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Securities Litigation and Insolvency: the Case for the Director and Officer Insurance Proceeds

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I. Introduction:

The availability of director-and-officer — or “D&O” — insurance has for many years been one of the primary financial protections for individuals serving as directors and officers. Individuals agree to serve as directors and officers based, in part, on the expectation that D&O policies will protect them from suffering significant — and often devastating — financial loss by paying their legal defense costs and any settlements or judgments entered against them in securities and other litigation.

However, even as the recent spate of failing companies has highlighted the importance of D&O insurance, a very real threat to the availability of D&O insurance proceeds has materialized. This threat manifests itself when companies file for bankruptcy protection and parties to the proceeding — trustees, creditors or estate representatives — claim the proceeds of the D&O insurance are assets not of the directors and officers, but rather, of the debtor’s bankruptcy estate. A finding that the proceeds are the property of the estate can have devastating consequences for individual directors and officers. Assets that are the property of the estate can be frozen indefinitely pending resolution of the bankruptcy proceeding. As a result, directors and officers may not be able to draw down on the D&O insurance proceeds to defend themselves in pending securities class actions or fiduciary duty cases, or to satisfy any finding of liability that may result from such actions. Such a result is a strong disincentive to talented and competent individuals serving as directors and officers. This article describes the current state of the law on this issue, assesses the strength of the various positions taken by the courts addressing the issue and suggests the proper analytical framework within which such cases should be decided.

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II. When the Crisis Arises: Securities Claims Against Directors and Officers of Financially Troubled Corporations.

Modern D&O policies typically contain three separate types of coverage: (i) liability coverage, which insures directors and officers directly for attorneys' fees and costs they incur defending themselves against claims of securities fraud and most claims of breach of fiduciary duty, as well as any judgments entered against them as a result of those claims; (ii) indemnity coverage, which reimburses the corporation for any indemnification payments it is permitted or required by law to make to reimburse its directors or officers for attorneys' fees and costs and judgments for which the directors and officers become liable; and (iii) entity coverage, which insures the corporation for attorneys' fees and costs it incurs defending itself against claims of securities fraud, as well as any judgment entered against it as a result of those claims.

The crisis of coverage for directors and officers occurs at the intersection of securities and bankruptcy law. Often, the directors and officers of a financially troubled company that has become the target of multiple securities class actions and related litigation will decide to seek bankruptcy protection. When a corporation files for bankruptcy protection, the Bankruptcy Code provides for the creation of a bankruptcy estate.¹ This estate includes "all legal or equitable interests of the debtor in property as of the commencement of [the bankruptcy] case,"² including all "[p]roceeds, products, offspring, rents, or profits of or from property of the estate."³ The Supreme Court has interpreted this section broadly: "The scope of . . . [the estate] is broad. It includes all kinds of property, including tangible or intangible property [and] causes of action."⁴

The debtor company's creditors, bankruptcy trustee and/or estate representative, frustrated at the often meager assets available to satisfy the company's debts, seek to maximize the estate assets available for distribution to creditors in any way possible. Often, the only significant asset available is the D&O insurance obtained by the company for the protection of its officers and directors. Relying on the broad language of the Code and pointing to the indemnity and entity coverages of the corporation's D&O insurance, the creditors, trustee or estate representative lay claim to the insurance, insisting it is the exclusive property of the estate and may only be used to satisfy their claims against the company and its directors and officers. They also seek to stay indefinitely all pending securities claims against the directors and officers filed by the company's shareholders, in the alternative, seek to prohibit the directors and officers from drawing down on the D&O insurance to pay defense costs, a settlement or a judgment in those cases.⁵

III. Why the Crisis Arises: the Distinction Between Ownership of a D&O Policy and Ownership of that Policy's Proceeds.

Courts generally agree the D&O policy itself is property of the estate.⁶ Many courts also recognize that D&O policies are different from other types of liability policies, and distinguish between ownership of a D&O *policy* and ownership of the *proceeds* of that policy.⁷ While the corporation purchases a D&O policy, the beneficiary of the policy is actually the director or officer covered by the policy.⁸ Thus, some courts have recognized that the ownership of D&O policies and the proceeds of those policies may diverge.⁹ These courts therefore caution that the ownership of the proceeds of D&O policies must be analyzed in light of the facts of each case.¹⁰

The opinion by the Court of Appeals for the Fifth Circuit in *Louisiana World Expo., Inc. v. Federal Ins. Co. (In re Louisiana World Expo., Inc.)*, 832 F.2d 1391 (5th Cir. 1987) generally is recognized as the seminal case establishing the policy/proceeds ownership dichotomy. In that case, Louisiana World Exposition, Inc. ("LWE") filed a Chapter 11 bankruptcy petition seeking to reorganize.¹¹ Prior to its financial

difficulties, LWE had purchased a number of insurance policies intended to provide its directors and officers with coverage for liabilities and legal expenses that they might incur in connection with their positions.¹² The policies also reimbursed LWE if it was required to indemnify its directors and officers for legal expenses or liabilities.¹³ The limit of these combined policies was \$20 million.¹⁴

After LWE filed for bankruptcy, its creditors' committee sued LWE's directors and officers on LWE's behalf for mismanagement and malfeasance.¹⁵ A year after the suit was filed, at least one of the insurance companies had paid or been billed for \$500,000 in legal expenses incurred by the directors and officers.¹⁶ The creditors' committee, concerned that should they prevail in their lawsuit against the directors and officers, the \$20 million policy would be insufficient to pay damages to the corporation *and* the directors and officers' litigation expenses, filed an adversary proceeding in the bankruptcy court requesting that the court enforce the automatic stay and prohibit further payment of the directors and officers' litigation expenses.¹⁷ The case was dismissed without comment by the bankruptcy court, and the district court affirmed the dismissal.¹⁸

The Fifth Circuit affirmed the district and bankruptcy court's decisions, holding the D&O policy proceeds were not property of LWE's bankruptcy estate.¹⁹ In its rationale supporting the decision, the court recognized the dual nature of the insurance policies — that is, that the policies consisted of both liability coverage for liability and expenses incurred by the directors and officers and indemnification coverage for the corporation's indemnification of its directors and officers.²⁰ The court likewise recognized that, as is usually the case, both policies were part of “a single package,” and were “[subject to] a single total amount of coverage which was applicable to both the indemnification and liability protections jointly.”²¹ Despite the dual nature of this “single package,” however, the court asserted the case before it involved only the liability part of the policy and claimed, without explanation, that the indemnification part of the policy was irrelevant to the case.²²

