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The Interminable 'Insured vs. Insured' Battle

A New Obstacle to D&O Recoveries for Creditors

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In the world of Chapter 11 negotiations, the creation of a litigation trust to pursue claims on behalf of unsecured creditors is a common strategy employed by official committees of unsecured creditors as a means to maximize creditor recoveries. Committees often seek to pursue avoidance actions and claims against a company's directors and officers (D&Os) for breaches of fiduciary duties, among other things.

In some cases, such claims may be the sole potential source of recovery available for unsecured creditors. However, no matter how meritorious a claim may be, its ultimate value to creditors depends upon one thing — whether there is a viable source to satisfy any judgment obtained, since many D&Os do not have sufficient personal assets to satisfy any significant damages that may be awarded.

That is where director and officer liability insurance (D&O Insurance) comes into play. Companies routinely purchase D&O Insurance to protect their D&Os from claims relating to their performance, or decisions made in their capacity as such. That is why Committees routinely focus on available D&O Insurance as a potential source of recovery for unsecured creditors.

The IVI Exclusion

While D&O Insurance typically covers the company itself as an insured party, it also typically excludes from coverage claims by insured parties against other insured parties. This common exclusion — the so-called "insured versus insured" (IVI) exclusion — is now found in nearly all D&O Insurance policies. The IVI exclusion is designed to avoid collusion among the company and its officers and directors in making a claim for losses based upon poor management decisions. The exclusion has been compared with an exclusion in a homeowner's insurance policy for a fire set deliberately by the homeowner.

The IVI exclusion has been the subject of extensive litigation and controversy in the bankruptcy context for many years, with insurers often contending that the exclusion applies to suits brought not only by the postpetition debtor-in-possession (DIP) — which some courts view as a distinct legal entity while others do not — but also when brought on behalf of the DIP's bankruptcy estate (the Estate) by Estate representatives, such as court-appointed Chapter 11 and Chapter 7 trustees, official committees and trustees for liquidating or litigation trusts formed through a confirmed plan (of reorganization or liquidation), or through what is commonly referred to as a "structured dismissal."

The vast majority of courts have held that a DIP, or a voluntary assignee of a DIP, is the same legal entity as the prepetition debtor and therefore cannot sue the DIP's own D&Os without triggering the IVI exception. *See, e.g., Biltmore Assocs., LLC v. Twin City Fire Ins. Co.*, 572 F.3d 663, 671 (9th Cir. 2009) ("We conclude that for purposes of the insured versus insured

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exclusion, the prefiling company and the company as debtor in possession in Chapter 11 are the same entity."); *Redmond v. Ace Am. Ins. Co.*, 614 Fed. Appx. 77 (3rd Cir. 2015) (not precedential or binding under Third Circuit rules); *Terry v. Fed. Ins. Co.* (*In re R.J. Reynolds – Patrick County Mem'l Hosp., Inc.*), 315 B.R. 674, 679 (Bankr. W.D. Va. 2003) ("A pre-petition debtor is the same entity as a debtor-in-possession … "). In most of these cases, the lawsuit against the D&Os was commenced by the company or the DIP, and then assigned to a litigation trust, or the litigation was taken over by a subsequently appointed estate representative.

Numerous courts, however, have ruled that where a statutorily appointed Estate representative (such as a Chapter 11 or Chapter 7 trustee, or a creditors' committee) seeks to prosecute an action against D&Os that was not initially commenced by the DIP, the IVI exclusion does not apply. *See, e.g., Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D. Del. 2002); *Cirka v. National Union Fire Ins. Co. of Pittsburgh*, 2004 Del. Ch. LEXIS 118 (Del. Aug. 6, 2004); *Fed. Ins. Co. v. Cont'l Cas. Co.*, 2006 U.S. Dist. LEXIS 85323 (W.D. Pa. 2006); *Cohen v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.* (*In re County Seat Stores, Inc.)*, 280 B.R. 319 (Bankr. S.D.N.Y. 2002); *Gray v. Executive Risk Indem., Inc.* (*In re Molten Metal Tech., Inc.*), 271 B.R. 711 (Bankr. D. Mass. 2002); *Rieser v. Baudendistel* (*In re Buckeye Countrymark, Inc.*), 251 B.R. 835 (S.D. Ohio 2000). These courts reason that statutory trustees and committees are separate legal entities from the company or the DIP, who owe fiduciary duties to the Estate, rather than to the company itself, and who present little risk of colluding with the DIP in bringing claims against the D&Os.

