Lawyer Insights

In re National Fish: Keeping Your D&O Insurer on the Hook in Chapter 7

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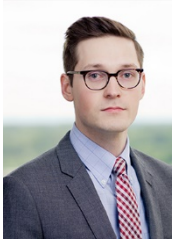

When a company files Chapter 7 bankruptcy, the U.S. Bankruptcy Code provides for the appointment of a trustee that, essentially, displaces the company's existing management. The Bankruptcy Code tasks the trustee with administering the company's assets and making distributions to creditors. This process often includes reviewing transactions that occurred prior to the filing of the bankruptcy petition and determining whether causes of action may exist against third parties, including the company's former officers and directors.

When former directors and officers become the target of a trustee investigation and subsequent litigation, one of the first items that both the bankruptcy trustee and the former directors and officers will address is whether the company purchased an executive risk insurance policy (a "D&O Policy") prior to the bankruptcy filing. D&O Policies frequently play outsized roles in determining the course and outcome of trustee investigations and litigation against former directors and officers because trustees view these policies as easily accessible sources of recovery for creditors. At the same time, former directors and officers typically rely on D&O Policies as the source of payment of defense costs—most notably attorney's fees—in defending against trustee litigation since the Chapter 7 debtor is no longer permitted to indemnify the former directors and officers for their defense costs.

Bankruptcy courts often must resolve the competing interests in the D&O Policies. One common dispute involves the interplay between the automatic stay and the beneficiaries' desire to access the D&O Policy proceeds to pay the defense costs. Trustees may seek to block the former directors and officers from accessing policy proceeds to pay defense costs to preserve the policy proceeds for the trustee's potential claims. It is important for attorneys retained to handle such disputes to make the right arguments in support of accessing D&O Policy proceeds, and those arguments require counsel to understand the various coverages under a D&O Policy and who has the right to benefit from those coverages.

SIDE A COVERAGE

Most D&O Policies provide coverage for losses incurred directly by directors and officers for their alleged wrongful acts to the extent those losses are not reimbursed by the company. This coverage is known as "Side A" coverage. Defense costs incurred by directors and officers to defend against a lawsuit filed by a bankruptcy trustee alleging breaches of fiduciary duties is a common example of a loss covered by Side A. In a Chapter 7 bankruptcy, even if the debtor had the resources, the trustee would not agree to, nor the would the bankruptcy court permit, reimbursement of the directors'

and officers' defense costs out of bankruptcy estate assets for defending litigation brought by the trustee. Thus, Side A coverage benefits the directors and officers exclusively, and the bankruptcy trustee, standing in the shoes of the company, should not have any claim to D&O Policy proceeds under the Side A coverage.

SIDE B COVERAGE

Another type of coverage commonly found in D&O Policies, "Side B" coverage, is for losses incurred by the company in indemnifying directors and officers for losses the executives incurred for their wrongful acts in accordance with the company's governance provisions. The company, and thus the bankruptcy trustee, may benefit from policy proceeds of this coverage to reimburse the company for its indemnification obligations. An example of a claim for such coverage in the bankruptcy context would be the efforts of a bankruptcy trustee to recover monies for which the debtor reimbursed its former directors and officers in defending claims against them, such as shareholder litigation, and for which the insurer had not paid the company under the policy at the time of its Chapter 7 bankruptcy filing. In this instance, the trustee may seek to preserve policy proceeds on account of the company's claim against the insurer under the D&O Policy's Side B coverage rather than agreeing to allow the Side A beneficiaries to drain the policy proceeds in which Side B claims may share. It would be much more difficult for the trustee to argue that policy proceeds should be preserved for Side B coverage claims if the company had not incurred any eligible losses as of the bankruptcy petition date. This is because there are few, if any, circumstances in which a Chapter 7 trustee would reimburse the debtor company's former directors and officers out of estate assets for losses related to their pre-petition wrongful acts.