Within this frame of reference, the court reasoned that LWE had no property interest in the proceeds of the liability coverage, regardless of the fact that it had purchased the policies.²³ In doing so, the court noted that the directors and officers were the “named and only insureds”²⁴ and distinguished cases that held proceeds of policies covering the bankrupt's liability belonged to the estate:

In such cases, the estate owns not only the policies, but also the proceeds designated to cover corporate losses or liability That is different from the liability coverage here, which does not cover the liability exposure of the corporation at all, but only of its directors and officers and is payable only to them.²⁵

The fact that the bankrupt corporation was not directly insured for liability distinguished the cited cases from the case before the court.²⁶

The court further distinguished the other cases by examining what entity brought the suits.²⁷ In the distinguished cases, individual third-party plaintiffs had sued the estate seeking recovery for themselves.²⁸ The courts stayed the actions because of a concern the D&O proceeds would be exhausted, and the directors and officers would then turn to the estate for indemnification, thus depleting an asset of the estate.²⁹ In comparison, in the case before the *Louisiana World* court, the creditors' committee brought the action seeking to *enlarge* the debtor's estate.³⁰ The court reasoned that any payment under the liability coverage directly to the directors and officers would proportionally reduce the risk the directors and officers would have to seek indemnification from the estate.³¹ Thus, the court stated, “[t]here is not the potential for increasing the estate's exposure by payment of liability proceeds due.”³²

In sum, the *Louisiana World* court held that where only the liability coverage of a D&O policy is at issue, the liability proceeds belong only to the directors and officers, and not to the estate.³³ Because the *Louisiana World* court limited the issue before it to whether the liability portion of an insurance policy was property of the estate³⁴, however, subsequent cases have wrestled with how to apply its holding to other factual circumstances.

For example, in *Circle K Corp. v. Marks (In re Circle K Corp.)*, 121 B.R. 257 (Bankr. D. Ariz. 1990), the bankruptcy court found continued securities litigation against directors and officers would affect the debtor corporation's property interest in the proceeds of the D&O policy, reasoning that where the legal costs would exceed the policy limits an estate asset is diminished and the debtor's exposure in other litigation would be increased.³⁵ Whether the insurance proceeds were depleted by direct payments to the directors and officers or indemnification through the corporation did not matter.³⁶ Under either circumstance, the court held that where expenditures exceed the amount of insurance, the insurance proceeds are property of the estate and the court may properly stay any litigation that invokes the insurance.³⁷ However, the court did concede that "[i]f the instant policies only provided coverage for directors and officers, and not indemnification coverage for the debtor [corporation], the *Louisiana World* case could perhaps be on point."³⁸

Similarly, in *In re Sacred Heart Hospital of Norristown*, 182 B.R. 413 (Bankr. E.D. Pa. 1995), the court emphasized that because payment to the directors and officers under liability coverage would diminish the available "pot," the debtor would be "arguably exposed . . . to claims of indemnification which otherwise would have been paid by the insurer."³⁹ Thus, the *Sacred Heart* court concluded that "[w]e think that such an indemnification interest in proceeds is sufficient to bring those proceeds into the estate."⁴⁰

In contrast, other courts have followed the lead of *Louisiana World* and focused solely on the liability aspect of the insurance policy, with little or no reference to the type of policy in front of the court. At least one court — the District Court for the Northern District of California in *In re Daisy Systems Sec. Litig.*, 132 B.R. 752 (Bankr. N.D. Cal. 1991) — followed *Louisiana World* without any apparent regard to the Fifth Circuit's limiting its holding to a D&O policy's liability coverage, and concluded that D&O policy proceeds are "not simply assets of [the bankrupt corporation's] estate to be divided among creditors according to bankruptcy law."⁴¹ The bankruptcy court in *Daisy* held that D&O liability proceeds are not property of the estate even where the depletion of the proceeds could result in claims for indemnification under the corporation's policy.⁴² This case, however, has been criticized for failing to take into account the fact-specific nature of *Louisiana World*.⁴³

The court in *Zenith Labs., Inc. v. Sinay (In re Zenith Labs., Inc.)*, 104 B.R. 659 (Bankr. D.N.J. 1989), found the proceeds of a D&O policy were not an asset of the estate, but under the facts and circumstances distinct to the state law of that case.⁴⁴ In *Zenith*, the bankrupt corporation was required to indemnify its directors and officers "to the extent provided in the Business Corporation Act ["BCA"] of the State of New Jersey."⁴⁵ The New Jersey BCA, in turn, permitted but did not require the corporation to indemnify its directors and officers.⁴⁶ The court reasoned that, because the corporation could always refuse to indemnify, the corporation would not be necessarily exposed to an increased indemnification risk where the amount of coverage had been reduced by direct payments on the liability part of the policies.⁴⁷ Thus, because the policies did not necessarily either increase the debtor's worth or decrease its liabilities, the court held that the D&O policies were not property of the estate.⁴⁸

The Fifth Circuit itself has refined its holding in *Louisiana World*, and recognized the possibility of different analyses applying to different factual scenarios. In *Houston v. Edgeworth (In re Edgeworth)*, 993

F.2d 51 (5th Cir. 1993), the Fifth Circuit outlined a simplified test to determine whether D&O proceeds were property of the estate.⁴⁹ In *Edgeworth*, the court looked solely to whether the debtor would have a right to receive and keep the proceeds that the insurer paid on a claim.⁵⁰ Because the insured physician's liability policy paid him directly, and not through the hospital, the court held the proceeds were not property of the estate and could not enhance the bankruptcy estate for the benefit of other creditors.⁵¹

The Fifth Circuit later suggested its analysis in *Edgeworth* was incomplete. In *Homsy v. Floyd (In re Vitek)*, 51 F.3d 530 (5th Cir. 1995), the court stated the language in *Edgeworth* “confutes the broad understanding” that where the policy provides the debtor with coverage for judgments or losses against the bankrupt corporation, the debtor owns the policy regardless of whether the D&O can also recover directly from the insurer).⁵² The court then summarized the state of the law in the Fifth Circuit as follows:

