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Delaware Opinion's Implications for Post-Confirmation Trust Litigation

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In recent chapter 11 history, it has become expected that where potential claims exist against directors and officers (D&Os) of the debtor, those claims are litigated by a post-confirmation trust on behalf of the estate. This is exactly what was planned in the *Washington Mutual* (WaMu) case,[1] and when the D&O policy insurers disclaimed liability, the estate sued the insurers in bankruptcy court to compel their payment of defense costs. The court's order granting summary judgment in favor of the insurer defendants and dismissing the suit will compel changes in how such claims are approached, both in terms of disclosure in plans of liquidation or reorganization and in how the claims are pursued by post-confirmation trusts.

WaMu was a bank holding company, the owner of the eponymous Washington Mutual Bank. In 2008, months before the bank run that led to Washington Mutual Bank's failure, the company purchased $250 million of D&O liability coverage (the "policies") to cover claims made during a one-year period starting May 1, 2008. In September 2008, after a downgrade in WaMu and Washington Mutual Bank's credit ratings, a 10-day run on the bank occurred during which more than $16 billion in deposits were withdrawn. In late September, the Office of Thrift Supervision seized Washington Mutual Bank and appointed the Federal Deposit Insurance Corp. (FDIC) as the receiver, which sold substantially all of the bank's assets to JP Morgan Chase the same day. The following day, WaMu filed chapter 11 petitions in the U.S. Bankruptcy Court for the District of Delaware.

The official committee of unsecured creditors in the chapter 11 cases investigated a $500 million downstream capital contribution (the "downstream payment") to Washington Mutual Bank that was made shortly before regulators seized the bank's assets. In October 2011, the debtors and committee sent a demand letter to the directors and officers, asserting various claims related to the downstream payment and seeking repayment of the $500 million. Several directors and officers notified the insurers under the policies, and by the end of 2011, the primary insurer had denied coverage.

The seventh amended reorganization plan, confirmed several months later in February 2012, provided for a contingent litigation reserve of $65 million for the directors and officers, with the majority of those funds ($55 million) allocated to pay for the defense costs of the directors and officers related to the claims related to the downstream payment (which, coincidentally, was an amount sufficient to cover the lead policy's retention, or the amount of expenses that the beneficiaries of the policy had to pay before coverage was triggered). Within weeks of plan confirmation, the debtors filed an adversary proceeding[2] against the issuers of the policies alleging breach of contract and tortious breach of the duty of good faith and fair dealing, and sought a declaratory judgment that the insurers are not subrogated to the directors' and officers' indemnity claims, also seeking equitable subordination of any subrogated claims that the insurers might have. Unsurprisingly, the insurers moved to dismiss the case.

At the outset, it is worth noting the nature of the litigation: It was not claims against the directors and officers that were being litigated; rather, it was litigation about how to ultimately get to the litigation of the claims against directors and officers, and who might pay for the defense in that action. A takeaway from this case is that one should let "litigation about other litigation" be a warning sign as to the unlikeli-

1 *In re Wash. Mut. Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del.).

2 *Wash. Mut. Inc. v. XL Speciality Ins. Co. (In re Wash. Mut. Inc.)*, Adv. No. 12-50422 (MFW) 2012 Bankr. LEXIS 4673, at *1 (Bankr. D. Del. Oct. 4, 2012).

hood of bankruptcy court jurisdiction. From the standpoint of practicality and hindsight, perhaps it would have been both more efficient and more effective to have simply given over the $65 million in the plan as funds for creditors' recoveries instead of providing a potential $10 million recovery for the estates vs. a $55 million war chest for defense counsel.

The insurers' motion to dismiss focused on several aspects of the litigation at bar. First, they raised the argument that WaMu, in the form of its own bankruptcy estate, was pursuing claims against its own directors and officers—in essence, WaMu would be suing itself. Second, the insurers asserted that because the adversary proceeding asserted state law breach-of-contract claims and because these claims would arise outside of a bankruptcy case, the bankruptcy court lacked jurisdiction under Rule 12(b)(1) of the Federal Rules of Civil Procedure[3] because there was no "close nexus" between the claims at hand and the debtors' confirmed reorganization plan. These were claims that the insurers asserted were neither core nor "related to" bankruptcy.

