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THE DANGER ZONE: FIDUCIARY DUTY ISSUES IMPACTING DIRECTORS AND OFFICERS IN THE ZONE OF INSOLVENCY AND BEYOND

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TABLE OF CONTENTS

I. INTRODUCTION[1]

This paper addresses fiduciary duty issues that impact upon directors and officers of a company on the brink of bankruptcy and while in bankruptcy. First, this paper examines the critical question of when the fiduciary duties of directors and officers can be said to have shifted to the creditor body at large, or in other words, when has the company entered into the zone of insolvency. An analysis of the common law reveals that despite the fact that the seminal case on the issue of zone of insolvency is ten years old, this continues to be an evolving area of law.

Second, this paper analyzes the impact of shareholder suits against directors and officers for breach of fiduciary duty upon the filing of bankruptcy. The company typically has several arguments that shareholder actions should be stayed by the automatic stay or by an injunction issued under Bankruptcy Code section 105(a).

Finally, this paper examines recent trends in bankruptcy case law concerning the impact of a bankruptcy filing on director and officer ("D&O") insurance policies, and the ability of directors and officers to recover defense costs under such policies upon a bankruptcy filing.

II. FIDUCIARY DUTIES

A. When Has a Company Entered Into the Zone of Insolvency?

Before the decision of *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp*, the bright line rule was that upon insolvency in fact of a corporation, the duties of the corporate directors shifted from the shareholders to the greater corporate body. *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981); *Unsecured Creditor's Committee of Debtor STN Enters. v. Noces*, 779 F.2d 901 (2nd Cir. 1985); *FDIC v. Sea Pines Co.*, 692 F.2d 973 (4th Cir. 1982). In *Credit Lyonnais*, that bright line rule was expanded so that the fiduciary duties owed to the corporate body as a whole shifted at some point before the corporation was technically insolvent. *Credit Lyonnais*, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

In *Credit Lyonnais*, the plaintiff shareholder owned 98% of MGM-Pathe Communications, Inc. ("MGM"), the debtor, which had been in and out of bankruptcy. To get it out of bankruptcy, the plaintiff entered into a corporate governance agreement whereby he turned over control of the company to MGM's lenders. The agreement provided that the plaintiff would regain control when the debt was paid down to a certain amount. The plaintiff demanded that the company's board cause MGM to sell certain of its assets to pay down the debt sufficiently to restore the plaintiff's control. The board did not authorize the sale, and the plaintiff shareholder sued for breach of the directors'

1 Portions of this paper were also co-authored by Theodore L. Freedman, Esq., of the Kirkland & Ellis New York office.

fiduciary duty of loyalty to the plaintiff as MGM's principal shareholder. The Court held:

> At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [the shareholders], but owes its duty to the corporate enterprise . . . Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991). It is important to note however, that there does not appear to have been any actual question as to whether MGM was operating in the vicinity of insolvency because at all relevant times, the company was either in bankruptcy or "thereafter the directors labored in the shadow of that prospect." *Id.* at *34. Accordingly, the court's discussion of director's duties in the vicinity of insolvency is dicta.

Subsequent to the *Credit Lyonnais* case, it has become "universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors." *In re Kingston Square Assocs.*, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997). Unfortunately, neither the *Credit Lyonnais* decision nor subsequent cases and comments have explained or been able to capture when a company has entered into the "vicinity of insolvency."[2]

Only a few cases discuss the zone of insolvency concept, let alone elaborate on when a company has entered into the zone of insolvency. Three different fact patterns arise from these cases as to when the fiduciary duties of directors of a corporation shift as a consequence of the company's insolvency: (1) the company is insolvent in fact; (2) the board authorizes a transaction that will render the company insolvent or close to insolvency; or (3) the board has sufficient knowledge that insolvency is imminent.

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[2] Donald S. Bernstein & Amit Sibal, *Current Developments: Fiduciary Duties of Directors and Corporate Governance in the Vicinity of Insolvency*, 819 PLI/COMM 653 (2001) ("No court has yet expressed a view on how one determines whether a corporation is in the 'vicinity' of insolvency for the purposes of applying this test."); Brent Nicholson, *Recent Delaware Case Law Re: Director's Duties to Bondholders*, 19 Del. J. Corp. L. 573, 588 (1994) ("That vicinity is presumably somewhere or sometime between solvency and insolvency."); Corinne Bell & Robert Messineo, *Fiduciary Duties of Officers and Directors of the Financially Troubled Company: A Primer*, 971 PLI/Corp. 171 (1996) ("The 'vicinity of insolvency' standard appears to combine the 'bankruptcy' (or 'balance sheet') standard and the 'equitable' (or 'cash flow') standard of insolvency such that if either condition is approached, the director fiduciary duties expand to include creditors.").

