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Insurance Coverage Update

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Transfer of Entity's Claim Against D&Os to Liquidating Trustee Doesn't Avoid IvI Exclusion

A Liquidating Trustee's $18.8 million breach of fiduciary duty claim fell within the IvI exclusion of a D&O policy despite an assignment of that claim by the insured entity as part of a liquidation plan. *Indian Harbor Ins. Co. v. Zucker for Liquidation Trust of Capitol Bancorp Ltd.*, 860 F.3d 373 (6th Cir. 2017).

Capitol Bancorp Ltd. ("Capitol"), a holding company that owned community banks across 17 states, suffered large losses during and following the financial crisis, causing it to file for Chapter 11 bankruptcy in 2012. In 2013, as part of a liquidation plan, Capitol assigned all of its causes of action to a Liquidating Trust to pursue on behalf of the creditors.

Capitol purchased a management liability insurance policy from Indian Harbor Insurance Company ("Indian Harbor") that contained an IvI exclusion, which excluded from coverage "any claim made against an Insured Person ... by, on behalf of, or in the name or right of, the Company or any Insured Person," except for derivative suits by independent shareholders and employment claims.

In August 2014, the Liquidation Trustee sued Capitol's former D&Os for $18.8 million, alleging they breached their fiduciary duties to Capitol through a number of improper actions. Indian Harbor denied the Trustee's claim for coverage and filed a declaratory judgment action seeking a declaration that the Trust's claims fell within the IvI exclusion.

The Sixth Circuit noted that, had Capitol sued its D&Os for mismanagement, it would be a claim "by" the company (an insured) against its own officers (also insureds), meaning the exclusion would bar the claim. The facts of the current case were "one-step removed" from the hypothetical as, while the officers and theory of liability remain the same, the claimant is no longer the company but instead the Trustee who received rights by assignment. "As a voluntary assignee," according to the majority opinion, "the Trust stands in Capitol's shoes and possesses the same rights subject to the same defenses." Therefore, according to the court, "[j]ust as the exclusion covers a lawsuit 'by' Capitol, it covers a lawsuit 'by' the Trust 'in the . . . right' of Capitol."

The Trustee argued that the term "Company" in the exclusion referred to Capitol in its pre-bankruptcy form. Upon filing for Chapter 11 bankruptcy, Capitol became a debtor in possession administering the bankruptcy estate and Capitol's former assets (including the cause of action against the D&Os) for the benefit of the creditors. The Trustee's suit, then, is not a suit "by" the Company, or on its behalf, but by a legally distinguishable entity.

The Sixth Circuit rejected this argument, noting that before bankruptcy Capitol could not have dodged the exclusion by transferring a mismanagement claim to a new company for the purpose of filing a mismanagement claim against the D&Os. No matter how legally distinct the new company might be, the claim would still be "by, on behalf of, or in the name or right of" Capitol.

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The same conclusion applies to a mismanagement claim filed after bankruptcy. In this case the voluntarily transferred claim would still be filed "on behalf of" or "in ... the right of" Capitol, and the IvI exclusion applies.

The court also rejected the Trustee's arguments that bankruptcy code provisions defining "debtor" and "debtor in possession" support the contention that the debtor in possession and the pre-bankruptcy company are distinct legal entities. While the court conceded that there are settings in which it makes good sense to treat the debtor and debtor in possession as legally distinct, "this is not one of them."

Circuit Judge Bernice Donald dissented, arguing that the decision went against principles of bankruptcy law. Judge Donald pointed out that Sixth Circuit precedent held that a court-appointed trustee in bankruptcy was normally exempt from an IvI exclusion. An assigned liquidating trustee should likewise be exempt from this exclusion.

The dissent pointed to the primary intent of the IvI exclusion as preventing collusive lawsuits wherein an insured corporation would force its insurer to pay for the poor business decisions of its D&Os, and contended that there is no functional distinction between an assigned trustee and one that is appointed by the bankruptcy court for purposes of independence and the risk of collusion.

Discussion

The IvI exclusion here was broad—excluding claims "by, on behalf of, or in the name or right of, the Company"—but did not include a carve-back for claims brought by bankruptcy court trustees, receivers, liquidators and the like. This carve-back is sometimes found in D&O insurance policies to allow the bankrupt entity to access policy proceeds when claims against its former D&Os have value. If this carve-back was included in the IvI exclusion, the outcome may have been different. This was a split decision after all.

Some D&O policies define "Company" to include the company as debtor in possession, which strengthens insurers' arguments that the types of claims discussed in this case clearly fall within the IvI exclusion. Of course, this leaves company management without the protection of D&O insurance when claims allege their mismanagement caused bankruptcy.

One stated purpose of the IvI exclusion is to prevent collusive claims. The wording of the exclusion, however, does not specify that it only applies in that context. Parties seeking coverage cannot escape the effect of an IvI exclusion by arguing that their particular claim is not collusive. If the circumstances of the claim place it within the confines of the IvI exclusion as written, it precludes coverage, whether or not the claim is collusive.

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