On June 20, 2017, the U.S. Court of Appeals for the Sixth Circuit, in *Indian Harbor Insurance Company v. Zucker, et al.*, 2017 U.S. App. LEXIS 10821, ruled that a liquidation trust formed pursuant to a confirmed plan of liquidation was the same entity as both the prepetition debtor (the company) and the DIP, and that coverage was therefore not available to satisfy claims against the company's former D&Os, who were being pursued by the liquidation trustee for the benefit of unsecured creditors. *Zucker* is significant because it takes things one step further than any other court by ruling that a litigation trustee, even under a confirmed plan and notwithstanding that neither the Company nor the DIP was the party that commenced the lawsuit, could not pursue claims against D&Os without triggering the IVI exclusion. Thus, the ruling in *Zucker* is an impediment to committees seeking to pursue D&O claims through a trust, even under a confirmed plan.

The Sixth Circuit Opinion

In *Zucker*, the Sixth Circuit ruled — in a two-to-one decision — that despite the creation of a new bankruptcy estate, a DIP was not a new entity for purposes of the IVI coverage exclusion. As a result, the court held that there was no difference between a claim pursued by a liquidation trustee who took an assignment of a DIP's claims, and a claim pursued by the prepetition company itself. The DIP was the same entity as the company, and the liquidation trustee simply stepped into the shoes of the DIP. Coverage for such claims, according to the Sixth Circuit, was contractually excluded under the terms of the D&O Insurance policy at issue in *Zucker*, and thus properly denied.

The *Zucker* case involved a common scenario in many liquidating Chapter 11 cases. A confirmed plan of liquidation provided for the creation of a trust to, among other things, pursue certain Estate claims against the former D&Os of the DIP that were assigned to it by the bankruptcy Estate. After plan confirmation, the liquidation trustee (the LT) commenced a lawsuit against the company's D&Os, alleging breaches of fiduciary duties, and seeking damages. The LT notified the insurance carrier of the lawsuit, after which the carrier filed its own lawsuit against the LT and the D&Os, seeking a declaratory judgment that it had no obligation to cover any damages awarded to the LT in the lawsuit. The insurance carrier argued that the alleged claims were excluded from coverage by the IVI exclusion contained in the D&O Insurance policy. The trial court ruled in favor of the insurance carrier.

On appeal, the Sixth Circuit began its analysis with the plain language of the insurance policy, which contained a typical IVI exclusion that applied to claims "by, on behalf of, or in the name or right of, the Company or any Insured Person" against an "Insured Person." The court ruled that the LT, as a voluntary assignee of the company, stood in the shoes of the company and was therefore subject to the coverage exclusion. *Zucker* at *6. The court also rejected the argument that the creation of a bankruptcy estate, and the distinction between a DIP and the prepetition company, should alter this outcome. It reasoned that the company could not have avoided the coverage exclusion by assigning its claims to a third party before bankruptcy, and therefore the same result should follow if the claims were assigned to a third party by the DIP after bankruptcy.

The Third Circuit also rejected the notion that a DIP is a new legal entity separate and distinct from the prepetition company. The court pointed to the provisions in the insurance policy and the Bankruptcy Code, as well as precedential case law, in support of this position. The court noted that a prior case (*Gordon Sel-Way v. United States*, 270 F.3d 280, 290 (6th Cir. 2001) acknowledged a distinction between the prepetition company and the postpetition DIP in the context of set-off rights. However, the court reframed that distinction as one between the prepetition company and the bankruptcy estate itself, rather than between the prepetition company and the postpetition DIP. At the same time, the court noted the possibility that such a distinction could exist in other circumstances: "Even if settings remain in which it makes good sense to treat the debtor and debtor-in-possession as legally distinct, this is not one of them."

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The Sixth Circuit downplayed the fact that the bankruptcy court had approved the plan transferring the estate's causes of action to the liquidation trust, which may have neutralized the threat of collusive behavior that the IVI exclusion seeks to prevent. The lack of collusive behavior "does not eliminate the practical and legal difference between an assignee and a court-appointed trustee that receives the right to sue on the estate's behalf by statute."

According to the Sixth Circuit, the key point is whether the DIP is still "the company" that entered into the insurance contract. The court concluded that it is, and that a voluntary assignee like the LT stands in the shoes of the company and the DIP in bringing an action against the D&Os, and is therefore subject to the IVI coverage exclusion.

