

# 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.<sup>1</sup> 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,<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup>

*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.<sup>6</sup> But, even if directors may benefit from that protection, there is no such exculpation for corporate officers under Delaware law,<sup>7</sup> and the protection afforded directors will not cover breaches of the duty of loyalty or a failure to act in good faith.<sup>8</sup>

### 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.<sup>9</sup> Section 502(e)(1)(B) of the Code requires disallowance of a claim if three criteria are met.<sup>10</sup> *First*, the claim must be for reimbursement or contribution. The concept of reimbursement includes indemnity.<sup>11</sup> *Second*, the claim must be contingent.<sup>12</sup> While indemnification claims are often considered to be contingent until the underlying litigation is resolved,<sup>13</sup> a director's or officer's claim for advancement of defense costs is not contingent.<sup>14</sup> *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.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup>

### 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,<sup>18</sup> even if the advancement or indemnification claims arise post-petition.<sup>19</sup> Claims involving post-petition conduct may be entitled to first priority administrative expense treatment, but such treatment is rare.<sup>20</sup> And administrative expense treatment may be denied even for post-petition conduct if the claims have been asserted by *former* directors and officers.<sup>21</sup>

Moreover, even an allowed claim may be *subordinated* to other unsecured claims pursuant to section 510(b) of the Code.<sup>22</sup>

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.<sup>23</sup> But the outcome becomes less certain if "Side B" coverage (company reimbursement for amounts advanced or indemnified) is provided.<sup>24</sup> 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.<sup>25</sup>

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.<sup>26</sup> 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.<sup>27</sup>

Even if directors and officers can establish potential entitlement to the insurance proceeds, carriers often will 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.<sup>28</sup> Other actions by carriers may include cancellation or rescission of the D&O policy based upon corporate wrongdoing (subject to obtaining relief from the automatic stay to do so).<sup>29</sup>

## 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

1. See E. Norman Veasey, et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 Bus. Law. 399 (1997).
2. See *In re Troll Communications, LLC*, 385 B.R. 110, 120, 49 Bankr. Ct. Dec. (CRR) 236 (Bankr. D. Del. 2008) (“[U]nder Delaware law, officers and directors owe a fiduciary duty to creditors once a corporation becomes insolvent.”).
3. See, e.g., *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d 973, 976 (4th Cir. 1982); *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981); see also *Voest-Alpine Trading USA Corp. v. Vantage Steel Corp.*, 919 F.2d 206, 217 (3d Cir. 1990).
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, 792 (Del. Ch. 2004) (“[T]he 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. Edgcomb*, 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.”).
8. *In re Fedders North America, Inc.*, 405 B.R. 527 (Bankr. D. Del. 2009).
  9. William E. Knepper & Dan A. Bailey, *2 Liability of Corporate Officers and Directors*, § 22.16 (17th ed. 2008).
  10. *In re Touch America Holdings, Inc.*, 409 B.R. 712, 715-716 (Bankr. D. Del. 2009); (citing *In re RNI Wind Down Corp.*, 369 B.R. 174, 181, 48 Bankr. Ct. Dec. (CRR) 140, 58 Collier Bankr. Cas. 2d (MB) 486 (Bankr. D. Del. 2007)).
  11. *In re Touch Am.*, 409 B.R. at 716 (citing *In re RNI*, 369 B.R. at 181-182).
  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).
  15. *In re Touch Am.*, 409 B.R. at 719 (citing *In re Drexel Burnham Lambert Group Inc.*, 148 B.R. 982, 989, 23 Bankr. Ct. Dec. (CRR) 1315 (Bankr. S.D. N.Y. 1992)).
  16. *In re Touch Am.*, 409 B.R. at 719 (citing *In re Drexel*, 148 B.R. at 989).
  17. See *In re RNI*, 369 B.R. at 190-191.
  18. See *In re Pinnacle Brands, Inc.*, 259 B.R. 46, 52, 37 Bankr. Ct. Dec. (CRR) 127, 45 Collier Bankr. Cas. 2d (MB) 1037 (Bankr. D. Del. 2001); *In re Christian Life Center*, 821 F.2d 1370, 1374, Bankr. L. Rep. (CCH) P 71894 (9th Cir. 1987); *In re Amfesco Industries, Inc.*, 81 B.R. 777, 778 (Bankr. E.D. N.Y. 1988).
  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).
  20. Under section 503 of the Code, administrative expenses are allowed for the “actual, necessary costs and expenses of preserving the estate.” Under section 507(a)(1), administrative expenses are entitled to first payment priority. See *In re Heck’s Properties, Inc.*, 151 B.R. 739, 766-768 (S.D. W. Va. 1992)(directors and officers entitled to indemnification and administrative cost priority because claim against directors and officers related solely to post-petition conduct).
  21. See *Matter of Baldwin-United Corp.*, 43 B.R. 443, 445, 451-456, 11 Collier Bankr. Cas. 2d (MB) 1391 (S.D. Ohio 1984)(refusing to permit debtor to advance defense costs to former directors for post-petition conduct because the expenditures did not constitute “actual and necessary costs” of preserving the estate for the benefit of its creditors).
  22. See *In re Mid-American Waste Systems, Inc.*, 228 B.R. 816, 826, 33 Bankr. Ct. Dec. (CRR) 958 (Bankr. D. Del. 1999)(noting that “claims [including the directors’ and officers’ indemnification claims] emanating from tainted securities law transactions should not have the same priority as the claims of general creditors of 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.”).
  24. *In re Jasmine, Ltd.*, 258 B.R. 119, 128 (D.N.J. 2000), and *In re Sacred Heart Hosp. of Norristown*, 182 B.R. 413, 420, 27 Bankr. Ct. Dec. (CRR) 284

