

Director Exposure & Coverage

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Overview of Exposure¹

After a company begins to experience economic distress or other legal and financial challenges, opportunities to minimize risk to the company and its individual directors are limited. When directors are most focused on the company and its difficulties, they face increased exposure, potential limitations on indemnification and insurance coverage, and greater challenges from government agencies, private plaintiffs and even a trustee in bankruptcy. Planning ahead to manage exposure involves understanding the risks and the available protection for directors, including a director of a wholly-owned nonpublic subsidiary.

Due Diligence—Understanding the Risks

Before joining a board of directors, and periodically while serving as a director, seasoned directors conduct due diligence on the company not dissimilar to that which would be conducted for a corporate merger. Risks can arise from tax status, pending and threatened litigation, experience and tenure of management, and capital structure, including debt terms, working capital and liquidity.

Serving as the director of an independent company with no corporate parent or affiliates simplifies the fiduciary duties that apply and reduces potential conflicts of interest. A director owes a duty of loyalty and care to each corporation served. Thus, a director who serves multiple corporations owes duties to each. Conflicts of interest may arise unless a complete identity of interest (*i.e.*, same shareholders and creditors) exists among all entities within the affiliated group.

Regulated industries often encounter further risks. Although regulatory agencies provide some oversight, directors can take little comfort from a litigation perspective—as a company cannot bring a cause of action against an agency for negligent regulatory supervision. In fact, regulatory oversight often imposes political agendas that may lead to litigation brought by the regulators or third parties against directors.

Hidden Sources of Personal Liability

Relatively few lawsuits against directors arise from a clear-cut intentional tort such as fraud or embezzlement. Rather, lawsuits that name directors generally arise from an unintentional failure to act or prevent the acts of others. Personal liability results primarily from breach of a director's duty of care or loyalty (including, in Delaware, the duty of good faith), improper declaration of dividends, violation of statutory requirements or government enforcement actions initiated against the company and its insiders.

Government Enforcement Actions

Actions by government agencies such as the Securities and Exchange Commission (SEC) can generally be grouped into formal and informal actions. Almost all SEC actions start as informal investigations, which can lead to a Wells notice indicating that the SEC staff is considering recommending a civil enforcement action. Formal actions against an organization include cease and desist orders, written agreements, the imposition of corporate monitors and civil monetary penalties.² Formal action against individuals include bars against the individual serving as an officer or director of a public company, civil monetary penalties and cease and desist orders. The SEC may also enter into cooperation agreements, deferred prosecution agreements and non-prosecution agreements.³

Government inquiries by and settlements with the SEC, Department of Justice (DOJ) and other agencies increase the scrutiny of company records, require directors to provide added oversight, multiply risks of private litigation and may limit the company's business operations and restrict the conduct of officers and directors. For individual directors of public companies, certain kinds of governmental proceedings may require adverse disclosures in the annual proxy statement and effectively foreclose a director from continuing to serve as a director or officer of a public company.

Because of highly publicized insider misconduct, regulators more and more frequently focus attention on directors, including outside directors. Each director, before entering into any settlement agreement with a government agency binding on the company and/or its insiders, needs to fully understand the provisions, the procedures required to ensure compliance, the potential for any criminal charges and the consequences to the company and individual directors of any future violations of the agreement. Settlements of enforcement actions, as originally drafted and presented by the regulators, are broadly worded, leaving maximum discretion and interpretation with the regulator. Some SEC settlements may prevent individuals from receiving reimbursement, indemnification or insurance payments for penalties imposed.

Breach of Duty

The duty of loyalty owed by directors prohibits a director from advancing personal or business interests, or interests of others, at the expense of the corporation. The duty of care requires a director to act as a prudent and diligent businessperson in conducting the affairs of the company. This standard makes a director responsible for selecting, monitoring and evaluating competent management; establishing business strategies and policies; monitoring and assessing business operations; considering business alternatives establishing and monitoring adherence to policies and procedures required by statute and regulation; and making business decisions on the basis of fully informed and meaningful deliberation.