In this circuit, we are . . . in the position of knowing how to resolve cases on either end of the continuum, but we have not yet decided how to resolve cases lying somewhere along the continuum. On one extreme, when a debtor corporation owns a liability policy that exclusively covers its directors and officers, we know from *Louisiana World Exposition* that the proceeds of that D&O policy are not part of the debtor's bankruptcy estate. On the other extreme, when a debtor corporation owns an insurance policy that covers its own liability vis-a-vis third parties, we — like almost all other courts that have considered the issue — declare or at least imply that both the policy and the proceeds of that policy are property of the debtor's estate. But we have not yet grappled with how to treat the proceeds of a [policy which falls in the middle of the continuum].⁵³

The Fifth Circuit's description of the law in *Edgeworth* and *Vitek* mirrors the practice of most other courts. The trend is to draw a distinction between treatment of policy ownership and proceeds ownership under liability and indemnification policies. Although these courts have agreed that a reduction of the total amount of coverage available under combined D&O policies could potentially expose the debtor to uncovered claims, they have refused to find that such an amorphous, contingent claim can cause the insurance proceeds to be considered property of the estate.⁵⁴ One court emphasized that a debtor has no property interest in the insurance “until the debtor is legally obligated to pay damages which fall under the under the definitions contained in the policies.”⁵⁵ Pursuant to this reasoning, the mere likelihood, or even probability, that a policy will be fully exhausted due to payment of D&O defense costs is irrelevant to a determination of whether the policy is property of the estate.⁵⁶

Recently, two courts have applied a flexible, fact-intensive analysis to determine the ownership of proceeds of a type of D&O policy that had never been explicitly examined before — an entity policy that covered securities claims against the corporation itself. See *Ochs v. Lipson (In re First Central Fin. Corp.)*, 238 B.R. 9 (E.D.N.Y. 1999) and *In re CHS Electronics, Inc.*, 261 B.R. 538 (Bankr. S.D. Fla. 2001). In *First Central*, the Bankruptcy Court for the Eastern District of New York held that the proceeds of a D&O policy containing indemnification and entity provisions were not property of the estate where neither the indemnification nor entity provisions were implicated by currently pending claims.⁵⁷ There, the trustee of a Chapter 7 debtor corporation sought an injunction to prevent the potential distribution of the proceeds of the corporation's D&O policy, arguing the proceeds were the property of the estate.⁵⁸ The D&O policy provided both liability coverage directly to the officers and directors, as well as indemnity coverage to the corporation for reimbursement of any monies expended to indemnify the officers and directors.⁵⁹ In addition, the policy contained a rider that provided entity coverage to the debtor for alleged violations of securities laws.⁶⁰ The trustee argued the entity coverage in the rider mandated a finding that the proceeds of the policy be considered property of the estate, but the court

disagreed.⁶¹ While the court ultimately determined the lack of any claims against the corporation meant that the entity coverage was not implicated, it noted:

It may well be that proceeds of certain D&O insurance policies, which provide direct entity coverage to a corporate debtor, can be considered property of the estate. Perhaps, this determination would be appropriate when many and/or large entity coverage claims against the debtor threaten to become a “free-for-all” that might exhaust the insurance proceeds and thereby jeopardize estate assets over and above the limits of the policy. In such situations, the debtor’s entity coverage competes for proceeds with the officer and director liability portion of the insurance policy. For every dollar paid out to the officers and directors there is one less dollar of coverage protecting the debtor’s estate.⁶²

The *First Central* court thus suggested that the very existence of entity coverage *and* claims invoking that coverage could convert D&O proceeds to property of a corporation’s bankruptcy estate. However, due to the lack of such entity claims, the proceeds there were found not to be an asset of the estate. Because the case before it involved no claim against the corporation, however, the court found the proceeds were not part of the corporation’s bankruptcy estate.⁶³

Most recently, the Bankruptcy Court for the Southern District of Florida, in *In re CHS Electronics, Inc.*, 261 B.R. 538 (Bankr. S.D. Fla. 2001), adopted *First Central* and rejected an attempt by a bankruptcy trustee to prevent the directors and officers of the debtor from using the proceeds of the D&O policy to settle securities claims against them.⁶⁴ Relying on *Sacred Heart*, the debtor corporation’s trustee claimed the presence of entity and indemnification coverage in the corporation’s D&O policy automatically transformed the proceeds of the policy into the property of the estate.⁶⁵ The court rejected this argument, finding instead that since there were no securities claims pending against the estate, the entity provision of the policy was not implicated.⁶⁶ Regarding indemnification coverage, the court observed that claims for indemnification already had been submitted and would simply be subtracted from the remaining amount of the proceeds.⁶⁷ In any case, the court observed, the entity and indemnification coverage provisions were not what was driving the trustee’s “vigorous” attempts to prevent the directors and officers from using the proceeds of the D&O policy to settle the class action claims against them:

[The trustee’s] efforts to protect sufficient insurance proceeds to satisfy what he believes will be a large judgment against the Debtor’s former officers and directors is certainly consistent with a general policy in favor of maximizing the size of a bankruptcy estate. Unfortunately, [the trustee] could not cite to, and this Court is unaware of, any Bankruptcy Code provision or case law that would give a bankruptcy trustee any different status than a non-bankruptcy plaintiff with an unliquidated claim against third-parties which may be covered by insurance proceeds to be used to settle or satisfy a judgment entered in favor of other plaintiffs. . . . Simply because [he is] a trustee in bankruptcy does not arm him with super-plaintiff powers in causes of action between third parties.⁶⁸

While *First Central* and *CHS Electronics* represent a positive trend toward a more thoughtful, flexible and practical analysis of the ownership of the proceeds of D&O policies, these cases have not been universally adopted. In fact, many bankruptcy courts, actively seeking to advance the bankruptcy policy of maximizing the estate’s assets, continue to apply the simple, straightforward rule of *Circle K* and *Sacred Heart*. Exacerbating the uncertainty created by this split is the fact that the Fifth Circuit is the only circuit to have ruled definitively on the issue.

