Bankruptcy: The Game-Changer for Directors & Officers Who May Face Claims by Shareholders or Others

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Directors of solvent Delaware corporations typically hope and expect to look to what has been referred to as the “three-legged stool” of protection against loss: (i) exculpation from liability for money damages caused by a breach of the fiduciary duty of care; (ii) advancement of defense expenses, and end-of-the-matter indemnification of defense expenses or other losses; and (iii) director and officer liability insurance coverage. Likewise, officers of solvent Delaware corporations, while not subject to exculpation, expect to rely on advancement/indemnification and, in turn, on D&O insurance, when advancement/indemnification will not or cannot be provided by the corporation. But, with a corporation’s filing for bankruptcy protection, the game can change in material respects. In particular, the playing field can include challenges for directors and officers such as expanded duties, some or no opportunity to limit liability, burdens associated with establishing the allowance of claims for advancement or indemnification and establishing the priority of those claims, and no or limited access to D&O insurance and the policy’s proceeds.

Expanded Duties, with Some or No Opportunity to Limit Liability

First, the duties of directors and officers are expanded to include fiduciary duties to the company’s creditors, as well as to the company and its shareholders. In fact, some courts have held that the company’s duties to its creditors become superior to its duties to shareholders. Creditors of an insolvent corporation have no right to assert
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direct claims for breach of fiduciary duty against the corporation’s directors. Instead, creditors may protect their interests by bringing derivative claims on behalf of the insolvent corporation and any other direct non-fiduciary claim that may be available to individual creditors.

Second, with regard to limitation of liability, directors may continue to rely on exculpatory charter provisions adopted pursuant to section 102(b)(7) of the Delaware General Corporation Law. But, even if directors may benefit from that protection, there is no such exculpation for corporate officers under Delaware law, and the protection afforded directors will not cover breaches of the duty of loyalty or a failure to act in good faith.

Threshold Issue in Bankruptcy: Allowance of the Claim

Third, advancement or indemnification claims will be subjected to enhanced scrutiny not imposed pre-petition. As a threshold matter, the bankruptcy court will consider whether the claim is allowable under section 502 of the Bankruptcy Code (the “Code”). If the claim is allowed, the court then will determine what priority to give the claim pursuant to section 507 of the Code, if any.

Only claims against the bankruptcy estate that are deemed “allowed” will be paid in whole or in part. Section 502(e)(1)(B) of the Code requires disallowance of a claim if three criteria are met. First, the claim must be for reimbursement or contribution. The concept of reimbursement includes indemnity. Second, the claim must be contingent. While indemnification claims are often considered to be contingent until the underlying litigation is resolved, a director’s or officer’s claim for advancement of defense costs is not contingent. Finally, the claimant must be co-liable with the debtor with respect to the claim. Co-liability is determined by reference to the underlying third-party action. This factor is satisfied if the underlying action asserts claims that, if proven, would give rise to liability against the debtor but for the automatic stay. A claim for advancement of defense costs should not be disallowed under section 502(e)(1)(B) because the debtor and the director or officer could only be co-liable on the underlying claims, not the defense costs associated with such claims.

Priority of Claims/Alternatives

Fourth, with regard to the priority of an allowed claim, advancement or indemnification claims predicated upon pre-petition conduct typically are treated as general unsecured claims, even if the advancement or indemnification claims arise post-petition. Claims involving post-petition conduct may be entitled to first priority administrative expense treatment, but such treatment is rare. And administrative expense treatment may be denied even for post-petition conduct if the claims have been asserted by former directors and officers.

Moreover, even an allowed claim may be subordinated to other unsecured claims pursuant to section 510(b) of the Code. Thus, even allowed claims for advancement or indemnification ultimately may be worth little or nothing.

Access to D&O Insurance & The Policy Proceeds

Finally, all the foregoing highlights the critical importance to current and former directors and officers of being able to look to D&O insurance proceeds. But that prospect, too, can present daunting challenges in the bankruptcy context.

Perhaps most notably, the automatic stay, as imposed by section 362(a) of the Code, will prevent access to a D&O insurance policy and its proceeds if the policy and proceeds are determined to be property of the bankruptcy estate. Directors and officers will stand their best chance of establishing entitlement to the proceeds when only so-called “Side A” coverage is provided by the policy, namely, coverage intended to provide insurance proceeds directly to directors and officers. But the outcome becomes less certain if “Side B” coverage (company reimbursement for amounts advanced or indemnified) is provided. And the outcome becomes most problematic if “Side C” (entity) coverage is provided and claims have been asserted against the corporation as well as the directors and officers.
Some commentators have suggested that, as a preventative measure, directors and officers should insist on the inclusion of “priority of payments” provisions in insurance policies at the negotiating/drafting stage.26 But other commentators have expressed little confidence in such provisions, predicting that bankruptcy courts may exercise their broad equitable powers to hold such provisions unenforceable.27

Even if directors and officers can establish potential entitlement to the insurance proceeds, carriers may assert one or more defenses to coverage. Those defenses may involve, for example, the “insured vs. insured” exclusion if, as often occurs, either the debtor-in-possession or a trustee in bankruptcy asserts claims against directors and officers, or if creditors assert such claims and the claims are not subject to a derivative claim carve-out in the exclusion.28 Other actions by carriers may include cancellation or rescission of the D&O policy based upon corporate wrongdoing.29

Conclusion

If anything is certain, it is that the filing of a corporate bankruptcy petition is a game-changer for the debtor’s directors and officers.

