

# The John Liner Review

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## *Insurance Strategies*

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*An insurer may not deny a claim due to the insured's bankruptcy.  
If a claim denial led directly to bankruptcy, the insurer  
may be liable to the insured for damages.*

# “Death of Company”: Insurance Coverage in Bankruptcy

JOSHUA GOLD

Given the jump in insolvencies and bankruptcy filings due to the moribund economy, insurance claims again are becoming a focal point for the administration of debtor assets and liabilities.

Bankruptcy trustees may find themselves pursuing first-party property insurance claims if the policyholder was rendered insolvent by the refusal of the insurance company to pay, in part or in full, the claims for business income loss or full property damage suffered by the policyholder following a calamity.

Third-party and hybrid policies often in play during bankruptcy include directors and officers

(D&O) insurance policies, fidelity bonds, and commercial crime insurance policies. Often, for D&O insurance claims, this is a reflection of the fact that shareholder suits tend to spike when companies struggle to stay afloat and the stock price gets pounded as a result.

As for crime insurance or fidelity bond claims, the debtor company may have been pushed over the edge by a large theft or a rogue trader.

Insurance claims pursued during bankruptcy are often complicated by the fact that many insurance claim issues — especially ones involving D&O insurance claims — give rise to conflicts between competing insureds.

## Bankruptcy Does Not Relieve Insurance Company of Its Obligations

No matter what type of insurance policy is involved, a general rule of thumb is that bankruptcy proceedings of the policyholder do not negate the obligations of the policyholder's insurance companies to provide insurance coverage for claims. Indeed, many insurance policies expressly provide that bankruptcy proceedings of the policyholder do not relieve the insurance companies of their coverage obligations. For example, one primary D&O insurance policy states that "[b]ankruptcy or insolvency of the Company or the Insured or of their estates shall not relieve the Insurer of any of its obligations hereunder." Similarly, another insurance policy form provides that "[b]ankruptcy or insolvency of an Insured or of the estate of an Insured shall not relieve the Company of its obligations nor deprive the Company of its rights under this policy."

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*Insurance companies should not be relieved of their insurance coverage obligations by virtue of their policyholder's filing for bankruptcy protection.*

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Like D&O insurance policies, certain general liability insurance policies also state that "bankruptcy or insolvency of the insured or of the insured's estate will not relieve [the insurance company] of [its] obligations ...."

Relevant case law has held that insurance companies should not receive a windfall, and be relieved of their insurance coverage obligations, by virtue of their policyholder's filing for bankruptcy protection. Nevertheless, trustees, attorneys, and others responsible for representing the interests of bankrupt businesses need to be mindful of certain key insurance coverage issues. Should they be confronted with an insurance claim or coverage right that has not been honored by the insurance company, competent representation of the debtor requires that the following issues be considered and pursued where appropriate.

## Did an Insurance Coverage Denial Cause the Company to Go Bankrupt?

A threshold question to always ask (and answer) is: How did the insolvent entity get to this point? If it turns out that an insurance company's misconduct in handling an insurance claim caused the policyholder to become insolvent or file for bankruptcy, then the insurance company may be liable for consequential and exemplary damages.

For many businesses, a denial of insurance coverage for a large claim can be ruinous. Insurance companies that fail to honor their insurance coverage obligations in a fair and prompt manner can lead to some policyholders becoming insolvent, given their reliance on insurance proceeds to deal with a serious liability, catastrophe, or loss of business income claim.

This is true whether the policyholder is a corporation or an individual.<sup>1</sup> Some insurance companies have referred to this situation as "death of company."<sup>2</sup> The potential insurance-related causes of a death of company are numerous, from the refusal of primary or excess insurance companies to settle a third-party claim within policy limits to refusing coverage in full or in part for a catastrophic property loss.