1. Insolvency In Fact

This is the clearest scenario for determining when the directors' duties shift. Once the company is insolvent, there is no question that the directors' duties shift to the corporate enterprise as a whole, including the creditor body. *Geyer v. Ingersoll Publ'n Co.*, 621 A.2d 784, 787 (Del. Ch. 1992); *see also Odyssey Partners, L.P. v. Fleming Cos.*, 735 A.2d 386, 417-18 (Del. Ch. 1999) (citing *Geyer*). In *Geyer*, the Court noted that the directors do not generally owe any duties to creditors beyond contractual terms absent special circumstances. *Geyer*, 621 A.2d at 668. Insolvency constitutes a "special circumstance." *Id.*

The "insolvency exception," as it has thus been called, arises either upon balance sheet insolvency or inability to pay debts as they come due. *Id.* at 670. So, for example, where the company's financial statements reflect a negative shareholder equity, this has been found to be a sufficient factual requisite demonstrating that the company was in the "vicinity of insolvency." *Pereira v. Cogan*, 2001 WL 243537, at *9 (S.D.N.Y. Mar. 8, 2001). On the other hand, where the company is clearly solvent, such as where the value of assets exceeds liabilities by a significant amount, no shifting of the directors and officers' fiduciary duty will be found. *See La Salle Nat'l Bank v. Perelman*, 82 F. Supp. 2d 279, 291-92 (D. Del. 2000).

As a corollary to the insolvency exception, a presumption of insolvency may also be found to apply immediately before the filing of bankruptcy. For example, in *In re Mortgage & Realty Trust*, the court held that the debtor's board of trustees owed a fiduciary duty to creditors four days before the filing of the bankruptcy. Even though there was no actual evidence of insolvency at the time the board ratified the sale of a major asset in an insider transaction, the court presumed insolvency by virtue of the fact that the company filed bankruptcy only four days after the transaction. The court relied on the balance sheet insolvency approach and found that since scheduled liabilities exceeded assets on the bankruptcy filing date, the same must have been true when the transaction was approved. 195 B.R. 740, 751. Similarly, in *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*, 305 N.Y. 1, 5 (1953), the court created a presumption of insolvency immediately before insolvency-in-fact where the corporation was "technically solvent but insolvency was only a few days away."[3]

2. Transaction Will Render Company Insolvent Or Close To Insolvency

The courts have also extended the insolvency exception to scenarios in which the directors approve a transaction that benefits shareholders but leaves the corporation insolvent, on the "brink of insolvency", or with "unreasonably small capital."

[3] We note that although some courts may presume insolvency immediately before a company files for bankruptcy, there is no requirement under the Bankruptcy Code that a company actually be insolvent when it files for bankruptcy. While most companies that file for bankruptcy are insolvent, some are not, and, thus, this presumption may be inapt in those cases.

In *In re Healthco Int'l, Inc.*, the company was balance-sheet solvent at the time the board authorized a leveraged buyout that saddled the company with loans and subordinated debentures. 208 B.R. 288 (Bankr. D. Mass. 1997). The proceeds of the LBO passed to the selling shareholders rather than to creditors. The Court agreed with the plaintiffs that the directors breached their fiduciary duties, noting: "When a transaction renders a corporation insolvent, or to the brink of insolvency, the rights of the creditors become paramount. In those circumstances, notwithstanding shareholder consent, a representative of the corporation may recover damage from the defaulting directors." *Id.* at 300.

In *Healthco,* the Court also noted that a director can be liable for authorizing transactions that leave the corporation with "unreasonably small capital." *Id.* at 302. In attempting to define "unreasonably small capital," the court explained:

> It connotes a condition of financial debility short of insolvency (in either the bankruptcy or equity sense) but which makes insolvency reasonably foreseeable. In other words, a transaction leaves a company with unreasonably small capital when it creates an unreasonable risk of insolvency, not necessarily a likelihood of insolvency.

Id. Thus, not only can the director be liable for transactions that actually render the company insolvent, the director can be held liable for transactions that render the company on the verge of insolvency. *Healthco* equated this duty of directors not to engage in transactions that render the company insolvent or close to insolvent as "merely an incident of the fiduciary obligations owed by directors to their corporation." *Healthco*, 208 B.R. at 301.

