policy. In so holding, the Court noted that that the debtor had no right to proceeds because the policy provided only liability coverage for its officers and directors and did not provide corporate reimbursement coverage.[11]

5. **Automatic Stay Issues**

   (a) To the extent that insurance proceeds are considered estate property, the payment of proceeds is stayed and the officers and directors will not have access to such funds without relief from or modification of the automatic stay. There are a number of options officers and directors can consider.

   (1) One option is to enter into a prepetition waiver of the automatic stay with the insurance carrier. Generally, however, prepetition stay waivers are not enforceable. [12]

   (2) Another option is to consider a "Side A excess policy." "Side A excess coverage" kicks in when other insurance is not available to the directors and officers. For example and depending on the terms of the policy and when the policy applied, if the D&O Policy is considered stayed by virtue

---

9 Id. at 722; see also Allied Digital Tech. Corp., 306 B.R. 505 (Bankr. D. Del. 2004) ("When a debtor's liability insurance policy provides direct coverage to the debtor the proceeds are property of the estate, because the proceeds are payable to the debtor. Further, when the liability insurance policy provides direct coverage only to the directors and officers the proceeds are not property of the estate. However, 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. Lastly, when the liability policy provides the debtor with indemnification coverage but indemnification either has not occurred, is hypothetical, or speculative, the proceeds are not property of the estate").

10 Louisiana World Exposition v. Federal Ins. Co., 864 F.2d 1147 (5th Cir. 1989).

11 Id. at 1152.

12 See generally In re Atrium High Point Ltd. Partnership, 189 B.R. 599 (Bankr. M.D.N.C. 1995) (standing for the proposition that prepetition waivers of the automatic stay should be enforced when negotiated between sophisticated parties).

of the corporation's bankruptcy proceeding, the "Side A excess coverage" would "drop down" to provide coverage for the directors and officers only. Because the corporation would not be an insured under this strictly "Side A" coverage, the proceeds should remain available and not be subject to the stay or considered estate property.

(3) Another potential option is to eliminate entity coverage entirely. While this eliminates automatic stay issues for the directors and officers, leaving the corporate entity with no coverage is a far from ideal solution.

(b) **Cancellation/Termination**. The right to terminate an insurance policy postpetition that was issued to a debtor prepetition has uniformly been held to be stayed by Bankruptcy Code § 362(a)(3). However, the Bankruptcy Code does not prevent such a policy from expiring by its own terms postpetition.[13]

D. **"Insured vs. Insured" Exclusion**

Most director and officer liability policies exclude coverage for claims against insured directors and officers brought by an insured person or organization.[14] Such an exclusion typically provides that the coverage does not apply to loss in connection with claims made against a director or officer brought by or on behalf of the company or another insured.

1. Litigation Trusts

(a) Problems with regard to the extent of insured v. insured exclusions often arise in the context of a bankruptcy proceeding where the identity of the insured becomes unclear. In particular, in a bankruptcy proceeding entities such as creditors' committees, trustees, debtors in possession and other litigation entities seek coverage under a D&O Policy. In determining if the policy excludes coverage when initiated by a litigation trustee, courts focus on whether the trustee has initiated the litigation on behalf of the excluded debtor.

---

13 See In re American Medical Imaging Corp., 133 B.R. 45 (Bankr. E.D. Pa. 1991); Aetna Casualty & Sur. Co. v. Gamel, 45 B.R. 345 (N.D.N.Y. 1984).

14 See generally Fidelity & Deposit Co. of Maryland v. Conner, 973 F.2d 1236, 1245 (5th Cir. 1992) (stating that "the plain language of the insured v. insured exclusion bars [the former director's] claim against his former colleagues [who are also former directors]"); Levy v. National Union Fire Ins. Co., 889 F.2d 433, 434 (2d Cir. 1989) (stating that "[t]he policy self-evidently excludes claims arising from suits brought by 'one or more past, present or future Directors… and/or the Company'").

