Threats to Insurers

By John C. Kilgannon

The Policyholder Just Filed For Chapter 11—Now What?

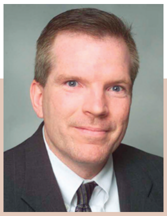
Claims managers and coverage counsel alike often find themselves in a quandary after an insured files for bankruptcy protection. While the bankruptcy filing may initially be viewed as a positive development insofar as it causes a temporary stay of pending litigation against the policyholder, insurers face significant risks that must be addressed during the course of a bankruptcy proceeding. The relationship between insurer and insured depends on a reciprocal set of rights and obligations embedded in most commercial liability policies. Those rights and obligations are structured to accomplish the common objective of limiting exposure on any tendered claim. However, that relationship can be upended during the bankruptcy process.

Indeed, if an insurer fails to take appropriate action in a bankruptcy case, its ability to enforce its contractual rights and to ensure that the insured's corresponding contractual obligations are satisfied may be eviscerated. Under that scenario, an insurer could be forced into the untenable position of being required to defend and indemnify claims without the ability to control the defense of them or to compel the insured/debtor to cooperate in the defense. Further, when one or more insurance policies are the most significant asset in a bankruptcy proceeding, the insurers must be prepared to resist efforts by the insured and claimants to expand the scope of coverage beyond that which is available under the four corners of the policy.

The purpose of this article is to examine briefly the various threats to insurers that may arise over the course of a corporate policyholder's bankruptcy case. As discussed below, critical policy provisions may become degraded or impaired unless an insurer implements protective measures.

The Insurance Policy

To appreciate fully these bankruptcy-related threats, a brief review of the fundamental terms found in most commercial liability policies is warranted. Insurance policies include contractual rights and corresponding contractual obligations. To ensure that an insured assists in the defense of tendered claims, standard policy terms impose certain contractual obligations on the



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insured. Those obligations include a duty to cooperate in the defense of claims. Among the components of the duty of cooperation is an insured's obligation (1) to provide the insurer with notice of any claims for which coverage is sought; (2) to assemble and preserve documents relating to such claims; and (3) to provide deposition or trial testimony or both in support of any defense. Insureds also have contractual obligations (1) to obtain the insurer's consent to the assignment of any policies; (2) to refrain from making voluntary settlements or assuming obligations; (3) to assist in the enforcement of any rights of contribution or indemnity; and (4) to continue to satisfy any payment obligations such as retrospective premiums, deductibles, or self-insured retentions.

Another key policy term that is often implicated in bankruptcy cases is the anti-assignment provision. The underlying purpose of this provision is to ensure that the risk factors that an insurer considered when the policy was issued remain constant throughout the term of the policy. In other words, anti-assignment provisions intend to protect insurers from involuntary assignments to a new entity that has increased risk factors beyond those that were originally intended when a policy was issued and the premiums were negotiated. As discussed below, although most insurance policies contain anti-assignment provisions, debtors frequently attempt to assign policies, policy proceeds, or both in bankruptcy cases without an insurer's consent.

An insurer's primary contractual obligations are to indemnify and defend the insured for covered claims. Insurers are typically vested with the contractual right to control or to associate in the defense of tendered claims. At bottom, insurance policies are structured to allow an insurer to control the investigation, defense, and settlement of any covered claims because, ultimately, it is the insurer who will be called upon to pay any covered claims.

The Bankruptcy Code Automatic Stay

If an insurer has assumed the defense in any litigation that was commenced against an insured before the insured filed for the bankruptcy, there is no question that the Bankruptcy Code automatic stay offers some protection for an insured and, in turn, the insurer. The automatic stay provision in 11 U.S.C. §362(a) prevents commencement or stops continuation of litigation against a debtor when the debtor files a bankruptcy petition. This statutory injunction, which takes effect immediately and automatically upon the bankruptcy filing, is designed to provide a debtor with a temporary "breathing spell" from creditor actions. The respite from litigation is intended to afford a debtor the opportunity to develop a plan of reorganization to facilitate its exit from bankruptcy or otherwise provide for an orderly liquidation of its assets.

