CPCU SOCIETY
INSURING YOUR SUCCESS

Risk Management Interest Group

Volume 26 • Number 2 • August 2009

Competing Insurance Interests in Bankruptcy

by Joshua Gold, J.D.

Joshua Gold, J.D., is a shareholder in the New York office of the law firm of Anderson Kill & Olick PC. He regularly represents policyholders in insurance coverage matters and disputes concerning time element insurance, electronic data and other property insurance coverage issues. Gold can be reached at (212) 278-1886 or jgold@andersonkill.com.

Editor's note: This article originally appeared in the May/June 2009 issue of *Policyholder Advisor,* a bimonthly publication of Anderson Kill & Olick PC. It is reprinted with permission.

As bankruptcy filings rise in this prolonged economic downturn, insurance claims are becoming a focal point for the administration of debtor assets and liabilities. Many insurance claims that arise in bankruptcy — particularly D&O claims — give rise to conflicts issues between competing insureds.

A recurring question in bankruptcy proceedings is whether the benefits of a D&O policy are assets of the estate or personal assets of the insured officers and directors. Creditors of a bankruptcy estate have an obvious interest in keeping available as many assets as possible to satisfy claims. In the Enron case, a state attorney general tried to bar Enron officers and directors from tapping the defense cost insurance coverage of Enron's D&O insurance, arguing that to permit payment of defense costs would siphon off money from the estate that could be used to pay creditors' claims.

The question of whether a D&O insurance policy is property of the estate or the insured officers and directors becomes even more heated when the D&O policy expressly provides so-called "entity" insurance coverage to the company itself, as most now do. Some have argued that a D&O insurance policy, which 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. While the bulk of the cases rendered thus far do not necessarily support this conclusion, the issue is still debated. Even insurance companies have seized on this debate as a marketing point for the sale of nonentity D&O coverage and so-called Side A policies.

In a bankruptcy, insurance benefits, like all other assets, become increasingly sought-after by trustees, creditors and other claimants. Different groups of "insured" often vie for limited amounts under the D&O insurance before the well runs dry.

Policyholders in these situations should be aware of certain critical points of potential conflict. One is whether a priority of payments clause is contained in the primary or excess D&O insurance policies. These 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.

The question of whether a D&O insurance policy is property of the estate or the insured officers and directors becomes even more heated when the D&O policy expressly provides so-called "entity" insurance coverage to the company itself, as most now do.

Priority of payment clauses can generate their own ambiguities, however. In particular, most such clauses purport to have no application until a "loss" exceeds the remaining limits of the policy. Accordingly, the timing of loss payments claimed under the policy often comes under dispute. To figure out whether the clause is triggered, can one extrapolate from a monthly or quarterly

Continued on page 2

Competing Insurance Interests in Bankruptcy

Continued from page 1

burn rate to determine 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 the clauses I have reviewed.

In a bankruptcy, insurance benefits, like all other assets, become increasingly sought-after by trustees, creditors and other claimants. Different groups of "insured" often vie for limited amounts under the D&O insurance before the well runs dry.

Also, a question may arise as to whether application of the clause is discretionary or automatic. Both forms exist. If 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 there is a conflict of interest even in that scenario, as current management might want to invoke it even if it would be in the entity's coverage interest not to.

Where 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.

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. Despite this historic rationale, too many D&O insurance companies have sought far broader applications — including a forfeiture of coverage for any lawsuit brought by a bankruptcy trustee.

While cases have split on whether a trustee's claims against officers or directors of the company invoke the insured vs. insured exclusion, the majority of decisions rendered on this favor policyholders. As long as the trustees' suit is not collusive in nature, the exclusion should not apply to the insured officers and directors. Some recent D&O forms have sought to clarify this point and specifically except from the exclusion trustee claims.

Despite this, attorneys representing debtors should be aware of the background and purpose for the insured vs. insured exclusion to combat improper insurance company attempts to apply the exclusion beyond its intended scope.

More broadly, all parties to a bankruptcy with some claim on insurance assets must be aware of the ambiguities, the potential conflicts and the direction from which competing claims are likely to arise. ■