Understanding Insurance Coverage in Pursuit of Civil Claims

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Understanding Insurance Coverage in Pursuit of Civil Claims

When catastrophe strikes and bankruptcy estates have suffered losses Trustees should know their insurance remedies. This panel will shine a bright light on insurance policies and policy requirements and deadlines and they will examine the elements of and coverage levels and limits of Directors and Officers Claims, Bad Faith Claims, Professional Liability and Other Tort Claims.

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1. Liability Insurance Proceeds and Coverage Considerations When Insureds File for Bankruptcy

1.1. Property of the estate?

Upon a bankruptcy petition's filing, all of the debtor's property, including its contractual rights, becomes the property of its bankruptcy estate. [11 U.S.C. § 541] At the same time, a broad automatic stay of collection activity or other proceedings against the debtor is implemented. [11 U.S.C. § 362(a)(1) (covering "the commencement or continuation … of a[n] … action or proceeding against the debtor … to recover a claim against the debtor that arose before the [petition]")] But where does this leave those with claims against the debtor for pre-petition acts or omissions that are covered under liability insurance policies? If the debtor was insured for the claims in question, would proceeds from those policies be considered estate property to be divvied up among other creditors? And might an insurer (whether primary or excess) have a defense to coverage if the insured is unable to pay an applicable deductible due to the bankruptcy proceedings?

The answer to these questions requires a careful analysis of the insurance policies in question and the law of the controlling jurisdiction. For example, determining whether proceeds of a D&O policy qualify as estate property is inherently complex because D&O policies usually cover both the corporation itself and individual directors and officers. But as a general rule, the proceeds of most standard liability policies are not considered estate property. [There are important exceptions to this general rule, such as in the mass-tort setting or when claims are sure to exceed policy limits. *See, e.g., MacArthur Co. v. Johns-Manville Corp*., 837 F.2d 89, 91 (2d Cir. 1988); *In re Equine Oxygen Therapy Res., Inc.*, No. 14-51611, 2015 WL 1331540, at *1 (Bankr. E.D. Ky. Mar. 20, 2015).] As the Fifth Circuit has explained:

1.2. Clear examples of property of the estate

Examples of insurance policies whose proceeds are property of the estate include casualty, collision, life, and fire insurance policies in which the debtor is a beneficiary. Proceeds of such insurance policies, if made payable to the debtor rather than a third party such as a creditor, are property of the estate and may inure to all bankruptcy creditors. **But under the typical liability policy, the debtor will not have a cognizable interest in the proceeds of the policy**. Those proceeds will normally be payable only for the benefit of those harmed by the debtor under the terms of the insurance contract. *In re Edgeworth*, 993 F.2d 51,56 (5th Cir. 1993).

1.3. Exceptions that bring liability proceeds into an estate

Because liability policy proceeds usually do not belong to the estate, bankruptcy courts are often receptive to requests to lift an automatic stay for the sole purpose of allowing a claimant to initiate or continue outside proceedings against the debtor and collect proceeds from insurance policies that cover the resulting judgment. *See In re Calsol, Inc*., 419 F. App'x 753 (9th Cir. 2011); *Baez v. Med. Liab. Mut. Ins. Co*., 136 B.R. 65, 68 (S.D.N.Y. 1992); *In re Fernstrom Storage & Van Co*., 100 B.R. 1017, 1023 (Bankr. N.D. Ill. 1989), aff'd, 938 F.2d 731 (7th Cir. 1991). Bankruptcy judges have considerable discretion in determining whether sufficient “cause” exists to lift the automatic stay, and the fact that the debtor’s insurer bears responsibility for defending debtor in an action outside the bankruptcy proceedings weighs in favor of lifting the stay to pursue any potentially applicable insurance proceeds. *See In re Abeinsa Holding, Inc*., No. 16-10790 (KJC), 2016 WL 5867039, at *3 (Bankr. D. Del. Oct. 6, 2016).

Practice Pointer: What should the trustee consider when a motion for relief to pursue coverage is filed? Does coverage exist? Are there deductibles or self-insured retentions? How are those dealt with in the relief sought? Was the debtor being represented pre-bankruptcy by counsel paid by the carrier? Will that continue? Is the claim well within the coverage limits? Is the relief sought narrowly tailored to available coverage? Will the relief impose any burden upon the estate (discovery, monitoring, etc.)? Will the claimant withdraw or waive its claim in the bankruptcy estate?

