US Bankruptcy Procedure: What Insurers Should Know

Gotham Insurance Webinar Series

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Bankruptcy 101: Overview of Bankruptcy Options

- **Chapter 11 (business or individuals with significant assets)**
  - Reorganization
  - Going Concern Sale
  - Orderly Liquidation
  - Easier rules for small business bankruptcies (less than $7.5 million of debt)
- **Chapter 7 (business or individual)**
  - “Fire sale” liquidation/generally no business operations
  - Independent Trustee appointed
- **Chapter 9 (municipalities and local governmental units)**
- **Chapter 13 (individual wage earners)**
- **Chapter 12 (family farmers)**

Bankruptcy 101: Chapter 11 Players

- **Chapter 11 Debtor in Possession**
- **Possible Trustee in Chapter 11**
  - Appointed only upon strong showing of “cause”
  - Trustee automatically appointed in Chapters 7 and 13
- **Official Chapter 11 Committees**
  - Unsecured Creditors - Need at least 3 creditors willing to serve
  - Equity holders - Rarely appointed
  - Other Special Constituents (Tort Claimants, Retirees, etc.)
- **Unofficial/Ad Hoc Committees**
- **Secured Creditors (e.g. Lenders)**
- **Office of the United States Trustee**
- **DIP Lender**
- **Other Individual Creditors and Stakeholders**

Bankruptcy 101: The Automatic Stay and What That Means for Insurance Litigation

The automatic stay is a provision of the Bankruptcy Code – Section 362, which creates an injunction automatically at the moment the bankruptcy is filed and stays:

- The commencement or continuance of any legal or other proceeding against the debtor. 11 U.S.C. § 362(a)(1).
  - E.g. Must halt any lawsuit *against* the Debtor or any non-judicial proceeding against a Debtor (e.g. foreclosure proceeding).
- Enforcement of any judgment against the debtor that arose prior to filing bankruptcy. 11 U.S.C. § 362(a)(2).
- Any act to obtain possession of a debtor's property (11 U.S.C. § 362(a)(3)), perfect a lien (11 U.S.C. § 362(a)(4) and (a)(5)) or otherwise try to collect a debt 11 U.S.C. § 362(a)(6)).

Automatic Stay Cont.

Impact of Automatic Stay on Actions Specific to Insurers:

- Actions to obtain proceeds that may be property of the estate (e.g. first party insurance and shared insurance).
- Suits against the Debtor for declaration of insurance coverage.
- Garnishment actions.
- Cancellations of insurance policies by insurers (and enforcement of *ipso facto* termination clauses for insolvency or bankruptcy of insured).
- Direct actions against insurers are typically stayed upon the bankruptcy of the insured.

Bankruptcy 101: The Automatic Stay and What That Means for Insurance Litigation - Cont.

Stay remains in effect unless/until:

- Stay is lifted for "cause" - 11 U.S.C. § 362(d).
  - Cause to lift stay to cancel policy has been found to exist where Debtor fails to pay post-petition premiums. *See In re Payless Cashways, Inc.,* 305 B.R. 303 (Bankr.W.D.Mo.2004).
  - Stay may be lifted to allow claimant to collect claim against Debtor to the extent of available insurance policy. *See In re Holtkamp,* 669 F.2d 505 (7th Cir. 1982).
  - Stay may be lifted to permit directors and officers to collect D&O coverage, provided no harm to estate. *See In re Dowrey Financial Corp.,* 428 B.R. 595 (Bankr.D.Del.2010).
- Stay will expire once property subject to the stay is dealt with in a plan of reorganization or otherwise. 11 U.S.C. § 362(c)(2).
- Case ends by way of dismissal or property abandoned. *See* 11 U.S.C. § 362(c)(2); *Jeffries v. Browning*, 821 F.2d 520 (8th Cir. 1987) (creditor may levy on property that is no longer property of the estate).
- The close of the case or once property is no longer property of the bankruptcy estate. However, stay is replaced with permanent injunction upon discharge. 11 U.S.C. § 524(a), 1141(d).

Insurance as Property of the Bankruptcy Estate

Why does it matter?