Other routine defenses raised were related to WaMu not being the beneficiary of certain of the policies, which were designed solely to pay the defense costs of directors and officers, and that the litigation that could ultimately give rise to the need for defense costs had yet to commence so. Therefore, the matter was not yet ripe for any decision as to what costs would even exist, let alone be paid. Finally, the insurers asserted that there could not have been a failure to pay costs when no costs were eligible to be paid. With a $50 million retention on the primary policy and the adversary case being "devoid of allegations to show that the directors and officers have incurred defense costs even approaching the $50 million mark,"[4] the insurers asserted that they could not have failed to pay a claim that could not conceivably exist at the time.

The bankruptcy court considered extensively the issue of jurisdiction. Third Circuit case law[5] provides for bankruptcy courts to exercise jurisdiction of distinct matters, including:

- cases filed under title 11;
- proceedings arising under title 11;
- proceedings arising in a case filed under title 11; and
- proceedings related to a case filed under title 11.

The court, in its argument and through the various pleadings, explored the parties' relative views on how jurisdiction rested in the bankruptcy court. The trust, as plaintiff, admitted that the claims being pursued against the insurers were only "related to" a case filed under title 11. In previous cases of a similar scope, bankruptcy courts have found that insurance disputes are only "related to" a chapter 11 case and were not, in any tangible manner, related to the Bankruptcy Code nor dependent on a case being filed under title 11.[6] The court in *WaMu* found that the present case, a declaratory judgment action to determine performance on what was a pre-petition state law contract, was sufficiently removed from the heart of a chapter 11 case such that it achieved only a "related-to" jurisdiction. The claims being pursued did not involve a bankruptcy petition or any acts or subacts with a bankruptcy case, so the claims did not involve a case filed under chapter 11, a proceeding arising under chapter 11, or a proceeding arising in a case filed under chapter 11.

Because the debtors' plan had already been confirmed (although the adversary proceeding was filed days before the plan went effective), the bankruptcy court's "related-to" jurisdiction becomes even more limited. Citing *AstroPower*,[7] the court found that "[p]ost-confirmation, a bankruptcy court only has jurisdiction over a claim that has 'a close nexus to the bankruptcy plan or proceeding'" such as one that "affects the interpretation, implementation, consummation, execution or administration of a confirmed plan or incorporated litigation-trust agreement."[8] Addressing the issue of "close nexus," the trust asserted that creditors would benefit if the insurers were required to pay the directors' and officers' defense costs and the $55 million escrow were released for the benefit of unsecured creditors. However, the trust also conceded that under *Resorts*, that fact alone was insufficient to confer jurisdiction over such matters post-petition.[9]

Turning to the equities of the case, the court noted that the plan provided for payment in full to most unsecured creditors, with approximately $7 billion to be distributed to creditors and equityholders. Viewing the $55 million claims reserve against the $7 billion in already-provided-for distributions, the court found that an additional distribution represented by the $55 million (which would be a .79 percent increase in the $7 billion distributed) was not compelling, stating that "even in the worse-case scenario where the trust is forced to pay the D&O's defense costs without insurance coverage, creditors under the Plan will largely be unaffected," with the additional proceeds to be distributed being *de minimus*. Given the lack of relative impact on distributions (either positive or negative) from the $55 million reserve, the court concluded that any decision regarding coverage by the insurers would neither significantly augment—nor diminish—creditors' interests. The court again cited the *Resorts* court's opinion that if the merest possibility of *any* gain or loss of trust assets were enough for the bankruptcy court to take jurisdiction, then "any lawsuit involving a continuing trust would fall under the 'related-to' grant. Such a result would widen the scope of bankruptcy court jurisdiction beyond what Congress intended."[10]

The trust, seeking jurisdiction in the language of the plan and confirmation order, asserted that the influence that the potential to increase trust assets had on determining jurisdiction was increased by the fact that the suit was related to the plan and, by extension, the confirmation order. The trust argued that because the insurers, in the denial-of-coverage letter, claimed that they did not have to cover an "insured versus insured" claim, the insurers ran afoul of the confirmation order, which provided that the creditors' committee would prosecute the claims against the directors and officers. The court again found basis in *Resorts* to punt on the trust's claims of jurisdiction, with the *Resorts* court's finding that just because the plan and confirmation order happen to mention state law claims, that does not vest the bankruptcy court

3 Fed. R. Civ. P. 12(b).

4 Memorandum of Law in Support of Defendants' Motion to Dismiss at 4, *In re Wash. Mut. Inc.*, Adv. No. 50422 (MFW) (Bankr. D. Del. May 7, 2012), ECF No. 35.