Liability Insurance Proceeds are Estate Property When Claims Exceed Policy Limits - In *Martinez v. OGA Charters, L.L.C. (In re Charters, L.L.C.),* 901 F.3d 599 (5th Cir. 2018), the Fifth Circuit found that there were “secondary impacts” or “secondary effect” as contemplated by *Edgeworth*, and as discussed in *MacArthur Co. v. Johns-Manville Corp*., 837 F.2d 89, 92 (2d Cir. 1988) (having claims against the estate satisfied out of insurance proceeds has a “secondary effect” on the overall administration of the bankruptcy estate, since every dollar that an insurance policy pays for covered tort claims is an extra dollar for other, non-tort creditors and potentially for the debtor as well. *See A.H. Robins Co., Inc. v.*

Piccinin, 788 F.2d 994, 1008 (4th Cir. 1986), *cert. denied*, 479 U.S. 876, 107 S.Ct. 251, 93 L.Ed.2d 177 (1986)) Accident claims in the OGA bankruptcy exceeded $400 million, dwarfing the $5 million in NYM policy limits, "giving rise to an equitable interest of the debtor in having the proceeds applied to satisfy as much of those claims as possible[.]" and in the limited circumstances, the proceeds were properly classified as property of the estate under 11 U.S.C. § 541. *In re Charters, L.L.C.*, at 604. The claimant creditors race to the courthouse, or settlement with a carrier, whenever a policy is too small to satisfy several potential plaintiffs, could mean unfair results as between potential plaintiffs; it could also prevent a bankruptcy court from marshalling the insurance proceeds, and, along with other assets, arranging for their distribution so as to maximize their ability both to satisfy legitimate creditor claims and to preserve the debtor's estate. *See In re Forty-Eight Insulators, Inc*., 54 B.R. 905, 907-08 (Bankr. N.D. Ill. 1985). In the "limited circumstances," where a siege of tort claimants threaten the debtor's estate over and above the policy limits, the court classifies the proceeds as property of the estate. Where tort claims exceed policy limits, the policy proceeds may be property of the estate.

The *OGA Charter's* analysis was extended to apply to the trustee's avoidance actions seeking to claw back payments exhausting insurance policy proceeds pre-bankruptcy in a scenario where the coverage was insufficient to meet all of the claims that triggered it. The court agreed that the pre-petition payment of the Policy Proceeds directly affected the Debtor's equitable interest in the Policy Proceeds when the petition was filed. *In Re: Josiahs Trucking, LLC* (USBC SD TX CASE NO: 21-70009 11/9/2022).

1.4. General considerations

1.4.1. Maintenance of Insurance

Maintaining insurance during bankruptcy is not optional. Cases that convert to a Chapter 7 case should have insurance in place. The bankruptcy code provides that failure to maintain adequate insurance may be "cause" to dismiss or convert a debtor's case. State law and various regulations often require that insurance be in place in order to maintain good standing, and the guidelines of the U.S. Trustee, who oversees Chapter 11 cases, also mandate sufficient insurance coverage.

Bankruptcy's automatic stay provisions generally preclude insurance companies from canceling policies post-petition for nonpayment of premiums, except financed premiums, where the finance company can terminate a policy as attorney in-fact for the insured.

1.4.2. Self-Insured Retentions

As a general matter, self-insured retentions, or SIRs, typically represent the policyholder's "skin in the game." For an insolvent policyholder, however, any requirement that it actually pay loss in order to exhaust a SIR often conflicts with the dual goals under bankruptcy law of providing a debtor breathing room and avoiding the favoring of one creditor over another. What if the debtor cannot pay the SIR? Most courts do not permit insurance companies to escape their coverage obligations when a policyholder lacks the financial resources to pay the SIR; however, the insurance company is only liable for amounts exceeding its attachment point, and generally is not required to "drop down" to provide coverage below that attachment point unless such coverage is promised under the insurance policy.

Either the underlying claimants or the insurance company, depending on the jurisdiction, will be granted an unsecured claim for unpaid SIR amounts under the attachment point.

1.4.3. Timeliness of Insurance Notification

All insurance policies and D&O policies in particular will have a notice period for the making of claims. It is important, therefore, for trustees to retain counsel before such notice periods expire, thereby foreclosing recovery under any otherwise eligible policy. Recovery may be available in many instances even for earlier wrongdoing, so long as a claim is made during the existence of the policy. Thus, preserving this right under the policy should be of paramount importance to the bankruptcy trustee.

1.4.4. Preservation of Evidence

Because a bankruptcy filing often occurs in the midst of chaos, it is wise to retain attorneys and accountants who can gather vital documents such as insurance policies, financial records and board minutes before they are misplaced. Attorneys can also move quickly to interview principles of the debtor and to identify and locate background witnesses who can help uncover important information about the business habits of directors and officers and the identities of the debtor's professional advisers. The information collected will form the basis for negotiating with professionals, directors, officers, and D&O carriers, and for bringing suit if necessary. It is often easier to obtain these documents and conduct informational interviews at this stage instead of getting involved in costly and time-consuming discovery after the case proceeds to litigation.

2. Special circumstances: D&O policies

Whether a "Directors and Officers Liability Policy" ("D&O") exists, whether it provides coverage for the alleged conduct at issue, and how exactly to assert viable claims against a D&O carrier in a timely manner are all important questions that the bankruptcy trustee, and counsel, should address as soon as possible after a bankruptcy petition is filed.

