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Tolling a Legal Malpractice Action: Proceeding with Caution

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Many legal malpractice lawsuits begin when business transactions that attorneys structured for their clients become the focus of a dispute. The transaction was not structured with litigation in mind, but ultimately, the client ends up in court over a deal in which the attorneys did much of the dealing.

Also, legal malpractice lawsuits typically are the only kind of lawsuit in which a lawyer will sue another lawyer. While there are lawyers who specialize in suing lawyers, other lawyers may do so reluctantly, and only when there is clearly malpractice.

Inevitably, these two factors lead to requests that the attorney or law firm enter into a tolling or "standstill" agreement. Consider these three situations:

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Lessons from Recent Decisions Concerning D&O Policy Proceeds and Estate Property in Bankruptcy

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It is a disconcerting fact of director and officer representation that just when client directors and officers need their D&O insurance coverage the most, it can be the least reliable: when a corporation has filed for protection under the bankruptcy laws.

Because statutory advancement and indemnification of legal expenses as well as amounts paid in settlement/judgment are generally not available – at least not as a practical matter – to directors and officers following a bankruptcy filing by their corporation, D&O insurance is typically the last – and *only* – line of defense for directors and officers of an insolvent corporation. Director and officer litigation, moreover, is often most virulent following a corporate bankruptcy filing. D&O insurance thus serves perhaps its most important function following a corporation's filing for bankruptcy protection.

Yet, as several recent decisions reveal, the filing of the bankruptcy petition itself can have unintended and undesirable effects on the availability of D&O coverage. Several courts have held that D&O policies and amounts payable under those policies are an asset of the debtor's bankruptcy estate and therefore subject to the automatic stay in bankruptcy. Directors and officers consequently face considerable challenges in ensuring that their D&O insurance coverage will respond following a bankruptcy filing by the corporation they serve.

Highlighting the challenges faced by directors and officers of insolvent corporations, several recent decisions have reached differing conclusions regarding the limitations on accessing D&O insurance following a corporate bankruptcy filing. On August 25, 2003, for example, the United States District Court for the Southern District of New York reversed a ruling by the bankruptcy court in the *Adelphia Communications* case regarding whether the proceeds of the Adelphia D&O program are an asset of the Adelphia bankruptcy estate. *In re Adelphia Communications*

> **The filing of the bankruptcy petition itself can have unintended and undesirable effects on the availability of D&O coverage.**

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Corp., No. 03-CIV. 609(HB), 2003 WL 11005944 *1, *2 (S.D.N.Y. August 25, 2003) (hereinafter "*Adelphia II*"). The district court's ruling in the *Adelphia* case is only the most recent in a series of decisions rendered over the past eighteen months addressing whether D&O insurance proceeds are an asset of a corporate debtor's bankruptcy estate and therefore governed by the automatic stay.

Despite the varied judicial outcomes, the recent decisions do point to a solution for directors and officers wishing to ensure that their coverage remains available following a bankruptcy filing by the corporation. Certain contractual provisions included in a D&O policy combined with informed legal advice during the negotiation phase of D&O coverage can reduce, and may go a long way toward eliminating, this and other pitfalls. In the D&O context, an ounce of prevention is truly worth a pound of cure.

Insurance Coverage and Bankruptcy Estate Property Generally

When a corporation files for protection under the Bankruptcy Code, the filing of the bankruptcy petition operates automatically to stay "any act to obtain possession of the property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3) (2001). Property of the estate is defined under the Bankruptcy Code "to include 'all legal or equitable interests of the debtor in property as of the commencement of the case.'" *Adelphia Communications, Inc. v. Associated Electric & Gas Ins. Services (In re Adelphia Communications Corp.*), 285 B.R. 580, 590 (Bankr. S.D.N.Y. 2002) (hereinafter "*Adelphia I*") (quoting 11 U.S.C. § 541 (a)(1)).

