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Feature

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Liquidation Trustee Cannot Recover Under D&O Policy Due to Insured-vs.-Insured Exception

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In a variety of contexts where reorganization through a plan is not possible, a liquidating plan is frequently the best end result for a chapter 11 case. This is often the preferred exit strategy for cases where sale processes have concluded and the primary remaining assets in the estate are potential causes of action. These assets are sometimes the only possible source of recovery for unsecured or undersecured creditors. As a part of the plan process, these creditors typically negotiate for the creation and control of liquidation trusts to pursue the actions.

However, a recent Sixth Circuit decision restricts the utility of this approach when underlying director and officer (D&O) liability insurance policies include "insured vs. insured" coverage exclusions. In *Indian Harbor Insurance Co. v. Clifford Zucker, et al.*,[1] the Sixth Circuit held that an insured-vs.-insured exclusion precluded coverage for a liquidation trustee's claims against a debtor's D&Os, finding that the debtor in possession (DIP) and prebankruptcy company were the same legal entity for purposes of the insured-vs.-insured exclusion. As the DIP was bound by the exclusion and voluntarily assigned the claims to the trust, the exclusion applied with equal force to the trustee's claims.

The Insured-vs.-Insured Exclusion

Insured-vs.-insured exclusions are intended to prevent collusive lawsuits where the insured company files suit against its own D&Os on account of their decisions in managing the company. The Sixth Circuit likened the exclusion to a homeowners' insurance policy exclusion for fires that the homeowner intentionally sets.[2] Insured-vs.-insured exclusions typically provide that subject to certain carveouts such as shareholder-derivative suits or employment claims, the policy does not cover claims against the insured parties by, on behalf of or in the name of the insured company. Here, the policy's insured-vs.-insured exception stated that "[t]he Insurer shall not be liable to make any payment for Loss in connection with any claim made against an Insured Person ... by, on behalf of, or in the name or right of, the Company or any Insured Person."[3] Prior to the Sixth Circuit's decision, there was no circuit-level case law on the question of whether claims assigned by a DIP to a liquidation trustee fall within the exception.

Background

Capitol Bancorp Ltd. was a bank-holding company that owned community banks in 17 states. Joseph Reid was its chairman and chief executive officer. His daughter, Cristin Reid, was Capitol Bancorp's president, and her husband, Brian English, was its general counsel. The U.S. financial crisis beginning around 2007 was debilitating to Capitol Bancorp, as many of its banks took losses when customers stopped repaying loans. In 2012, Capitol Bancorp and one of its subsidiaries filed for chapter 11 protection in the U.S. Bankruptcy Court for the Eastern District of Michigan.

Capitol Bancorp's efforts to reorganize were not long-lived. In 2013, Capitol Bancorp proposed three separate liquidation plans, each of which included releases for its executives. The creditors'

1 860 F.3d 373, 2017 WL 2641085 (6th Cir. 2017).
2 *Id.* at 375.
3 *Id.* at 386. The policy further defined "company" as "the parent Company [*i.e.*, Capitol Bancorp] and any Subsidiary created or acquired on or before the Inception Date set forth in item 2 of the Declarations or during the Policy Period, subject to General Conditions VI(D)." *Id.*

committee appointed in the cases objected to the releases in each plan and eventually moved for derivative standing to sue the executives. The bankruptcy court denied confirmation and the standing motion, forcing the parties back to the negotiating table.

Following significant negotiations, the parties reached a settlement that facilitated a consensual plan. By the settlement, the parties agreed that certain claims against Capitol Bancorp's directors and officers would be transferred to a liquidation trust to be administered by a third-party trustee, but that any recovery by the trust on the D&O claims would be limited to applicable insurance proceeds. The bankruptcy court approved the settlement and consensual liquidation plan, finding that the settlement and plan had been negotiated and proposed in good faith.

Following the creation of the liquidation trust, the trustee brought suit against the Reids and English in federal district court.[4] Thereafter, the insurer filed an action in the same court seeking a declaratory judgement that, *inter alia*, the insured-vs.-insured exclusion in the underlying insurance policy applied to the D&O claims. The district court held that the D&O claims fell within the exclusion and granted declaratory judgment for the insurer.[5] The Sixth Circuit agreed.[6]

The Court's Decision

In holding that the exclusion applied, the majority focused on the plain language of the contract and looked to nonbankruptcy case law regarding an assignee's rights. Rejecting certain critical bankruptcy-specific arguments detailed below, the majority found that a third-party liquidating trustee was the equivalent of the pre-petition company *vis-à-vis* claims assigned to the trustee through a court-approved process.

