JOURNAL OF THE NATIONAL ASSOCIATION OF BANKRUPTCY TRUSTEES

NABTALK®

IN THIS ISSUE:

Remarks of Clifford J. White III, Director, Executive Office for U.S. Trustees at the NABT 2013 Annual Convention

The ABC's of D&O Claims for Trustees

Trustees: When Retaining Counsel, Don't Forget About Special Counsel

Nuts and Bolts of Pursuing Fraudulent Conveyance Actions in Bankruptcy Cases

Preference Action Primer: Key Strategies for Successful Prosecution by Trustees

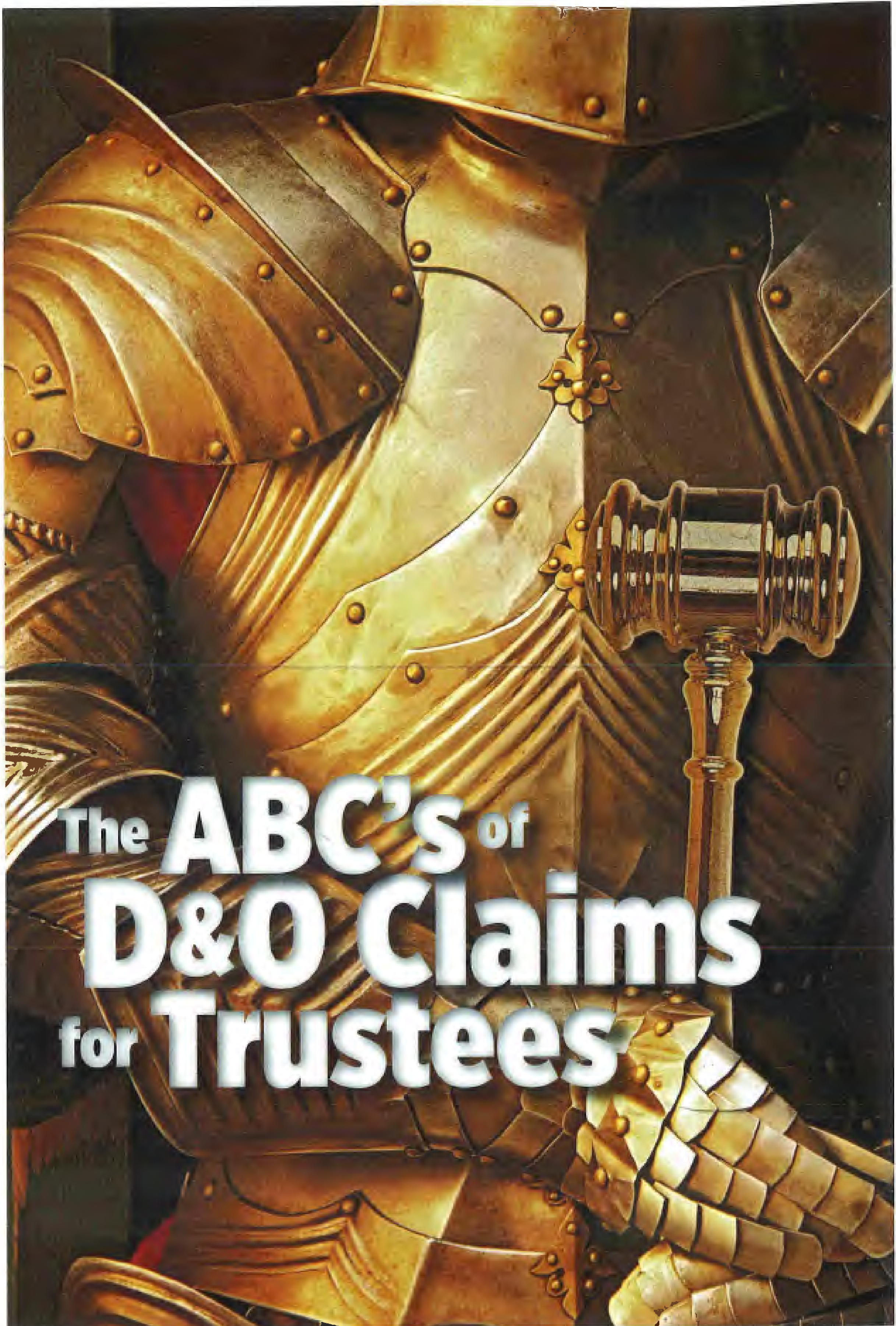
A Financial Advisor's Role in Chapter 7 Bankruptcies

You're Right, But Can You Prove It: Reliance on a Debtor's Business Records in Litigation

Ruminations on FED. R. BANKR. P. 2004

The Litigation Issue

FALL 2013
VOLUME 29
ISSUE 3



The ABC's of D&O Claims for Trustees

Kevin G. Hroblak and Cara C. Murray[1]

