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Building Blocks

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From Adviser to Defendant: The Rising Risk for Independent Directors

An article earlier this year¹ provided a detailed overview of directors and officers (D&Os) liability insurance and its applicability in bankruptcy proceedings. Namely, it covered whether the D&O insurance policy is property of the debtor's estate, and if so, the causes of action that a liquidating trustee could pursue against former D&Os, including breaches of fiduciary duties.

Independent directors have recently emerged as a prominent and common feature in large chapter 11 bankruptcies. Independent directors, sometimes referred to as "bankruptcy directors," are professionals or experts who have been appointed to the board or a special committee of a company that is on the verge of insolvency. To qualify as an independent director, the director cannot have any direct or indirect connection to the company, meaning that the independent director is not an employee, owner, insider or shareholder of the company.

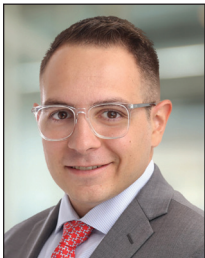
Generally, the role of the independent director is to provide their knowledge and expertise in bankruptcy prior to the filing of a petition, and to assist the company in its restructuring efforts. Specifically, the independent directors maintain close relationships with prominent players in the industry, including bankruptcy attorneys who regularly represent debtors, as well as private-equity firms and investment bankers, who are common fixtures in large chapter 11 cases.

Independent directors are usually tasked with monitoring the company's management, investigating potential claims of fraud and other causes of action against the company. They also can

be entrusted with scrutinizing the conduct of the board of directors and other management decisions. The independent director can be viewed as an impartial decision-maker, which can minimize allegations that the company's decisions were made for the benefit of insiders and contrary to the best interests of shareholders and/or the company's creditors.

The recent emergence of independent directors has been a controversial topic in the bankruptcy industry. Proponents of independent directors contend that they expedite reorganizations, thus increasing the chance of emerging from bankruptcy, as well as saving costs and administrative expenses. Conversely, independent directors have come under heavy criticism based on purported conflicts of interest and biases favoring the private-equity firms that indirectly own the distressed companies, as well as the law firms that commonly represent large debtors. In addition, independent directors are also criticized for failing to conduct thorough investigations of companies and for failing to adequately consider all potential claims during negotiations, thus resulting in less money for the estate.

Independent directors, similar to the company's D&Os, owe the company and its shareholders fiduciary duties, including the duty of care and loyalty. Given that independent directors must remain independent and abide by their fiduciary duties, independent directors are not immune from claims regularly asserted against the D&Os. Claims against independent directors might be precluded if they are included as a released party in the debtor's plan or if they are exculpated in the plan or in the company's charters. Independent directors will also typically argue that their actions are protected by the business-judgment rule. Recent examples demonstrate instances where independent directors have been



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¹ Agostino A. Zammiello, "An Overview of D&O Insurance and Its Applicability in Bankruptcies," *XLIV ABI Journal* 6, 26-27, 62, June 2025, abi.org/abi-journal/an-overview-of-do-insurance-and-its-applicability-in-bankruptcies (last visited on July 28, 2025).

dismissed in adversary proceedings, as well as the cautionary tale where the D&O insurer made a settlement payment after the court did not dismiss the breach-of-fiduciary-duty claims against the independent directors.

In *In re Bayou Steel BD Holdings LLC*, the Bayou Steel chapter 7 trustee sued various parties, including the independent directors, for claims related to a \$40 million secured loan to the debtor and a \$30 million distribution paid from sale proceeds.² In August 2022, the trustee filed an amended complaint and repleaded claims for, among other things, breach of fiduciary duties (including claims against the independent directors) and equitable subordination.³

The bankruptcy court dismissed all claims related to the \$40 million loan, but the breach-of-fiduciary-duty claims against the independent directors related to the \$30 million distribution survived the motion to dismiss, as the bankruptcy court held that the trustee “plausibly allege[d] that the Independent Directors breached their duty of loyalty with respect to the [\$30 million distribution]. As alleged, the Independent Directors (at least one of whom was aware of the Debtors’ poor financial health in the fall of 2016) did not participate or involve themselves in the decision to authorize the [\$30 million distribution], including making any inquiry as to its impact on the Debtors’ financial position.”⁴ Accordingly, the court could infer that the independent directors “failed to undertake their fiduciary responsibilities and simply yielded to the interested directors when the Debtors’ liquidity issues required their attention.”⁵ Thereafter, on Dec. 3, 2024, the court approved the settlement between the trustee and the company’s former independent directors whereby, among other things, the independent directors would pay \$2.75 million through their D&O liability insurance policy.⁶

Conversely, in *Alan D. Halperin, as the Litigation Trustee for the Tops Holding Litigation Trust v. Morgan Stanley Investment Management Inc., et al.*, the litigation trustee for the Tops Holding Litigation Trust filed a complaint against various former private-equity investors and members of the board of directors, including the two independent directors.⁷ The complaint asserted claims for fraudulent transfers and sought to avoid and recover approximately \$375 million in dividends approved by the board of directors and made to the private-equity investors in an alleged years-long looting scheme before the company filed for chapter 11.⁸ The trustee claimed that the D&Os, including the independent directors, unlawfully authorized the dividends and breached their fiduciary duties under New York law.⁹

After briefing on the motions to dismiss, the bankruptcy court dismissed the claims for breach of fiduciary duty

against the independent directors, as the complaint, aside from conclusory allegations, did not allege that the independent directors lacked independence or that they intentionally disregarded their fiduciary duties.¹⁰ The trustee did not re-plead its claims for breach of fiduciary duty; however, the independent directors remained as defendants in two counts for the recovery of purported illegal dividends.¹¹

The retention of D&O insurance is an important consideration for D&Os and independent directors as their companies contemplate filing for bankruptcy.

