FOUR INSURANCE PITFALLS THAT EVERY BANKRUPTCY LAWYER SHOULD AVOID

by Lynda A. Bennett and Eric Jesse

When a company is in bankruptcy, insurance policies are a critical, but often overlooked, asset of the estate. For instance, policy proceeds may be a significant, and possibly the only, source of recovery for some creditors. For debtors, company executives increasingly need to rely on the protections of directors and officers (D&O) insurance to defend and resolve creditors' claims that their mismanagement drove the company into bankruptcy.

Unlocking the benefits and protections of insurance often presents challenges. Insurers do not just 'open their checkbook,' and they often insist on strict compliance with policy terms and conditions, particularly if doing so allows them to deny coverage. Therefore, bankruptcy practitioners must carefully navigate the road to coverage, avoiding pitfalls along the way that could lead to a claim denial. While there are many potential pitfalls, there are four common ones for every bankruptcy lawyer to be aware of: 1) the assignability of insurance proceeds; 2) the impact of a broad release provided to directors and/or officers; 3) the characterization of allegations against an insured and settlement payments; and 4) judicial limitations on executives' access to defense coverage.

The Assignability of Insurance Claims

Whether in bankruptcy or not, insurance companies often stand in the way of resolving claims by (wrongly) withholding coverage. Outside of bankruptcy, the insured is typically responsible for pursuing the insurer for coverage. But that is not necessarily practical in bankruptcy. Therefore, debtors and creditor-claimants often resolve claims in bankruptcy through a creative solution: an assignment to the claimant of the right to receive insurance proceeds, making the claimant responsible for pursuing coverage and giving it a chance at recovery that may otherwise be absent through the estate.

Before committing to an assignment, however, the parties (and in particular, the claimant) must ensure it will be enforceable. Insurance policies commonly contain anti-assignment provisions stating, for example, "Your rights and duties under this policy may not be transferred without our express written consent." Some jurisdictions strictly enforce the wording of such provisions, invalidating assignments of insurance policy proceeds that are made after the loss.[1] Many other courts, however, hold that the anti-assignment clause does not prohibit an assignment so long as it is made after the loss has occurred and is limited to the right to receive insurance proceeds. Those courts reason that the "[a]ssignment of the right to collect or to enforce the right to proceed under a...policy does not alter, in any meaningful way, the obligations the insurer accepted" after the loss has occurred.[2] Therefore, bankruptcy practitioners must confirm that the applicable law permits post-loss assignments and that the scope of the assignment is confined to the right to receive insurance proceeds. It is also important to keep in mind that the applicable law may not be the law where the bankruptcy proceeding is pending.

Moreover, if the assignment, as is common, is accompanied by a settlement or consent judgment[3] (in each case for a sum-certain), many courts require that the amount must be reasonable and the negotiations must have been conducted in good faith.[4] Once the claimant-turned-assignee pursues the insurance company for recovery, the insurer may challenge the settlement amount as excessive and contend it was a result of a collusive bargain. Therefore, the claimant must be prepared to prove that the settlement was arms length and why the amount was reasonable (*e.g.*, the settlement was achieved through a mediator; it was in line with the insured's potential liability; it was approved by the bankruptcy court).

Scope of Release to Directors and Officers

To maximize the funds available to satisfy their debts, creditors' committees often bring claims against the debtors' directors and officers for their alleged mismanagement and role in driving the

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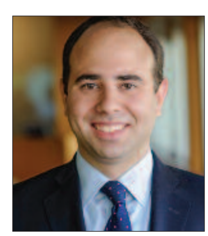

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company into bankruptcy. Usually, the committee's prime target is the debtor's D&O insurance. Similarly, plaintiffs who commenced lawsuits against the company and/or their executives before bankruptcy (*e.g.,* in a securities class action) may find that, after the company's bankruptcy, their main source of recovery is from the D&O insurance asset.

Stakeholders in bankruptcy must be careful how claims against directors and officers are resolved and released. Often, claimants are willing to confine their recovery solely to D&O policy proceeds and, at the same, release the directors and officers and/or agree to forego recovery from them personally. D&O insurers are attuned to these efforts. Increasingly, D&O policies exclude amounts that an insured is not 'financially liable' for, or for which there is no 'legal recourse' against the insured. Because directors and officers understandably insist on 'complete peace' as part of the overall resolution of the bankruptcy proceeding, that exclusion can be a stumbling block in negotiations because claimants may not be able to give such 'peace' without triggering the exclusion. Therefore, claimants enter into such a settlement at their own risk.

However, some courts have allowed claimants to 'walk the tightrope' and avoid the exclusion. In one case, the court did not apply the exclusion when the plaintiff class took an assignment of the right to receive insurance proceeds but "agreed to seek payment of the [consent] judgment only from [the insurer] and not [the insured]."[5] The court reasoned that "an insured remains legally obligated to pay despite an assignment of indemnification rights to a third party and the third party's covenant not to execute against the insured."[6] The court was also moved because "the Settlement Agreement explicitly provided that [the plaintiff class] was not releasing [the insured] from liability."[7]

Despite this favorable decision, bankruptcy practitioners must still proceed with caution: Many other courts have not hesitated to apply the exclusion when a claimant agrees to forgo recovery against the insured.[8]

Characterizing the Claim and the Settlement Amount

When a creditors' committee brings a claim against the directors and officers, the committee may be particularly keen on pursuing fraud claims. Yet, from a D&O insurance perspective, the committee must be careful in doing so: D&O policies contain exclusions for fraudulent conduct. However, if such claims are brought, directors and officers should be able to secure defense cost coverage. Many of those exclusions have an exception stating they do not apply unless and until there is a 'final non-appealable adjudication' establishing the fraudulent conduct.