### **West Am. Ins. Co. v. Freeman**

In *West Am. Ins. Co. v. Freeman*,<sup>3</sup> the First District California Court of Appeal affirmed an award of actual damages and a \$12 million award of punitive damages. In *West Am.*, the insurance company sold a comprehensive general liability (CGL) policy to its policyholder, a contractor. When the contractor was sued and filed a claim with his insurance company, the insurance company allegedly began looking for ways in which to dispose of the claim inexpensively, thereby compromising the contractor's interests and reputation.<sup>4</sup>

After engineering a quick and cheap settlement, the insurance company then went after its own policyholder, suing him in an effort to recoup the cost of the settlement it had made plus the attorney fees incurred in the case. This caused the policyholder to lose his business and his assets and made him liable for over \$320,000 in legal fees<sup>5</sup> — on top of the \$60,000 plus that the policyholder had paid in premiums to the insurance company for the policy.

The policyholder countersued, charging the insurance company with, among other things, bad faith. The policyholder offered evidence of bad faith conduct, including evidence that the insurance company lied about the destruction of the claims file.<sup>6</sup>

In affirming the \$12 million punitive damage award against the insurance company, the court held that “the award was based on the reprehensibility of [the insurance company’s] conduct toward [the policyholder] and its failure to accord [the policyholder] the consideration to which he was entitled.”<sup>7</sup> The Court of Appeal accorded great weight to the trial court’s finding that “the conduct of the insurance company in this case was egregious.”<sup>8</sup>

***Bi-Economy Market, Inc. v. Harleystown Insurance Company of New York, et al.***

In a more recent case, the New York Court of Appeals rendered a landmark ruling last year where it held that an insurance company that wrongly denies coverage and causes the demise of its policyholder’s business is responsible for consequential damages.<sup>9</sup> In the case, the policyholder had suffered a fire at its facility. Rather than provide coverage in full, the insurance company disputed its obligations and paid only a fraction of the policyholder’s property damage claim and a bit more than half of the policyholder’s business income claim. The policyholder charged that the refusal by the insurance company to promptly honor its insurance coverage obligations caused the business to collapse.

The high court of New York held that the “purpose served by business interruption coverage cannot be clearer — to ensure that [the policyholder] had the financial support necessary to sustain its business operation in the event disaster occurred.” The court held that the policyholder’s “claim for consequential damages including the demise of its business, were reasonably foreseeable and contemplated by the parties[.]” The court also found that the insurance policy required the insurance company to “evaluate a claim, and to do so honestly, adequately, and — most importantly — promptly.”<sup>10</sup>

The bottom line for attorneys representing policyholders under such circumstances is that it is critically important to evaluate and pursue bad faith and consequential damages claims against insurance companies that refuse to provide coverage for covered claims.

**Competing Interests in the Insurance Policy**

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 often have an obvious interest in keeping available as many assets as possible, including insurance assets, in the debtor’s estate to satisfy claims. For example, in the Enron case several years back, a state attorney general attempted 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. While this attempt failed, it demonstrated that there will often be competing interests under D&O policies in the context of insolvencies.

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**Who Owns the D&O Policy?**

The question of whether a D&O insurance policy is property of the estate or the insured officers and directors becomes even more heated where the D&O policy expressly provides so-called “entity” insurance coverage to the company itself. Historically, under D&O insurance policies without entity insurance coverage, D&O insurance companies had been taking the position that anytime the company itself was being sued alongside its officers and directors (almost always the case), the D&O insurance company was entitled to “allocate” the loss. The argument stemmed from the insurance companies’ claims that only officers and directors were “insured” under the D&O policy and thus, allegations made against the company itself were not covered. As such, many insurance companies would seek to allocate the loss and reduce insurance coverage — sometimes, by as much as 50 percent or more.

*Evolution of Entity Coverage*

After a string of losses in court by insurance companies on their allocation arguments, “entity” coverage was developed and sold to expressly grant insurance coverage to the company itself in certain circumstances (typically, in securities cases specifically naming the company as a defendant in addition to the officers and directors).

Some have argued that a D&O insurance policy that 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. The bulk of the cases rendered thus far do not support this conclusion, but it is an issue that continues to be debated. Even insurance companies have seized on this debate as a marketing point for the sale of so-called Side A policies.

