

Corporate Restructuring & Bankruptcy

WWW.NYLJ.COM

VOLUME 262—NO. 59

MONDAY, SEPTEMBER 23, 2019

D&O Policy ‘Bankruptcy Exclusion’ Held To Be an **Unenforceable** ‘Ipso Facto’ Clause

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Among the more mundane aspects of Chapter 11 bankruptcy analysis—whether pre-petition planning by a prospective debtor or post-petition evaluation by creditors—is the review of contracts which may be deemed “executory” under 11 U.S.C. §365. This is because a debtor, pursuant to that statute’s subsection (a), and subject to certain restrictions not relevant here, may “assume” valuable contracts or “reject” those which are financially disadvantageous.

As a predicate to such assumption, a debtor must either “cure” or provide “adequate assurance” that it will “promptly cure” any defaults in existence at the time that assumption is proposed. 11 U.S.C. §365(b)(1)(A). If a contract

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provides that simply being in bankruptcy is a default, although such cure would seem to be impossible to accomplish, the Bankruptcy Code solves for this problem by providing that the cure obligation “does not apply to a default that is a breach of a provision relating to (A) the insolvency or financial condition of the debtor ... [or] (B) the commencement of a [bankruptcy] case ...” 11 U.S.C. §365(b) (2). These disfavored provisions

generally are referred to (although not in the statute) as “ipso facto clauses.”

Recently, in the U.S. District Court for the Eastern District of Michigan, these principles were determined to prevent an insurance company from enforcing an insurance policy exclusion purporting to prevent coverage for claims asserted by a reorganization trust against a debtor’s former officers and directors. In reaching this conclusion, the court

made two significant and necessary findings: First, the court determined that the insurance policy was an executory contract susceptible to assumption during the bankruptcy case; second, the relevant exclusion was classified as an unenforceable “ipso facto clause.”

This new decision is significant because lawsuits against former (and current) officers and directors of debtors commonly are brought by trustees, creditors’ committees so-empowered by bankruptcy court orders, or, as here, by trusts established under plans of reorganization. Because insurance policies often are the only viable source of recovery for the claims asserted in such lawsuits, this decision potentially opens a pathway to creditor recovery in other similar matters.

The Decision

In *CMH Liquidating Trust v. National Union Fire Insurance Company of Pittsburgh*, Case No. 2:16 cv-14434 (E.D. Mich. July 23, 2019) (*CMH*), a debtor hospital prior to commencing its bankruptcy case owned a directors and officers insurance policy sold to it by National Union. The insurance policy contained an exclusion from coverage stating that the insurance company would not pay any claim:

(1) alleging, arising out of, based upon, attributable to, or in any way involving, directly or indirectly: (i) any Wrongful Act which is alleged

to have led to or caused directly or indirectly, wholly or in part, the bankruptcy or insolvency of the Organization, or to the Organization filing a petition, or a petition being filed against the Organization, pursuant to the federal Bankruptcy Code or any similar state law, or the Organization assigning its assets for the benefits of its creditors; or (ii) the Organization having sustained a financial loss due, directly or indirectly, wholly or in part, to a Wrongful Act of the Insured(s), but only if such Claim is made after the Organization has been determined to be insolvent or has filed a petition for bankruptcy, or a petition has been filed against it, or the Organization has assigned its assets for the benefit of its creditors; or

(2) brought by or on behalf of any creditor or debt-holder of the Organization, or arising out of any liability (whether alleged or actual) to pay or collect accounts, including but not limited to Claims alleging misrepresentation in connection with the extension of credit or purchase of a debt instrument, or Claims alleging any deterioration in the value of the debt as a result of (wholly or in part) the bankruptcy or insolvency of the Organization.

The D&O insurance policy in question contained the three usual coverages: “Side A” (referred to as “Type A” in the *CMH* opinion) covering directors and officers in the event of a failure of their company to indemnify them; “Side B” to the company on account of its indemnification obligation; and “Side C” providing coverage to the entity for its own direct exposure to claimants for wrongful acts

allegedly done by its directors and officers.

