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CAN A CHAPTER 11 LIQUIDATING TRUSTEE PURSUE CLAIMS UNDER THE DEBTOR'S D&O INSURANCE POLICIES? THE SIXTH CIRCUIT SAYS NO!

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Many plans of reorganization under Chapter 11 of the U.S. Bankruptcy Code[1] provide for the assets of the Chapter 11 debtor, including causes of action and claims under director and officer ("D&O") liability insurance policies, to be transferred to a liquidating trust. Pursuant to the plan and the terms of the trust, the liquidating trustee selected by the plan proponent is charged with pursuing the debtor's insurers for claims arising from breaches of fiduciary duty by officers and directors. The actions usually are brought on behalf of and for the benefit of unsecured creditors of the debtor.

In the June 2016 decision of *Indian Harbor Insurance Co. v. Zucker*[2] the U.S. Court of Appeals for the Sixth Circuit upheld the district court's decision that a lawsuit brought by the liquidating trustee constituted an "insured versus insured" lawsuit, which was barred by the terms of a management liability insurance policy issued by Indian Harbor Insurance Company. If widely followed, this decision could significantly reduce the utility of liquidating trusts, at least where claims under D&O policies are among the principal assets to be pursued. The costs of concluding Chapter 11 cases wherein D&O claims are among the principal assets would increase dramatically.

Facts

Capitol Bancorp ("Capitol") owned community banks in 17 states. Enervated by the financial crisis, in 2012 Capitol and its subsidiary, Financial Commerce Corporation, succumbed and filed Chapter 11 petitions. Unable to reorganize, Capitol decided to liquidate its assets, proposing three separate liquidation plans, each of which contained provisions releasing the company's executives from liability—and all of which were objected to by the creditors' committee. Meanwhile, the creditors' committee sought but was denied standing from by the bankruptcy court to sue the directors and officers on behalf of the estate.

In 2014, Capitol and the creditors' committee finally agreed upon a plan of liquidation pursuant to which all of Capitol's causes of action were assigned to a liquidating trust. The plan of liquidation provided that Capitol's directors and officers would have no liability for post-petition conduct, and any liability for pre-petition conduct would be limited to amounts recovered from Capitol's liability insurer, Indian Harbor Insurance Company. Prior to the bankruptcy, Capitol had purchased a one-year management liability insurance policy from Indian Harbor, which was extended twice during the bankruptcy case. The policy covered losses arising from a "Wrongful Act" committed during the policy period by "Insured Persons," a group of people which included Capitol's directors, officers and employees. However, the policy excluded from coverage "any claim made against an Insured Person . . . by, on behalf of, or in the name or right of [Capitol] or any Insured Person."[3]

In August 2014, the liquidating trustee sued the officers and directors for $18.8 million, alleging they had breached their fiduciary duties by actions taken pre-petition. The liquidating trustee notified Indian Harbor, which in response filed a declaratory judgment action seeking a ruling that it had no liability because the asserted claims fell within the "insured versus insured" exclusion. The district court held that the exclusion applied. The officers and directors and the liquidating trustee appealed.

Is the Debtor in Possession Different from the Pre-Petition Debtor?

The court began by noting that had Capitol sued the directors and officers for mismanagement pre-petition, the exclusion would clearly have applied. Does this change, asked the court, when the claimant is not the debtor but is a post-petition liquidating trust to which the claims have been assigned? Because the policy exclusion covers a lawsuit "by" Capitol, the court concluded that the exclusion also covers a lawsuit "by" the liquidating trust "in the . . . right of Capitol."[4]

The litigation trust trustee argued that, upon the bankruptcy filing, all of Capitol's assets were transferred to a bankruptcy estate under Code Section 541 for the benefit of Capitol's creditors. Pre-petition Capitol and the Capitol bankruptcy estate, argued the trustee, were legally distinct, making the insured versus insured exclusion inapplicable.[5] The court rejected this argument, stating that this "new entity" argument would not work pre-petition and that the same conclusion applied post-petition, and further noted that Capitol paid over $3 million in premiums post-petition to twice extend the policy.[6] Moreover, the construct that the debtor in possession is a wholly new entity was rejected by the U.S. Supreme Court in the *Bildisco* decision.[7] If Capitol were to emerge from Chapter 11, it would be the same "Company" covered by the policy.[8]

The court acknowledged that prior Sixth Circuit decisions treated the pre-petition debtor and the debtor in possession as legally distinct, for example, in connection with the prohibition of setoff of prepetition claims against debts arising by the other party post-petition.[9] However, the court concluded that "[E]ven if settings remain in which it makes good sense to treat the debtor and the debtor in possession as legally distinct, this is not one of them."[10]

The court also rejected the argument that bankruptcy court approval of the plan of liquidation and the liquidating trust was an adequate safeguard against the collusive lawsuits the insured versus insured exclusion was designed to prevent.[11] The risk of collusion, said the court, is higher when the insured persons in control of debtor in possession can negotiate and place conditions on the trustee's right to sue them.[12] Moreover, even though a contractual term was designed to prevent a problem like collusion, it was not necessary for collusion to be present for the contractual term to apply. The only question was whether, for the purposes of the insured versus insured exclusion, the term "the Company" included Capitol as debtor in possession. The court concluded that the "contract itself, together with the core principles of bankruptcy law, confirmed that it does."[13]

Would the Insured v. Insured Exclusion Extend to a Court-Appointed Trustee or a Creditors' Committee?