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*“Priority of payment” clauses, however, are not panaceas. Rather, they have their own set of ambiguities.*

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**Fight for Assets**

In the context of a bankruptcy, every asset, including insurance benefits, becomes increasingly sought after by trustees, creditors, and other claimants. These dynamics can lead to fights between certain groups of “insureds” vying for limited amounts under the D&O insurance before the well runs dry.

**“Priority of Payment” Clauses**

What should policyholders be doing under these circumstances? Unfortunately for many policyholders, there is no single path to follow in these situations. There are, however, critical points to look out for. One is whether a “priority of payments” clause is contained in the primary or excess D&O insurance policies. These clauses have increasingly permeated D&O policies over the last few years. Priority of payment 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.

*Timing of Payments*

“Priority of payment” clauses, however, are not panaceas. Rather, they have their own set of ambiguities. Perhaps, the most important is that most such clauses purport to have no application until a “Loss” will exceed the remaining limits of the policy. As such, timing of loss payments claimed under the policy becomes a very important (and often disputed) issue. To determine whether the clause is triggered, can one extrapolate from a monthly or quarterly burn rate to figure out 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 most of these clauses.

*Discretionary vs. Automatic*

Also, a question may arise as to whether the clause is discretionary in its application or automatic. Both forms of the clause exist. If it is 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 this entails a conflict of interest, as current management might want to invoke the clause even if it would be in the entity’s coverage interest not to. Current management may want to preserve coverage for future claims (that may not even arise), whereas the entity may be better off recovering money it has paid in connection with indemnifying its officers and defending itself pursuant to Side B and Side C coverages.

**Trustee, FDIC, and Creditors Suits vs. Former Management: Insured vs. Insured Exclusion**

When 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, which seeks to bar insurance coverage for claims made by one “insured” against another.

Similarly, some insurance companies have ar-

gued that coverage for suits brought by the Federal Deposit Insurance Corporation (FDIC), Resolution Trust Corporation (RTC), Federal Savings and Loan Insurance Corporation (FSLIC), and state insurance commissioners were barred by the 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.<sup>11</sup>

### Insurers Seek Broad Application of the Exclusion

Despite the historic rationale for the insured vs. insured exclusion, too many D&O insurance companies have sought a far broader application of the exclusion than its original intended purpose would suggest.<sup>12</sup> The broad application sought by insurance companies carries over into the bankruptcy context. Many insurance companies over the last decade or more have sought a forfeiture of insurance coverage for any lawsuit brought by a bankruptcy trustee or creditors committee.<sup>13</sup>

While cases have split on whether a trustee's claims against officers or directors of the company invoke the insured vs. insured exclusion, many of the decisions rendered on this issue favor policyholders' claims for insurance coverage. As long as the suit by the trustee is not collusive in nature, the exclusion should not effect a forfeiture of insurance coverage for the insured officers and directors. In fact, some of the more recent forms of D&O insurance have even sought to clarify this point and specifically except from the exclusion trustee claims. Specifically, some forms of D&O insurance carve out claims by trustees or creditors committees from the insured vs. insured exclusion.

### *Biltmore Assoc., LLC v. Twin City Fire Ins. Co.*

One recent case from California, however, went against the creditors' trust. In *Biltmore Assoc., LLC v. Twin City Fire Ins. Co.*,<sup>14</sup> the U.S. Court of Appeals for the Ninth Circuit affirmed a trial court ruling in favor of the insurance company. In *Biltmore*, the trustee for the creditors' trust (Biltmore) received an assignment of D&O insurance policy rights from the debtor in possession, Visitalk. Biltmore argued the claim against the former directors and officers for, among other things, looting, was on behalf of the creditors and brought by the creditors' trustee

— not on behalf of an insured. The Ninth Circuit found to the contrary and held the insured vs. insured exclusion barred coverage because a contrary ruling would create a moral or collusion hazard where the debtor in possession would assign its D&O insurance claim in exchange for a covenant by the creditors not to execute against the former managers of the bankrupt company.

