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When Worlds Collide: The Battle for D&O Insurance Proceeds in Bankruptcy

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Editor's Note: *Please see the feature on page 58 for an article addressing the related topic of how to maximize fiduciary liability coverage.*

Directors and officers of large companies expect their benefits to include insurance protecting them from third-party claims arising from actions they take performing their corporate duties. This coverage, known as directors and officers (D&O) insurance, indemnifies directors and officers and pays defense costs in actions brought against them in their corporate capacities. Directors and officers rely on this coverage when making hard decisions and taking risks on behalf of the company. However, if the company files for bankruptcy, or is placed into a receivership, they may find themselves battling for their D&O benefits with a trustee or receiver who contends that the proceeds belong to the debtor's estate. How can this happen?

Sharyn B. Zuch

This article examines the increasingly common conflict over D&O proceeds between estate fiduciaries and insureds. These fights will arise more frequently in high-stakes financial fraud cases with criminal cases pending against the directors and officers in addition to securities violations alleged against the company.

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While most companies purchase D&O coverage with sufficiently high limits, when a company collapses due to alleged financial fraud such as a Ponzi scheme, the resulting creditors' claims may exceed the policy limits and the company's other unencumbered assets. This sets the stage for a battle over D&O proceeds.

Such a drama recently played out between the receiver and the alleged Ponzi scheme masterminds in the pending *Stanford Financial Group* case.[1] In February 2009, the Securities and Exchange Commission (SEC) seized the assets of Stanford Financial Group and its affiliates. Prosecutors charged R. Allen Stanford and some of Stanford's directors and officers, including Laura Pendergest-Holt, the chief investment officer, with facilitating a massive Ponzi scheme. Although the individual insureds ultimately gained access to the D&O coverage to fight the criminal charges, they endured months of uncertainty in a hard-fought battle with the Stanford receiver for access to the proceeds of three D&O policies.

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Historically, courts have been sympathetic to the notion that the directors and officers rely on the existence of the D&O coverage and have understood that companies may have difficulty in attracting independent directors without generous D&O coverage. Indeed, courts have generally respected D&O policy language requiring that directors' and officers' defense costs get paid first, as specified in priority of payment provisions. For instance, in the *Enron* case, the debtors' interest in the D&O policy was limited by its clear language and the court upheld the priority of payment provision, which favored payment of the directors' and officers' defense costs.[2]

Courts addressing this priority of payment issue usually first look to the policy language to resolve the dispute between the insureds and the trustee or receiver. However, many D&O policies lack clearly-worded priority of payment provisions or, in some cases, lack one entirely. In these instances, the courts have been left to carve out the policy limits based on the Bankruptcy Code and general rules of equity. On occasion, these principles have led to some peculiar results, and it is expected that bankruptcy trustees and receivers in high profile cases will become more aggressive and creative in seeking to recover D&O proceeds in the future.

1 *See SEC v. Stanford Int'l Bank Ltd.*, Case No. 3:09-CV-298-N (N. D. Tex. Oct. 9, 2009) [Docket No.831].

2 *See In re Enron Corp.*, Case No. 01-16034 (Bankr. S.D.N.Y. April 11, 2002) [Docket No. 3278].

Types of D&O Coverage: A, B and C Side

Current D&O policies typically provide three kinds of coverage against third-party claims. Side A coverage is conventional direct-liability coverage, which pays directors' and officers' defense and indemnity costs if the company has not agreed to indemnify them. Side B coverage is indirect indemnification which pays the company for the defense and indemnity of its directors and officers if the company has agreed to indemnify them. Side C coverage, which is relatively new, is direct-entity coverage that pays the insured company for its own defense and indemnity costs when a securities claim is made directly against it.