Breach of duty cases are by their nature fact specific. Factors leading to liability in litigation against directors include:

- Excessive absence from meetings;
- Failure to give even a cursory reading of financial records;

- Failure to respond promptly and appropriately to negative information received from auditors, and other reliable sources; and
- Failure to require adherence to corporate policy.

Directors are advised to avoid the appearance of these factors, which may lead to liability, especially in conjunction with other “bad facts” and troubled circumstances for the company. Under Delaware law, directors who act with a conscious disregard for their responsibilities do not act in good faith, and cannot be exculpated under a limitation on liability provision in the company’s charter.

Improper Dividends

Most states have statutes which provide that a board of directors of a corporation cannot declare a distribution if the distribution would cause the corporation to become insolvent or unable to pay its debt. These statutes follow the Model Business Corporation Act (MBCA).⁴ The determination of solvency rests on an equity test which requires “that decisions be based on cash flow analysis that is itself based on a business forecast and budget for a sufficient period of time to permit a conclusion that known obligations of the corporation can reasonably be expected to be satisfied over the period of time that they will mature.”⁵ The statutes also require a company to have a positive net worth reflected on the balance sheet. Accounting errors or irregularities, or insufficient analysis of a company’s debt and other financial obligations, can put directors at risk when the Board declares dividends.

The MBCA suggests that the validity of the determining factors depends on the circumstances, and must also be reasonable within those circumstances.⁶ Specifically, the statute provides that directors who approve “the declaration of any dividend or other distribution of assets to the shareholders contrary to the provisions of this act

or contrary to any restrictions in this certificate incorporation” will be liable to the corporation, which acts on behalf of its creditors or shareholders.⁷ To the extent recovery is sought against the directors, the directors are allowed to be subrogated to the rights of the corporation—but only “against shareholders who received such dividend or distribution with knowledge of facts indicating that it was not authorized by this act,” and only “in proportion to the amounts received by them respectively.” In effect, directors are charged with reviewing relevant circumstances at the time of declaring dividends and may face personal liability for improperly declared dividends.

Business Judgment Rule

The business judgment rule offers a potential defense to personal liability if directors meet the duty of loyalty. Generally, the business judgment rule protects actions by members of a board of directors if the actions were made in good faith, and comport to the standard of the prudent person in the same or similar position as the director. Directors may also seek the advice of experts and officers of the company to support the applicability of the business judgment rule. For example, directors act prudently and therefore (in the absence of bad faith) will not be liable if they relied upon “the opinion of counsel for the corporation; upon written reports setting forth financial data concerning the corporation and prepared by an independent public accountant or certified public accountant or firm of such accountants; upon financial statements, books of account or reports of the corporation represented to them to be correct by the president, the officer of the corporation having charge of its books of account, or the person presiding at a meeting of the board; or upon written reports of committees of the board.” However, if the board of directors acts beyond the corporation’s by-laws, the business judgment rule does not apply.

Potential Plaintiffs

The scope of potential personal liability for directors is broad. Thus, a plethora of plaintiffs will target a corporate officer or director as a potential defendant if the entity finds itself in financial distress or legal difficulties. Plaintiffs include government agencies such as the SEC, DOJ and Internal Revenue Service (IRS), as well as private plaintiffs such as shareholders and creditors. The more complex the corporate structure, the more potential plaintiffs will come forward. Thus, a director who serves both a parent and its subsidiary could be the target of litigation by subsidiary creditors as well as the parent company's shareholders and creditors, and bankruptcy trustee if applicable, to name a few.

Derivative Claims in Bankruptcy

If a company fails, derivative claims against directors become the property of the bankruptcy trustee. A derivative claim means "a wrong to an incorporated group as a whole that depletes or destroys corporate assets and, as a consequence, reduces the value of the corporation's stock."⁸

In bankruptcy, the fiduciary obligations of corporate directors, normally enforced by the corporation or through a shareholder's derivative action, can only be enforced by the bankruptcy trustee.⁹ Courts have consistently found that property of the bankruptcy estate includes actions for fiduciary misconduct, mismanagement or neglect of duty which are brought for the benefit of creditors in general.¹⁰ Several policies underlie this principle. Allowing any one of the creditors to prosecute the claim individually would undermine the fundamental bankruptcy policy of equitable distribution among creditors¹¹ and would also open the door to a multi-jurisdictional rush to judgment by the various creditors.¹² Because claims against directors form a part of the bankruptcy estate, directors face additional exposure in the event of a bankruptcy filing.

