

By Wayne E. Borgeest  
and Robert A. Benjamin

**A** review, from both underwriting and claims perspectives, of the general issues faced by insurers when an insured files for bankruptcy.

# The Intersection of Bankruptcy and Insurance

This article is intended to provide a basic foundation of bankruptcy terminology and identify issues that arise at the intersection of bankruptcy and insurance law, with a focus on directors' and officers' liability insurance.

Topics of consideration include policy issuance, policy cancellation, premium payments, issuing coverage correspondence, applicability of policy retentions, litigation stays, defense cost payments, coverage disputes and settling claims. We will examine these topics from both underwriting and claims perspectives. Each issue mentioned in this article has the potential to raise a myriad of other sub-issues and disputes, each too fact-dependent and complex to address generally here.

## Bankruptcy Basics

There are a few overriding things to keep in mind. The Bankruptcy Code is intended to allow a company to call a "time out" to address the demands made by its creditors in an orderly manner. To accomplish that goal, the Bankruptcy Code generally freezes the ability of creditors to make demands and the ability of a company to transfer things of value. 11 U.S.C. §362.

Once all of the creditors' demands have been documented, and all of the debtors' assets have been accounted for, a plan is put in place to distribute those assets to the creditors. In a Chapter 11 reorganization, the goal is to allow a company to emerge post-bankruptcy with a fresh start and to meet the ongoing demands of its creditors. In a Chapter 7 liquidation, the goal is to gather as many assets as possible and distribute those assets to the creditors while closing down all future company activity.

## Chapter 7

Chapter 7 is a liquidation of a debtor's non-exempt assets for distribution to creditors. Chapter 7 bankruptcy is available to both individuals and businesses. Businesses will have few, if any, exempt assets. It is often the case that businesses in Chapter 7 bankruptcy will engage in an asset sale under 11 U.S.C. §363 through which key assets are sold to raise money to satisfy creditor



■ Wayne E. Borgeest is a founding partner of Kaufman, Borgeest & Ryan LLP in New York City, where he practices directors' & officers' liability, employment practices liability, ERISA liability and insurance law matters. Mr. Borgeest is a member of DRI, the ABA and the Professional Liability Underwriting Society. Robert A. Benjamin is a senior associate with Kaufman, Borgeest & Ryan LLP, where his practice focuses on D&O liability and coverage litigation. Mr. Benjamin is a member of the American Bankruptcy Institute and the Professional Liability Underwriting Society.

claims. In Chapter 7 bankruptcy, a trustee is appointed to oversee the debtor's assets during the distribution to creditors.

## Chapter 11

Chapter 11 bankruptcy is the corporate restructuring facility. A company enters Chapter 11 bankruptcy either voluntarily or involuntarily and renegotiates its debts with its creditors. The goal of Chapter 11 is to confirm a plan under which a corporate debtor will pay its debts and emerge from bankruptcy as a functioning entity. Often, the plan will stipulate that some creditors will receive only a portion of what they are owed, and some unsecured creditors may receive nothing.

In Chapter 11 bankruptcy, a trustee is not appointed unless a court orders it. Generally, a debtor continues to operate its business as a "debtor-in-possession," known as a DIP, during the pendency of a Chapter 11 case. Often, a Chapter 11 debtor will receive a loan to finance its operations during this period. That loan is given a super-priority for repayment and is known as DIP financing.

There are times when a company will file for Chapter 11 bankruptcy, but it will then become apparent that the company cannot survive. In these cases, a company can convert a Chapter 11 filing into a Chapter 7 liquidation.

## Trustees

There are three different types of trustees. In Chapters 7 and 13, and in Chapter 11 by court order, a trustee is appointed to oversee the debtor's assets during the pendency of the bankruptcy case. Chapter 13 bankruptcy, a personal reorganization, also involves a specific "Chapter 13 trustee," which is a ministerial office that accepts the debtor's payments from current income and distributes those payments to creditors in accordance with the plan.

Finally, a United States trustee works for the Department of Justice and monitors bankruptcy cases for the government. The United States trustee also appoints the specific individuals who will act as trustees in Chapter 7 and 13 cases. The trustee appointed by the United States trustee can be replaced by a nominee appointed by a vote of the creditors. This often happens in corporate cases with a large, secured cred-

itor, which will seek to appoint a friendly trustee to oversee the assets securing its loan. Trustees are almost always lawyers, although that is not a requirement. Sometimes they are accountants.