- Stay only applies to debtor and its property and not to non-debtor parties or property that is not estate property. *See Advanced Ribbons & Office Prods., Inc. v. Interstate Distrib., Inc. (In re Advanced Ribbons & Office Prods., Inc.)*, 125 B.R. 259, 264 & n.8 (B.A.P. 9th Cir. 1991) (automatic stay does not stay actions against sureties to recover property in which the debtor has no interest).

  - **Guarantor liability** – Stay does not apply by its terms to guarantors. *See, e.g., Fifth Third Bank v. McClure Properties, Inc*., 2010 WL 3063579, at *1 (S.D. W. Va. 2010); *Chicago Title Ins. Co. v. Lerner*, 435 B.R. 732, 736 (S.D. Fla. 2010).
    - Springing guaranties are enforceable against the non-debtor principals.

  - **Letters of Credit** - Obligor of the letter of credit is the issuing bank, not the debtor – "Independence Principle." Thus, drawing down a letter of credit is not subject to the automatic stay. *See In re Marine Distributors,* 522 F.2d 791 (9th Cir.1975); *see also In the Matter of Compton Corp*., 831 F.2d 586 (5th 1987); *In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293 (11th Cir.1988).
    - Debtor can't stop beneficiary from drawing on LOC absent extraordinary circumstances. *See Wysko Inv. Co. v. Great Am. Bank*, 131 B.R. 146 (D. Ariz. 1991) (enjoining draw of letter of credit).

Insurance as Estate Property Cont.

The policy is property of the debtor's bankruptcy estate.

- "Property of the Estate" includes all of the Debtor's legal and equitable interest in property as of the commencement of the case. 11 U.S.C. § 541(a)(1).
- Property of the Estate also includes all "proceeds, product, offspring, rents or profits of or from property of the estate." 11 U.S.C. § 541(a)(6).
- It is universally held that a Debtor's interest in its insurance policies is property of its bankruptcy estate. *See, e.g., In re Equinox Oil Co., Inc.,* 300 F.3d 614 (5th Cir. 2002); *In re Minoco Group of Cos., Ltd.,* 799 F.2d 517 (9th Cir. 1986); *A.H. Robbins Co. v. Piccinin,* 788 F.2d 994 (4th Cir. 1986).

Insurance as Estate Property - Cont.

Whether policy proceeds are property of the estate depends on who is entitled to the proceeds when the insurer pays the claim.

- **Casualty and Debtor Beneficiary Policies**: If the Debtor is entitled to receive the proceeds of a policy upon receipt of payment of a claim - for example, a fire casualty policy - then proceeds of the policy are property of the estate. *See In re Edgeworth,* 993 F.2d 51 (5th Cir. 1993) ("Examples of insurance policies whose proceeds are property of the estate include casualty, collision, life and fire insurance policies in which the debtor is a beneficiary*.)*
- **Third Party Liability Policies**: If the Debtor has no right to receive the proceeds of the policy upon payment of a claim - for example, a commercial general liability policy - then the proceeds are generally ***not*** be property of the estate. *See In re Edgeworth,* 993 F.2d 51 (5th Cir. 1993) ("[U]nder the typical liability policy, the debtor will not have a cognizable interest in the proceeds of the policy.)
- **BUT,** shared policies and/or "secondary effect" of insurance proceeds on administration of Debtor's bankruptcy may bring insurance proceeds into the bankruptcy proceedings…

Insurance as Estate Property - Cont.

- **D&O Policies:** D&O proceeds are not property of the estate if the proceeds benefit only the directors and officers. *See Louisiana World Exposition v. Federal Ins. Co. (In re Louisiana World Exposition, Inc.),* 832 F.2d 1391 (5th Cir. 1987).
- But if the D&O Policy also provides coverage to the Debtor, then the proceeds may ***also*** be property of the estate. In such cases, the Bankruptcy Court must balance the interest of the debtor and non-debtor beneficiary of the D&O Policy. *See In re MF Global Holdings, Ltd.,* 469 B.R. 177 (Bankr. S.D.N.Y. 2012) (granting relief from the automatic stay to directors and officers to obtain policy proceeds after considering competing interests and harms to the debtor and the directors and officers).
- **Mass Tort Cases:** Special consideration is given to insurance policies in a mass tort bankruptcy to prevent "free-for-all." Bankruptcy Courts may administer policy proceeds for the benefit of larger creditor body, including by approving trust mechanism to which policy proceeds are assigned. 11 U.S.C. § 524(g).

