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**An Overview of Selected Director and Officer Liability Insurance Issues that
Arise in the Context of Insolvencies of the Insured Companies**

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I. An Introduction to D&O Coverage

In today's business climate, directors and officers of corporations confront an ever-present risk of being sued for breach of duty by reasons of perceived deficiencies in corporate governance. As the Seventh Circuit has noted, "Litigation is an occupational hazard for corporate directors, albeit one that may often be shifted to the corporation through indemnification." *Hefferman v. Pacific Dunlop GNB Corp.*, 965 F.2d 369, 370 (7th Cir. 1992).

Particularly as a company moves towards insolvency, the responsibilities of directors and officers compound: their fiduciary duties are expanded to include responsibilities not only to shareholders but also to creditors. In a financially solvent company, directors and officers can look to corporate indemnification for the defense of lawsuits and protection against judgments and settlements, but when the company becomes insolvent, their only protection is often the company's director and officer ("D&O") liability insurance policy.

A. Mandatory vs. Permissive Indemnification

Before the advent of D&O insurance, directors and officers were dependent on the corporations they served for indemnification against claims against them in their capacity as directors and officers. All fifty states, by statute, provide for corporate indemnification, both permissive and mandatory. Most states, however, prohibit corporate indemnification of an officer or director who is unsuccessful in his or her defense, absent judicial approval.

Typically, state indemnification statutes *mandate* indemnification when a director or officer has been "successful on the merits or otherwise in defense" of any action. *See, e.g.*, Del. CLP §145. State statutes generally *permit*, but do not require, indemnification on a case-by-case basis, provided the director or officer acted: (1) in good faith; and (2) in a manner reasonably believed to be in the best interests of the corporation. In some states, such as New York, in addition to acting in good faith for a purpose which the director or officer reasonably believed to

be in the best interests of the corporation, a director or officer may also be indemnified where: (1) either a court orders indemnification; or (2) there is a post hoc determination made in the following manner that the director or officer is entitled to indemnification in the specific case: (a) by the board acting by a quorum of disinterested directors; (b) by independent legal counsel in a written opinion that indemnification is proper; or (c) by a majority vote of all shareholders.

Typically included within the scope of corporate indemnification are expenses, judgments, fines and settlements that directors and officers reasonably incur in actions against them by reason of their being directors or officers but, again, only if they act in “good faith” and in a manner they reasonably believe to be “in or not opposed to the best interests of the corporation.” *See, e.g.*, Del. CPL §145. These statutes also authorize corporations to advance the litigation expenses their directors and officers incur in such actions, and in practice, corporations routinely advance such expenses. The ability of corporations to advance defense expense, like providing broad indemnification rights, is considered to be critical to a corporation’s ability to attract qualified people to serve in management, especially given the substantial expense of defending director and officer litigation. Advancing litigation expenses also helps the corporation promote a common representation and coordinated defense. Generally, advancement can be conditioned upon the recipient’s undertaking to reimburse the corporation if the recipient ultimately is not entitled to indemnification or upon any other conditions the corporation requires, including the retention of counsel the corporation selects. However, advancement is not indemnification, but a loan in anticipation of indemnification.

A corporation may, of course, provide greater protection, via the corporation’s certificate of incorporation or by-laws, than that granted by statute, and on this basis, many corporations have sought to ameliorate the “occupational hazard” of litigation by adopting indemnification provisions that are not only broad but also mandatory. Unless there has been a judgment or other final adjudication determining that the director or officer acted in bad faith or was deliberately dishonest, a by-law can make permissive indemnification mandatory. There are also limitations on permissive indemnification according to the type of action for which indemnification is being sought. Generally, indemnification against judgments, fines, settlement payments and

reasonable litigation expenses is permitted with respect to third-party (non-derivative) actions. But with respect to derivative actions, indemnification is often more limited. In New York, for instance, indemnification of fines and judgments is prohibited, and if a derivative action settles or a director or officer is found liable to the corporation, indemnification is permitted only if a court, upon application, determines that the director or officer is fairly and reasonably entitled to indemnity for such portion of the expenses and/or settlement amount as the court deems proper in view of the circumstances of the case.