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However, in many instances, the automatic stay is not permanent, and an insurer must be poised to protect its interests if and when a stay is terminated. Indeed, claimants rarely sit idly by and allow their claims to be divested through the bankruptcy process in exchange for a de minimis distribution from the bankruptcy estate. Under the Bankruptcy Code, claimants may seek relief from the automatic stay to commence or continue to prosecute litigation in a non-bankruptcy forum. To obtain this relief, a claimant must establish that "cause" exists to grant relief from the automatic stay. Among the factors considered in determining "cause" are whether (1) any great prejudice to the bankruptcy estate will result from continuation of the litigation; (2) the hardship that the creditor will experience from maintaining the stay outweighs the hardship that the debtor will experience; and (3) the creditor has a probability of success on the merits. *See generally*, *Matter of Rexene Products Co.*, 141 B.R. 574, 577–78 (Bankr. D. Del. 1992). Often a claimant and debtor/insured will stipulate that it will not oppose a motion for relief in consideration for the claimant's agreement to waive any direct recovery against the debtor and to limit the recovery to the extent of any available insurance proceeds. In such instances, an insurer must be prepared to continue to defend the claims in a non-bankruptcy forum and should evaluate any defenses that may arise by virtue of the insured's cooperation with the claimant. *See*, *e.g.*, *US Bank v. Federal Insurance Company et al.*, 2011 WL 6154998 (8th Cir. Mo. Dec. 13, 2011) (holding that an agreement that released the insured from liability in exchange for the insured's agreement to stipulate to assign certain claims vitiated the insurer's coverage obligations because no "loss" occurred under the policies).

Further, while the imposition of the automatic stay offers some short-term benefits to both an insurer and an insured, it may also become a burden to an insurer that wishes to terminate an insurance policy after a bankruptcy filing. Indeed, insurers may be precluded by the automatic stay from canceling the policies when insureds fail to pay premiums or commit other defaults. If an insurer does so, that may be deemed as violating the automatic stay and could potentially subject the insurer to sanctions imposed by the bankruptcy court. As such, when an insurer wants to terminate a policy that remains in effect after a bankruptcy filing, prudence dictates the filing of a motion for relief from the automatic stay to secure authorization from the bankruptcy court to cancel the policy in accordance with its terms. It is also important to note that policy provisions that purportedly authorize an insurer to cancel an insurance policy if the insured files for bankruptcy protection—known in bankruptcy parlance as ipso facto clauses—are not enforceable in bankruptcy proceedings.

Lastly, the automatic stay may also be deemed to prohibit an insurer from advancing defense costs relating to any tendered claim. While bankruptcy practitioners continue to debate whether insurance proceeds constitute property of the bankruptcy estate subject to the automatic stay, the best practice for insurers is to seek authorization from the bankruptcy court before advancing defense costs. *See In re*

MF Global Holdings Ltd., 2012 WL 1191892 (Bankr. S.D.N.Y. 2012) ("the courts are in disagreement over whether the proceeds of liability insurance policy are property of the estate."). Doing so avoids potential liability for violating the automatic stay and eliminates the risk that advancement of such defense costs will not be credited against the aggregate policy limits. Insurers should also exercise similar discretion before making any payments on account of any judgments or settlements that are entitled to coverage. Indeed, because most policies include aggregate limits, in the event that there are competing claims against a finite pool of insurance proceeds, bankruptcy courts will want to ensure that those proceeds are distributed in an equitable pro rata fashion. Insurers should make sure that they don't unilaterally elect which claimants will receive payments. Again, an insurer's best course of action would be to seek approval from the bankruptcy court before paying adjudicated or settled claims that a policy might cover.

Asset Sales

One of the most significant developments in corporate bankruptcy practice over the past decade has been the increasing frequency with which companies use bankruptcy proceedings to sell company assets. This "363 sale," named after the provision of the Bankruptcy Code that authorizes it, allows a selling debtor to transfer the sale assets to the purchaser free and clear of liens, claims, and encumbrances. *See* 11 U.S.C. §363(f) (authorizing sale of property "free and clear of any interest in such property"). By immunizing the purchaser from all of the seller's liabilities (other than those that the buyer expressly assumes), the bankruptcy sale process offers obvious advantages over sales conducted outside of bankruptcy. Thus, an insurer may become involved in bankruptcy proceedings when an insured proposes to sell substantially all of its assets to a third party.