Types of Insurer Claims in Bankruptcy Case

- Insurer may have claim for unpaid pre-petition premiums.
- Insurer may have claim for retrospective premiums or unpaid reimbursement costs.
  - Although retrospective premiums and reimbursement claims may not be calculated until after the bankruptcy is filed, they are still "pre-petition" claims that must be filed in accordance with applicable claims procedures approved in the bankruptcy case.
- Insurer may have a “secured claim” against collateral.
- Insurer may have an "administrative" claim for post-petition premium payments if the Debtor continues to receive benefits from the insurance policy post-petition. 11 U.S.C. § 507(a)(2)
- Insurer may have subrogation claims arising from payments to its insured.

Insurer Claims in Bankruptcy Case - Cont.

An Insurer Acting as Creditor Must File a Proof of Claim

- Section 501(a) allows, but does not require, creditors to file proofs of claim.
- In order to participate in any distributions from the bankruptcy estate, an insurer must have an allowed claim.
- Pursuant to Section 502, a proof of claim is deemed allowed unless a party in interest files an objection.
  - Objection to the proof of claim results in the commencement of a “contested matter” in which the merits of the claim may ultimately be decided by the bankruptcy judge in trial.
- Whether to file a proof of claim may involve strategic decisions by the insurer regarding whether to subject itself to the jurisdiction of the bankruptcy court.

Claims of Creditors Seeking to Recover Insurance

- Bankruptcy courts will usually grant a creditor relief from the automatic stay to initiate a lawsuit naming the Debtor as a nominal defendant for the purpose of collecting ***solely*** from insurance proceeds.
- To the extent that a creditor seeks to recover from property of the estate, including insurance proceeds, they creditor must have an allowed claim.
  - This includes mass tort cases where the claims against the Debtor are likely to exceed the insurance limits. In such cases, the recovery and distribution of insurance proceeds will probably be administered within the bankruptcy case or a trust established pursuant to the bankruptcy plan.
- The discharge injunction does not preclude an action naming the debtor as a defendant in an action to collect on the debtor's insurance policy. *In re Beeney*, 142 B.R. 360 (9th Cir BAP 1992); *Arreygue v. Lutz*, 116 Wash.App. 938, 69 P. 3d 881 (2003).
- Filing a proof of claim in the bankruptcy case is not required to proceed against the debtor's insurer. *Hawxhurst v. Pettibone Corporation*, 40 F3d 175 (7th Cir.1994).

Creditor Claims - Cont.

Filing a proof of claim may be preclusive

- The Bankruptcy Court's allowance (including a "deemed allowance" pursuant to Section 502(a)) or disallowance of a claim is a final judgment for the purposes of res judicata. *In re Los Gatos Lodge, Inc*., 278 F. 3d 890, (9th Cir., 2002); *Siegel v. Federal Home Loan Mortg. Corp*., 143 F. 3d 525 (9th Cir. 1998).
- Whether the Bankruptcy Court's order allowing or disallowing a claim has preclusive effect in a subsequent action to collect on the debtor's insurance policy probably turns on whether the order was based on the merits of claim and the level of the involvement of the insurance company in the bankruptcy case. *See Wolkowitz v. Redland Ins. Co*., 112 Cal. App.4th 154 (2003) (holding that the bankruptcy court's allowance of an uncontested claim without an evidentiary hearing is not binding on the insurer and insurer had no obligation to appear and object to the claim).

Resolution of Insurance Disputes in Bankruptcy

Litigating Insurance Disputes with the Debtor: Where and When?

- Insurance coverage issues may lead to high stakes, "bet the company" litigation in large, multi-party bankruptcy cases. This is particularly true in mass tort cases where the potential insurance recoveries present the largest asset available to creditors.
- Coverage actions to declare rights in insurance policies may be brought by the Debtor or the insurer in the bankruptcy court.
- Insurers are often wary of the Debtor's "home court" and would prefer a perceived friendlier forum. *See In re United States Brass Corp.,* 110 F.3d 1261 (7th Cir. 1997).
  - Insurers often invoke mandatory or permissive abstention doctrines to avoid determination of insurance rights by the bankruptcy court. *See* 28 U.S.C. 1334(c).
  - Insurers may seek to have district court withdraw the automatic reference to the bankruptcy court. *See* 28 U.S.C. § 157(d).

