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Policyholder Alert

Storm Clouds on the Horizon — Bankruptcy and Insurance Issues Related to Bank Failures


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Key points:

While banks cannot file for bankruptcy under Chapter 7, some banks can file under Chapter 11.

In a bank insolvency, directors and officers may have to struggle to tap D&O insurance funds for their own defense.

While a "priority of payments" clause may protect directors and officers, they may have to contend with a trustee seeking to limit payment under the automatic stay in bankruptcy.

Not since the 2008 financial crisis have insurance policyholders and other professionals needed to consider the issues of insurance and bankruptcy in bank failures. In each new banking crisis, these dormant issues of bankruptcy and insurance awaken. The quiescent period between crises is used to resolve the issues, and they then trail off forgotten until a new crisis focuses the mind yet again. We may now stand at the precipice of such a crisis. On March 15, swiftly following two major bank failures in the U.S., Swiss regulators provided 50 billion francs in emergency loans to "systemically important" Credit Swiss.

Does the U.S. Bankruptcy Code Apply to Bank Failures?

Anyone following the banking travails over the past week will ask "when is the bankruptcy?" That, however, presupposes that banking institutions are susceptible to the United States Bankruptcy Code. In fact, they generally are not. Bankruptcy Code's section 109, helpfully entitled "Who may be a debtor", tells us (under subsection (b)(2)) that "[a] person may be a debtor under Chapter 7 of this title only if such person is not — … a … bank, savings bank, cooperative bank, savings and loan association, building and loan association…" and other similar organizations. And, to clarify, "person" is defined in the Code as including an "individual, partnership and corporation…".

Nevertheless, those hoping for a federal bankruptcy proceeding should take heart, for later, in Section 109(d), qualifications for being a debtor under Chapter 11 are laid out. There the Code clearly states that "Only a railroad, a person that may be a debtor under chapter 7 of this title (except a stockbroker or a commodity broker), and an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act,

which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991 may be a debtor under chapter 11 of this title."

Some banks do appear to qualify to be a chapter 11 debtor.

Does a Bankruptcy Proceeding Impact My Insurance Which Protects Against Liabilities Related to Bank Failures?

Whether the operating bank or a corporate parent (or sibling corporate entity) ends up in a formal bankruptcy proceeding, if the past is prologue, a battle over the proceeds of D&O liability insurance policies will take place. While corporations usually pay the premiums for the insurance policies, individual officers and directors are 'insureds' under such policies with direct rights as insureds. Consistent with that dichotomy, bankruptcy courts have differentiated between "ownership" of the D&O liability insurance policy itself versus the right to the "proceeds" of such policy. With limited exceptions, property of a debtor's bankruptcy estate, "wherever located and by whomever held" will include "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. §541(a)(1).

In the case of D&O policies, the multi-party nature of D&O policies circumscribes those debtor "interests." One leading court stated that "the liability proceeds payable to the directors and officers are not part of the bankruptcy estate." In re Louisiana World Exposition, Inc., 832 F. 2d 1391, 1460 (5th Cir. 1987). And, although most contemporary D&O policies contain so-called "Side C" or "entity" coverage for the benefit of the corporate policyholder, many recent policies also include a "priority of payments" clause which describes how covered directors and officers may recover their defense costs and indemnity claims ahead of the company. Absent clear policy language, however, some courts have held that the policy proceeds — at least to the extent of the debtor company's interests – will come into the estate. *In re Pasguinelli Homebuilding, LLC*, 463 B.R. 468, 473 (Bankr. N.D. Ill 2012); *Davis v. Connolly*, 2011 WL 1378875, *1 (N.D. Ill. Apr. 12, 2011).

Further, some trustees in bankruptcy have sought to limit payment of proceeds under the automatic stay in bankruptcy. 11 U.S.C. §362. Policyholders under D&O liability insurance policy can seek a 'comfort order' to permit the payment of defense costs for individual D&Os despite the assertion by a trustee of the automatic stay. The comfort order would authorize the D&O insurance company to advance defense costs subject to certain conditions, thus preserving one of the primary promises in the D&O policy — the advancement of defense costs on a current basis to defend claims related to a bank failure.

Storm clouds may be on the horizon, but experience in past episodes of bank failures – the savings and loan crisis of the 1990s during which almost one-third of savings and loans failed; the dot-com crisis of the early 2000s; and the financial crisis of 2008 during which over 460 FDIC-insured banks failed – inform us of what the future may bring. A company or individual with rights to insurance may have to navigate regulatory, bankruptcy and insurance issues to obtain

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the insurance coverage to which they are entitled. An educated policyholder can weather that storm and need not take 'No' for an answer.

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