IV. How the Crisis Should be Resolved: Courts Should Adopt the Analysis Espoused by the *First Central* and *CHS Electronics* Courts.

The flexible, fact-intensive analysis of *First Central* and *CHS Electronics* is the more appropriate way to determine who owns the proceeds of a D&O policy when a corporation is in bankruptcy. The inflexible, *per se* rule espoused by the *Circle K* and *Sacred Heart* courts suffers several flaws. First, it creates a property interest in the proceeds of the D&O policy for the estate based only on the *possibility* that the estate might be called upon to indemnify the directors and officers under the indemnification provisions of the D&O policies at issue. This means directors and officers are effectively precluded from defending themselves in the currently pending securities class actions today based on what the corporation might be forced to pay at some date in the future. In any event, the amount an estate could pay to indemnify its officers and directors is likely to represent only a tiny fraction of the total proceeds of a D&O policy. Typically, D&O policies provide that an estate may only be reimbursed under the indemnification coverage amounts the estate *actually paid* to indemnify the directors and officers. But the claims of officers and directors for indemnification are merely “dubious general unsecured claims against their now-bankrupt employer corporation.”⁶⁹ Officers and directors seeking indemnification line up at the end of a very long line of other unsecured creditors hoping to recover, at best, a few pennies on each dollar of their claims. In short, because of the low priority of directors’ and officers’ indemnification claims, the amount an estate actually will pay on the claims will be very small, possibly zero. If the debtor can seek reimbursement from the insurer only for the amounts it actually pays to indemnify the directors and officers, the amount for which the estate can seek reimbursement under the policies also will be very small, possibly zero.⁷⁰

Moreover, any indemnification claims the directors and officers may have are subordinated to the level of common stock.⁷¹ Unless all the creditors’ claims are paid in full — an unlikely event in any bankruptcy — the directors and officers never will be entitled to *any* payment from the estate. And any contingent claims for indemnification a director or officer has may be denied when the court rules on claims allowance.⁷² It is unfair to deny the directors and officers access to the proceeds of the D&O policy based on indemnification interests theoretically possessed but rarely exercised by the estate. As the court in *First Central* observed, “[i]f entity coverage is hypothetical and fails to provide some palpable benefit to the estate, it cannot be used by a trustee to lever himself into a position of first entitlement to policy proceeds.”⁷³

Second, the *Circle K/Sacred Heart* analysis elevates the property interest of the estate at the expense of the property interest of the directors and officers. If a remote indemnification interest creates a property right in the estate, explicit contractual provisions of the policy requiring immediate payment of attorneys fees and costs incurred by the directors and officers must create *some* property interest for the directors and officers. Neither *Circle K* nor *Sacred Heart* even acknowledges, let alone protects, this interest. Instead, they stop at a finding that the proceeds are property of the estate, extinguishing the indisputable property interest of the directors and officers and abrogating the explicit contractual language of the D&O policy.

Even if a court finds an estate has some interest in the D&O policy proceeds, it still should find the directors and officers have a significant, if not predominant, interest in those proceeds. “A debtor’s interest in a portion of property does not subject the entire property to [Section] 541 [defining property of the estate]. Nor does a debtor’s claim to property mean that the entire property is a part of the bankruptcy estate.”⁷⁴ Consequently, even if the estate had some interest in the D&O policy proceeds, it would not compel the conclusion that the entire proceeds are property of the estate.

The Bankruptcy Code specifically acknowledges circumstances in which property is co-owned by both a debtor and a nondebtor, and establishes procedures for apportioning such property. For example, real property co-owned by the debtor and a non-debtor that cannot be partitioned may be sold and the proceeds from the sale divided between the debtor and non-debtor.⁷⁵ This principle of dividing an asset in which both the debtor and the non-debtor have an interest in certain property can be applied to D&O policy proceeds. While most policies do not have a cash surrender value that would permit it to be sold and the proceeds of the sale divided between the estate and the directors and officers, a court could divide the two interests in the policy proceeds equitably between the debtor and the non-debtor according to the degree of interest each has in them.

Third, *Circle K* and *Sacred Heart* elevate the public policy served by bankruptcy law at the expense of the important public policies served by D&O insurance. D&O policies are purchased by a corporation for the protection of its directors and officers: “D&O policies are obtained for the protection of individual directors and officers. . . . In essence and at its core, a D&O policy remains a safeguard of officer and director interests and not a vehicle for corporate protection.”⁷⁶ Courts have recognized that an important public policy is served by protecting the officers and directors of a corporation, finding that D&O policies “protect directors and officers from the potential liability they might incur in performing their duties, thereby encouraging better directors and officers to accept responsibilities and allowing them to take management risks they might not otherwise take.”⁷⁷ Moreover, D&O policies

promote the desirable end that corporate officials will resist what they consider unjustified suits and claims, secure in the knowledge that their reasonable expenses will be borne by the corporation they have served if they are vindicated. Beyond that, its larger purpose is to encourage capable men to serve as corporate directors, secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve.⁷⁸

Directors and officers are induced to serve as directors and officers in part by their belief that they will be protected from claims against them by the D&O policy purchased by the corporation on their behalf. Few reasonable individuals would serve as a director or officer if they knew they could be subjected to the potentially staggering cost of defending themselves against multiple lawsuits, not to mention the possibility of being forced to satisfy any judgments entered in those lawsuits, out of their own pockets. Hence the public policy of ensuring capable women and men are willing to serve as directors and officers of corporations is subverted by a finding that the proceeds of a D&O policy are sole property of the estate.

On the other hand, the goal of the bankruptcy laws is marshaling the assets of the debtor’s estate to maximize the distribution to the debtor’s creditors. When a corporation becomes insolvent and files a petition in bankruptcy, the bankruptcy laws’ goal of maximizing the estate disrupts the incentives built into such devices as indemnity provisions and D&O insurance:

The basic problem . . . is that the officers and directors have served in reliance on indemnification, and to have them now personally held liable for costs and judgments against them for acts done in their corporate capacities, and giving them only dubious general unsecured claims against their now-bankrupt employer corporation seems unfair.⁷⁹

The *First Central* and *CHS Electronics* analyses actually advance both corporate *and* bankruptcy policies by simultaneously minimizing the threat of indemnification claims against the estate⁸⁰ and

maximizing the directors and officers' ability to defend claims resulting from their service to the corporation by holding that the directors and officers have a property interest in the proceeds of a D&O policy. Such a result protects the incentives built into indemnity provisions and D&O policies without compromising the goals of the bankruptcy laws. It minimizes unfairness to directors and officers by fulfilling the expectation of reimbursement that in part induced them to serve the corporation.