Resolution of Insurance Disputes in Bankruptcy - Cont.

Insurance Settlements

- Standards for insurance settlements are governed by Section 363 and Rule 9019 and will be approved when settlement is "fair and equitable" and "in the best interests of the estate." *See In re A&C Properties,* 784 F.2d 1377 (9th Cir. 1986).
- Settlement may provide for "**coverage in place**" wherein the insurer agrees to continue coverage and disputes such as indemnification obligations and defense costs are resolved. In a coverage in place settlement, the insurer will retain control over the defense of claims.
- **Policy buyback** settlements occur when the insurer "buys back" the policy in exchange for releases and extinguishment of future coverage responsibilities. This involves a full monetary settlement of all coverage issues in exchange for a free and clear sale order approved pursuant to Section 363(f). *See In re General Motors Corp.*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009).

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Insured Transactions in Bankruptcy

Lessons Learned: Trade Credit Insurance and Reinsurance

- Trade Credit Insurance – insurance for a lender against risk of non-payment
- Trigger may be buyer default
- Post-default recoveries reduce insured loss
- There are ways that a bankruptcy can be structured that could ultimately disadvantage the primary insurer and reinsurer.
- For instance, if an insured's counterparty becomes a debtor in bankruptcy where the insured has a security interest in the debtor we've witnessed ways in which the insured can work with the debtor and consent to the structuring of the bankruptcy resolution to preserve a full limits claim.
- The insurer and reinsurer may not have standing in the bankruptcy to object, but should monitor the bankruptcy and work closely with insured's bankruptcy counsel.

Insured Transactions in Bankruptcy

Example

- Insured is lender to “Acme”
- Insured notifies trade credit insurer of default and attempted work-out with Acme
- 6 months later, insured notifies insurer that work-out unsuccessful; Acme has filed for bankruptcy; owes Insured $ 60m
- Insured makes claim under the policy – full policy limits ($ 45m)
- Insurer knows (and reinsurers eventually find out) that the insured received proceeds of sale of Acme in bankruptcy - $ 61m
- Yet insured says the $ 61m sale proceeds is not sufficient to cover the “DIP Financing” that it provided to Acme in the bankruptcy, thus the $ 45m insured loss is unaffected (no recovery)
- How can this be?