While a company may purchase a single D&O policy, most will purchase a D&O program, called an insurance tower, which consists of multiple policies with stacked limits. For example, a company may have a self-insured retention (SIR) (or a deductible) for the first $1 million of defense and indemnity costs. Insurer No. 1 may then provide $4 million of coverage in excess of the $1 million SIR, Insurer No. 2 may provide the next $10 million in excess of the first $5 million and Insurers No. 3 and 4 may each provide 50 percent of next $20 million defense and indemnity costs, for a total policy limit of $34 million above the SIR.[3] Importantly, the potential liabilities resulting from fraudulent financial activities are likely to be much higher than the typical limits of a company's D&O limits.

Assume a hypothetical company's $50 million Ponzi scheme has collapsed. The directors, officers and company have all been sued by investors for $50 million in damages for securities fraud and there are also criminal charges against the directors and officers. The company has no real assets, and the directors and officers have incurred $5 million in attorney's fees. The $34 million insurance limits are clearly insufficient to pay both the directors' and officers' indemnity and defense costs and the claims against company. If our hypothetical company ends up in bankruptcy, the trustee's compensation under §§ 326 and 330 of the Bankruptcy Code will be based on the amount of money disbursed to parties in interest in the case. Therefore, it is easy to see that the trustee will be incentivized to fight to have the policy limits included as assets of the estate.

Insurance Policies Are Property of the Estate; Proceeds May or May Not Be

It is black-letter law that insurance policies are property of the estate under § 541 of the Code.[4] Therefore, the automatic stay applies to any action to obtain possession or control of D&O policies. However, the issue of whether D&O proceeds are property of the estate is a question about which the courts have not achieved a consensus. Even the methods of analysis have not been uniform. The inquiries have been fact-specific and seem to turn on the issues of how immediate is the directors' and officers' need for the coverage compared to how remote or speculative is the likelihood that the debtor will actually face third party actions and submit a claim for coverage.

At one end of the spectrum are the cases such as *In re Adelphia Communications Corp.,*[5] which held that Adelphia's D&O proceeds, urgently needed by the company's former CEO and other executives to defend themselves in their civil and criminal corporate fraud cases, were not property of the estate. The debtors had "[n]o cognizable equitable and legal interest" in the proceeds since they had not made any payments for which they were entitled to indemnification, nor had they even committed to making such payments using their entity coverage.[6] The court analogized the debtors' claim to the D&O proceeds to a car owner's claim that he has a present right to the proceeds from his collision policy just because he might crash into someone the next day.[7]

The *Lehman Brothers* court similarly resolved the conflict concerning a suit against Lehman's directors and officers. The debtors moved for an order to modify the automatic stay to fund a $1.6 million settlement in the Openwave litigation from D&O policy limits of $250 million. The policies had no Side C coverage. Although they had not yet asserted any claims against the Lehman officers and directors, three creditors objected to the lift-stay motion, on grounds that the settlement would deplete the policy limits otherwise available to them. The court overruled the objections and granted the motion to allow the insurers to fund the settlement from the D&O limits, finding that the objections were premature and "predicated on a great deal of speculation."[8]

At the other end of the spectrum are cases holding that the estate does have an interest in the D&O proceeds and that they are property of the estate. For instance, the court in *In re Cybermedica Inc.*[9] held that the D&O proceeds were property of the estate because "the estate is worth more with it than without it."[10]

Importantly, even courts finding D&O proceeds to be property of the estate attempt to balance the directors' and officers' immediate needs to have their defense costs paid against the estate's need for the benefits. The *Cybermedica* court, for example, lifted the automatic stay to give two of the company's directors the right to seek payment of their defense costs in a suit brought against them by the chapter 7 trustee, finding that the directors "may suffer substantial and irreparable harm" without access to such benefits "*now*."[11] The court reasoned that the harm to the estate was speculative: The D&O policy had no Side C coverage and there were no pending indemnification claims against the debtor implicating the Side B coverage.[12]

Other cases have attempted to fairly divide the D&O coverage between the directors and officers and the estate. An unconventional apportionment calculation was used in at least one case where, in the absence of a clear language in the policy, the court relied on general equitable principles to carve up the D&O policy limits. *In re National Century Enterprises Inc.*[13] was a perfect storm of an accounting and financial fraud case. There was $5 million in D&O cover-

3 Most D&O policies are subject to a single aggregate limit, which makes the battle for the proceeds a zero sum game: Every dollar paid to the directors' and officers' lawyers for their defense costs or settlement of suits (Side A or B coverage) reduces the amount that might otherwise be available for Side C coverage.

