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Effectively Defending Adversarial Actions Brought Against Former D&Os in Bankruptcy Court

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For many litigants, the decision whether to prosecute or defend a lawsuit vigorously boils down to a rather basic calculus: What are my chances of success? What is the potential recovery or loss? Is this a "bet the company" litigation? And, how much will I have to pay the lawyers? In many respects, it is not all that different from a poker player eyeing his chip stack and deciding whether the pot odds and implied odds warrant the call of a big bet.

In a traditional litigation, parties usually do not know the other party's entire hand until discovery is conducted. Parties usually can estimate their chance of success at trial and calculate whether it makes financial sense to continue to invest in their hand. And the judge usually does not care who wins, as he or she should be interested only in seeing that the game is played fairly, in accordance with the rules.

These are some basic assumptions that often guide the way litigation plays out. However, many of them—and sometimes all—get thrown out the window when defending a director or officer in an adversarial proceeding in a bankruptcy court. As explained in detail below, the unique interplay between the bankruptcy court, a trustee for a bankruptcy estate, the bankruptcy estate itself, and a defendant who served as a director or officer of a now-bankrupt company requires a different approach to risk assessment.

A trustee is likely to already have the vast majority of a defendant's responsive discovery—i.e., data owned by the estate.

Rarely do plaintiffs have many of the documents, access to former employees, outlines of likely testimony, and other evidence they need to prove their case prior to the start of litigation. They may have enough on "information and belief" to assert the necessary allegations and elements in a complaint to survive a motion to dismiss, but until discovery runs its course, they rarely have the smoking gun or the chain of documents necessary from the defendant's files to pull their case together. Instead, those documents sit in the possession of the defendant, in its files, data centers, and the memories of its employees—repositories to which plaintiffs rarely have access prior to the commencement of formal discovery.

But, in the bankruptcy context, the plaintiff-trustee does not need to wait for discovery because the trustee likely comes loaded for bear with documents, interviews with former employees, and a map of the case with key supporting evidence before the complaint is even drafted. If the defendant is a former officer or director, that defendant's relevant acts and statements are likely already captured in files and documents owned and retained by the bankrupt company itself—e.g., board meeting minutes, emails housed on company servers, or company purchase or sale orders. There may still be some documents and data that the plaintiff-trustee lacks—maybe emails between board members sent from their personal email accounts—but a lot of data that will be needed to substantiate a claim will already be in the plaintiff-trustee's possession.

A trustee will have had the opportunity to fully analyze his position.

As discussed above, the plaintiff-trustee will likely have a wealth of relevant data in his possession before he and his outside counsel even consider filing an adversary action. This often means that the plaintiff-trustee had the opportunity to review that data, interview employees and other individuals, and consult with his lawyers before bringing an adversary action. Given that the adversary proceeding will likely be filed with the same judge overseeing the bankruptcy itself, the plaintiff-trustee will already have a good feel for how the bankruptcy judge may resolve an adversary proceeding. And the plaintiff-trustee probably knows the personality of the company well enough to decide whether to go after an entire board of directors or instead take a divide and conquer strategy and target specific individual directors and officers; taking whichever approach is most likely to score a payout from the D&O insurance policy at risk in either scenario. After all, the plaintiff-trustee views the D&O insurance policy as an asset of the estate and is just evaluating how best to unlock the policy limits.

The takeaway here is that, unlike many plaintiffs, a trustee often has an opportunity to review a significant amount of responsive material, consult his experts, and weigh his likelihood of success. He may have even reached settlements and entered cooperation agreements with other officers, directors, employees and/or third parties earlier in the proceedings in a manner that helps his pursuit of certain officers and/or directors. This means a trustee—and his counsel working on contingency—is unlikely to be firing blind or bluffing when filing an adversary action; to the contrary, there is a greater possibility that he has reason to hold a certain level of confidence in his case.

A trustee has personal incentives.