As a consequence of obligatory advancement provisions in the by-laws of a corporation, the board of directors may not have any discretion in determining whether to advance fees. However, in the context of commercial D&O insurance for large public companies, securities entity coverage and/or fiduciary coverage present risks of erosion or exhaustion that may leave the individual directors and officers without coverage. With financial services companies, the inclusion of professional liability coverages in combined programs similarly presents an additional threat of erosion or exhaustion.

B. Types of Coverages Afforded by D&O Policies

D&O policies generally provide coverage against third-party litigation and typically provide for payment of defense costs as part of the limit of liability. D&O policies are ordinarily obtained by the company, which pays the premiums and to which the policies are issued. Public-company D&O policies typically have three basic insuring agreements, often referred to as Side A, Side B, and Side C.

Side A is the coverage that applies when the company cannot indemnify directors for claims against them. A company cannot indemnify its directors and officers if it is insolvent. In most cases, it also is not permitted to indemnify directors or officers for settlements and judgments in derivative actions (lawsuits brought on behalf of the company against the directors or officers). Even the attorney's fees spent in defending such a derivative lawsuit may not be indemnifiable if a director or officer is ultimately adjudged liable to the corporation. In those

instances – that is, where the company is bankrupt or where indemnity is prohibited by law—a director would look to Side A coverage for protection.

Side B coverage, on the other hand, is really a form of company coverage. Under Side B, the insurer reimburses the company for the expense of indemnifying its directors or officers as a result of claims made against them. Thus, while Side A operates a personal asset protection for the directors and officers, Side B operates as balance-sheet protection for the company.

Side C coverage insures the company for claims made directly against it, commonly referred to as “entity coverage.” In public-company D&O policies, the company is usually only covered for securities law claims, i.e., suits brought by a shareholder against the company in connection with the purchase or sale of securities. In contrast, Side A and B are not limited to claims brought by shareholders, but instead, subject to exclusions, cover claims based on a variety of acts committed by a director or officer in his or her capacity as such.

In the last few years, a number of companies have begun adding a stand-alone Side A policy to their insurance programs. As noted above, Side A covers directors or officers for non-indemnifiable claims (when the company is insolvent or not permitted to indemnify, such as for settlements and judgments in derivative lawsuits).

There are a number of advantages to a stand-alone Side A policy. Since a traditional policy combines Side A, B, and C, there is always a danger that the limit of the policy can be exhausted—that is, used up in paying claims if claims against the company or indemnifiable claims are paid before non-indemnifiable claims. In contrast, if a company has a stand-alone Side A policy, the policy can never be used to cover claims against the company or to reimburse the company or the cost of honoring its indemnity obligations. The stand-alone Side A policy is coverage dedicated to those instances in which indemnity is not available.

If a company files for bankruptcy, a bankruptcy trustee may seek to freeze the policy, claiming that the policy proceeds are in asset of the estate. This risk is particularly acute where the policy provides Side C coverage (*i.e.*, protects the company for claims made directly against

it). If the trustee is successful in making such a claim, directors may find themselves without the D&O policy just when they need it most. A stand-alone Side A policy, on the other hand, is virtually immune to such claims by a bankruptcy trustee.

II. Current Hot Topics in the D&O Insurance World

A. Advancement of Defense Costs

Advancement of defense costs under D&O policies has become a hot topic, particularly in the context of company insolvencies, as the insureds and their insurers struggle to strike a balance between often competing concerns. If, because of insolvency, a company cannot meet its indemnification obligations, directors and officers will look to their D&O policies to advance their defense costs. Most D&O policies allow for advancement of defense costs, prior to the final disposition of a claim, subject to an undertaking by the director or officer, whose defense costs are being advanced, that the director or officer will repay any amounts advanced, if it is ultimately agreed or established that the carrier has no liability to that director or officer for that claim.