Fourth, neither *Circle K* nor *Sacred Heart* acknowledge or address the logical consequence of a finding that D&O proceeds are exclusive property of the estate: the parties seeking such a finding — the creditors, trustee or estate representative — cannot actually recover the proceeds. Most D&O policies provide that the proceeds can only be paid in three circumstances: (i) to the directors and officers to cover defense of and any judgment entered in claims against them; (ii) to the estate to the extent that it indemnifies those directors and officers; and (iii) to the estate to cover the defense of and any judgment entered in securities claims leveled directly against it. If the proceeds are deemed exclusive property of the estate, claims against the directors and officers under (i) cannot be paid from the proceeds. This means proceeds could only be paid directly for claims against the estate under (iii), but creditors, trustee and estate representative cannot bring such claims because they have no standing to do so. The only group that has such standing is the corporation's shareholders. The only way a court applying *Circle K* or *Sacred Heart* could avoid this result is to ignore the express language of the D&O policy and transform the proceeds into a "checking account" available to all creditors. Nothing in the Bankruptcy Code permits such a drastic modification of the terms of an insurance agreement. Courts unwilling to engage in such wholesale reformation of insurance contracts will be left at the close of the bankruptcy with a pot of money that can only be used to pay indemnification claims submitted by the directors and officers — claims the court would otherwise deny or drastically reduce.

The *First Central* and *CHS Electronics* analyses do a better job of advancing the goals of the bankruptcy laws because such an analysis permits all parties with claims against the estate or directors and officers to recover from the proceeds of the D&O policy. As explained above, a finding that the proceeds are the sole property of the estate effectively precludes the creditors or the estate from recovering anything from the D&O policy. In contrast, a finding that the proceeds are property of the directors and officers or the joint property of the estate and the directors and officers would permit the creditors and the estate to recover on their claims against the directors and officers.

In sum, *Circle K* and *Sacred Heart* suffer so many flaws and ignore so much of the real-world workings of D&O indemnification provisions that courts applying these cases run the risk of seriously undermining the legitimacy of their decisions. In contrast, the fact-intensive framework employed by *First Central* and *CHS Electronics* is flexible enough to accommodate all relevant issues — legal, practical and public policy — and therefore yields decisions which are more analytically sound and more readily and universally accepted.

V. An Additional Concern for Insureds: Insolvency of the Carrier.

A development in 2001 highlighted yet another peril of which publicly traded companies and their directors and officers should be aware, especially in today's economy: the solvency — or lack thereof — of the carrier from whom they purchased their D&O insurance. As the failed rehabilitation and subsequent liquidation of Reliance Insurance Company brought home to the company's insureds, not only does the failure of a D&O insurance carrier essentially destroy the coverage the carrier itself wrote, if the carrier was primary over which excess layers of insurance were stacked, the failure also

essentially destroys the tower of insurance above it. The fall of Reliance also demonstrated a carrier's fall can be lightning-quick.

As described by the Pennsylvania Insurance Commissioner (the governmental agency that placed Reliance first into rehabilitation and then into liquidation), Reliance was founded in 1817 a century ago in Philadelphia, Pennsylvania, and licensed to write coverage in all 50 states.⁸¹ As recently as 1998, the company appeared to be in excellent financial condition; its 1998 annual statement reflected the company's surplus was an estimated \$1.7 billion — the highest in its history.⁸² Reliance's 1999 annual statement showed, however, that only a year later, the company's capital level was below standard.⁸³ Pennsylvania's Insurance Department, acting on warnings arising from risk-based capital requirements enacted in the state in 1997, increased its financial monitoring of Reliance and ordered a financial examination of the company on March 2, 2000 — the day after Reliance filed its 1999 annual statement.⁸⁴ The monitoring revealed that Reliance was experiencing larger and more frequent claims in certain types of high-risk businesses, which, in turn, increased loss reserve levels.⁸⁵ In addition, A.M. Best downgraded Reliance's financial rating in June 2000 because of substantial debt held by its parent company, Reliance Group Holdings, Inc., resulting in the loss of the company's brokered commercial business.⁸⁶ Reliance's Unicover pooling arrangement also failed.⁸⁷ These factors, among others, destroyed Reliance's financial stability.⁸⁸

Consequently, on May 29, 2001, the Commonwealth Court of Pennsylvania granted a petition by the Pennsylvania Insurance Department to place Reliance into receivership.⁸⁹ The rehabilitation was to allow the Insurance Department to protect and preserve Reliance's assets for policyholders, and determine whether the company could be rehabilitated or must be liquidated.⁹⁰

Just over four months later, Reliance's financial condition had deteriorated to the point that the Insurance Department sought to liquidate the company. On October 3, 2001, the Insurance Department announced the Commonwealth Court had granted its petition seeking Reliance's liquidation.⁹¹ As the Insurance Commissioner explained, the Department had "determined that a plan of rehabilitation for Reliance is not financially viable. In fact, further attempts to rehabilitate would be futile. . . . [The Department] now [has] been able to evaluate the company's financial condition in sufficient detail to see that the continued rehabilitation of Reliance would substantially increase the risk of loss to policyholders, creditors and the public."⁹² More specifically, Reliance experienced liquidity problems caused by slowdowns in payments from its reinsurers; suffered a decline in value of other assets; was unable to obtain \$95 million in assets held by its parent holding company; and an audit of its financial statements revealed the company had total liabilities of \$9.9 billion but total assets only of \$8.8 billion — a \$1.1 billion negative surplus position.⁹³

The results of Reliance's liquidation on its insureds were immediate and unfortunate. With few exceptions, cases against both Reliance itself and its insureds were stayed only for 90 days.⁹⁴ However, pursuant to the Liquidation Order, "[a]ll policies or contracts of insurance issued by Reliance [were] cancelled and terminated for all purposes effective thirty days from the date of [the] Order."⁹⁵ Thus, insureds against whom claims had been made but not yet resolved, or against whom potential claims had not yet been made, were left without coverage as of November 2, 2001. Litigation on claims against them could continue as of January 2002, and the insureds were left without coverage to reimburse their defense costs or pay potential liability. And while the Insurance Department began setting up a process by which Reliance insureds could seek reimbursement for claims made on Reliance policies before they expired, recovery on such claims is highly uncertain. Moreover, the claim deadline is not until December 31, 2003, and as the Insurance Department itself

notes, “claims will not be paid for many years.”²⁶ This likely will be especially so for contingent claims, i.e., claims which had not at the time of Reliance’s liquidation been liquidated.

