COVID-19 FALLOUT MAY FLOOD BANKRUPTCY COURTS: SIX TO-DOS FOR D&O INSURERS

BY: JOHN HOWELL

The Covid-19 pandemic has contributed to the bankruptcy of at least 133 companies since the crisis gained national attention in March.1 Companies seeking bankruptcy protection include household names like Hertz and J.C. Penney, along with dozens of small and mid-size businesses.2 Observers predict that 2020 will see “more bankruptcies than in any businessperson’s lifetime.”

The expected deluge of bankruptcy filings prompted a committee of the Bankruptcy & Covid-19 Working Group to urge Congress to add capacity to the bankruptcy court system.4 The group of academics warned that “a significant fraction of viable small businesses will be forced to liquidate,” giving rise to fears that bankruptcy courts will be “overwhelmed by this flood of cases.”

In a business bankruptcy, D&O insurance is likely to be a key asset — sometimes the main asset from which the bankrupt entity’s creditors seek to recover on their claims. However, directors and officers of a distressed or defunct company may assume that insurance was put in place to protect them against claims: to pay or advance defense costs and to settle claims if a reasonable settlement can be reached. Policyholder bankruptcies can present insurers with multiple constituencies of claimants, insureds and trustees wrestling over limited policy proceeds in an unfamiliar procedural context. Below are six steps insurers can take to stay on top of bankruptcy claims situations.
1. Know the players.

Chapter 7 of the Bankruptcy Code addresses the liquidation of assets and, in the case of an individual, the discharge of a debtor's liabilities. Chapter 11, on the other hand, addresses reorganizations and is used by businesses to restructure equity and liabilities after emerging from the Bankruptcy Court's protection.

In a Chapter 7 case, the Office of the United States Trustee appoints an interim Chapter 7 trustee upon the commencement of the Chapter 7 case. At the first meeting of creditors, 30 to 45 days after the case is commenced, the company's unsecured creditors have the right to elect a trustee. If the creditors do not elect a trustee, the interim trustee becomes the permanent trustee. Upon their appointment, the trustee acquires control over all the debtor's property of every type and in every location and determines whether to liquidate such assets and pay the proceeds to the debtor's creditors after paying administrative costs.

In a typical Chapter 11 case, the bankrupt company remains in possession and control of its assets and affairs and is referred to as a “debtor-in-possession.” Typically, the debtor-in-possession operates its business and conducts its affairs in the ordinary course of its business without special permission from the bankruptcy court until a Chapter 11 plan reorganizing the company is confirmed and substantially consummated, a sale of substantially all assets is approved, the case is converted to Chapter 7, or a Chapter 11 trustee is appointed. The appointment of a Chapter 11 trustee is not common and is often the result of some malfeasance by the debtor-in-possession after the bankruptcy filing.

In both Chapter 7 and Chapter 11 cases, a Creditors' Committee represents the interests of the debtor's unsecured creditors. Creditors' committees can investigate the debtor and potential claims that might be brought to recover more money for the estate and its creditors and may seek standing to assert claims against the debtor's directors and officers or other third parties.

A plan of liquidation under Chapter 7 or reorganization under Chapter 11 may also create a Liquidating Trustee or a Litigation Trustee, which is assigned claims belonging to the bankrupt company to pursue recoveries on behalf of a trust that benefits creditors. These trustees are trustees of the trust created by the bankruptcy plan to process claims and distribute assets; they are not trustees of the company itself like a Chapter 7 trustee or a Chapter 11 trustee.

2. Recognize likely claims.

Claims against a debtor that existed before the debtor filed bankruptcy are automatically stayed with respect to the debtor entity itself. Litigation may proceed against other parties, including the debtor’s directors and officers. A plaintiff whose lawsuit against the debtor is stayed may file a claim in the bankruptcy proceeding itself. Alternatively, the plaintiff may seek to lift the stay against suing the debtor to proceed outside of the bankruptcy process only to the extent that the debtor has insurance for the suit.

After bankruptcy has been filed, litigation against the debtor’s directors and officers is common. These claims may be brought by the debtor-in-possession itself or by a trustee on behalf of the debtor. Creditors’ committees can also petition the court for standing to bring such claims. The suits often allege mismanagement by the directors and officers or breaches of fiduciary duties that purportedly caused the company to fail.

