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Insurance Issues

By Agostino A. Zammiello

An Overview of D&O Insurance and Its Applicability in Bankruptcies

Directors and officers liability insurance (hereinafter "D&O insurance") plays a critical part in bankruptcy proceedings by protecting former D&Os in litigation, including adversary proceedings, and D&O insurance proceeds are viewed as a form of substantial recovery for trustees who seek to maximize the value of the estate for the benefit of creditors. This article provides an overview of D&O insurance and issues that typically arise with D&O insurance in a bankruptcy case.

Agostino A. Zammiello
Fox Rothschild LLP
Morristown, N.J.

Agostino Zammiello is an attorney with Fox Rothschild LLP in Morristown, N.J., and a member of the firm's Financial Restructuring and Bankruptcy Group.

Overview of D&O Insurance

D&O insurance is a form of insurance typically used to protect the directors, officers or other company managers from personal liability in the event they are personally sued for actual or alleged wrongful actions or decisions taken while managing a company. In certain instances, D&O insurance also can cover the company itself for amounts the company is required to pay to indemnify its D&Os. D&O insurance will generally cover legal fees and costs incurred in defending actions against the D&Os, as well as pay any judgment or settlement involving the D&Os. While all D&O policies differ and are customizable, they usually include three types of coverage:

- Side A coverage is used to protect the D&Os for defense costs, settlement amounts or judgments when the company does not or is unable to indemnify them.
- Side B coverage, or company reimbursement coverage, is used to reimburse the company when it indemnifies the D&Os.
- Side C coverage, also known as "entity coverage," differs from Side A and B coverage in that it is used to protect against certain losses incurred by the company itself.

Critically, to ensure coverage in the event that the company files for bankruptcy, the D&O insurance policy should contain "runoff" or "tail" coverage once the policy expires, which affords the former D&Os the ability to report claims after the policy terminates or expires. Most D&O policies contain various exclusions and other provisions that can limit coverage, such as "change in control" provisions,[1] cancellation clauses,[2] order-of-payment provisions[3] or "insured vs. insured" exclusions.[4]

Independent directors appointed to a board of directors or placed on a special committee are normally covered by the company's D&O policy (Side A coverage). However, a company can obtain an independent director liability (IDL) insurance policy, which is typically an excess of a Side A policy that is specifically designed to protect the independent directors.[5]

D&O Insurance and Bankruptcy

Disputes over D&O policies and the proceeds thereof are often litigated in bankruptcies. Specifically, D&Os likely need access to the D&O insurance funds to defend themselves and the company in lawsuits, while fiduciaries of the bankruptcy estate, including the unsecured creditors' committees and trustees, view the D&O policies as potential significant sources of income that can be

1 Change-in-control provisions terminate coverage when there is a change in majority interest in the company, which may cause the D&O policy to be "put into run-off."
2 These clauses list scenarios where the insurer may cancel the policy.
3 This provision provides that the D&O policy limits should be applied first to losses due under the Side A coverage, followed by payment to the company under Side B and/or Side C coverages.
4 The exclusion bars claims brought by or on behalf of one insured against another insured.
5 A discussion regarding the interplay between D&O insurance and the recent emergence of independent directors will be addressed in more detail in a later article.

used to repay creditors. Considering that most D&O policies are "wasting" policies, meaning that the policy limits are reduced by legal fees and costs, these disputes can be highly contentious.

One of the issues that is often litigated is whether the D&O policy and its proceeds are considered property of the bankruptcy estate. The Bankruptcy Code provides that the bankruptcy estate is comprised of "all legal and equitable interests of the debtor in property as of the commencement of the case."[6] While bankruptcy courts generally consider D&O policies property of the estate, bankruptcy courts disagree about whether the proceeds from a D&O policy are property of the estate.[7] Proceeds of a D&O policy that only provide coverage to the D&Os (Side A) are generally not considered property of the estate because the proceeds are paid directly to the D&Os, not the estate.[8] Conversely, when the D&O policy provides exclusive coverage to the debtor (Side C), the proceeds of the insurance policy are considered property of the estate.[9]

When a D&O policy covers both the debtor corporation and the D&Os (usually a combination of Sides A, B and C), the court's determination usually turns on the specific facts of the case and the policy's plain language.[10] The court in *Allied Digital Technologies* explained that "the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution."[11]

Ultimately, the key inquiry is whether the debtor would have a right to receive and keep the proceeds from the D&O policy.[12] A "narrow exception to the rule" exists in the Fifth Circuit, whereby, in "limited circumstances ... where a siege of tort claimants threaten the debtor's estate over and above the policy limits, we classify the proceeds as property of the estate," as it "serve[s] to reduce some claims and permit more extensive distribution of available assets in the liquidation of the estate."[13]

In an effort to protect the estate's interests, bankruptcy courts may impose certain limitations on D&Os who are accessing the D&O policy proceeds, particularly when the D&O policy is a wasting policy. For example, in *SVB Financial Group*, the bankruptcy court modified the automatic stay to allow payment of defense costs under the D&O policy for the benefit of the debtor's current and former directors, although it did not determine whether the D&O policy was property of the estate.[14] Despite this finding, the court required that the directors provide a quarterly aggregate reporting of fees and expenses paid by the D&O policies, as well as mandated the bankruptcy court's approval before insurance proceeds could be used to pay a settlement. However, the court did not impose a soft cap on the defense costs advanced under the D&O policy.[15]

When the proceeds of a D&O policy are determined to be property of the debtor's estate, it is routine for unsecured creditors' committees to insist on language in a liquidating plan that preserves a liquidating trustee's right to pursue D&O claims and other claims under chapter 5 of the Bankruptcy Code on behalf of the debtor against its former D&Os. Causes of actions and theories normally asserted against D&Os include breach of fiduciary duty; negligence and causes of action under chapter 5, including recovery of preference payments and fraudulent transfers, conversion, unjust enrichment, disallowance of claims, fraud and statutory violations; and violations of the Securities Exchange Act of 1934.

