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**D&O INSURANCE COVERAGE AND INDEMNIFICATION
ISSUES RELATING TO BANKRUPTCY**

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The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

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I. D&O POLICY INSURING AGREEMENTS

D&O insurance policies typically have one or more of three basic insuring agreements. First, all D&O policies will have an insuring agreement which covers Loss incurred by directors and officers resulting from Claims against the directors and officers for which the Company does not indemnify the directors and officers. This insuring agreement is frequently referred to as “Clause A” or “Side A” coverage. Second, most D&O policies also cover the Company to the extent the Company indemnifies directors and officers for Loss incurred by directors and officers resulting from Claims against the directors and officers. This is frequently referred to as “corporate reimbursement” coverage. Third, beginning in the mid-1990s, many D&O policies added a third insuring agreement which covers Loss incurred by the Company resulting from Securities Claims against the Company. This “entity coverage” was intended to eliminate the need for a difficult and frequently contentious allocation under a standard D&O policy between Loss allocable to Securities Claims against directors and officers (which traditionally is covered) and Loss allocable to Securities Claims against the Company (which traditionally is not covered). As explained below, the addition of this “entity coverage” potentially impairs the coverage available for directors and officers if the Company files bankruptcy.

II. POLICY AS ASSET OF ESTATE

When an entity files a bankruptcy petition, an “estate” is created which is comprised of all legal or equitable interests of the debtor in property owned at the time of the commencement of the case or acquired thereafter. 11 U.S.C. § 541(a). If a D&O insurance policy and its proceeds are assets of the bankruptcy estate, the policy and its proceeds will be subject to the automatic stay, thereby preventing the insurer from making any payments under the policy for the benefit of the insured D&Os while the stay remains in effect.

Insurance Policies Generally. Generally, a corporation’s insurance policies are property of the bankruptcy estate because the corporation pays for and owns the insurance policies. *A.H. Robins Co., Inc.*, 788 F.2d at 1001 (“Under the weight of authority, insurance contracts have been said to be embraced in this statutory definition of ‘property’”); *In re First Central Financial Corp.*, 238 B.R. 9, 15-16 (Bankr. E.D. N.Y. 1999), aff’d 2002 U.S. Dist. LEXIS 22005 (E.D.N.Y. 2000); *In re Davis*, 730 F.2d 176 (5th Cir. 1984); *Celotex Corp. v. AIU Ins. Co. (Matter of Celotex Corp.)*, 152 B.R. 667, 675 (Bankr. M.D. Fla. 1993); *In re Equinox Oil Company*, 2002 U.S. App. LEXIS 16170 (5th Cir., Aug. 12, 2002). One court has ruled that an insurance policy paid for by the debtor is not ipso facto an asset of the debtor’s estate. *Zenith Labs., Inc. v. Sinay (In re Zenith Labs., Inc.)*, 104 B.R. 659 (D.N.J. 1989). Rather, an insurance policy purchased by the debtor is only an estate asset to the extent that it increases the debtor’s worth or diminishes its liabilities.

D&O Policy. Courts have consistently held that D&O liability policies constitute property of the estate. *In re Youngstown Osteopathic Hosp. Ass’n*, 271 B.R. 544 (Bankr. N.D. Oh. 2002); *In re Chiles Power Supply Co.*, 264 B.R. 533 (Bankr. W.D. Mo. 2001); *In re First Central Financial Corp.*, 238 B.R. at 16; *Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Re: Insurance Corp. (In re Minoco Group of Cos., Ltd.)*, 799 F.2d 517 (9th Cir. 1986)(“we see no significant distinction between a liability policy that insures the

debtor against claims by consumers and one that insures the debtor against claims by officers and directors”)(emphasis in original); *Louisiana World Exposition, Inc. v. Federal Ins. Co. (In re Louisiana World Exposition, Inc.)*, 832 F.2d 1391, 1399 (5th Cir. 1987); *Duval v. Gleason*, 1990 U.S. Dist. LEXIS 18398 (N.D. Cal. Oct. 19, 1990); *In re Florian*, 233 B.R. 25, 27 (Bankr. Conn. 1999); *Houston v. Edgeworth (Matter of Edgeworth)*, 993 F.2d 51, 55 (5th Cir. 1993)(“Insurance policies are property of the estate because, regardless of who the insured is, the debtor retains certain contract rights under the policy itself.”). *But see, In re First Central Financial Corp.*, 238 B.R. at 16-17 (ruling that because no covered entity claims had yet been filed during the first eighteen months of the bankruptcy proceeding, the company did not need the entity coverage and therefore the D&O policy (with entity coverage) was not an asset of the bankruptcy estate).

D&O Policy Proceeds. Although the D&O policy is generally considered an asset of the bankruptcy estate, some courts have held that the proceeds of certain D&O policies are not assets of the estate, but instead belong to the directors and officers as beneficiary of the policies. *In re First Central Financial Corp.*, 238 B.R. at 16 (“While a majority of courts consider a D&O policy estate property [citations omitted], there is an increasing view that a distinction should be drawn when considering treatment of proceeds arising under such policies.”). The directors and officers normally are deemed the owners of the policy’s proceeds under the “Side-A” coverage; while the corporation is deemed the owner of the policy’s proceeds under the “corporate reimbursement” coverage.