Some courts have held that when a company is in a near-insolvency—in the “zone of insolvency”—the company’s directors and officers owe fiduciary duties directly to the company’s creditors as well as to its shareholders. In those jurisdictions, there may be a cause of action for “deepening insolvency”—that is, prolonging the life of the corporation and causing it to take on additional debt. In other states, significantly including Delaware, there is no cause of action for deepening insolvency, and trustees/creditors can bring a breach-of-fiduciary duty case against a debtor’s executives only as a derivative case on behalf of the company when the company is actually insolvent—not merely in the “zone.” Other states recognize “deepening insolvency” only as a theory of damages for breach of fiduciary duty, not as a standalone cause of
action. Regardless of the theory, when the company has become insolvent, alleged damages to the corporation caused by the directors’ and officers’ fiduciary breaches can be significant.

Other claims that can be made against directors and officers of the debtor—or other third parties—revolve around the power of a bankruptcy trustee to claw back payments the debtor made shortly before filing for bankruptcy. Under federal bankruptcy law, certain “preferential” transfers can be recovered if they were made within 90 days of the bankruptcy petition (or within one year for payments to insiders). To be recoverable, the debtor must have been insolvent at the time of the payment, and the payment must have allowed the creditor to receive more than its proportionate share of the debtor’s assets. A trustee can recover “fraudulent” transfers—which include payments made within two years of the bankruptcy filing if the payment was made in order to delay or defraud creditors, or if the debtor received less than a reasonably equivalent value in exchange—if the debtor was insolvent at the time of the transfer or was rendered insolvent on account of the transfer.

3. Pay attention to the automatic stay before paying defense costs or settlements.

Under the Bankruptcy Code, an automatic stay bars any effort to collect on property of the debtor’s bankruptcy estate. Most courts around the country consider D&O policies property of the debtor’s estate. The more significant issue for the bankrupt company and insurers, however, is whether the D&O policy proceeds—rather than the policy itself—are the property of the estate. This issue typically arises when an insurer is asked to advance defense costs or make other payments under a policy issued to a company in bankruptcy.

Numerous courts have held that, where the debtor company does not have a “direct interest” in the proceeds of a D&O policy, the proceeds are not property of the bankruptcy estate. For example, in Louisiana World Exposition, the Fifth Circuit reasoned that the D&O policy benefited only the directors and officers by providing either direct coverage for claims made against them or indirect coverage by reimbursing the corporation for its indemnification of the directors and officers. Because the debtor did not have a direct interest in the policy’s proceeds, the court determined that the proceeds were not the property of the bankruptcy estate.

Other courts have found, however, that where there are claims for indemnification coverage under Insuring Agreement B or “B-Side Coverage” of a D&O policy, the D&O policy proceeds may be property of the bankruptcy estate. These courts reason that payments for directors’ and officers’ defense costs would deplete the policy limits, thereby increasing the debtor’s exposure to indemnification claims in other litigation. Thus, according to these courts, the debtor’s interest in being reimbursed by the insurer for the amounts it must indemnify its directors and officers is sufficient to make the policy’s proceeds an asset of the bankruptcy estate.

 Courts have held that the proceeds of D&O policies that provide entire coverage are the property of the bankruptcy estate. These courts reason that the existence of direct coverage for the corporation makes the policy a vehicle for both individual and corporate protection. Because the proceeds of the policy are “commingled,” one court found that the debtor’s interest in the policy proceeds is sufficient to bring all of the policy proceeds into the bankruptcy estate. Moreover, where a single aggregate limit of liability applies to both the D&O coverage and entity coverage, depletion of the aggregate limit by payment of covered loss to the directors and officers will affect the amount of coverage available to the debtor and thus to the debtor’s estate.

Other courts have held that the proceeds of a D&O policy are not the property of the bankruptcy estate, even if the policy includes entity coverage, particularly where there are no actual claims against the debtor entity that would be covered. For example, in First Central Financial Corp. v. In re New York City Municipal Employees’ Retirement System, a New York bankruptcy court found that “[t]he entity coverage is hypothetical and fails to provide some palpable benefit to the estate, it cannot be used by a trustee to lever himself into a position of first entitlement to policy proceeds.”
To avoid the possibility that a D&O insurer might be found to have violated the automatic stay by paying defense costs or settlements in claims against the debtor's directors and officers, either the directors and officers or the insurer often seek a “comfort order.” A comfort order motion typically requests that the bankruptcy court find that the automatic stay does not apply to the D&O policy proceeds or that cause exists to lift the stay to permit payment of the defense costs or settlement. Substantial hardship to the debtor's directors and officers in the absence of a comfort order is often sufficient cause for the court to grant a motion to lift the automatic stay.23