Insured Transactions in Bankruptcy

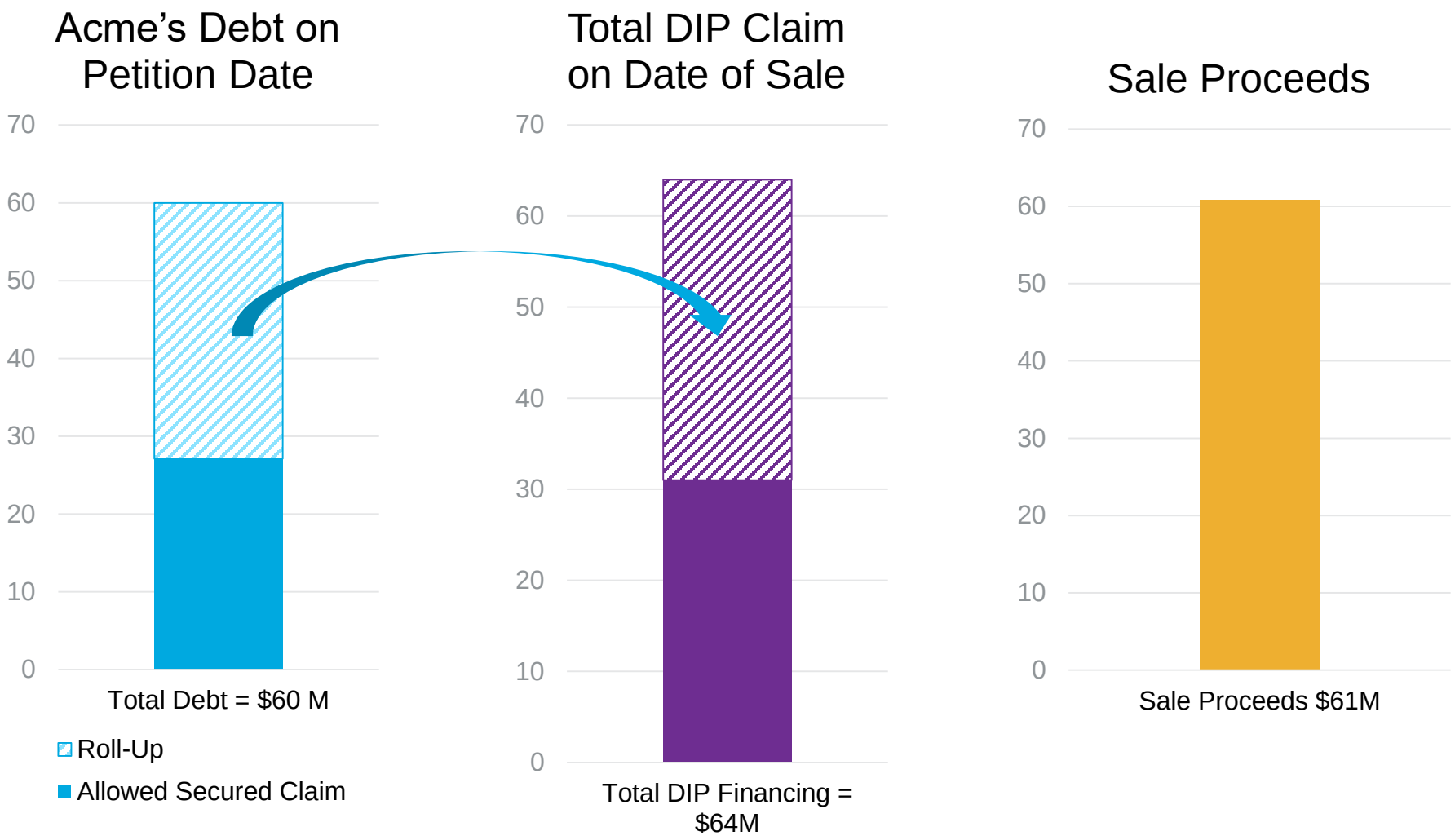
What happened?

- On Petition Date, Acme filed a motion for an order approving a Settlement Agreement between it and Insured whereby:
  - Insured receives a pre-petition secured claim of $27,000,000
  - Insured agrees to act as a Debtor-in-Possession (“DIP”) Lender, in which capacity Insured would provide essential financing to allow Acme to, among other things:
    - fund its ongoing operations;
    - fund the marketing and sale of Acme’s assets;
    - pay obligations owed to Creditors; and
    - pay amounts necessary to enable Acme to cure defaults under its agreements with the Insured.
- With no objections, and indeed with the consent of the Insured, the Court approved the Settlement Agreement one month after filing.