NOTES

4. North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007)(NACEPF)(“Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors’ duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.”).
5. NACEPF, 930 A.2d at 103.
6. Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 782 (Del. Ch. 2004)(“The fact of insolvency does not change the primary object of the director’s duties, which is the firm itself. The firm’s insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value and logically gives them standing to pursue these claims to rectify that injury.”), overruled in part on other grounds, NACEPF, 930 A.2d 92; Radnor Holdings Corp. v. Tennenbaum Capital Partners, 353 B.R. 820, 843 (Bankr. D. Del. 2006); (“Section 102(b)(7) provisions act as a complete bar to liability even when creditors or a trustee, rather than stockholders, are suing derivatively.... Thus, ‘the business judgment rule protects the directors of solvent, barely solvent, and insolvent corporations, and... the creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm.’”) (internal citations omitted). See also Continuing Creditors’ Committee of Star Telecommunications, Inc. v. Edgecomb, 385 F. Supp. 2d 449, 4662 (D. Del. 2004); (applying Production Resources to bar claims in bankruptcy premised on breach of the duty of due care).
7. Gantler v. Stephens, 965 A.2d 695, 709 n.37 (Del. 2009)(“Under 8 Del. C. § 102(b)(7), a corporation may adopt a provision in its certificate of incorporation exculpating its directors from monetary liability for an adjudicated breach of their duty of care. Although legislatively possible, there currently is no statutory provision authorizing comparable exculpation of corporate officers.”); McPadden v. Sidhu, 964 A.2d 1262, 1276 (Del. Ch. 2008)(“Though an officer owes to the corporation identical fiduciary duties of care and loyalty as owed by directors, an officer does
not benefit from the protections of a Section 102(b)(7) exculpatory provision, which are only available to directors.

12. Under section 502(j) of the Code, a disallowed contingent claim can be reconsidered once the contingency is removed.
13. In re Touch Am., 409 B.R. at 716. See also In re RNI, 369 B.R. at 185-186 (“The right is typically subject to a requirement that the indemnitee [has] acted in good faith and in a manner that he reasonably believed was in the best interest of the company. As a result, an indemnification dispute generally cannot be resolved until after the merits of the underlying controversy are decided because the good faith standard requires a factual inquiry into the events that gave rise to the lawsuit.”) (quoting Majkowski v. American Imaging Management Services, LLC, 913 A.2d 572, 586 (Del. Ch. 2006)).
14. In re RNI, 369 B.R. at 186 (“[A]dvancement, by contrast, is a right whereby a potential indemnitee has the ability to force the company to pay his litigation expenses as they are incurred regardless of whether he will ultimately be entitled to indemnification. Advancement is typically not conditioned on a finding that the party seeking advancement has met any standard of conduct. The only proviso is that the officer must undertake to repay all monies advanced to him if it is later determined that he is not entitled to indemnification.”) (internal quotations and citations omitted).
17. See In re RNI, 369 B.R. at 190-191.
19. See In re Consolidated Oil & Gas, Inc., 110 B.R. 535, 537-538, 22 Collier Bankr. Cas. 2d (MB) 1423, Bankr. L. Rep. (CCH) P 73270 (Bankr. D. Colo. 1990); In re Christian Life Ctr., 821 F.2d at 1374; But see In re Sahlen & Associates, Inc., 113 B.R. 152, 153, Bankr. L. Rep. (CCH) P 427 (Bankr. S.D. N.Y. 1989) (finding that the indemnification claims of a debtor’s directors or officers may be permitted to receive administrative expense treatment, even though the claims relate to pre-petition actions, if the directors or officers can demonstrate that their services benefited the estate).
23. See, e.g., In re Allied Digital Technologies, Corp., 306 B.R. 505, 512, 42 Bankr. Ct. Dec. (CRR) 204 (Bankr. D. Del. 2004)(“When liability insurance policy provides direct coverage to the directors and officers the proceeds are not property of the estate.”); In re Laminate Kingdom, LLC, 2008 WL 1766637, at *2 (Bankr. S.D. Fla. 2008)(“Typically, the proceeds of a directors and officers liability insurance policy are not considered property of a bankruptcy estate.”).


28. See Reliance Ins. Co. of Illinois v. Weis, 148 B.R. 575, 583 (E.D. Mo. 1992), (court found that the “insured vs. insured” exclusion precluded coverage under the D&O policy for claims asserted by the plan committee against former directors and officers, reasoning that because the debtor’s rights to sue were transferred to the estate upon the bankruptcy filing, “for purposes of this litigation, there is no significant legal distinction between [the debtor] and its bankruptcy estate”). aff’d in part, 5 F.3d 532 (8th Cir. 1993)