Directors owe fiduciary duties not only to shareholders but to creditors as well when the holding company becomes insolvent or, in some jurisdictions, is in the “vicinity” or “zone” of insolvency.¹³ Thus, when the company becomes insolvent or nears insolvency, in addition to their other duties, the directors become legally obligated to consider, and to act in the reasonable interests of, the creditors of the corporation. Until then, they owed their sole fiduciary duties to the company and its shareholders.

The majority of cases hold that the duty to creditors is breached the moment the director acts in a way that causes the corporation to lack fairly-valued net worth or liquidity, and this result was inevitable, likely or reasonably foreseeable. One of the leading cases in this area, *Geyer v. Ingersoll Publications Co.*,¹⁴ explains the reasons for imposing liability on directors at the point when the decision leading to insolvency is made.

The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders’ wishes should not be the directors’ only concern. Furthermore, the existence of the duties at the moment of insolvency rather than the institution of statutory proceedings prevents creditors from having to prophesy when directors are entering into transactions that would render the entity insolvent and improperly prejudice creditors’ interests.

In *Brandt v. Hicks, Muse & Co. (In re Healthco Int’l, Inc.)*,¹⁵ the court, drawing on this reasoning, held that the director’s duty to the creditors existed the moment he acted in a way that likely caused the corporation to lack fairly-valued net worth or liquidity. The court noted, “When a transaction renders a corporation insolvent, or brings it to the brink of insolvency, the rights of creditors become paramount.

In those circumstances, notwithstanding shareholder consent, a representative of the corporation may recover damage from the defaulting directors.”

Direct Actions by Shareholders and Creditors

A direct, non-derivative claim arises from breaches of duties owed to a shareholder or creditor as opposed to the entity. Thus, in bankruptcy, a company’s bankruptcy trustee does not have standing to assert claims of those shareholders and creditors who have suffered individualized injuries not in common with other shareholders and creditors.¹⁶ Direct actions by creditors and shareholders of public companies arise primarily under securities laws applicable to material misstatements and omissions in connection with the purchase or sale of any security (such as Rule 10b-5 of the Securities and Exchange Act of 1934¹⁷ and Section 11 of the Securities Act of 1933¹⁸). If a director has responsibility for issuing materially misleading financial information to buyers and sellers of securities, class actions are prevalent.

SEC and Government Actions

The SEC has authority to pursue enforcement actions against directors which can result in civil money penalties, a bar against serving as a director or officer of a public company, or the issuance of permanent injunctions enjoining directors from future violations of security laws, and increasingly engages in parallel proceedings with prosecutors and other agencies that can result in criminal penalties.¹⁹ Actions have been brought against directors, among other things, for participating in decisions to withhold a company’s SEC filings and backdating options. In addition, if the company becomes the subject of an SEC inquiry or investigation, directors often become the ultimate targets of private litigation.

IRS

A company experiencing financial distress typically has a cash flow shortage and may “slow pay” its creditors. As a practical matter it keeps current on payments that cannot be delayed, such as payroll, and tends to postpone payment of less pressing items. These circumstances may tempt management to delay the payment of employee withholding taxes. All too often the company reaches the day when it simply does not have sufficient cash to pay the withheld taxes to the IRS²⁰—a dark day for directors. Civil and criminal penalties are severe. Personal financial liability for 100% of the trust fund taxes can be imposed on “responsible persons” whose failure to collect or payover the accrued taxes was reckless.²¹ A responsible person is a person who knew or had reason to know of the unpaid taxes, had the means and failed to ensure the taxes were paid. A director who has in his or her possession financial statements or other board materials showing the overdue, unpaid taxes faces grave risks.

