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Insurance Issues

By Marc J. Carmel

Maximizing Recoveries from Post-Confirmation Litigation

Part I: D&O Insurance Issues

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Editor's Note: *This is Part I of a two-part series.*

In bankruptcy, debtors often do not have enough cash to pay all creditors in full, let alone make a distribution to equityholders. Sometimes debtors distribute non-cash considerations, which could include an interest in plaintiff-side litigation. Depending on a number of factors, including the debtor's size, a "litigation trust" can be a key component to that debtor's successful exit from bankruptcy.[1] A litigation trust is formed to hold the estate's claims, then sue parties that breached contracts or committed torts against the debtors.

To maximize recoveries from post-confirmation confirmation litigation, the creditors need to address certain issues pre-confirmation.[2] Sometimes, the value of the creditors' interests in the litigation trust can be only maximized if both the creditors and their debtor planned appropriately and addressed certain issues prebankruptcy. This two-part series of articles addresses these issues.

Part I highlights certain key ways for creditors receiving interests in litigation trusts (*i.e.*, the "litigation trust beneficiaries") to minimize risks and maximize recoveries from post-confirmation litigation by focusing on the debtor's director and officer (D&O) liability insurance. Part II (in a forthcoming issue) will focus on litigation trust beneficiaries preserving causes of action; reviewing release and exculpation provisions in a chapter 11 plan and other documents in a chapter 11 case; transferring litigation privileges and protections; litigation trusts; and the possibilities of using litigation funding to maximize recoveries.

Pay Attention to D&O Insurance Issues to Maximize Value of Coverage

D&O insurance is generally divided into three types of coverage: Side A, Side B and Side C. Side A coverage protects D&Os from losses that they suffer personally from serving in their roles as D&Os. Side B coverage reimburses the insured company for amounts it pays to D&Os under indemnification obligations. Side C coverage provides insurance coverage to the insured company for claims directly against it.

These three components are sometimes combined into a single policy, and sometimes they are purchased as separate insurance policies. When Side A coverage is combined in a single policy of D&O insurance with Side B and Side C coverage, it will be more difficult for nondebtor parties to access that coverage because the D&O insurance will be more likely to be considered property of the estate and subject to the automatic stay.[3]

Accordingly, creditors will need to carefully review the fine print in the policy to understand the D&O insurance and determine whether there will be coverage. The fine print will explain what types of actions by D&Os that caused economic harm will be compensated by the insurance carrier, which can include damages resulting from D&Os who breached fiduciary duties, misrepresenting a company's assets, misusing a company's assets, committing fraud, failing to comply with laws, and managing the company without proper corporate governance.

1 This article uses the term "litigation trust" generically to describe whatever legal entity pursues litigation post-confirmation. This could be a reorganized entity that is a successor to a debtor, one or more litigation trusts created under a debtor's chapter 11 plan (frequently as grantor trusts), or any other legal entities that are assigned causes of action.

2 Equityholders who expect to receive interests in litigation will have the same concerns as creditors who expect to receive interests in litigation.

3 *See, e.g., In re La. World Exposition Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987); *In re Downey Fin. Corp.*, 428 B.R. 595, 603 (Bankr. D. Del. 2010) (citing *In re Allied Digital Techs. Corp.*, 306 B.R. 505, 512 (Bankr. D. Del. 2004)).

Even assuming that a litigation trust is pursuing the types of claims that are covered by D&O insurance, there are issues creditors should consider. First, before the possibility of bankruptcy is even on the horizon, creditors must make sure that the insurance premiums are paid on time because they, as litigation trust beneficiaries, likely will be relying on proceeds from the D&O insurance.

Clarify the Insured-vs.-Insured Exclusion to Avoid Denial of Insurance Coverage

The "insured vs. insured" exclusion is a typical provision in D&O insurance that applies when one party who is insured under the D&O insurance sues another party who is insured under the policy. If the plaintiff is considered an "insured party" under the terms of the D&O insurance, the exclusion prevents the plaintiff from collecting from the insurance carrier. In practice, the exclusion might prevent a debtor — or a litigation trust pursuing litigation in the debtor's name — from recovering from the carrier in litigation against the D&Os. This happens if the exclusion is drafted in such a way that the litigation trust is considered a successor or assignee of the company that purchased the insurance policy.

Creditors should review the insured-vs.-insured provision in the D&O insurance and make sure that it does not provide the D&O insurance carrier a basis to deny coverage. After all, it is typically the D&O insurance carrier who has the true economic interest in such litigation because, when the litigation trustee sues the D&Os, the alleged damages frequently exceed the assets of the named defendants. Therefore, even before a D&O insurance carrier focuses on defending against the substance of litigation, the carrier will review whether a D&O insurance policy's insured-vs.-insured coverage exclusion applies. If the exclusion exists and applies, it alone will allow the D&O insurance carrier to deny coverage.

In a recent case brought by a litigation trustee appointed pursuant to a chapter 11 plan, the Sixth Circuit affirmed a declaratory judgment in favor of the insurance carrier (and against the litigation trust pursuing litigation against D&Os) after determining that the insured-vs.-insured exclusion was written so that the litigation trust was considered to be an "insured" because it was deemed to be an assignee of the debtor-company that purchased the D&O insurance.[4] As a result, the litigation trustee could not recover under the D&O insurance.