Other courts have also held that if a director approves a transaction that renders the company insolvent or close to insolvency, this will constitute a breach of the director's duties. *In re Buckhead Am. Corp.*, 178 B.R. 956, 968-69 (D. Del. 1994) (transaction with parent company approved by the directors of subsidiary resulting in the subsidiary's insolvency or leaving the subsidiary "undercapitalized and unable to pay its debts" was sufficient to state a breach of fiduciary duty claim); *see also Askanase v. Fatjo*, 1993 WL 208440 (S.D. Tex. April 22, 1993) (holding that per *Credit Lyonnais*, a corporation's bankruptcy trustee could recover payments made prior to the bankruptcy to a defendant director by the corporation so long as the trustee could establish that the corporation was "insolvent or on the brink of insolvency.").

3. Insolvency Is Imminent

A third scenario in which the director may be held liable for a breach of fiduciary duty is if the director knows with a fair degree of certainty that the company will be bankrupt or insolvent in the near future. In such an instance, a court will likely find that the director's fiduciary duty shifts at the point of knowledge.

The definition of "unreasonably small capital" set out by *Healthco* connotes that a director should have the necessary foresight to avoid entering into a transaction that "makes insolvency reasonably foreseeable" or creates an "unreasonable risk of insolvency." *Id.* 208 B.R. at 302. At least one scholar has noted of *Healthco*: "This concept of 'unreasonably small capital' seems to approximate what is meant by the nebulous concept of 'in the vicinity of insolvency.'" Christopher L. Barnett, *Healthco and the "Insolvency Exception": An Unnecessary Expansion of the Doctrine?,* 16 Bankr. Dev. J. 441 (2000).

Similarly, in the recent case of *In re Hechinger Investment Company of Delaware*, 274 B.R. 71 (D. Del. 2002), the court held, relying on *Healthco*, that the unsecured creditors' committee of the *Hechinger* bankruptcy estate had sufficiently alleged a claim for breach of fiduciary duty against the company's directors based on the "forseeability" of insolvency. The complaint alleged that the directors had approved a merger of the company, which was eventually effectuated by a leveraged buy-out that rendered the company insolvent. In their motion to dismiss, the directors argued that the complaint failed to state a cause of action because the directors had only approved the merger of the LBO, and not the pledging of the debtor's assets, which occurred post-LBO. In denying the directors' motion to dismiss, the court ruled that it was possible to construe the entire LBO transaction as "one integrated transaction" or, alternatively, that the "forseeability of the alleged harm" as alleged in the complaint was sufficient to allege a breach of fiduciary duty. *Id.* at 91. "Courts thus focus 'not on the structure of the transaction but the knowledge and intent of the parties involved in the transaction.'" *Id.* (citations omitted).

It can be argued that the inquiry as to when the zone of insolvency arises thus turns on the question of when the director has knowledge of the likelihood of insolvency. For example, in *In re Shultz,* 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997), the court held that when the defendant director knew that if certain proposed transactions came to fruition, they would render the company insolvent, the director knew that the company was at "the brink of insolvency" prior to the transactions. Even though the corporation was solvent at the point the transactions were being considered, the director owed a duty to act in the best interests of the corporation at that point. *Id.* The court acknowledged the vicinity of insolvency rule in *Credit Lyonnais*, and then proceeded to apply a *Healthco*-type analysis to conclude that the director could be liable for breach of fiduciary duty for not acting in the best interests of the corporation at a time before the actual transactions were entered into, but when s/he knew that insolvency was imminent. The point when the zone of insolvency was found to arise in this instance was not so much temporal closeness to insolvency-in-fact, but rather the instance when the director had knowledge of the specter of insolvency.

B. The Board's Duties in the Zone of Insolvency

1. To Whom Does The Board Owe Its Duties?

Once a corporation is in the zone of insolvency, the case law is conflicted as to whom the board owes its duties. Most courts would rule that the board's constituency at the point of insolvency or in the zone of insolvency is the corporate enterprise as a whole. *Credit Lyonnais*, 1991 WL 277613, at *34 n. 55 ("The beneficiaries are expanded to include creditors and any other party having an interest in the "corporate enterprise."); *Askanase v. Fatjo*, 1993 WL 208440, at *5 ("The directors must be capable of conceiving of the corporation as a legal and economic entity, with the interests of the corporation as a whole put before all others."); *Geyer*, 621 A.2d at 787-89 ("[F]iduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation."); *In re Xonics, Inc.*, 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) (directors of insolvent corporation owe fiduciary duties to corporation, shareholders and creditors). Some courts hold that at the point of insolvency the board's duties are owed only to creditors because the shareholders no longer have an equity stake in the corporation. *FDIC v. Sea Pines Co.*, 692 F.2d at 977; *In re Hoffman Assocs., Inc.*, 194 B.R. 943, 964 (Bankr. D.S.C. 1995).