The Insurance Policy Is Held To Be an Executory Contract

As a predicate to determining the applicability of the prohibition against enforcement of ipso facto clauses, the District Court needed first to conclude whether the insurance policy in fact was an executory contract. Here, the debtor had purchased a so-called “tail” policy that purported to tack on to a pre-petition policy an extended period of insurance coverage. National Union contended that this “tail” policy was distinct, separate, and apart from the pre-petition policy and, having been entered into post-petition, was not susceptible to the provisions and limitations of Bankruptcy Code §365. The plaintiff reorganization trust, conversely, argued that because the “tail” merely added time to the scope of the policy’s coverage, but in all other material respects was identical to the debtor’s pre-petition policy, it was coextensive with that pre-petition policy. That is, it could be assumed and the ipso facto clause prohibition applied.

The Bankruptcy Court below, and the District Court considering the lower court’s “report and recommendation,” agreed with the plaintiff trust that the tail policy was part-and-parcel of the pre-peti-

tion insurance contract. Further, both courts concluded that the policy was executory. Both courts reached this latter conclusion having applied a traditional analysis and finding that “the obligation of both the bankruptcy and the other party to [the] contract [were] so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other” (quoting Executory Contracts in Bankruptcy, Part 1, Minn. L. Rev. 439, 460 (1973) (brackets added)).

In helping the courts reach the conclusion that the insurance policy was a pre-petition contract susceptible to executory status, the plaintiff trust successfully argued that “the proper focus is not when the tail coverage came into existence, but whether the contractual relationship was continuous and essentially unchanged from the pre-petition period through the post-petition period, such that the same contractual relationship and the same contract can and should be deemed to have been extant pre-petition.” *CMH* at 6.

The Exclusion Is Held To Be an ‘Ipso Facto Clause’

Having established the insurance policy’s status as an executory contract, the District Court turned to the question of whether the exclusion the insurance

company sought to enforce was a void “ipso facto clause.” Interestingly, the opinion says little on this point, other than noting that “[t]he Bankruptcy Court agreed with the Trust’s argument that ‘since National Union attempt[ed] to modify the existing contractual rights of a debtor, the ipso facto provisions of the Bankruptcy Code, especially Section 365, prohibit National Union from doing so.’” *CMH* at 6 (brackets added).

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National Union unsuccessfully attempted to rely upon opinions from other courts in which, unlike here, renewed policies had been held to be “distinctly different” (*In re New England Marine Services*, 174 B.R. 391 (Bankr. E.D.N.Y. 1994)), or a new post-petition policy with a new insurance company was determined to not be an executory contract (*In re Bolin Oil Co.*, 51 B.R. 936 (Bankr. N.D. Ohio 1985)), or where “there was no pre-bankruptcy relationship between the parties” (*In re Bogey’s Barn, Ltd.*, 47 B.R. 555 (Bankr. S.D. Fla. 1985)). The District Court found these decisions,

and others, to be inapposite and determined the disputed exclusion to be void. *CMH*, at 8.

Conclusion

The significance of the *CMH* decision is best understood by consideration of the distinction drawn by the District Court to the authorities proffered by National Union. In essence, because the post-petition “tail” D&O policy was styled by National Union as a continuation of the prior pre-petition coverage, the fact that it was a new document was irrelevant. As the District Court noted, “[t]he Bankruptcy Court rightly focused on whether the policies in effect pre- and post-petition were *essentially the same*” *CMH* at 7 (emphasis added) (citing *In re Garnas*, 38 B.R. 221 (Bankr. D.N.D. 1984)).

“Essentially the same” is a phrase that every bankruptcy lawyer should well consider when confronted by a debtor’s post-petition insurance policy renewal or tail policy purchase. If the policy is found to so qualify, it may well provide a basis for post-petition or post-confirmation creditor recovery on account of claims covered by the original pre-petition directors and officers insurance policy.