Worsening the insurers dilemma was the fact that not surprisingly, carriers who wrote D&O insurance excess to Reliance policies, concerned about the unexpected significant increase in potential liability, refused to “drop down” to cover Reliance’s insureds. If the insureds could not personally fund the Reliance layer, the carriers excess to that layer would not “drop down.” In short, insureds who purchased insurance from Reliance to protect them from losses have been left largely unprotected.

Reliance was a major D&O insurer. And its downfall was sudden; as the Pennsylvania Insurance Commission itself noted, as recently as a year before the Commission placed it in receivership, Reliance’s financial statements indicated it was in the strongest financial position in its history.

The need for insureds to closely scrutinize the financial health of the companies from which they purchase D&O insurance has thus significantly been heightened. Not only must directors and officers be concerned about the insolvency of their corporation — the entity with primary responsibility to indemnify directors and officers for losses suffered in the course of their service — they must also guard against the insolvency of the carrier from whom they purchase insurance to further insulate against such losses.

VI. Conclusion:

A court faced with the issue of the ownership of the proceeds of a D&O policy should apply the fact-intensive analysis of *First Central* and *CHS Electronics*. Where no entity coverage exists or where no claims implicating the entity coverage have been filed, the proceeds are not property of the estate. If entity coverage exists and claims implicating the coverage have been filed by the shareholders, shareholders seeking access to the proceeds of the D&O policy should foresee the problem and voluntarily dismiss the entity upon the filing of bankruptcy, yielding the same result as if there had been no claim against the entity in the first place. In the alternative, the court should find that both the estate and the directors have an interest in the proceeds of the D&O policy and apportion the proceeds in some equitable fashion between the estate and the directors and officers. However, if language in the D&O policy states the coverage afforded to individual directors and officers is to have priority in the event of a bankruptcy filing by the insured entity, such contractual priority should be honored by the bankruptcy courts.

Further, never has the flight to quality been more important than in today’s choice of carrier to provide D&O coverage. A poor choice might result not only in coverage from that carrier being lost, but also a loss of any excess layers above that layer.

Notes

- 1 See 11 U.S.C. § 541(a).
- 2 11 U.S.C. § 541(a)(1).
- 3 11 U.S.C. § 541(a)(6).
- 4 *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204-05 n.9 (1983).
- 5 While it is settled that these parties lack standing to bring the personal claims of shareholders, see, e.g., *Fisher v. Apostolou*, 155 F.3d 876, 879 (7th Cir. 1998) (trustee “has no standing to bring personal claims”), it is generally agreed that a creditors’ committee has standing, with the permission of the court, to bring actions on behalf of the estate. See *In re Perkins*, 902 F.2d 1254, 1258 (7th Cir. 1990). Of course, the right to bring the action does not mean the trustee, estate representative or creditors’ committee can recover the proceeds from the typical D&O policy. To avoid collusive lawsuits, most policies contain an exclusion which precludes recovery where one insured (the corporation, or anyone standing in the corporation’s shoes) sues another (the directors and officers) (an “insured vs. insured exclusion”). Whether the insured vs. insured exclusion applies to cases brought by the estate or a creditors’ committee is unsettled. Compare *In re Buckeye Countrymark, Inc.*, 251 B.R. 835, 840 (Bankr. S.D. Ohio 2000) (claims against insurance brought by trustee are not “by the [d]ebtor” nor are they brought “on behalf of the [d]ebtor”) with *Reliance Ins. Co. of Illinois v. Weis*, 148 B.R. 575 (E.D. Mo. 1992) (insured vs. insured exclusion barred coverage), *aff’d* 5 F.3d 532 (8th Cir. 1993). These issues, while important, are beyond the scope of this article.
- 6 See, e.g., *Houston v. Edgeworth (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.”); *Louisiana World Expo, Inc. v. Federal Ins. Co. (In re Louisiana World Expo, Inc.)*, 832 F.2d 1391, 1401 (5th Cir. 1987) (“We agree that the policies in this case belong to the bankrupt[’s] . . . estate; this empowers the bankruptcy court to prevent their cancellation, for example.”).
- 7 See, e.g., *Oels v. Lipson (In re First Central Fin. Corp.)*, 238 B.R. 9, 16-18 (Bankr. E.D.N.Y. 1999); *Louisiana World*, 832 F.2d at 1399-1401; cf. *Ford Motor Credit Co. v. Stevens (In re Stevens)*, 130 F.3d 1027, 1029 (11th Cir. 1997) (“The fact that the insurance policy is property of the bankruptcy estate, however, does not necessarily mean that the proceeds from that policy are also property of the estate.”). *Stevens* did not deal with D&O policies, but the case is nonetheless analogous. In *Stevens*, the bankrupt corporation held an insurance policy for the benefit of a secured creditor in the event of the destruction of the security. Like the corporation in *Stevens*, corporations purchase and hold D&O policies for the benefit and protection of their directors and officers.
- 8 See *First Central*, 238 B.R. at 16 (“D&O policies are obtained for the protection of individual directors and officers. Indemnification coverage does not change this fundamental purpose. . . . In essence and at its core, a D&O policy remains a safeguard of officer and director interests and not a vehicle for corporate protection.”).
- 9 See, e.g., *First Central*, 238 B.R. at 16-18 (observing that policy proceeds distinction in *Louisiana World* derived from fact that “D&O insurance arrangements differ substantially from the typical liability insurance policy.”); *Louisiana World*, 832 F.2d at 1399-1401 (“The question is not who owns the policies, but who owns the liability proceeds. Although the answer to the first question quite often supplies the answer to the second, this is not always so.”).
- 10 See *In re Sfuzyj, Inc.*, 191 B.R. 664, 667 (Bankr. N.D. Tex. 1996) (“[I]nsurance **policies** are property of the estate . . . but the question of whether the **proceeds** are property of the estate must be analyzed in light of the facts of each case.”) (emphasis in original).
- 11 See *Louisiana World*, 832 F.2d at 1393.
- 12 See *id.*
- 13 See *id.* This type of policy is commonly referred to as a “liability and indemnification insurance policy” and does not provide direct coverage for the corporation.
- 14 See *id.*
- 15 See *id.* at 1393-94.
- 16 See *id.* at 1394.
- 17 See *id.*
- 18 See *id.*
- 19 See *id.* at 1393-94.
- 20 See *id.* at 1394.
- 21 *Id.*
- 22 See *id.* at 1399.
- 23 See *id.*
- 24 *Id.*
- 25 *Id.* at 1399-1400 (citing *In re Davis*, 730 F.2d 176, 184 (5th Cir. 1984) (general liability policy); *In re Minoco Group of Companies, Ltd.*, 799 F.2d 517, 519 (9th Cir. 1986) (D&O policy); *A.H. Robins Co. v. Picinin*, 788 F.2d 994, 1001 (4th Cir. 1986) (products liability policy); *In re Johns-Manville Corp.*, 40 B.R. 219, 230-31 (S.D.N.Y. 1984) (same); *In re Johns-Manville Corp.* 33 B.R. 254, 263 (Bankr. S.D.N.Y. 1983) (same); *In re Meigo Int’l, Inc.*, 28 B.R. 324, 326 (Bankr. S.D.N.Y. 1983) (D&O policy); *In re Johns-Manville Corp.*, 26 B.R. 420, 436 (Bankr. S.D.N.Y. 1983) (products liability policy); *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 548 (5th Cir. 1983) (same); *Tringali v. Hathaway Machinery Co.*, 796 F.2d 553, 560-61 (1st Cir. 1986) (general liability policy); *Holland America Ins. Co. v. Succession of Roy*, 777 F.2d 992, 996 (5th Cir. 1985) (fire insurance policy); and *In re Crownover*, 43 B.R. 22, 24 (Bankr. E.D. Mo. 1984) (same)). While their factual dissimilarity should preclude the citation of cases involving policies other than D&O policies by those seeking a