2.1. Potential Recovery from D&O Insurance Policies

Bankruptcy trustees have the statutory duty to maximize recovery for the bankrupt estate. One potential source of funds for the bankrupt estate consists of recovery from directors and officers whose breach of their fiduciary duties contributed to the company's insolvency. D&O policies typically provide coverage for each "wrongful act" committed by a director or officer, a term defined in the policy. A general definition of "wrongful act" would include "an error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted, by an Insured Person" in his or her insured capacity. Therefore, if a bankruptcy trustee can reach funds under a D&O policy through negotiation or litigation, those assets may bolster the estate.

2.1.1. Who Owns the D&O Policy?

The question of whether a D&O insurance policy is property of the estate or the insured officers and directors becomes even more heated where the D&O policy expressly provides so-called "entity" insurance coverage to the company itself. Historically, under D&O insurance policies without entity

insurance coverage, D&O insurance companies had been taking the position that anytime the company itself was being sued alongside its officers and directors (almost always the case), the D&O insurance company was entitled to "allocate" the loss. The argument stemmed from the insurance companies' claims that only officers and directors were "insured" under the D&O policy and thus, allegations made against the company itself were not covered. As such, many insurance companies would seek to allocate the loss and reduce insurance coverage — sometimes, by as much as 50 percent or more.

2.2.2. Evolution of Entity Coverage

After a string of losses in court by insurance companies on their allocation arguments, "entity" coverage was developed and sold to expressly grant insurance coverage to the company itself in certain circumstances (typically, in securities cases specifically naming the company as a defendant in addition to the officers and directors).

Some have argued that a D&O insurance policy that promises "entity" coverage transforms the policy into an asset of the bankruptcy estate with the potential effect of leaving the officers and directors "bare" in the event of litigation. The bulk of the cases rendered thus far do not support this conclusion, but it is an issue that continues to be debated. Even insurance companies have seized on this debate as a marketing point for the sale of so-called Side A policies.

2.2. Fiduciary Duties Owed by Directors and Officers

When investigating and analyzing whether D&Os may have engaged in actionable conduct, it helps to consider and understand the various roles and duties of corporate D&Os.

2.2.1. “Inside” and “Outside” Directors

2.2.2. Duty of Care, Loyalty, and Good Faith

2.2.3. Duty owed to creditors

2.3 The Fight for Proceeds

Corporate directors and officers continue to feel the effects of financial turmoil. With increased litigation and regulatory enforcement, the importance of reliable protection for senior management under companies’ D&O insurance has never been greater. Corporate bankruptcies raise the stakes exponentially. D&O insurance is a critical asset in bankruptcy and triggers fights between directors and officers, who seek the proceeds to defend against and settle claims asserted against them and trustees who want to enhance the estate’s value.

Because many D&O policies have a single limit for both defense costs and damages, there is an inherent tension between D&Os’ use of proceeds to pay attorneys’ fees and the company’s desire to retain proceeds to pay its own claims. A recurring dispute in bankruptcy is whether D&O policy proceeds belong to the estate or to individual directors and officers (as opposed to the policies themselves, which are universally considered estate property). If the proceeds are property of the bankruptcy estate, the automatic stay may preclude directors and officers from accessing them. In the context of a bankruptcy, every asset, including insurance benefits, becomes increasingly sought after by trustees, creditors, and

other claimants. These dynamics can lead to fights between certain groups of "insureds" vying for limited amounts under the D&O insurance before the well runs dry.

Most courts hold that D&O claims involving side A coverage — which affords direct coverage to the directors and officers for acts for which the corporate organization is not legally required to indemnify them — are not estate property. Because the proceeds are paid directly to the directors and officers, the debtor does not have a property interest in the proceeds. Nevertheless, if side A defense costs are being paid on behalf of a director or officer, prudence merits seeking a “comfort order” from the bankruptcy court to avoid a claimed violation of the automatic stay.

The “property of the estate” inquiry becomes particularly acute under side B or C coverage. Side B, or “entity,” coverage provides coverage for the company’s indemnification obligations to directors and officers. Some courts have determined that the debtor has no interest in the proceeds since they flow through to the directors and officers. Other courts disagree because payments to corporate managers deplete the amount of proceeds available for other liability claims, thereby increasing the estate’s financial exposure. Side C coverage protects the company from its own wrongful acts (typically limited to securities claims in policies issued to publicly traded companies). Where side C claims exist, most courts give priority to the entity and consider side C proceeds to be estate property. They reason that reimbursement payments to directors and officers under side A/B deplete the proceeds that could be paid to the corporation under side C, and, in turn, deplete the bankruptcy estate and increase the debtor’s financial liability. Thus, directors and officers might have little or no coverage for their losses where side C claims exist.