SIDE C COVERAGE

A third type of coverage that D&O Policies may contain, known as "Side C" coverage, is "entity coverage" for situations in which a corporation is sued along with its directors and officers. Insurers typically offer this type of coverage to public corporations to cover claims of securities laws violations, while broader coverage may be available for private companies. Bankruptcy trustees may cite existing or potential claims covered by Side C as reasons to preserve policy proceeds and limit directors and officers from accessing coverage to pay defense costs. However, many D&O Policies subordinate Side C coverage to other D&O policy coverages, such as Side A. Directors and officers, and their counsel, should review the D&O Policy's payment priority provisions carefully to understand how these provisions may affect access to policy proceeds if the company files bankruptcy.

A RECENT BANKRUPTCY COURT DECISION ADDRESSING THESE ISSUES

In *In re National Fish & Seafood, Inc.*, No. 19-11824, 2021 WL 771652 (Bankr. D. Mass. Feb. 26, 2021), the U.S. Bankruptcy Court for the District of Massachusetts recently issued an opinion addressing a bankruptcy trustee's challenge to attempts by directors and officers to access D&O Policy proceeds.

In May 2019, National Fish and Seafood, Inc. (the "Debtor") filed for Chapter 7 bankruptcy and a trustee (the "Trustee") was appointed to administer the Debtor's estate. In April 2020, the Trustee

filed a complaint against three of the Debtor's former directors and officers (collectively, the "D&Os"), alleging that the D&Os breached their fiduciary duties by authorizing a series of transactions that removed $31 million in assets from the Debtor (the "D&O Litigation"). In early-2021, the D&Os filed a motion seeking relief from the automatic stay imposed by Section 362 of Title 11 of the U.S. Code (the "Bankruptcy Code"), to allow the D&Os to receive payment and/or the advancement of defense costs from the Debtor's D&O Policy, which was purchased prior to the bankruptcy filing, for fees and expenses incurred in connection with defending the D&O Litigation. The Trustee opposed the D&Os' request to access the D&O Policy proceeds.

The D&O Policy provided for up to $3 million of primary insurance coverage, along with an additional $500,000 in executive coverage applicable to the D&Os. The D&O Policy further provided for the advancement of defense costs incurred in connection with a covered claim. The D&O Policy included all three types of coverages discussed above: Side A, Side B, and Side C.

Additionally, the D&O Policy provided that any loss covered by the Side A coverage would be paid first, the Side B coverage would be paid second, and the Side C coverage would be paid last. The D&Os and the Trustee agreed that the claims asserted in the D&O Litigation constituted Side A covered claims, and that no Side B or Side C claims either had been or were expected to be asserted under the D&O Policy (although the D&Os may ultimately have a Side B indemnification claim against the Debtor, but such claim would be unlikely based on the direct Side A coverage).

The D&Os demanded payment of their defense costs in the D&O Litigation as covered Side A claims. The insurer agreed to cover defense costs upon entry of an order authorizing such advances and a finding that making the advances was not a violation of the automatic stay. First, the Court addressed whether the proceeds of the D&O Policy constituted property of the Debtor's estate. While the D&Os and the Trustee agreed that the D&O Policy itself was property of the estate pursuant to Section 541 of the Bankruptcy Code, the parties disagreed with respect to the proceeds of the policy. The Trustee argued that the policy proceeds were property of the estate, and therefore any distribution of such proceeds would violate Section 362(a)(3) of the Bankruptcy Code, which prohibits acts to obtain possession of and exercise control over property of the estate.

While courts universally hold that pre-petition insurance policies issued to the debtor are property of the estate, they are divided concerning whether the proceeds of such policies also constitute estate property. Such determination commonly depends on the language of the insurance policy, as well as the other specific facts and circumstances of the case and the jurisdiction. "Where the policy covers claims against the directors and officers (Side A Coverage) as well as claims against the corporation (Side B or Side C Coverage), courts have almost uniformly found the proceeds to be assets of the estate. . . . These cases focus on the proposition that the bankruptcy estate is worth more with the D&O policy that includes entity coverage than without it." *In re Nat'l Fish & Seafood, Inc.*, 2021 WL 771652, at *3.

