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Insuring against the Risk of Collusion in Corporate Bankruptcy Cases: The Uncharted Waters of the Insured vs. Insured Exclusion in Directors' and Officers' Liability Insurance Policies

Cullen Ann Drescher

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INSURING AGAINST THE RISK OF COLLUSION IN CORPORATE BANKRUPTCY CASES: THE UNCHARTED WATERS OF THE “INSURED VS. INSURED” EXCLUSION IN DIRECTORS’ AND OFFICERS’ LIABILITY INSURANCE POLICIES

Cullen Ann Drescher*

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Directors and officers of an insolvent corporation face considerable uncertainty in embarking on a voyage through the bankruptcy process. In these uncharted waters, many such professionals view their company’s directors’ and officers’ liability insurance policy (D&O coverage) as a life-raft providing in-

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demnification for liability resulting from a leadership misjudgment. Owing to the Delaware Supreme Court’s recent decision in In re Bridgeport Holdings, the risk that a director or officer will be found liable for guiding a company astray during a bankruptcy proceeding is enhanced. Thus, sufficient D&O coverage is essential for corporations entering restructuring or liquidation.

Even if sufficient insurance coverage exists, bankruptcy presents a risk that an insurer will deny D&O coverage under an exclusion in the policy. Exclusions are contractual provisions that describe situations in which a policy of insurance will not respond to a claim. For example, many homeowners insurance policies do not provide coverage for damages arising from pollution or flood situations. D&O insurance policies frequently exclude coverage for employment, intellectual property, and personal injury claims. In addition, D&O insurers routinely disallow indemnity when one insured party brings an action against another insured party under an “insured vs. insured” exclusion. This particular exclusion is often implicated in a bankruptcy proceeding because of the possibility that the administrator of a bankruptcy estate will be deemed an “insured” by the court. In that event, coverage will be barred, potentially leaving the corporate officials named in the underlying suit with significant personal liability.

2 ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 424 (3d ed. 2002) (citing Spencer Kimball, The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law, 45 MINN. L. REV. 471, 496 (1961)). Exclusions “carve out areas in the affirmative grant of coverage where no coverage will be provided.” Id.
5 See Murray v. Loewen Group, 133 F. Supp. 2d 1110, 1117 (E.D. Wis. 2001). The purpose underlying the exclusion is to prevent collusion, “such as suits in which a corporation sues its officers and directors in an effort to recoup the consequences of their business mistakes . . . thus turning liability insurance into business-loss insurance . . . .” Level 3 Comme’ns, Inc. v. Fed. Ins. Co., 168 F.3d 956, 958 (7th Cir. 1999); see also Twp. of Center, Butler County, Pa. v. First Mercury Syndicate, Inc., 117 F.3d 115, 119 (3d Cir. 1997) (“The primary focus of the exclusion is to prevent collusive suits in which an insured company might seek to force its insurer to pay for the poor business decisions of its officers or managers.”).
Courts have reached different results when considering whether administrators associated with a bankrupt corporation are precluded from seeking coverage by an “insured vs. insured” exclusion. The lack of judicial consensus results partly because cogent analytical tools are not presently available to courts in applying the exclusion to a constituent in bankruptcy. Currently, courts consider a handful of relevant factors, employing inconsistent rationales in reaching their decisions. The absence of uniform analytical guidelines leads different courts to render varying and sometimes irreconcilable opinions when considering similar facts.

To assist courts in creating a cogent and consistent framework, this Article proposes an analytical methodology that fuses the bodies of insurance and bankruptcy law. By creating an environment in which courts give effect to the objectives of both systems, the proposed framework seeks to provide direction to litigants, bankruptcy judges, and drafters of D&O policies who require guidance in the contract’s formative stages. If adopted, the proposed analysis will

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8  See Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376 (D. Del. 2002) (finding that the “insured vs. insured” exclusion should not apply to claims brought by a bankruptcy Estate Representative against the former directors and officers of the Debtor where the Debtor is the insured entity, because the Debtor's Estate Representative . . . and the Debtor . . . are separate entities.”); Am. Cas. Co. of Reading Pa. v. Sentry Federal Savings Bank, 867 F.Supp. 50 (D. Mass. 1994) (finding that a conservator of a receivership’s claims asserted against directors and officers of a receivership were not barred from coverage under “insured vs. insured” exclusion as the conservator was not the “Institution” named in the policy); In re Pintlar Corp., 205 B.R. 945 (Bankr. D. Idaho 1997) (finding that litigation trustees who were not acting for the benefit of the corporation but for the benefit of the corporation's creditors and thus their claims against former officers and directors were not barred from coverage under “insured vs. insured” exclusion found in Chapter 11 debtors’ insurance policy, but trustees acting on behalf of the debtor itself could not bring covered claims). But see In re R.J. Reynolds, 315 B.R. 674 (Bankr. W.D. Va. 2003) (finding that bankruptcy trustee’s suit against debtor's former officers was brought as assignee and was excluded under “insured vs. insured” exclusion); Nat'l Union Fire Ins. Co. v. Olympia Holding Corp., No. 1:94-CV-2081, 1996 WL 33415761 (N.D. Ga. June 4, 1996) (finding a bankruptcy trustee's claims against the former officers were excluded under the “insured vs. insured” exclusion as the trustee “can only assert claims against insureds that belong to” the company and thus “there is no legal distinction between the trustee and the company”); Reliance Ins. Co. v. Weis, 148 B.R. 575 (E.D. Mo. 1992) (finding that a plan constituent of bankrupt corporation’s action against former officers of bankrupt corporation was excluded from coverage under “insured vs. insured” exclusion as action was on the behalf of bankrupt corporation); Powell v. American Cas. Co. of Reading Pa., 772 F. Supp. 1188, 1191 (W.D. Okla. 1990) (finding that an “insured vs. insured” exclusion applied to claims which arose when the FDIC brought an action against former directors and officers of a bank as the FDIC “stands in the shoes of the Security Bank in prosecuting claims.”).

9  The term “constituent” shall be used throughout this Article to refer to the administrator of a bankruptcy estate, such as a debtor-in-possession, a bankruptcy trustee, or a creditors’ committee.


11  Id. at 10. Sousa’s article is discussed at length in Section III, infra.
still the uncharted waters, adding a measure of predictability to the sea of questions companies face in traversing through a perilous bankruptcy proceeding.

Part I of this Article provides a brief explanation of the purpose behind D&O policies and the insurer’s reasons for including “insured vs. insured” provisions. Part II explains how the recent holding in In re Bridgeport Holdings amplifies the potential for a finding of D&O liability in the context of a bankruptcy proceeding, thereby increasing the probability that “insured vs. insured” exclusions will be implicated in future cases. Part III examines the inconsistent interpretation of such exclusions heretofore employed by various courts, specifically regarding whether a debtor-in-possession, a bankruptcy trustee, or a creditors’ committee is considered an “insured” for the purpose of the exclusion. Part IV proposes a framework for applying the “insured vs. insured” exclusion in bankruptcy cases based on the characteristics and role of each constituent according to bankruptcy law. The test sets forth the appropriate presumption to be employed as to each bankruptcy constituent, and identifies two important factors to be considered in rebutting the presumption.

PART I. DIRECTORS’ AND OFFICERS’ LIABILITY INSURANCE AND THE “INSURED VS. INSURED” EXCLUSION

In the words of Professor Spencer Kimball, “[i]nsurance is a small world that reflects the purposes of the larger world outside it.”12 It should come as no surprise, then, that our larger world’s economic evolution has caused parallel adaptations in the business of insurance.13 Expanding commercial vitality produces novel risks, and insurance responds in kind by providing ways in which we manage them.14 Evidence of the symbiosis of commerce and insurance was observable in the early maritime economy, where seafaring vessels were the engines of prosperity.15 Merchants recognized the importance of entering into mutual aid agreements to spread the risk of goods being lost at sea so that no individual merchant would be forced to bear the entire financial injury resulting from a jettison.16 The benefits of this form of risk-distribution “were so obvious that it became the equivalent of an implied term in all maritime shipping ventures.”17

12 JERRY, supra note 2, at 20 (citing Spencer Kimball, The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law, 45 MINN. L. REV. 471, 524 (1961)).
14 TOM BAKER, INSURANCE LAW AND POLICY 8–12 (2003).
15 JERRY, supra note 2, at 20–22 (discussing mutual aid arrangements whereby each maritime merchant would contribute pro rata to the loss of the merchant whose goods were tossed overboard in the event of jettison).
16 Id.
17 Id. at 21.
Another implied term in early maritime insurance embodied the necessity for able leadership aboard merchant vessels. In 1811, a Massachusetts court discussed the implicit duty of care and diligence that was owed by holders of maritime insurance policies:

It is the duty of the owner [of the vessel] to see that he entrusts the property insured with a man of competent skill, prudence, and discretion. He is responsible for all losses or damage to the goods committed to his charge, which arise from his negligence, ignorance, or willful misconduct.... The principle of an implied warranty on the part of the assured, that every thing shall be done to prevent a loss, pervades the whole subject of marine insurance....

Thus, early maritime insurance effectively distributed many risks of commercial voyage and demanded the utmost in responsible conduct from those who took a vessel’s helm.

Today, corporations drive commercial progress. Each depends upon its leaders to navigate through the often hostile conditions of a highly integrated market economy, where rapid decision-making and swift action are essential to achieving financial viability for every major business organization. Like sea captains who traversed the oceans in the early nineteenth century, today’s corporate leaders owe specific duties to the enterprise, and may be held personally liable if their actions breach those obligations.

As Professor Kimball would predict, insurance law in the United States has acclimated to the risk that the negligence of corporate directors and officers may result in liability. Over the course of several decades, directors’ and off-

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19 Adolph Berle, Jr. & Gardiner C. Means, The Corporation and Private Property 1 (rev. ed. 1948) (“[T]here may be said to have evolved a ‘corporate system’ — as there was once a feudal system...”).
20 Under principles of corporate law, officers and directors have two basic fiduciary duties: the duty of care and the duty of loyalty. The duty of care requires that a director or officer discharge his or her duties in good faith, with the care an ordinarily prudent person in like position would exercise, and in a manner the director reasonably believes to be in the best interest of the corporation. Great Rivers Co-Op. of Sc. Iowa v. Farmland Indus., Inc., 198 F.3d 685 (8th Cir. 1999); Rehab. Advisors, Inc. v. Floyd, 601 So. 2d 1286 (Fla. Dist. Ct. App. 1992). The duty of loyalty requires that directors and officers remain loyal to the corporation, acting at all times in the best interests of the corporation and its shareholders, whose interests must take precedence over any self-interest of the director, officer, or controlling shareholder that is not shared by the stockholders generally. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
21 Generally speaking, directors and officers of corporations face two types of claimants: (1) disgruntled shareholders who sue on behalf of the corporation in a derivative action or in their own right, and (2) third parties such as creditors, employees, vendors, customers, or government agencies. Roberta Romano, What Went Wrong with Directors’ and Officers’ Liability Insurance?, 14 Del. J. Corp. L. 1, 3 (1989).
ficers’ liability insurance became a fixture in the modern corporate environment.22 "Plaintiffs who sue directors and officers typically seek large judgments, potentially resulting in substantial losses to both the corporation as well as individual officers and directors."23 This risk of liability prompted state legislatures to authorize corporations to purchase D&O policies that indemnify the corporation and its directors against liability exposures.24 Most D&O policies provide coverage for exposure corresponding to claims first made during the policy period.25 In addition, the vast majority of D&O policies commit the insurer to absorbing the costs of mounting legal defense against the claims.26 Risks of liability are thereby transferred to the insurer in exchange for the insured’s premium payments.