2. What Are The Board's Duties?

The traditional ambit of fiduciary duties owed by a director of a solvent corporation, including the duty of care, duty of loyalty, duty of candor, duty of disclosure, duty to protect and preserve confidential information, still apply when the corporation is insolvent or in the vicinity of insolvency. "As a general rule, the law provides that directors of the insolvent corporation are subject to the same duties of loyalty and care to creditors as those that run to shareholders when the corporation is solvent." Bell & Messineo, *Fiduciary Duties of Officers and Directors of the Financially Troubled Company: A Primer*, 971 PLI/Corp. at 185 (citing *In re O.P.M. Leasing Servs., Inc.*, 28 B.R. 740 (Bankr. S.D.N.Y. 1983)).

There are express additional duties that arise in the zone of insolvency as set forth in the *Credit Lyonnais* decision, as follows: "'The MGM board or its executive committee had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity." *Credit Lyonnais*, 1991 WL 277613 at *34 n.55. The board's duty to "maximize the corporation's long-term wealth creating capacity" has been likened to the board as trustee of the corporate res, which has a duty to preserve the corporation's value for eventual distribution to creditors. *New York Credit*, 110 N.E.2d at 400; Mohammad R. Pasban, *A Review of Directors' Liabilities of an Insolvent Company in the U.S. and England*, Journal of Bus. Law 2001, Jan. 33-57, at 41. In *New York Credit*, the court held that the directors were free to liquidate assets as they saw fit.

> "However, they were obligated to obtain for the corporation the full value of assets as of that period under the circumstances. [The directors] were, in effect, trustees . . . for the creditors . . . obligated to protect the trust res for the creditors and to account for waste in not obtaining full value for the res, if there was any waste by reason of their conduct."

Id. at 400; *see also In re Schulz*, 208 B.R. at 729.

The decisions of management should still be entitled to the protections of the business judgment rule, which presumes that the Board's decisions were made in the best interests of the company under the requisite duties of care and loyalty. *See* Trost & Schwartz, *Fiduciary Duties of Directors in the Chapter 11 and Insolvency Contexts*, SE71 ALI-ABA 265, 281 (Feb. 24, 2000). However, at least one court has concluded that in the context of insolvency, the directors' decisions may be held to a higher level of scrutiny and that the "the business judgment rule and other rules applicable to solvent corporations are of no effect in the context of insolvency and serve as no defense. . . ." *Askanase*, 1993 WL 208440, at *5 (citing *New York Credit Men's Adjustment Bureau v. Weiss*, 110 N.E.2d 397, 400 (N.Y.App.1953)); *see also* Bell & Messineo, *Fiduciary Duty of Officers and Directors*, 971 PLI/Corp. at 188 (directors may be held to a higher business judgment standard when the corporation is insolvent or at the zone of insolvency), *but cf.*, *Angelo, Gordon & Co., L.P. v. Allied Riser Communications Corp.*, 2002 WL 208074, at *6 (Del. Ch. Jan. 30, 2002) (court "tentatively" concluding that the business judgment rule may still apply in the zone of insolvency). Thus, it is important that the board and officers carefully measure decisions when in the zone of insolvency.

The duty to consider the corporate enterprise as a whole means that the board should not approve transactions that overtly favor one creditor constituency over another. *In re Ben Franklin Retail Stores*, 225 B.R. 646, 653-54 (Bankr. N.D. Ill. 1998) ("[C]reditors have a right to expect that directors will not divert, dissipate or unduly risk assets necessary to satisfy their [creditors'] claims."). Directors get into trouble when they prefer one group over another. "All of the decisions in which the courts have allowed creditors to recover for breach of fiduciary duty have involved directors of an insolvent corporation diverting corporate assets for the benefit of insiders or preferred creditors." *Ben Franklin*, 225 B.R. at 655 (citing Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 Vand. L. Rev. 1485, 1512 (1993)). Along the same lines, the director's duty of loyalty not to put their personal financial interests above the interests of the corporation is also heightened. *In re Healthco Int'l, Inc.*, 208 B.R. at 302. "As fiduciaries for the firm's creditors, directors cannot cause the firm to pay even bona fide obligations owed to themselves ahead of the firm's noninsider creditors." *Collie v. Becknell*, 762 P.2d 727, 731 (Colo. App. 1988). Thus, a board in the vicinity of insolvency must walk a fine line of not preferring one constituency over another, while simultaneously attempting to preserve the corporate res for the benefit of eventual distribution to all stakeholders.

C. What are the Fiduciary Duties for Directors and Officers in Bankruptcy?

Generally, the same common law fiduciary duties discussed above are applicable to directors and officers upon the filing of bankruptcy. For example, directors and officers have (i) the "duty to protect and conserve property in its possession for the benefit of creditors;" and (ii) and the duty to make "open, honest and straightforward disclosure to the Court and creditors." *In re Marvel Entm't Group, Inc.*, 140 F.3d 463, 474 (3d Cir. 1998) (citations omitted).