determination that the proceeds are property of the estate, *A.H. Robins* and *Jobns-Manville* still are cited regularly in ostensible support for the proposition that D&O insurance proceeds are property of the bankruptcy estate. In addition to being distinguishable because they do not involve D&O policies, see *First Central*, 238 B.R. at 16-18 (“D&O insurance arrangements differ substantially from the typical liability insurance policy.”), neither actually addresses the central issue of ownership of the proceeds of the policies — they simply stand for the undisputed proposition that insurance **contracts** belong to the estate. See *A.H. Robins* 788 F.2d at 1001 (“Under the weight of authority, insurance **contracts** have been said to be embraced in this statutory definition of ‘property.’”) (emphasis added); *Jobns-Manville*, 40 B.R. at 230-31 (same). While *Minoco* and *Mego*, which do involve D&O policies, cannot be distinguished on the former grounds, *Minoco* does suffer the latter flaw. See 799 F.2d at 518-19. *Mego*, while facially addressing the proceeds of the D&O policy, predates *Louisiana World* and does not acknowledge the possibility of the divergence of ownership of an insurance policy and its proceeds. See 28 B.R. at 325-26. *Mego* is therefore of little precedential value to those seeking to counter *Louisiana World*, *First Central* and their progeny.

26 *See id.*

27 *See id.*

28 *See id.*

29 *See id.*

30 *See id.*

31 *See id.*

32 *Id.*

33 *See id.*

34 *See id.* at 1398-99.

35 *See* 121 B.R. at 262.

36 *See id.*

37 *See id.*

38 *Id.* at 260.

39 182 B.R. at 420.

40 *Id.* The Court in *In re Jasmine*, 258 B.R. 119, 128 (D.N.J. 2000), followed *Sacred Heart*, finding that where the duty to indemnify under a D&O policy is established prior to the initiation of bankruptcy proceedings, the estate has an interest in the proceeds and the proceeds are property of the estate. *See id.*

41 132 B.R. at 755.

42 *See id.*

43 *See, e.g., Sacred Heart*, 182 B.R. at 421 (“[W]e certainly do not agree with the breadth with which certain decisions [including *Daisy*] on this issue have read [*Louisiana World*] . . .”).

44 *See* 104 B.R. at 665.

45 *Id.*

46 *See id.*

47 *See id.* at 665-66.

48 *See id.* at 666.

49 *See* 993 F.2d at 55.

50 *See id.* (“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.”).

51 *See id.*

52 *Vitek*, 51 F.3d at 533 and n.17; *but see Sfuazz*, 191 B.R. at 668 (continuing to apply *Edgeworth*); *Landry v. Exxon Pipeline Co.*, 260 B.R. 769, 784-85 (Bankr. M.D. La. 2001) (applying *Edgeworth* and criticizing *Vitek* for “assum[ing] that proceeds are property of the estate as a justification for finding that proceeds are, indeed, property of the estate”); *In re Scott Wetzel Services, Inc.*, 243 B.R. 802, 804-805 (Bankr. M.D. Fla. 1999) (continuing to apply *Edgeworth* and calling *Vitek*’s clarification of *Edgeworth* an “erroneous generalization”)

53 *Id.* at 535.

54 *See, e.g., Duval v. Gleason*, No. C-90-0242-DLJ, 1990 WL 261364, at *6 (N.D. Cal. Oct. 19, 1990) (“[T]his Court does not find such future concerns to have a sufficient, direct impact on the present proceedings to compel that they be stayed.”).

55 *Amatex Corp. v. Stonewall Ins. Co.*, 102 B.R. 411, 414 (Bankr. E.D. Pa. 1989).

56 *See id.*

57 *See* 238 B.R. at 17-18.

58 *See id.*

59 *See id.*

60 *See id.* at 15.

61 *See id.* at 17.

62 *Id.* (citations omitted).