One way to better preserve defense cost coverage for corporate managers is to obtain a “priority of payments” provision that specifies that the individuals be paid before the company. This would tend to lead a bankruptcy court to uphold the directors and officers’ contractual right to the proceeds. We should point out, however, that several courts recently have restricted director and officer access to proceeds under a priority of payments clause by setting soft caps and instituting reporting requirements on the amount of defense costs. It would also be a good idea to include a provision where the corporation agrees to waive the automatic stay so that proceeds can be used to fund the defense.

2.3.1. Common Coverage Fights

Former directors and officers of a bankrupt company face significant financial risk. Many of their prebankruptcy actions are carefully examined to determine if any actionable wrongful conduct contributed to or caused the insolvency, particularly in this era of heightened corporate scrutiny and accountability.

When a bankruptcy trustee or other third party brings claims against a company’s former directors and officers, insurance companies often argue that such claims made on behalf of the bankruptcy estate trigger the so-called “insured versus insured” exclusion. Most courts note that the exclusion was originally intended to prevent collusive lawsuits brought by one insured against another to reap the benefits of the D&O policy. In bankruptcy, insurance companies seek to apply the exclusion to bar truly adversarial claims against directors and officers by arguing that a bankruptcy trustee, creditors’ committee or assignee of litigation rights stands in the debtor’s shoes for purposes of commencing actions, and are therefore an “insured” so that coverage might be denied the directors and officers

under the exclusion. The majority of courts opining on this coverage defense have upheld the policyholder's claim for insurance coverage, agreeing that there is no identity of interest between a trustee or other third party and the pre-petition debtor, and that the claims are being brought on behalf of creditors, not the debtor. Adding an express carve-out to the insured-versus-insured exclusion that includes claims brought by a debtor-in-possession, a Chapter 11 trustee, creditors or other bankruptcy constituencies is a good way to avoid having to litigate this issue in the first place. Insurance companies should be receptive to incorporating these carve-outs because they do not affect the exclusion's primary purpose of preventing collusive lawsuits.

On the flip side, a fair number of D&O policies contain endorsements with a "bankruptcy" exclusion, which purports to preclude coverage for suits brought by a bankruptcy trustee that "arise out of" a bankruptcy. Unfortunately, there is a split of authority on the enforceability of such exclusions. One line of cases holds that section 541(c) of the Bankruptcy Code invalidates contractual terms that are conditioned on the insolvency of the debtor or on the commencement of a bankruptcy case; hence, the exclusion is unenforceable. Other courts rely on contract interpretation to hold that broadly worded exclusions for actions "arising out of bankruptcy" should be enforced, but have not considered how section 541(c) might alter that analysis. Regardless, policyholders should carefully analyze whether such an exclusion should be included in their D&O policy.

2.3.2. The effect of bankruptcy proceedings on existing D&O insurance coverage

At the outset, one should consider how filing for bankruptcy affects D&O insurance coverage that is already in place at the time of the bankruptcy filings. Bankruptcy courts have generally considered existing D&O insurance coverage for the entity property of the bankruptcy estate, and this includes reimbursement for the indemnification of directors, officers or employees. Bankruptcy courts have not traditionally allowed for D&O coverage to continue as a matter of right (either entity coverage or reimbursement to the entity for indemnification of directors, officers or employees). [*In re Downey Fin. Corp*., 428 B.R. 595, 603 (Bankr. D. Del. 2010)] Instead, any deploying of limits would typically be ruled upon by the bankruptcy judge.

In their rulings, however, bankruptcy courts have been more accommodating of insurance defense payments or reimbursements directly to Insured Individuals, where there is no aspect of insurance coverage or reimbursement directly to the entity. Insured individuals (directors, officers or employees) must specifically petition for the bankruptcy court to lift the stay in order to receive insurance reimbursement payments. *[In re Hoku Corp*., No. 13-40838-JDP, 2014 Bankr. LEXIS 1167 (Bankr. D. Idaho Mar. 25, 2014).]

One formulation of a general rule is that the D&O insurance policy is an asset of the estate, but proceeds for the protection of Insured Individuals may not be. [Martin J. O'Leary, Directors & Officers Liability Insurance Deskbook (4th ed. 2016), 258–264] Some courts have taken it a step further in recognizing the need to preserve separate insurance proceeds to be set aside specifically for the defense of individual directors and officers. [See, e.g., In re Petters Co., 419 B.R. 369 (Bankr. D. Minn. 2009); In re Nat'l Century Fin. Enters., Bankr. No. 02-65236, 2005 (Bankr. S.D. Ohio Jan 10, 2005); Groshong v. Sapp (In re MILA, Inc.), 423 B.R. 537 (B.A.P. 9th Cir. 2010).] Yet another approach by bankruptcy courts is that the

debtor entity has no property interest in the D&O insurance policy until it indemnifies the Insured Individuals. [In re Adelphia Communs. Corp., 336 B.R. 610 (Bankr. S.D.N.Y. 2006)] Ultimately, the debtor entity may be subject to how much creditors will want to support the ongoing operation of the D&O policy, as opposed to having it stayed during the course of the bankruptcy.