One problem that hinders the ability of D&O insurers to spread risk arises in the form of a “moral hazard.”28 In a general sense, the term is used to describe the perverse effect that insurance may have on the probability that covered losses will occur.29 If an insured’s risk is completely eliminated through transfer to an insurer, then the insured might have less incentive to take measures that prevent the loss from occurring.30 In the D&O context, moral hazard is used to describe the theoretical tendency for insurance to reduce the incentives for corporate directors and officers to protect against loss or to minimize the cost of loss.31 For example, a director or officer might be tempted to make hasty

22 Sousa, supra note 10, at 366 (“[P]resently, as many as ninety-five percent of Fortune 500 companies maintain directors and officers liability insurance.”).
24 Id.
25 DIRECTORS AND OFFICERS LIABILITY INSURANCE DESKBOOK 3 (David E. Bordon et al. eds., American Bar Association 1998). Liability insurance policies come in one of two forms: “occurrence” and “claims-made.” Most liability policies are occurrence-based, but claims-made policies are the norm in professional malpractice insurance. Claims-made policies provide coverage only if the act of neglect is discovered and brought to the insurer’s attention during the policy term, regardless of when the act occurred. Thus, the insured event is the filing of the claim, and coverage will extend to events that occurred even before the policy became effective. Id. at 5.
26 Id. at 93. Most D&O policies now provide for advancement of defense costs by the insurer upon request by an insured. Typically, a D&O policy is a “wasting policy” because defense costs effectively reduce the policy limits.
27 Id. at 3.
28 BAKER, supra note 14, at 4.
29 Id.
30 JERRY, supra note 2, at 17. “For example, if a mechanic knows that in the event his tools are stolen the insurer will reimburse the loss in full, [he] may be less likely to suffer the inconvenience of putting tools in a locked storage area at the end of each working day.” Id.; see also Biltmore Assoc., L.L.C. v. Twin City Fire Ins. Co., 572 F.3d 663, 669 (9th Cir. 2009) (“[A]lmost nobody intentionally indicts someone else to collide with his car, but some might have an interest in burning down his own house if he owed more on it than it was worth.”).
31 See BAKER, supra note 14, at 4.
decisions in selling corporate assets because he or she is secure in the knowledge that the insurance company will pay for any losses resulting from a legal challenge to that decision. Economists characterize this as ex ante moral hazard.\textsuperscript{32} The inclusion of a ‘duty to defend’ clause may exacerbate the problem on an ex post basis, when the director or officer (and, by extension, the corporation) does not care very much about the expense of defending against the claim, as long as the insurance company honors its promise to recompense the insured.\textsuperscript{33}

In D&O insurance, moral hazard takes two additional forms. First, because of the unique identity between the entity corporation and its own directors and officers, a temptation arises for parties who are insured under D&O policies to collude.\textsuperscript{34} In so doing, the insureds ‘would in essence ‘force’ its insurer to pay for the poor business decisions of its officers and directors by the corporation filing an action against its own officers and directors.’\textsuperscript{35} If those ‘sacrificial lambs’ are held liable, they may seek to avoid using personal funds to satisfy the judgment by claiming the amount of damages against the corporate D&O insurance policy.\textsuperscript{36}

A second layer of moral hazard emerges where the corporation is careless in appointing competent officials because it expects to be compensated for damages resulting from bad decisions. In the zone of insolvency, such misjudgments might include the hasty sale of corporate assets to the detriment of the corporation, its creditors, and ultimately, the D&O insurer. Under Bridgeport Holdings, such actions or inactions may lead to liability and subsequent invocation of provisions in a D&O policy by both parties to the contract. In an effort to address the moral hazards to which D&O policies give rise, and to prevent D&O liability insurance from functioning as business-loss insurance, insurers design contracts so as to exclude collusive claims from coverage.\textsuperscript{37} Commonly appearing in D&O policies is the so-called “insured vs.

\textsuperscript{32} Id.

\textsuperscript{33} See id.

\textsuperscript{34} See, e.g., Lawton v. Nyman, 62 F. Supp. 2d 533 (D. R.I. 1999) (directors and officers speak on behalf of the corporation and may be held vicariously liable for its acts).

\textsuperscript{35} Sousa, supra note 10, at 370.


\textsuperscript{37} See Palmore, supra note 23, at 103–04 (“The exclusion was designed to prevent collusion among the corporation and its directors and officers. In effect, allowing a corporation to recover its losses by simply suing its own executives . . . .”); see also Level 3 Communications, 168 F.3d at 958 (The purpose underlying the exclusion is to prevent collusion, “such as suits in which a corporation sues its officers and directors in an effort to recoup the consequences of their business mistakes . . . thus turning liability insurance into business-loss insurance . . . .”); Biltmore Assoc., L.L.C. v. Twin City Fire Ins. Co., 572 F.3d 663, 669 (2009) (“Because risks such as collusion and moral hazard are much greater for claims by one insured against another insured on the same policy than for claims by strangers, liability policies typically exclude them from coverage. Allowing such claims would turn liability insurance into casualty insurance, because the company
insured” exclusion, which “bars coverage for claims made by one insured under the policy . . . against another insured under the same policy.”

Through the “insured vs. insured” exclusion, insurers endeavor to minimize moral hazards that inhere in the business of insuring corporate directors and the entities for whom they speak against potential breaches of fiduciary duty.

The public also has an interest in ensuring that “insured vs. insured” exclusions are properly applied. Because collusion in connection with a corporate bankruptcy is civilly punishable through punitive damages and can rise to the level of criminal behavior, the public’s interest in punishing and deterring such behavior is only served when the wrongdoers — and not their insurers — are required to account for their deeds. Liability for such misconduct is established in section 363 of the Bankruptcy Code, which delivers a clear mandate against the use of collusive practices in the sale of assets of a bankruptcy estate.

While section 363 provides explicitly for punitive damages, it does not specifically mention criminal liability for collusion. However, criminal prosecution may be authorized by other parts of the United States Code. As Binford explains:

Title 18 . . . lists at least two circumstances under which a colluding party could be prosecuted criminally. Under section 152, in a bankruptcy case, a party may be held criminally liable for knowingly and fraudulently making a false oath or filing a false statement under penalty of perjury. Liability could arise, therefore, if a party falsely denies engaging in collusive behavior when questioned by the court at a [section] 363 hearing to approve the sale of assets. Moreover, section 152 provides that parties can be held criminally liable for knowingly and fraudu-

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38 Sousa, supra note 10, at 368.
39 See id.
40 11 U.S.C. § 363(n) provides that: “[t]he Trustee may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated, and may recover any costs, attorneys’ fees, or expenses incurred in avoiding such sale or recovering such amount. In addition to any recovery under the preceding sentence, the court may grant judgment for punitive damages in favor of the estate and against any such party that entered into such an agreement in willful disregard of this subsection.” As was true in Bridgeport Holdings, directors and officers who breach fiduciary duties in bankruptcy often do so in connection with the disposition of assets under Code section 363. For other examples, see In re Schipper, 933 F.2d 513 (7th Cir. 1991); In re Performance Nutrition, Inc., 239 B.R. 93, 42 Collier Bankr. Cas.2d (Bankr. N.D. Tex. 1999) (debtor-in-possession breached fiduciary duties by failing to appropriately market the debtor’s business, and by failing to disclose his interest in the sale of the business’ assets as a shareholding officer of the same).
41 11 U.S.C § 363(n).
lently receiving property “with intent to defeat the provisions of [the Bankruptcy Code].” 42

This admonition finds support from section 157, which prohibits “bankruptcy fraud,” among other false and fraudulent schemes. 43 Since collusion in the sale of assets in a bankruptcy estate may be tantamount to common-law fraud, 44 the participants therein may “knowingly and fraudulently receive property” in defiance of the Bankruptcy Code — an act that is criminally punishable under Title 18 of the United States Code.

Because Titles 11 and 18 of the United States Code elevate collusion in connection with bankruptcy sales to a level of conduct to which punitive damages and criminal liability may attach, courts must interpret “insured vs. insured” exclusions to ensure that collusive behavior is not covered under policies of D&O insurance. The public policy at play in this context is the same that motivates the inclusion of “punitive damages” and “criminal acts” exclusions in other types of insurance policies. 45 Frequently, insurers refuse indemnification of punitive damages and criminal penalties because these fees are imposed to punish the wrongdoer for his actions and to deter similar conduct from occurring in the future. 46 These purposes are seriously undermined if the wrongdoer

44 Stephen R. Schmidt, The Bad Faith Setup, 29 TORT & INS. L.J. 705, 727–28. Schmidt explains that “[c]ollusion and fraud . . . are not necessarily tantamount to the common-law tort of fraud in that there need not be a misrepresentation of a material fact. Any negotiated settlement involves cooperation to a degree. It becomes collusive when the purpose is to injure the interest of an absent or nonparticipating, such as an insurer or nonsettling defendant. Among the indicators of bad faith and collusion are unreasonableness, misrepresentation, concealment, secretiveness, lack of serious negotiations on damages, attempts to affect the insurance coverage, profit to the insured, and attempts to harm the interests of the insurer. They have in common unfairness to the insurer, which is probably the bottom line in cases in which collusion is found.” Id. (emphasis added).
45 Vargas v. Calabrese, 714 F. Supp. 714, 725 (D. N.J. 1989) (“First, an insurer’s coverage of intentional acts is violative of public policy unless the breadth of coverage is limited by exclusion of criminal acts . . . . Second, coverage or defense of punitive damages is always against public policy.”); Peterson v. Superior Ct., 31 Cal. 3d. 147, 158 (Cal. 1982).
46 Although punishment is the most often cited reason for assessing punitive and criminal damages, courts also respect the deterrent objectives of these fees. When an insurer must bear the cost of a wrongdoer’s penalty, the goal of deterrence is similarly undermined. Putative wrongdoers will not be deterred by the threat of being punished if they are permitted to shift that punishment to the innocent insurer. See Hartford Cas. Ins. Co. v. Powell, 19 F. Supp. 2d 678, 693 (N.D. Tex. 1996) (“given the punitive and deterrent components of punitive damages, public policy considerations . . . should override an analysis of contract language”); see also S. Loyd Neal, Comment, Punitive Damages: Suggested Reform for an Insurance Problem, 18 ST. MARY’S L.J. 1019 (1987) (advocating legislative reform and insurer’s express exclusion of liability for punitive damages).
is permitted to transfer his penalty to the innocent insurer through a contract of insurance.\footnote{See Neal, supra note 46.}

The principle applies with equal force in the context of collusion in bankruptcy proceedings. “Insured vs. insured” exclusions must be interpreted by courts in a way that prevents wrongdoers from shifting punishment for their nefarious acts onto innocent insurance providers.\footnote{Economic externalities may also result from judicial misinterpretation of insurance policies. If courts demand that insurers provide coverage for events that were intended to be excluded, the result is unexpected costs inuring to the insurer. These costs will be passed on to consumers in the form of heightened premiums. Said another way, if an exclusion is not effective to bar unintended coverage, then prices will respond to account for the broader coverage actually provided.} By making informed, reasoned, and appropriate determinations as to the applicability of such exclusions, courts will preserve public’s interest punishment and deterrence, and properly admonish against the practice of collusion where bankruptcy and insurance intersect.