The marked difference, however, is that in bankruptcy, the debtor in possession ("DIP") is charged with additional statutory duties under Bankruptcy Code § 1106 (made applicable to DIPs under Bankruptcy Code § 1107) for fair reporting and investigation of the debtor's acts and financial condition. In essence, the DIP generally assumes the same fiduciary duties as would an appointed trustee. Accordingly, "the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession. . . . Indeed, the willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'" *Commodity Futures Trading Comm'n v. Weintraub,* 471 U.S. 343, 355 (1985) (citing *Wolf v. Weinstein,* 372 U.S. 633, 651 (1963)); *In re Intermagnetics Am., Inc.*, 926 F.2d 912, 917 (9th Cir. 1991) ("Officers of a debtor-in-possession are officers of the court because of their responsibility to act in the best interests of the estate as a whole and the accompanying fiduciary duties.").

D. What Protection Do Directors and Officers Have in Bankruptcy?

The directors and officers of companies have at least two protections under the Bankruptcy Code while in bankruptcy. First, any decision outside of the ordinary course of business must be sanctioned by the bankruptcy court under 11 U.S.C. § 363(b), after notice and a hearing. What constitutes "outside" of the ordinary course of business is not defined under the Bankruptcy Code. Thus, directors and officers would be well advised to seek the court's guidance when in doubt as to whether a transaction may be outside of the ordinary course of business as this provision of the Bankruptcy Code affords a built-in mechanism to shield risky decisions of officers and directors.

Second, the Bankruptcy Code requires that the unsecured creditors in a case be represented by a committee. 11 U.S.C. § 1102(a). Thus, where there may be an issue as to the appearance of impropriety, the debtor's management should consult with and obtain the consensus of the unsecured creditors' committee to the extent possible. Where the unsecured creditors' committee has assented to the proposed plan or course of action, it is far more difficult to prove a breach of fiduciary duty with respect to the creditor body. *See In re The Leslie Fay Cos., Inc.*, 207 B.R. 764, 792 (Bankr. S.D.N.Y. 1997) (grant of stock options to management in connection with a plan of reorganization was not a breach of fiduciary duty by management, in large part because the transaction was negotiated with the creditors' committee). We note that although the committee's assent is valuable in situations where there is a question of impropriety, the committee's assent will not sanction decisions that are made in violation of the management's fiduciary duties.

III. STAY OF SHAREHOLDER SUITS

Where a shareholder allegedly has a claim against the directors and officers of the company for breach of fiduciary duty and the company files for bankruptcy, the question arises as to whether the shareholder suit can be maintained or whether the cause of action is stayed.

A. Stay of Shareholder Suits as Function of Automatic Stay

Bankruptcy Code section 541 defines property of the estate broadly to include all legal or equitable interests of the debtor, wherever located and by whomever held. 11 U.S.C. § 541(a). Property of the estate thus includes those causes of action that belong to the bankruptcy estate.

It is generally held that "if the debtor could have raised a state claim at the commencement of the bankruptcy case, then that claim is the exclusive property of the bankruptcy estate and cannot be asserted by a creditor." *In re Van Dresser Corp.*, 128 F.3d 945, 947 (6th Cir. 1997). Thus, in the context of derivative suits, the action is typically stayed because the claim is one that the debtor company could have asserted at or before the filing of bankruptcy. *See, e.g., In re Ionosphere Clubs, Inc.*, 17 F.3d 600 (2d Cir. 1994); *In re Ionosphere Clubs, Inc.*, 156 B.R. 414 (S.D.N.Y. 1993); *In re General Dev. Corp.*, 179 B.R. 335, 338 (S.D. Fla. 1995) ("A corporation's filing for bankruptcy cuts off a shareholder's ability to bring a derivative claim."). This analysis as to who has the right to assert the claim as of the filing of bankruptcy is largely a function of state law. *Van Dresser Corp.*, 128 F.3d at 947; *Ionosphere Clubs*, 17 F.3d at 604-05.

Claims for mismanagement, breach of fiduciary duty, and appropriation or waste of corporate opportunities are prototypical derivative claims that can be brought on behalf of a corporation and, thus, are viewed as debtor claims, recoverable for the benefit of the estate's creditor body at large. *In re Granite Partners, L.P.*, 194 B.R. 318, 327-28 (Bankr. S.D.N.Y. 1996).

> As a general rule, and outside the context of a bankruptcy case, the fiduciary obligation of officers, directors, and shareholders is enforceable directly by the corporation or through a stockholder's derivative action. However, 'it is, in the event of a bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interest in the corporation-- creditors as well as stockholders.'