## Examiner

An examiner may be appointed in a Chapter 11 case to investigate a debtor. The goal of this investigation is to uncover possible wrongdoing by a debtor, or on behalf of the debtor. By uncovering this wrongdoing, it may be possible to bring suit against the wrongdoers on behalf of the debtor, thereby adding recovery to the debtor's estate. An examiner usually compiles a detailed report with recommendations. An examiner usually will not bring suit himself, but rather, the creditors committee or the trustee, if appointed, will sue. Possible targets of this type of litigation are directors, officers and outside advisors.

## Receiver

A receiver is often synonymous with a trustee. A receiver is appointed by the bankruptcy court to maximize a debtor company's value to the estate. A bankruptcy court may appoint a receiver to run the company if a profit can be realized to benefit the creditors, or the court may charge the receiver with organizing an orderly sale of assets under 11 U.S.C. §363. In most cases, however, a bankruptcy court will appoint a receiver when the preexisting management cannot be trusted to effectively operate the debtor company.

The FDIC also appoints a receiver when a bank fails. We note that 2009 has seen the failure of over 130 banks. Therefore, we can reasonably expect that FDIC-appointed receivers will sue directors or officers who may bear responsibility for the oversight of failed banks. We expect that litigation initiated by FDIC receivers may allege that these directors and officers failed to properly oversee these banks' lending practices. *See, e.g., In re Integrity Bank of Alpharetta Georgia*, Index No. 1:09-CV-1156-RWS (N.D.G.A. Nov. 30, 2009).

## Committee

The committee of unsecured creditors, mentioned briefly above, also referred to as the creditors' committee, or simply "the committee," is selected from a debtor's 20

largest, unsecured creditors. A creditors' committee is usually represented by counsel and is charged with protecting the interests of all unsecured creditors, to which counsel owes fiduciary duty. The creditors' committee usually has the largest motivation to sue third parties, since recovery will increase the size of the debtor's estate, thereby increasing the percentage of recov-

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ery that all unsecured creditors will realize.

## Underwriting

We will now turn to some basic concerns of underwriters when an insured faces bankruptcy.

## Cancellation

Frequently, the first response that an underwriter has on learning that an insured has filed for bankruptcy protection is to ask if it can cancel the policy or binder. The answer is almost uniformly no. An insurer cannot unilaterally cancel a policy or binder solely because the insured has filed for bankruptcy protection. Although an insurer cannot cancel a policy, an insurer will probably and should examine the change of control provision, because some policies provide a wrongful act cut-off once debtor-in-possession financing is secured.

## Policy Issuance

If an insurer has only issued a binder when the insured has filed for bankruptcy, should the insurer issue the policy? This is a tricky question without a clear answer. On one hand, the insured will expect that the insurer will issue the policy. On the other hand, the insurer will need absolute certainty that the issued policy does not deviate at all from the terms of the binder. If you are an insurer or an attorney for an insurer, this is a time to remember that all the "T"s need to be crossed and all the

“T”s dotted. Did the insured pay the premium? Have all of the subjectivities been met, including the issuance and receipt of any underlying policies? Does each of the underlying policies strictly follow the underlying binders? Do any potential application, warranty or knowledge defenses exist to coverage of any potential claim? An insurer must consider each of these ques-

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tions before issuing a policy to an insured that has filed for bankruptcy. If an insured has not paid the premium or if the insured has failed to meet another responsibility, such as providing answers to subjectivities, the policy or binder may still be considered an “executory contract” pursuant to 11 U.S.C. §365. See *In re Gamma Fishing Co.*, 70 B.R. 949 (Bankr. S.D. Ca. 1987) (finding an insurance policy was an executory contract); *In re Pester Refining Co.*, 58 B.R. 189 (Bankr. S.D. Iowa 1985) (same). A trustee must accept or reject an executory contract, and, if accepted, all contract defects must be cured. 11 U.S.C. §365(a).

### Premiums

Every insurer should check the status of premium payments from insureds that have sought bankruptcy protection. If an insured has outstanding payments when it files a bankruptcy petition, the insurer will need to file a proof of claim in the bankruptcy court to add itself to the list of creditors seeking money from the insured. One cautionary note is that it has been argued that filing a proof of claim may subject an insurer to the general jurisdiction of the bankruptcy court. This is not the time to send demands for payment to an insured because it may violate the automatic stay

and possibly expose an insurer to sanctions for contempt. *In re Ionosphere Clubs Inc.*, 171 B.R. 18, (Bankr. S.D.N.Y. 1994). The involvement of premium financing would raise a host of other issues, including whether the premium financing would render the policy an executory contract and whether the premium financier would become subject to the automatic stay.

