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BY ALAN J. BRODY

D&Os' Unrestricted Right to Use Insurance Proceeds

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Directors and officers (D&Os) frequently find themselves caught in a "catch-22" when their actions as D&Os of a distressed company are challenged. On the one hand, companies typically have insurance policies to pay D&O's defense costs. On the other, debtors, trustees and creditors' committees claim that the limited proceeds of the policy are property of the estate and must be preserved to satisfy claims of creditors.

Unfortunately, the litigation between D&Os and estate representatives caused by this initial conflict, in and of itself, leads to the quick depletion of available funds for both sides. The question then becomes: To whom do the proceeds belong? While a D&O policy itself may be property of the estate, whether the monetary proceeds of that policy are property of the estate is a fact-specific question that relies on the scope of the policy coverage and the identity of the actual beneficiary of the insurance payments.[1]

D&O policies are useful in three typical situations: (1) D&Os are covered against wrongful-act claims that were committed by them in their capacity as D&Os ("Coverage A"); (2) the debtor is covered for indemnification claims by D&Os ("Coverage B"); and (3) the debtor is covered for wrongful-act claims committed by the debtor itself ("Coverage C"). Claims under these three types of coverage are usually subject to a single policy limit. The U.S. Bankruptcy Court for the District of Delaware aptly summarized the still-evolving law on this issue:

> [W]hen a debtor's liability insurance policy provides direct coverage to the Debtor, the proceeds are property of the estate because the proceeds are payable to the Debtor. Further, when the liability insurance policy only provides direct coverage for the directors and officers, the proceeds are not property of the estate. However, when there is coverage for the directors and officers and the Debtor, the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent [that] the policy actually protects the estate's other assets from diminution. Lastly, when the liability policy provides the Debtor with indemnification coverage but indemnification either has not occurred, is hypothetical, or speculative, the proceeds are not property of the bankruptcy estate.[2]

Absent indemnification claims or direct claims against the debtor, the operative coverage for the D&Os, Coverage A, falls into the second category identified by the court in *Allied Digital* as it "only provides direct coverage for the directors and officers."[3] Under this scenario, the coverage causes D&O claims to be similar to those discussed by the Fifth Circuit in *In re Louisiana World Exposition Inc.*,[4] which affirmed the bankruptcy court's dismissal of a complaint that was filed by the creditors' committee seeking to protect the proceeds of a D&O policy.

The court reasoned that "[w]ith regard to the liability proceeds, the obligation of the insurance companies was only to the directors and officers, and they are the named and the only insureds. These proceeds would be paid only if the directors and officers incurred some covered legal expense or liability."[5] Therefore, although Coverages B and

1 *See, e.g., In re La. World Exposition Inc.*, 832 F.2d 1391, 1400 (5th Cir. 1987) ("[D]istinction between owning a policy and owning the proceeds."); *In re CyberMedica Inc.*, 280 B.R. 12, 16 (Bankr. D. Mass. 2002).

2 *In re Allied Digital Techs. Corp.*, 306 B.R. 505, 512 (Bankr. D. Del. 2004).

3 *Id.*

4 832 F.2d 1391, 1400 (5th Cir. 1987).

5 *Id.* at 1399; *see also In re NC12 Inc.*, 478 B.R. 820, 837 (Bankr. S.D. Tex. 2012); *In re World Health Alternatives Inc.*, 369 B.R. 805, 811 (Bankr. D. Del. 2007).

C superficially appear to extend coverage to the debtor, in the absence of actual claims against the entity (indemnification or direct), mere hypothetical or speculative claims are insufficient to bring the proceeds of the policy into the entity's estate.[6]

Therefore, *Allied Digital* distinguished between an actual and established duty to indemnify and a mere hypothetical duty to indemnify: "[W]hen the liability policy provides the Debtor with indemnification coverage but indemnification either has not occurred, is hypothetical, or speculative, the proceeds are not property of the bankruptcy estate."[7] On these grounds, the court distinguished the District of New Jersey's decision in *In re Jasmine Ltd.*,[8] which held that "[s]ince [the debtor's] duty of indemnification was established and not merely speculative, it ... had an indemnification interest in the proceeds and the proceeds [were] part of the estate."[9]

Allied Digital reasoned that "[t]he policy in question provides direct coverage to the directors and officers for claims and defense costs (which are real), and indemnification coverage to the company for amounts paid to the directors and officers (which are hypothetical)."[10] The hypothetical and speculative potential for indemnification, without any actual or established duty to indemnify, was insufficient to bring the proceeds into the estate.[11] The District of New Jersey adopted a similar reasoning in concluding that a D&O policy containing indemnification coverage was not an asset of the debtor. Hon. Dickinson R. Debevoise made the following reasoning:

> As these provisions demonstrate, the Debtor is not required by its bylaws to indemnify the directors; it may choose to do so if the directors acted in good faith…. Although the Debtor argues that it might choose to do so, and that it would then be required to pay any amount exceeding the policy coverage, this is a purely theoretical possibility. Nor is the Debtor unconditionally required to reimburse the directors for litigation expenses; the Debtor must pay only if the directors prevail. Although in this case the Debtor might be required to pay the amount of the deductible for expenses, since this liability is currently contingent it appears that it would be disallowed under Section 502(e)(1)(B)…. In the present case … the corporation is not unconditionally required to reimburse its officers and directors for legal expenses.[12]

Accordingly, where the costs being incurred by the D&O in defending the lawsuit are very real, but the potential for indemnification by the debtor is only a theoretical possibility, a D&O's access to the policy proceeds for defense costs should not be restricted.

The policy in *Allied Digital* also provided direct coverage for the debtor's wrongful acts. However, the mere presence of direct-entity coverage was insufficient to render the proceeds property of the estate. Since "[t]he Trustee has made no credible showing that the direct coverage of *Allied Digital* under Clause B(i) for securities claims has any continuing vitality," the court concluded that there was no basis to restrict the D&O's access to the proceeds.[13] Thus, as with indemnification coverage, courts must look beyond the superficial policy language to determine whether the debtor has some interest that is more substantial than a mere hypothetical possibility of payment due to a claim of wrongdoing.

[I]n the absence of a realistic non-hypothetical claim against the debtor that would reasonably lead to payment ... the proceeds of a D&O policy belong to its actual beneficiaries: the D&Os.

The U.S. Bankruptcy Court for the Eastern District of New York reached a similar conclusion in *In re First Central Financial Corp.*[14] Holding that the proceeds of the policy were not property of the estate, the court focused on the specific facts of the case:

> During the eighteen months [that] this bankruptcy case has been pending, there have been no claims filed against the Debtor [that] would implicate the narrow scope of the Policy's entity coverage. Indeed, no one has stepped forward to express any interest in suing the Debtor for a violation of securities laws. Nor has the Trustee intimated that any action against the Debtor is imminent or likely. We are skeptical that any individual or entity will ever emerge to assert such claims prior to the expiration of the discovery period in December 1999. If 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.[15]

The Court properly looked beyond the form of the policy and instead focused on the substance of the applicable coverage and the actual potential beneficiaries of payments in determining whether the proceeds were property of the estate.

Also instructive is a series of decisions by the bankruptcy and district courts for the Southern District of New York in the *Adelphia Communications Corp.* bankruptcy.[16] In *Adelphia I*, the bankruptcy court held that the proceeds of the policy were property of the estate, and in order to

6 *Allied Digital*, 306 B.R. at 512-13.

7 *Id.* at 512.

8 258 B.R. 119 (D.N.J. 2000).

9 *Id.* at 128; *accord In re Boston Reg'l Med. Ctr. Inc.*, 285 B.R. 87, 91 (Bankr. D. Mass. 2002) ("[V]arious officers, directors, and trustees have asserted claims against BRMC for indemnification as to their defense costs and potential liability, and BRMC, as an insured with Side B coverage, is entitled to coverage of such claims.").

10 *Allied Digital*, 306 B.R. at 512-13.

11 *Id.*; *see also In re Downey Fin. Corp.*, 428 B.R. 595, 606 (Bankr. D. Del. 2010) ("While the Debtor had, in fact, indemnified the Insureds in the amount of $588,000 prior to filing this bankruptcy proceeding, it has still not exhausted the Policy's $1 million Retention. Therefore, no indemnification for which the Debtor would be entitled to coverage under the Policy has occurred. Unless the Debtor would be entitled to coverage under the Policy, indemnification would not 'adversely affect the Debtor's estate,' because such indemnification would not deplete the Policy proceeds.... [Because it is 'very unlikely' that the debtor/trustee would pay $412,000 in indemnification costs to exhaust the $1 million retention in order to be entitled to coverage under the policy], the Court finds that indemnification in this case is hypothetical and speculative, and that the Policy's indemnification coverage, like its entity coverage, is no longer protecting the estate's other assets from diminution.").

12 *In re Zenith Labs. Inc.*, 104 B.R. 659, 665-66 (D.N.J. 1989); *see also In re Youngstown Osteopathic Hosp. Ass'n*, 271 B.R. 544, 550 (Bankr. N.D. Ohio 2002) (debtor's argument that it had pecuniary interest in D&O policy was without merit because there had been no claim made against indemnity coverage).

13 *Id.* at 513; *see also Downey Fin. Corp.*, 428 B.R. at 604 ("[B]ecause there are no longer any covered Securities Claims pending against the Debtor, the Debtor no longer enjoys any direct entity coverage. Therefore, the Court finds that the Policy's entity coverage is no longer protecting the estate's other assets from diminution.").