The breach-of-fiduciary-duty claim is the most prominent claim asserted against D&Os, as they have a fiduciary duty to act in the best interests of the company, its shareholders and creditors. While states have different standards, generally speaking the duty of loyalty means that the D&Os must avoid self-dealing or conflicts of interest and act in the best interests of the corporation.[16] In addition, the duty of care mandates that the D&Os exercise reasonable care and due diligence when making business decisions (*i.e.*, the same care as the ordinarily careful and prudent person would under similar circumstances).[17]

Common breaches of fiduciary duties include mismanagement of the company's assets; self-dealing for the benefit of the D&Os to the detriment of the company, its shareholders and its creditors; failing to act in the company's best interests; failing to conduct shareholder meetings; undertaking too much debt; failing to act upon knowledge of a fellow director's improprieties; failing to respond to due-diligence requests due to personal financial interests; and issuing too many shares. Essentially, the former D&Os will come under scrutiny for all actions taken with respect to the company prior to its filing for bankruptcy.

Conclusion

It is evident that D&Os will remain susceptible to claims, including claims for breaches of fiduciary duties, as

6 11 U.S.C. § 541(a)(1).
7 *See In re MF Global Holdings Ltd.*, 469 B.R. 177, 190 (Bankr. S.D.N.Y. 2012).
8 *See In re Allied Digit. Techs. Corp*, 306 B.R. 505, 510 (Bankr. D. Del. 2004) (citing *In re Louisiana World Exposition Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987); *In re Daisy Sys. Sec. Litig.*, 132 B.R. 752, 755 (N.D. Cal. 1991)).
9 *See In re Allied Digital Techs. Corp.*, 306 B.R. at 512; *see also In re MF Global Holdings Ltd.*, 469 B.R. 177, 190 (Bankr. S.D.N.Y. 2012).
10 *See In re Allied Digital Techs. Corp.*, 306 B.R. at 512; *In re MF Global Holdings Ltd.*, 469 B.R. at 190.
11 *Id.*; *see also In re Downey Financial Corp.*, 428 B.R. 595, 604 (Bankr. D. Del. 2010) (same); *In re Pasquinelli Homebuilding LLC*, 463 B.R. 468, 472 (Bankr. N.D. Ill. 2012) ("A debtor's interest in the proceeds requires protection from depletion and overrides the interest of the directors and officers."); *In re CyberMedica Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002) ("There is a fundamental test that has been used in determining whether or not property belongs to the estate and that test is whether the debtor's estate is worth more with them than without them.") (internal quotation omitted); *In re Jasmine Ltd.*, 258 B.R. 119, 128 (D.N.J. 2000) (holding that proceeds of D&O policy, with both Side A and B coverage, was property of bankruptcy estate because debtor had indemnification interest in proceeds).
12 *In re GWG Holdings Inc.*, Case No. 22-90032, 2024 WL 3418190, at *2 (Bankr. S.D. Tex. July 15, 2024) ("Although a debtor's liability insurance policies are generally property of the estate, '[t]he overriding question when determining whether insurance proceeds are property of the estate is whether the debtor would have a right to receive and keep those proceeds when the insurer paid on the claim.' 'When a payment by the insurer cannot inure to the debtor's pecuniary benefit, then that payment should neither enhance nor decrease the bankruptcy estate. In other words, when the debtor has no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate.'") (citing *Houston v. Edgeworth (In re Edgeworth)*, 993 F.2d 51, 55-56 (5th Cir. 1993)).
13 *In re GWG Holdings Inc.*, 2024 WL 3418190, at *2 (citing *Martinez v. OGA Charters LLC (In re OGA Charters LLC)*, 901 F.3d 599, 604 (5th Cir. 2018)).
14 *In re SVB Fin. Grp.*, 650 B.R. 790, 799-802 (Bankr. S.D.N.Y. 2023).
15 *Id.* at 802-03; *see also In re Celsius Network LLC*, 652 B.R. 34, 45-46 (Bankr. S.D.N.Y. 2023) (imposing quarterly reporting of fees and expenses paid by D&O policy).
16 *In re Tops Holding II Corp.*, 646 B.R. 617, 697-98 (Bankr. S.D.N.Y. 2022).
17 *In re Think3 Inc.*, 529 B.R. 147, 172-73 (Bankr. W.D. Tex. 2015).

these claims represent a significant source of recovery for the debtor's estate, which will ultimately benefit all unsecured creditors. As such, the retention of D&O insurance is an important consideration for officers and directors, especially as a company contemplates filing for bankruptcy, and the D&Os must be mindful of a policy's exclusions or conditions, which could limit or deny coverage. Critically, bankruptcy courts will examine the plain language of the D&O policy to determine whether the proceeds of a D&O insurance policy are property of the estate, which will ultimately impact the funds that are available to the D&Os under the D&O policies, as well as potential recoveries for the creditors. abi

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