It is wise to find out if an insured made any premium payments in the 90 days prior to filing for bankruptcy. In one of the last stages in the lifespan of a bankruptcy case, creditors pursue “preference actions” under section 547 of the Bankruptcy Code. 11 U.S.C. §547(b). These preference actions seek payments made by the debtor to other creditors in the 90 days leading up to the bankruptcy filing. The assumption is that during this period the debtor likely knew that it would file for bankruptcy protection and elected to “prefer” and pay some creditors over others. Although substantial and effective defenses exist to preference actions, we have seen preference actions brought against insurers that received premium payments during the 90 day pre-filing period. *Millenium Seacarriers, Inc. v. Cap-Marine Assurances Reassurances S.A. (In re Millenium Seacarriers, Inc.)*, Index No. 04-AP-01022 (Bankr. S.D.N.Y. 2004); *Kirschner v. Marsh Inc., et al.*, Index No. 07-AP-03050 (Bankr. S.D.N.Y. 2007). At minimum, it would be wise to advise subsequent transferees of these payments—brokers, reinsurance intermediaries and reinsurers—that the payments may be subject to recovery. The tracing mechanisms found in 11 U.S.C. §550 permit a trustee to recover preference payments from either the direct or mediate transferee, although there are several enumerated exceptions.

### Claims

When an insured has filed for bankruptcy, claims handling can raise many challenging issues with few clear answers. It is important to keep in mind that when an entity has filed for bankruptcy, the individual insureds have not. In a small handful of cases, bankruptcy courts have used their general power under 11 U.S.C. §105(a) to stay litigation against a debtor’s key directors and officers. See *Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973 (1st Cir. 1995); *In re Sudbury, Inc.*, 140 B.R. 461 (Bankr.

N.D. Ohio 1992); *In re MacDonald Associates, Inc.*, 54 B.R. 865 (Bankr. R.I. 1985); *In re Smurfit-Stone Container Corp.*, Index No. 09-AD-51067-BLS (Bankr. Del. Nov. 18, 2009). Accordingly, before taking action, an insurer or its attorney needs to ask, “will this have any possible effect on the coverage available to the entity?” If that question is answered in the affirmative, it is generally wise to seek approval from the bankruptcy court before proceeding. For an insurer, the primary concern is violating the automatic stay.

### Coverage Letters

If an insured submits a claim requesting coverage, an insurer may respond with a coverage position letter. *Benz v. Dtric Ins. Co. (In re Benz)*, 368 B.R. 861, (9th Cir. BAP 2007). Nevertheless, we have seen instances in which the insured entity has claimed that the coverage denial constituted an unauthorized removal of assets from the estate, which violated the automatic stay, although case law does not support that position. It appears that an insurer can safely reserve rights, and even deny coverage, without violating the automatic stay. However, making demands of an insured, such as requiring the insured to submit to an examination, probably does violate the automatic stay.

Rescinding a policy is a different matter, and most jurisdictions would consider a policy rescission to constitute a violation of the automatic stay. *Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reinsurance Corp. (In re Minoco Group of Cos., Ltd.)*, 799 F.2d 517 (9th Cir.1986). It is good practice to copy the debtor’s bankruptcy counsel on all coverage correspondence, but copying the trustee is generally unnecessary.

### Retention

Does the retention, the portion of a claim paid by an insured, still apply if an insured has filed for bankruptcy? The short answer is that loss within the retention amount is still an insured’s responsibility, *but generally*, if the insured does not pay that amount, the insurer must still provide coverage. *Home Ins. Co. of Illinois v. Hooper*, 294 Ill. App. 3d 626 (1st Dist. 1998). That is, most courts have held that an insurer cannot deny coverage for loss in excess of the

retention amount simply because the insured has not paid its share. *But see Koch Dev. Co., Inc. v. Clarendon America Ins. Co.*, Index No. 08-1803 (8th Cir. Feb. 24, 2009) (strictly enforcing satisfaction of retention as pre-condition to coverage). In reality, if an insured defaults by failing to respond to a claim, there may be a judgment entered in excess of the retention. In those situations, the courts acknowledge that an insurer may be compelled to voluntarily pay the insured's retention solely to protect itself from exacerbating its loss in excess of the retention. Of course, it is also important to remember that the automatic stay usually stays all pending litigation against an insured debtor.