When a trustee is appointed, one of the many tasks is to assess property of the debtor's estate. Such property may include a corporate debtor's causes of action against its directors and officers. In assessing if claims may exist, a trustee may uncover deficiencies in the company's corporate governance, and specifically, conduct and decisions of the directors and officers that contributed to the company's downfall, wasted assets or otherwise harmed its enterprise value. But what should a trustee do with this information? Is the conduct actionable? Is there a business judgment or other defense that would bar recovery? Is D&O insurance available? This article briefly examines certain issues a trustee should consider in determining whether to pursue an investigation or lawsuit against a company's directors and/or officers.[2]

Fiduciary Duties

There are three principal fiduciary duties owed by directors of a for-profit corporation: care, loyalty and good faith.[3] These fiduciary duties are owed to the corporation and its shareholders. When a company is insolvent, however, the focus of these duties broadens to include the interests of creditors.[4] The primary reason for this shift is when a company is insolvent, the creditors, not the shareholders, become the primary residual interest holders of the company's value. Put another way, when the company is insolvent, its directors stand in a fiduciary relationship not only to the corporation upon whose board they serve and its shareholders, but also its creditors.[5]

The duty of care requires that directors and officers inform themselves of material information reasonably available to them, act in an informed and deliberate manner and exercise the degree of care that an ordinarily prudent person would exercise under the same or similar circumstances.[6] The majority of jurisdictions require gross negligence for a breach of the duty of care by directors, but a few states apply a simple negligence standard.[7]

To satisfy the duty of loyalty, directors and officers must "protect the interests of the corporation" and "refrain from doing anything that would work injury to the corporation or to deprive it of profit or advantage," including usurpation of a corporate opportunity and self-dealing.[8] To act in good faith, a director or officer must act at all times with "honesty of purpose and in the best interests and welfare of the corporation."[9] Examples of a lack of good faith include (i) "consciously and intentionally disregarding their responsibilities," (ii) intentionally acting "with a purpose other than that of advancing the best interest of the corporation" and (iii) in extreme cases, acting with the intent to violate the law.[10] Although officers may also have agency fiduciary duties in their role as agents of the corporation, their conduct is measured at least by the traditional directorial duties. Several states, unlike Delaware, have adopted statutes that address, or codify, the duties of directors and officers.

In addition to the traditional fiduciary duties of care, loyalty and good faith, directors owe other duties such as candor, oversight and transaction-related duties, which are often at issue with a financially-troubled company. The most common transaction-related duty, a "*Revlon* duty"[11] requires directors to obtain the best price for the company. This duty arises when a corporation "initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company," responds to a bidder's offer by abandoning a long-term strategy and seeking to break-up the company, or "when approval of a transaction results in a sale or change in control."[12] In such circumstances, directors cannot play favorites with bidders and must take an active role in overseeing a sale process designed to secure the highest value reasonably attainable.

KEY POINTS

1. When analyzing a potential D&O claim, a trustee must understand the nature and scope of the specific fiduciary duties owed by directors and officers.
2. A trustee must consider the business judgment rule and exculpatory provisions in the company's governing documents before filing suit.
3. A comprehensive understanding of D&O insurance policies is necessary to assess whether damages are recoverable for wrongful conduct of directors and officers.

Who Can Bring a D&O Claim?

In the corporate governance context, there are several parties that may sue for breach of fiduciary duty. First, the corporation itself, including through a receiver or a trustee, may bring claims for breach of fiduciary duty against the directors or officers for injury it sustained as a result of the directors' and officers' misconduct.[13] Second, shareholders or creditors may bring direct claims against the directors and officers for injury sustained directly by the specific shareholder or creditor that is individualized harm not suffered by the company or its shareholders or creditors as a whole.[14] Third, shareholders may bring derivative claims on behalf of a company, and creditors may also bring derivative claims on behalf of the company when it is insolvent, but these derivative claims become property of the debtor's estate upon the commencement of a bankruptcy proceeding.[15] In such cases, the corporate debtor-in-possession or trustee is properly substituted for the individual shareholder or creditor plaintiff in a derivative action.

Business Judgment and Exculpation

After determining that there is actionable conduct, a trustee should next consider the oft-cited "business judgment rule" and

About the Authors

Kevin G. Hroblak is a partner at Whiteford, Taylor & Preston L.L.P. ("WTP") and is co-chair of the firm's Litigation Department. Mr. Hroblak focuses his practice on representing trustees and companies in investigations and litigation of business fraud cases, director and officer liability claims, auditing malpractice, and other professional liability claims in state and federal courts across the country.

