FTX Proceedings Highlight D&O Issues Amid Bankruptcy

By Geoffrey Fehling and Justin Paget
Published in Law360 | May 09, 2023


Insurance recently took center stage in the closely watched FTX bankruptcy proceedings when U.S. Bankruptcy Judge John T. Dorsey of the U.S. Bankruptcy Court for the District of Delaware refused a request by former FTX executive and founder, Samuel Bankman-Fried, to access the company's $10 million directors and officers liability policy to help defray his legal expenses.

Bankman-Fried is under siege on multiple fronts, ranging from federal securities fraud claims by the U.S. Securities and Exchange Commission to class actions by FTX trading customers.

Bankman-Fried argued that the automatic stay in bankruptcy does not prevent him from accessing policy proceeds for payment of his defense costs and that, even if it did, the stay should be lifted because he would suffer substantial and potentially irreparable harm without access to FTX's D&O policies.

FTX and its creditors opposed the motion on various grounds. After the parties failed to reach an agreement, the court stated at a hearing that Bankman-Fried had failed to offer any evidence of his need to access the company's D&O policies.

The court denied the motion without prejudice for Bankman-Fried to refile later with more support for his request.

The downfall of FTX, and Bankman-Fried's alleged wrongdoing, has been well publicized.

But the core questions at issue in his motion — that is, are directors and officers still protected by D&O policies during bankruptcy and, if so, what impediments might they face when trying to receive those protections — apply broadly to many other individuals serving in directorship or executive roles at companies facing insolvency risks, as shown by recent market turmoil, banking liquidity concerns, and other economic pressures on companies of all sizes and industries.

We discuss below the interplay of bankruptcy and D&O insurance policies, key policy provisions that arise during bankruptcy, and some best practices when pursuing D&O coverage during bankruptcy.

Bankruptcy and the ABC's of D&O Insurance

Insurance disputes similar to those arising in the FTX bankruptcy are relatively common because often times a bankrupt company's insurance policies are one of the few assets available to protect insureds who may face a claim that arises before, during or after the company files for bankruptcy.

As with most insurance disputes, the devil is in the details as to the availability and scope of coverage for claims against directors and officers during the pendency of a bankruptcy.

The U.S. Bankruptcy Code stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."[1]

Most insurance companies will not permit directors or officers to access policy proceeds unless they first seek an order from the bankruptcy court determining whether the insurance assets are subject to this automatic stay.

Whether directors and officers will be successful in obtaining such an order depends on the nature of the coverage at issue, and potentially the facts surrounding the claims.

Most D&O policies contain three types of coverage:

- Side A coverage for losses of individual directors and officers not indemnified by the company;
- Side B reimbursement coverage for indemnification the company pays on behalf of directors and officers; and
- Side C coverage for direct claims against the company.

Bankruptcy courts generally have viewed Side B and C coverages as implicating the automatic stay under the rationale that policy proceeds for claims under each coverage are available to the debtor.

However, many times bankruptcy courts conclude that D&O coverage for Side A claims — losses incurred by individuals that are not indemnified by the company — are not property of the estate, i.e., the debtor has no claim to policy proceeds under that coverage, and, therefore, are not subject to the automatic stay, according to the Delaware bankruptcy court's 2010 ruling in In re: Downey Financial Corp.[2]

Other courts — such as the U.S. Bankruptcy Court for the District of Minnesota in In re: Petters Company Inc. in 2009, and the U.S. Bankruptcy Appellate Panel for the Ninth Circuit in Groshong v. Sapp in 2010 — go ever further, stating that insurance proceeds must be protected specifically for the benefit of individual officers and directors.[3]

This is consistent with the core purpose of D&O policies as "a safeguard of officer and director interests and not a vehicle for corporate protection," according to the U.S. Bankruptcy Court for the Eastern District of New York's 1999 ruling in In re: First Central Financial Corp.[4]

As discussed below, directors and officers are more likely to obtain access to D&O policy proceeds in bankruptcy where there is Side A coverage alone, or possibly where the Side B and Side C coverages are subordinate to the Side A coverage.