In addition to concluding that, in light of the insured versus insured exclusion, the debtor in possession and, by extension, a liquidating trustee as its assignee, could not bring a breach of fiduciary action against the insurer, the court raised the possibility that the exclusion may also bar a court-appointed trustee or an unsecured creditors' committee from bringing an action against the insurer. Any such lawsuit might be "in the . . . right of" Capitol, observed the court, and therefore excluded. On the other hand, a court might conclude that a breach of fiduciary duty claim becomes property of the estate immediately upon the bankruptcy filing, and any lawsuit brought by a trustee or creditors' committee would be in "name or right of the estate" and not Capitol. Raising the specter—but avoiding the issue—the court said that it was not necessary to "take sides on this debate today."[14]

The Dissent

Judge Bernice Donald forcefully dissented from the majority opinion. She began by noting that the primary purpose of the insured versus insured exclusion was to avoid collusion, and that many cases have held that court-appointed trustees are independent entities and therefore are exempt from the exclusion because there is no risk of collusion.[15] Judge Donald stated that there is no functional difference between a court-appointed trustee and an assigned trustee determined to be independent by the bankruptcy court.[16]

Viewing the exclusion in light of its plain language, it was clear that a lawsuit brought by an estate representative, such as a liquidating trustee, was not made "by the Company or any Insured Person" or on "behalf of an Insured Person." The trustee is an entity separate and distinct from the Company.[17] Judge Donald cited the Sixth Circuit's *Gordon v. Sel-Way* decision, which held that a "debtor-in-possession is considered to be a separate legal entity from the debtor himself,"[18] and other Sixth Circuit precedent holding that the bankruptcy estate and the debtor are separate legal entities, and that upon bankruptcy, a new entity is formed.[19] This conclusion was consistent with the fundamental principles of bankruptcy law,[20] said Judge Donald and, moreover, it was exactly what the parties had bargained for.[21]

Judge Donald then turned to the effects of the majority's decision, should it become settled precedent. Plans proposing to assign claims against directors and officers to liquidating trusts would be subject to objection, and creditors would instead have to move for the appointment of a Chapter 11 trustee, or, alternatively, the creditors would have to 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."[22]

Finally, Judge Donald addressed the majority's concern that the risk of collusion is higher with a liquidating trustee designated in the plan of reorganization or liquidation by the plan proponent (which may be the debtor in possession) than the risks present with a court-appointed trustee. To address this risk which underpins the insured versus insured exclusion, Judge Donald said the court should evaluate the liquidating trustee's independence on a case-by-case basis.[23]

Conclusion

Even if upon filing the debtor does not become a "wholly new entity," as *Bildisco* holds, the majority opinion seems to be inconsistent with prior Sixth Circuit precedent addressing the distinction between debtor and the debtor in possession or other estate representatives. More importantly, the majority's rigid and overly formalistic discussion of the risks of collusion which underpins the insured versus insured exclusion ignores the protective oversight role of the bankruptcy court. The debtor in possession, a creditors' committee, a court-appointed trustee or a liquidating trustee are all fiduciaries for creditors and subject to the oversight of the bankruptcy court. Their duty is to increase the estate for the benefit of creditors, a duty which seems far removed from the risk of an insured company collusively suing its insurer for breaches committed by its own covered officers and directors. Although this case is limited to a liquidating trustee, particularly troubling is the majority's suggestion that its holding might extend to actions brought against insurers by court-appointed trustees or by a creditors' committee.

The dissent, on the other hand, seems to have it right. Estate representatives acting as fiduciaries subject to bankruptcy court oversight—with little or no ability to collude—seem to be sufficiently distinct from the pre-petition debtor so as to be exempt from the insured versus insured exclusion aimed solely at preventing collusion. Moreover, the dissent appropriately highlights the contortions creditors would have to suffer to preserve a breach of fiduciary duty cause of action against an insurer which is clearly an estate asset, coupled with the significant expense engendered by such unnecessary machinations. It seems that neither the principles of the Code are upheld nor the interests of creditors served by the Sixth Circuit's approach.

Endnotes

[1] 11 U.S.C. §§ 101-1532 (the "Code").

[2] *Indian Harbor Insurance Company v. Zucker*, 860 F. 3d 373 (6th Cir. 2017).

[3] *Id.* at 375.

[4] *Id.*

[5] *Id.* at 376.

[6] *Id.*

[7] *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513 (1984).

[8] *Zucker*, 860 F.3d at 377.

[9] *See Gordon Sel-Way v. United States* (*In re Gordon Sel-Way*), 270 F.3d 280 (6th Cir. 2001).

[10] *Zucker*, 860 F.3d at 377.

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.* at 378.

[16] *Id.*

[17] *Id.* at *6.

[18] *Gordon Sel-Way*, 270 F.3d at 290.

[19] *Zucker*, 860 F.3d at 380, citing *Frank v. Mich. State Unemployment Agency*, 252 F.3d 852, 853 (6th Cir. 2001) and *Mgmt. Inv'rs v. United Mine Workers of Am.*, 610 F.2d 384, 392 (6th Cir. 1979).

[20] *Zucker*, 860 F.3d at 380.

[21] *Id.* at 381.

[22] *Id.* at 382.

[23] *Id.*

About the Author

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