Advancements of defense costs in the context of insolvent companies carry additional complications, because often accompanying a company's insolvency are revelations that the company's financials were misstated or that other material information was misrepresented or omitted in the underwriting of the D&O policies, necessitating rescission of those policies by the carriers or the application of other, relevant policy exclusions.² When a carrier has rescinded a

² The elements of rescission vary from state to state, and many states have codified the standards for rescission. *See, e.g.,* LA. REV. STAT. ANN. § 22:619 (West 1978 & 1994 Supp.); R.I. GEN. LAWS § 27-18-16 (1979); TEX. INS. CODE § 21.16 (Vernon 1981); DEL. CODE ANN. tit. 18, § 2711 (1989); FLA. STAT. ANN. § 627.409 (1996); 215 ILL. COMP. STAT. ANN. 5/154 (West 1997); MASS. GEN. LAWS ch. 175, § 186 (1998); WASH. REV. CODE ANN. § 48.18.090 (West 1999); VA. CODE § 38.2-309 (Michie 2004). As recent cases show, judicial interpretations of rescission requirements vary by state, as well as by the terms of the insurance policy and the underlying facts. *See Associated Elec. & Gas Ins. Servs., Ltd. v. Rigas*, 2004 WL 540451 (E.D. Pa. Mar. 17, 2004); *In re HealthSouth Corp. Insurance Litigation*, 308 F. Supp.2d 1253 (N.D. Ala. 2004); *Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F. Supp.2d 1253 (W.D. Wash. 2004); *Federal Ins. Co. v. Tyco Int'l Ltd.*, 784 N.Y.S.2d 920 (Table), 2004 WL 583829 (Sup. Ct. Mar. 5, 2004); *In re Adelphia Communications*, 298 B.R. 49 (S.D.N.Y. 2003). Generally speaking, an insurer must prove some or all of the following elements in order to rescind a policy: (1) the making of a representation; (2) the falsity of the representation; (3) the materiality of the misrepresentation; (4) the insurer's

D&O policy as void *ab initio* or asserts other defenses to coverage, the question then becomes whether that carrier must continue to advance defense costs pending a judicial determination of the coverage issues.

Recent case law suggests that courts are more reluctant to permit a carrier to stop advancing defense costs before a final decision on coverage issues where the company to which the D&O policy was issued is insolvent. *See, e.g., In re Worldcom, Inc. Securities Litig.*, 354 F.Supp.2d 455 (S.D.N.Y. 2005) (with respect to D&O policy of an insolvent entity, holding that carrier was required to advance defense costs during pendency of rescission action); *Associated Elec. & Gas Ins. Servs., Ltd. v. Rigas*, 382 F.Supp.2d 684 (E.D. Pa. 2004) (same). In *Great American Ins. Co. v. Gross, et al.*, 2005 WL 1048752 (E.D. Va., May 3, 2005), the court granted a motion for preliminary injunction, obligating the insurer to continue to advance defense costs to two officers of an insolvent insurance company who had pled guilty to insurance fraud in a related criminal investigation, notwithstanding the insurer's assertion of the fraud exclusion. The court appeared to base its decision in that case on its view that the guilty pleas concerned narrower grounds than those alleged in the underlying litigation and on the officers' argument that they could not defend the underlying actions, absent the insurer's continued advancement of defense costs. The court did not appear to be concerned by the inconsistency in the officers' argument that, while they lacked the resources to fund their own defense, the insurer could recoup any amounts that were later determined not to be owed under the policy.

In contrast, in *Gaon v. Twin City Fire Ins. Co.*, No. 1:05-CV-04477-KMW (S.D.N.Y. Jun. 3, 2005), the U.S. District Court for the Southern District of New York denied a motion for preliminary injunction that would have required the D&O carrier of a bankrupt corporation to advance defense costs to two former officers of the corporation. The carrier had denied coverage as a result of a misrepresentation in the application process. Among other things, as in *Great American Ins. Co. v. Gross*, the former officers argued that they would be irreparably harmed if

reliance on the misrepresentation in underwriting the policy; and (5) in some jurisdictions, the insured's knowledge of the representation's falsity.