2.3.3. D&O insurance coverage during the pendency of bankruptcy proceedings

Regardless of where the suit is brought against Directors and Officers, and where it is ultimately decided, there would remain only one source of insurance proceeds to protect the directors, officers and employees of the entity if they are sued—the D&O insurance policy. Because the bankruptcy court typically considers proceeds under the D&O insurance policy to be part of the bankruptcy estate, claims are not generally paid to indemnify Insured Individuals unless the bankruptcy court consents. Notably, the consent of the bankruptcy court is typically required for the deployment of limits, regardless of where the lawsuit is brought.

The D&O policy serves as an effective lifeline to millions of dollars of defense or loss. In a Chapter 11 proceeding, the debtor in possession might have the availability of cash to indemnify the Insured individuals, after which the entity could petition the bankruptcy court for indemnification by the D&O policy. In the event that the entity would lack the availability of cash to indemnify the individual due to insolvency (under either Chapter 7 or 11), Side A coverage would apply. The policy limits would deploy to cover the first dollar of defense or loss incurred by the individuals. Without a D&O policy in place prior to filing for bankruptcy, the directors, officers and employees are left without a lifeline—they must rely upon their own individual assets to cover the cost of litigation along with any verdicts or settlements.   29 Richard L. Epling, Kerry A. Brennan, and Brandon Johnson. “Intersections of Bankruptcy Law and Insurance Coverage Litigation.” 2012.

2.3.4. Bankruptcy Does Not Relieve Insurance Company of Its Obligations

No matter what type of insurance policy is involved, a general rule of thumb is that bankruptcy proceedings of the policyholder do not negate the obligations of the policyholder's insurance companies to provide insurance coverage for claims. Indeed, many insurance policies expressly provide that bankruptcy proceedings of the policyholder do not relieve the insurance companies of their coverage obligations. For example, one primary D&O insurance policy states that "[b]ankruptcy or insolvency of the Company or the Insured or of their estates shall not relieve the Insurer of any of its obligations hereunder." Similarly, another insurance policy form provides that "[b]ankruptcy or insolvency of an Insured or of the estate of an Insured shall not relieve the Company of its obligations nor deprive the Company of its rights under this policy."

Like D&O insurance policies, certain general liability insurance policies also state that "bankruptcy or insolvency of the insured or of the insured's estate will not relieve [the insurance company] of [its] obligations ...."

Relevant case law has held that insurance companies should not receive a windfall, and be relieved of their insurance coverage obligations, by virtue of their policyholder's filing for bankruptcy protection. Nevertheless, trustees, attorneys, and others responsible for representing the interests of bankrupt businesses need to be mindful of certain key insurance coverage issues. Should they be confronted with an insurance claim or coverage right that has not been honored by the insurance company, competent representation of the debtor requires that the following issues be considered and pursued where appropriate.

2.3.5. "Priority of Payment" Clauses

What should policyholders be doing under these circumstances? Unfortunately for many policyholders, there is no single path to follow in these situations. There are, however, critical points to look out for. One is whether a "priority of payments" clause is contained in the primary or excess D&O insurance policies. These clauses have increasingly permeated D&O policies over the last few years. Priority of payment clauses typically provide a strict formula for divvying up policy proceeds, affording a coverage preference to nonindemnifiable claims first, followed by claims indemnified by the corporation, and then furnishing entity coverage last.

2.3.6. Timing of Payments

"Priority of payment" clauses, however, are not panaceas. Rather, they have their own set of ambiguities. Perhaps, the most important is that most such clauses purport to have no application until a "Loss" will exceed the remaining limits of the policy. As such, timing of loss payments claimed under the policy becomes a very important (and often disputed) issue. To determine whether the clause is triggered, can one extrapolate from a monthly or quarterly burn rate to figure out when something such as defense costs will exhaust the policy? If so, can the priority of payments provision be triggered at that moment and require the application of the formula months before the policy limit is actually exhausted? Depending upon the competing interests in the policy, one side will argue "yes" and the other "no." Very little guidance as to which side is correct is provided under the express terms of most of these clauses.

2.3.7. Discretionary vs. Automatic

Also, a question may arise as to whether the clause is discretionary in its application or automatic. Both forms of the clause exist. If it is discretionary, which insured has the discretion to invoke it? Typically, the corporation as "Named Insured" will have that right, but it may be charged that this entails a conflict of interest, as current management might want to invoke the clause even if it would be in the entity's coverage interest not to. Current management may want to preserve coverage for future claims (that may not even arise), whereas the entity may be better off recovering money it has paid in connection with indemnifying its officers and defending itself pursuant to Side B and Side C coverages.