While the Court in *National Fish* agreed that the proceeds of the D&O Policy constituted estate property subject to the automatic stay, "cause" existed for relief from the automatic stay pursuant to Section 362(d)(1) of the Bankruptcy Code. The D&Os cited a number of facts supporting cause for relief from stay, including:

- the D&O Policy provides for payment of defense costs;
- the D&Os relied on that coverage in serving as directors and officers;
- the D&Os had a real need for the coverage and would be unable to retain counsel to defend themselves in D&O Litigation if they were denied access to the policy proceeds;
- the Side B and Side C coverage that the Trustee sought to protect was, at best, highly speculative and remote; and
- the Trustee's real concern was to preserve Side A coverage to fund the Trustee's anticipated judgment in the D&O Litigation, which is not an appropriate basis for opposition because the Side A coverage belongs entirely to the D&Os and is not subject to any right of control by the Debtor (or the Trustee standing in the place of the Debtor).

Ultimately, the Court agreed with the D&Os, finding that the Trustee's request to continue the automatic stay to determine whether any Side B or Side C claims might arise was not supported by the terms of the D&O Policy. "The property of the estate that requires protection here is limited to the Debtor's rights under the policy, such as they are. In the policy, they coexist with and are limited by the right of officers and directors to A-side coverage." *Id.* at *4. Additionally, the priority of payments provision in the D&O Policy clearly stated that Side A claims are to be paid in full first, and therefore always take priority over any Side B or Side C coverage rights the Trustee may someday accrue (if ever). Thus, continuation of the stay would not protect the estate and only delay the inevitable distribution to Side A covered claims. Finally, the Trustee's "real reason for his opposition" – preserving the amount of Side A coverage to pay any judgment in the D&O Litigation – was not a valid basis to deny relief from the automatic stay. Thus, the Court permitted the insurer to distribute funds to the D&Os for attorney's fees.[1]

TAKEAWAYS

When a company files Chapter 7 bankruptcy, the appointed bankruptcy trustee has a duty to investigate potential causes of action, including against the company's directors and officers. While it is imperative that directors and officers ensure that adequate insurance coverage is in place, Chapter 7 trustees may target the D&O Policy as a potential source of recovery for creditors. This creates a potential conflict between the directors and officers who are insureds under the D&O Policy and the trustee who steps into the shoes of the corporation as the owner of the policy.

Notwithstanding the ruling in *National Fish*, and the fact that the matter was contested, the first step for any directors and officers facing this situation is to attempt to negotiate an agreed order with the Chapter 7 trustee (or other estate representative) and the insurer to allow access to the D&O Policy proceeds. A Chapter 7 trustee may request a cap on payments to the directors and officers for defense costs. Frequently, the parties agree to a soft cap, which allows the executives to seek additional payments if the cap is reached and circumstances justify further payments. To assist the parties in ascertaining whether to seek further relief from the court, an agreed order may include a reporting provision that requires the insurer to periodically report any amounts it pays under the D&O Policy.

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Notes

1. The insurer already had advanced $100,000 in defense costs to the D&Os before the Court rendered its opinion. The Court, however, refused to make its ruling retroactive to encompass such payments, finding that the D&Os had not offered a compelling reason to justify retroactivity. If the parties are unable to reach agreement on an order permitting access to D&O Policy proceeds, directors and officers may have no choice but to file a contested motion to access the policy to pay defense costs. In that situation, *National Fish* and other cases in which courts address this issue provide a good road map for the arguments to make. More specifically, counsel should carefully review the D&O Policy to understand what coverages it contains and how they relate to each other, particularly with respect to any priorities of payment provisions that may favor the directors and officers.

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