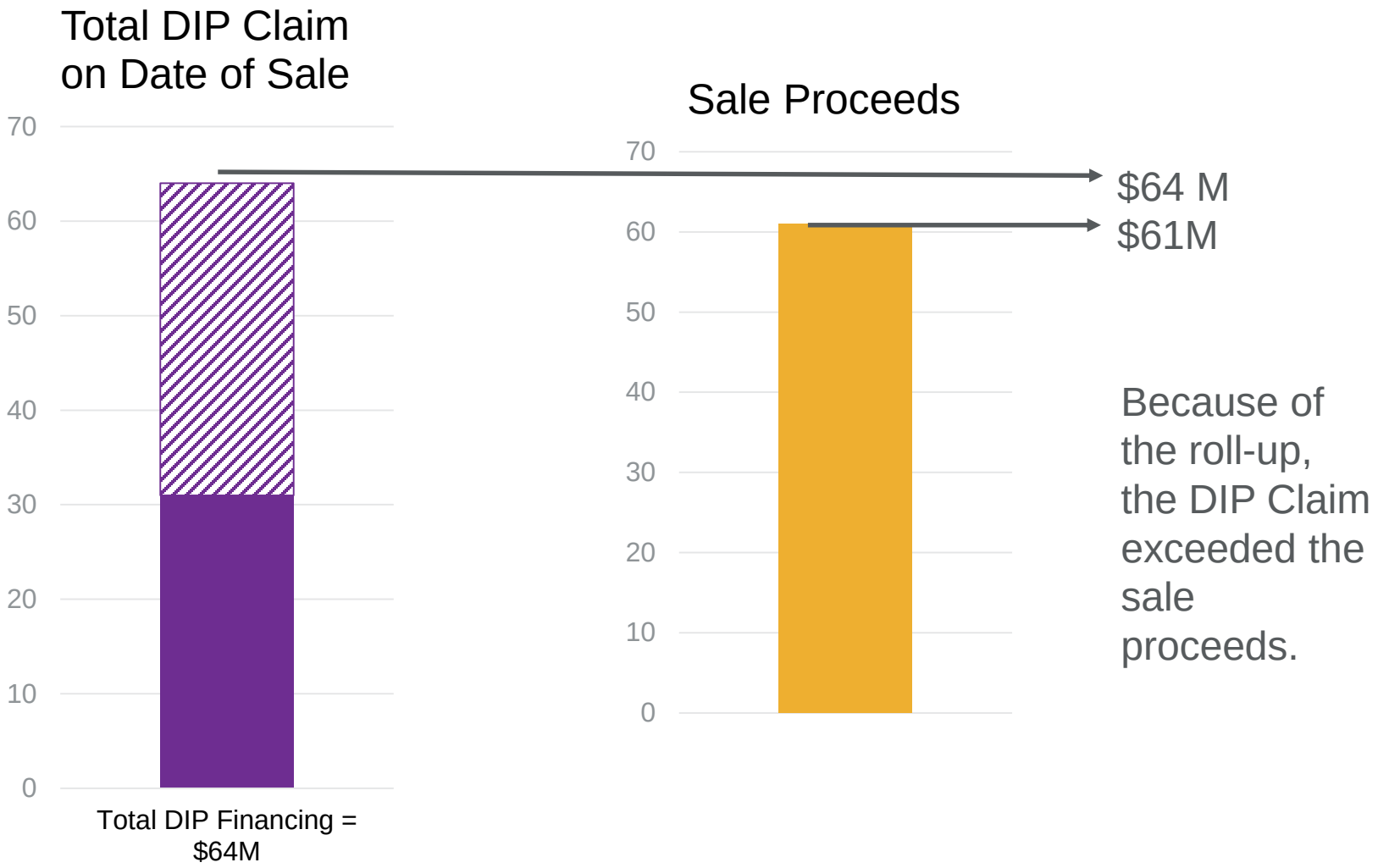
Insured Transactions in Bankruptcy

- Months later, Acme is sold for $ 61m.
- DIP Financing = $ 64m.
- DIP Lender Claims have super-priority status over pre-petition secured claims.
- Insured as DIP Lender receives the $ 61m.
- $ 0 attributable to the $ 27m pre-petition secured claim.
- Through complicated series of maneuvers, a portion of Acme's pre-petition obligations were "rolled up" into the DIP Lender Claims