2.4. Obstacles to Recovery: defenses and exclusions

2.4.1. Trustee, FDIC, and Creditors Suits vs. Former Management: Insured vs. Insured Exclusion

When a trustee in bankruptcy brings suit against current or former officers of the bankrupt company, a coverage battle with the D&O insurance company may ensue. Some D&O insurance companies argue that claims made by a trustee on behalf of the estate implicate and otherwise trigger the so-called

"insured vs. insured" exclusion, which seeks to bar insurance coverage for claims made by one "insured" against another.

Similarly, some insurance companies have argued that coverage for suits brought by the Federal Deposit Insurance Corporation (FDIC), Resolution Trust Corporation (RTC), Federal Savings and Loan Insurance Corporation (FSLIC), and state insurance commissioners were barred by the insured vs. insured exclusion. Most commentators and courts agree that the insured vs. insured clause is designed to prevent collusive lawsuits brought by one insured against another with the purpose of tapping D&O insurance proceeds to bolster the company's bottom line. *See American Casualty Co. v. Sentry Fed. Sav. Bank*, 867 F. Supp. 50 (D. Mass. 1994).

2.4.2. Insurers Seek Broad Application of the insured vs. insured Exclusion

Despite the historic rationale for the insured vs. insured exclusion, too many D&O insurance companies have sought a far broader application of the exclusion than its original intended purpose would suggest. The broad application sought by insurance companies carries over into the bankruptcy context. Many insurance companies over the last decade or more have sought a forfeiture of insurance coverage for any lawsuit brought by a bankruptcy trustee or creditors committee. *Cirka v. National Union Fire Ins. Co*., 2004 WL 1813283 (Del. Chan. Aug. 16, 2004) (holding that "insured vs. insured" exclusion did not apply to claim of committee of unsecured creditors).

While cases have split on whether a trustee's claims against officers or directors of the company invoke the insured vs. insured exclusion, many of the decisions rendered on this issue favor policyholders' claims for insurance coverage. As long as the suit by the trustee is not collusive in nature, the exclusion should not effect a forfeiture of insurance coverage for the insured officers and directors. In fact, some of the more recent forms of D&O insurance have even sought to clarify this point and specifically except from the exclusion trustee claims. Specifically, some forms of D&O insurance carve out claims by trustees or creditors committees from the insured vs. insured exclusion.

Biltmore Assoc., LLC v. Twin City Fire Ins. Co.

One case from California, however, went against the creditors' trust. In Biltmore Assoc., LLC v. Twin City Fire Ins. Co., No. 06-16417, 2009 U.S. LEXIS 15322 9th Cir. (July 11, 2009), the U.S. Court of Appeals for the Ninth Circuit affirmed a trial court ruling in favor of the insurance company. In Biltmore, the trustee for the creditors' trust (Biltmore) received an assignment of D&O insurance policy rights from the debtor in possession, Visitalk. Biltmore argued the claim against the former directors and officers for, among other things, looting, was on behalf of the creditors and brought by the creditors' trustee — not on behalf of an insured. The Ninth Circuit found to the contrary and held the insured vs. insured exclusion barred coverage because a contrary ruling would create a moral or collusion hazard where the debtor in possession would assign its D&O insurance claim in exchange for a covenant by the creditors not to execute against the former managers of the bankrupt company.

The court held that a debtor in possession is the same as the policyholder that existed before filing for bankruptcy. The court then concluded that the trustee of the creditors' trust had assigned rights of coverage from the debtor in possession that were subject to the insured vs. insured clause. While this decision is certainly bad for creditors and potentially others who might otherwise have a right to D&O insurance benefits, it is likely a reflection of the specific circumstances of the case, where the suit

against the former managers was brought by the debtor in possession before assignment of the claims to the creditors' trust. The Ninth Circuit, in rendering its opinion, was obviously concerned about the potential for collusive litigation where the debtor was still in charge of the corporation while in bankruptcy. A different result likely would have obtained had there been a bankruptcy trustee or a different arrangement with different timing between the debtor and the creditors.

See Gray v. Exec. Risk Indemnity, 271 B.R. 711 (D. Mass. 2002) (holding that insured versus insured exclusion did not apply to claim by bankruptcy trustee as there was no evidence of collusion); QBE International Ins. Ltd. v. Clark, 2003 U.S. Dist. LEXIS 19106 (N.D.Ill. Oct. 23, 2003) (holding exclusion inapplicable).

2.4.3. Business Judgment Rule

2.4.4. State statutes that limit personal liability

2.4.5. In Pari Delcto Defense

2.4.6. A-B-C coverage

2.4.7. “Wrongful Act”, “Loss” and “Insured”

2.4.8. Fraud or Intentional Conduct Exclusion

3. Bad Faith

In common parlance, the phrase insurance “bad faith” is bandied about when an insurance company refuses to do something someone wants it to do or does something someone does not want it to do. The law, of course, is much more precise, and a bankruptcy trustee must carefully examine an insurer’s behavior and the impact on the debtor to determine whether an insurer’s behavior creates an asset for a bankruptcy estate. Because there are many types of insurance policies and many jurisdictions governing claims that might be an estate asset, there are many types of insurance “bad faith.”