Pension Plans

If the company sponsors a pension plan, a director of the plan sponsor becomes subject to liability as a plan fiduciary to the Department of Labor as well as the plan beneficiaries. A director is a plan fiduciary “to the extent he or she (1) exercises any discretionary authority or control over the management of the plan or any authority or control over management or disposition of its assets; (2) renders investment advice for a fee or other compensation; or (3) has discretionary authority or control in the administration of the plan.”²²

As in the case of employment tax liabilities, liability accrues to directors who fail to forward employee contributions to 401(k) or other pension plans or who know that such amounts have not been forwarded. Additionally, actions taken by the corporation that negatively affect plan assets can subject directors to personal liability. To the extent insurance is available, directors should be insured in their

capacity as ERISA plan fiduciaries, although this coverage is not part of standard D&O insurance. If a company has a defined benefit plan, directors may have liability to the extent the Pension Benefit Guaranty Corporation (PBGC) must make up the shortfall in benefits due to an underfunded plan.

Sources of Recovery by Directors

When directors become litigation targets, they look to their indemnity from the corporation and its D&O insurance for protection. When these sources are inadequate, the director's personal assets are at risk. Because the indemnification of an entity in financial distress is likely impaired and the director does not want to put his or her personal assets at risk, careful review of D&O insurance coverage is critical.

Corporate Indemnity

As a standard practice, corporations indemnify their officers and directors in the Bylaws and Articles of Incorporation,²³ as well as under individual indemnification agreements provided by some companies. In bankruptcy, the claims by directors and officers to receive indemnity for prepetition acts or omissions are normally classified as unsecured, non-priority claims against a bankrupt company. As such, they may be worth pennies on the dollar at distribution time. Additionally, if the director is owed money by the bankrupt debtor, the threat of litigation against the director may be viewed as a bargaining chip to settle the director's claim. The bankruptcy trustee also has the weapon of equitable subordination in his arsenal of defenses to the director and officer claims for indemnity.

Insurance

Directors should closely review the details of insurance policies to determine whether the D&O coverage provides maximum protection.²⁴ Additionally, because D&O insurance forms continually evolve, directors should regularly consult with an insurance broker and

counsel experienced with D&O insurance to identify any new standard terms or possibilities for enhanced coverages that should be included. Certain key provisions warrant particular attention:

Insured vs. Insured Exclusion

D&O insurance policies often disallow coverage when one insured party (*e.g.*, the corporation) brings an action against another insured party (*e.g.*, the directors). In bankruptcy the insurer may argue that a claim brought by the trustee in bankruptcy against the directors is not covered by the policy because the trustee stands in the shoes of the corporation, another insured party. A director will seek to ensure that the D&O policy does not allow the trustee in bankruptcy to be deemed the corporation for this purpose or otherwise expand this exclusion.

Regulatory Exclusion

Standard D&O insurance policies exclude coverage for actions brought by a federal or state regulatory body such as the SEC. This “regulatory exclusion” purports to preclude any government agency from recovering under the policy, even if the losses arising from any wrongful acts of a director would have been recoverable by other claimants such as a derivative action by shareholders of the company. In the 1980s government agencies were able to defeat regulatory exclusions “by arguing that they were vague, unenforceable and contrary to public policy.” However, more recently courts have “largely upheld regulatory exclusions” as contractual provisions²⁵ negotiated between a company and the insurer. Counsel should review the wording of any regulatory exclusions to clarify the availability of coverage for directors.

Shared Limits

D&O insurance policies generally provide coverage for both the directors and officers and the corporation itself. “Entity coverage” could reduce coverage for directors to the extent that a policy’s per-

claim and aggregate limits are reached or reduced by claims in respect of the corporation's own liability and related defense costs. Three options can mitigate this risk.

One option is to create different sublimits for the corporation on the one hand and the directors and officers collectively on the other hand. However, even with separate sublimits, if the insured entity becomes subject to bankruptcy proceedings, the individual directors and officers can face substantial delays if the trustee or creditors contend that the policy or its proceeds are property of the parent estate. Understandably, insurance companies now regularly seek bankruptcy approval for payments to directors and officers if they perceive any risk that the D&O policy or its proceeds will be considered property of the debtor's estate. Resulting delays can complicate settlement of potential individual liability.