(Bankr. E.D. Pa. 1995), the courts determined that policies containing Side B indemnification proceeds were property of the bankruptcy estate. Conversely, in *In re CHS Electronics, Inc.*, 261 B.R. 538, 542, 37 Bankr. Ct. Dec. (CRR) 221 (Bankr. S.D. Fla. 2001), and *In re Daisy Systems Securities Litigation*, 132 B.R. 752, 755, Bankr. L. Rep. (CCH) P 74223, Fed. Sec. L. Rep. (CCH) P 96190 (N.D. Cal. 1991), the courts determined that policies containing Side B indemnification proceeds were not property of the bankruptcy estate.

25. The court in *Ochs v. Lipson* refused to establish a per se rule as to whether the existence of entity coverage would result in ownership by the corporation of the D&O insurance proceeds and, instead, stated that the question had to be answered on a case-by-case basis. *In re First Cent. Financial Corp.*, 238 B.R. 9, 16, 34 Bankr. Ct. Dec. (CRR) 1210, 42 Collier Bankr. Cas. 2d (MB) 1410, Bankr. L. Rep. (CCH) P 77996 (Bankr. E.D. N.Y. 1999) (*Ochs v. Lipson*).
26. See Rick Grimes & Karen Kutger, *Would Your D&O Liability Insurance Policy Withstand A Bankruptcy Filing?*, P&C Nat'l Underwriter, Aug. 3, 2009, available at <http://www.property-casualty.com/Issues/2009/August-3-2009/Pages/Would-Your-DO-Liability-Insurance-Policy-Withstand-A-Bankruptcy-Filing.aspx> (last visited

Dec. 1, 2009); Catherine Chaskin, *Bankruptcy D&O: Avoiding Crashes at the End of the Road*, Risk & Ins., at 3, Oct. 1, 2008, available at <http://www.riskandinsurance.com/story.jsp?storyID=131255186> (last visited Dec. 1, 2009); Mathew L. Jacobs et al., *Director and Officer Liability Coverage-The Basics*, 774 PLI/Lit 137, at 152 (2008); Nan Roberts Eitel, *Now You Have It, Now You Don't: Directors' and Officers' Insurance After Corporate Bankruptcy*, 46 Loy. L. Rev. 585, 604-605 (2000).

27. See Elina Chechelnitsky, *D & O Insurance in Bankruptcy: Just Another Business Contract*, 14 Fordham J. Corp. & Fin. L. 825, 846 (2009).
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)
29. See Leonard P. Goldberger, *Five Easy Pieces: A Guide to Dealing with D&O Insurance in Subprime Mortgage Bankruptcy Cases*, 26-8 ABIJ 18.