PART II. \textit{In re Bridgeport Holdings, Inc. and the Amplified Potential for D&O Liability in Corporate Bankruptcy Cases}

Before 1985, liability was rarely imposed upon corporate directors and officers for bad judgment or unsuccessful business decisions due to the protection offered by the “business judgment rule.”\footnote{Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982).} The rule embodies three notions: that shareholders voluntarily undertake the risk of bad judgment on the part of corporate leadership, that post hoc litigation is an imperfect vehicle by which to evaluate corporate business decisions, and that corporate leaders should not be overly dissuaded from undertaking risks, as risks often lead to profit.\footnote{Id. at 885–86.} In its strongest form, the business judgment rule operated to insulate corporate directors and officers from liability so long as they had not breached their duty of loyalty to the corporation through fraud, self-dealing, or bad faith.\footnote{Id.}

Most observers acknowledge that the increased rise in litigation against corporations and their directors and officers is attributable to the weakening of the business judgment rule, effectuated by the Supreme Court of Delaware\footnote{Delaware is widely regarded as the nation’s most influential jurisdiction in the development and interpretation of principles in corporate law. In their treatise on derivative actions, Donald Wolfe and Michael Pittinger described the Delaware Chancery Court as “the nation’s most influential corporate tribunal.” Donald J. Wolfe, Jr & Michael A. Pittinger, \textit{Distinguishing Derivative Claims from Direct Claims Under Delaware Law}, 1486 P.I.L.1 CORP. 1293, 1293 (2005).} in \textit{Smith v. VanGorkom.}\footnote{Smith v. VanGorkom, 488 A.2d 853, 863 (Del. 1985); accord Sousa, supra note 10, at 373.} That case involved a shareholder class action suit
against the board of directors of Trans Union Corporation. The plaintiffs alleged that members of the board breached their fiduciary duties to the corporation by approving a cash-out merger between Trans Union and New T Company, a wholly owned subsidiary of Marmon Group, Inc., without informing themselves about the details of the transaction.

Reversing the decision of the appellate court below, the Delaware Supreme Court refused to insulate the directors from liability arising from “their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the . . . merger” and their “failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the . . . offer.” Thus, even in the absence of fraud, self-dealing, or bad faith on the part of the directors, the board’s business judgment was not afforded the type of deference that had been routinely offered by courts in prior precedent. Commentators note that the VanGorkom decision “highlighted the risk of director liability for failing to make an informed business judgment and caused insurance companies to become “skittish” about issuing liability insurance coverage for a corporation’s directors and officers.”

Similarly, the recent decision in In re Bridgeport Holdings, Inc. highlights the potential for director and officer liability incurring as a result of failure to make a considered business decision in the context of a corporate bankruptcy. In Bridgeport Holdings, the United States Bankruptcy Court for the District of Delaware denied a motion to dismiss certain breach of fiduciary duty claims asserted by the Bridgeport Holdings, Inc. Liquidating Trust against the former directors and officers of Bridgeport Holdings, Inc. The Trust alleged that the D&O defendants failed to consider potential alternatives to the sale of

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54 VanGorkom, 488 A.2d at 863.
55 Id.
56 Id. at 893. The court found that the board of directors failed to adequately inform themselves as to [the CEO’s] role in forcing the sale of Trans Union and in selecting the per se share price. In addition, the board remained uninformed as to the intrinsic value of Trans Union. According to the court, these acts constituted gross negligence on the part of the board where its approval was given upon two hours’ consideration, without prior notice, and without the exigency of a crisis or emergency. Id. at 874.
58 Sousa, supra note 10, at 374.
60 Id. at 559.
the company, abdicated their decision-making authority to a restructuring advisor, and acquiesced to the advisor’s decision to sell corporate assets on the eve of bankruptcy instead of proceeding to court-supervised sale under section 363 of the Bankruptcy Code. 61

Like in VanGorkom, the court in Bridgeport Holdings found the actions taken by the director and officer defendants gave rise to a claim for the breach of fiduciary duty even in the absence of self-dealing or fraud. 62 The board’s failure to make affirmative, deliberate, and informed decisions prior to bankruptcy was, in the Bridgeport Holdings court’s view, a sufficient basis upon which to deny the directors and officers the protection of the business judgment rule. 63 Bridgeport Holdings extends the rule in VanGorkom to the bankruptcy context. For the leaders of businesses on the brink of financial failure, Bridgeport Holdings should signal that the zone of insolvency is a “no wake” area in which abundant measures of caution must be observed.

PART III. BANKRUPTCY CONSTITUENTS, COLLUSION, AND THE “INSURED VS. INSURED” EXCLUSION IN CORPORATE D&O POLICIES

Without question, a corporate bankruptcy has always been “an event that is likely to precipitate lawsuits against the corporation’s directors and officers in their individual capacities as all interested parties scramble to find avenues to augment the bankruptcy estate.” 64 After Bridgeport Holdings, however, the risk that lawsuits will be filed in the zone of insolvency is amplified. According to that case, a failure to act or to exercise careful discretion in delegating responsibilities prior to filing for bankruptcy protection may lead to liability. 65 Thus, where economic conditions threaten the financial health of corporations, cautious directors and officers will demand the shelter of a D&O policy. 66

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61 Id. at 555. The Liquidating Trust asserted that the D&O Defendants breached their duty of loyalty on the grounds that the board (a) did not attempt to sell the assets of the company before a liquidity crisis ensued; (b) waited too long to hire a restructuring advisor despite the request to do so by the company’s secured lenders; (c) abdicated its decision-making authority to the COO; and (d) acquiesced to the COO’s decision to sell the assets of the company on the eve of bankruptcy. No formal sale process was undertaken by the COO or the Defendants, and the COO did not seek competing bids despite the existence of a potential market for the assets. The D&O defendants approved the sale of substantially all assets of the company for $28 million — a fraction of the $126 million present value of the company’s operations. Id. at 553.

62 Id. at 555.

63 Id.

64 Sousa, supra note 10, at 369 (citing Nan Roberts Eitel, Now You Have It, Now You Don’t: Directors’ and Officers’ Liability Insurance After a Corporate Bankruptcy, 46 LOY. L. REV. 585 (2000)).


Assuming that insurers are able to predict, based on economic factors, that the incidence of corporate bankruptcies will rise, such organizations will have reason to grow even more “skittish” about issuing D&O liability policies. Premium prices will rise in response, causing insureds to accept stronger exclusions to control increases in the cost of policies. In a bankruptcy proceeding, perhaps the most directly implicated exclusion is the “insured vs. insured” exclusion, which denies coverage for liability generated when one “insured” sues another “insured.”

The special relevance of the “insured vs. insured” exclusion in bankruptcy results from the procedural mandates of the Bankruptcy Code. The filing of every bankruptcy case results in the creation of an estate which is comprised of the property owned by the debtor when the case began. The estate is a separate legal entity that is overseen throughout the proceeding by one or more bankruptcy constituents, who “step into the shoes” of the pre-petition entity. “Simply stated, the bankruptcy estate takes whatever interest a debtor has in property as of the petition date, subject to the same limitations and restrictions on the use of property that existed pre-petition.” Under Code section 541, the original debtor’s interest in any cause of action that has accrued prior to the filing of the petition is property of the estate. It follows in fact and logic that the estate is subject to the same insurance coverage limitations and defenses to coverage to which the debtor was bound pre-petition. Since the estate brings claims against corporate directors and officers through its administrating constituent, insurers who have included an “insured vs. insured” provision in a D&O

is featured in bankruptcy environments; (“along with the market turmoil of the last two years, public companies have experienced one of the toughest — if not the toughest — periods of retrenchment and contraction in the D&O insurance marketplace in recent memory”).


68 This point is intuitive, as corporate directors and officers are often assigned culpability for contributing to the financial decline of the organizations they serve. Once a corporation files for bankruptcy protection, the estate may choose to sue directors and officers in an effort to recoup the losses for which such individuals may be responsible.

69 11 U.S.C. § 541(a) (2000). In reorganization cases, the debtor’s estate also includes property acquired by the debtor after the case has begun.

70 Sousa, supra note 10, at 415.

71 United States v. Transp. Admin. Servs., 260 F.3d 909, 913 (8th Cir. 2001) (“Most importantly, the property of the bankruptcy estate includes all causes of action that the debtor could have brought at the time of the bankruptcy petition.”).

72 Under 11 U.S.C. § 365, executory contracts and unexpired leases may be avoided by the court post-petition. However, since an insurance policy is not executory during the coverage term, such contracts are not subject to modification by the bankruptcy court. Thus, if the debtor had rights of indemnification pre-petition, as assets of the bankruptcy estate they are subject to the same limitations under contract and law as they were then. In re Schauer, 835 F.2d 1222, 1225 (8th Cir. 1987).
policy attempt to characterize those parties as “insureds” so as to render the exclusion applicable to bar coverage.\textsuperscript{73}

The United States Court of Appeals for the Eighth Circuit was the first federal appellate court to rule on the issue of whether the “insured vs. insured” exclusion will bar recovery when claims against directors and officers are asserted on behalf of a bankruptcy estate. In \textit{Reliance Insurance Co. of Ill. v. Weis}, the court affirmed a lower court ruling that there is “no significant legal distinction between [the original debtor] and its bankruptcy estate” for the purposes of determining whether an “insured vs. insured” exclusion applies.\textsuperscript{74} In \textit{Weis}, the insurer issued a D&O policy to Band Building and Equipment Company (“BBC”).\textsuperscript{75} BBC filed for bankruptcy protection under Chapter 11 and created a trust to implement BBC’s asset liquidation plan.\textsuperscript{76}

Trust administrators in \textit{Weis} filed an action against the former directors and officers of BBC, alleging breaches of fiduciary duty and asserting that the corporation had been managed negligently.\textsuperscript{77} The insurer denied coverage and filed a declaratory judgment action asking the court to confirm that the “insured vs. insured” exclusion barred the suit brought on behalf of the estate against BBC’s former directors and officers.\textsuperscript{78} The court held that recovery was barred under the “insured vs. insured” exclusion because the action was brought “on behalf of” the corporation and its bankruptcy estate, even though the “benefits sought might eventually inure to creditors.”\textsuperscript{79}

The Eleventh Circuit agreed with the court’s decision in \textit{Weis} when it decided \textit{National Union Fire Insurance Co. of Pittsburgh v. Olympia Holding Corp.}\textsuperscript{80} There, the court concluded that there is no legal distinction between a pre-petition debtor and a chapter 7 liquidating trustee for the purposes of interpreting the “insured vs. insured” exclusion in a D&O liability policy.\textsuperscript{81} The \textit{National Union} court echoed \textit{Weis} in explaining that, because the bankruptcy

\begin{footnotesize}
\begin{enumerate}
\item \textit{In re} County Seat Stores, 280 B.R. 319, 328 (S.D.N.Y. 2002).
\item 148 B.R. 575 (E.D. Mo. 1992), aff’d, 5 F.3d 532 (8th Cir. 1993). Like many courts charged with the interpretation of insurance policy contracts, the court in \textit{Weis} neglected to undertake a close reading and analysis of the contractual language included in the policy itself. The court did cite the exclusion in question and represented the same within the text of its opinion. \textit{Id.} at 578. However, in construing the meaning of the exclusion, the court seems only to consider the interpretations offered by the two adverse parties without affording sufficient attention to the words contained in the policy. \textit{See id.}
\item \textit{Id.} at 577.
\item \textit{Id.} at 577–78.
\item \textit{Id.} at 578. The trust sought $50 million in damages against the former directors and officers of BBC. \textit{Id.}
\item \textit{Id.} at 580.
\item \textit{Id.} at 583.
\item No. 1:94-cv-2081-GET (N.D. Ga. Sept. 18, 1995), aff’d without opinion, 148 F.3d 1070 (11th Cir. 1998).
\item \textit{Id.}
\end{enumerate}
\end{footnotesize}
trustee “stands in the shoes of the debtor corporation in prosecuting a cause of action belonging to the debtor,” the trustee is properly considered an “insured” within the meaning of the exclusion.82 Recovery under the policy was accordingly denied.83

While the Eighth and Eleventh Circuits may seem to have achieved consensus in their application of the “insured vs. insured” exclusion in the bankruptcy context, case law arriving at contrary conclusions has since developed in many lower courts. For example, in In re County Seat Stores, the court found that “the language of the ‘insured vs. insured’ exclusion . . . does not include or contemplate a bankruptcy trustee.”84 In that case, a court-appointed Chapter 11 trustee brought an action against the former officers and directors of County Seat Stores, Inc. for breach of fiduciary duties.85 The purpose of the trustee’s action “was to benefit the bankruptcy estate with the intent of having the potential proceeds distributed to . . . creditors pursuant to the Bankruptcy Code.”86 The court reasoned that the “insured vs. insured” exclusion is designed to prevent collusive lawsuits, and that “[t]he trustee, as a truly adverse party, does not, or should not, raise concerns of collusion because the trustee does not represent the interests of any party that could be a participant of a conspiracy to collude.”87 Thus, the insurer was required to remit payment pursuant to the D&O policy it had entered with County Seat Stores.88