A second alternative is to amend the policy to provide that directors' and officers' coverage is paid before the corporation's. However, these sublimits may come under attack by a bankruptcy trustee.

The best alternative is to have completely separate primary or excess policies for individuals with limits that cannot be affected by claims against the corporation. A D&O policy that insures only individuals will not be treated as property of the bankruptcy estate.

Extended Reporting Periods or "Tails"

D&O coverage is written on a "claims made" basis, which requires notice of claims, or notice of circumstances which could lead to claims, to be submitted to the insurer during the policy term. These policies typically include a "retroactive date" which defines the earliest date for which the policy provides coverage for wrongful acts.

Under most state laws a plaintiff has two years to sue a director for breach of duty or other negligent acts. This period typically does not begin to run until the plaintiff "discovers" the negligence. When a corporation is found to be "adversely dominated" by a board made

up of potential defendants, this period may not begin to run on the corporation's derivative claims until the corporation is no longer adversely dominated. If a company is placed in bankruptcy, the statute of limitations is further extended or "tolled" under federal law, during which period D&O insurance may expire. Extended reporting periods or "tail" coverage becomes critical for directors dealing with a company in distress, as does prompt notice of potential claims to the carrier.

Additionally, if a company changes D&O insurers, the new insurer may decline to retain the retroactive date used in the previous policy. Under these circumstances, the directors should consider whether to purchase extended reporting under the previous policy, which would preserve the old retroactive date to allow a year or more to report claims under the old policy. Similarly, exercise of any extended reporting option should be considered whenever a new policy provides narrower coverage than an existing policy that is about to expire, such as when the new policy excludes claims based on circumstances of which the insureds are aware at, or acts that occurred prior to, the inception of the new policy.

Some insurers limit the availability of extended reporting options or price these options at historic highs. Options for one, two and three years are desirable to cover claims arising from acts prior to the policy's expiration even if made thereafter. For transactional matters, a six-year period may be desired (and is customary in some public mergers), and the insurer should be asked at inception to commit to offer six years of coverage.

Misrepresentation in the Application

An insurance company may refuse to pay a claim for all insured parties if a misrepresentation was committed by the person who signed the insurance application. The policy should clarify that any misrepresentation by the signing officer does not affect otherwise innocent directors (*i.e.*, that the misrepresentation is severable from the coverage available to the other insureds).

Fraud

D&O policies typically exclude claims arising out of fraud. The exclusion should apply only if fraud is found by the court in a final judgment. Moreover, it is crucial to make clear that the fraud of one officer or director is not imputed to anyone else.

D&O policies typically exclude claims that arise from a director's wrongful act done for personal benefit or through his or her intentional conduct. Final judicial determination of personal benefit, fraud and intentional conduct should be required for these exclusions to apply. Many insurers attempt to remove the "final adjudication" limitation on the applicability of these exclusions from standard policies, which makes coverage easier for the insurer to dispute later.

Preferred Counsel

A director should ensure that the policy does not restrict his or her choice of defense counsel in the event of a claim to a panel list mandated by the insurer. A director should make sure his or her desired counsel is listed when placing or renewing coverage.

Claims versus Investigations

A director should verify that SEC inquiries and investigations constitute a "claim" under the policy. A company can spend millions of dollars responding to an SEC inquiry or investigation even in the absence of litigation. Coverage should be sought for these "defense" costs. The best approach is to obtain a policy that covers both SEC investigations and civil or criminal charges against directors which may arise out of government investigations.²⁶

Other Exclusions

Directors and officers should request a briefing on *all* of the exclusions included in the policy. Other exclusions typically included in D&O policies deny coverage for, among other things, criminal acts, punitive

damages, claims resulting from ERISA violations and terrorist acts. For public companies, or private companies contemplating a private placement or initial public offering, directors should of course verify that the policy does not contain a “securities law” exclusion.