Trustees bring suits against former directors and officers in order to augment the assets in the bankruptcy estate.[1] However, trustees also have some incentives that influence their decision whether to pursue an adversary proceeding. Chapter 7 trustees receive a commission based on a sliding scale relative to the amount of money disbursed by the estate to professionals and creditors. Specifically, 11 U.S.C. § 326 allows a trustee to receive 25% of the first $5,000; 10% of amounts between $5,000 and $50,000; 5% of amounts between $50,000 and $1 million; and 3% of amounts over $1 million. Therefore, if a trustee can bring a profitable adversary proceeding against a former director or officer, the trustee himself profits. But, simultaneously, if funds are spent on what results in being an unsuccessful litigation, the trustee will have less to pay creditors and, therefore, less to pay himself.

Bankruptcy judges have connections to the local bankruptcy bar.

Unlike federal district court judges, bankruptcy judges are appointed and serve terms of fourteen years.[2] These appointments are made by the courts of appeals for the circuit in which the bankruptcy court is found, meaning that bankruptcy judges are not subject to the same Congressional review and approval as other federal judges.[3] Whether it is this hiring process or the fundamental nature of the position that causes it, bankruptcy judges often have a different background than other federal judges. For example, in four of the busiest bankruptcy courts across the country, over 80% of the bankruptcy judges were in private practice immediately before taking the bench, many of them as active members of the local bankruptcy bar. Compare this to the U.S. District Court for the District of Columbia, where only about half of the judges took their seats on the federal bench immediately after leaving private practice.

But this goes deeper than simply the number of judges who may have been in private practice before taking the bench. In some bankruptcy courts, it is not unheard of that an attorney may be serving as a trustee in one matter and as counsel for the trustee in another; where counsel for the trustee in the first is the trustee in the second. This can create a heightened level of familiarity between members of this bar—and with the bankruptcy judges who preside over it. Further, when a bankruptcy case also requires counsel for various individual creditors, for the unsecured creditors committee, and all the other various constituents and interests in a bankruptcy case, it potentially involves most local bankruptcy counsel in a larger matter. There is no analogue in the courts of general jurisdiction. When individuals are elevated from this small pool to positions as bankruptcy judges, they may bring with them a higher degree of intimacy and collegiality with this local bar.

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[1] John Rapisardi & Mark Douglas, Looking Elsewhere for Creditor Recovery: Insurance Claims, D&O Actions, Reinsurance, American Bankruptcy Institute, May 6, 2001.

[2] 28 U.S. Code § 152.

[3] Id.

Bankruptcy judges emphasize maximizing the estate.

The fundamental goal of a bankruptcy trustee is to maximize the value of a bankrupt estate.[4] Indeed, this is the very purpose of the bankruptcy code,[5] and value maximization is thus simultaneously a prime concern for a bankruptcy judge.[6] How is value created in a bankruptcy estate? If a company is liquidating, value often will be created by auctioning assets to the highest bidder. But value can also be created by obtaining judgments or settlements from defendants in adversary proceedings—especially if doing so triggers an otherwise dormant and tough-to-reach D&O insurance policy. The presiding bankruptcy judge likely used this same strategy in private practice as a bankruptcy trustee at some point in his or her career.

Bankruptcy judges do not regularly work with the rules of civil procedure.

Bankruptcy judges primarily focus on the administration of bankruptcy estates, done by applying the Federal Rules of Bankruptcy Procedure. When that administration involves an adversary proceeding, the Federal Rules of Bankruptcy Procedure often incorporate the Federal Rules of Civil Procedure.[7] The frequency with which bankruptcy judges have the opportunity to work with the Federal Rules of Civil Procedure is limited. For example: in the year ending March 31, 2015; 911,086 bankruptcy cases were filed.[8] During that same time period, only 34,369 adversary proceedings were filed.[9] Bankruptcy judges therefore have less experience with these rules that might be expected from a district judge. This creates yet another variable for the defense in an adversary proceeding. Practitioners defending directors and officers in adversary proceedings should not be surprised if the traditional limits of discovery expand and open the door to burdensome and sometimes invasive discovery.

Few cases get dismissed on the pleadings or by summary judgment.

