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Feature

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Liquidating Trustee's Breach-of-Fiduciary-Duty Claims Excluded from D&O Coverage

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The "insured vs insured" exclusion is a standard provision in directors and officers liability policies (hereinafter "D&O policies") that precludes coverage for claims asserted by one "insured person" (namely, the company that purchased the policy) against another "insured person" (namely, the company's directors or officers). The exclusion's purpose is "to prevent collusive suits in which an insured company might seek to force its insurer to pay for the poor business decisions of its officers or managers."[1]

When a company commences a bankruptcy case and breach-of-fiduciary-duty claims are asserted against former directors and officers (hereinafter "D&O claims"), whether the claims are covered by a D&O policy typically hinges on the degree to which the plaintiff is considered "the same person" as or "stands in the shoes" of the pre-petition debtor.[2] Thus, courts generally hold that D&O claims asserted by a debtor in possession (DIP) or reorganized debtor are excluded from coverage because in both cases, pre-petition management typically remains in control and operates the pre-petition debtor's business.[3] In contrast, courts generally hold that D&O claims asserted by a trustee or creditors' committee are not excluded from coverage because they either displace management or operate independently of management.[4]

A recent decision arising out of bank holding company Capitol Bancorp's chapter 11 case, *Indian Harbor Ins. v. Zucker*, held that D&O claims asserted by a liquidating trustee were excluded from coverage under the terms of the applicable D&O policy's insured-vs.-insured provision.[5] Although the result in *Indian Harbor* is generally consistent with the few reported decisions to have addressed this issue, significant questions exist concerning the extent to which a collusive motivation should be attributed to liquidating trustees, who are often selected by creditors, even in debtor-proposed plans, and ordinarily report to an oversight committee comprised of creditors. Nevertheless, the issue can be avoided with advance planning.

Prior to bankruptcy, this issue can be avoided by ensuring that D&O policies include an exception to the insured-vs.-insured exclusion for claims asserted by liquidating trustees (a "carve-back"

1 *Twp. of Center, Butler Cnty., Pa. v. First Mercury Syndicate Inc.*, 117 F.3d 115, 119 (3d Cir. 1997) (noting that exclusion arose from wave of litigation in mid-1980s when corporations attempted to use D&O policies to recoup operational losses).

2 *See* Michael D. Sousa, "Making Sense of the Bramble-Filled Thicket: The 'Insured vs. Insured' Exclusion in the Bankruptcy Context," 23 *Emory Bankr. Dev. J.* 365, 404 (2007) ("The applicability of an 'insured vs. insured' exclusion in the bankruptcy context can perhaps best be understood as a linear continuum, whereby the points on this continuum represent, in sequential order, the debtor in possession, Chief Restructuring Officer, plan trustee, bankruptcy trustee, and creditors' committee ... [and] the further away from the debtor in possession on the continuum and the closer to the creditors' committee, the more likely it is that a court will find that the 'insured vs. insured' exclusion does not apply.").

3 *See, e.g., Biltmore Assocs. LLC v. Twin City Fire Ins. Co.*, 572 F.3d 663, 671 (9th Cir. 2009) (citing *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 528 (1984)) (concluding "that for [the] purposes of the insured versus insured exclusion, the prefiling company and the company as debtor in possession ... are the same entity," and noting that the U.S. Supreme Court held in *Bildisco*, "[I]t is sensible to view the debtor in possession as the same 'entity' [that] existed before the filing of the bankruptcy petition"); *Stratton v. Nat'l Union Fire Ins. Co.*, No. 03-cv-12018, 2004 WL 1950337, at *4-6 (D. Mass. Sept. 3, 2004) ("MHC [the reorganized debtor] is the fully feathered phoenix arising from the ashes of MPAN's and MHG's Plan of Reorganization. MHC ... established residence in MPAN's corporate headquarters, kept on MPAN's key employees ... and took control of MPAN's assets and subsidiaries. If this does not describe a 'successor' company [for purposes of determining applicability of the insured-vs.-insured exclusion], it would be difficult to describe any legal meaning to the word at all.").