14 238 B.R. 9 (Bankr. E.D.N.Y. 1999).

15 *Id.* at 17-18.

16 *See In re Adelphia Commc'ns Corp.*, 285 B.R. 580 (Bankr. S.D.N.Y. 2002) (*Adelphia I*); *In re Adelphia Commc'ns Corp.*, 298 B.R. 49 (S.D.N.Y. 2003) (*Adelphia II*); *In re Adelphia Commc'ns Corp.*, 302 B.R. 439 (Bankr. S.D.N.Y. 2003) (*Adelphia III*).

protect those proceeds, the court imposed a $300,000-per-insured cap on the defense costs that the individual defendants could draw from the proceeds.[17] The district court, however, disagreed with this analysis and vacated the bankruptcy court's decision:

> Here, as far as I can tell, Adelphia does not have a property interest in the proceeds of the insurance policies yet. Although the D&O policies reimburse each estate to the extent that the estate advances funds because of the indemnification obligations in the charter or bylaws, "[i]t has not been suggested that any of the Debtors [have] made any payments for which it would be entitled to indemnification coverage, or that any such payments are now contemplated." Furthermore, "none of the Debtors [have] made or committed themselves to payments using their entity coverage." Claiming [that] the Debtors now have a property interest in those proceeds makes no sense at this juncture.… No cognizable equitable and legal interest in the proceeds from the D&O policies has arisen here. Without legal and equitable interest in the proceeds, Adelphia's estate cannot be ascribed to hold a property interest in those proceeds.[18]

On remand, the bankruptcy court concluded that the proceeds were not yet property of the estate and that the individual D&Os' voluntary agreement to a $300,000-per-insured limit on defense costs was sufficient to protect current D&Os.[19] The district court's analysis in *Adelphia* properly considered the specific facts of the case in holding that the proceeds of the D&O policies were not property of the estate.

Moreover, D&O policies routinely contain an "order of payments" endorsement that establishes a hierarchy for payment of policy proceeds. Typically, losses under Coverage A, the individual D&O coverage, are to be paid first, and only then would the remaining policy limit be available to pay losses under Coverage B, followed by Coverage C. Thus, under the plain language of such an endorsement, payments to D&Os under Coverage A are superior to payments under Coverage B or Coverage C.[20] Even if payments to the D&Os exhausted the entirety of the policy proceeds, the debtor would still have no right to payment. Permitting the estate to limit the defense costs that D&Os are contractually entitled to would improperly grant the estate greater rights in the policy proceeds than the debtor had prior to its bankruptcy petition.[21]

This precise issue was addressed in *Downey Financial Corp.*[22] In this case, the D&O policy established a "clear chain of priority among the three types of coverages," requiring a holding that the proceeds of the policy were not property of the debtor's estate.[23] Faced with similar facts, the court in *In re DDMG Estate*[24] held that proceeds of a D&O policy were not property of the debtor's estate to the extent that those policies provide direct coverage to D&Os, especially when the policies include an express priority-of-payments provision that requires that the policy proceeds be paid to D&O coverage ahead of any entity on corporate coverage.[25] Accordingly, in the absence of a realistic non-hypothetical claim against the debtor that would reasonably lead to payment under either Coverage B or C, the proceeds of a D&O policy belong to its actual beneficiaries: the D&Os. abi

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17 *Id.* at 590-91, 600.
18 *Adelphia II*, 298 B.R. at 53-54 (quoting *Adelphia I*, 285 B.R. at 587).
19 *Id.* at 452-54.
20 *See In re G-I Holdings Inc.*, 278 B.R. 725, 726 (Bankr. D.N.J. 2002).
21 *See Integrated Solutions Inc. v. Serv. Support Specialties Inc.*, 124 F.3d 487, 492-93 (3d Cir. 1997) ("[U]nless federal bankruptcy law has specifically preempted a state law restriction imposed on property of the estate, the trustee's rights in the property are limited to only those rights that the Debtor possessed pre-petition. In other words, without explicit federal pre-emption, the trustee does not have greater rights in the property of the estate than the Debtor had before filing for bankruptcy."); *In re GB Holdings Inc.*, 2006 Bankr. LEXIS 4131, *12 (Bankr. D.N.J. Sept. 21, 2006) ("While it is recognized that amounts incurred in defense costs will reduce the limit of liability available to pay the debtor's potential claims under the D&O Policy, that fact alone cannot elevate the debtor's interest in the policy proceeds above the interest of the other insureds, the debtor's directors and officers.").
22 428 B.R. 595.
23 *Id.* at 607-08.
24 2012 WL 6645398, No. 12-12568 (BLS) (Bankr. D. Del. Nov. 16, 2012).
25 *Id.* at p. 6.