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Insurance Coverage and Bankruptcy at the Crossroads: *What You Should Know*

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The domains of bankruptcy and insurance law each present their own hazards. When their paths intersect —and they frequently do — competing interests collide and the way forward can get bumpy. Here, we offer a brief navigational guide through the intersection of bankruptcy and insurance coverage law.

Maintenance of Insurance

Maintaining insurance during bankruptcy is not optional. The bankruptcy code provides that failure to maintain adequate insurance may be "cause" to dismiss 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.

Debtors must obtain court approval to pay their insurance obligations. While the bankruptcy code does not expressly permit such payments, courts routinely grant payment applications under their broad equitable powers because it is consonant with Chapter 11's value-preservation policy. 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.

Self-Insured Retentions

As a general matter, self-insured retentions, or SIRs, typically represent the policyholder's "skin in the game." For an insolvent policy-

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holder, 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.

The Fight for Proceeds

Corporate directors and officers continue to feel the ripples of the great financial tsunami of 2008. 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 debtors (or trustees) and creditors' committees, 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.

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.

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.

Be Vigilant!

Policyholders must be particularly watchful when they attempt to navigate the intersection of bankruptcy and insurance, where many factions vie for critical insurance assets and insurance companies are looking to exploit the resulting chaos. Failure to be vigilant could leave you standing at the side of the road with no coverage when it is most needed.

About Anderson Kill

Anderson Kill practices law in the areas of Insurance Recovery, Commercial Litigation, Environmental Law, Estate, Trusts and Tax Services, Corporate and Securities, Antitrust, Bankruptcy, Real Estate and Construction, Public Law, Government Affairs, Anti-Counterfeiting, Employment and Labor Law, Captives, Intellectual Property, Corporate Tax and Health Reform. Recognized nationwide by Chambers USA for Client Service and Commercial Awareness, and best-known for its work in insurance recovery, the firm represents policyholders only in insurance coverage disputes — with no ties to insurance companies and has no conflicts of interest. Clients include Fortune 1000 companies, small- and medium-sized businesses, governmental entities, and nonprofits as well as personal estates. Based in New York City, the firm also has offices in Ventura, CA, Dallas, TX, Stamford, CT, Washington, DC, Newark, NJ, and Philadelphia, PA.