Similarly, in *In re Quadrant 4 System Corp.*, the chapter 11 debtor filed an adversary proceeding against the independent directors alleging that they were liable for at least \$29 million due to breaches of fiduciary duties and gross mismanagement.¹² The amended complaint alleged that the independent directors knew (or should have known) about the fraud being perpetrated by the other directors.¹³ In granting the independent directors’ motion to dismiss the breach-of-fiduciary-duty claims, the bankruptcy court held that the amended complaint failed to clearly allege what should have put the independent directors on notice aside from the conclusory allegation of “due attention.”¹⁴ “The Independent Directors’ failure to detect the complained of fraud alone shows ‘merely the possibility of misconduct,’ which is insufficient under the pleading requirements” of Rule 8(a)(2) of the Federal Rules of Civil Procedure.¹⁵ The court found that the complaint did not plead facts that would infer a breach of fiduciary duty or gross negligence, and ruled that the plaintiff “failed to plead what about the fraud committed by [the other directors] should have arisen suspicion in the Independent Directors, or importantly, what actual required actions they failed to take.”¹⁶

Recently, in *In re Chicken Soup for the Soul Entertainment Inc.*, the chapter 7 trustee filed a complaint against, among others, the independent directors, alleging multiple causes of action that included breach of fiduciary duty and aiding and abetting breach of fiduciary duty.¹⁷ In response to the adversary complaint, the independent directors filed a motion to dismiss, arguing that the breach-of-fiduciary-duty claim must be dismissed because the company, Chicken Soup for the Soul Inc., adopted exculpatory provisions pursuant to § 102(b)(7) of the Delaware General Corporation Law, and the plaintiff cannot overcome the exculpatory provision because the plaintiff could not prove that the independent directors

² George L. Miller, in His Capacity as Chapter 7 Trustee for the Jointly Administered Bankruptcy Estates of Bayou Steel BD Holdings LLC v. Black Diamond Capital Mgmt. LLC, Adv. Pro. No. 21-51013 (KBO) (Bankr. D. Del. Aug. 11, 2021) [Docket No. 1].

³ *Id.* at Docket No. 59.

⁴ *In re Bayou Steel BD Holdings LLC*, 651 B.R. 179, 189 (Bankr. D. Del. 2023).

⁵ *Id.*

⁶ George L. Miller, in His Capacity as Chapter 7 Trustee for the Jointly Administered Bankruptcy Estates of Bayou Steel BD Holdings LLC v. Black Diamond Capital Mgmt. LLC, Adv. Pro. No. 21-51013 (KBO) (Bankr. D. Del. Sept. 3, 2024) [Docket No. 149].

⁷ Alan D. Halperin, as the Litigation Trustee for the Tops Holding Litigation Trust v. Morgan Stanley Inv. Mgmt. Inc., et al., Adv. Pro. No. 20-08950-SHL (Bankr. S.D.N.Y. Feb. 12, 2020) [Docket No. 1].

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at Docket Nos. 88 and 89.

¹¹ *Id.*

¹² *In re Quadrant 4 Sys. Corp.*, 624 B.R. 237, 238-39 (Bankr. N.D. Ill. 2020).

¹³ *Id.* at 239.

¹⁴ *Id.* at 241-42.

¹⁵ *Id.* at 242.

¹⁶ *Id.*

¹⁷ George L. Miller, Chapter 7 Trustee v. William J. Rouhana, Jr., et al., Adv. Pro. No. 25-50399 (MFW) (Bankr. D. Del. March 12, 2025) [Docket No. 1].

(1) were interested parties in the challenged transactions that were allegedly approved by the independent directors; (2) lacked independence from a party that was interested in the challenged transactions; or (3) acted in bad faith in approving the challenged transactions.¹⁸ The bankruptcy court has not rendered a decision as of late July 2025 on the independent directors' motion to dismiss.

Based on these examples, it is evident that independent directors are not immune from lawsuits, including those alleging breaches of fiduciary duties. To ensure that the independent director remains protected from these sorts of claims, it is imperative that the independent director confirms that he or she is covered under the company's D&O and/or independent director liability (IDL) policy. An IDL policy might be appropriate to protect an independent director if there are concerns that the company's entire D&O insurance policy will be exhausted by litigation or enforcement actions.

In addition, independent directors can further protect themselves by entering into indemnification agreements with the company whereby the company agrees to pay legal fees and any losses in the event that the independent director is named in a lawsuit in his or her capacity in this role. An independent director can also opt to purchase a wealth security policy, whereby the entire policy is reserved for the independent director. Similar to a Side A policy,¹⁹ a bankruptcy court will likely find that an IDL policy is not property of the estate, as the coverage would solely be used to protect the independent director. Conversely, an indemnification agreement, which would be akin to Side B coverage,²⁰ might be viewed as property of the estate, given that funds paid to defend the independent director would deplete assets of the estate.

Conclusion

It is evident that former D&Os and independent directors will remain susceptible to claims, including claims for breaches of fiduciary duties, as these claims represent a significant source of recovery for the debtor's estate, which will benefit all unsecured creditors. The retention of D&O insurance is an important consideration for D&Os and independent directors as their companies contemplate filing for bankruptcy. **abi**

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¹⁸ *Id.* at Docket Nos. 31 and 35.

¹⁹ 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.

²⁰ Side B coverage, or company-reimbursement coverage, is used to reimburse the company when it indemnifies the D&Os.