Delgado Oil Co., Inc. v. Torres, 785 F.2d 857, 860-61 (10th Cir. 1986) (quoting *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939)); *In re MortgageAmerica Corp.*, 714 F.2d 1266 (5th Cir. 1983) (state law corporate trust fund doctrine or denuding the corporation theory is in the right of the corporation and thus becomes property of the estate after the bankruptcy filing).

However, a shareholder is generally permitted to assert a claim against a defendant director for a specific injury to the shareholder, so long as the shareholder's injury and right to recover are distinct from the estate's. *See, e.g., Van Dresser Corp.*, 128 F.3d at 949 (shareholder's right to seek defense costs were not property of the estate); *In re Reliance Acceptance Group Inc.*, 235 B.R. 548 (D. Del. 1999) (shareholder suit under Securities and Exchange Act and Rule 10b-5 for injuries allegedly caused by fraudulent statements inducing shareholders to approve transaction raised distinct injuries not subject to injunction or automatic stay); *Granite Partners*, 194 B.R. at 329.

B. Stay of Shareholder Suits as Competing Claims

Even if the estate does not own the shareholder's claims, shareholder suits alleging breach of fiduciary duty may be enjoined pursuant to 11 U.S.C. § 105(a) or an extension of the automatic stay under at least two theories.

First, courts have preliminary or temporarily enjoined shareholder suits under the argument that the shareholder's pursuit of its claim against the debtor's director or officer interferes with the debtor's reorganization efforts. *In re Continental Airlines*, 177 B.R. 475, 481 (D. Del. 1993) (extending scope of automatic stay to enjoin shareholder suit against directors and officers where suit was attempt to circumvent automatic stay and defendant directors and officers were essential to reorganization process); *In re Zenith Labs., Inc.*, 104 B.R. 659, 666 (D.N.J. 1989) (affirming 105(a) injunction of shareholder suit against its directors and officers where suit would detract from reorganization efforts).[4]

Second, courts have granted an injunction to stay a shareholder suit where the shareholder's claim is a "related claim" to the estate's claim. This is particularly true where the shareholder's claim arises from the same transaction, seeks the same remedy, and alleges the same harm against the same defendants. Significantly, these cases tend to support the argument that a bankruptcy court may allow the estate's claims to take precedence over a shareholders' independent claims to the extent that pursuit of those claims interferes with the estate's claims. *See, e.g.*, *Fisher v. Apostolou*, 155 F.3d 876 (7th Cir. 1998); *In re Van Dresser Corp.*, 128 F.3d 945 (6th Cir. 1997); *In re Stirling Homex Corp.*, 579 F.2d 206 (2d Cir. 1978).

In *Fisher*, a group of defrauded investors asserted securities, commodity, and fraud claims against individuals that had solicited and then illegally spent their money. The bankruptcy trustee asserted similar claims against the same defendants for damages arising out of the same injury on behalf of the estate. The issue before the court was whether it had the authority to stay the investor suit and prefer the trustee's suit. The Seventh Circuit approved a section 105 injunction to enjoin the shareholders reasoning that the shareholders "must wait their turn behind the trustee, who has the responsibility to recover assets for the estate on behalf of the creditors as a whole. . . ." *Fisher*, 155 F.3d at 881. The *Fisher* court drew its authority from the "power and responsibility of the bankruptcy court to preliminarily enjoin 'suits to which the debtor need not be a party but which may affect the amount of property in the bankrupt estate.'" *Fisher*, 155 F.3d at 883 (citation omitted).

Similarly, in *In re Van Dresser Corp.*, 128 F.3d 945 (6th Cir. 1997), a shareholder was enjoined from pursuing its related claim against a non-debtor third party as an interference with the estate's right to pursue the same claim. In *Van Dresser*, the plaintiff was a shareholder of the debtor who had also guaranteed a loan on behalf of the debtor. The shareholder sought to recover from third parties amounts allegedly defrauded from the company and the shareholder. After bankruptcy was filed, the estate sought the same

4 The controversial issue of non-debtor releases in connection with reorganization plans is outside the scope of this paper.

recovery. Although the Sixth Circuit noted that both the shareholder and the debtor had state law claims for damages against the non-debtor defendants, the court held that "[t]he estate's recovery takes precedence over [the shareholder's]." *Id.* at 946. Where the shareholder's recovery would essentially leap-frog that shareholder's right to recovery against other similarly situated creditors, the equitable distribution principle of bankruptcy assets prohibit that result. *See also Bankers Trust Co. v. Rhoades*, 859 F.2d 1096, 1106 (2d Cir. 1988) (although the creditor may have standing to pursue its own claim against a non-debtor defendant, where the injury alleged "overlaps" with the estate's claims, the creditor can be enjoined to prevent a double recovery).