A review by Katten of data available through LexisNexis concerning adversary proceedings brought by trustees against directors and officers demonstrated that these proceedings were rarely, if ever, dismissed by either a motion to dismiss or a motion for summary judgment prior to trial. Indeed, less than 10% of the adversary actions reviewed were dismissed upon a motion by the defendant at any point in time. Compare this to civil cases terminated by the U.S. District Courts, where in the 12 months ending June 30, 2015, 185,784 of the 273,312 cases pending—almost 68%—were terminated by court action before the pretrial conference.[10]

These trends continue when considering cases that reach trial, in that a higher percentage of adversary actions against directors and officers reach trial than general civil cases in the district courts. Using the same data sets as above, only 1.1% of civil cases in the U.S. District Courts made it to trial, whereas 17.5% of the cases in the survey of adversary proceedings made it to trial. And while every case may be different, these numbers suggest a higher likelihood exists for a director/officer-defendant in an adversary proceeding to be brought all the way to trial than the defendant in a standard civil litigation.

[4] See U.S. Department of Justice, Handbook for Chapter 7 Trustees, available here. ("The trustee should administer the estate so as to maximize the distribution to the beneficiaries."); In re Ames Dept. Stores, Inc., 136 B.R. 357, 359 (Bankr. S.D.N.Y. 1992) ("One of the policies fundamental to the bankruptcy process is that of the Trustee to marshal and maximize estate assets. Section 363(b) fosters that policy by allowing the sale of all, or substantially all, of the debtor's assets outside the context of a plan of reorganization.")

[5] See Commodity Futures Trading Comm'm v. Weintraub, 471 U.S. 343, 352 (1985). See also Toibb v. Radloff, 501 U.S. 157, 163 (1991) (noting that an underlying purpose of the Bankruptcy Code is to maximize the value of the estate).

[6] In re Integrated Res., Inc., 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992) ("[W]hen a debtor desires to sell an asset, its main responsibility, and the primary concern of the Bankruptcy Court, is the maximization of the value of the asset sold . . . . In general, to receive approval of a proposed sale of assets, the debtor will need to demonstrate to the Bankruptcy Court that proffered purchase price is the highest and best offer. These tenets also apply to the outright purchase of a debtor or its primary assets, as well as the effective acquisition of a debtor through the funding of a plan of reorganization.").

[7] E.g., Fed. R. Bankr. P. 7026 ("Rule 26 F.R.Civ.P. applies in adversary proceedings.").

[8] U.S. Courts, Statistics & Reports, Table F – Bankruptcy Filings (March 31, 2016), http://www.uscourts.gov/statistics/table/f/bankruptcy-filings/2016/03/31.

[9] U.S. Courts, Statistics & Reports, Table F-8 – U.S. Bankruptcy Courts Federal Judicial Caseload Statistics (March 31, 2015).

[10] U.S. Courts, Statistics & Reports, Table C-4 – U.S. District Courts-Civil Statistics Tables For The Federal Judiciary (June 30, 2015).

Can directors and officers rely on their D&O insurance coverage?

When litigating a case in bankruptcy court, directors and officers of the bankrupt organization typically expect that their D&O insurers will help fund their defense and indemnity obligations. But bankruptcy proceedings can handicap D&O insurers' ability to provide protection and can complicate the overall insurance process. And without planning ahead, directors and officers might be left without insurance to protect their interests when they need it most.

Understanding and addressing the potential insurance limitations before filing for bankruptcy is crucial to ensure that directors or officers are adequately protected. When considering how to structure insurance programs, be aware that:

- ***Bankruptcy court limits a policyholder's rights to negotiate and purchase insurance.*** All expenses and major decisions affecting a bankrupt company need to be approved by the bankruptcy court.
- ***Insurers' actions may be limited.*** Once a company enters bankruptcy, a D&O insurer is often unable to pay any of its limits without approval of the court. Also, when a director or officer is in the process of defending a claim or is sued during the bankruptcy, D&O insurance may not be able to respond as expected.
- ***There may be competing interests on a finite amount of insurance.*** D&O insurance might be considered by some as one of the largest assets of the estate. A significant number of competing interests—whether from the bankruptcy trustee or from other directors and officers—may quickly erode the policy limits.