(b) In so deciding, one Court looked at the insured v. insured exclusions and stated that the underlying purpose of such exclusions is inapplicable in the context of a claim asserted by a trustee against the debtor's former officers and directors because,

> [t]he intent behind the 'insured v. insured' exclusion in a [D & O] Policy is to protect the insurance companies against collusive suits between the insured corporation and its insured officers and directors. [citation omitted] When the plaintiff is not the corporation but a bankruptcy trustee acting as a genuinely adverse party to the defendant officers and directors, there is no threat of collusion.[15]

(c) Accordingly, notwithstanding the fact that at one point the debtor itself could have brought the claim against the officers and directors, courts have found insured v. insured exclusions to be inapplicable when a litigation trustee asserts the claim.[16]

E. **Defense Costs**

1. To the extent a D&O policy has a duty to pay defense costs provision, the obligation to reimburse the directors and officers attaches as soon as attorneys' fees are incurred.[17] One court has even stated that "to hold otherwise would not provide insureds with protection from financial harm that insurance policies are presumed to give."[18]

---

15 In re Buckeye Countrymark, Inc., 251 B.R. 835, 840-41 (Bankr. S.D. Ohio 2000).

16 Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376 (D. Del. 2002); In re Molten Metal Technology Inc., 271 B.R. 711 (Bankr. D. Mass. 2002) (holding that held that the insured v. insured exclusion in the debtor's D&O liability policies was not triggered where the trustee was acting on behalf of the estate, rather than on the debtor's behalf, in prosecuting causes of action that arose prepetition); In re Pintlar Corp., 205 B.R. 945 (Bankr. D. Idaho 1997) (holding that the litigation trustee to whom the debtor had assigned its claims against its former officers was not pursuing claims on behalf of debtor, but on behalf of creditors of bankruptcy estate, where the terms of assignment of such claims specifically precluded debtors from receiving any benefit from prosecution of claims); but see Reliance Ins. Co. of Illinois v. Weis, 148 B.R. 575 (Bankr. E.D. Mo. 1992) (holding that the insured v. insured exclusion applied because the cause of action that the debtor had against its former officers and directors became estate property upon the filing of the bankruptcy petition and, once the estate liquidated, the plan committee was obligated to recover assets for the estates; as such, the Court found no legal distinction between the debtor corporation and its bankruptcy estate).

17 See generally, In re WorldCom, Inc. Securities Litigation, 2005 WL 254684 (S.D.N.Y. 2005); McCuen v. American Cas. Co. Of Reading Pennsylvania, 946 F.2d 1401, 1406-07 (8th Cir.1991); Okada v. MGIC Indem. Corp., 823 F.2d 276, 282 (9th Cir.1987).

18 Nu-Way Environmental, Inc. v. Planet Ins. Co., 1997 WL 462010, *3 (S.D.N.Y. Aug. 12, 1997) (stating the D&O Policy did not address timing of payment of defense costs).

2. Furthermore, even where a D&O Policy does not explicitly state that "defense costs" and/or "attorneys' fees" are covered, courts have held that such costs are included within the scope of the term "loss." Which is to say that if a D&O Policy covers officers and directors for all "losses," such a policy would cover defense costs.[19] Accordingly, the duty to pay defense costs is "construed liberally and any doubts about coverage are resolved in the insured's favor."[20]

III. Fiduciary Obligations of Directors and Officers – General Overview

A. **Fiduciary Duties**. The duties of officers and directors are "fiduciary" in nature because officers and directors are charged with acting in the best interests of others. State law generally determines the extent and scope of the duties of officers and directors to shareholders. It is well settled in each state that directors of a corporation owe a fiduciary duty to the corporation and its shareholders.[21]

1. **Duty of Care**. Generally, directors and officers are expected to exercise ordinary care in the execution of their duties. Essentially, the duty of care requires directors to exercise the level of care that an ordinarily prudent person would use in similar circumstances.[22] Under the duty of care, officers and directors are expected to devote the attention and judgment necessary to make reasoned business decisions. That being said, it is important to provide officers and directors with sufficient information to allow them to make an informed decision.