4 *See, e.g., MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89 (2d Cir. 1988).

5 *In re Adelphia Communications Corp.*, 298 B.R. 49 (S.D.N.Y. 2003).

6 *Id.* at 53.

7 *Id.*

8 *See in re Lehman Bros. Holdings Inc., et al.*, Case No. 08-13555 (Bankr. S.D.N.Y. Dec. 16, 2009) [Docket No.6297] and Transcript [Docket No. 9812] pp. 69-70. *See also In re La. World Exposition Inc.*, 832 F.2d 1391, 1401 (5th Cir. 1987) (proceeds of D&O policy, which had no Side C coverage, belonged only to executives); *In re World Health Alternatives Inc.*, 369 B.R. 805, 811 (Bankr. D. Del. 2007) (proceeds were not property of estate and directors and officers were entitled to use Side A coverage to settle securities fraud case where debtor had no Side B indemnification claim); *Ochs v. Lipson (In re First Cent. Fin. Corp.)*, 238 B. R. 9, 10 (Bankr. E.D.N.Y. 1999) (proceeds, not estate property, where no securities claims pending against debtor because "[i]f entity coverage is hypothetical it cannot be used by the trustee to lever himself into a position of first entitlement.").

9 *In re Cybermedica Inc.*, 280 B.R. 12, 15 (Bankr. D. Mass. 2002).

10 *See also Homsy v. Floyd (In re Vitek Inc.)*, 51 F.3d 530, 538 (5th Cir. 1995) (reinstating bankruptcy court's order authorizing trustee to use all D&O proceeds to settle mass tort litigation against debtor to detriment if its coinsured officers).

11 *Id.* (emphasis in the original).

12 *Id. See also In re Arter & Hadden LLP*, 335 B.R. 666, 674 (Bankr. N.D. Ohio 2005) (proceeds were property of estate, but stay was lifted because directors and officers had been sued by bankruptcy trustee and could "suffer substantial and irreparable harm" without access to firm's D&O proceeds).

13 *In re National Century Enterprises Inc.*, 2005 Bankr. Lexis 1052 (Bankr. S.D. Ohio Jan. 10, 2005).

age, $2.6 billion in allowed claims and defense costs of nearly $4 million. In the absence of a priority-of-payment provision, the bankruptcy court allocated 70 percent of the D&O proceeds to the directors and officers and 30 percent to the entity for payment to creditors. Since the policies were purchased primarily for the benefit of the directors and officers, the court decided that a simple proration would be inequitable because it would leave the directors and officers with "virtually nothing for their defense costs." Instead, the court adopted a *per capita* method to divvy up the proceeds, giving $500,000 to each of the directors and officers.[14]

Another court skirted the issue of whether the proceeds are property of the estate in ruling for the directors and officers. In the *Stanford* receivership case[15] mentioned above, both sides cited bankruptcy cases for guidance. The relevant issue was whether the district court's order restricting the use of receivership assets prohibited the D&O carrier from disbursing funds to pay the defense costs for several of Stanford's officers and directors, whom the SEC alleged were running a $7 billion Ponzi scheme. The court held that even if the proceeds were property of the estate (an issue the court declined to resolve), it was exercising its equitable discretion "in the interest of fairness" to permit D&O proceeds to be used to pay for the directors' and officers' criminal defense costs. The court found that the potential harm to the directors and officers, who faced multiple criminal charges, was "real and immediate," and that the receiver's claim was "presently speculative."[16] The *Stanford* court found it noteworthy that the receiver had not tendered a single claim against the debtors to the insurer for a defense.[17]

How Directors, Officers Can Avoid the Battle in the Future

As a starting point, directors and officers should be certain that the corporation's bylaws include a duty to indemnify them to the full extent permitted under applicable state law. Next, directors and officers should ascertain that their company's D&O policies contain clear, unambiguous priority of payment provisions that subordinate the entity's coverage to their own, since the courts that have addressed the issues discussed in this article have usually started their analysis with a review of the terms of D&O policy.

