DIRECTORS' AND OFFICERS' LIABILITY
BANKRUPTCY STAYS OF LITIGATION AGAINST NON-DEBTORS

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Most courts have held the "insured versus insured" exclusion in D&O liability insurance policies does not bar coverage for claims brought by a bankruptcy estate representative against directors and officers, making the D&O policy a key source of potential recovery by estates asserting claims against directors and officers of the debtor. Because the estate rarely is alone in seeking recovery from D&O policies, bankruptcy trustees are increasingly commencing adversary proceedings seeking to enjoin the prosecution of shareholder plaintiff claims against directors and officers outside of bankruptcy that threaten to erode D&O liability insurance proceeds from which both shareholders of the debtor and the bankruptcy estate seek to recover. Courts have reached divergent results when deciding the circumstances under which section 105(a) of the Bankruptcy Code authorizes bankruptcy courts to enjoin non-bankruptcy proceedings that might result in the erosion of D&O liability insurance proceeds. Last month, a federal district court issued a thoroughly reasoned decision affirming the power of a bankruptcy court to preliminarily enjoin suits to which the debtor is not a party and which do not involve claims that are property of the estate, but which still may affect the amount of property ultimately available to the estate. The decision properly acknowledges that the determination of whether to stay a suit that does not directly involve the debtor entails a separate inquiry from the determination of whether D&O policy proceeds are property of the bankruptcy estate, and that a bankruptcy court's "related to" jurisdiction is broad enough to stay claims seeking recovery against D&O policy proceeds pending the outcome of the bankruptcy proceeding.

Bases for Stay

The automatic stay of non-bankruptcy proceedings against a corporate debtor ordinarily does not extend to non-debtors, so that litigation against directors and officers of the debtor usually may proceed unless the litigation threatens to impair the debtor's ability to pursue reorganization efforts under Chapter 11.[1] The three statutory bases and one equitable basis under which bankruptcy courts may enjoin suits against the debtor, however, also permit extension of the injunction to suits involving assets and property in which the debtor has an interest. The most familiar provisions are 11 U.S.C. § 362 (a)(1), which imposes an automatic stay of any proceeding "commenced or [that] could have been commenced against the debtor" at the time of the bankruptcy filing, and § 362(a)(3), which stays an action involving the

possession or custody of property of the estate, irrespective of whether the suits are against the debtor or others. "Property of the estate" includes "all legal or equitable interests of the debtor in property," including insurance policies.[2] The proceeds of D&O policies that include entity coverage are increasingly being recognized as property of the estate, although most courts have lifted the automatic stay to permit directors and officers to receive advancement of defense costs under such policies.[3] These decisions pragmatically recognize that even though "[f]or every dollar paid out to the officers and directors there is one less dollar of coverage protecting the debtor's estate," no need exists to enforce an estate's property right unless "claims against the debtor threaten to become a 'free-for-all' that might exhaust the insurance proceeds and thereby jeopardize estate assets over and above the limits of the policy."[4]

Corporate by-laws often obligate the company to indemnify, to the fullest extent permitted by applicable law, its directors and officers for any judgments against them in lawsuits challenging actions taken by them in their official capacity, and to advance the litigation expenses of directors and officers in defending these actions. In a widely cited decision in *A.H. Robins Co., Inc. v. Piccinin*,[5] the Fourth Circuit held that actions seeking recovery from corporate officers and employees who are entitled to indemnification by the debtor may be stayed under section 362(a)(3) because the indemnification obligation may directly affect the debtor's assets. Recent decisions have tended to interpret this principle narrowly, extending the 362(a)(3) stay to shareholder litigation against directors and officers only where director and officer claims for indemnification are likely to represent a sizable portion of the estate, or where the litigation itself will divert existing directors and officers from reorganization efforts.[6]

The statutory power of the bankruptcy court to stay actions involving the debtor or its property, however, is not limited to sections 362(a)(1) and (a)(3). Section 105(a) of the Bankruptcy Code provides that a court "may issue any order, process or judgment that is necessary or appropriate to carry out" the purposes of the bankruptcy. This provision permits a bankruptcy court to enjoin any proceeding that arises under, arises in, or is related to a bankruptcy case. In *Celotex Corp. v. Edwards*,[7] the Supreme Court defined proceedings "related to" the bankruptcy to include (i) claims belonging to the debtor that are property of the estate under section 541 of the Code, and (ii) actions between third parties which have an effect on the estate. As the Seventh Circuit has noted, there is "no conflict between affirming the power and the responsibility of the bankruptcy court to preliminarily enjoin 'suits to which the debtor need not be a party but which may affect the amount of property in the bankruptcy estate,' and recognizing the freedom . . . of creditors to bring suits that are 'only nominally against the debtor because the only relief sought is against his insurer,' guarantor or other similarly situated party."[8] The bankruptcy court's statutory powers to stay litigation are supplemented by its general equity powers to grant stays in furtherance of the efficient management of litigation.[9]