By pressing a fraud claim, the committee will not recover insurance dollars on that claim if the lawsuit is litigated to a final non-appealable judgment. Moreover, even though the exclusion (if it has the exception) would not apply in a settlement context, the practical reality is that D&O insurers are loath to fund a settlement of a lawsuit that is solely focused on fraudulent conduct. Therefore, if a committee does allege a fraud claim, it must be tempered by claims for breaches of fiduciary duties, including the duties of care and loyalty, negligent misrepresentation, mismanagement, failure to exercise reasonable care and competence, and failure to act in good faith.

Claimants must also be attuned to how they characterize the monetary relief they seek through the lawsuit (*e.g.*, damages versus statutory fines/penalties). Further, when the lawsuit shifts into settlement mode, the parties must exercise care when describing the nature of the settlement proceeds. D&O policies have a definition of loss (*i.e.*, the amount the insurer will pay for a covered claim) that includes 'damages.' But the loss definition often has exclusions for amounts that are 'fines' or 'penalties. The policies also often exclude 'amounts uninsurable at law,' which, insurers argue, encompasses disgorgement or restitution. Insurers will challenge any monetary amounts that could, even remotely, be tied to those excluded categories. Therefore, the best chance to maximize insurance recovery is to describe the monetary relief sought and any subsequent settlement amount paid as damages.

Accessing Defense Cost Coverage

When directors and officers face claims in a bankruptcy setting that are potentially covered by the debtor's D&O policy, the directors and officers expect to have access to defense costs. Typically, defense costs erode the policy limits; therefore, every dollar spent on the defense results in one less dollar for a settlement or judgment satisfaction.

Creditors want to preserve policy limits so maximum insurance dollars are available at the negotiation table to fund a settlement or, if the suit goes to verdict, to pay a resulting judgment. To that end, creditors' committees have succeeded before bankruptcy judges in curtailing directors' and officers' access to defense costs, often arguing that the D&O policies are property of the estate.[9] Consequently, bankruptcy courts have imposed caps on the amount of defense costs available to defend a committee's claim, which can only be increased with judicial approval. Those courts also have required the executives to submit periodic reports about the defense costs being incurred and remaining policy limits.

These restrictions place the debtor and its executives in the awkward position of having the party that is suing them looking over their shoulder as they defend themselves. The executives may also feel compelled to scale back an otherwise vigorous defense for fear they will hit the cap too soon or a court may decline to increase it. To try to avoid this pitfall, bankruptcy practitioners should advise their debtor clients to secure a favorable 'priority of payments' in their D&O policy *before* filing for bankruptcy, which makes clear that D&O policy proceeds are, first and foremost, for the benefit of executives, and that the company's bankruptcy will not inhibit such access to those proceeds. When those policy protections are absent, bankruptcy lawyers representing creditors' committees should be ready to pursue court-sanctioned restrictions to try to secure the litigation advantages they bring and preserve policy limits for a settlement (or judgment). ⚖

Endnotes

1. *Keller Foundations, Inc. v. Wausau Underwriters Ins. Co.*, 626 F.3d 871 (5th Cir. 2010) ("Texas courts, however, diverge from this majority and enforce non-assignment clauses even for assignments made post-loss.").
2. *Elat, Inc. v. Aetna Cas. & Surety Co.*, 280 N.J. Super. 62, 67 (App. Div. 1995).
3. Bankruptcy attorneys should also be aware that if their client has an unsatisfied judgment, they may be able to proceed directly against the insurer for a recovery, even without an assignment. Many states have laws providing that "an action may be maintained by the injured person…against the [insurer] under the terms of the policy for the amount of the [unsatisfied] judgment…." N.J.S.A. 17:28-2. However, in many jurisdictions, this direct right of action is only available to a judgment creditor who sustained bodily injury or property damage. *See, e.g., GDF Intern'l, S.A. v. Associated Elec. & Gas Ins. Serv., Ltd.*, 2003 WL 926790, at *4 (N.D. Cal. March 4, 2003).
4. *See, e.g., Griggs v. Bertram*, 88 N.J. 347, 364 (1982). *But see Great Am. Ins. Co. v. Hamel*, 525 S.W.3d 655 (Tex. 2017) (requiring a judgment resulting from a "fully adversarial trial" before a claimant-turned-assignee can recover from the defendant's non-defending insurer).
5. *Illinois Union Insurance Co. v. U.S. Bus Charter & Limo, Inc.*, 291 F. Supp. 3d 286, 289 (E.D.N.Y. 2018).
6. *Id.* at 292.
7. *Id.*
8. *See, e.g., U.S. Bank, N.A. v. Fed. Ins. Co.*, 664 F.3d 693, 697-98 (8th Cir. 2011).
9. *See, e.g., In re: MF Global Holdings, Ltd.*, S.D.N.Y. Bankr. Case No. 11-15059, Doc. No. 1901 (May 30, 2014).