The seminal case discussing the ownership of the proceeds of a D&O policy is *Louisiana World Exposition v. Federal Ins. Co. (In re: Louisiana World Exposition, Inc.)*, 832 F.2d 1391 (5th Cir. 1987). There, a creditors’ committee sought to invoke the automatic stay and halt the payment of defense costs under the debtor’s D&O insurance policies. The Fifth Circuit held that, while the policies themselves were deemed part of the debtor’s estate, the debtor had no ownership interest in the proceeds of the policies since those policies only provided liability coverage for its directors and officers, not reimbursement coverage for the corporation. Therefore, because the policy proceeds were not found to be property of the estate, the automatic stay could not be invoked to prevent dissipation of the policy proceeds. The Fifth Circuit expressly distinguished between a policy reimbursing directors only (i.e., a Side-A only policy) and a policy reimbursing both the corporation and its directors. With respect to policies providing coverage to the debtor itself, “the estate owns not only the policies, but also the proceeds designated to cover corporate losses or liability.” *Id.* at 1400; *see generally In re First Central Financial Corp.*, 238 B.R. at 16-17.

Some subsequent cases have adopted this “policy/proceeds” distinction even with respect to D&O policies that afford corporate reimbursement coverage. *See, e.g. In re Youngstown Osteopathic Hospital Assoc.*, 271 B.R. 544 (N.D. Ohio 2002) (D&O policy with corporate reimbursement but not entity coverage was property of bankruptcy estate, but proceeds were not); *Duval v. Gleason*, No. C-90-0242-DLJ, 1990 U.S. Dist. LEXIS 18398 (N.D. Cal. Oct. 19, 1990) (D&O policy was property of the estate, but court was “not persuaded that the insurance policy proceeds...necessarily constitute ‘property’ of the debtor policy-owner within the meaning of § 541(a)(1) such that the present proceedings [against non-debtor codefendants] should be stayed”); *In re Daisy Sys. Sec. Litig.*, 132 B.R. 752 (N.D. Cal. 1991) (proceeds of D&O policies were not assets of estate to be divided among creditors because the directors and officers were the primary beneficiaries of the policies); *In re Edgeworth*, 993 F.2d 51, 55-56 (5th Cir. 1993)

(same); *In re Florian*, 233 B.R. 25, 26-27 (Bankr. Conn. 1999) (reasoning that when the debtor had no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate); *In re Pelullo*, No. 98-6181, 1999 U.S. Dist. Lexis 14920, at *6-7 (Bankr. E.D. Pa. Sept. 29, 1999).

Other courts, though, appear to eschew the “policy/proceeds” distinction, focusing instead on whether payment of a particular loss erodes policy proceeds that would otherwise be available to the debtor for other claims. See *In re Leslie Fay Companies, Inc.*, 207 B.R. 764 (Bankr. S.D.N.Y. 1997); *In re Circle K*, 121 B.R. 257, 259-60 (Bankr. D. Ariz. 1990); *A. H. Robbins Co., Inc.*, 788 F.2d at 1001; *In re Johns-Manville Corp.*, 40 B.R. 219, 230-31 (D.C.N.Y. 1984); *In re Minoco Group*, 799 F.2d 517, 519 (9th Cir. 1986). Under these cases, the proceeds of a D&O policy containing corporate reimbursement coverage will likely be an asset of the bankruptcy estate, but proceeds of a policy containing only direct D&O coverage will likely not be an asset.

If the policy affords only direct D&O liability coverage and not corporate reimbursement coverage or if the dispute involves only the direct liability coverage, the policy may not be an asset of the estate. *In re Vitek, Inc.*, 51 F.3d 530, 535 (5th Cir. 1995); *Pintlar Corporation v. The Fidelity and Casualty Company of New York*, 124 F.3d 1310 (9th Cir. 1997).

D&O Policy with Entity Coverage. If a D&O policy provides coverage for claims against the entity (usually applicable only to securities claims), the policy proceeds are more likely to be assets of the bankruptcy estate. Examples of cases which have ruled that the automatic stay applies to the proceeds of a D&O policy which covers claims against the insured company include the following: *In re Republic Technologies International, LLC*, 275 B.R. 508 (Bankr. N.D. Oh. 2002); *In re Sacred Heart Hospital of Norristown*, 182 B.R. 413 (Bankr. E.D. Pa. 1995); *In re CyberMedica*, 280 B.R. 12 (Bankr. D. Mass. 2002); *Morris v. National Union Fire Ins. Co. of Pittsburgh, PA*, 303 B.R. 743 (Bankr. E.D. Pa., Jan. 14, 2004); *In re National Century Financial Enterprises, Inc.*, 298 B.R. 133 (Bankr. S.D. Ohio, August 19, 2003). These cases generally are decided under the premise that the bankruptcy estate is worth more with the D&O policy than without it by reason of the entity coverage.