Megliola

Last month, an Illinois federal court affirmed a bankruptcy court ruling granting a Chapter 7 trustee's motion for a preliminary injunction staying a federal securities class action against former directors and officers of the debtor. In *Megliola v. Maxwell*,[10] after the shareholder class was certified in federal court, the trustee filed an adversary complaint against the former directors and officers of the debtor, alleging breaches of fiduciary duties to the debtor and to the debtor's creditors. The principal potential source of recovery in both actions was $50 million in the debtor's D&O liability insurance program, which featured traditional "Side A" direct coverage for directors and officers to the extent loss was not indemnified by the debtor, and "Side B" coverage which included reimbursement coverage to the debtor for amounts paid in indemnification to directors, and direct entity coverage for the debtor. The insurers, however, contested coverage.

The trustee commenced an adversary proceeding seeking (a) to enjoin the class action plaintiffs from prosecuting their claims or otherwise seeking to exercise control over the D&O liability insurance proceeds, and (b) a declaration that the policy proceeds were property of the debtor. The bankruptcy court embraced the majority view that while a D&O liability insurance policy is property of the estate, the proceeds of the policy are not. The court invoked 11 U.S.C. section 105(a), however, to enjoin the continuation of non-discovery proceedings in the shareholder class action. Adopting the reasoning of the bankruptcy court, the district court held that section 105(a) authorizes an injunction against the prosecution of proceedings in other courts – even if the proceedings do not involve claims that belong to the estate -- without the traditional showing of irreparable harm needed for injunctive relief. Rather, if a suit involving third parties threatens to "affect[] the bankruptcy estate or the allocation of property among creditors," then the injunction may issue.[11] The court concluded that the shareholder class action could interfere with the administration of the estate because if the shareholders prevailed, the insurers would either deny coverage or pay policy proceeds to the shareholders. If the insurers denied coverage, then the shareholders and the trustee would be competing for the same finite assets of the directors and officers. If the insurers covered the claim, the estate would lose those funds as a source of recovery.

The bankruptcy court concluded that the stay was appropriate because the estate and the shareholders sought "damages arising from the same or similar transactions and acts allegedly committed by the directors and officers, albeit under different legal theories. All of the parties hope to be recompensed from the proceeds of the insurance policies."[12] It was irrelevant that the federal securities claims of a debtor's shareholders against non-debtors are not property of the estate, and that recovery in a debtor's action on behalf of all creditors against the same entities would not reduce the amount recoverable under the shareholders' securities claims. If the insurers paid the shareholders, there was a real possibility that the insurance coverage would be exhausted, depriving the trustee of a crucial source of recovery in the bankruptcy. Accordingly, it was appropriate to temporarily enjoin the shareholders from taking action that might diminish the funds available for the trustee to pursue on behalf of the

estate. The injunction would terminate upon the completion of the trustee's actions to recover property for the estate.

The district court expressly rejected the shareholders' invitation to limit the injunctive reach of section 105(a) to cases in which the plaintiff whose action will be enjoined is a creditor of the estate that would benefit from the injunction. The rationale for the stay, the shareholders urged, is to allow the bankruptcy proceeding to run its course, after which the amount in which the plaintiffs were compensated for their loss through distributions in the bankruptcy would reduce their recovery outside the bankruptcy. However, "[t]he relevant inquiry is not whether the Class Action plaintiffs are creditors of the estate, ... it is whether the Class Action affects the bankruptcy estate or the allocation of property among creditors."

Other courts have interpreted the authority to stay third party litigation more narrowly, reserving its use for bankruptcies in which the trustee brings an action for all creditors based on the same transaction and seeks the *same* damages as are sought by the plaintiffs in the suit to be enjoined, so that any recovery by the trustee would reduce the plaintiffs' recoverable damages in the other suit. In *In re Reliance Acceptance Corp.*,[13] the district court vacated a preliminary injunction entered by a bankruptcy court enjoining federal court shareholder plaintiffs from pursuing class action securities law claims against, among others, former directors and officers of the debtor. The securities claim involved a board-approved transaction in which the debtor's founder exchanged its shares in the debtor for shares in affiliated companies shortly before the announcement of information leading to a precipitous decline in the debtor's stock. The bankruptcy court had agreed with the debtor that the shareholders were pursuing under a different legal theory the same fraud claim that the debtor would assert in bankruptcy, and that recovery by the shareholders might deplete the proceeds of a D&O policy from which the debtor also sought to recover.