Pursuing D&O Insurance Recoveries During Bankruptcy

Aside from the nature of the coverage sought, there are other common issues that can affect the availability and scope of potential coverage in bankruptcy or similar insolvency-related claims.

We outline several of those below with best practices to keep in mind when pursuing D&O insurance recovery during bankruptcy.

Comfort Orders

As Bankman-Fried did with FTX, parties must file motions asking the court to lift the automatic stay to authorize payment of legal fees and expenses in connection with D&O claims.

That is typically true even where the claims are non-indemnified Side A losses that should not be subject to the automatic stay, since insurers will often require a comfort order to issue payment.

Other interested parties, such as bankruptcy trustees or creditors' committees, may also seek to impose limitations on access to policy proceeds, which could include a cap on payment of defense costs or periodic reporting requirements for insurers issuing payments, so interested parties can stay informed about the availability of remaining policy limits.

Many times, orders governing access to D&O policies are negotiated and agreed to between the insureds and other interested parties, which makes the bankruptcy court's ruling in the FTX proceedings somewhat unusual.

One concern raised by FTX and its creditors was that Bankman-Fried was trying to obtain special status and that, if any relief is granted, it should be fashioned to permit the insurers to pay all insureds, rather than solely Bankman-Fried.

Equal access to insurance proceeds, among other things, can be part of negotiated agreements to allow for orderly and equitable distribution of scarce insurance assets.

Bankruptcy Waiver

Given the frequent need for directors and officers to seek relief from the automatic stay to access insurance coverage, D&O policies commonly have language stating that, in the event of bankruptcy, all insureds are prohibited from opposing or objecting to efforts by any other insured to obtain relief from the automatic stay.

In the case of FTX, the D&O policies had such a provision, making the company contractually bound to not oppose Bankman-Fried's efforts to seek relief from the automatic stay with respect to the D&O policy proceeds.

The company took the position, however, that the waiver provision did not prevent the company from objecting to the relief Bankman-Fried was seeking on the ground that all directors and officers should have access, not solely Bankman-Fried.

Priority of Payments

D&O policies often include built-in mechanisms to deal with competing insurance claims by individual and entity insureds that may exceed the available policy limits.

The FTX policy had such language — called priority of payment provisions — stating that, where the total losses exceed the then-remaining limits, payment of covered non indemnified loss of individual insureds under Side A must be made before payment under any other insuring agreement.

Bankman-Fried cited the priority-of-payments provision to support payment of his legal fees under Side A prior to payments under any other insuring agreement.

The company disagreed, arguing that the provision is only relevant if the total loss presented to the insurer exceeds the amount of available coverage under the policy.

Before that time, FTX argued, the insurer is within its right to pay other categories of damages. The court sided with FTX — at least at the initial hearing — finding that Bankman-Fried had not met his evidentiary burden warranting relief from the automatic stay, based on the priority-of-payments provision or otherwise.

Careful consideration of all policy provisions, particularly with an eye toward the burden that insureds may face when trying to access insurance during bankruptcy, is critical to obtain relief from the automatic stay.

D&O Exclusions

Many D&O policy exclusions can come into play with insolvency-related claims.

The most common is the insured versus insured exclusion, which bars coverage for claims by or on behalf of one insured against another insured. Issues can arise in bankruptcy where a bankruptcy or liquidation trustee, creditors committee, or receiver asserts claims against directors and officers on behalf of the debtor.

Without appropriate carveouts to the insured versus insured exclusion, claims may be denied because those putative claimants are acting on behalf of the debtor company — an insured — against the individual directors and officers, other insureds.

Negotiating appropriate exceptions to this often broad exclusion can protect coverage in the event of bankruptcy.

Another potential limitation is an insolvency exclusion, which can be added to policies in times of economic uncertainty or when a company is facing undue financial stress — either individually or as part of an industry or sector-specific risk.