The types of insurance bad faith vary among jurisdictions. A single jurisdiction may have several types of “bad faith” distinguishing between first-party and third-party claims. Others jurisdictions address several types of “bad faith” in one statute.

3.1. What is Bad Faith

3.1.1. Denial of coverage

3.1.2. Treatment

3.1.3. Pay the Insured

3.1.4. Pay the Claimant

3.1.5 Defend a lawsuit

3.2. Did an Insurance Coverage Denial Cause the Company to Go Bankrupt?

Threshold questions the trustee should always consider includes: How did the insolvent entity get to this point? If it turns out that an insurance company's misconduct in handling an insurance claim caused the policyholder to become insolvent or file for bankruptcy, then the insurance company may be liable for consequential and exemplary damages.

For many businesses, a denial of insurance coverage for a large claim can be ruinous. Insurance companies that fail to honor their insurance coverage obligations in a fair and prompt manner can lead to some policyholders becoming insolvent, given their reliance on insurance proceeds to deal with a serious liability, catastrophe, or loss of business income claim.

This is true whether the policyholder is a corporation or an individual. Some insurance companies have referred to this situation as "death of company." The potential insurance-related causes of a death of company are numerous, from the refusal of primary or excess insurance companies to settle a third-party claim within policy limits to refusing coverage in full or in part for a catastrophic property loss.

3.2.1. *West Am. Ins. Co. v. Freeman*

In *West Am. Ins. Co. v. Freeman*, 37 Cal. App.4th 1469 (Cal. App. 1st Dist. 1995), rev. granted, 907 P.2d 1323(1995), the First District California Court of Appeal affirmed an award of actual damages and a $12 million award of punitive damages. In West Am., the insurance company sold a comprehensive general liability (CGL) policy to its policyholder, a contractor. When the contractor was sued and filed a claim with his insurance company, the insurance company allegedly began looking for ways in which to dispose of the claim inexpensively, thereby compromising the contractor's interests and reputation. See *Egan v. Mut. of Omaha Ins. Co*., 24 Cal.3d 809 (1979). "For the insurer to fulfill its obligation not to impair the right of the insured to receive the benefits of the agreement, it again must give at least as much consideration to the latter's interests as it does to its own."

After engineering a quick and cheap settlement, the insurance company then went after its own policyholder, suing him in an effort to recoup the cost of the settlement it had made plus the attorney fees incurred in the case. This caused the policyholder to lose his business and his assets and made him liable for over $320,000 in legal fees — on top of the $60,000 plus that the policyholder had paid in premiums to the insurance company for the policy.

[*In Re: Cooper Mfg. Corp. v. Home Indem. Co*., No. 94-C-901-BU (N.D. Okla.), the liquidating trustee in bankruptcy for the policyholder brought an action against the policyholder's insurance companies for bad faith conduct and improper denials of insurance coverage that constituted the sole basis for the policyholder's need to seek bankruptcy protection. The insurance companies referred to this allegation as "death of company."]

The policyholder countersued, charging the insurance company with, among other things, bad faith. The policyholder offered evidence of bad faith conduct, including evidence that the insurance company lied about the destruction of the claims file.

In affirming the $12 million punitive damage award against the insurance company, the court held that "the award was based on the reprehensibility of [the insurance company's] conduct toward [the policyholder] and its failure to accord [the policyholder] the consideration to which he was entitled."

The Court of Appeal accorded great weight to the trial court's finding that "the conduct of the insurance company in this case was egregious."

3.2.2. *Bi-Economy Market, Inc. v. Harleysville Insurance Company of New York, et al.*

In *Bi-Economy Market*, 10 N.Y.3d 187 (2008).the New York Court of Appeals rendered a landmark ruling where it held that an insurance company that wrongly denies coverage and causes the demise of its policyholder's business is responsible for consequential damages. In the case, the policyholder had suffered a fire at its facility. Rather than provide coverage in full, the insurance company disputed its obligations and paid only a fraction of the policyholder's property damage claim and a bit more than half of the policyholder's business income claim. The policyholder charged that the refusal by the insurance company to promptly honor its insurance coverage obligations caused the business to collapse.

The high court of New York held that the "purpose served by business interruption coverage cannot be clearer — to ensure that [the policyholder] had the financial support necessary to sustain its business operation in the event disaster occurred." The court held that the policyholder's "claim for consequential damages including the demise of its business, were reasonably foreseeable and contemplated by the parties[.]" The court also found that the insurance policy required the insurance company to "evaluate a claim, and to do so honestly, adequately, and — most importantly — promptly."