One explanation for this decisional divergence may involve the methodology — or lack thereof — currently employed by courts in considering the applicability of the “insured vs. insured” exclusion in bankruptcy cases.89 Often, courts will focus on one or some of various possible factors, attributing varying degrees of weight to each in analyzing facts presented.90 One product of this unguided analytical technique is an apparent disagreement among courts as to the effect of the “insured vs. insured” exclusion in bankruptcy. Another re-

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82 Id.
83 Id.
84 In re County Seat Stores, 280 B.R. 319 (S.D.N.Y. 2002).
85 Id. at 328.
86 Id. at 329.
87 Id.
88 Id.
89 Sousa, supra note 10.
90 Eric C. Peterson, D&O Coverage for Bankruptcy Litigation: Does the ‘Insured vs. Insured’ Exception Leave Executives Exposed?, 4 No. 6 ANDREWS BANKR. LITIG. REP. 2 (July 2007) (discussing the “various factors” coming into play when courts analyze the applicability of the “insured vs. insured” exclusion: whether the plaintiff is a third-party trustee or debtor-in-possession; whether the claims were first made by the company and were later inherited by a court-appointed trustee; whether the claims are raised by a non-statutory assignee; the importance of the anti-collusion policy behind the exception; and whether the policy is ambiguous such that the doctrine of contra proferentum would militate interpretation in favor of the insured).
sult is the emergence of inappropriate bright-line rules when decisions interpreting the exclusion are compared.

For instance, a comparison of *In re Molten Metal Technology, Inc.*,\(^91\) and *In re R.J. Reynolds*\(^92\) may lead a court to draw an overly rigid bright-line distinction on the question of whether a bankruptcy constituent was voluntarily appointed. In *Molten Metal*, the Bankruptcy Court for the District of Massachusetts held that a court-appointed Chapter 11 trustee was not the legal equivalent of the original debtor.\(^93\) In defense of their decision to deny coverage based on the “insured vs. insured” exclusion, the company’s D&O insurers argued that the debtor’s active negotiation of the terms of the contract was evidence that the debtor understood and agreed to be bound by those terms.\(^94\) In addition, the insurers relied on an opinion by the debtor’s outside counsel stating that coverage would likely be barred under the exclusion by virtue of the trustee’s identity with the debtor.\(^95\) Finally, the insurers pointed to a representation made by the trustee during a preliminary hearing, in which the trustee acknowledged that he “stands in [the debtor’s] shoes in nearly every respect.”\(^96\) The court disagreed with the insurer’s conclusions, holding that D&O coverage was not barred by the “insured vs. insured” exclusion because the trustee was not the legal equivalent of the pre-petition debtor.\(^97\)

In dicta, the *Molten Metal* court instructed that “the insurers would establish the legal equivalence of the trustee and the original debtor by pointing to three factors: that a Chapter 11 trustee exercises the same rights and powers as would a debtor-in-possession under Chapter 11 and therefore is virtually interchangeable with the debtor; that the trustee is prosecuting the Company’s causes of action; and that, in prosecuting those causes of action, he “stands in the Company’s shoes” and is subject to such defenses [that] could have [been] asserted against the Debtor [had the action been brought pre-petition].”\(^98\) Further, the

\(^91\) *Id.* (citing *In re Molten Metal Technologies, Inc.*, 271 B.R. 711 (Bankr. D. Mass. 2002)).

\(^92\) 315 B.R. at 674.

\(^93\) *Molten Metal*, 271 B.R. at 729.

\(^94\) *Id.* at 722.

\(^95\) *Id.*

\(^96\) *Id.* at 721.

\(^97\) *Id.* at 732.

\(^98\) *Id.* at 729. The court concluded that the insurers failed to satisfy this standard because “[w]ith respect to each factor, the insurers either misstate the law or gloss over significant features.” *Id.* Specifically, the insurers failed to demonstrate that, although the trustee could exercise the same rights as a debtor-in-possession, the trustee enjoyed the same equivalence with the company generally. In addition, the insurers failed to show that the trustee was prosecuting causes of action on the debtor’s behalf, even though they did establish that the claims being prosecuted did arise in favor of the debtor. Finally, the court found that,

while it is certainly true that a trustee “stands in the shoes of a debtor” when prosecuting causes of action that arose in favor of the debtor before the commencement of the bankruptcy case, it is also true that this doctrine does not mean that the trustee is the debtor. It only means that the trustee, despite his or
court explained that, as a matter of Massachusetts law, insurance contracts were to be construed against the carrier where ambiguities arose, and that no express reference to [bankruptcy constituents or other parties] was “indication that no broader exclusion was intended.”  

Considering a similar pattern of facts but employing very different rationales, the Bankruptcy Court for the Western District of Virginia reached a conclusion in direct disagreement with the court in *Molten Metal*. In *In re R.J. Reynolds*, the court addressed the question of whether claims brought against corporate officers by a Chapter 11 trustee triggered the “insured vs. insured” exclusion in its D&O policy. The court characterized the language of the provision as follows:

The Policy excludes claims which are “brought or maintained by or on behalf of any Insured.” This exception includes any claims that are brought or maintained by or on behalf of the Debtor. There is an exception to this exception. The exception does not apply to “a claim that is derivative action brought or maintained on behalf of [the Debtor] by one or more persons who are not Insured persons, and who bring or maintain the Claim without the solicitation, assistance or participation of [the Debtor] . . .”

The insurers argued that because the trustee brought the claims “by or on behalf of an insured,” recovery was barred by the exclusion. The court agreed with the insurers, but maintained that the mere fact that the trustee steps into the shoes of the debtor with regard to the claims against the directors and officers does not necessarily trigger the “insured vs. insured” exclusion.

According to the court in *R.J. Reynolds*, “the determining factor is that the Trustee steps into the shoes of the Debtor by virtue of a voluntary affirmative act of the Debtor, not by [an] involuntary appointment [by the court].” Indeed, the court expressed that the voluntary nature of the trustee’s appointment was the “critical distinction” between the facts of that case and those presented in *Molten Metal*. In explaining the emphasis it placed on this particu-

her nonidentity with the debtor, is nonetheless subject to such defenses as the defendant has against the debtor.

*Id.* at 729–30. For these reasons, the court reached the “inescapable conclusion” that the trustee and the company were distinct entities without legal equivalence. *Id.* at 730.


101 *Id.* at 677.

102 *Id.* at 675.

103 *Id.*

104 *Id.* at 678.

105 *Id.* at 679.
lar factor, the *R.J. Reynolds* court recounted the policy concerns that give rise to the inclusion of an “insured vs. insured” clause in a D&O indemnity contract:

A primary reason that insurers require [such] clauses be included in D&O policies is to avoid the possibility of collusion between the corporation and the directors and officers. In *Molten Metal* the Court reasoned that it need not place any reliance on the purpose of the exclusion because chapter 11 trustees have no incentive to collude with directors and officers. In a case in which the debtor voluntarily transfers the causes of action to a third party, there is the distinct possibility of collusion between the debtor and the directors and officers. Furthermore, the debtor may have an incentive to assign its claims against the directors and officers, without colluding with them, in order to obtain a larger concession from the creditors. This is especially true when the plan is a plan of reorganization and the debtor contemplates continuing his operations.\textsuperscript{106}

Observing that the debtor “solicited the action against [the directors and officers] by creating the trustee,” the court found that the trustee brought the action “only with the solicitation, assistance, or participation of the debtor.”\textsuperscript{107} Since such activity was expressly excluded from coverage under the exception to the exception appearing in the debtor’s policy, the court absolved the insurer of its duty to indemnify the officers for liability on the claims.\textsuperscript{108}

*Molten Metal* and *R.J. Reynolds* demonstrate that, absent clear guidance as to how the “insured vs. insured” exclusion should be applied in bankruptcy cases, inappropriate bright-line rules may emerge in jurisprudence. In *Molten Metal*, the court focused on the legal inequivalence between the original, prepetition debtor and the involuntarily created bankruptcy constituent to whom the estate was entrusted.\textsuperscript{109} In *R.J. Reynolds*, the court found that the voluntary nature of the trustee’s appointment engendered the threat of collusion since it was effectuated with the “solicitation, assistance, or participation” of the debtor.\textsuperscript{110} Clearly, the distinguishing line between these cases is drawn on the question of

\textsuperscript{106} *Id.*

\textsuperscript{107} *Id.* at 682.

\textsuperscript{108} *Id.*


\textsuperscript{110} *R.J. Reynolds*, 315 B.R. at 682.
whether the bankruptcy constituent was appointed voluntarily. When read in tandem, *Molten Metal* and *R.J. Reynolds* establish an improper bright-line rule: the “insured vs. insured” exclusion cannot apply in a case of voluntary appointment. Although a bright-line rule may be attractive for its ability to foster predictability and avoid litigation, such a rule would yield inappropriate results when applied to many cases.\(^1\) Because of the complexity of corporate bankruptcy proceedings and the variation in contractual language at play in each, a simplistic test should not guide a court’s analysis of an “insured vs. insured” exclusion in the context of business insolvencies.

To avoid the misguidance of overly rigid, bright-line rules that have emerged in case law thus far, courts are in need of a more comprehensive diagnostic tool. This need has not gone unnoticed by scholars, some of whom have proposed solutions of their own. In 1997, Professor Michael Sousa proposed a four-factor test for applying the “insured vs. insured” exclusion in bankruptcy.\(^2\) He asks courts to consider “1) whether ‘true adversity’ exists between litigating parties; 2) the status of the plaintiff at the time the claim is made; 3) the identity of the beneficiaries of the claim . . . and 4) the reasonable expectations of the parties.”\(^3\) Sousa goes on to apply each of these factors to different bankruptcy constituents, arriving at predictive conclusions about the applicability of the exclusion to each one.\(^4\)

Although it follows a thorough and insightful treatment of the issue’s history in the courts, Sousa’s proposed solution fails for two reasons. First, Sousa has identified from case law a group of considerations that have emerged as most instructive.\(^5\) His multi-factor test, however, leaves courts in the same problematic position in which he found them: faced with a multiplicity of factors to consider without clear guidance as to how to consider them in assessing unfamiliar actors in bankruptcy. Even more precarious are the conclusions he draws about the bankruptcy constituents examined. Taken at their face, these predictions form the same type of inappropriate bright-line rules that Sousa himself condemns.\(^6\) Contrary to Sousa’s conclusions, bankruptcy constituents and

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\(^1\) One such case would involve a voluntary appointment that was effectuated without the “solicitation, assistance or participation” of the debtor. See *In re R.J. Reynolds*, 315 B.R. 674, 682 (Bankr. W.D. Va. 2003). Such an appointment could arise by the voluntary action of a creditor’s committee, corporate shareholders, or other party with significant non-identity to the original debtor.


\(^3\) *Id.* at 365.

\(^4\) *Id.* at 404. Sousa applies his multi-factor test to the following bankruptcy constituents: the debtor-in-possession, the Chief Restructuring Officer, the plan trustee, the bankruptcy trustee, and the creditors’ committee.

\(^5\) *Id.*

\(^6\) Sousa, *supra* note 10, at 404 (“A completely overriding, definitive rule . . . under an ‘insured vs. insured’ provision would prove unworkable when applied to the bankruptcy context, given the dynamics of the bankruptcy process and the differing ways in which an ‘insured vs. insured’ exclusion might arise in litigation.”).
their activities should not be evaluated prospectively for the purposes of every future case. Rather, each should be examined on a case-by-case basis according to an organized analysis that is easy for courts to apply.