The court held that a debtor in possession is the same as the policyholder that existed before filing for bankruptcy. The court then concluded that the trustee of the creditors' trust had assigned rights of coverage from the debtor in possession that were subject to the insured vs. insured clause. While this decision is certainly bad for creditors and potentially others who might otherwise have a right to D&O insurance benefits, it is likely a reflection of the specific circumstances of the case, where the suit against the former managers was brought by the debtor in possession before assignment of the claims to the creditors' trust. The Ninth Circuit, in rendering its opinion, was obviously concerned about the potential for collusive litigation where the debtor was still in charge of the corporation while in bankruptcy. A different result likely would have obtained had there been a bankruptcy trustee or a different arrangement with different timing between the debtor and the creditors.

### All Parties in Bankruptcy Must Understand the Exclusion

Even though many insured vs. insured exclusions now create exceptions for claims by creditors, trustees, and others, the context and purpose of the exclusion should still be understood. Those attorneys representing debtors, creditors, the FDIC, and other parties in bankruptcy or bank failures should be knowledgeable about the insured vs. insured exclusion in order to combat improper insurance company attempts to apply the exclusion beyond its intended scope.<sup>15</sup>

### Endnotes

1. See Segal, Joseph, "Sluggish Claim Process Can Cause Insured Business' Demise," *Claims* (February 1995): 86.
2. See, e.g., "Motion For Partial Summary Judgment And Incorporated Brief In Support Thereof" (August 29, 1995), *In Re: Cooper Mfg. Corp. v. Home Indem. Co.*, No. 94-C-901-BU (N.D. Okla.): 3.

3. *West Am. Ins. Co. v. Freeman*, 37 Cal. App.4th 1469 (Cal. App. 1st Dist. 1995), rev. granted, 907 P.2d 1323 (1995).
  4. *See Egan v. Mut. of Omaha Ins. Co.*, 24 Cal.3d 809 (1979). “For the insurer to fulfill its obligation not to impair the right of the insured to receive the benefits of the agreement, it again must give at least as much consideration to the latter’s interests as it does to its own.” *Ibid.*: 881–19 (citation omitted).
  5. In a different case, *In Re: Cooper Mfg. Corp. v. Home Indem. Co.*, No. 94-C-901-BU (N.D. Okla.), the liquidating trustee in bankruptcy for the policyholder brought an action against the policyholder’s insurance companies for bad faith conduct and improper denials of insurance coverage that constituted the sole basis for the policyholder’s need to seek bankruptcy protection. The insurance companies referred to this allegation as “death of company.” “Motion For Partial Summary Judgment And Incorporated Brief In Support Thereof,” *id.*
  6. *See ibid.*: 6; *see also* “Summary Judgment Is Denied; Insured Alleges Bad Faith,” *New York Law Journal* (October 14, 1994): 25.
  7. *West Am.*, *id.*
  8. *See ibid.* The trial court further explained that the insurance company’s claims adjuster “somehow seemed to determine that he wasn’t going to cover this claim, and that he would do what he wanted despite the evidence to the contrary. He exhibited an absolute total disregard for [the policyholder’s] rights under the contract, and for his rights as a person to be treated decently.” The case was settled before the California Supreme Court ruled on the appeal.
  9. *Bi-Economy Market, Inc. v. Harleysville Insurance Company of New York, et al.*, 10 N.Y.3d 187 (2008).
  10. *Ibid.*
  11. *See American Casualty Co. v. Sentry Fed. Sav. Bank*, 867 F. Supp. 50 (D. Mass. 1994).
  12. *See id.*
  13. *Cirka v. National Union Fire Ins. Co.*, 2004 WL 1813283 (Del. Chan. Aug. 16, 2004) (holding that “insured vs. insured” exclusion did not apply to claim of committee of unsecured creditors).
  14. *Biltmore Assoc., LLC v. Twin City Fire Ins. Co.*, No. 06-16417, 2009 U.S. LEXIS 15322 9th Cir. (July 11, 2009).
  15. *See Gray v. Exec. Risk Indemnity*, 271 B.R. 711 (D. Mass. 2002) (holding that insured versus insured exclusion did not apply to claim by bankruptcy trustee as there was no evidence of collusion); *QBE International Ins. Ltd. v. Clark*, 2003 U.S. Dist. LEXIS 19106 (N.D.Ill. Oct. 23, 2003) (holding exclusion inapplicable).
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