### Stay of Litigation

The automatic stay initially postpones all impending litigation against a debtor and prevents the prosecution of new litigation against the debtor during the pendency of the bankruptcy action. 11 U.S.C. §362. Nevertheless, there are a few exceptions for certain actions brought under the police powers of governmental agencies, including Equal Employment Opportunity Commission proceedings. *Eddleman v. U.S. Dept of Labor*, 923 F.2d 782 (10th Cir. 1991). Sometimes a bankruptcy court will lift the automatic stay to allow specific actions to proceed. Finally, some actions filed within a bankruptcy case itself, termed "adversary actions," will proceed despite the automatic stay.

To the extent that defense counsel are already involved in defending claims, it is important for insurers to promptly notify them of insured bankruptcy filings and for attorneys to advise insurer clients to keep them informed so that they can file appropriate notices in their litigations.

It is also important to remember that if litigation names other defendants, it may proceed against those non-debtor defendants. However, many courts seem to determine that it is inefficient to proceed against some defendants and then repeat everything later against a debtor defendant. In fact, as previously mentioned, some bankruptcy courts have used their general powers under 11 U.S.C. §105(a) to stay litigation involving non-debtor parties under the theory that a stay is necessary to carry out a successful reorganization under Chapter 11.

### Payment of Defense Costs and Appointing Counsel

Determining whether and how to fund costs of defense for proceedings that are not stayed, or that are filed despite the automatic stay, will depend on a number of factors and should be carefully considered with the insured debtor and in light of the policy provisions. This is often the single most contentious topic when handling claims in a bankruptcy context.

Best practice is to receive bankruptcy court approval in advance to pay defense costs from the policy. Although solid arguments can be made that the proceeds of the policy are not subject to the automatic stay, many courts have disagreed. *In re Felt Mfg.*, Index No. 05-13724-JMD, Doc. 945 (Bankr. N.H. 2006). Since there generally is no downside to seeking approval from a bankruptcy court, other than submitting to the court's jurisdiction, it is often the wise course of action. Generally, a fairly simple motion will suffice. The motion will ask the court to find that either (1) the automatic stay does not apply to the proposed payments, or (2) good cause exists to lift the automatic stay to permit the proposed payments.

Disputes may arise regarding who is responsible for initiating this motion. An insurer may find it advantageous for the defense counsel to bring the motion if defense costs are included in the limit of liability. Defense counsel may argue that since the insurer wants the protection, it should bring the motion. Generally, the motion is brought by defense counsel, but there are no set guidelines. Important considerations in this context include, would a decision affect entity coverage—for instance, eroding the available liability limit—or would it affect any priority of payment provisions in the policy.

Occasionally, a debtor, trustee, receiver or the creditors' committee will object to the payment of defense costs by the insurer. For example, in the Stanford Financial matter the receiver attempted to block the insurers' payment of defense costs incurred by so-called "black hat" officers. In a matter of first impression, the court declined to decide whether the proceeds of the policy were property of the estate, and used its "equitable discretion" to permit payment of the defense costs over the re-

ceiver's objection. The court specifically acknowledged that, although a defendant may spend its resources as it pleases to retain counsel, the issue at bar was whether the proceeds from the policies constituted assets tainted by the alleged fraud. The court determined that even if the premiums were paid with stolen money, it would not entitle the victims of the fraud to the proceeds of the policies. The receiver argued that dollars spent as defense costs depleted policy limits available to pay claims by Stanford's investors. Here, the court found that the receiver's claim against the policy was hypothetical because at the time of the opinion: (1) there had not yet been a claim made by the receiver against the insured entities; and (2) the insurers adamantly maintained that any hypothetical claim by the receiver would be excluded from coverage. Importantly, the court also highlighted that its decision was limited to permitting the insurers to pay defense costs, and it left the determination of coverage to the insurers. That is, the court did not order the insurer to pay. It merely found that the insurers *could* pay if the insurers determined that coverage were otherwise available. *SEC v. Stanford Int'l Bank, et al.*, Index No. 03-09-CV-298 (Doc. 831) (N.D.T.X. Oct. 9, 2009).

In other cases, directors and officers have sought to have defense costs advanced under D & O policies, even when coverage has been hotly contested. Many courts, especially bankruptcy courts, have been willing to grant this relief over the objection of insurers. These so-called "advancement motions" are generally based on a Fed. R. Civ. P. 65 preliminary injunction standard, although most courts have neither required insureds to show immediate irreparable harm, nor have they required insureds to post security, even though posting security is specifically required under rule 65(c). Although technically insurers can recover payments that result from advancement motions if they ultimately establish that coverage was unavailable to the insureds, in reality, insurers usually end up at the end of very long lines of creditors and are unable to meaningfully recover these funds. While courts acknowledge this inequity, they view it as a risk inherent in the insurance business.