4 *See, e.g., Cohen v. Nat'l Union Fire Ins. Co. of Pittsburgh (In re County Seat Stores Inc.)*, 280 B.R. 319, 326 (Bankr. S.D.N.Y. 2002) (D&O claims asserted by chapter 11 trustee not excluded from coverage because "a bankruptcy trustee charged with a statutory duty and endowed with special statutory powers is an independent and disinterested entity, separate and distinct from the debtor, as well as the pre-petition company, and as such does not strictly 'stand in the shoes' of the debtor. Nor does he assume the identity of the debtor"); *Biltmore*, 572 F.3d at 670 n.15 (citing similar authority); *Cirka v. Nat'l Union Fire Ins. Co. of Pittsburgh*, No. Civ. A. 20250, 2004 WL 1813283, at *7-8 (Del. Ch. Aug. 6, 2004) (D&O claims asserted by creditors' committee granted derivative standing not excluded from coverage).

5 No. 14-cv-1017, 2016 WL 1253040 (W.D. Mich. March 31, 2016).

provision). Absent such a provision, policy proceeds can still be preserved by having the D&O claims initially asserted by an entity other than the liquidating trustee (*e.g.*, chapter 7 trustee or creditors' committee).

Indian Harbor v. Zucker

Capital Bancorp and certain of its subsidiaries commenced chapter 11 cases in 2012. In 2014, the bankruptcy court confirmed a liquidating plan proposed by the debtors. Under the plan, the debtors transferred potential causes of action against management to a liquidating trust for which **Clifford A. Zucker** (CohnReznick LLP; Edison, N.J.) was appointed trustee, and a three-member oversight committee was established to oversee the wind-down process.[6]

The liquidating trustee subsequently commenced a lawsuit asserting D&O claims against three officers. The officers then demanded coverage under substantially similar D&O policies issued by Indian Harbor. Indian Harbor disclaimed the coverage and commenced a separate action against the liquidating trustee and officer defendants seeking a declaratory judgment that the liquidating trustee's causes of action fell within the scope of the policies' insured-vs.-insured exclusion.[7] The provision at issue provided, subject to certain inapplicable exceptions, that Indian Harbor "shall not be liable to make any payment for Loss in connection with any Claim made against an Insured Person ... by, on behalf of, or in the name or right of, the Company."[8]

The Indian Harbor court held that the liquidating trustee's action fell within the scope of the exclusion because the liquidating trust "step[ped] into the proverbial shoes of the Debtors" pursuant to a plan settlement between the debtors and the creditors' committee.[9] Pursuant to the settlement, the DIP transferred the causes of action at issue to the liquidating trust, but significantly, it limited recoveries to available insurance proceeds.[10] Although the liquidating trust agreement established a three-member oversight committee comprised mostly of creditors' committee designees, the court found this insufficient because the debtor-appointee was also a defendant in the liquidating trustee's action and executed the agreement on behalf of both the debtor and the trust oversight committee.[11]

The *Indian Harbor* court further noted that this result was consistent with three decisions that have addressed this issue. First, and most recently, in *Biltmore*, the Ninth Circuit concluded that D&O claims initially asserted by a DIP, subsequently transferred to a liquidating trust and settled by the liquidating trustee were excluded from coverage because D&O policies exist primarily to protect against derivative actions brought by "outsiders," and a determination that the claims at issue were covered would contravene the "reasonable expectation of the parties."[12] Second, in *Terry v. Fed. Ins. Co. (In re R.J. Reynolds-Patrick Cnty. Mem. Hosp.)*, the court determined that D&O claims asserted by a liquidating trustee were excluded from coverage because collusion risks exist with respect to causes of action transferred to a liquidating trustee under a debtor-proposed plan.[13] Third, the *Indian Harbor* court cited approvingly of *Reliance Ins. Co. of Ill. v. Weis*, a 1992 decision summarily concluding that a liquidating trustee "stands in the shoes of the debtor."[14]