Other courts confronting similar facts to those in the Sixth Circuit's *Indian Harbor Insurance* case reach the opposite conclusion.[5] However, litigation beneficiaries might not know which way a court adjudicating their case is going to rule, and the fact that a court might rule in the litigation trust's favor likely is not sufficient comfort given the stakes.

Consequently, in order to avoid a court determining that the insured-vs.-insured exclusion prevents a litigation trust from collecting under D&O insurance, creditors who expect to become litigation trust beneficiaries should examine the D&O insurance and, if necessary, demand that the debtor negotiate with the carrier for language in the D&O insurance to clarify that a litigation trust will not be deemed to be an "insured." A company is more likely to be successful if it negotiates with the carrier before it is in bankruptcy. The language can often be fixed as part of the renewal process, but that is not to say that a company should not try as it approaches a bankruptcy filing or even during bankruptcy.

A company might succeed at getting an insurance carrier to agree to amend the policy language, even if it is negotiating changes to its D&O insurance right before filing or during its bankruptcy. This is more likely to be successful if it is requested when the company is pursuing the annual renewal of its D&O insurance or as part of the company purchasing tail coverage for the D&O insurance. If it is possible that the litigation trust will be considered an "insured" and that the insured-vs.-insured exclusion will be a basis for the D&O insurance carrier to deny coverage under the terms of the D&O insurance, the debtor and creditors should use other tactics so that litigation is more likely to be covered.

First, the litigation should be transferred to the litigation trust in a manner such that the plaintiff can pursue the litigation without triggering the exclusion, which will depend on the precise language of the D&O insurance's insured-vs.-insured exclusion. Second, the creditors should consider requiring that the court include findings of fact and conclusions of law — to minimize the likelihood that the litigation would be subject to the exclusion — in the chapter 11 plan documents and bankruptcy orders that create the litigation trust, appoint the litigation trustee and transfer the litigation. How the debtor and creditors here will proceed depends on many factors, including the applicable case law in the jurisdiction in which the bankruptcy is pending and the specific language of the D&O insurance.

Purchase Tail Coverage (or an Extended Reporting Period) for D&O Insurance

D&O insurance is "claims-made"; it provides coverage for conduct that occurred after the "past acts" date stated in the policy for claims that are made during the relevant policy period. For example, if the D&O insurance has a past-acts date of Jan. 1, 2017, and provides coverage for 2018, it will provide coverage for conduct that occurred in 2017 and 2018 if a claim is made in 2018 in accordance with the other requirements in the D&O insurance. If a claim is made in 2019, even for conduct that occurred in 2018, the policy will not provide coverage. This is particularly relevant if the D&O insurance ends when a debtor exits bankruptcy, which is typically the case because the debtor's exit from bankruptcy will typically qualify as a change in control under the D&O insurance that will trigger a policy termination.

To address the situation where litigation might be brought post-confirmation against D&Os for acts that occurred pre-confirmation, the creditors (as potential future litigation trust beneficiaries) should make sure that they can make a claim against the D&O insurance after the policy term. To do this,

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4 *See Indian Harbor Ins. Co. v. Zucker*, 860 F.3d 373 (6th Cir. 2017); *see also Redmond v. Ace Am. Ins. Co.*, 614 Fed. App'x 77 (3d Cir. 2015) (not precedential or binding); *Biltmore Assocs. LLC v. Twin City Fire Ins. Co.*, 572 F.3d 663 (9th Cir. 2009).

5 It is far from universal that the insured-vs.-insured exclusion favors the insurance carrier, especially where the plaintiff is a trustee appointed by statute and the plaintiff filing the litigation is not the company who purchased the insurance policy. *See, e.g., Willson v. Vanderlick*, No. 10-08009, 2012 WL 293173 (Bankr. W.D. La. Jan 31, 2012); *Cox Comms. Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 708 F. Supp. 2d 1322 (N.D. Ga. 2010); *FDIC v. Cont'l Cas. Co.*, 2006 U.S. Dist. LEXIS 85323 (W.D. Pa. 2006); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D. Del. 2002); *Cohen v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 280 B.R. 319 (Bankr. S.D.N.Y. 2002); *Gray v. Exec. Risk Indem. Inc.*, 271 B.R. 711 (Bankr. D. Mass. 2002); *Rieser v. Baudendistel*, 251 B.R. 835 (S.D. Ohio 2000).

creditors need to require that the debtor purchase "tail coverage" that extends the reporting period for the litigation trust beneficiaries to assert claims against the D&O insurance. The D&Os will likely also want tail coverage so that insurance is available to protect them. Given the mutuality of interests, obtaining such coverage should be achievable.

Conclusion

In a bankruptcy, creditors might receive a distribution of litigation interests, which could include litigation claims against D&Os. In this scenario, pre-litigation planning could be the difference between there being insurance coverage or not, which, in turn, could mean the difference between a substantial recovery and no recovery. These are important issues, and creditors who expect to become litigation trust beneficiaries should demand that their debtors consult with legal advisors and an insurance broker who understands how these D&O insurance issues work. Part II of this series will provide additional ways for litigation beneficiaries to minimize risk and maximize recoveries from post-confirmation litigation. abi

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