Some courts have used their equitable powers to rewrite insurance policies

to distribute advances while adhering to the limited policy limits to the competing demands of several individual insureds. For example, in the Adelpia bankruptcy, the court granted advances of up to \$300,000 in defense costs to each of five director insureds who appeared to be “black hat” defendants, in an effort to preserve the remaining liability coverage amount for other “white hat” individual insureds and claimants. *In re Adelpia Comm. Corp.*, 2002 WL 31557175 (Bankr. S.D.N.Y. Nov. 15, 2002).

### Coverage Disputes

Coverage disputes are a reality with all manner of insureds, including entities that are under the protection of bankruptcy courts. Several questions arise—especially in the area of D & O coverage. It is important to note that, as mentioned above, although an entity has filed for bankruptcy protection, the individual directors and officers have not. Therefore, parties often argue about the proper venue to litigate a coverage dispute with a debtor’s directors and officers. It seems settled that a D & O policy itself is property of the debtor’s estate. Nevertheless, it remains unsettled whether the right to proceeds from that policy are property of the debtor’s estate. *In re Daisy Systems Securities Litigation*, 132 B.R. 752 (Bankr. N.D. Cal. 1991); *In re Louisiana World Exposition*, 832 F.2d 1391 (5th Cir. 1987); *In re Minoco Group of Cos., Ltd.*, 799 F.2d 517 (9th Cir. 1986). The answer to these questions is important in determining whether coverage litigation will take place in a bankruptcy court or in a federal district or state court.

Bankruptcy courts are subsets of the federal district courts. Although original jurisdiction over all bankruptcy matters rests in the federal district courts, standing orders in the various district courts throughout the country refer all

matters “arising under Title 11” or “arising in or related to cases under title 11” to the bankruptcy courts in each district. In *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 102 S. Ct. 2858 (1982), the Supreme Court determined that in ascertaining jurisdiction over bankruptcy-related issues, matters should be categorized as either core or not core to bankruptcy. In *Northern Pipeline*, the Supreme Court held that bankruptcy courts cannot issue final determinations in matters that are not core to bankruptcy. In response to *Northern Pipeline*, Congress enacted 28 U.S.C. §157, which provides that bankruptcy courts can only issue final determinations in core bankruptcy matters, and specifically defined matters that are “core.” In sum, core proceedings must invoke a substantive right created by federal bankruptcy law that would not exist outside of a bankruptcy case. Non-core proceedings have little or no relation to the Bankruptcy Code, do not arise under federal bankruptcy law and would exist in the absence of a bankruptcy case. Accordingly, although a bankruptcy court can adjudicate non-core matters, it cannot issue final determinations. A bankruptcy court also cannot hold jury trials unless all parties consent.

Many courts have held that insurance coverage disputes—especially those involving directors and officers of debtor corporations—do not constitute core bankruptcy matters. Therefore, bankruptcy courts cannot issue final determinations. But most bankruptcy courts still interpret this to permit them to issue advancement orders, as discussed above.

A useful tool to a coverage litigator is a motion to withdraw the reference. This motion asks a district court to withdraw the referral to the bankruptcy court and move the coverage litigation to the district court. The most persuasive arguments for

withdrawing a referral are (1) since a bankruptcy court cannot issue final rulings on non-core matters, orders are reviewed *de novo* by the district court, resulting in largely duplicative litigation; and (2) a bankruptcy court cannot hold a jury trial without the consent of all parties, and in most cases, all parties do not consent.

### Payment of Claims and Settlements

As with the payment of defense costs, it is advisable for an insurer to seek bankruptcy court approval before paying any claims or settlements. In fact, it is wise to make bankruptcy court approval a precondition to all settlement negotiations. In many cases there are competing demands from individual insureds, or from individuals and the entity, for the policy proceeds. Even if a policy contains express priority of payments language, it is always advisable to ask a bankruptcy court to approve all payments made under the policy because when faced with claim payments that should not have been paid, generally, courts will find that improper payments do not erode liability limits.

On a related note, when dealing with an insured that has not filed for bankruptcy protection but for which a future bankruptcy filing is a concern, although beyond the scope of this article, an attorney drafting a settlement agreement can and should add clauses to a settlement agreement to protect the insurer’s interests in the event that the insured files for bankruptcy before the settlement is finalized or shortly afterwards.

The foregoing is intended to provide a general outline of issues faced by insurers when an insured files for bankruptcy. It is not intended to provide advice on any particular matter, and the specific facts of any particular matter will dictate the actions that an insurer should take. 