Comments

Serious questions exist concerning the rationale for excluding D&O claims asserted by a liquidating trustee from coverage where coverage would otherwise exist for identical claims asserted by a chapter 7 or 11 trustee or creditors' committee. Prior decisions have cited the opportunity for collusion as a basis for excluding such claims from coverage, but this rationale ignores the economic reality that even where D&O claims are transferred to a liquidating trust pursuant to a debtor-proposed plan, creditors typically select the liquidating trustee and comprise (or at a minimum, control) the trust-oversight committee, making the liquidating trustee more akin to a creditors' committee than a DIP.[15]

An alternative rationale for excluding D&O claims asserted by a liquidating trustee from coverage is that ownership of such claims is typically the result of a voluntary assignment by the DIP, which itself cannot assert covered D&O claims (and in turn, also raises concerns regarding collusion).[16] However, this rationale ignores the fact that in chapter 11, the alternative to such assignment of D&O claims is abandonment, which under § 554 of the Bankruptcy Code would require that the plan proponent demonstrate that such claims are of inconsequential value or that retaining the same would be burdensome — a standard that likely cannot be satisfied where derivative standing can be conferred on a third party whose D&O claims would not be excluded from coverage (*e.g.*, a creditors' committee).

Conclusion

Valuable lessons can be derived from *Indian Harbor*. Most importantly, management for potential debtors should carefully evaluate their D&O policies prior to a bankruptcy filing to make sure that the insured-vs.-insured exclusions included therein also include a carve-back provision, which provides that the applicable exclusion shall not apply to claims asserted in bankruptcy by a trustee or liquidator, in order to avoid the applicable policy being rendered worthless in the event that D&O claims are asserted against management by a subsequently appointed liquidating trustee.

In the event that a debtor's policies do not include a carve-back provision and D&O claims are expected to be a significant source of recovery, estate professionals

6 2016 WL 1253040, at *3-4.
7 *Id.* at *1.
8 *Id.* at *4.
9 *Id.* at *8.
10 *Id.*
11 *Id.* at *3, 8.
12 *Biltmore*, 572 F.3d at 667-68.

13 315 B.R. 674, 680-81 (Bankr. W.D. Va. 2003) ("The [Liquidating] Trustee in this case *is* a mere assignee. His rights arise by virtue of provisions in the plan, not directly by operation of statute.… In a case in which the debtor voluntarily transfers the causes of action to a third party, there is a distinct possibility of collusion between the debtor and the directors and officers."); *see also Willson v. Vanderlick (In re Cent. La. Grain Coop. Inc.)*, 467 B.R. 390, 397 (Bankr. W.D. La. 2012) ("In [contrast], claims brought by a Chapter 11 or 7 trustee do not typically raise any danger of collusion.").
14 148 B.R. 575, 582 (E.D. Mo. 1992); *aff'd*, 5 F.3d 532 (8th Cir. 1993).
15 *See, e.g., Biltmore*, 572 F.3d at 667, 675 (D&O claims prosecuted post-confirmation by trustee originally retained by creditors' committee).
16 *See* n.13, *supra.*

should tread carefully to ensure the preservation of policy proceeds. One (obvious) method of circumventing the result in *Indian Harbor* would be to convert the case to one under chapter 7 instead of pursuing the confirmation of a liquidating plan. An alternative method would be to have the creditors' committee seek and obtain derivative standing to assert D&O claims prior to confirmation of a liquidating plan, and then have such claims assigned to the liquidating trust after the committee's complaint has been filed and the debtor's plan has been confirmed. Either course would significantly reduce the likelihood that D&O policy proceeds are forfeited. abi

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