they were not awarded defense costs because they would be unable to fund the ongoing litigation, whereas the carrier would not be harmed by advancing defense costs because it was obligated to do so under the policy and the officers would agree to repay the defense costs if the court ultimately determined that there was no coverage. In denying the officers' motion for preliminary injunction, the court noted that if the officers could not afford the defense costs now, then they likely could not repay the carrier at a later time and concluded that, even assuming the officers would suffer irreparable harm, that factor alone was not sufficient to support issuance of the requested injunction. *See also National Union Fire Ins. Co. of Pittsburgh v. Ambassador Group, Inc. (In re Ambassador Group, Inc. Litig.)*, 1991 WL 110033784 (E.D.N.Y. Feb. 27, 1991) (denying request by directors of collapsed insurance company for payment of legal fees pending determination of carrier's liability under a D&O policy, while noting "if, as the Ambassadors Directors contend, they do not have funds available to finance their own defense, then any advances made for legal costs will surely be irrecoverable").

B. Zone of Insolvency

An emerging trend among numerous courts is the imposition of a common law duty running from a corporation's board of directors to the corporation's creditors. This duty to creditors has been imposed in situations where, although the corporation has not yet filed for bankruptcy protection, the corporation is virtually on its financial death bed. This duty to creditors is often referred to as the "zone of insolvency theory," "deepening insolvency theory" or the "vicinity of insolvency theory." The trend in imposing a fiduciary duty to creditors appears to be at odds with the traditional idea that a corporation's board of directors owes a fiduciary duty exclusively to its shareholders.

1. Background

Outside of bankruptcy, the traditional rule is that so long as a corporation is solvent, the obligations of its officers and directors, including the duties of care and loyalty, run to stockholders, not creditors. *See, e.g., Simons v. Conan*, 549 A.2d 300, 303 (Del. 1988).

Directors owe a duty of care and duty of loyalty to the corporation on whose board they serve, and to the corporation's shareholders. However, when an entity is operating in the "vicinity" or in the "zone of insolvency," many courts have extended the obligations of directors to include creditors as well.

The zone of insolvency theory holds that the debtor's property is "damaged" if an officer, director or third party professional prolongs the life of a corporation after it has become insolvent, to the detriment of creditors and other interest holders. According to the zone of insolvency theory, such harm to the corporation can be averted, and the value of the insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than continuing losing operations that have the effect of "deepening" the company's insolvency.

In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991), the Delaware Chancery Court offered yet another reason for treating officers and directors of an insolvent corporation as fiduciaries of creditors. Accordingly to the court, since a company that is insolvent or "in the vicinity of insolvency" is of little or no value to its stockholders, stockholders have an incentive to pursue high-risk strategies to increase the value of their investment. If the strategy proves successful, the stockholders' position is improved. If the strategy fails, the entire cost is borne by creditors. If, however, directors are deemed to be fiduciaries of creditors, directors would be prohibited from taking action that promotes only the interests of stockholders.

Thus, in *Credit Lyonnais*, the court held that the board of MGM/Pathé Communications Co. had not acted improperly in refusing to permit the company's controlling stockholder, who lost control of the company to the banks that held pledges of his stock, to liquidate assets at "fire sale" prices and engage in other desperate attempts to raise enough cash to regain control. The court held not that fiduciary duties of directors abruptly shifted from stockholders to creditors upon the occurrence of insolvency, but rather that the board had a duty to serve "the community of interests that sustained the corporation, the exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity. 1991 Del. Ch. LEXIS 215, at

*108-09. The court reasoned that directors could solve the problem of representing competing interests “by conceiving of the corporation as a legal and economic entity,” and by recognizing that “circumstances may arise when the right (both the efficient and the 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. *Id.* at *108-09 n. 55.

Directors owe a duty of care and a duty of loyalty both to the corporation on whose board they serve and to the corporation’s shareholders. However, when an entity is operating on in the “vicinity” or in the “zone of insolvency,” many courts have extended the obligations of directors to include creditors as well.