Unfortunately, existing policies contain a wide variety of wordings on the priority of payment issue. Some do not address any priority-of-payment rules at all, which is the worst scenario for insureds. In light of this fact, it may be tempting to structure D&O programs with separate liability limits for Side A, B and C. For example, a program could provide limits of $15 million for Side A and B coverage and provide a separate $20 million for Side C coverage. This structure is, however, inefficient for insureds. If the directors and officers are sued but the company is not, the directors and officers would not have access to the $20 limits reserved exclusively for the defense and indemnity of the company. Instead, a clear priority of payment provision with a single policy limit is best.

Some policies acknowledge the potential conflict between the directors and officers and the company, but provide limited or unclear wording. For example, one policy currently in use states:

> In the event of bankruptcy of the Company, the Insurer shall first pay... Loss on behalf of the Directors and Officers under Insuring Agreement A. until all Claims against the Directors and Officers are resolved, and only then pay Loss on behalf of the Company under Insuring Agreements B. and C.

This language may be adequate in some cases. However, assuming that there is no Side A coverage available for the directors and officers (because the company has agreed to indemnify them), if the company and the directors and officers are all sued for securities fraud, both Side B and C coverage could be involved. Under this language, there is no priority of payment specified between the Side B and C coverage, leaving the court to interpret the insureds' and insurer's intention. In such a case, how will the bankruptcy court carve out the proceeds if the trustee seeks them for the benefit of the estate? The answer may depend on a number of factors including whether any claims have been asserted against the debtor, and if not, whether they any claims have been or threatened or are purely speculative, the size of any claims against the company, the amount of the directors' and officers' defense costs already incurred and the perceived immediacy of the directors' and officers' need for the proceeds versus the trustee's.

There are better examples of priority-of-payment provisions that offer directors and officers more certainty that their defense costs will be paid even in the event of a bankruptcy filing by their company. Comprehensive priority-of-payment provisions define the scenario under which the provision is triggered, address the priority between Side A versus Side C and Side B versus Side C coverage, and state that the insurance was procured for the benefit of the directors and officers.

In addition to demanding that a company's D&O policies contain clear priority of payment provisions, directors and officers should seek policies that state that in the event of a bankruptcy, the insurer is not relieved of its obligations to all insureds, and that the corporation waives and releases its rights to the automatic stay as to the proceeds, as well as waives the right to seek a § 105 Code injunction to stop the payment of the D&O proceeds to the directors and officers. Finally, directors and officers might request that their corporations purchase D&O policies without Side C coverage because a number of the reported decisions have held that where there is no such coverage, the proceeds cannot be property of the estate. The company should then consider buying separate coverage that would respond if the company was faced with a suit alleging securities fraud.

Without a doubt, the best solution to conflicting claims on the D&O proceeds are clear priority-of-payment provisions stating which insureds are entitled to policy proceeds and when they are entitled to them *vis-à-vis* other insureds. With clear language, courts should be expected to honor the parties' intent even when faced with a trustee's competing claim for D&O proceeds. ■

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14 *Id.* at *29-35 (relying in part on vacated bankruptcy court decision in *Adelphia*, which had found D&O policy to be property of estate but partially lifted automatic stay to allow payment of $300,000 in defense costs for each director or officer).

15 *See SEC v. Stanford Int'l Bank Ltd.*, Case No. 3:09-CV-298-N (N.D. Tex. Oct. 9, 2009) [Docket No.831].

16 *Id.* at pp. 7-8.

17 *Id.* at p. 7.