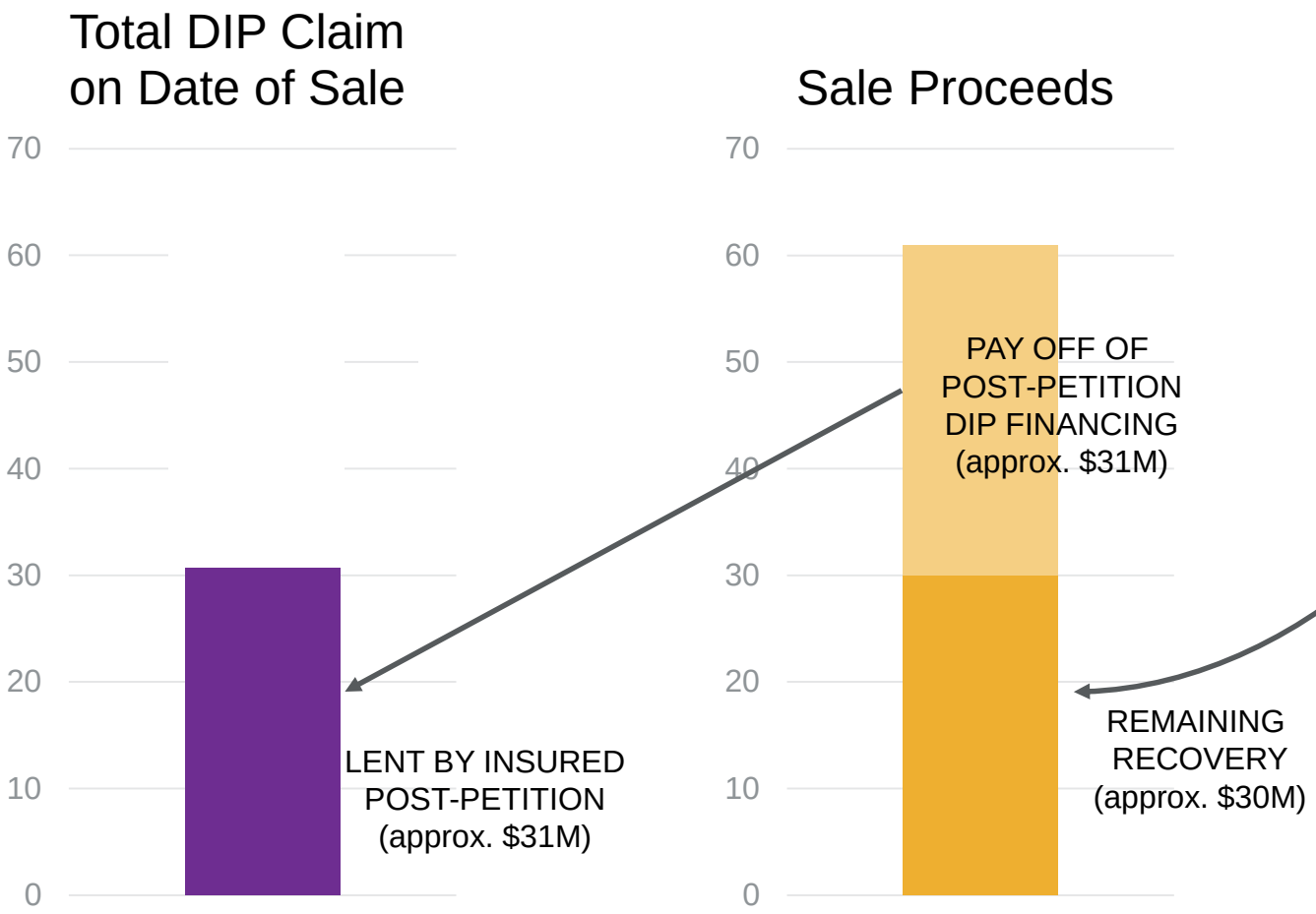
Effect of the Roll-Up Scheme



The Roll-Up Scheme Allowed Insured to Artificially Inflate the Insured Loss



Insured's Recovery Allocation Without Roll-Up



Without the roll-up, nearly $30 million would have remained after paying the DIP Claim.

Insured Transactions in Bankruptcy

- A priming DIP financing is only available as a last resort when the debtor is unable to obtain any other type of financing and the holders of existing liens consent or the debtor can demonstrate that secured creditors are adequately protected.
- Insured was Acme's sole secured lender.
- As sole secured lender, consented to priming of its own security interests.

Insured Transactions in Bankruptcy

- The Primary Insurer and/or the Reinsurers could have taken a number of actions to prevent the roll-up scheme from prejudicing them, including:
  - asserting a breach of the Trade Credit Insurance Policy and thereby pressuring the Insured not to carry out the roll-up scheme;
  - negotiating with the Insured to ensure that the roll-up amount would continue to be deemed pre-petition debt for insurance purposes;
  - bringing the facts before the Bankruptcy Court, which may not have allowed the roll-up if it had known about the Primary Insurer's and the Reinsurers' interests; or
  - providing an alternate method of financing without prejudicing the Primary Insurer's or the Reinsurers' interests.
- **Lesson Learned**: If an insured transaction ends up in default and bankruptcy is likely, the insurers and reinsurers should retain sophisticated bankruptcy counsel to closely monitor and work with insured's bankruptcy counsel to protect their interests.

QUESTIONS AND ANSWERS