- 63 Recently, the Court in *In re Youngstown Osteopathic Hospital Assoc.*, 271 B.R. 544, 550 (Bankr. N.D. Ohio 2002), adopted *First Central*. Faced with the debtor's claim that the proceeds of a D&O policy belonged to the estate, the Court observed that while the debtor was the named insured on the policy, the policy did not contain any entity coverage, the debtor had not paid any of the defendants' defense costs and the debtor had made no claim against the policy's indemnity coverage. *Id.* at 550-51. The Court therefore concluded that the debtor did not have pecuniary interest in the proceeds of the D&O policy, but cautioned that its analysis could change if it was faced with a policy that provided entity coverage. *Id.* at 551.
- 64 *See* 261 B.R. at 542-43.
- 65 *See id.*
- 66 *See id.*
- 67 *See id.* at 543.
- 68 *Id.* at 544.
- 69 *In re Amfesco Indus., Inc.*, 81 B.R. 777, 785 (Bankr. E.D.N.Y. 1988) (quotation omitted). Former directors' and officers' requests for indemnification by the estate are not claims entitled to administrative priority under Sections 503 and 507 of the Bankruptcy Code. *See id.* at 784-85; *In re Baldwin-United Corp.*, 43 B.R. 443, 456 (S.D. Ohio 1984); *In re THC Fin. Corp.*, 446 F. Supp. 1329, 1332 (D. Hawaii 1977); *Amfesco*, 81 B.R. at 784-85.
- 70 Typical indemnification provisions provide that the insurer initially pays the policy proceeds to the estate. However, the insurer only pays the proceeds to the estate for the purpose of reimbursing the estate for amounts it has already paid to the directors and officers pursuant to its indemnification obligations set forth in statute, corporate articles and/or by-laws. In essence, the proceeds merely "pass through" the estate on their way to the directors and officers; the corporation never profits or "comes out ahead" as a result of the payments. Thus, proceeds paid under the reimbursement provision never inure to the benefit of the corporation. The result is a "zero sum game" where the estate is only repaid that which it has paid out. Once a corporation declares bankruptcy, however, a finding that the proceeds of the D&O policies are property of the estate turns this result on its head. Directors and officers incur expenses for which they seek indemnification from the debtor. The debtor turns to the insurance company under the indemnification coverage provision of the D&O policy. The insurance company reimburses the debtor, but the debtor never reimburses the directors and officers; instead, the debtor places the proceeds in its general assets "pot," which is distributed in order of preference as determined by the Bankruptcy Code. The directors and officers stand at the end of the line, and as a result, receive only pennies on the dollar of monies originally intended to reimburse them in full.
- 71 *See* 11 U.S.C. § 510(b)
- 72 *See* 11 U.S.C. § 502(e)(1)(B).
- 73 *First Central*, 238 B.R. at 17-18 (citing *In re Reliance Acceptance Group, Inc.*, 235 B.R. 548, 561 (D. Del. 1999)).
- 74 *In re Carousel Int'l Corp.*, 89 F.3d 359, 362 (7th Cir. 1996); *see also Liberty Mut. Ins. Co. v. Official Unsecured Creditors' Committee of Spaulding Composites Co. (In re Spaulding Composites Co.)*, 207 B.R. 899, 907 (B.A.P. 9th Cir. 1997) (same).
- 75 *See, e.g.*, 11 U.S.C. § 363(h).
- 76 *First Central*, 238 B.R. at 16.
- 77 *Caterpillar, Inc. v. Great Am. Ins. Co.*, 62 F.3d 955, 957 n.1 (7th Cir. 1995) (citation omitted).
- 78 *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 334-44 (Del. 1983) (internal quotations and citation omitted).
- 79 *Amfesco*, 81 B.R. at 785 (citation omitted).
- 80 The court in *Landry*, 260 B.R. at 779, explained this point in the analogous context of a debtors' general liability policy: "[r]ecover against the Insurers lessens the sum total of claims for which the estate is or may be liable, while at the same time potentially increases the *pro rata* recovery of creditors that are situated, as a matter of priority, the same as the Plaintiffs' claims (or are situated in a position of lesser priority), but are not afforded by applicable non-bankruptcy law the right to liability insurance coverage." *Id.*
- 81 *See* Reliance Insurance Company Rehabilitation Official Statement by Pennsylvania Insurance Commissioner M. Diane Koken dated May 29, 2001 ("Rehabilitation Official Statement"); Pennsylvania Insurance Commissioner's May 29, 2001 Press Release ("May 29, 2001 Press Release"); Pennsylvania Insurance Commissioner's October 3, 2001 Press Release ("October 3, 2001 Press Release"). (The Pennsylvania Insurance Commissioner's Official Statements, Press Releases and Notices and the Orders by the Pennsylvania Commonwealth Court cited herein can be viewed at the Pennsylvania Insurance Department's "Reliance Insurance Company in Liquidation" website at www.insurance.state.pa.us/html/reliance_liq.html).
- 82 *See* Rehabilitation Official Statement.
- 83 *See id.*
- 84 *See id.*
- 85 *See id.*
- 86 *See id.*
- 87 *See id.*
- 88 *See id.*
- 89 *See id.*; *see also* May 29, 2001 Press Release; Order of the Commonwealth Court of Pennsylvania in *Koken v. Reliance Ins. Co.*, 269 MD 2001 dated May 29, 2001 ("May 29, 2001 Order").
- 90 *See* Rehabilitation Official Statement; May 29, 2001 Press Release; May 29, 2001 Order.

- 91 See October 3, 2001 Press Release; *see also* Order of the Commonwealth Court of Pennsylvania in *Koken v. Reliance Ins. Co.*, 269 MD 2001 dated October 3, 2001 (“October 3, 2001 Order”), ¶ 2.
- 92 See Reliance Insurance Company Liquidation Official Statement by Pennsylvania Insurance Commissioner M. Diane Koken dated October 3, 2001 (“Liquidation Official Statement”).
- 93 See Liquidation Official Statement.
- 94 See October 3, 2001 Order, ¶ 23.
- 95 See October 3, 2001 Order, ¶ 17.
- 96 Notice of Commonwealth of Pennsylvania Office of Liquidations, Rehabilitations and Special Funds, Statutory Liquidator of Reliance Insurance Company (“Notice”).



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