However, a few courts have ruled that even the proceeds of a D&O policy containing entity coverage are not an asset of the bankruptcy estate under the unique facts of that case. For example, in *In re First Central Financial Corp.*, 238 B.R. at 17, the court recognized that although proceeds of a D&O policy with entity coverage may be considered property of the estate under certain circumstances, such a conclusion is not necessary in all cases. According to the court, “[t]he appendage of an inchoate entity coverage endorsement, without more, is not a license for a trustee to obtain first crack at the proceeds of a D&O policy.” *Id.* at 21. In *First Central*, no securities claims were filed against the Debtor during the first 18 months of the bankruptcy proceeding. Therefore, the estate was not in need of the entity insurance protection under the D&O policy and thus the policy proceeds were not an asset of the estate. According to the court, “[i]f 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.” *Id.* at 19. See, also, *In re Adelpia Comm. Corp.*, 2003 U.S. Dist. LEXIS 14505 (S.D.N.Y., August 19, 2003) (D&O policy with entity coverage not asset of bankruptcy estate if Debtors have not incurred Loss under the policy, although bankruptcy court can freeze the

policy's proceeds pursuant to §105 if proper factual record exists to show harm to the estate); *In re CHS Electronics, Inc.*, 261 B.R. 538 (Bankr. S.D. Fla., April 9, 2001) (all claims against the debtor were discharged and therefore the entity coverage was meaningless. As a result, proceeds of D&O policy were not asset of the bankruptcy estate); *In re marchFIRST, Inc.*, 288 B.R. 526 (Bankr. N.D. Ill., Dec. 16, 2002) (proceeds of D&O policy with entity coverage not property of the bankruptcy estate unless there is a judgment requiring the insurer to pay under the Policy).

Practice Pointer: The most effective way to reduce the risk of this undesirable result for D&Os is not to include within the D&O insurance policy coverage for the company. The safest approach is to purchase a policy affording only Side-A coverage. However, because this approach eliminates the valuable corporate reimbursement coverage, the next preferred approach is to include corporate reimbursement coverage and eliminate the entity securities coverage. The Insureds could rely on the policy/proceeds distinction to argue the policy proceeds are available to defendant directors and officers under such a policy even if the company files bankruptcy. In order to address the allocation issue (which originally was why entity securities coverage was added to the D&O policy), the policy would include a provision which predetermines the percentage allocation that will apply to securities claims in which an allocation is required. A sample predetermined allocation provision is as follows:

If in any Securities Claim the Insureds incur both Loss that is covered under this Policy and loss that is not covered under this Policy, the Insureds and the Insurer shall allocate such amount between covered Loss and non-covered loss as follows:

- (A) Loss consisting of Defense Costs shall be allocated to covered Loss as specified in Item 5(A) of the Declarations for this Policy; and
- (B) Loss not consisting of Defense Costs shall be allocated to covered Loss as specified in Item 5(B) of the Declarations for this Policy.

Practice Pointer: If entity coverage is desired in the D&O policy notwithstanding the bankruptcy issues, a method to potentially minimize the adverse consequences to directors and officers from this entity coverage in the event of a bankruptcy is to include a provision in the D&O policy which states that the Insured Organization agrees to waive the automatic stay with respect to the D&O policy in the event a bankruptcy petition is subsequently filed. The following paragraph sets forth such a sample provision:

If a liquidation or reorganization proceeding is commenced by or against an Insured Organization pursuant to the United States Bankruptcy Code, as amended, or any similar state or local law, the Insureds hereby (i) waive and release any automatic stay or injunction which may apply in such proceedings to this Policy or its proceeds under such Bankruptcy Code or law, and (ii) agree not to oppose or object to any efforts by the Insurer or any Insured to obtain relief from any such stay or injunction.

The enforceability of such a pre-petition waiver of the automatic stay has been considered by several bankruptcy courts in other contexts. The emerging decisional law upholds and enforces pre-bankruptcy waivers of the automatic stay. See *In re Excelsior Henderson Motorcycle Mfg. Co., Inc.*, 273 B.R. 920 (Bankr. S.D. Fla. 2002) (pre-petition agreements entered into as part of a former plan of reorganization and confirmed by the court are enforceable); *In re Shady Grove Tech Center Assocs. Ltd. Partnership*, 216 B.R. 386 (Bankr. D. Md. 1998) (...waiver is a factor in the decision as to whether cause exists to modify the stay...."); *Merridale Gardens Ltd. Partnership v. ALI, Inc. (In re Merridale Gardens Ltd. Partnership)*, 1996 U.S. Dist. LEXIS 22042 (D. Md. Feb. 28, 1996) ("The Court fails to discern any public policy that bars the waiver of § 362 protection."); *In re Darrell Creek Assocs., L.P.*, 187 B.R. 908, 913 (Bankr. D.S.C. 1995) ("Pre-petition agreements, such as the waiver of stay agreement in this case, are enforceable in bankruptcy."); *In re Powers*, 170 B.R. 480 (Bankr. D. Mass. 1994) (pre-petition agreements waiving opposition to relief from the automatic stay may be enforceable in appropriate cases); *In re Cheeks*, 167 B.R. 817 (Bankr. D.S.C. 1994) (upheld the enforcement of the pre-petition waiver agreement). *In re Club Towers, L.P.*, 138 B.R. 307, 311 (Bankr. N.D. Ga. 1991) ("Pre-petition agreements regarding relief from stay are enforceable in bankruptcy."); *In re Citadel Properties, Inc.*, 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988) ("[T]he terms of the prepetition stipulation are binding upon the parties and that sufficient cause exist to lift the automatic stay pursuant to section 362(d)(1)."); *In re Orange Park South Partnership*, 79 B.R. 79 (Bankr. M.D. Fla. 1987).