2. Zone of Insolvency Tests

The test for whether a company is in the “zone of insolvency” is not an exact science and has been applied differently by several courts. There are two distinct tests for insolvency that a court will utilize: (1) the balance sheet test and (2) the cash flow or equity test. *See LaSalle Nat’l Bank v. Perelman*, 82 F. Supp.2d 279, 291 (D. Del. 2000) (analyzing the solvency of a corporation using both the balance sheet test and the cash flow test). If a company satisfies either of these tests, a court may hold that it was operating in the zone of insolvency.

The balance sheet test inquires whether on a given date, the fair value of the corporations’ liabilities exceed the fair market value of its assets. Under this test the corporation must assign a fair market value to its assets, and must also estimate the amounts that will ultimately be required to pay on account of contingent liabilities. *See Brandt v. Hicks, Muse & Co. (In re Healthco. Int’l, Inc.)*, 208 B.R. 296, 301 (Bankr. D. Mass. 1997).

The cash flow test focuses on a company’s ability, on any given date, to produce sufficient cash (which can be derived from continuing operations, dispositions of assets and other capital raising activities) for the payment of debts as they become due. *See LaSalle Nat’l Bank*, 82 F. Supp.2d at 290.

Once a court determines that a company was in the zone of insolvency, the court will look to see if the directors and officers breached their fiduciary duties to creditors. However, courts disagree about whether the business judgment rule applies to directors and officers of corporations that are insolvent or in the zone of insolvency. Some courts have applied the business judgment rule to decisions by directors and officers of these corporations. *See Angelo Gordon & Co., L.P., v. Allied Riser Comm. Corp.*, 805 A.2d 221, 229 (Del. Ch. 2002). Other courts have ruled that the business judgment rule will not apply to decisions by directors and officers of an insolvent corporation. *See Unsecured General Creditors Committee v. General Homes Corp.*, 199 B.R. 148, 151-152 (S.D. Tex. 1996).

3. Recent Case Law on the Zone of Insolvency

The Delaware Court of Chancery has addressed key questions involving the obligations of and protections afforded to directors of insolvent corporations. In *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. Nov. 17, 2004), Vice Chancellor Strine of the Delaware Court of the Chancery articulated several important concepts as follows. First, the court explained that the Court of Chancery's landmark 1991 decision in *Credit Lyonnais*, which established the principle that the beneficiaries of a director's fiduciary duty expand to include creditors if the corporation is insolvent or in the "vicinity of insolvency," was actually intended to be a shield to protect directors from claims by shareholders that they acted too conservatively in managing the corporation's affairs.

Second, the court noted that the expansion of a director's fiduciary duty when a corporation is insolvent or in the zone of insolvency does not create a new body of creditor's rights law, but simply gives creditors of an insolvent corporation standing to assert a claim for a director's breach of fiduciary duty, which duty continues to be owed to the corporation itself. Third, a breach of fiduciary duty claim brought by a creditor of an insolvent corporation remains a derivative claim owned by the corporation, not a direct claim owned by the creditor. Fourth, the business judgment rule applies to claims brought by creditors of an insolvent corporation, as well as those brought by shareholders; and fifth, exculpatory provisions in the certificates of

incorporation of most Delaware corporations protecting directors from claims for monetary damages for breaches of the fiduciary duty of care, included under authority of Delaware General Corporation Law Section 102(b)(7), apply to derivative claims brought by creditors of an insolvent corporation as well as by shareholders.

The *Production Resources* decision is good news for directors of Delaware corporations. The Court rejects a trend among some courts and commentators of imposing a new set of fiduciary duties on directors in favor of creditors of insolvent corporations or those in the zone of insolvency in reliance on the 1991 Chancery Court decision in *Credit Lyonnais*. The court noted that directors of a solvent corporation are expected to undertake economic activities to maximize the value of the corporation's cash flows primarily for the benefit of the shareholders – the residual risk-bearers. When a corporation is insolvent, the creditors become the residual risk-bearers. Even so, directors must attempt “to maximize the economic value of the firm.” While the insolvency causes the creditors to “become exposed to substantial risk as the entity goes forward,” a risk that directors must consider, the court clarified that the “fact of insolvency does not change the primary object of the director's duties, which is the firm itself.”