Second, Sousa’s fourth factor (reasonable expectations of the parties) fails to recognize that the ex ante expectations of parties who do not anticipate bankruptcy, and who are unaware of its unique interplay with insurance law, may not be reasonable at all. Thus, the analysis he suggests imposes an artificial standard of reasonableness upon expectations that may have been formed in the absence of adequate information. That the insured corporation is likely “a sophisticated commercial entity with better than adequate legal representation” does not mean that its expectations of what will occur in bankruptcy are realistic.\(^\text{117}\) “Insured vs. insured” exclusions are included in D&O policies in contemplation of shareholder derivative suits, not bankruptcy proceedings.\(^\text{118}\) Expectations of what the exclusion will produce in bankruptcy cannot be formed with any degree of reasonability if bankruptcy itself is an unexpected event.\(^\text{119}\)

Problems arising from “insured vs. insured” exclusions in bankruptcy require systematic analysis that is informed by the intersecting bodies of insolvency and insurance law. Taking guidance from relevant jurisprudence that has emerged, the next section of this Article suggests such a system of analysis, and intends to lead courts to correct results through two straightforward steps.

**PART IV. A TWO-STEP INQUIRY TO ACHIEVE PREDICTABLE RESULTS**

Because the issue exists at the nexus of insurance law and bankruptcy law, courts cannot properly apply “insured vs. insured” exclusions in the insolvency context without harmonizing the substantive principles of both bodies of law.\(^\text{120}\) Simultaneously, courts must adhere to their duty to “ascertain the intent of the parties as manifested in the language of the agreement.”\(^\text{121}\) Given the dynamics of the bankruptcy process and the myriad ways in which in “insured vs. insured” exclusion might arise in insolvency litigation, an analytical frame-

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117 Sousa, supra note 10, at 414.
118 See infra note 158 and accompanying text (block quote from Bilitmore opinion).
119 Moreover, only six jurisdictions currently use a pure-form “reasonable expectations” approach to the interpretation of insurance contracts. See Jeffrey W. Stempel, Undue Restriction of the Reasonable Expectations Approach and the Misleading Mythology of Judicial Role, 5 Conn. Ins. L.J. 181, 198–99 (1998). While some states employ variants on the doctrine, other states, such as Idaho, Iowa, Pennsylvania, Minnesota, and New Jersey have rejected the “reasonable expectations” doctrine outright. Id. at 195; see also Max True Plastering Co. v. U.S. Fidelity & Guar. Co., 912 P.2d 861 (Okla. 1996) (discussing reasons for rejection of the doctrine).
120 Sousa, supra note 10, at 404 (noting the “significance of this issue to the substantive laws of bankruptcy, insurance, and corporations” and recognizing that “a framework is needed to provide a more uniform application of the exclusion in future bankruptcy cases”).
121 Id. at 383 (quoting E. Associated Cola Corp. v. Aetna Cas. & Sur. Co., 632 F.2d 1068, 1075 (3d Cir. 1980)).
work to determine its applicability is much preferable to a bright-line rule.\textsuperscript{122} Indeed, a rigid rule is incompatible with the contractual nature of insurance law — a more flexible approach is needed to give voice to the formative parties in interpreting their agreement.

This section provides a logical analytical framework to be employed by courts in considering the true nature of the bankruptcy constituent in every case, and in deciding whether to bar coverage for the claims they assert against corporate directors and officers under the “insured vs. insured” exclusion. With added predictability in this area, the risk that disputes over the exclusion will lead to litigation are diminished, and costs to both insurers and insureds will decrease in response. The suggested analysis carefully considers the relevant aspects of bankruptcy law, insurance law, and contract interpretation as it uniquely pertains to D&O insurance agreements. By (1) assigning a presumption of applicability or non-applicability based on the type of bankruptcy constituent involved, and (2) considering two important factors that may serve to rebut the presumption, courts will remain sensitive to the facts of each case while giving effect to the central tenets of each interplaying body of law.

Before embarking on the task of such analysis, it is crucial for a court to distinguish between two sets of claims that are typically asserted in bankruptcy cases that implicate the “insured vs. insured” exclusion.\textsuperscript{123} First, the bankruptcy constituent asserts claims against the corporate directors and officer for the commission of wrongful acts.\textsuperscript{124} These are to be characterized as the “underlying claims.”\textsuperscript{125} Second, the bankruptcy constituent asserts that the directors and officers have a claim against the D&O insurer for indemnification of any damages for loss arising from the prosecution of the underlying claims. Claims in this second category are properly understood as the “insurance claims.”\textsuperscript{126} As the R.J. Reynolds court made clear, “[i]t is the source of the [bankruptcy constituent]’s standing to assert the underlying claims that determines whether there is coverage under the policy.”\textsuperscript{127} Such standing may accrue to the constituent by way of an express directive issued by the pre-petition debtor, or by virtue of the constituent’s functional capacity as the creditors’ representative.\textsuperscript{128}

\textsuperscript{122} Sousa, supra note 10, at 404 (citing Judge Posner in Level 3 Communications 168 F.3d at 958 (“A simple, flat rule is deliciously clear and easy to apply, but it may be both under-inclusive and over-inclusive in relation to the purpose that animates it.”)).


\textsuperscript{124} Id. In R.J. Reynolds, the “wrongful acts” were specifically defined within the language of the D&O policy. However, “wrongful acts” may also generally describe breaches of fiduciary duty owed to the corporation by its directors and officers under traditional concepts in the law of corporations.

\textsuperscript{125} Id.

\textsuperscript{126} Id.

\textsuperscript{127} Id.

\textsuperscript{128} Id.
The question as to how the bankruptcy constituent obtained standing to bring the underlying claims has pivotal implications for the applicability or non-applicability of the “insured vs. insured” exclusion. Generally, if the bankruptcy constituent merely “stands in the shoes” of former corporate management, the exclusion should be implicated.129 However, if its function is more akin to a party representing and serving the interests of a debtor’s bankruptcy estate, the exclusion should normally not apply.130 The exact character of a bankruptcy constituent is often difficult to comprehend from a surface-level evaluation of the facts appearing in any given case. Further, a cursory factual review will not reveal whether a bankruptcy constituent was created as a result of the debtor’s unilateral volition. For these reasons, the proposed analysis takes thoughtful instruction from the principles of bankruptcy, insurance, and contractual interpretation to evaluate the particular facts and circumstances of each individual transaction.

A. Step One: Getting Our Bearings from the Bankruptcy Code

Step one of this Article’s proposed analysis seeks to account for the relationships between each bankruptcy constituent and an original debtor in addressing the “insured vs. insured” exclusion. By applying a rebuttable presumption of applicability, or non-applicability, as to each constituent based on its role under bankruptcy law, Step One answers concerns about collusion that the exclusion is intended to address. The greater identity the constituent bears with the original debtor, the stronger the presumption that collusion will occur, and that the “insured vs. insured” exclusion should properly be invoked as a bar to insurance coverage.

The filing of a bankruptcy petition has many important consequences for corporations with respect to the management of their assets.131 As mentioned, the filing of a petition creates a bankruptcy estate pursuant to § 541 of the Bankruptcy Code.132 While the creation of a bankruptcy estate does not expand or change a debtor’s interest in its assets, it does change the party who holds and administers the assets throughout the pendency of the bankruptcy proceeding.133 Bankruptcy estates are most commonly administered by one of two primary constituents: a “debtor-in-possession” or a bankruptcy trustee.134

130 Id.
131 Sousa, supra note 10, at 415.
132 11 U.S.C. § 541 (2000). Section 541 provides that “[t]he commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held: (b) except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.” Id.
133 In re Sanders, 969 F.2d 591, 593 (7th Cir. 1992).
In many cases, creditors’ committees will oversee and participate in the administration of the estate. Each of these constituents has a different functional status vis-à-vis the original debtor during liquidation or reorganization. However, all three forms of bankruptcy constituents may be entitled to bring claims against corporate directors and officers for their wrongful acts in the administration of the bankruptcy estate.

1. Debtor-in-Possession — A Presumption of Applicability

The debtor-in-possession is a new legal entity that is created whenever a debtor files a case under Chapters 11, 12, or 13 of the Bankruptcy Code. The debtor-in-possession conducts whatever negotiations precede the filing of a plan of reorganization, and assumes responsibility for deploying the estate’s assets for the benefit of the debtor’s creditors. Indeed, the debtor-in-possession is a fiduciary whose duties flow to all parties interested in the bankruptcy estate.

Given that a debtor-in-possession who assumes control of a bankruptcy estate also assumes a heightened fiduciary duty to conserve and protect property therein, some courts have concluded that a debtor-in-possession is not an “insured” for the purposes of an “insured vs. insured” exclusion in a D&O policy. For example, in Cigna Insurance Co. v. Gulf USA Corp., the court held that because the debtor-in-possession assumed a fiduciary duty to Gulf’s shareholders and creditors upon the filing its bankruptcy petition, the debtor-in-possession was not an “insured” for the purposes of the “insured vs. insured” exclusion in the D&O policy at issue. In that case, the court compared the debtor-in-

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135 *Id.* at 149.

136 The goal of a corporate reorganization is the confirmation and successful completion of a “plan,” which is the fruit of a process of negotiation among the debtor, creditors, and (in some cases) equity interest holders. *Id.* at 730. In liquidation cases, the assets of the corporation are sold and the entity ceases to exist in its pre-petition form. 11 U.S.C. § 1141(d)(3) (2000).


139 *Id.* at 147. 11 U.S.C. § 1107(a) describes the duties of a debtor-in-possession as follows:

   Subject to any limitations on a trustee serving in a case under this chapter and to such limitations or conditions as the court prescribes, a debtor-in-possession shall have all the rights, other than the right to compensation under section 330 of this title, and power, and shall perform all the functions and duties, except the duties specified in section 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.


possession to the FDIC in its role as a receiver for a failed bank. The court explained that

[in several instances, courts have concluded that a lawsuit by the FDIC against the former directors and officers of a failed bank was not subject to . . . an insured vs. insured exclusion because the D&O action was brought on behalf of the creditors and shareholders, and not on behalf of the insured, failed bank.]

Extending the analogy to the debtor-in-possession, who was bound to similar duties under the Bankruptcy Code, the court held that the debtor-in-possession was distinct from the pre-petition debtor and therefore not subject to the “insured vs. insured” exclusion in Gulf’s D&O policy.

Accepting that the estate and the debtor-in-possession are entities legally distinct from the pre-petition debtor according to legal formalism, decisions from other courts reflect judicial concern about the practical realities of a debtor-in-possession’s identity. While the term technically applies to the debtor itself, it is universally used to describe the debtor’s management. “Literally, the debtor’s management remains ‘in possession’ of the estate’s property [including cause of action against officers and directors] and remains responsible for managing the estate’s financial affairs while the case is pending.” Importantly, the debtor’s managers are “the very same directors and officers who unquestionably fall within the definition of ‘insureds’ under [a D&O policy].”

Thus, notwithstanding the fiduciary duties imposed on a debtor-in-possession by the Bankruptcy Code, some courts regard the distinction between a pre-petition

[Once Gulf entered bankruptcy, and assumed its status as a debtor-in-possession, its relationship to its creditors and shareholders was subject to a different set of legal obligations . . . These obligations include a fiduciary responsibility to the creditors, and a duty to manage the property of the estate for the benefit of the entire community of interest in the corporation-creditors as well as stockholders.

Id. (internal citations omitted).

Id.

Id.

Id.

“The distinction between a debtor and a debtor-in-possession is nuanced and unclear and has yielded varying results in district courts [and] among the circuits. . . . The application of this distinction to an insured vs. insured contract provision is more complex and has also yielded varying results.” Biltmore Assoc., L.L.C. v. Twin City Fires Ins. Co., 2006 U.S. Dist. LEXIS 56034 at *13, n.4 (D. Ariz. 2006) aff’d on other grounds, Biltmore Assoc., L.L.C., 572 F.3d 663 (9th Cir. 2009).