However, some courts have refused to enforce a waiver of the automatic stay. See *In re Trans World Airlines, Inc.*, 261 B.R. 103 (Bankr. D. Del. 2001) (pre-petition agreement where debtor agrees to waive its debtor-in-possession authority to assume or reject an executory contract should bankruptcy occur is unenforceable); *In re Pease*, 195 B.R. 431 (Bankr. D. Neb. 1996) (a pre-bankruptcy waiver of the automatic stay is unenforceable per se); *In re Jenkins Court Assocs. Ltd. Partnership*, 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995) ("[T]he court believes that enforcement of the pre-petition waiver of the automatic stay...too closely approximates the more reviled prohibition against filing for bankruptcy protection."); *Farm Credit for Cent. Fla., ACA v. Polk*, 160 B.R. 870 (M.D. Fla. 1993) (pre-petition agreements waiving the automatic stay are not per se binding on the debtor for public policy reasons); *In re Sky Group Int'l, Inc.*, 108 B.R. 86 (Bankr. W.D. Pa. 1989) (refusing to enforce a pre-petition waiver agreement).

Lifting Automatic Stay. If the proceeds of the D&O insurance policy are considered an asset of the bankruptcy estate, the next question is whether the bankruptcy court should lift that automatic stay to allow insured directors and officers access to the policy proceeds. Courts generally have granted relief from the automatic stay when requested since D&O insurance policies are obtained primarily for the protection of individual directors and officers. *In re Enron Corp.*, 2002 Bankr. LEXIS 544 (Bankr. S.D.N.Y., May 17, 2002); *In re Adelphia Communications Corp.*, 285 B.R. 580 (Bankr. S.D.N.Y. Nov. 15, 2002) ("in essence and at its core, a D&O policy remains a safeguard of officer and director interest and not a vehicle for corporate protection..., bankruptcy court should be wary of impairing the contractual rights of directors and officers even in cases where the policies provide entity coverage as well."); *In re CyberMedica, Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002) (harm from withholding policy proceeds from two directors outweighs the risk that there will be nothing left under the policy to pay any judgment the trustee may win against the directors); *In re Sacred Heart Hospital of Norristown*, 182 B.R. 413 (Bankr. E.D. Pa. 1995).

Where the interest of the debtor is particularly compelling, a few courts have lifted the automatic stay only to a limited extent, thereby assuring that significant insurance proceeds will remain available for the benefit of the estate. *In re Adelphia Communications Corp.*, 285 B.R. 580 (Bankr. S.D.N.Y. Nov. 15, 2002) (in order to induce non-defendant outside directors to continue to serve on the Debtor's board of directors, the automatic stay was lifted to allow the insurer to pay only up to \$300,000 per insured defendant director and officer for defense costs); *In re Boston Regional Medical Center, Inc.*, 285 B.R. 87 (Bankr. D. Mass. Apr. 2, 2002) (automatic stay lifted to authorize the payment of \$600,000 under the D&O policy for expert costs, thereby preserving most of the policy's limits of liability for two competing plaintiffs).

Practice Pointer: In order to minimize the risk that coverage for directors and officers is not unreasonably diluted by the entity coverage and in order to maximize the chance a bankruptcy court will lift any applicable stay, many newer D&O policy forms now include a "priority of payments" provision. An example follows:

In the event of Loss arising from a Claim or Claims for which payment is due under the provisions of this policy but which Loss in the aggregate exceeds the remaining available Limit of Liability of this policy, the Underwriter shall:

1. first pay such Loss for which coverage is provided under Insuring Clause A of this policy [i.e., coverage for Loss not indemnified by Company], then
2. with respect to whatever remaining amount of the Limit of Liability is available after payment under (1) above, pay such Loss for which coverage is provided under any other Insuring Clause of this policy.

Such a provision arguably renders the debtor's interest in the policy minimal, thus reducing the risk that a bankruptcy court will impair the debtor's estate if the court lifts the stay.