Excess Coverage

The company may obtain non-rescindable excess executive liability insurance for the benefit of directors. This insurance policy covers the independent directors if the underlying policy is rescinded or commuted, has its limits exhausted or excludes the claim due to a financial restatement exclusion. This policy is not cancelable (except for non-payment of premiums), includes any “securities claim” brought by a bankruptcy trustee, and does not exclude coverage due to a financial reporting restatement or insider wrongdoing.

Directors may negotiate a provision that requires the insurer to respond if the insured corporation itself does not honor its indemnification obligations, particularly for defense costs, within a defined period of time (30-90 days) after they have made a written demand on the institution (or bankruptcy trustee). This provision limits out-of-pocket advances of costs by the directors.

Adequacy of Insurance Coverage

Coverage is costly and the cost of D&O insurance continues to rise. As a practical matter, in the event of a bankruptcy, policies are often inadequate to cover the exposure, or insurance may be paid for other claims ahead of claims by insiders. The director faces increased risks of personal exposure if the company is experiencing financial distress.

Personal Exposure

A director’s personal assets are at risk if insurance coverage is inadequate or unavailable because it is either voided or excludes coverage for the actions complained of. As a result of legislative

efforts by the SEC, personal bankruptcy to discharge many of these types of judgments is not an option.²⁷ A director should consider purchasing a personal umbrella policy to, at a minimum, cover legal defense costs. A supplement to annual directors' fees can allow the director to essentially recoup this cost.

Conclusion

When a company fails or faces legal and financial difficulties in a litigious society, blame is assessed for financial, political and psychological reasons and may fall on directors. An incumbent director or candidate for a position on a corporate board can benefit from due diligence on the risks associated with the company and its industry, as well as advance planning to reduce liability or, at a minimum, avoid personal exposure.

- 1 Portions of the article are taken from "Understanding the Risks of Directing an Institution in Financial Distress," Chapter 5 of Handbook for Directors of Financial Institutions (Robin Russell and Dr. Ben Branch) (Edward Elgar Publishing 2005).
- 2 17 C.F.R. Part 201.
- 3 Press Release, SEC, "SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations" (Jan. 6, 2010), available at <http://www.sec.gov/news/press/2010/2010-6.htm>; see also Press Release, SEC, "SEC Charges Former Carter's Executive with Fraud and Insider Trading" (Dec. 20, 2010), available at <http://www.sec.gov/news/press/2010/2010-252.htm>.
- 4 § 6.40
- 5 Model Business Corporation Act § 6.40 comment 2 (1984).
- 6 Model Business Corporation Act § 6.40 comment 4(b) (1984).
- 7 MBCA does not provide a specific cause of action by the corporation against the recipient of the dividend. Those are recoverable under the Uniform Fraudulent Transfer Acts of each state.
- 8 In re Southeast Banking Corp., 827 F. Supp. 742, 745 (S.D. Fla. 1993) and 855 F. Supp 353 (S.D. Fla. 1994).
- 9 Pepper v. Litton, 308 U.S. 295, 307 (1939); Mitchell Excavators, Inc. v. Mitchell, 734 F.2d 129, 131 (2d Cir 1984); 4 Collier on Bankruptcy ¶1541,10[8], at 541-72 (15th ed.). "[T]hat standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation creditors as well as stockholders." Pepper, 308 U.S. at 307.
- 10 See Delgado Oil Co., Inc. v. Torres, 785 F.2d 857, 860-61 (10th Cir. 1986) (trustee of bankruptcy estate succeeds to right to bring action for corporate mismanagement against directors and officers of debtor corporation for benefit of all creditors of the estate). S.I. Acquisition Service, Inc. v. Eastway Delivery Service, Inc. (In Re