The legislative history of the Bankruptcy Code makes clear that the scope of Section 541 is very broad and "includes all kinds of property, including tangible or intangible property." *See Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New Engl. Reins. Corp. (In re Minoco Group of Cos. Ltd.*), 799 F.2d 517, 518 (9th Cir. 1986). Section 541's definition of property "was intended, [in the words of one court], to be broad and all-inclusive." *Id.* (quoting *In re Bialic*, 712 F.2d 426 (9th Cir. 1983)). Property of the debtor's estate may not be accessed or utilized without authorization of the bankruptcy court.

While there is little question that an insurance *policy* issued to a debtor corporation is an asset of the debtor's bankruptcy estate, courts have disagreed widely concerning whether amounts payable under an insurance policy - the proceeds of the policy - are also property of the debtor's estate. *Adelphia II*, 2003 WL 11005944 at *2.

Courts are generally in agreement that insurance *policies* are property of a debtor's bankruptcy estate. *Adelphia I*, 285 B.R. at 590; *see also In re CHS Electronics, Inc.*, 261 B.R. 538, 541 (Bankr. S.D. Fla. 2001) (observing that "[n]umerous bankruptcy cases hold that debtor-owned insurance policies are property of the estate") (citing cases); *In re Minoco*, 799 F.2d at 519. Accordingly, the ability to cancel or to rescind an insurance policy issued to the debtor is restricted by the automatic stay. *In re Minoco*, 799 F.2d at 519. It is important, however, to recognize a distinction, for purposes of determining property of the estate, between the insurance policy itself and the proceeds of that insurance policy. *See Ochs v. Lipson (In re First Central Financial Corp.)*, 238 B.R. 9, 16 (E.D.N.Y. 1999). A debtor may own an insurance policy and yet, under certain circumstances, not have any claim to the proceeds of the insurance policy. *See Louisiana World Exposition, Inc. v. Federal Ins. Co. (In re Louisiana World Exposition, Inc.)*, 832 F.2d 1391, 1399 (5th Cir. 1987) ("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 . . . ").

Recent decisions do point to a solution for directors and officers wishing to ensure that their coverage remains viable following a bankruptcy filing.

D&O Policy Proceeds as Estate Property

Where the proceeds of a D&O policy are held to be an asset of a debtor's estate, the implications can be disastrous for the unlucky directors and officers relying on that policy for coverage. Under such circumstances, officers and directors will be barred by the automatic stay from accessing policy proceeds for purposes of paying their legal expenses - which alone can run into the hundreds of thousands (if not millions) of dollars in such cases - and for funding any settlement or judgment.

Courts are not in complete agreement as to when the proceeds of a D&O insurance policy may be considered an asset of the corporate debtor's estate. Indeed, "the question of whether the proceeds [of an insurance policy] are property of the estate must be analyzed in light of the facts of each case." *In re First Central Financial Corp.*, 238 B.R. at 17. While some courts have found that policy proceeds are not property of the debtor's estate, *see, e.g., Adelphia II*, 2003 WL 11005944 at *2 (citing cases); *In re CHS Elecs., Inc.*, 261 B.R. at 542-43; *In re First Central Financial Corp.*, 238 B.R. at 16 ("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"), others have found policy proceeds to be property of the estate subject to the automatic stay. *See, e.g., Adelphia I*, 285 B.R. at 590; *In re Sacred Heart Hosp.*, 182 B.R. 413, 421 (Bankr. E.D. Pa. 1995); *Circle K Corp. v. Marks (In re Circle K Corp.)*, 121 B.R. 257 (Bankr. D. Ariz. 1990).

The two principal bases that have been identified by the courts as grounds for finding that proceeds of a D&O insurance policy are an asset of a debtor's bankruptcy estate are as follows.