C. Priority of Payments

Another issue that arises when an insured company becomes insolvent is whether the D&O policy is available to the individual directors and officers at all. Many courts have held that insurance policies, including D&O policies, issued to an insolvent company, are “property of the estate” of the debtor, subject to the automatic stay under Section 362 of the Bankruptcy Code. *See, e.g., MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89, 92 (2d Cir. 1988); *In re Minoco Group of Cos., Ltd.*, 799 F.2d 517, 519 (9th Cir. 1986); *In re Cybermedica, Inc.*, 280 B.R. 12, 16 (D. Mass. 2002). Although their conclusions are largely fact-driven, courts disagree as to whether the *proceeds* of a D&O policy, as contrasted with the policy itself, are property of the estate. Some courts have held that, if the debtor does not have a direct or immediate interest in the proceeds of a D&O policy, the proceeds are not property of the debtor's estate. *See, e.g., Louisiana World Exposition, Inc. v. Federal Ins. Co. (In re*

Louisiana World Exposition, Inc.), 832 F.2d 1391, 1400-01 (5th Cir. 1981); *In re Youngstown Osteopathic Hosp. Ass'n*, 271 B.R. 544, 550-51 (Bankr. N.D. Ohio 2002); *see also Houston v. Edgeworth (Matter of Edgeworth)*, 993 F.2d 51, 56 (5th Cir. 1993) (“When the debtor has no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate.”). In the context of a D&O policy, the existence of entity coverage may weigh in favor of a determination that both the policy and its proceeds are property of the estate, but the mere inclusion of entity coverage does not necessarily provide a sufficient predicate to convert the proceeds into estate property. *Ochs v. Lipson (In re First Central Fin. Corp.)*, 238 B.R. 9, 17 (Bankr. E.D.N.Y. 1999).

One way in which directors and officers may seek to protect their access to their company’s D&O policy proceeds, in case of the company’s insolvency, is through a priority-of-payments clause providing that the nonindemnifiable losses of individual insureds will be paid before any loss of the entity. In its simplest form, such a clause states, “In the event of Loss arising from a covered Claim, the Insurer shall first pay Loss for which coverage is provided for directors and officers.” The primary intent of a priority-of-payments clause is to give priority to the individuals when the proceeds of the D&O policy are distributed: the liabilities of the individuals (the directors, officers or trustees, for example) will be recognized first and the remainder of the limit is then available for the corporation's loss.

In the Enron bankruptcy, Enron’s primary D&O carrier and certain of Enron’s present and former directors and officers moved for relief from the automatic stay to permit payment and/or advancement of defense costs in multiple underlying lawsuits to individual directors and officers. The motions were opposed by a number of different parties, including the Official Committee of Unsecured Creditors (the “Committee”). The Committee argued that the D&O policy provides entity coverage to Enron for the actions pending against it and that the D&O policy proceeds are property of the estate that should be preserved to satisfy the Committee’s own claims against certain Enron directors and officers. In contrast, the outside directors argued that even though the D&O policies also insure the corporation, they were obtained primarily for the protection of management, and thus, the policy proceeds are not the property of the estate. In

support of this argument, the outside directors relied heavily on an endorsement to Enron's primary D&O policy that provides a first-priority payment to directors and officers before any payment may be made to Enron.³

In an oral ruling from the bench on April 11, 2002, the Bankruptcy Court sided with the outside directors, thus allowing payment by Enron's lead D&O insurer of millions of dollars to cover defense costs. This ruling is being appealed.