III. TERMINATION OF POLICY

Insurer Cancellation. The right to cancel an insurance policy issued pre-petition to a debtor has uniformly been held to be stayed by section 362(a)(3) of the Bankruptcy Code. *A. H. Robins Co., Inc.*, 788 F.2d at 1001; *In re Minoco Group*, 799 F.2d 517, 519 (9th Cir. 1986); *In re First Central Financial Corp.*, 238 B.R. at 16; *Federal Ins. Co. v. Sheldon*, 150 B.R. 314, 319 (S.D.N.Y. 1993). In *Minoco*, the insurer sought to terminate certain D&O policies two months after the debtor commenced its Chapter 11 case by giving notice as required in the policy. The policy permitted either party to cancel the policies at any time on thirty days' notice. The court held that cancellation of the D&O policies was automatically stayed because the policies were property of the estate. An insurer's post-petition cancellation of an insurance policy for nonpayment of pre-petition premiums also has been held to violate the automatic stay. *In re Augustino Enter., Inc.*, 13 B.R. 210 (Bankr. D. Mass. 1981).

Purported cancellations of insurance policies that violate the automatic stay provisions are void *ab initio*. *Scrima v. John Devries Agency, Inc.*, 103 B.R. 128 (W.D. Mich. 1989); *In re Rath Packing Co.*, 35 B.R. 615 (Bankr. N.D. Iowa 1983).

Similarly, language in the policy which purports to cancel or restrict coverage upon the insolvency or bankruptcy of the insured (i.e., ipso facto termination clauses) are generally rendered unenforceable by the “anti ipso facto” provisions of the Bankruptcy Code contained in 11 U.S.C. § 365(e)(2). See *In re Huntington Ltd.*, 654 F.2d 578 (9th Cir. 1981); *In re Texaco, Inc.*, 73 B.R. 960 (Bankr. S.D.N.Y. 1987). Thus, the rights and obligations of an insured debtor and its carrier under the policy are not altered because of the debtor’s bankruptcy filing.

While a D&O insurer is precluded from canceling a D&O policy by the automatic stay, the Bankruptcy Code does not prevent such a policy from expiring according to the terms of the insurance contract. *Nationwide Life Ins. Co. v. American Medical Imaging Corp.* (*In re: American Medical Imaging Corp.*), 133 B.R. 45 (Bankr. E.D. Pa. 1991); *Aetna Casualty & Sur. Co. v. Gamel*, 45 B.R. 345 (N.D.N.Y. 1984).

Debtor Cancellation. Although the insurer is generally prohibited from prematurely canceling the policy, the debtor may be able to cancel by rejecting the policy as an executory contract. Insurance contracts, if not terminated pre-petitioned, often are considered executory contracts which the debtor can either assume or reject. *Aetna Casualty & Sur. Co. v. Gamel*, 45 B.R. 345; *In re Wheeling-Pittsburgh Steel Corp.*, 67 B.R. 620 (W.D. Pa. 1986).

An executory contract is a contract under which the obligations of both the debtor and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other. Countryman, “Executory Contracts In Bankruptcy, Part I,” 57 Minn. L.Rev 439, 460 (1973); *Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986); See generally *In re Bergt*, 241 B.R. 17, 26 (Bankr. Ala. Oct. 22, 1999). A debtor can reap the benefits of an insurance policy only if it chooses to fulfill its obligations under the policy (e.g., payment of premiums) and assumes it pursuant to section 365(b)(1) of the Bankruptcy Code. *In re American Medical Imaging Corp.*, 133 B.R. 45, 55 (Bankr. E.D. Pa. 1991).

Consensual Cancellation. A debtor and its D&O insurer may consensually agree to cancel coverage under mutually agreeable terms, as approved by the bankruptcy court. However, such a cancellation may not be binding on the insured directors and officers who have vested rights under the policy and who are not parties to the bankruptcy proceeding. *Helfand v. National Union Fire Ins. Co.*, 10 Cal. App. 4th 869, 13 Cal. Rptr. 2d 295 (1993).

IV. RETENTION UNDER THE POLICY

D&O policies ordinarily contain two distinct retention or deductible provisions: one for the Side A coverage (i.e., non-indemnified loss) and another for the corporate reimbursement coverage. The retention under the Side A coverage is typically quite small or nonexistent. The retention under the corporate reimbursement coverage is usually a substantially larger sum, potentially ranging up to several million dollars.

Most D&O policies contain a provision providing that if the corporation is permitted or required to indemnify its directors or officers, it will be presumed to have done so. This “presumptive indemnification” provision applies the larger company reimbursement retention whether or not the corporation actually indemnifies, provided the company is legally and financially able to indemnify. The purpose of such a provision is to prevent the corporation from circumventing the large corporate reimbursement retention simply by failing to grant permissible indemnification.

Typically, these presumptive indemnification provisions do not apply if the corporation is unable to indemnify due to “financial insolvency” or “financial impairment”, which are frequently defined terms in the policy. Absent such an exception, the directors and officers could be required to fund personally the large corporate reimbursement retention before obtaining any coverage under the policy.