IV. INSURANCE ISSUES

A. Intersection of the Automatic Stay and D&O Insurance Policies

A debtor's D&O insurance policy is generally recognized to be property of the estate. *In re Edgeworth, M.D.*, 993 F.2d 51, 55 (5th Cir. 1993) ("insurance policies are property of the estate because, regardless of who the insured is, the debtor retains certain contract rights under the policy itself"). The bulk of case law dedicated to the topic of D&O insurance policies deals with the scope of the automatic stay. Because a D&O policy is property of the estate, it takes on all the indicia of a debtor contract.[5] While it is clear that once the policy is deemed property of the estate, it is protected by the automatic stay, it is less clear whether the stay can be extended to protect non-debtors in the name of preserving the D&O policy proceeds.

The cases generally address two different D&O insurance clauses, which may or may not be contained in the same policy: (1) "direct coverage" payable to directors and officers directly from the insurance company for reimbursement of defense costs; and (2) "indemnification coverage" of defense costs payable to the company for amounts that it is required to reimburse directors and officers.

First, under the "direct coverage" policy, where proceeds are payable directly to directors and officers for defense costs, the cases consistently hold that such proceeds are not property of the estate. The case of *In re Louisiana World Exposition*, 832 F.2d 1391 (5th Cir. 1987), is cited as the seminal authority for this proposition. *In re Youngstown Osteopathic Hosp. Assoc.*, 271 B.R. 544 (Bankr. N.D. Ohio 2002); *In re CHS Elecs., Inc.*, 261 B.R. 538 (Bankr. S.D. Fla. 2001); *In re Zenith Labs, Inc.*, 104 B.R. 659 (Bankr. D.N.J. 1989). In *Louisiana World*, the D&O insurance policy provided for direct payment to the directors and officers for reimbursement of defense costs. The directors and officers sought payment from the D&O insurance policy, and the creditors' committee brought suit to enjoin the payment as violative of the automatic stay. The Fifth Circuit rejected the argument that the estate had any property interest in proceeds of

[5] *See, e.g., In the Matter of Jasmine, Ltd.*, 258 B.R. 119 (D.N.J. 2000) (court approved settlement between trustee and insurance company canceling D&O insurance policy over objection of directors and officers); *In re Minoco*, 799 F.2d 517 (9th Cir. 1986) (third party insurance company cannot cancel the policy based on the bankruptcy filing by an insurance company because of the stay).

the insurance policy. *See also In re Edgeworth, M.D.*, 993 F.2d 51 (5th Cir. 1993) (noting that the important inquiry is whether the debtor has right to receive and keep proceeds when paid under the policy and if it has no right, the proceeds are not property of estate); *but see Landry v. Exxon Pipeline Co.*, 260 B.R. 769, 784-94 (Bankr. M.D. La. 2001) (noting difference in Fifth Circuit's interpretation of *Louisiana World*).

On the other hand, where the debtor is entitled to indemnification for reimbursement costs paid to directors and officers, the courts typically hold that this policy is property of the estate such that the automatic stay will apply to bar directors and officers from seeking reimbursement against such policy. *In re Sacred Heart Hosp. of Norristown*, 182 B.R. 413, 420 (Bankr. E.D. Pa. 1995) ("We think that that such an indemnification interest in proceeds is sufficient to bring those proceeds into the estate."). *See also Circle K Corp. v. Marks (In re Circle K Corp.)*, 121 B.R. 257 (Bankr. D. Ariz. 1990) (D&O policy that provided for indemnification of debtor's expenses was property of the bankruptcy estate). In *Sacred Heart Hospital*, the D&O policy contained an indemnification clause with a set amount available for payout of reimbursement costs. The court held that because a potential payment under policy would lead to the reduction of the "pot" thereby triggering indemnification claims against the debtor, the insurance constituted property of the estate and the automatic stay barred recovery efforts by the directors and officers. However, not all cases lead to such a harsh result for directors and officers where indemnification clauses are involved. In *In re Zenith Laboratories, Inc.*, the court determined that where the obligation of the debtor to indemnify the Ds&Os was merely optional under the insurance policy and where state law did not require indemnification, the necessity for payment by the company was merely a "theoretical possibility," and thus, the directors and officers should not be barred from exercising their rights under the policy. *Zenith Labs.*, 104 B.R. at 665-66.