2. **Duty of Loyalty**. The underlying premise of the duty of loyalty is that directors must act in the best interests of the corporation and its stockholders. The duty of loyalty requires directors to act in good faith and in the reasonable belief that the action taken is in the best interests of the corporation. Accordingly, this duty requires directors to disclose any and all pertinent information relating to proposed corporate transactions, especially to the extent that aspects of any such transactions could result in personal benefit to the directors, and requires directors to deal fairly with the corporation and its equity holders.

---

19 See Wedtech Corp., 740 F.Supp. 214 at 221; Pepsico, Inc. v. Continental Cas. Co., 640 F.Supp. 656, 659 (S.D.N.Y.1986); Okada, 823 F.2d at 282.

20 See, In re WorldCom, Inc., 2005 WL 254684, *6 (citation omitted).

21 See generally, Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del.Ch.1992) (stating that "the general rule is that directors do not owe creditors duties beyond the relevant contractual terms."); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 369 (Del. 1993).

22 See generally Model Business Act § 8.30.

3. **Duty of Complete Candor.** The duty of complete candor is not a traditional fiduciary duty; rather, it is related to the duty of loyalty. This duty generally arises when a corporation seeks an action from the shareholders, such as a proxy solicitation. Whenever such an action from the shareholders is sought, the duty of candor requires that all material facts be accurately and sufficiently disclosed to the shareholders such that they can make an informed decision.

4. **Duty of Good Faith.** The duty of good faith is considered an "emerging duty." Under Delaware law, it is questionable whether the duty of good faith is a subset of another fiduciary duty or a separate duty.[23] The Federal District Court in Delaware has stated that "[o]nly a sustained or systematic failure of the board to exercise oversight… will establish the lack of good faith that is necessary to condition liability."[24]

B. **Business Judgment Rule**. The Business Judgment Rule is a judicially created presumption that in making a business decision the officer or director of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.[25] Generally, directors and officers will demonstrate that they have performed their duty to inquire and be informed if they:

1. Regularly attend board meetings;
2. Obtain, review and question materials provided at and between meetings;
3. Participate in board discussions;
4. Make independent inquiries as appropriate;
5. Register objections when appropriate; and
6. Review stockholder reports and securities filings.[26]

---

23 See In re Walt Disney Co., 2004 WL 2050138, *3 (Del.Ch. 2004) ("[t]here has also been much discussion regarding a duty of good faith, which may or may not be subsumed under the duty of loyalty." (citation omitted)).

24 See In re Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959, 971 (D. Del. 1996) (holding that directors followed procedures to inform themselves regarding contracts and were protected under the business judgment rule from claims of personal liability when impermissible contracts were entered into).

25 See In re Healthco Int'l Inc., 208 B.R. 288, 306 (Bankr. D. Mass. 1997) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

26 See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

C. **Entire Fairness**. To the extent a court determines that the Business Judgment Rule does not apply, the Entire Fairness standard applies. Generally, once the presumption is rebutted, the Entire Fairness doctrine shifts the burden to the officers and/or directors to prove that the transaction was "entirely" or "intrinsically" fair. Fairness has two components: fair dealing and fair price.[27] This means that a defendant must show that the substance of the transaction and the process of the transaction were fair to the corporation.

D. **State Law Limitations on Liability**. Director and officer liability can be limited as a matter of State law. In particular, Delaware's General Corporations Law allows for a charter provision limiting personal liability of directors.[28] However, this provision is strictly limited to situations in which the following do not apply:

- Breach of the director's duty of loyalty to the corporation or its stockholders;
- Acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law;
- Acts regarding unlawful payment of a dividend or an unlawful stock purchase or redemption; or
- Any transaction from which the director derived an improper personal benefit.[29]

IV. Fiduciary Obligations in The Context of an Insolvent Company

A. In the context of a solvent company, officers and directors owe a fiduciary duty only to the company's shareholders. As a corporation approaches insolvency, the fiduciary duties of officers and directors begin to shift toward the creditors.[30]

---

27 See Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del 1983) (holding that the merger in question did not meet the "test of fairness," where a feasibility study prepared by two of the subsidiary's directors, who were also directors of parent, indicating that a price in excess of what the parent ultimately offered for the subsidiary's outstanding shares would have been a good investment for parent, was not disclosed to the subsidiary's outside directors).