Practice Pointer: To maximize the financial protection of directors and officers, the D&O insurance policy should either not have a “presumptive indemnification” provision or, more commonly, expressly state that such provision does not apply in the event the company is “financially impaired” or “financially insolvent” (as properly defined in the policy).

V. INSURED V. INSURED EXCLUSION

Most D&O policies contain an exclusion known as the “insured v. insured” exclusion. This exclusion typically provides that the insurer is not liable for payment of loss in connection with any claim made against a director or officer brought by or on behalf of the company or another insured person. In the bankruptcy context, a dispute frequently arises as to whether this exclusion applies to claims by or on behalf of the debtor’s estate.

If the claim is brought directly by the debtor, this exclusion will likely apply. *Reliance Ins. Co. of Illinois v. Weis*, 148 B.R. 575 (E.D. Mo. 1992), aff’d, 5 F.3d 532 (8th Cir. 1993) (excluding coverage for a suit brought by the bankruptcy Plan Committee against the company’s officers and directors); *National Union Fire Ins. Co. v. Olympia Holdings Corp.*, Case No. 1:94-CV-2081-GET (9/18/1995), aff’d without opinion, 148 F.3d 1070 (Table) (11th Cir. 1998); *Youell v. Grimes*, Case No. 2:00-CV-02207-JWL (D. Kan. Aug. 19, 2002) (when representative of estate takes a lead role in suing the directors and officers, exclusion applies and duty of cooperation under policy is breached).

However, if the claim is brought by a representative of the debtor’s estate under circumstances where creditors can be viewed as the true beneficiary of the claim, the exclusion may not apply. *In re County Seat Stores, Inc.*, 280 B.R. 319 (Bankr. S.D.N.Y. July 10, 2002) (bankruptcy trustee separate entity from Debtor; suit by trustee for benefit of creditors, not Debtor); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp.2d 376 (D. Del. 2002) (debtor’s estate representative and the debtor are separate entities); *Narath v. Executive Risk Indem., Inc.*, 2002 U.S. Dist. LEXIS 8162 (D. Mass. March 14, 2002) (‘insured v. insured’ clause is inapplicable as to claims brought by trustee against insolvent partnership’s board members); *Gray v. Executive Risk Indem. Inc.*, 2002 U.S. Dist. LEXIS 8155 (D. Mass. May 6, 2002); *In re Molton Metal Tech., Inc.*, 271 B.R. 711, 726 (Bankr. D. Mass. 2002) (the phrase “claim brought by” unambiguously focuses on “who is bringing the claim, not who it initially belonged to”); *Zurich*

American Ins. Co. v. Boyes, 2001 U.S. Dist. LEXIS 15123 (N.D. Tex. July 31, 2001) (“on behalf of” language in the “insured v insured” clause is ambiguous and should be strictly construed against the insurer); *In re Buckeye Countrymark, Inc.*, 251 B.R. 835, 840 (Bankr. S.D. Oh. 2000) (the underlying purpose behind an ‘insured v insured’ clause is to prevent collusive suits against the insurer by an insured corporation and its insured management. In the bankruptcy situation, there is no threat of collusion because the bankruptcy trustee is acting as a genuinely adverse party to the defendant officers and directors); *Cigna Ins. Co. v. Gulf USA Corp.*, 1997 U.S. Dist. LEXIS 23816 (D. Id. Sept. 11, 1997) (claims asserted for benefit of shareholders and creditors, so “insured v. insured” exclusion not applicable).

A recent case refined this analysis significantly by focusing on how the plaintiff obtained the claim against the D&Os, rather than on the beneficiary of such claim. In *Terry v. Federal Ins. Co.*, 2003 Bankr. LEXIS 1481 (Bankr. W.D. Va., Aug. 15, 2003), the court held that claims by the trustee of a litigation trust established for the benefit of creditors pursuant to the debtor’s plan of reorganization was excluded from coverage under the D&O insurance policy by reason of the insured v. insured exclusion. The court reasoned that because the trustee obtained standing to sue the D&Os by virtue of the debtor’s voluntary assignment through the plan of reorganization (as distinct from an involuntary appointment of a chapter 11 trustee), the exclusion should apply. Otherwise, the debtor would be permitted to avoid the exclusion by assigning its claim against the D&Os to another party. Alternatively, the court held that the debtor solicited and assisted in the prosecution of the claim by reason of its assignment of the claim to the trustee, thus further confirming the applicability of the exclusion.

Practice Pointer: Most policies contain exceptions to the exclusion (i.e., cover) certain types of claims that are sufficiently adversarial to justify coverage. For example, several newer D&O policy forms expressly except from the exclusion (i.e., cover) claims “brought or maintained by or on behalf of a bankruptcy or insolvency trustee, examiner, liquidator or receiver for the Company or any assignee of such trustee, examiner, liquidator or receiver.”