While rare, these exclusions can have severe adverse implications in bankruptcy. If the exclusion cannot be avoided entirely, care should be taken to limit its scope by, for example, negotiating narrower causation language or triggering events.

The so-called conduct exclusion — which bars coverage for deliberate criminal, fraudulent or dishonest acts — can also be implicated if claims allege reckless or intentional conduct in breaching fiduciary duties to the debtor.

Allegations of fraud, even if groundless, can pose significant obstacles to advancement of legal fees if the conduct exclusion does not have appropriate final adjudication language preventing application of the exclusion until the wrongful conduct is established by a final, nonappealable adjudication.

Other exclusions can be industry specific, like exclusions in FTX's policy for federal securities violations involving coin offerings, or unique to a particular set of facts.

Understanding the nuances in exclusionary language and how they may be enforced can be critical to maximize executive protection during bankruptcy and other proceedings.

Takeaways and Lessons from the FTX Bankruptcy

The recent FTX motion illustrated many of the above issues that can arise when insureds try to access policies during bankruptcy.

There, the creditors committee took the position that relief from the stay was not appropriate because, among other reasons, Bankman-Fried was requesting coverage for conduct barred under the D&O policy exclusions for the purchase or sale of coin offerings, alleged violation of federal securities laws, transfer of criminal property and any criminal or willful violations of law.

The committee also pointed to the potential for depletion of coverage for claims against the debtor — which the committee specifically identified — if Bankman-Fried were allowed to access the policy proceeds to pay for the defense of claims against him.

Although the D&O policy contained a priority payment provision in favor of claims under Side A, the committee pointed out that the policy did not require proceeds to be first used to exhaust Side A coverage in full prior to payment of other coverage. Interestingly, the committee also noted the possible existence of another $20 million policy that could provide coverage to Bankman-Fried.

For these reasons, the committee argued that cause did not exist to lift the automatic stay because it would greatly prejudice the debtor's bankruptcy estate.

At the hearing on Bankman-Fried's motion, the bankruptcy court declined to lift the automatic stay, citing the lack of evidence offered in support of the motion. The denial was without prejudice to Bankman-Fried refiling the motion and setting it for an evidentiary hearing.

While the court did not reach many of the arguments made the creditors committee, the denial is somewhat unusual.

However, this is a particularly unique and highly publicized case involving an individual insured that previously had a net worth in the billions of dollars and is accused of serious fraudulent and criminal conduct.

Judge Dorsey likely felt that in the absence of any evidence from Bankman-Fried about his ability to pay his own defense costs or access other insurance, it was appropriate to preserve the debtor's right to coverage as an asset of the estate, at least at this juncture.

The decision may also serve as an impetus for the parties to settle. If Bankman-Fried returns to bankruptcy court with evidence of financial hardship and demonstrated need to access the policy and entitlement to coverage, the bankruptcy court may ultimately decide to lift the stay and leave the question of coverage to the insurer.

Unless the bankruptcy court issues a subsequent decision adverse to Bankman-Fried following an evidentiary hearing, we would caution against ringing any alarm bells based on the court's initial denial.

Nevertheless, insureds seeking access to a debtor's D&O insurance policies during bankruptcy should be prepared to present evidence supporting the requested relief, especially where other interested parties are contesting access to coverage.

Directors and officers pursuing relief from the automatic stay have the evidentiary burden, as the FTX ruling made clear.

At bottom, the decision is a reminder about the intersection of D&O coverage and bankruptcy and that companies and their officers and directors would be well served in taking a proactive approach to understanding how potential recoveries under the company's insurance policies may be affected in the event of insolvency.

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Notes

1. 11 U.S.C. §362(a)(3).
2. In re Downey Fin. Corp., 428 B.R. 595 (Bankr. D. Del. 2010).
3. In re Petters Co., 419 B.R. 369 (Bankr. D. Minn. 2009); Groshong v. Sapp (In re MILA, Inc.), 423 B.R. 537 (B.A.P. 9th Cir. 2010).
4. In re First Cent. Fin. Corp., 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999).

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