S.I. Acquisition, Inc.), 817 F.2d 1142, 1150-54 (5th Cir. 1987) (claim against parent company of debtor corporation to pierce corporate veil, although ordinarily creditor's action, is property of the estate and belongs to the trustee under § 548(a)(1) of the Bankruptcy Code); The American National Bank of Austin v. MortgageAmerica Corp. (In re MortgageAmerica Corp.), 714 F.2d 1266, 1275 (5th Cir. 1983) (action by creditor under the trust fund and the Texas Fraudulent Transfers Act properly belonged to the bankruptcy estate); ANR Ltd. Inc. v. Chattin, 89 B.R. 898, 901-02 (D. Utah 1988) (noting that Delgado Oil supports the proposition that certain claims of creditors can be grouped among claims for corporate mismanagement that are property of the bankruptcy estate); Dana Molded Products, Inc. v. Brodner, 58 B.R. 576 (N.D. Ill. 1986) (creditor lacked standing under RICO to sue for fraud which was committed against corporation in an attempt to hinder creditors generally); see also In re STN Enterprises, 779 F.2d at 904-05 (creditors committee can bring such a claim when Chapter 11 Trustee or debtor in possession fails to do so); Koch Refining v. Farmers Union Cent. Exchange, Inc., 831 F.2d 1339, 1349 (7th Cir. 1987), cert. denied, 485 U.S. 906 (1988) (where liability to creditors arises without regard to personal dealings between officers and creditors, claim is general and may be maintained by Trustee as a creditors under the "strong-arm" provision of § 544 of the Bankruptcy Code).

11 Dana Molded Products, Inc. v. Brodner, 58 B.R. at 578-79.

12 Koch Refining v. Farmers Union Cent. Exchange, Inc., 831 F.2d at 1341-46 (7th Cir. 1987); In re MortgageAmerica Corp., 714 F.2d at 1277 (trust fund "denuding" claim).

13 Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation, 1991 WL 277613 (Del. Ch.) p. 83 and n. 55; accord Geyer v. Ingersoll Publications Company, 621 A.2d 784, 1992 WL 455473 (Del. Ch.) at 3-5; Clarkson So. Ltd. v. Shaheen, 660 F.2d 506, 512 and n. 5 (2d Cir. 1981) (applying New York law), cert. denied, 455 U.S. 990 (1982); see Francis v. United Jersey Bank, 87

N.J. 15, 36, 432 A.2d 814, 824 (1981) citing Whitfield v. Kern, 122 N.J. Eq. 332, 341, 192 A. 48 (1937); McGivern v. AMASA Lumber Company, 77 Wisc. 2d 241, 252 N.W. 2d 371, 378-79 (1977); see also Unsecured Creditors Committee of Debtor STN Enterprises, Inc. v. Noyes (In re STN Enterprises), 779 F.2d 901, 904-05 (2d Cir. 1985) (most states recognize such a duty).

14 *621 A.2d 784, 789 (Del. Ch. 1992). See also Andrew D. Shaffer, Corporate Fiduciary-Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About, 8 Am. Bankr. Inst. L. Rev. 479, 519 (2000).*

15 *208 B.R. 288, 300 302 (Bankr. D. Mass. 1997).*

16 *See e.g., Cumberland Oil Corp. v. Thropp, 791 F.2d 1037, 1042 (2d Cir. 1986), cert. denied, 479 U.S. 950 (1986) (fraud claim of contract creditor against the president of oil drilling company belonged to creditor personally and was not properly a part of estate in bankruptcy). See also Hurley v. FDIC, 719 F. Supp. 27, 30 (D. Mass. 1989); Howard v. Haddad, 916 F.2d 167, 170 (4th Cir. 1990).*

17 *Rule 10b-5 under the Securities Exchange Act of 1934 makes illegal in connection with the purchase or sale of any security the use of any means of interstate commerce, the mail system or any national securities exchange to (i) employ any device, scheme or artifice to defraud, (ii) make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading or (iii) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.*

18 *Section 11(a) of the Securities Act of 1933 provides that a person who purchased a security covered by a registration statement may recover damages from, among others, the directors who sign the registration statement, if any part of the registration statement, when it became effective, (i) contained a misstatement of a material*

fact or (ii) omitted to state a material fact that was either required to be stated in the registration statement or was necessary to make the statements in the registration statement not misleading. A majority of the board of directors are required to sign the registration statement. Although only a majority of the directors of the issuer are required to sign the registration statement, each director has potential Section 11 liability, including those persons who consent to act as a director. Stephen E. Older and Jack R. T. Jordan, "Staying Out of Trouble: Officer and Director Liability in Connection with Registration Statements; How to Draft Documents to Limit Liability" Andrews Corporate Risk Spectrum (November 1999).