Cary C. Murray is an associate at WTP in the Business Reorganizations and Bankruptcy Litigation practice group. She concentrates her practice on Chapter 11 reorganizations, trustee representations and related litigation.

also whether there is an exculpation provision in the company's governing documents that would bar recovery of damages. The business judgment rule is a presumption that a director's decision was made on an informed basis, without self-interest, in good faith, and in the honest belief that the decision was in the best interest of the company and its shareholders and creditors, as applicable.[16] The rule protects against proverbial 20/20 hindsight, and if its elements are met, a director is insulated from liability for a breach of the duty of care, even if the decision at issue was a bad business decision. The business judgment rule, however, does not protect a director against breaches of loyalty or good faith. Additionally, because it is merely a rebuttable presumption, if there is evidence of bad faith, self-interest, a lack of information on which a decision is based or the absence of an actual board decision, the burden of proof shifts to the directors to prove that the challenged transaction or decision was "entirely fair" to the company.[17]

Another protection that directors may use to shield themselves from liability is an exculpation provision in the company's governing documents. The statutes of certain states, including Delaware, allow a company in its corporate documents to limit the recovery of monetary damages from directors.[18] Like the business judgment rule, these exculpation protections are not applicable where directors act in bad faith or disloyally, and the exculpation provisions generally protect only directors, not officers. A review of the relevant state's statute and the company's governing documents is important to understand the extent of protections and whether any damages are recoverable. A trustee particularly should be wary of contractual provisions in operating agreements of limited liability company debtors. These provisions may modify or even eliminate fiduciary duties owed by its managers.[19] Because limited liability companies are entities created and governed by contract (*i.e.* the operating agreement), parties to an operating agreement may contract around, create additional or eliminate traditional fiduciary duties.[20] Although the issue has not been squarely addressed by the Delaware Supreme Court, the current trend of cases is that managers of Delaware limited liability companies owe "default" fiduciary duties of care and loyalty.[21]

...if there is evidence of bad faith, self-interest, a lack of information on which a decision is based or the absence of an actual board decision, the burden of proof shifts to the directors to prove that the challenged transaction or decision was "entirely fair" to the company.

D&O Insurance

After analyzing potential legal obstacles to recovery, a trustee should next determine whether insurance may provide an avenue for recovery of the damages. Director and officer insurance, commonly referred to as D&O insurance, is typically comprised of three types of coverage known as Side A, Side B and Side C coverage. Side A coverage, which is relevant for claims involving directors and officers of a financially-troubled or bankrupt company, provides coverage directly to the directors and officers as named insureds under the policy when the company cannot or will not indemnify them for loss. This inability to indemnify generally arises because the insured company files bankruptcy or becomes insolvent. Side B coverage is a reimbursement or indemnity coverage for the corporate entity and provides insurance to the company for amounts it pays to the directors and officers for indemnification of claims made against them. Side C coverage also provides coverage for the corporate entity, but unlike Side B coverage, Side C coverage protects the company for claims brought against it directly, such as securities claims. In addition to the types of coverage, some companies have a "tower" of director and officer insurance, which consists of a primary insurance policy with one or more excess insurance carriers stacked on top of the primary coverage. The excess policies typically follow the form and terms of the primary policy, and the primary policy coverage, in most instances, must be exhausted completely before the excess carrier is obligated to provide any coverage. A trustee must review or seek advice on the terms of the base policy, the excess policies and all endorsements thereto because the policies are creatures of contract and as such are not uniform.

In analyzing whether insurance coverage exists, a trustee first should review the policy for the definition of "Wrongful Act," or other similar definition, to determine whether the suspected misconduct falls within the scope of insurance coverage. A "Wrongful Act" is typically defined as any act, error, misstatement, omission, neglect or breach of duty that is committed by the director or officer while acting in such capacity. The next definition to examine under the policy is "Loss." While a covered Loss is generally the damages that the director or officer would be liable to pay on account of the misconduct, the types of economic payments may be narrowed by the terms of the policy. For instance, while compensatory damages are typically covered, assuming no exclusions to coverage exist, coverage for punitive damages, penalties, fines, restitution, exemplary damages and disgorgement of monies varies by policy and by the law of the state that governs interpretation of the insurance policy.

If a Loss exists resulting from a Wrongful Act, the next inquiry is to determine whether the policy has been "triggered." Most director and officer insurance policies are "claims-made" policies, as contrasted with "occurrence" policies. This means that the claim for which coverage is sought must be made within the policy period, and must also be reported to the insurer within a prescribed period provided for in the policy. To connect the dots of coverage further, a trustee must examine whether a "Claim" has been made, or if the policy period has not expired, make such a Claim. The filing of a complaint is an obvious Claim, but policies and some courts have held other circumstances fit the requirement of making a Claim, including a pre-suit written demand and a notice of facts and circumstances. If a Claim is anticipated to be made after the expiration of the current policy period, the insureds (including a trustee for the insured company) should consider the purchase of an extended reporting period ("ERP") or "tail" coverage. The right of an insured to purchase an ERP is typically found within the policy and allows for the making and reporting of a Claim after the policy period, but only for conduct

...the claim for which coverage is sought must be made within the policy period, and must also be reported to the insurer within a prescribed period provided for in the policy.

giving rise to a Wrongful Act that occurred during the original policy period. This ERP or tail coverage, depending on the length, can close the gap between the end of a policy period and the expiration of an applicable statute of limitations for filing a claim.