FERRIEL & JANGER, supra note 134, at 146.

Id.

Sousa, supra note 10, at 422.
debtor and its debtor-in-possession as a creature of legal fiction that does not exist in fact.  

Arguably, the additional fiduciary duties assumed by debtors-in-possession produce even higher risks that collusion will occur. As a fiduciary to a bankruptcy estate, a debtor-in-possession has affirmative duties to maximize available assets for the estate’s beneficiaries by producing funds from wherever they may be available. This creates incentives for the debtor-in-possession to bring claims in an effort to collect funds from the company’s D&O insurer, as those proceeds will augment the bankruptcy estate and decrease the original debtor’s ultimate liability to the extent that the debtor had a right to receive the proceeds prior to filing for bankruptcy. When considered as to a bankruptcy constituent who is only fictionally distinct from the original debtor, the incentive to generate insurance proceeds becomes an invitation for collusion between the two. Since the “insured vs. insured” exclusion is directed toward precisely this behavior, it should properly apply to a debtor-in-possession absent strong evidence to the contrary.

A recent decision by the only circuit court to consider the issue reflects a similar conclusion. In *Biltmore Associates, L.L.C. v. Twin City Fire Insurance Co.*, the Ninth Circuit held that, for purposes of the “insured vs. insured” exclusion, “the prefiling company [Visitalk] and the company as debtor in possession in chapter 11 are the same entity.” Recognizing that the fact of bankruptcy changes the interests of those who manage a debtor corporation, the court disagreed with the Gulf court about the transformative nature of a “debtor-in-possession” designation. The *Biltmore* court was straightforward in stating that “[t]he differences in the fiduciary responsibilities of Visitalk’s management on account of bankruptcy . . . do not make Visitalk a different entity for the purposes of the insured vs. insured exclusion.”

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149 Zilkha Energy Co. v. Leighton, 920 F.2d 1520, 1523 (10th Cir. 1990).

150 The status of debtor-in-possession imposes substantial responsibilities on the holder. The most salient and central of these is the obligation to subordinate one's own financial interests to those of one's creditors—the beneficiaries of the trust imposed by law upon the commencement of a bankruptcy case. *In re Burke*, 147 B.R. 787, 800 (Bankr. N.D. Okla. 1992); *In re Spoor-Weston, Inc.*, 139 B.R. 1009, 1016–17 (Bankr. N.D. Okla. 1992). In the reorganization context, that obligation translates to a duty to utilize the continuing possession of the assets of the estate so as to promote creditors' interests in their value.

151 *See In re Edgeworth*, 993 F.2d 51, 55 (5th Cir. 1993) (“Insurance policies are property of the estate because, regardless of who the insured is, the debtor retains certain contract rights under the policy itself. Any rights the debtor has against the insurer, whether contractual or otherwise, become property of the estate.”). The overriding question when determining whether insurance proceeds are property of the estate is whether the debtor would have a right to receive and keep those proceeds when the insurer paid on a claim. However, when the debtor has no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate. *Id.* at 55–56.

152 *Biltmore Assoc.*, 572 F.3d at 671.

153 *Id.* at 673.

154 *Id.*
In presenting its reasoning, the *Biltmore* court struck at the heart of the problem by acknowledging that “insured vs. insured” exclusions are not included in D&O contracts in anticipation of bankruptcy.\(^{155}\) Rather, they are intended to control the cost of D&O insurance in the face of derivative shareholder litigation.\(^{156}\) As the court explained, “if the exclusion were ignored, then those companies who only want to pay for protection against third party claims they cannot control would have to bear the additional financial burden [in the form of higher premiums] of paying for claims over which companies have more control.”\(^{157}\) The court refused to permit Visitalk’s misuse of the exclusion in its capacity as debtor-in-possession:

The liability insurance that the corporation and its principals bought to protect against shareholders’ derivative suits cannot be turned into an available pot for the corporation’s creditors by enforcing the insurers’ obligations while disregarding the parties’ agreement to limit those obligations to exclude insured versus insured claims . . . . The alternative position would create a perverse incentive for the principals of a failing business to bet the dwindling treasury on a lawsuit against themselves and a coverage action against their insurers, bailing the company out with the money from the D&O policy if they win and giving themselves covenants no to execute if they lose. That is among the kinds of moral hazard that the insured versus insured exclusion is intended to avoid.\(^{158}\)

To give the exclusion its intended effect, and to adhere to the plain meaning of the Bankruptcy Code, the *Biltmore* court affirmed the court below in holding that the Chapter 11 debtor-in-possession were both "the insured" for purposes of Visitalk’s D&O policy.\(^{159}\)

For the reasons articulated by the *Biltmore* court, it is sensible to view the debtor-in-possession as the same “entity” which existed before the filing of the bankruptcy petition. The debtor-in-possession is the same as the debtor prepetition, but empowered by virtue of the Bankruptcy Code to deal with the property of the estate in a manner it would not have legally employed absent the bankruptcy filing.\(^{160}\) In short, the debtor-in-possession does not lose its factual

\(^{155}\) *Id.* at 668.

\(^{156}\) *Id.*

\(^{157}\) *Id.* at 669.

\(^{158}\) *Biltmore*, 572 F.3d at 674.

\(^{159}\) *Id.*

\(^{160}\) For example, the Code empowers a debtor-in-possession to avoid executory contracts and unexpired leases. 11 U.S.C. § 547 (2000). Outside of bankruptcy, such action would expose the debtor to liability for material breach of contract.
identity with the pre-petition debtor upon filing for bankruptcy protection; instead, the legal identity of corporate management is adjusted with the addition of fiduciary duties.

To deal with the tension that arises when a debtor-in-possession asserts a cause of action against its present or former directors and officers, the proposed framework should lead to a rebuttable presumption that the debtor-in-possession is an “insured” for the purposes of the “insured vs. insured” exclusion. In transforming to a debtor-in-possession when the bankruptcy petition is filed, a debtor does not take the form of a new and independent entity. Instead, existing corporate management are vested with additional duties. Since these duties do not alter the identity of the debtor in fact, the debtor-in-possession is one and the same with the debtor and necessarily acts in concert therewith. Accordingly, the debtor-in-possession should be considered an “insured” both before and after the bankruptcy petition is filed.

2. The Bankruptcy Trustee — A Presumption of Non-Applicability

The appointment of a bankruptcy trustee is governed by section 1104 of the Bankruptcy Code. Under that section, in the event the court elects to enlist the service of a bankruptcy trustee, the United States Trustee “shall appoint” a “disinterested person” to administer the estate in the bankruptcy case. A Section 101(14) of the Code defines “disinterested person” as a person that is not a creditor, an equity security holder, or an insider; and who is not and was not within two years before the date of the filing of the petition, a director, officer, or employee of the debtor.162

Unlike a debtor-in-possession, who is most often personified by corporate managers who would be insured under the company’s D&O policy pre-petition, a bankruptcy trustee cannot hold such a position in a debtor corporation under the Code’s definition. The Code thus clearly contemplates that a trustee in bankruptcy is not someone who would be “insured” by virtue of his relationship with the debtor before bankruptcy proceedings begin. Rather, the law mandates that the trustee must have “no prior connection to either the debtor or [the debtor’s] creditors.”164

163 A trustee is the “legal representative” and “fiduciary” of the estate. See 11 U.S.C. § 323 (providing that the trustee is the representative of the estate); In re Rigden, 795 F.2d 727, 730 (9th Cir. 1986); In re Joseph, 208 B.R. 55, 60 (9th Cir. B.A.P. 1997); In re Mehr, 153 B.R. 430, 439 (Bankr. D. N.J. 1993). It follows that a bankruptcy trustee must have no interest adverse to the estate and must not profit from her handling of the estate.
164 The trustee is “is an independent person with no prior connection to either the debtor or the creditors.” Joseph, 208 B.R. at 60 (emphasis added) (quoting In re Reed, 178 B.R. 817, 821 (Bankr. D. Ariz. 1995)).
Despite the clear statutory indication that a trustee should normally not be considered an “insured,” courts have reached the opposite conclusion in reliance on the Code’s description of the trustee’s administrative role. For example, in National Union Fire Ins. Co. of Pittsburgh v. Olympia Holding Corp, the court relied on the statement in section 1104 that “the bankruptcy estate includes all legal or equitable interests of the debtor in property as of the commencement of the case.”165 Citing Reliance Co. v. Weis, the court found that “[t]he bankruptcy trustee stands in the shoes of the debtor corporation in prosecuting a cause of action belonging to the debtor.”166 The Olympia Holding court continued by explaining that “[w]henever a cause of action ‘belongs’ to the debtor corporation, the trustee simply has the authority to pursue the cause of action.”167 However, the legal and equitable interests in the property rise no higher than those of the debtor.168 The court held that the trustee, acting in his capacity under the Bankruptcy Code, “can only assert claims against the insureds that belong to [the debtor corporation].”169 Therefore, for purposes of this litigation, there is no legal distinction between [the debtor] and the Trustee for the bankruptcy estate.”170

Recognizing that Olympia Holding reflects a misunderstanding of the Bankruptcy Code’s intent in distinguishing between constituents, the court in In re Buckeye Countrymark, Inc. found “very real differences between the Trustee and the Debtor.”171

First and foremost, a bankruptcy trustee is a separate legal entity that neither represents the Debtor nor owes the Debtor a fiduciary obligation. Instead, the Trustee’s responsibility is to the bankruptcy estate that he or she represents. As such, the Trustee and the Debtor often take adversarial positions [regarding the financial affairs of the debtor-corporation]. In these respects, the Trustee and the Debtor are neither the same entity nor alter egos of each other.172

166 Weis, 148 B.R at 580.
168 Id.
169 Id.
170 Id.
171 Id.
172 Id.
Like the court in Cigna, the Buckeye Countrymark court also analogized the bankruptcy trustee to the FDIC when it acts as a receiver for a failing bank.\(^{175}\) Citing Fidelity and Deposit Co. of Maryland v. Zandstra,\(^{174}\) the Buckeye Countrymark court explained that “the FDIC, when acting as a receiver for a failed institution in claims against the institutions officers and directors, carried no threat of collusion and did not fall under the intent of the ‘insured vs. insured’ exclusion.”\(^{175}\) Similarly, found the court, “when the plaintiff is not the corporation but a bankruptcy trustee . . . there is no threat of collusion.”\(^{176}\) Because “the intent behind an ‘insured vs. insured’ exclusion in [a D&O] policy is to protect insurance companies against collusive suits between the insured corporation and its insured officers and directors,” the Buckeye Countrymark court held that “the ‘insured vs. insured’ exclusion does not excuse insurance companies from coverage” when a suit is filed by an adverse bankruptcy trustee.\(^{177}\)

The United States Supreme Court also provided guidance as to the relationship between a debtor and the bankruptcy trustee in Commodity Futures Trading v. Weintraub.\(^{178}\) That Court described the appointment of the bankruptcy trustee as an event which “completely oust[s]” the debtor’s management.\(^{179}\) While “the Bankruptcy Code gives the trustee wide-ranging management authority over the debtor,” the debtor’s powers are “severely limited” when the trustee assumes control of the business.\(^{180}\) Therefore, unlike a debtor-in-possession, a bankruptcy trustee is distinct from the debtor in his or her identity and as to his or her powers with respect to the bankruptcy estate.

Because a bankruptcy trustee and the debtor corporation are detached in both fact and function, the trustee should be viewed in most cases as separate and legally distinct from the debtor for the purposes of the “insured vs. insured” exclusion. To accomplish this result, Step One of the proposed analysis should produce a rebuttable presumption that militates non-applicability of the exclusion when a bankruptcy trustee asserts claims against corporate directors and officers. Since there is little danger that the debtor and the bankruptcy trustee will conspire to bring lawsuits against the insured officers and directors, the “insured vs. insured” exclusion is not necessary to protect against such collusive behavior.