- 19 Devin M. LaCroix, "Outside Director Liability: Recent SEC Enforcement Actions," the D&O Diary (November 29, 2006).
- 20 Henderson & Goldring, Tax Planning for Troubled Companies, CCH 2007.
- 21 Internal Revenue Code § 6672.
- 22 C. Frederick Reich and Joseph C. Faucher, "What's in a Name?—Director and Officer Liability Under ERISA," WP & BC News (Summer 1998), citing ERISA § 3(21)(A).
- 23 See generally, *Delaware Corporation Laws*.
- 24 "D&O Insurance: What Directors and Officers Should Be Thinking about in the Sarbanes-Oxley World" (March 11, 2003); Valerie Ford Jacob, Richard A. Brown, Stuart Gelfond, Robert Juceam, Michael Levitt, Paul H. Falon, Timothy E. Peterson and Daniel J. Bursky.
- 25 *Id.*
- 26 Stephen J. Weiss and Thomas H. Bentz, Jr. "Ways to Improve Your D&O Insurance Coverage," The Metropolitan Corporate Counsel (November 2005).
- 27 Section 523 of the US Bankruptcy Code provides:
§ 523. Exceptions to discharge.¹

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

(11) provided in any final judgment, unreviewable order, or consent order or decree entered in any court of the United States or of any State, issued by a Federal depository institutions regulatory agency, or contained in any settlement agreement entered into by the debtor, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union;

(12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution, except that this paragraph shall not extend any such commitment which would otherwise be terminated due to any act of such agency;

(19) that—

(A) is for—

(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or

(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and

(c)(1) Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified in paragraph (2), (4) or (6) of subsection (a) of this section unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4) or (6), as the case may be, of subsection (a) of this section.

(2) Paragraph (1) shall not apply in the case of a Federal depository institutions regulatory agency seeking, in its capacity as conservator, receiver, or liquidating agent for an insured depository institution, to recover a debt described in subsection (a)(2), (a)(4), (a)(6), or (a)(11) owed to such institution by an institution-affiliated party [as defined in section 3(U) of the Federal Deposit Insurance Act] unless the receiver, conservator, or liquidating agent was appointed in time to reasonably comply, or for a Federal depository institutions regulatory agency acting in its corporate capacity as a successor to such receiver, conservator, or liquidating agent to reasonably comply, with subsection (a)(3)(B) as a creditor of such institution-affiliated party with respect to such debt.

(e) Any institution-affiliated party of an insured depository institution shall be considered to be acting in a fiduciary capacity with respect to the purposes of subsection (a)(4) or (11).

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company finds itself in bankruptcy court, you need a heavyweight in your corner. Andrews Kurth has a team of more than 40 bankruptcy and business restructuring lawyers prepared to fight for our clients investing in or facing distressed situations. When the hits start coming don't throw in the towel. Andrews Kurth will help you navigate the big blows, throw your own punches and emerge victorious.

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- Regularly appears in Chapter 11 and Chapter 7 cases in bankruptcy courts throughout the country.
- Has significant experience representing buyers and sellers in distressed M&A transactions.
- Boasts a substantial practice involving prosecuting and defending bankruptcy related litigation.

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Robin Russell

Office Managing Partner, Houston

Robin Russell's practice combines a depth of experience in bankruptcy restructuring and litigation with financial transaction work. She represents clients throughout the U.S. in in- and out-of-court corporate restructuring and reorganization as well as providing strategic advice to corporate clients and independent boards on the legal risks associated with counterparty insolvency and the structuring of corporate acquisitions to minimize economic risks in the event of a counterparty's subsequent financial distress. She received her LL.M. in 1993 in Banking Law Studies from Boston University School of Law and her J.D. in 1986, *cum laude*, from Baylor University School of Law where she was the Highest Ranking Graduate and Editor-in-Chief of *Baylor Law Review*. She earned her B.S. in 1983, *magna cum laude*, in International Trade from Texas Tech University where she was on the Mortar Board, a student government Senator and outstanding Greek Woman on campus.



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