4. Keep an eye on indemnification rights.

Many D&O policies are subject to self-insured retentions that are excused if the insured company is unable to indemnify its executives due to financial insolvency. And Side A-only policies may not be triggered at all if indemnification is available. In certain cases, an executive's indemnification claim against a debtor may be given priority as an administrative expense—increasing the likelihood that indemnification will actually be available—but generally only if the conduct for which they seek indemnification occurred after the bankruptcy filing.23

Indemnification claims by directors and officers typically are based on pre-bankruptcy conduct. If claim was made against the policyholder before the bankruptcy filing, the claim will not be given administrative expense priority and instead will be treated as a general unsecured claim. General unsecured claims often receive nothing in bankruptcy. However, if the bankruptcy has enough assets, there may be some recovery by the holders of unsecured claims, including directors and officers seeking indemnification. Such indemnification claims may be subject to other defenses and could be disallowed or subordinated—moved to a lower level of priority in the bankruptcy payout—because of misconduct by the executive or because the indemnification claim relates to a claim that itself has low priority.

Nevertheless, insurers may request that directors and officers file claims in the bankruptcy for indemnification to protect the ability to recover amounts within a retention or that may be advanced under a Side A-only policy.

5. Consider potential coverage issues.

Bankruptcy claims may raise unique coverage issues that should be examined carefully in light of the specific policy language and circumstances.

Non-Recourse Agreements: Some bankruptcy plans contain provisions limiting the ability of a litigation or liquidation trustee to recover on claims against or officers of the debtors challenging their pre-bankruptcy conduct. Such “non-recourse” agreements may require the trustee to recover only from available insurance, rather than against the individuals directly. D&O policies commonly contain exceptions or carve-outs from the definition of covered “Loss” for “amounts for which an Insured is not financially liable or which are without legal recourse to an Insured” or “any amount for which the Insured Person is absolved from payment by reason of any covenant, agreement or court order.” So, a non-recourse agreement contained in a bankruptcy plan may preclude coverage for a settlement or judgment in a trustee claim.

Insured v. Insured Exclusion: The terms of insured v. insured exclusions vary. The exclusions often bar coverage for claims “brought by” an insured entity or claims “brought by or on behalf of” an insured entity. Most modern insured v. insured exclusions contain carve-outs for actions by a bankruptcy trustee or other limitations on applicability. In any event, the first issue in the bankruptcy context is whether the claimant—be it the debtor-in-possession, bankruptcy trustee, creditor/committee or assignee of the debtor’s or creditors’ rights—stands in the shoes of the insured entity such that claims they bring against the insured entity’s executives trigger the exclusion.

Insurers have maintained that, because a bankruptcy trustee stands in the debtor's shoes for purposes of asserting claims against its directors and officers, the insured v. insured exclusion bar coverage for a trustee’s claims, just
as it would bar coverage for claims brought in the name of or by the debtor itself. They have also argued that a claimant that receives a claim by assignment from the insured entity—such as a liquidation trust under a bankruptcy plan—brings that claim “on behalf of” the insured entity for purposes of the insured’s insured exclusion. Trustees, creditors’ committees and insurers argue, however, that the debtor and the trustee or other claimant are legally separate entities and that the purpose of the insured’s insured exclusion—purportedly to prevent collusive litigation—is not implicated in the bankruptcy context because the suits by trustees or creditors’ committees are not collusive.