\(^{173}\) Id.

\(^{174}\) Id.


\(^{176}\) Buckeye Countrymark, 251 B.R. at 840.

\(^{177}\) Id.

\(^{178}\) Id. at 841.


\(^{180}\) Id. at 353.
3. A Creditors’ Committee — A Presumption of Non-Applicability

For two specific but non-obvious reasons, an “insured vs. insured” exclusion should not ordinarily apply to bar coverage for claims brought by a creditors’ committee. The first reason pertains to the identity of a creditors’ committee under the Bankruptcy Code and the unique process by which the committee obtains standing to sue corporate officers and directors. The Bankruptcy Code describes the role of the creditors’ committee in section 1103(c):

A creditors’ committee may

(1) Consult with the trustee or debtor-in-possession concerning the administration of the case;

(2) Investigate the acts, conduct, assets, liabilities, and financial conditions of the debtor, the operation of the debtors business and the desirability of the continuance of such business, and any other matter relevant to the case or to formulation of the plan;

(3) Participate in the formulation of a plan;

(4) Request the appointment of a trustee or examiner; and

(5) Perform such other services as are in interest of those represented.\(^\text{181}\)

The purpose of providing these duties to a creditors’ committee is to serve as a check on managerial powers in circumstances where a bankruptcy trustee is not appointed, and to ‘ensure that the debtor-in-possession maximizes the value of the estate instead of promoting the interest of any one constituency,’ or even its own self interest.\(^\text{182}\)

The Code, thus, envisions the creditors’ committee as fulfilling a supervisory role, where it assists in the formulation of the terms of the debtor’s proposed plan of reorganization or liquidation.\(^\text{183}\)

Since the role of a creditors’ committee only involves overseeing the administration of the bankruptcy estate, it follows that the actual administrative duties are performed by an entity that is not the creditors’ committee. Instead,


\(^{182}\) Sousa, supra note 10, at 311.

\(^{183}\) FERRIELL & JANGER, supra note 134, at 149.
the Bankruptcy Code directs that such responsibilities will be borne by “one of two participants: a trustee, or a debtor-in-possession.”\textsuperscript{184} Moreover, the Code does not confer standing to sue upon a creditors’ committee.\textsuperscript{185} Where a creditors’ committee oversees the actions of a corporate debtor-in-possession, therefore, the debtor-in-possession will assume the task of bringing suit against corporate directors and officers for their managerial transgressions, not the creditors’ committee. In these circumstances, the applicability of an “insured vs. insured” exclusion to a creditors’ committee is moot. The committee does not appear as a party to the litigation, and can thus never be considered an “insured” who sues another “insured” for the purposes of the exclusion.

Under some circumstances, however, a creditors’ committee may obtain derivative standing to sue corporate directors and officers for their wrongful acts. To do so, the creditors’ committee must satisfy four prerequisite conditions:

(1) The asserted claim must be “colorable;”

(2) The committee must make a demand on the debtor-in-possession to bring the action;

(3) The debtor-in-possession must have refused unjustifiably to pursue the claim; and

(4) The committee must first obtain leave to sue from the bankruptcy court.\textsuperscript{186}

Thus, in order to obtain derivative standing, the debtor-in-possession must have unjustifiably refused to pursue the claim despite demand by the creditors’ committee. The committee’s standing to sue, therefore, depends for its existence on adversity between the debtor-in-possession and the committee regarding the claim the committee asserts.\textsuperscript{187} Any possibility that the suit results from collusive action between the committee and the debtor-in-possession is thus greatly diminished by necessary implication. Therefore, even in circumstances where a creditors’ committee is a party to litigation against directors and

\textsuperscript{184} Id.

\textsuperscript{185} Cirka v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa., 2004 WL 1813283, at *6 (Del. Ch. 2004) (“Neither Section 1103(c)(5) nor Section 109(b) of the Bankruptcy Code Creates a Direct Right of Creditors’ Committees to Bring Suit.”).

\textsuperscript{186} Fogel v. Zell, 221 F.3d 955, 965 (7th Cir. 2000); In re Gibson Group, Inc., 66 F.3d 1436, 1441–42 (6th Cir. 1995).

officers of a corporation, the “insured vs. insured” exclusion should not operate to bar recovery where liability is discovered.\footnote{188}

Second, because a creditors’ committee represents a group that is not insured under a corporate D&O policy, it cannot logically be considered an “insured” when it sues to vindicate corporate rights for the benefit of uninsured parties (creditors of the insured). Plainly, and because creditors are not “insureds” within the meaning of D&O policies issued to the debtor, a derivative suit by a committee that represents creditors is not brought by an “insured.” The committee’s initiation of a derivative lawsuit does not render the creditor pool “insured,” it merely allows the committee to vindicate the rights of the insured corporation for the benefit of the uninsured creditor pool. Since the creditors’ committee is never transformed into an “insured” when it sues in its derivative capacity, the “insured vs. insured” exclusion should ordinarily not apply to actions brought by a creditors’ committee.

The court in Cirka v. National Union Fire Insurance Co. of Pittsburgh, Pennsylvania\footnote{189} recognized both aforementioned reasons as relevant in its decision to deny summary judgment in favor of an insurer who denied coverage for liabilities incurred by the former directors and officers of a bankrupt health care corporation on the basis of the “insured vs. insured” exclusion.\footnote{190} In that case, a committee of the debtor corporation’s unsecured creditors successfully petitioned the bankruptcy court to allow it to sue the former directors and officers for various breaches of their fiduciary duties to the corporation, including the issuance of improper compensation packages.\footnote{191} The Delaware Chancery Court framed the issues as to whether a creditors’ committee that had properly obtained standing to initiate action that could have been brought by a debtor-in-possession necessarily brings that action “on behalf of” the debtor-in-possession.\footnote{192}

Recognizing that the claims made in the underlying action were claims that belonged to the corporation prior to the bankruptcy — and to the debtor’s estate following the filing of the bankruptcy — the court explained that it is the trustee in bankruptcy that becomes the representative of the debtor’s estate.\footnote{193} In contrast, the creditors’ committee is created by the Bankruptcy Code to pro-

\footnotesize{\textit{Accord Cirka,} 2004 WL 1813283, at *5 (“the [c]ommittee itself is an independent entity created by federal statute”).}

\footnotesize{\textit{Id.}}

\footnotesize{\textit{Id.} The exclusion provided that “[t]he Insurer shall not be liable to make any payment for Loss in connection with a Claim made against an Insured: (i) which is brought by or on behalf of any Insured or the Company; or which is brought by any security holder or member of the Company, whether directly or derivatively, unless such security holder's or member's Claim is instigated and continued totally independent of, and totally without the solicitation of, or assistance of, or active participation of, or intervention of, any Director or Officer of the Company.” \textit{Id.} at *2.}

\footnotesize{\textit{Id.} at *3.}

\footnotesize{\textit{Id.} at *4.}

\footnotesize{\textit{Id.} at *5.}
vide an additional check on the management of the estate. Characterizing the underlying suit as derivative in nature, the Cirka court held that, although the committee brought a suit that could have been asserted by the debtor-in-possession, there was no doubt that the committee did not bring the action on behalf of the debtor-in-possession. Rather, the committee simply sought to enforce rights belonging to the estate that the debtor-in-possession could also have enforced.

The result achieved in Cirka finds further support from principles of public policy that animate corporate law’s accommodation of derivative suits. Typically, shareholders are permitted derivative standing for the purpose of protecting their investments against the misguidance of corporate directors and officers. In bankruptcy, where equity is non-existent or severely impaired, creditors replace shareholders as the de facto beneficiaries of whatever assets remain. The Bankruptcy Code effectively preserves the “watchdog” function once performed by equity shareholders by allowing creditors’ committees to sue derivatively where equity in assets no longer exists. Given the anti-collusive intent of “insured vs. insured” exclusions, the fiduciary constituent charged with overseeing the debtor corporation in its management of its bankruptcy estate clearly falls outside the exclusion’s purview. Accordingly, Part One of the proposed analysis should yield a presumption of non-applicability where an “insured vs. insured” exclusion is considered as to a committee comprised of the debtor’s creditors.

194 Id: accord In re AKF Foods, Inc., 36 B.R. 288, 289 (Bankr. E.D.N.Y. 1984) (“The function of a creditors’ committee is to act as a watchdog on behalf of the larger body of creditors which it represents.”).
196 Id.
197 First Hartford Corp. Pension Plan & Trust v. United States, 194 F.3d 1279 (Fed. Cir. 1999); Bansbach v. Zinn, 801 N.E.2d 395 (N.Y. 2003) (noting that derivative actions serve the important purpose of protecting corporations and minority shareholders against officers and directors who, in discharging their official responsibilities, place other interests ahead of those of the corporation).
198 As a general rule, in deciding whether a claim should be equitably subordinated, a bankruptcy court will prefer claims of innocent general creditors over a claim of a shareholder or subordinated creditor deceived by officers of a corporation. 11 U.S.C. § 510 (2000); see, e.g., In re Structurlite Plastics Corp., 224 B.R. 27, 35–36 (B.A.P. 6th Cir. 1998) (quoting In re Stirling Homex Corp., 579 F.2d 206, 211 (2d Cir. 1978), cert. denied, 439 U.S. 1074 (1979)) (upholding bankruptcy court’s “subordination of the former shareholders’ claims to [those] of general unsecured creditors”).
199 See also Westmoreland Human Opportunities, Inc. v. Walsh, 327 B.R. 561, 573 (W.D. Pa. 2005) (“Reflection upon the fact that the members of the unsecured creditors committee are in fact selected from the class of unsecured creditors strengthens the rationale for the existence of a fiduciary relationship among the committee members as they are serving each other as well as the unsecured creditors not selected as members of the committee.”).
B. Step Two: On the Lookout for Rebuttal Evidence

Courts should consider two primary factors that may serve to rebut or buttress the presumptive inference that arose in the first stage of the analysis. The first and most important factor involves examination of the written contract. Since insurance law is, in substantial part, the law of contractual interpretation, the policy itself should be given appropriate consideration by a court that undertakes to properly apply its exclusions. Second, courts should inquire as to the circumstances under which the bankruptcy trustee took control of the estate, and what role the pre-petition debtor played in effecting that transition.

1. The Contract: A Careful Map of the Agreement

As the court in Molten Metal explained, “[k]nowing the general purpose [of the contract] does not tell us precisely how the parties intended to accomplish it.” Thus, a court’s primary objective in interpreting the language in insurance agreements is to ascertain and to give effect to the intention of the parties as expressed in the agreement. Courts have conclusively established that insurance policies are subject to the same rules of construction applicable to other types of contracts. However, many court decisions rendered on the basis of language contained in insurance contracts cannot be cogently explained by reference to ordinary principles of interpretation.

For instance, in North Pacific Ins. Co. v. Hamilton, the Supreme Court of Oregon addressed the question of whether a provision in the exclusions section of a motor vehicle liability policy operated to reduce liability coverage for an injured insured. The insureds argued that “Exclusion 10” was incom-

203 Nicor, Inc. v. Associated Elec. & Gas Ins. Serv. Ltd., 860 N.E.2d 280, 285–86 (Ill. 2006) (relying on Cont’l Cas. Co. v. McDowell & Colantoni, Ltd., 668 N.E.2d 59 (Ill. 1996) (delineating the traditional rules of contract interpretation)); see also RESTATEMENT (SECOND) OF CONTRACTS §§ 202–207. General principles of contract interpretation direct that where competing claims are made about the meaning of a contract, one must determine whether an ambiguity exists. In resolving an ambiguity, a court must assess the competing interpretations offered by the parties and decide which is to be preferred taking into account the “plain meaning” of the words. If the meaning is not sufficiently plain, the concept of contra proferentum militates to interpretation against the drafter. This allows the court a way to shift the calculus in favor of the parties with less knowledge and bargaining power where there is otherwise no basis for preferring one party’s view over the other. Id.
204 JERRY, supra note 2, at 155.
205 22 P.3d 739 (Or. 2001).
prehensible, while the insurer argued that the provision “clearly . . . limits coverage to the insured.” To resolve the dispute, the court approved and extended the traditional doctrine of contra proferentum, explaining that

any reasonable doubt as to the intended meaning of [the term] will be resolved against the insurance company and in favor of extending coverage to the insured . . . . [W]hen [a] term in an insurance policy is ambiguous, [the] court will interpret it according to [the] perceived understanding of [an] ordinary purchaser of insurance.