28 DGCL § 102(b)(7).

29 Id.

30 It is critical to be able to define what insolvency is and to determine when it occurs. The Bankruptcy Code defines insolvency, with respect to an entity other than a partnership or municipality, as a "financial condition such that the sum of each entity's debts is greater than all of such entity's property, at a fair valuation…" 11 U.S.C § 101(32). Courts often use different definitions, however, and many courts believe that insolvency is a

(Continued…)

B. Credit Lyonnias,[31] the seminal case regarding fiduciary duties in insolvency, involved a leveraged buyout where the plaintiff, Credit Lyonnais, ceded governance and control to its lender. The plaintiff sought a judicial determination regarding the persons who comprised the lawfully elected board of directors. The Delaware Chancery Court stated that, in circumstances where a corporation was "operating in the vicinity of insolvency," directors owed a duty to the entire corporate enterprise.[32] In a well known footnote, the Court essentially concluded that in the context of an insolvent company, interests of shareholders should be subordinated to those of creditors when such interests conflict. In so stating, the Court implied that directors have discretion, and indeed the duty, to limit the risk they take in expectation of long-term returns to shareholders when the corporation is in the zone of insolvency.[33]

C. Thus, Credit Lyonnias placed directors in the precarious position of needing to balance the interests of shareholders, who seek long-term market value, against those of creditors, who seek payment even at the cost of liquidation. Courts are split on whether there is a continuing duty to shareholders in the context of an insolvent company. It appears that most cases state, or at least imply, that fiduciary duties are owed to both creditors and stockholders when a corporation is in the zone of insolvency.

D. In a recent opinion, the Delaware Chancery Court again addressed the issue of fiduciary obligations in an insolvency situation.[34] In deciding the propriety of appointing a receiver under the Delaware Corporate Code, the Production Resources Court addressed the Credit Lyonnais case and specifically stated that it appeared that Credit Lyonnais provided a "shield" to directors from equityholders who may assert that directors had a duty to undertake risk that may result in long

---

fluid concept and that the duty shifts to the creditors when a company is in the "vicinity of insolvency." Credit Lyonnais Bank Nederland v. Pathe Comm's Corp., 1991 WL 277613 (Del. Ch. Dec. 30, 1991). Most recently, the Delaware Chancery Court has also stated that insolvency is proven by showing either "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof" or "an inability to meet maturing obligations as they fall due in the ordinary course of business." Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 782 (Del.Ch. 2004). Such criteria and definitions notwithstanding, as a practical matter, identifying the precise moment of insolvency is rather difficult, if not impossible.

31 Credit Lyonnais Bank Nederland v. Pathe Comm's Corp., 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

32 Id. at *34.

33 Credit Lyonnais Bank Nederland v. Pathe Comm's Corp., 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

34 Production Resources Group, L.L.C., 863 A.2d 772, 788 (Del. Ch. 2004) .

term profit, "so long as the company would not technically breach any legal obligations."[35]

E. **Fiduciary Duties of a Debtor in Possession.** Once a company files for bankruptcy, a debtor in possession owes the creditors the same fiduciary duties that a trustee would owe. In this regard, the Supreme Court has noted that,

> [t]he fiduciary duty of the trustee runs to shareholders as well as to creditors…. if a debtor remains in possession - that is, if a trustee is not appointed - the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession.[36]

---

35 Id.

36 Commodity Futures Trading Com'n v. Weintraub, 471 U.S. 343, 355 (1985).