VI. D&O INDEMNITY RIGHTS AGAINST CORPORATION

A director or officer may be entitled to indemnification from the corporation for defense costs, settlements or judgments if the director or officer was sued in his or her capacity as a director or officer. The corporation’s indemnification rights and obligations are defined by the indemnification statute in the state in which the corporation is incorporated. *McDermott, Inc. v. Lewis*, 531 A.2d 206 (Del. 1987). Typically, the state statute authorizes but does not mandate the indemnification (unless the director or officer is successful in defense of the claim). For that reason, most companies require indemnification in the company’s bylaws, certificate of incorporation or in an indemnity agreement with the director or officer.

Two issues typically arise concerning indemnification claims in the bankruptcy context: (i) is the indemnification claim an allowable claim; and (ii) if allowed, what priority is the claim given?

A. Allowable Claim

Under section 502(e)(2) of the Bankruptcy Code, a claim for reimbursement or contribution that is fixed after the commencement of the bankruptcy case shall be determined and either allowed or disallowed as if the claim had become fixed pre-petition. *See In re Pettibone Corp.*, 110 B.R. 837 (Bankr. N.D. Ill. 1990)(a claim for reimbursement that becomes fixed post-petition is deemed a pre-petition claim for purposes of allowance).

Disallowance of Claims. Section 502(e)(1)(B) of the Bankruptcy Code commands disallowance of claims for reimbursement or contribution against the estate if the claimant is “liable with the debtor,” and the claim is contingent at the time the court determines the allowance or disallowance of claims. Disallowance under section 502(e)(1)(B) requires that three elements be established: (1) the claim must be one for reimbursement or contribution; (2) the claimant must be liable with the debtor on the underlying claim; and (3) the claim must be contingent at the time of its allowance or disallowance. *In re Pinnacle Brands, Inc.*, 259 B.R. 46 (Bankr. D. Del. 2001); *In re Drexel Burnham Lambert Group, Inc.*, 146 B.R. 98 (Bankr. S.D.N.Y. 1992); *In re Wedtech Corp.*, 85 B.R. 285, 289 (Bankr. S.D.N.Y. 1988); *In re Provincetown-Boston Airlines, Inc.*, 72 B.R. 307 (Bankr. M.D. Fla. 1987).

The concept of reimbursement includes claims for indemnification by directors and officers. *In re Drexel Burnham Lambert Group, Inc.*, 1992 U.S. Dist. LEXIS 16027 (S.D.N.Y., Oct. 19, 1992); *In re Wedtech Corp.*, 85 B.R. at 289. The co-liability factor is determined by reference to the underlying third-party action. If the underlying lawsuit asserts claims that, if proven, would give rise to liability against the debtor but for the automatic stay, then the co-liability factor is present. *In re Wedtech Corp.*, 85 B.R. at 290. Finally, Claims are contingent if they are undetermined at the time the court rules on their allowance. *In re Wedtech Corp.*, 85 B.R. at 289.

Proof of Claim. In a fairly typical case, a director or officer may be sued with the debtor in an action alleging violations of federal securities laws. If the director or officer may be entitled to indemnification for his or her defense costs, judgments or settlement payments incurred in connection with the lawsuit, the director or officer must file a proof of claim with the bankruptcy court.

Often, the director’s or officer’s indemnification rights are contingent and unliquidated at the time of filing the proof of claim because the third-party litigation has not yet been resolved and not all defense costs have been incurred. In that situation, a director or officer should attempt to delay a determination of the allowance or disallowance of the claim as long as possible to allow a greater portion of the claim to become fixed and noncontingent (e.g., defense costs incurred, settlements made). The director or officer should continue to amend the proof of claim to identify that portion of the claim that is no longer contingent.

Directors and officers should be mindful that by filing a proof of claim they submit to the jurisdiction of the bankruptcy court and waive their right to a jury trial. *Arecibo Cmty. Health Care, Inc. v. P.R.*, 270 F.3d 17 (1st Cir. 2001); *AEC One Stop Group v. Bain Capital Fund IV*, 2001 U.S. App. LEXIS 8867 (2nd Cir. May 9, 2001); *Langenkamp v. Culp*, 498 U.S. 42 (1990); *Superior Precast, Inc. v. Buckley & Co.*, No. 97-218, 1998 U.S. Dist. Lexis 1739, at *6 (E.D. Pa.

Feb. 18, 1998); *In re Kraeger Co., Inc.*, No. 97-10884, 1999 Bankr. Lexis 615, at *23 (Bankr. E.D. Pa. May 24, 1999); *In re Stansbury Poplar Place*, No. 93-1363, 1993 U.S. App. LEXIS 33656 (4th Cir. Dec. 27, 1993).

B. Claim Priority

Generally, an allowed D&O claim for indemnification is treated as a general unsecured claim. *See generally Woburn Assocs. v. Kahn (In re Hemingway Transport)*, 954 F.2d 1 (1st Cir. 1992); *In re Wilbur*, 237 B.R. 203, 206-07 (M.D. Fla. 1999). However, if a debtor's indemnification obligations arise post-petition, the directors or officers may be entitled to first priority administrative expense treatment.