Preference Actions and Fraudulent Transfers — Definitions of “Loss” and “Wrongful Act”: Preference actions may not allege a “Wrongful Act” under a D&O policy. The definition of “Wrongful Act” under most D&O policies includes any act, error, omission, misstatement, neglect or breach of duty by an insured. To prevail in a preference action, the debtor-in-possession or trustee must prove that the transfer was made: (1) “to or for the benefit of a creditor;” (2) “for or on account of an antecedent debt;” (3) “while the debtor was insolvent;” (4) within 90 days of, in the case of an insider, one year; and (5) that it resulted in the creditor receiving a greater distribution than it otherwise would have in a hypothetical Chapter 7 distribution. See 11 U.S.C. § 547(b). Accordingly, there is no requirement that the creditor have done anything improper other than receive a payment within the specified time prior to the bankruptcy filing. As such, preference litigation against directors or officers may not involve any error, omission, misstatement, neglect or breach of duty, and may not be covered under a D&O policy. Insurers often respond that the receipt of money itself is an “act” under the definition and, in some instances, that the operative alleged wrongful conduct of the debtor in paying the money was undertaken by the various directors and officers at issue. Moreover, usually preference counts are asserted in the same complaint as breach of fiduciary duty counts, which the insured argues supplies the relevant “Wrongful Act.” Insurers commonly argue that preference and fraudulent transfer actions do not seek covered “Loss” within the meaning of a D&O policy. In these lawsuits, trustees and debtor-in-possession seek to set aside, disgorge, avoid, rescind or recover as restitution either preferential or fraudulent pre-bankruptcy payments to which the directors or officers alleged or honestly were not entitled. Several courts have held that an insured may not seek reimbursement under a liability policy for a judgment or settlement that requires the insured to disgorge or make restitution for wrongfully acquired funds.


Various bankruptcy-related procedural and statutory protections may be available to insurers and other non-debtor third parties when settling claims against a debtor entity or its directors and officers. Settlement agreements or bankruptcy plans may incorporate a release, injunction, and/or bar order pertaining to potential claims against the debtor or its insurers, including contribution claims and claims regarding the insurer’s handling of the settlement, even in the absence of consent by the enjoined party. Such a release or injunction can be highly beneficial to insurers and settling insurers attempting to secure finality and avoid future claims. The Eleventh Circuit, for example, permits bankruptcy courts to approve releases and injunctions protecting non-debtors (including insurers) from claims by non-debtors in limited circumstances and despite objections from enjoined creditors. But the law concerning a bankruptcy court’s authority to grant these injunctions varies across jurisdictions.

Settling insurers in bankruptcy court may also seek good faith findings in conjunction with the approval and ratification of settlements with the debtor or a trustee or creditors’ committee. Bankruptcy Rule 9019 provides that “[i]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement.” Fed. R. Bankr. P. 9019(a). Settling insurers may seek a determination by the bankruptcy court of good faith by the insurer in the order approving and enacting the settlement between the parties, as well as an order lifting the automatic stay to permit payment of the settlement.

Although the Covid-19 crisis presents novel challenges on many fronts, some view the United States’ “high quality
bankruptcy law” as a “key comparative advantage for the United States in this unprecedented pandemic.” Insurers should remain conscious of the competing interests in any bankruptcy process that may look to a debtor’s insurance policies as a source of value. But there are also unique opportunities and protections available within the bankruptcy process that will continue to provide the framework for a significant volume of claims against distressed companies and their executives.

End Notes


2. Ibid.


23. National Union Fire Ins. Co. v. Olympus Holding Corp., No. 04-CV-00817-GJF, slip op. at 20-21 (N.D. Ga. June 4, 1999), aff’d 149 F.3d 507 (11th Cir. 1998) (holding appealing insurer had no vested interest in the bankruptcy court’s order to disqualify an appraiser by Chapter 7 trustee against a debtor’s directors).

24. See, e.g., Pennsylvania v. Baez, 611 F.Supp. 403 (E.D. Pa. 1985) (holding that, because the policyholder and a court-appointed trustee were bound to act in the best interests of the policyholder, the authority of the bankruptcy court, . . . was not the entity for purposes of the insured versus insured exclusion). The exclusion was inapplicable.


26. See, e.g., Level 3 Commun., Inc. v. Federal Ins. Co., 727 F.3d 908 (7th Cir. 2013) (noting, in a Delaware bankruptcy, that “bankruptcy courts are ‘not’ a ‘court of admiralty’ and therefore not subject to the admiralty jurisdiction”).

27. See In re Mantorp, Inc., 97 F.3d 849 (11th Cir. 1996). See also In re California Western Ins. Co., 354 F.3d 289 (5th Cir. 1999); In re St. John’s HOSP. Ltd., 233 B.R. 584 (Bankr. S.D. Fla. 2000); In re Dow Comin Corp., 280 B.R. 648 (6th Cir. 2002); In re American Commerce, 271 F.3d 626 (9th Cir. 2001).

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