Increasing Your Odds

Given that claims brought by a plaintiff-trustee against a director or officer in bankruptcy court bring certain unique challenges, it is imperative that the defense team explore potential strategic opportunities to obtain a more level playing field. Further, if a business valuation is needed, the defense should waste no time engaging an expert to confidently understand the potential exposure and begin formulating litigation and possible settlement strategy. As explained below, these efforts can help the defense better control the momentum of the litigation going forward.

Withdraw to district court if possible.

Even though a claim might be filed in the bankruptcy court, there is a chance that it can be withdrawn to the local district court. To initiate withdrawal, a party must timely file a motion with the applicable district court pursuant to 28 U.S.C. § 157(d). What is considered "timely" can vary between jurisdictions and circumstances, but such a motion may be due shortly after a defendant's answer is filed.[11]

A recent empirical study reviewed all of the motions to withdraw the reference from a bankruptcy court to a district court filed in 2013 where a decision was issued and available: 253 motions in all.[12] Of these 253, 153 had been filed solely by the defendant.[13] Of the motions to withdraw filed by defendants in actions brought by trustees, debtors-in-possession, or debtors, approximately two-thirds were granted.[14] However, approximately 58% of motions to withdraw (filed by any party) go unopposed.[15] Consequently, whether a motion to withdraw is unopposed has a strong bearing on the likelihood that it will be granted,[16] but there is still potential for an opposed motion to be granted, warranting an attempt.

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[11] Compare D. Md. Adm. R. 405(2)(c)(i) (motion to withdraw due within 21 days after last pleading) with Irwin v. Faller, 531 B.R. 704, 707 (W.D. Ky. 2015) (motion to withdraw was untimely when filed a year into litigation and subsequent to motions for summary judgment) and Michaelesco v. Shefts, 303 B.R. 249, 253 (D. Conn. 2004) (motion to withdraw based on Seventh Amendment grounds filed shortly before trial considered timely).

[12] Laura B. Bartell, Motions to Withdraw the Reference - an Empirical Study, 89 Am. Bankr. L.J. 397, 411-12 (2015).

[13] Id.

[14] Id.

[15] Id.

[16] Id. (finding 57 of 119—or 48%—of opposed motions to withdraw were granted in 2013, compared to 90% of unopposed motions).

Mandatory Withdrawals

For some matters, withdrawal is statutorily mandated.[17] Mandatory withdrawal is required for matters that involve substantial and material consideration of federal law beyond the bankruptcy code.[18] Matters that require only a "straightforward" application of federal law will not trigger the mandatory withdrawal requirement,[19] and the burden to demonstrate that a matter necessitates "substantial and material" consideration of federal law rests with the party seeking withdrawal.[20] The final determination is a case-by-case analysis, but courts have generally been reluctant to broadly apply the mandatory withdrawal statute.[21]

Permissive Withdrawals

If a matter does not qualify for mandatory withdrawal, it still may benefit from a permissive withdrawal to the district court "for cause shown."[22] Various factors are considered when analyzing whether cause exists: judicial efficiency, potential delay, cost to the parties, uniformity of bankruptcy administration, forum shopping, etc.[23]

Traditionally, the most important factor was determining whether a claim was "core" or "non-core" to the bankruptcy.[24] Determining whether a matter is "core" is not always clear and can be a complex, fact-specific analysis.[25] "Core" claims are those that, generally speaking, could arise only in the context of a bankruptcy case.[26] To be "non-core": (1) a claim must not be specifically identified as "core" under 28 U.S.C. § 157(b)(2); (2) a claim must have existed prior to the filing of bankruptcy; (3) a claim must be based entirely on state law and independent from Title 11 of the U.S.C. (the bankruptcy code); and (4) the parties' rights or obligations must not be significantly affected by the outcome of the underlying bankruptcy.[27] In recent years, courts have also considered whether the bankruptcy court holds the constitutional authority to issue a final ruling on the claims at issue, but when finding such authority lacking, some district courts have found that the bankruptcy court nonetheless held the authority to issue a report and recommendation on the claims, thus keeping the proceedings before the bankruptcy court.[28]

Finally, though a jury demand can weigh in favor of withdrawing a matter from the bankruptcy court, district courts have held that withdrawal in such cases is premature until shortly before trial.[29] Accordingly, a defendant may still litigate all discovery and dispositive motions before the bankruptcy judge until the matter is withdrawn to the district judge solely for the purpose of the jury trial.