Another somewhat unique aspect of a D&O policy, and one a trustee should be mindful of, is that it is an "exhausting" policy. In other words, every dollar of defense costs paid by the insurance carrier in defending the case against the directors and officers reduces the coverage limits available to pay a settlement or judgment. In other words, there is no separate coverage for defense costs of the litigation.

The next trip wires that a trustee must navigate in the policy are exclusions to coverage. For example, coverage is impacted by "Conduct" exclusions where a director or officer obtains illegal personal gain, engages in criminal misconduct or where there has been a final adjudication of fraudulent or dishonest acts. Another key exclusion that a trustee must analyze is the "Insured v. Insured" exclusion. This exclusion precludes coverage for claims brought by one insured against another insured, which often arises in a bankruptcy setting where a trustee, on behalf of the insured company, may sue the company's director and officer insureds. Most D&O policies, however, have carve-outs to the insured v. insured exclusion that generally cover shareholder derivative claims and claims brought by bankruptcy trustees, receivers and creditors' committees.

Conclusion

There are many aspects of investigating a director and officer claim that must be analyzed before asserting a cause of action. In addition to assessing whether a breach of fiduciary duty occurred and determining whether a trustee has standing to assert the claim, a trustee must consider the business judgment rule and review the relevant exculpatory statutes and corporate governing documents to determine whether, despite the misconduct, the directors are insulated from liability or from the payment of monetary damages. If those hurdles are overcome, an assessment of the collectability of the damages should be completed, including whether the directors and officers can satisfy a judgment personally and whether D&O insurance coverage exists, has been triggered and the conduct alleged does not fall within a coverage exclusion. Understanding these concepts of director and officer liability and D&O insurance prior to filing suit will assist in maximizing the value of the asset for the debtor's estate.

FOOTNOTES:

1 Any opinions expressed in this article are general in nature and may not apply to a specific factual context, and are also those of the authors and not necessarily those of Whiteford, Taylor & Preston L.L.P.

2 This article relies primarily on the law of Delaware, a common state of incorporation.

3 In some states, including Delaware, the duty of good faith has been subsumed within the duty of loyalty. *See, e.g., Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

4 *See Gheewalla v. N. Am. Catholic Educ. Found. Inc.*, 930 A.2d 92, 101 (Del. 2007).

5 *Id.*

6 *See Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985).

7 *Compare McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008) *with Resolution Trust Corp. v. Rahn*, 854 F. Supp. 480, 486 (W.D. Mich. 1994); *Fed. Deposit Ins. Corp. v. Raffa*, 882 F. Supp. 1236, 1245 (D. Conn. 1995).

8 *Guth v. Loft Inc.*, 5 A.2d 503, 510 (Del. 1939).

9 *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 755 (Del. Ch. 2005), *aff'd, Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.)*, 906 A.2d 27 (Del. 2006) ("Walt Disney II").

10 *See Walt Disney II*, 906 A.2d at 67.

11 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Paramount v. QVC*, 637 A.2d 34 (Del. 1994).

12 *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1289-90 (Del. 1994).

13 *Brandt v. Hicks, Muse & Co., Inc. (In re Healthco Int'l., Inc.)*, 208 B.R. 288 (Bankr. D. Mass. 1997) (applying Delaware law).

14 *Feldman v. Cutaia*, 951 A.2d 727, 733 (Del. 2008).

15 *See iXL Enterprises, Inc. v GE Capital Corp.*, 167 Fed. Appx. 824, 826 (2d Cir. 2006).

16 *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds, Brehm v. Eisner*, 746 A.2d 244, 255 (2000).

17 *See Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001).

18 *See* 8 Del. Code § 102(b)(7).

19 *See* 6 Del. C. § 18-1101(c) ("[t]o the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement...")

20 *Id.*; The ability to contract around fiduciary duties is consistent with the policy of the Delaware LLC Act. *See* 6 Del. C. § 18-1101(b) ("It is the policy of [the Delaware LLC Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.")

21 *See Feeley v. NHAOCG, LLC*, C.A. 2012 WL 6840577 (Del. Ch. Nov. 28, 2012) ("Until the Delaware Supreme Court speaks, the long line of Court of Chancery precedents ... provide persuasive reasons to apply fiduciary duties by default to the manager of a Delaware LLC").