Administrative Expense. Under section 503 of the Bankruptcy 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. Most courts generally allow administrative priority when the claim: (a) arises from a transaction with a debtor-in-possession or trustee, as distinct from the pre-petition debtor; and (b) the debtor-in-possession received a benefit in the operation of the business of the estate. *In re Jartran, Inc.*, 732 F.2d 584 (7th Cir. 1984); *In re Entertainment, Inc.*, 223 B.R. 141, 154 (Bankr. N.D. Ill. 1998). In the context of D&O indemnification claims, it is rare that administrative expense treatment is allowed. *In re Amfesco Indus., Inc.*, 81 B.R. 777 (Bankr. E.D.N.Y. 1988)(court found that priority should only be granted under extraordinary circumstances when a director's or officer's services are actual and necessary to preserve the estate); *In re Mid-American Waste Systems, Inc.*, 228 B.R. 816, 821 (Bankr. Del. 1999).

To qualify as an administrative expense, the D&O indemnification claim typically must arise from post-petition conduct which benefited the estate. *In re Heck's Properties Inc.*, 151 B.R. 739, 766-68 (S.D.W. Va. 1992) (because claim against directors and officers related solely to post-petition conduct, directors and officers entitled to indemnification and administrative cost priority); *In re Mid-American Waste Systems, Inc.*, 228 B.R. at 821; (emphasizing that in order to establish administrative priority under § 503, director or officer must demonstrate that claimed expense: (1) arose out of a post-petition transaction with the debtor-in-possession, and (2) directly and substantially benefited the estate).

Administrative expense treatment may be denied even for post-petition conduct if the indemnification claims are asserted by former officers and directors. *In re Baldwin-United Corp.*, 43 B.R. 443 (S.D. Ohio 1984). In that case, the court refused to permit a debtor to advance defense costs to former directors of the debtor because the expenditures did not constitute "actual and necessary costs" of preserving the estate for the benefit of its creditors. The court also refused to grant administrative priority to the defense costs of the debtor's present directors because it found that the corporate by-laws (which contained the mandatory indemnification provision) did not constitute an executory contract subject to assumption. The court further held that administrative priority is not available where the debtor became bound to honor an obligation pre-petition, regardless of when the amount owed comes due.

Pre-Petition Wrongful Acts. If the indemnification arises from pre-petition conduct, administrative expense priority is generally not available, even if the indemnification claim

arises post-petition. *Id*; *In re Consolidated Oil & Gas, Inc.*, 110 B.R. 535 (Bankr. D. Colo. 1990) (“[T]here is...an evident duty to indemnify these Claimants, and while that duty arose post-petition, the services were pre-petition. Therefore...these Claimants are not entitled to administrative expense priority.”); *In re Amfesco Indus., Inc.*, 81 B.R. 777, 784 (Bankr. E.D.N.Y. 1988) (“All of the operative facts, legal relationships, and conduct of the Applicants upon which is based the threatened litigation occurred pre-petition. The indemnification agreement...occurred pre-petition. Any duty to indemnify the Applicants arises from services provided to the pre-petition Corporation not for services rendered post-petition...as such, the Applicants’ legal fees claim arises from their pre-petition services rather than any post-petition services.”); *Christian Life Center v. Silva (In re Christian Life Center)*, 821 F.2d 1370 (9th Cir. 1987)(claims for legal fees of attorney who represented officer post-petition not entitled to administrative priority because they arose from debtor’s duty to indemnify officer based on officer’s pre-petition services and conduct). *But see, In re Sahlen & Assoc., Inc.*, 113 B.R. 152 (Bankr. S.D.N.Y. 1990) (Directors or officers of a debtor entitled to administrative expense treatment of their indemnification claims even though claims relate to pre-petition actions if the directors or officers can establish that their services benefited the estate).

Practice Pointer: In order to maximize the financial protection of directors and officers in light of these claim priority rules, at least one D&O policy form contains the following provision which is intended to maximize the financial protection of insured directors and officers by giving insurance coverage priority to pre-petition wrongdoing:

In the event the Company becomes a debtor in possession under the United States Bankruptcy Code or an equivalent status under the law of any other country and the aggregate Loss due under this Policy exceeds the remaining available Limit of Liability, the Insurer shall:

- (a) first pay such Loss allocable to Wrongful Acts that are actually or allegedly caused, committed, or attempted prior to the Company becoming a debtor in possession, then
- (b) with respect to whatever remaining amount of the Limit of Liability is available after payment under (a) above, pay such Loss allocable to Wrongful Acts that are actually or allegedly caused, committed, or attempted after the Company became a debtor in possession.

If the D&O insurance proceed will be inadequate to pay all loss arising from pre-petition and post-petition wrongdoing, this provision applies the insurance proceeds first to the pre-petition wrongdoing based on the assumption that the post-petition wrongdoing will likely be indemnified by the debtor’s estate.