Due to the fact-intensive nature of these determinations, coupled with the impact that their resolution will have throughout the life of the case, defense counsel should consider making a motion to withdraw an early priority. If an immediate withdrawal is granted, the defense will likely benefit from litigating discovery

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[17] 28 U.S.C. § 157(d) ("The district court shall on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires a consideration of both Title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce.")

[18] United States v. Delfasco, Inc., 409 B.R. 704, 707 (D. Del. 2009).

[19] Id.

[20] Id.

[21] Bankruptcy Law Manual § 2:11 (Reference and Withdrawal of Reference) (2016).

[22] 28 U.S.C. § 157(d) ("The district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown.").

[23] In re Lehman Bros. Holdings Inc., 480 B.R. 179, 188 (S.D.N.Y. 2012).

[24] The "core" or "non-core" determination goes further than just determining whether a matter will be withdrawn to the district court. It can impact the right to a jury trial and the standard applied during any potential review of the bankruptcy court's finding by the district court. Thomas Salerno & Jordan Kroop, § 9.02 Impact of Core Versus Non-Core Designation in Bankruptcy Litigation and Practice: A Practitioner's Guide (2016).

[25] In re O'Brien, 414 B.R. 92, 98 (S.D.W. Va. 2009); Michael Cook, et al., § 14.03 Determining Whether A Matter Is A Core Proceeding in Bankruptcy Litigation Manual (2016).

[26] In re O'Brien, 414 B.R. 92, 98 (S.D.W. Va. 2009).

[27] Id.

[28] In re Lehman Bros. Holdings Inc., 480 B.R. 179, 188, 194 (S.D.N.Y. 2012).

[29] Michaelesco v. Shefts, 303 B.R. 249, 253 (D. Conn. 2004).

and substantive issues before a judge more familiar with such issues and the procedural rules and less concerned with increasing the value of the bankruptcy estate.

Engage experts early.

For certain claims brought against directors and officers, such as a claim for breach of fiduciary duty, it may be necessary to obtain an expert valuation of the debtor.[30] Such valuations have become heavily contested aspects of bankruptcy cases, especially as different experts employ various analytical approaches and rely on complex assumptions.[31] Market turmoil will also complicate any potential analysis.[32] Resultantly, valuations can be uncertain and wildly disparate. Indeed, it is not unusual for experts assisting different parties to offer valuations that are millions, tens of millions, or even hundreds of millions of dollars apart.[33]

To better prepare for what will be an inevitable battle over valuation, a prudent defendant will retain an expert early, especially given the likelihood that a case will survive to trial if being litigated before a bankruptcy judge. The expert can then work with counsel to not only develop defendant's valuation, but also help counsel understand the likely flaws in plaintiff's valuation. This will help prepare for the inevitable battle over valuation while immediately informing any potential settlement strategy, hopefully providing the defense with tangible evidence to drive down the settlement value of the case.

Protect directors and officers: address insurance needs in advance.

Beyond understanding the ramifications of litigating in bankruptcy court, directors, officers and the companies they serve need to take all necessary steps to ensure that sufficient and accessible insurance coverage is in place to protect an officer or director during the bankruptcy process. Make sure to:

- ***Negotiate the terms of your D&O runoff policy before bankruptcy proceedings.*** Runoff occurs when there is a change in control of the company or where the company ceases to exist. Runoff insurance provides coverage for claims that arise out of wrongful acts that allegedly occurred prior to the date of the change in control. Policyholders can negotiate and purchase runoff coverage before the bankruptcy filing when the company still has control over its expenditures and the ability to negotiate policy terms. Depending on the terms of the policy, runoff is triggered either when the company emerges from bankruptcy or when the company enters bankruptcy. To obtain the most competitive policy terms, companies should try to purchase runoff coverage before filing for bankruptcy protection.
- ***Understand how your policy terms will play out in bankruptcy.*** To the extent possible, negotiate favorable policy terms that allow for the payment of insurance proceeds during the pendency of a bankruptcy—often known in an insurance policy as waiver of stay terms. If unable to obtain this language, most D&O insurers will agree to seek a comfort order from the bankruptcy court that will enable the insurer to pay the defense costs of a director or officer while the bankruptcy remains pending. Be aware that comfort orders can be limited; for example, the court might allow only a certain monetary amount to be paid or it might only allow payments to be made for a set period of time.
- ***Purchase Side-A difference-in-conditions (DIC) insurance.*** Standalone Side-A DIC coverage could help avoid conflicts with the bankruptcy trustee as to who is entitled to the insurance proceeds—the trustee on behalf of the bankrupt entity or the individual directors and officers. Because Side-A DIC insurance is dedicated to providing coverage to the directors and officers—and not the bankrupt company—limits for this coverage are rarely viewed as an asset of the estate.
- ***Ensure sufficient D&O insurance limits.*** Policyholders should plan appropriately to ensure that there are sufficient limits in place to protect their interests. In particular, the costly nature of litigating in bankruptcy court highlights the need for sufficient D&O insurance limits. This need should be carefully considered due, in part, to the fact that a bankruptcy trustee typically considers the D&O policy proceeds to be a significant asset of the estate; the larger the limits the more appealing litigation looks to the

[30] See Michael Cook & David Hillman, § 13.02 Context Of Common Valuation Disputes, Bankruptcy Litigation Manual (2016).

[31] Stan Bernstein et. al., Squaring Bankruptcy Valuation Practice with Daubert Demands, 16 Am. Bankr. Inst. L. Rev. 161, 162, 239, 263 (2008).

[32] 2009 Ann. Surv. of Bankr. Law 9.

[33] Stan Bernstein et. al., Squaring Bankruptcy Valuation Practice with Daubert Demands, 16 Am. Bankr. Inst. L. Rev. 161, 240-49 (2008) (summarizing valuations from multiple bankruptcy matters).

trustee. Side-A DIC limits are potentially one solution—as mentioned above—and are a critical component to ensure directors and officers are protected during a bankruptcy.

- ***Review all policy terms and consider how a bankruptcy filing will impact the application of the policy terms.*** Organizations should work with their insurance advisor to determine, for example, whether the policy's insured versus insured exclusion has a broad bankruptcy carve-back, how the conduct exclusions—the fraud and personal profit exclusions—might be triggered, and how the exclusions may apply should the case go to verdict in a potentially unfavorable venue. If the policy also provides entity coverage—known as Side-C coverage—determine whether there is favorable pre-set allocation wording in the policy.

Bankruptcy litigation can be complex and time consuming for organizations and their directors and officers. Make sure D&O insurance will appropriately respond when coverage is needed. Organizations should spend time reviewing their policies with an insurance professional in advance of a bankruptcy filing to best maximize insurance protection.

Conclusion

A successful poker player understands his opponents and the odds of winning a head-to-head battle. The same is true for a successful litigator. Because the bankruptcy backdrop affords a plaintiff-trustee a different position than a plaintiff in a traditional litigation scenario, litigators defending directors or officers in adversary proceedings need to alter their approach to risk assessment. The defense needs to consider variables that rarely appear in other cases but are more likely in the bankruptcy scenario. For example, the heightened possibility that the plaintiff-trustee already possesses the vast bulk of material it would otherwise receive through discovery, that the plaintiff already has sufficient documentary (and potentially testimonial) evidence to survive any motion for summary judgment, that the plaintiff-trustee is familiar with the judge and vice-versa, and that the plaintiff-trustee and her outside counsel, working on contingency, would be less likely to bring a potentially risky claim for fear of putting themselves at risk.

The defense needs to quickly and thoroughly understand the case: to get deep into the documents, to reach out to the available principals and witnesses and get the story from their points of view, and to explore and test the theories asserted by the trustee. Once all this is done, the defense must take the most difficult step and, considering all the aspects discussed above, explore and identify the most efficient paths to resolution. Importantly, in our view, the defense must take all steps necessary to get the claims against former officers and directors out of the bankruptcy court.