In another high-profile bankruptcy case – the Adelphia bankruptcy – the Bankruptcy Court found both the presence of indemnification and entity coverage and the lack of a priority-of-payments clause in the D&O policy at issue significant in concluding that the proceeds of the policy are assets of the debtor, subject to the automatic stay. *In re Adelphia Comm. Corp.*, 285 B.R. 580, 586-87 (Bankr. S.D.N.Y. 2002), *vacated and remanded by In re Adelphia Comm. Corp.*, 302 B.R. 439 (Bankr. S.D.N.Y. 2003). The District Court, however, held that the proceeds of the D&O policy were not *yet* property of Adelphia's bankruptcy estate because the debtor had not made any payments for which it would be entitled to indemnification coverage, because no such payments were contemplated, and because the debtor had not committed itself to payments using its entity coverage. *In re Adelphia Comm. Corp.*, 302 B.R. 439, 53-54 (Bankr. S.D.N.Y. 2003). On remand, while acknowledging its duty to comply with the District Court's "mandate," the Bankruptcy Court went to some lengths to question the soundness of the District Court's holding that the proceeds of the D&O property were not "yet" the property of the bankruptcy estate. *See In re Adelphia Comm. Corp.*, 302 B.R. 454 n.38 (Bankr. S.D.N.Y. 2003) (noting that a number of Supreme Court and Second Circuit cases hold that "property" of the estate "does not depend on whether enjoyment of the property is contingent or must be

³ The policy at issue contained the following "Priority of Payments Endorsement":

(7) With respect to the ULTIMATE NET LOSS for which payment is due the INSURER shall: first, pay such CLAIM which is covered by Insuring Agreement (A)(1), and then with respects [sic] to any remaining Limits of Liability after the payment of any CLAIM made under Insuring Agreement (A)(1), at the written request of the chief executive officer of the COMPANY, either pay or withhold payment of such remaining portion of the ULTIMATE NET LOSS for which coverage is provided under this Policy.

postponed” and emphasizing the fact that cases characterizing policy proceeds as property of the estate involved indemnification or entity coverage).

Open questions remain in situations where a priority of payments clause directs payment, first, to individuals insured under a D&O policy before payments to the corporation can be made but where there are varying exposures and varying defense costs among the individuals. Particularly where the policy would exhaust before the claims of the individuals can be satisfied, the question then becomes how to determine the priority of payments as among the individuals.

In a motion to lift the automatic stay to permit payment/advancement of defense costs under its D&O policy that was ultimately denied on procedural grounds, Enron argued that there was no basis for distinguishing among its directors and officers in terms of coverage rights, and regarding any concern that wrongdoers might benefit, Enron asserted that the repayment undertakings signed by each individual director and officer would insure that such individual would repay any amounts advanced if a court finally determined that their behavior did not entitle them to coverage. In *Anglo-American Ins. Co. v. Molin*, 670 A.D. 194 (1995), the Commonwealth Court of Pennsylvania held that a carrier should not be precluded from accepting a reasonable settlement offer for fewer than all insureds, even though that settlement would exhaust coverage under the D&O policy and leave the non-settling insureds without coverage for their defense costs. See also *Millers Mut. Ins. Assoc. of Illinois v. Shell Oil Co.*, 959 S.W.2d 864 (1998) (permitting an insurer to terminate its duty to defend and indemnify an additional insured upon paying the policy limit in settlement of a claim against the named insured). In contrast, in non-D&O, non-insolvency contexts, courts have held that, where an insurer settled a claim on behalf of one insured for the full amount of a policy, it acted in bad faith with respect to the other insureds who were left exposed. See *Smoral v. Hanover Ins. Co.*, 37 A.D.2d 23 (N.Y. 1st Dep’t 1971); *Shell Oil Co. v. Nat’l Union Fire Ins. Co. of Pittsburgh*, 44 Cal.App.4th 1633, 1648 (Cal. App. 1996).

III. Conclusion

Corporate directors and officers are subject to potential liability from a number of sources, including suits by shareholders on behalf of the corporation and suits by third parties based on allegations concerning the directors' and officers' action or inaction. Although D&O policies offer individual directors and officers coverage for defense costs and protection from settlements and judgments in these cases, where the company that the directors and officers serve becomes insolvent, various issues complicate the directors' and officers' access to the D&O policy proceeds.