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- **Entity Coverage**. Many D&O policies provide coverage directly to the corporate entity for liability arising out of claims for securities fraud. Where a D&O policy provides entity coverage, the likelihood that the proceeds will be considered property of the debtor's estate is increased. *See PHP Healthcare Corp. v. HIP Foundation, Inc.*, Case No. 98-2608, slip opinion at 6-7 (Bankr. D. Del. Mar. 31, 1999); *see also In re Sacred Heart*, 182 B.R. at 420; *but cf. In re Louisiana World Exposition*, 832 F.2d, at 1400; *Homsy v. Floyd (In re Vitek)*, 51 F.3d 530, 534 (5th Cir. 1995). The court in *Sacred Heart* held that the presence of entity coverage was sufficient to render the policy proceeds property of the debtor's estate. *In re Sacred Heart*, 182 B.R. at 420. Other courts have held, however, that the presence of entity coverage, in and of itself, is not sufficient to render the proceeds of a D&O policy property of the estate. *In re CHS Elecs., Inc.*, 261 B.R. at 542-43; *In re First Central Financial*, 238 B.R. at 17 (holding that "[t]he mere appendage of entity coverage . . . providing the Debtor with protection from securities claims, does not provide sufficient predicate, *per se*, to metamorphose the proceeds into estate property."). Similarly, in *In re CHS Electronics*, the court held that entity coverage did not render the policy property of the estate, in part because, with respect to securities claims asserted against the Debtor, all of these claims had been discharged. *In re CHS Elecs., Inc.*, 261 B.R. at 543.

Recent decisions highlight the divergent approaches courts have taken in addressing whether D&O insurance proceeds are an asset of a debtor's estate in bankruptcy.

- **Indemnification Coverage**. Another basis recognized by some courts for including D&O policy proceeds within the property of the estate is policy coverage for the indemnification obligations of a corporate debtor. *See, e.g., In re Sacred Heart*, 182 B.R. at 420. As the court in *Sacred Heart* explained, in critiquing the decision in *Louisiana World Exposition*:

  > [t]he court's distinction between liability and indemnification proceeds, however, is illusory. . . . [B]oth types of coverage were provided from the same pot of proceeds. Thus, payment of either type of claim would have diminished the pot and arguably exposed the debtor to claims which otherwise might have been paid by the insurer. We think that such an indemnification interest in proceeds is sufficient to bring those proceeds into the estate.

  In re Sacred Heart, 182 B.R. at 420; *see also In re Circle K Corp.*, 121 B.R. 257. The court in *Louisiana World Exposition*, by contrast, held that, because D&O proceeds will be applied to pay claims that would otherwise be subject to indemnification, those proceeds are not property of the estate. *Louisiana World Exposition*, 832 F.2d, at 1400 ("any payment under the liability coverage reduces the amount of the potential indemnification claim to the same extent that policy amounts available for indemnification are thus reduced."); cf. *Executive Risk Indemnity, Inc. v. Boston Regional Medical Center, Inc. (In re Boston Regional Medical Center)*, 285 B.R. 87, 91-92 (Bankr. D. Mass. 2002). At least one court, moreover, has limited the debtor's property interest in policy proceeds to amounts *actually paid* by the debtor pursuant to those indemnification obligations. *See In re CHS Elecs.*, 261 B.R. at 543.

Courts have varied significantly in their willingness to find that entity coverage or indemnification coverage renders the proceeds of a particular D&O policy property of a debtor's estate. *See Adelphia II*, 2003 WL 11005944 at *2.

Recent Notable Decisions

A number of recent decisions highlight the divergent approaches courts have taken in addressing the question of whether D&O insurance proceeds are an asset of a debtor's estate in bankruptcy:

- ***Adelphia I***. In a lengthy and thoughtful decision in the Adelphia Chapter 11 proceeding, the bankruptcy court reviewed the relevant case law concerning whether D&O policy proceeds are an asset of the debtor's bankruptcy estate and found that the proceeds of the Adelphia D&O program were indeed property of the Adelphia bankruptcy estate. *Adelphia I*, 285 B.R. at 592. The bankruptcy court focused on three factors that contributed to its finding that the proceeds of the Adelphia D&O program were an asset of the estate: First, the Adelphia policy provided for entity coverage for the debtor entities, Adelphia Communications Corp. and Adelphia Business Solutions, Inc. *Id.* at 591-92. Second, the D&O policies provided for indemnification coverage for the debtor entities. *Id.* Third, Adelphia's prepetition D&O coverage provided the sole source of D&O insurance for the directors serving Adelphia postpetition; in a novel twist, the court held that the debtor entities, therefore, had a property interest in preserving the proceeds of the prepetition policy so as to afford coverage to the Adelphia directors serving postpetition. *Id.* at 592-93. For these reasons, the bankruptcy court held that the proceeds of the Adelphia policies were an asset of the Adelphia bankruptcy estate.

- ***Adelphia II***. The United States District Court recently reversed the Adelphia bankruptcy court in a relatively terse decision that held simply that "[n]o cognizable equitable and legal interest [in the policy proceeds] has arisen here." *Adelphia II*, 2003 WL 22005944 at *3. In so holding, the district court pointed to the bankruptcy court's findings that (i) none of the debtor entities have "made any payments for which it would be entitled to indemnification coverage or that any such payments are now contemplated'"; and (ii) "'none of the Debtors [have] made or committed themselves to payments using their entity coverage.'" *Id.* The court reasoned that "[c]laiming the debtors now have a property interest in [the D&O] proceeds . . . would be akin to a car owner claiming he has a right to proceeds from his policy simply because there is a prospective possibility that his car will collide with another tomorrow . . . ." *Id.*

  In reversing the bankruptcy court's decision, the district court did not address the bankruptcy court's concern that the prepetition policy afforded the only protection for postpetition directors and officers and that the debtor, therefore, had a significant interest in ensuring that the D&O policy not be depleted through unfettered payments of the proceeds of the policy.

- ***Enron Corporation***. Following the filing of the Enron Corporation's petition for relief under Chapter 11 of the Bankruptcy Code, Enron sought the approval of the bankruptcy court to access some $450 million of D&O insurance coverage for the benefit of certain of its directors and officers. In the face of significant opposition by Enron's creditors, the bankruptcy court rebuffed Enron's initial efforts. See Tr. of Hrg. of February 28, 2002 (ECF #2191), *In re Enron Corp.*, Case No. 01-16034 (Bankr. S.D.N.Y.)(AJG). Thereafter, the outside directors of Enron requested that the bankruptcy court authorize Enron's D&O insurers to advance defense costs to the outside directors. The outside directors argued that the proceeds of the Enron policy were not property of the Enron bankruptcy estate despite the existence of indemnification and entity coverage. See Tr. of Hrg. Of April 11, 2002 (ECF #3358), *In re Enron Corp.*, Case No. 01-16034 (Bankr. S.D.N.Y.)(AJG). The outside directors pointed to a "priority of payments" endorsement, which expressly subordinates any interest that the corporation has in the proceeds of the policy to the interests of the individual directors and officers. *Id.* The court granted the relief requested by the outside directors, holding that the policy's "priority of payments" endorsement was a valid and enforceable prepetition contractual limitation on the corporation's interest in the proceeds of the Enron D&O policies and that the endorsement conferred upon the directors and officers a priority interest in the D&O proceeds. Oral Decision Tr. of Hrg. Of April 11, 2002 (ECF #3278), *In re Enron Corp.*, Case No. 01-16034 (Bankr. S.D.N.Y.)(AJG) at 13.