5 *See In re Marcus Hook Dev. Park Inc.*, 943 F.2d 261, 264 (3d Cir. 1991).

6 *See In re PRS Ins. Grp. Inc.*, 445 B.R. 402, 405 (Bankr. D. Del. 2011); *G-I Holdings Inc. v. Hartford Accident & Idem. Co. (In re G-I Holdings Inc.)*, 278 B.R. 376, 380 (Bankr. D.N.J. 2002).

7 *AstroPower Liquidating Trust v. Xantrek Tech Inc. (In re AstroPower Liquidating Trust)*, 335 B.R. 309, 323 (Bankr. D. Del. 2005).

8 *In re Wash. Mut. Inc.*, 2012 Bankr. LEXIS 4675 at *9 (citing *Binder v. Price Waterhouse & Co. LLP (In re Resorts Int'l Inc.)*, 372 F.3d 154, 168-69 (3d Cir. 2004)).

9 *See In re Resorts Int'l*, 372 F.3d at 170.

10 *See id.*

with jurisdiction, nor did it require the bankruptcy court to interpret the plan as it might apply to those state law claims. The Delaware court again found support for dismissal in other bankruptcy court decisions, including *Kmart*, in which that court noted that state courts are able and qualified to interpret a plan and confirmation order.[11]

While it may be conventional wisdom that for a claim to be valid post-confirmation it must be disclosed in the plan, the *WaMu* court went so far as to state that for the trust's claims against the insurers to have sufficiently close nexus such that the bankruptcy court would retain post-confirmation jurisdiction, the plan would have to "specifically describe an action over which the court had 'related-to' jurisdiction pre-confirmation and expressly provide for the retention of such jurisdiction to liquidate that claim for the benefit of the estate's creditors."[12] In short, the plan would have to explicitly state that "we're going to sue the insurers to compel them to pay defense costs before we bring the D&O suit and we're going to seek to have the $55 million defense costs escrow released for the benefit of creditors." So much for keeping one's cards close to the vest if one wishes to avail oneself of bankruptcy court jurisdiction. Even given those extreme circumstances, however, Hon. **Mary F. Walrath** was not convinced, writing that even when a plan "clearly and unambiguously reserves jurisdiction for a specific cause of action, the Court will not have post-confirmation jurisdiction unless a substantial nexus is established."[13] With no close nexus in the matter at hand, and only a derivative "related-to" jurisdiction, the court found basis to dismiss the breach-of-contract and breach-of-fiduciary-duty claims.

Perhaps not intending to kick the trust's assertions while they were down, Judge Walrath determined that as to the declaratory relief sought, the subrogation claims were "*far too hypothetical and speculative*" to warrant adjudication, as there was no actual controversy at the time: No subrogation claims had been filed by the insurers, nor by the directors and officers, because no defense costs had been paid at that time. While these claims might arise one day, they had not arisen as of the time of the filing of the complaint. Therefore, the declaratory judgment claims were dismissed.

Conclusion

What are we to make of this ruling? As a gating issue, becoming familiar with the *Resorts* case will save both time and estate assets. When given the choice between state court and bankruptcy court, post-confirmation trusts will often prefer bankruptcy courts. This author's bias leans in that direction based on his experience with the bankruptcy courts' efficiency and knowledge of the intricacies of bankruptcy. However, once one departs the realm of preference and fraudulent-conveyance claims, finding bankruptcy court jurisdiction becomes increasingly difficult. While a D&O suit alleging triangular preferences, fraudulent conveyances and other hallmarks of a poorly managed insider relationship are likely still safe in bankruptcy court, more traditional D&O claims, such as breach-of-fiduciary-duty claims, are likely to be sent to the state court of appropriate choice.

What the *WaMu* case tells us, however, is that even if a claim is the central tenet of a reorganization plan, and even if the matter brought before the bankruptcy court deals with estate assets—if it is related to a state court claim, such as breach of contract or breach of fiduciary duty, then it belongs in state court. Liquidating trustees be forewarned: Get comfortable with state court litigation, or prepare to spend time and money getting booted out of bankruptcy court. Do this a few times, and it is only a matter of time before someone starts asking why the trustee or counsel didn't know better. abi

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11 *See In re Kmart Corp.*, 307 B.R. 586, 596 (Bankr. E.D. Mich. 2004).
12 *In re Wash. Mut. Inc.*, 2012 Bankr. LEXIS 4673 at *14 (Bankr. D. Del.) (citing *AstroPower*, 335 B.R. at 325).
13 *See id.*