First, the majority rejected the proposition that a DIP is a legally distinct entity from the pre-petition company *in relation to the applicable insurance contract*, finding that certain facts and case law compelled the result.[7] The compelling facts included the following: (1) the policy's "change in control," which contemplated continuous coverage for the policy term if the company became a DIP; and (2) the debtor's renewal of the policy twice post-petition. In the court's view, these facts demonstrated the parties' understanding that the DIP and pre-petition company were the same entity. The court then found that bankruptcy case law did not alter the conclusion.[8]

The court recognized that a new legal entity — the bankruptcy estate — is created upon the filing of a bankruptcy petition and that the claims of the pre-petition company become the property of that estate.[9] However, the court did not find the creation of the estate as being dispositive. The court instead found that an estate does not act on its own but through the DIP, and therefore, the claim was still brought by the company (though on behalf of the estate).[10]

The majority further rejected the liquidation trustee's argument that the bankruptcy court's approval of the plan transferring the claims to the trust provided sufficient safeguards against the collusive behavior that the exception intended to guard against. In contrast to settled law, the majority went so far as to note that "because the exclusion also applied to claims 'in the ... right of' Capitol, it's not even clear that a court-appointed trustee or a creditors' committee could collect on the policy."[11] As the dissent pointed out, the majority of case law considering whether the exclusion applies to claims by a court-appointed chapter 7 or 11 trustee has determined that it does not.[12]

The Dissent

Hon. Bernice B. Donald, a former bankruptcy court judge, dissented. The dissent argued that the "assigned trustee in this case should have the same right to be exempt from the insured-versus-insured exclusion as a court-appointed trustee," noting that this result was supported by the language of the insurance contract and applicable precedent.[13] As to the contract language, the dissent argued that the liquidation trustee bringing a claim on behalf of the DIP, rather than the debtor company, did not fall within the plain language of the contract.[14]

The dissent further pointed to Sixth Circuit case law in a variety of contexts holding that a debtor company and an estate are separate legal entities.[15] Moreover, the dissent was unpersuaded by the majority's argument that the "new entity" argument would not work before a bankruptcy filing, pointing out that many companies file for bankruptcy specifically to obtain the special rights provided by the Bankruptcy Code *vis-à-vis* contracts.[16] As to the practical implications of the majority's opinion, the dissent poignantly states:

> If the majority's decision becomes settled precedent, this Court will send a clear message to creditors in chapter 11 proceedings that if claims against [D&Os] are deemed to be of significant value and the plan proposes to put those claims into a trust, the creditors must not agree to a plan proposed or even agreed to by the [DIP]. Instead, creditors will be required to seek the appointment of a bankruptcy trustee, where appropriate, or they will have to defeat the [DIP's] plan and propose their own disclosure statement and plan. The cost in terms of professional fees and judicial resources cannot be overstated, especially in light of the fact that there would be no practical difference to the insurance companies as they would still be required to defend the directors' and officers' claims.[17]

Instead of adopting a *per se* rule that D&O claims assigned to a trustee by a DIP fall within an insured-vs.-insured excep-

4 Although Ms. Reid was originally on the trust oversight committee, she resigned after the trustee filed the suit.
5 *Indian Harbor Ins. v. Zucker*, 553 B.R. 633 (W.D. Mich. 2016).
6 On July 5, 2017, the liquidation trustee's counsel moved for rehearing *en banc.*
7 *See Indian Harbor Ins.*, 2017 WL 2641085, at *3.
8 In particular, the court looked to the U.S. Supreme Court's *dicta* statements in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984), and reviewed general bankruptcy concepts. *Id.* at 377-78.
9 *Id.* at 378.
10 *Id.*
11 *Id.*
12 *See Willson v. Vanderlick (In re Cent. La. Grain Coop. Inc.)*, 467 B.R. 390 (Bankr. W.D. La. 2012) (suit by chapter 7 trustee); *Cohen v. Nat'l Union Fire Ins. Co (In re Cty. Seat Stores Inc.)*, 280 B.R. 319 (Bankr. S.D.N.Y. 2002) (suit by chapter 11 trustee); *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D. Del. 2002) (suit by estate representative); *Gray v. Exec. Risk Indem. Inc. (In re Molten Metal Tech.)*, 271 B.R. 711 (Bankr. D. Mass. 2002) (suit by chapter 11 trustee).
13 *Id.* at 379.
14 *Id.*
15 *Id.* at 379-80.
16 *Id.* at 380.
17 *Id.* at 382.

tion, the dissent proposes testing the independence of a trustee on a case-by-case basis.[18]

Practical Significance

The Sixth Circuit's decision creates significant uncertainty for parties seeking to resolve a case through assigning D&O claims to a liquidating trust where the underlying policy contains an insured-vs.-insured exception. At a minimum, parties to such negotiations must closely review the underlying policies.

Unlike the policy at issue in *Indian Harbor*, some policies include a bankruptcy carveout to the insured-vs.-insured exception. To the extent that no such carveout exists, creditors should carefully consider their options to maximize value, including seeking the appointment of a chapter 11 trustee, or obtaining derivative standing and transferring those claims to a liquidating trust. abi

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18 *Id.*