The bottom line for trustee policyholders under such circumstances is that it is critically important to evaluate and pursue bad faith and consequential damages claims against insurance companies that refuse to provide coverage for covered claims.

Practice Pointers for the Trustee – Insurance Assets

Whenever a debtor in bankruptcy is a defendant in a lawsuit sounding in some form of tort and/or if an existing judgment has been entered against the debtor, a trustee should promptly investigate the following:

Bad Faith Assets

1. Whether the debtor has liability insurance that might cover the claims alleged in the lawsuit. This might be obvious by the fact that the lawsuit against the debtor is being or was defended by an insurer. If the debtor is not being or was not defended, further investigation is required to determine if the debtor is or was owed a defense by virtue of being a named insured or an additional insured by virtue of an indemnification agreement, borrowing vehicles or tools used in the commission of the alleged tort, etc.

2. If insurance is or should be involved in a case before judgment is entered in that case, the trustee should evaluate the debtor's exposure to legal liability (usually by examining liability and damages) as compared to the available policy limits. If the potential exposure might exceed policy limits, the trustee should investigate whether there were opportunities for the insurer to settle the claim within policy limits.

3. If there is an existing judgment against the debtor at the time of the petition, a similar evaluation as described above should take place. The evaluation might cover different and discrete time periods, as the liability and damages evaluation changes over the course of a claim and resulting lawsuit. Also, the opportunity to settle could have taken place pre-suit, at a mid-suit mediation or even while the jury is deliberating after trial.

4. When a trustee sees the potential for a "bad-faith" asset, it behooves the trustee to open lines of communication with the attorney for the judgment creditor. As the attorney who prosecuted the underlying case that generated the excess judgment, that attorney is often the best source of information for facts necessary to evaluate the bad-faith asset. As the party who provided the debtor's insurer opportunities to settle within policy limits, the judgment creditor's attorney is often an important witness in the bad-faith case.

Claims Exceed Policy Limits - Assets

1. Are there multiple lawsuits and claims? Does the debtor have liability insurance that might cover the claims alleged in the lawsuit or at least provide a defense.

2. Is the coverage sufficient to cover all the lawsuits and claims assuming they all prevail? Reach out to the insurance agent/broker to determine the pending claims and coverage limits.

3.

D&O Policy Assets

Whenever the trustee suspects that the D&Os of the debtor may have breached their fiduciary duties and caused the insolvency of the debtor corporation, he or she must move swiftly to secure entitlement to any funds under applicable D&O policies. Employing attorneys and accountants early in the process

will ensure that these valuable assets are not overlooked, particularly where it appears that there are few funds to be located elsewhere:

1. Preservation of evidence. gather vital documents such as financial records and board minutes before they are misplaced. Attorneys can also move quickly to interview principles of the debtor and to identify and locate background witnesses who can help uncover important information about the business habits of directors and officers

2. Timeliness of Insurance Claim Notification: all D&O policies will have a notice period for the making of claims. It is important, therefore, for bankruptcy trustees to retain counsel before such notice periods expire, thereby foreclosing recovery under any otherwise eligible policy. Recovery may be available in many instances even for earlier wrongdoing, so long as a claim is made during the existence of the policy. Thus, preserving this right under the policy should be of paramount importance to the bankruptcy trustee.

3. Action items:

a. Interview the CPA and/or tax preparer for the bankrupt entity and obtain all work papers—they will often identify or have a copy of any D&O policy;

b. Review records of the debtor company to identify its insurance agent; he or she should have a copy of any D&O policy;

c. Review expense records for evidence of insurance premiums paid;

d. Ask the debtor’s counsel about the existence of D&O coverage and request the production of any D&O policy;

e. Send written notices to the debtor’s attorneys before any creditors meeting and request all documents to be produced to the trustee, including, of course, any D&O policy;

f. Determine the expiration date of any D&O policy and consider filing a notice of claim before policy lapses (if, of course, it is claims-made policy);

g. Claims can often be filed 30 to 60 days after the policy expiration date;

h. Consider purchasing extended reporting coverage (often 100% of original premium), thereby giving the trustee additional time (often 12 months or longer) to file a D&O claim timely;

i. Extended coverage can often can be purchased within a short period of time after expiration (i.e., 30 days); the policy will state the specific, applicable time limits;

j. Consider using Rule 2004 examinations of material witnesses to better investigate and determine whether filing suit against certain D&Os is worthwhile;

k. Hire experienced, competent special litigation counsel who should be able to advise and help you decide whether:

(i) you have a viable claim that is covered under the D&O policy;

(ii) how best to plead the material facts in either a notice letter and/or pleading to avoid the "insured vs. insured" and other policy exclusions and anticipated defenses;

(iii) which D&Os should be pursued and which should not be named, given the eroding nature of most D&O policies and other practical considerations.