Similarly, in *In re Cybermedica*, 2002 WL 1483256 (Bankr. D. Mass. July 2, 2002), although the D&O insurance policy provided for both direct coverage and indemnification, the court ruled that the automatic stay would be lifted to allow the debtors' directors to recover defense costs. The court reasoned that the harm to the debtor was "speculative" as there were no present claims for indemnification or entity coverage, and thus "there does not appear to be an immediate risk" of depletion of the policy. *Id.* at * 5; *see also In re Republic Technologies Int'l, LLC*, 275 B.R. 508, 518 (Bankr. N.D. Ohio 2002) (stating that the facts of each particular case must be analyzed to determine whether or not payment of insurance proceeds could alter the value of the bankruptcy estate at issue); *Granite Partners*, 194 B.R. at 336-38 (holding that mere threat of indemnification claim against D&O insurance is not sufficient basis for extending automatic stay to enjoin suits between nondebtors).

B. Other Notable Developments

Where the D&O insurance policy provides "entity coverage," or reimburses the company directly for claims asserted against it, courts may be inclined to hold that such a policy is property of the estate to the exclusion of the interests of directors and officers. *In re CHS Elecs., Inc.*, 261 B.R. 538 (Bankr. S.D. Fla. 2001); *In re First Central Fin.*

Corp., 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999).[6] However, in neither of these cases did the courts reach a definitive ruling on the issue.

In *CHS Electronics*, shareholders asserted fraud claims against the debtors' officers and directors. The shareholders filed a motion authorizing approval of a settlement with the directors and officers and also to utilize the proceeds of two D&O policies in connection with the settlement. The D&O policies provided for direct coverage for the directors and officers, as well as indemnification and entity coverage for security actions against the debtor. The chapter 11 liquidating trustee opposed, arguing that the settlement would deplete the estate's insurance assets. The court noted that the reality of the situation was that there could be no claims against the entity coverage because all securities claims against the debtor had been settled. *CHS Elecs.*, 261 B.R. at 543 ("Although a portion of the [insurance] Proceeds could *conceivably* constitute property of the estate based on the Entity Coverage, there is in actuality no Entity Coverage issue here."). Nevertheless, the court noted that to the limited extent that the proceeds could be used to satisfy hypothetical indemnification claims, those proceeds were property of the estate. But, since there were no indemnification claims, the court granted relief from stay to permit the shareholder settlement to be entered.

Similarly, in *First Central*, the court merely noted that: "It may well be that proceeds of certain D&O insurance policies, which provide direct entity coverage to a corporate debtor, can be considered property of the estate," but did not go on to address the issue or create a per se rule. *In re First Central Fin. Corp.*, 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999).

V. CONCLUSION

It is an unfortunate fact for directors and officers that published case law does not provide consistency as to when a company is considered to be in the zone of insolvency. The case law is clear, however, that once insolvency is imminent, the director has a duty to consider a larger body than the shareholders, and failure to do so can expose the director and the company to claims for breach of fiduciary duty.

Once in the zone of insolvency, the director owes a higher level of care to a broadened constituency that includes creditors, and must make a concerted effort not to prefer one group over another group, while simultaneously preserving the trust res for eventual distribution to the corporate enterprise as a whole. After the filing of bankruptcy, the directors and officers continue to have the same level of fiduciary obligations, in addition to those statutorily imposed fiduciary trustee obligations.

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6 *See also* David H. Kirstenbroker, et al., *Securities Litigation and Insolvency: The Case for the Director and Officer Insurance Proceeds*, 1269 PLI 661 (2001); Nan Robert Eitel, *Now you Have it, Now you Don't: Directors' and Officers' Insurance After a Corporate Bankruptcy*, 46 Loy. L. Rev. 585 (2000).

Shareholder claims of a derivative nature for breach of fiduciary duty against directors and officers will be stayed upon the filing of bankruptcy, with the right to pursue those claims vesting in the company. The extension of the automatic stay to shareholder claims may even result where the shareholder possesses an independent claim against the company if the claim arises from the same transactional facts as the estate's claims.

Directors and officers that incur defense costs may be able to recover under D&O policies once the company is in bankruptcy depending on the nature of the policy. Directors and officers of troubled companies should direct outside counsel to study the company's D&O policies and analyze the impact that a bankruptcy filing may have on the policy. Proceeds of a "direct coverage" policy are typically viewed as non-estate property, where indemnification coverage policies generally require a higher level of scrutiny as to whether recovery will be permitted. There is a recent trend by courts towards a factual analysis of the likelihood that recovery on an indemnification policy will trigger additional claims against the estate or will reduce policy limits to a low level. In the absence of cognizable harm to the estate, a court may permit recovery by directors and officers under an indemnification policy. Further analysis of whether directors and officers can recover under a D&O policy in the face of "entity coverage" will no doubt be the next chapter that courts will grapple with in this area, as evident from recent case law.