- ***Cybermedia Incorporated***. Former directors and officers of Cybermedia were sued for, among other claims, breach of fiduciary duty. *In re Cybermedia*, 280 B.R. 12, 14 (Bankr. D. Mass. 2002). The primary D&O insurer, Certain Underwriters of Lloyd's, declined to advance defense costs to the former directors and officers without an order from the bankruptcy court authorizing such advancement. *Id.* The directors and officers brought a motion seeking such an order from the Cybermedia bankruptcy court, arguing that the proceeds of the Cybermedia D&O policy were not property of the debtor's estate. *Id.* at 15. The bankruptcy court held that the proceeds of the D&O policy were property of the debtor's estate and that relief from the automatic stay was necessary before advancement of defense costs could be made. *In re Cybermedia*, 280 B.R. at 17. The court then proceeded to balance the interests of the directors and officers against the interests of the debtor: "[The directors] are in need *now* of their contractual right to payment of defense costs . . . the harm to the Debtor if relief from stay is granted is speculative given the fact that there are presently no claims for indemnification nor entity coverage, . . ." *Id.* at 18. (emphasis in original). The Court held that the balance of interests and hardship weighed in favor of the directors and, so, granted relief from the automatic stay to permit advancement of the directors' defense costs. *Id.*

- ***Boston Regional Medical Center***. In *In re Boston Medical Center*, the court held that the D&O policy's proceeds were an asset of the bankruptcy estate subject to the automatic stay and other limitations on the disposition of estate property. *In re Boston Regional Medical Center*, 285 B.R. at 98. The court based its holding principally on the policy's indemnifications coverage. *Id.* at 91. Although amounts paid by the insurer would reduce amounts owed by the debtor pursuant to its indemnification obligations, the court ruled nonetheless that the debtor had a property interest in the policy proceeds. *Id.* at 92. In particular, the court held that (i) the defense costs and amounts paid in settlement/judgment may well exceed the limit of liability of the policy; and (ii) certain individuals who would benefit from the policy may not be entitled to indemnification. *Id.* at 91-92. The court held that, as a consequence, the debtor has a property interest in preserving the policy proceeds by ensuring that non-indemnifiable claims are not paid by the insurer. *Id.* The court nevertheless allowed the directors and officers limited access to the D&O policy to pay defense costs and the costs of an expert.

- ***Youngstown Osteopathic Hospital***. In *In re Youngstown Osteopathic Hospital*, the bankruptcy court held that proceeds of the hospital's D&O policy were not property of the debtor's bankruptcy estate. *Youngstown Osteopathic Hospital Ass'n v. Ventresco (In re Youngstown Osteopathic Hospital Ass'n)*, 271 B.R. 544, 551 (Bankr. N.D. Ohio 2002). The court noted that "there is no liability [entity] coverage for [the hospital]." *Id.* The court held further that because the hospital has made no indemnification payments for which it could seek reimbursement under the policy, the policy's indemnification coverage was insufficient to render the proceeds of the policy property of the debtor's estate. *Id.* at 550-51. The court permitted the insurer to advance defense costs without risk of violating the automatic stay. *Id.* at 551.

Potential Contractual Solution to Coverage Risk

The recent decisions concerning D&O policy proceeds are property of a debtor's estate in bankruptcy highlight the uncertainty surrounding D&O coverage in bankruptcy. Much of this coverage uncertainty can be addressed by contractual provisions in the policy itself.

Above all, directors and officers wishing to minimize the risk that a bankruptcy court could decide, based on the facts and circumstances of the particular case, that the proceeds of their D&O policy are an asset of the debtor's bankruptcy estate and therefore unavailable to them, should include in their policy a "priority of payments" or "order of payments" endorsement. Such an endorsement expressly subordinates the debtor's interests in the proceeds of a D&O policy to the interests of individual directors and officers. Such a "priority of payments" endorsement was the difference between coverage and non-coverage in *Enron* and *Adelphia I* respectively. As the Bankruptcy Court in *Adelphia I* averred:

> In *Enron* the court did not stand in the way of a request for payment of defense costs when the insurers were prepared to advance them. . . . [R]eview of the transcript of the court's bench decision . . . reveals that there, while the debtors did have entity coverage (as well as indemnification coverage), the relevant policy had a 'priority of payments' endorsement, under which that coverage was expressly subordinated to the rights of the directors and officers under the policy.