The district court reversed, first concluding that the shareholders' federal securities law claims constituted a separate cause of action, even though the federal claims were asserted against the same parties and based on facts similar to those underlying the debtor's fraud claim seeking to rescind the share exchange transaction. The court next considered the debtor's argument that the shareholders' litigation should be stayed under section 105(a) because (i) any D&O policy funds expended in defending, settling or satisfying a judgment would erode the limits available to the debtor, and (ii) to the extent coverage was not available for the directors and officers, it would increase the amount of claims for indemnification the directors and officers had against the debtor. The court rejected both arguments with little discussion and no substantive discussion of section 105(a). It acknowledged "that allowing the Shareholders' Litigation to proceed will increase the magnitude of directors and officers' indemnification claims against the Estate," but simply concluded, "that does not appear to be a basis for permanently enjoining the Shareholders' Litigation."[14] Nor did the erosion of the policy through defense cost funding or possible settlements in the shareholder litigation justify a stay. The court concluded, without explication, that "those are matters that can be resolved between the insurers and the insured, without enjoining the Shareholders from proceeding with their

claims." *Reliance Acceptance Corp.* thus adopted the view that an injunction may not issue if the shareholders are not asserting claims as creditors of the estate, so that any damages they recovered against the directors and officers would not be reduced by amounts they would receive for claims filed in the bankruptcy. The *Megliola* district court rejected *Reliance Acceptance Corp.* as "neither controlling nor persuasive."[15]

In *In re First Central Fin. Corp.*,[16] a bankruptcy court also declined to enjoin a federal securities class action pending against directors and officers of a debtor that had filed for relief under Chapter 11. Echoing its conclusion that the proceeds of a D&O policy are not property of the estate as long as significant claims have not been made against the entity coverage available under the policy, the court disagreed that a section 105(a) injunction was warranted where claimants "who recover insurance proceeds outside of the bankruptcy proceedings would impermissibly receive dollar-for-dollar on their claim, rather than a *pro rata* share with other creditors.[17] The court also ruled (unlike *Megliola*) that a section 105(a) injunction requires the extraordinary showing needed for other injunctions, and that on the facts before it "the Trustee's unsupported perception that the estate will be injured" by the prosecution of shareholder securities litigation against directors and officers did not justify staying shareholder litigation.

Conclusion

A bankruptcy trustee has the right to bring any action in which the debtor has an interest, including actions against the debtor's directors and officers for breach of duty or misconduct. In that capacity, the trustee acts to benefit the debtor's estate, which ultimately will benefit the debtor's creditors upon distribution. Section 105(a) of the Bankruptcy Code separately authorizes a stay against any proceeding related to the bankruptcy that may affect the orderly administration of the estate, even one against directors and officers and not against the debtor or against the debtor's property. As *Megliola* recognizes, nothing in the language or purpose of section 105 limits the authority to stay litigation seeking to recover D&O policy proceeds to circumstances in which the plaintiffs' recovery would be reduced by the recovery in a debtor's action on behalf of all creditors against the same entities. Thus, even if a third party's claim does not belong to the estate, section 105(a) permits a stay if the plaintiffs' individual claims arise out of the same facts as the claim belonging to the estate.

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[1] *See In re First Central Fin. Corp.*, 238 B.R. 9, 18-19 (Bankr. E.D.N.Y. 1999); *Gray v. Hirsch*, 230 B.R. 239, 243 (S.D.N.Y. 1999).

[2] 11 U.S.C. § 541(a)(1).

[3] *In re Cybermedica, Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002); *In re Enron Corp.*, 2002 WL 1008240 (Bankr. S.D.N.Y. May 17, 2002).

[4] *First Central Fin. Corp.*, 239 B.R. at 17; *see also In re CHS Electronics*, 261 B.R. at 542-43 (Bankr. S.D. Fla. 2001).

[5] 788 F.2d 994 (4th Cir. 1986); *see also In re Continental Airlines*, 177 B.R. 475 (D. Del.1993).

[6] *In re First Central Fin. Corp.*, 238 B.R. at 18-19; *Gray*, 230 B.R. at 243.

[7] 514 U.S. 300 (1995).

[8] *Fisher v. Apostolou*, 155 F.3d 876, 883 (7th Cir. 1998).

[9] *A.H. Robins*, 788 F.2d at 1003.

[10] 2003 WL 21223270 (N.D. Ill. May 27, 2003).

[11] *Id.* at *5.

[12] *In re Marchfirst, Inc.*, 288 B.R. 526, 532 (Bankr. 2002).

[13] 235 B.R. 548 (D. Del. 1999).

[14] *Id.* at 557.

[15] 2003 WL 21223270, at *5 n.5.

[16] 238 B.R. 9 (Bankr. E.D.N.Y. 1999).

[17] *Id.* at 21.