Applying this analysis, the court held that:

It is the insurer's burden to draft exclusions and limitations that are clear. In this case, the ordinary purchaser of insurance would not be able to determine what Exclusion 10 means and, more particularly, would not be able to determine that it is meant to reduce the limits of liability for certain claimants below the amount that appears on the declarations page. Under such circumstances, and having used all the [traditional] methods for resolving the dispute in this case, we construe the policy against North Pacific, the party that drafted it. Under that construction, defendants are entitled to liability coverage in . . . the amount provided on the declarations page of the policy. The Court of Appeals erred in concluding otherwise.

*North Pacific* reflects a majority view that basic rules of contract interpretation apply to insurance agreements, but may be extended to impose heightened burdens on the drafters thereof.

Professor James Fischer shares this view, describing the special rules of insurance contract interpretations as “build[ing] on general rules applicable to all contracts” but which are “more than simple extensions of the basic rules of contract” and which “often have a significant twist.” Recognizing that “the rule of contra proferentum is literally the same between the insurance rule and

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206 “For bodily injury or property damage to you or any family member to the extent that the limits of liability for this coverage exceed the limits of liability required by the Oregon financial responsibility law.” *Id.* at 741 (emphasis removed).

207 *Id.* at 742.

208 *Id.* (citing Shadbolt v. Farmers Ins. Exch., 551 P.2d 478 (Or. 1976)).

209 *Id.* at 744.

210 Professor of Law, Southern University School of Law, Los Angeles, California. Fischer is cited with approval in JERRY, supra note 2, at 154–57.

the basic contract rule,” Fischer posits that “[s]ome insurance rules do not have a strict basic contract rule counterpart.” To refine and explain his point, Fischer identifies three rules of insurance contract interpretation that have emerged in precedent but that have no counterpart in general contract law: (1) contract terms providing coverage will be construed liberally whereas terms restricting coverage (exclusions) will be construed narrowly; (2) the language of the insurance contract is to be construed in accordance with the reasonable understanding of a layperson; and (3) if semantically possible, the contract will be construed so as to achieve its objective of securing indemnity to the insured for the losses to which the insurance relates.

In effect, Fischer suggests that where general contract law searches for the “mutual intent” of the contracting parties, insurance contract law focuses on one party to the contract — the insured. The analytical result of Fischer’s logic is “one rule for coverage terms [and a] different rule for exclusions.” The practical result, however, expresses a “profound pro-insured bias — one so great that courts will rely on it to reach results that are unimaginable elsewhere in the law of contracts.”

When applied to interpret an “insured vs. insured” exclusion in bankruptcy, Fischer’s non-traditional rules of construction have two unique implications. First, because the exclusion functions to restrict coverage, it will undergo narrow interpretation by courts and fail to bar coverage where such a result is reasonable. Second, because the question of whether a bankruptcy constituent falls within the definition of an “insured” under a D&O policy involves a matter of semantics, Fischer’s third rule begs for an additional measure of leniency in favor of granting coverage where a bankruptcy constituent asserts claims on behalf of the estate. Taken together, these two factors suggest that where an “insured vs. insured” exclusion lacks specific language barring claims asserted in bankruptcy, the provision should be judicially construed to allow for coverage.

Even where “insured vs. insured” exclusions are explicitly non-applicable to bankruptcy constituents, moral hazard concerns may militate against observance of that language. In the event an insured is encouraged to exercise only minimal amounts of loss avoidance in the zone of insolvency, a

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212 Id. at 1003–04.
213 Id. at 1004–05.
214 Id. at 1005.
215 Id.
216 Id. at 1007.
218 See Fischer, supra note 211, at 1058.
court may find that public policy demands disregard of the explicit language contained in the exclusion. By allowing moral hazards to negate the effects of contractual language, the rules of interpretation support the law of insurance in addressing one of its primary concerns. Thus, D&O policies enjoy an added safeguard against mismanagement in bankruptcy — the life raft of indemnification will be unavailable to those who rely on its rescue to the detriment of the estate.

To conclude, unless a contract specifically bars recovery from claims asserted by a bankruptcy constituent or the insurer stands to fall victim to a moral hazard, a court should ordinarily interpret an “insured vs. insured” clause to favor the provision of coverage for claims asserted under a D&O policy.

2. How Did We Get Here? Re-Charting the Crooked Path

The final question to be answered in analyzing the applicability of an “insured vs. insured” exclusion in the bankruptcy context provides explanation for the divergent holdings in R.J. Reynolds and Molten Metal.219 In R.J. Reynolds, the court’s primary concern was whether the administrating constituent may be said to have brought the action without the “solicitation, assistance, or participation” of the debtor.220 The court answered the question in the negative because the debtor in that case created a legal entity to sue on behalf of the creditors through confirmation of its Chapter 11 reorganization plan.221 The plan provided for the creation of a “Trust” and designated Roy Terry, Jr. as the “Trustee.”222 The plan also provided that the debtor would transfer to the Trust all claims against directors and officers on or before the date of confirmation.223

When the Trustee in R.J. Reynolds sought a declaration that the directors and officers were entitled to indemnification under the corporate D&O policy, the court ruled that coverage was excluded under the “insured vs. insured” provision.224 In so holding, the court reasoned that “[t]he provision in the Plan that transferred any claims against [the directors and officers] from the Debtor to the Trust, and the Trustee, constituted a voluntary assignment of these claims

219 Discussed supra Part III.
221 Id. A corporation filing under Chapter 11 of the Bankruptcy Code seeks to capture and preserve its “going concern” value through reorganization. The reorganization is achieved through the debtor’s successful completion of a Chapter 11 plan, which is the fruit of a process of negotiation among the debtor, creditors, and other equity holders. FERRIEL & JANIER, supra note 134, at 762. To be given legal effect, however, the plan must be confirmed by the court. Confirmation will be granted only if the plan complies with the applicable provisions of the Bankruptcy Code. 11 U.S.C. § 1129 (2000).
222 R.J. Reynolds, 315 B.R. at 676.
223 Id.
224 Id. at 682.
to the trustee by contract." 225 The court found that unlike a situation where a bankruptcy trustee is involuntarily appointed by the court, the voluntary transfer of claims through the plan required the “solicitation, assistance, and participation” of the debtor. 226

In considering the applicability of the “insured vs. insured” exclusion where the debtor was involved in the assignment of claims, the R.J. Reynolds court found guidance from the only other court that had previously considered an analogous pattern of facts. In In re Pintlar, a debtor-in-possession filed a complaint against former directors and officers of the debtor. 227 The debtor then assigned those claims under a trust agreement to the debtor’s president and other unnamed officials. 228 The debtor’s plan of reorganization provided that these individuals would serve as “litigation trustees,” who would bring the assigned claims on behalf of the estate. 229 The Pintlar court found that “the exclusion cannot be avoided by the process of assigning the claims to another entity merely for the purpose of avoiding the exclusion.” 230 Employing the Pintlar rationale, the R.J. Reynolds court found that “the debtor’s voluntary creation of the trust and assignment of [the claims] does not permit either the debtor or the trustee to circumvent the [‘insured vs. insured’] exclusion.”

The policy concerns that give rise to the inclusion of “insured vs. insured” exclusions in corporate D&O policies lend support to the holdings in Pintlar and R.J. Reynolds. As the R.J. Reynolds court recognized,

225 Id. at 678.
226 Id. at 682. “In most [corporate] reorganizations . . . , no trustee is appointed to take over the management of the debtor’s affairs” as that task is usually assumed by a debtor-in-possession. The appointment of a trustee “generally occurs only when both the creditors and the court have lost faith in the ability of incumbent management to turn the business around . . . .” Id. In such cases, the court is “empowered to displace current management by appointing a trustee.” Ferriell & Janger, supra note 134, at 709–10 (relying on In re Bonneville Pac. Corp., 196 B.R. 868 (Bankr. D. Utah 1996) (“requiring disgorgement of fees paid to attorneys who represented the debtor-in-possession, due to mismanagement of the debtor’s affairs”)).
227 In re Pintlar, 205 B.R. 945 (Bankr. D. Idaho 1997), overruled by Biltmore, 572 F.3d 663.
228 Id. at 946–47.
229 Id. at 947.
230 Id. The court in Pintlar did rule that the litigation trustees could proceed with the prosecution of the claims against the directors and officers as representatives of the creditors in a derivative action. There was no discussion concerning whether an exclusion applied to the litigation trustees in that capacity. Id.
[I]nsurers require that [such] clauses be included in D&O policies to avoid the possibility of collusion between the corporation and the directors and officers. . . . In a case in which the debtor voluntarily transfers the cause of action to a third party, there is the distinct possibility of collusion between the debtor and the directors and officers.232

The R.J. Reynolds court thus found that the “insured vs. insured” exclusion should apply to address the “distinct possibility” of collusion and coverage was accordingly denied.233

The contractual assignment of claims that appeared in Pintlar and R.J. Reynolds is only one mechanism by which debtors may attempt to avoid applicability of “insured vs. insured” exclusions in D&O policies. Only the limits of creativity constrain the number of ways in which debtors may “solicit, assist, or participate” in the assertion of claims against directors and officers.234 Therefore, the last step of the proposed analysis asks broad questions about the debtor’s involvement in the bringing of claims that might entitle the estate to indemnification under a D&O policy.235 If, as in R.J. Reynolds, the inquiry reveals that the debtor has been improperly instrumental in the arrangement, then the possibility that collusion has occurred should rebut a presumption that the “insured vs. insured” exclusion should not bar claims asserted on behalf of the bankruptcy estate.

CONCLUSION

The analytical framework proposed in this Article cogently explains the incongruent holdings in Molten Metal and R.J. Reynolds, and provides a sound mechanism by which “insured vs. insured” provisions may be evaluated in bankruptcy cases. In identifying collusion in a systematic way and applying “insured vs. insured” exclusions to deny coverage where it exists, courts may vindicate the public interest in punishing and deterring impropriety in connection with bankruptcy proceedings. The analysis proposed in this Article gives appropriate effect to the primary intent of “insured vs. insured” exclusions by effectively addressing collusion as a moral hazard arising from the presence of D&O insurance.

232 Id. at 680–81.
233 Id.
234 Hurley v. Columbia Cas. Co., 976 F. Supp 268, 276 (D. Del. 1997) (“Complicating the liquidation scenario is a possibility that the fertile mind of the bankruptcy practitioner might come up with other devices to directly avoid the consequences of the ‘Insured v. Insured’ exclusion.”).
235 These questions explore the debtor’s pre-petition and post-petition relationships with its creditors and the estate and are not limited to inquire only if the estate representative was voluntarily created.
In addition, the suggested two-step method creates an environment in which judges, contract drafters, and litigants may all understand the implications of bankruptcy and insurance law at their convergence in D&O liability policies. All such parties are thus empowered with a clear view of the horizon, and may chart their independent courses through the bankruptcy process with an added measure of confidence — for amidst insolvency’s choppy and uncharted waters, certainty regarding the “insured vs. insured” exclusion will provide for smoother sailing.