Adelphia I, 285 B.R. at 597, n. 25.

A priority of payments endorsement should accordingly be considered an essential part of any D&O policy and should be carefully drafted for maximum protection. For example, certain off-the-rack "priority of payments" endorsements condition the effectiveness of the endorsement on receipt by the insurer of a postpetition "written request" for prioritization by the debtor. Such an endorsement could be largely useless where a trustee or other person(s) hostile to the prepetition directors and officers controls the debtor postpetition. Furthermore, a well-crafted "priority of payments" endorsement can address the concern raised by the court in *Adelphia I* that unfettered access to policy proceeds will deplete the only source of insurance for postpetition directors and officers. *See Adelphia I*, 285 B.R. at 592-93. These provisions have, however, only been tested in two cases and, therefore, their reliability remains uncertain. See Oral Decision Tr. of Hrg. of April 11, 2002 (ECF #3278), *In re Enron Corp.*, Case No. 01-16034 at 13; Oral Decision Tr. of Hrg. of May 8, 2001, *In re Lernout & Hauspie Speech Products*, Cases No. 00-4397 through 00-4399 (Bankr. D. Del.) (JHW).

Conclusion

The availability of D&O insurance is critical to the decision to serve as a director or officer. It is, therefore, important for directors and officers to be able to predict with some certainty whether their D&O coverage will respond in extreme circumstances, such as corporate bankruptcy, when it is most needed.

Unfortunately, relevant case law varies significantly from jurisdiction to jurisdiction, court to court and, indeed, case to case. While directors and officers can implement contractual provisions that will increase the likelihood that D&O coverage will be available postpetition, the effectiveness of these provisions has not been broadly tested in court and remains its own source of unpredictability.

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- A law firm receives a letter from an attorney indicating that she has just been retained on behalf of their former client. The letter requests that the former client's file be forwarded to the writer for review. The letter indicates that because the new counsel would not want to sue such a prominent firm with its impeccable reputation unless there was clearly some wrongdoing, a tolling agreement is requested.

- A client of the law firm gets caught in a litigation battle over the interpretation of a contract the law firm drafted. The client 's new counsel writes that in the event there is an adverse outcome in the litigation, the client may have a claim against the law firm. Because of this, counsel requests that the law firm enter into a tolling agreement pending the outcome of the lawsuit against the client.

- A law firm had previously been retained to prepare an opinion letter involving a securities offering issued by the client. The client is sued for negligent misrepresentation after the notes or stock held by the plaintiffs become worthless. While the law firm is not sued as a party because of a lack of privity with the plaintiffs, the now former client wishes to enter into a tolling agreement because of reliance on the law firm in the representations made in the offering.

Law firms frequently welcome the tolling agreement with little scrutiny. The typical reaction is "we didn't do anything wrong." Therefore, the belief is that once the other side completes their investigation, they will come to the same conclusion, and simply go away.

Often, the request for a tolling agreement is brought before the firm's management committee who, as a group, have very little knowledge of the facts that may give rise to a potential malpractice action. The firm may also carry a sizeable deductible or self-insured retention that also applies to legal fees. Thus, the proposed tolling agreement appears as a no-brainer. Why should we force a lawsuit against the firm, and unnecessarily incur legal fees and possible negative publicity that may go along with a lawsuit?

While the purpose of a tolling agreement is to avoid a lawsuit or to attempt in good faith to resolve the claim without litigation, too often little attention is paid to either, and ultimately a lawsuit is filed against the law firm anyway. The only purpose that the tolling agreement served was to allow plaintiff's attorney to file a better malpractice action at a later date.

With reference to the above three scenarios, consider the possible disastrous consequences:

- The law firm forwards the complete file to their former client's new counsel, without making any copies. Three months later, defense counsel is retained to represent the firm. However, defense counsel is at a disadvantage since the former client's new counsel has the complete file. When the former client responds to discovery requests and defense counsel finally receives a purported copy of the file, crucial documents are mysteriously missing.