The Sixth Circuit even suggested that a court-appointed trustee or a creditors' committee might be deemed to step into the shoes of the company and therefore be subject to an IVI coverage exclusion, but made clear that its opinion "does not resolve that distinct question."

In sum, the Sixth Circuit rejected any meaningful distinction between the prepetition company and the postpetition DIP as distinct legal entities. The court was not persuaded by the fact that the cause of action at issue constituted property of the bankruptcy estate once the case was commenced, and that it was being pursued for the benefit of creditors. Rather, the court's focus was on the identity of the representative of the bankruptcy estate who was pursuing the claim at issue, and whether the plain language of the insurance policy applied to that representative. As a result, the insurance provider won simply because of who the plaintiff was. The estate and creditors were left holding an empty bag.

The Dissent

Judge Bernice B. Donald, one of the judges hearing the *Zucker* case, dissented from the majority opinion, and in doing so, set out a viable path for other courts to reach the opposite result. Judge Donald took the position that an "assigned trustee" should have the same rights to pursue causes of action on behalf of the Estate and be exempt from IVI coverage exclusion, just like a court-appointed trustee. Judge Donald correctly noted that the majority decision would make it "harder for companies to emerge from bankruptcy with a consensual plan of reorganization."

First, the dissent noted that the purpose of the coverage exclusion was to avoid collusion among a company and its D&Os in suing the insurance carrier. Just as there is no risk of collusion with a court-appointed trustee, there is similarly no risk of collusion with an independent court-approved plan trustee. Nor should the plain language of the IVI coverage exclusion extend to a representative of a bankruptcy estate, since the IVI exclusion in the policy did not include a DIP or a bankruptcy representative in the definition of the term "Company."

According to the dissent: 1) the bankruptcy estate is a new legal entity, separate and distinct from the prepetition company; 2) the LT was the representative of the bankruptcy estate who took assignment of a cause of action belonging to the estate, not the prepetition company; and 3) the LT is pursuing such cause of action for the benefit of creditors, not the company. The dissent noted that "[a]lthough this 'new-entity' argument may seem unfair, this is precisely the reason that many companies file bankruptcy. Companies in bankruptcy are afforded certain rights in bankruptcy that they would not be afforded outside of bankruptcy, especially in the context of contracts."

The dissent further noted that the majority opinion sends a clear message to creditors that they ought to seek the appointment of a Chapter 11 trustee or conversion to Chapter 7 any time they wish to pursue D&Os, rather than agreeing to a consensual plan to be confirmed by the DIP, because, at least in the Sixth Circuit, a litigation trust is no longer a viable mechanism for pursuing such claims where there is an IVI exclusion in the policy.

Impact on Future Plan Negotiations and Creditors' Committee Strategies

The *Zucker* opinion needs to be carefully considered as part of a Creditors' Committee's plan negotiations and case strategy. If the D&O policy contains an IVI exclusion, as most policies do, it is critical to consider the mechanism through which the claims will be pursued and the identity of the plaintiff who will pursue them. According to the Sixth Circuit, a DIP is the same entity as the prepetition company, and even a plan trustee will be viewed as a voluntary assignee who stands in the shoes of the prepetition company and will subject to the coverage exclusion. This is so even if the company or the DIP did not previously commence a lawsuit against the D&Os. It would appear that a trustee appointed in the context of a structured dismissal of a case — a popular yet controversial strategy employed in cases where neither a plan of reorganization nor liquidation can be confirmed — would fare even worse under this analysis.

Conclusion

Creditors' Committees must take note of the *Zucker* opinion and plan for its impact on their overall case strategy and plan negotiations where D&O Insurance coverage is being relied upon as a potential source of recovery for creditors. The only reason the insurance provider in the *Zucker* case did not have to provide coverage is because of who the plaintiff was, and the mechanism used to pursue the claims on behalf of the estate.

Having the wrong plaintiff or the wrong mechanism in place to pursue claims against D's & O's could result in losing the ability to recover value for creditors. Had the case simply been converted and a Chapter 7 trustee appointed to pursue the claims, or had the Creditors' Committee pursued the lawsuit itself, the insurance carrier would likely have been unable to hide behind the coverage exclusion, and creditors would not have been deprived of the value of estate assets that would have inured to their benefit, a result that would seem to be directly at odds with one of the fundamental objectives of the Bankruptcy Code.

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