Insurers have a number of significant risks to manage in 363-sales settings. Among other things, the asset purchase agreement and related documents that govern the terms of the sale must be scrutinized closely to determine whether the debtor proposes to assign any insurance policies to the buyer in contravention of the anti-assignment provisions in the policies. While some sale agreements are ambiguous regarding the proposed treatment of insurance policies, others expressly state that the sellers assign the policies, the insurance proceeds, or both to the buyers. If an assignment is effectuated, an insurer will confront the very situation that anti-assignment provisions intended to prevent: the insurer will be forced to deal with a stranger to the insurance policy. Then the insurer does not have assurances that the third-party assignee will adhere to the terms and conditions of the policies and the insurer will have to assume coverage exposure that was not originally contemplated when the insurer issued a policy. Further, the insurer may be forced to address claims tendered under the same policy by both the original insured, which arose before the assignment, and the assignee. Other sale agreements contemplate the assignment of liquidated insurance proceeds that may be payable in connection with an adjudicated claim. These assignments may put the insurers in the untenable situation of determining whether the insurers should pay the proceeds to the insureds or to the purchasers.

> Insurance companies must ensure that court-approved procedures are consistent with the terms of their policies and preserve any coverage defenses in the event that these rights are not honored.

In sum, asset sales create a number of pitfalls, and insurers must take affirmative steps to (1) clarify a debtor's intentions regarding insurance policies; and (2) address the potential ramifications arising from the assignment of policies, proceeds, or both.

Court-Approved Claims Resolution or ADR Procedures

Often an otherwise financially healthy company is forced to file for bankruptcy as a means to protect it from an onslaught of mass tort or personal injury claims. Perhaps the most common example in recent history arose from the explosion of asbestos litigation. Since the early 1980s, many companies facing hundreds, if not thousands, of asbestos claims filed across the country sought bankruptcy protection to create a centralized forum to marshal insurance assets and establish streamlined procedures to liquidate and satisfy the multitude of claims. In many of those Chapter 11 cases, the debtors established trust distribution procedures that created court-approved mechanisms to, among other things, (1) evaluate the merits of the claims; (2) establish procedures either to adjudicate or consensually resolve the claims; (3) assign dollar values to the claims; and (4) ultimately satisfy the claims with insurance proceeds. While the asbestos bankruptcies appear to have trailed off over the years, other mass tort settings have adopted claims resolution or ADR procedures.

The common element among these procedures is that they rarely if ever are constructed so that they honor an insurer's contractual right to control the investigation, defense, and settlement of possibly covered claims or require the debtor/insured to comply with its obligation to cooperate with the insurer in the defense of these claims. Instead, these procedures typically vest the debtor/insured, or a third party such as a trustee, with the exclusive right to object to and ultimately resolve claims that insurance may cover. In short, an insurer, which ultimately is expected to pay the claims, is completely excluded from the claims resolution process in contravention of the express terms of most, if not all, commercial liability policies. To combat this significant impairment of contractual rights, insurance companies must ensure that court-approved procedures are consistent with the terms of their policies and preserve any coverage defenses in the event that these rights are not honored.

Recovering Monetary Obligations Due Under Policies Issued to Debtors

Insurers must likewise preserve their rights to recover monetary obligations due to them under policies issued to a debtor/insured. Examples of such obligations may include policy premiums, self-insured retentions, or deductibles. In most bankruptcy proceedings, a claims bar date will be established. The bar date is the deadline by which all creditors must file proofs of claims detailing, among other things, the amounts owed by a debtor and the factual basis of the claim. Additionally, a deadline for administrative expense claims, which relate to claims arising after the bankruptcy filing and for which the claimant may receive payment in full, as opposed to a pro rata distribution, may also be established during the course of a Chapter 11 case. Failing to file appropriate claims by established bar dates and other deadlines may preclude insurers from recovering on these claims, from asserting rights or setoff or recoupment, or a combination of these.

It is also important to recognize that payments received from the insured within the 90-day period before the insured files for bankruptcy may be subject to avoidance. Debtors, and other parties acting on behalf of the bankruptcy estate, are authorized to avoid and recover preferential payments made to parties during the 90-day window preceding a bankruptcy. These clawback lawsuits are often commenced at the conclusion of bankruptcy cases by debtors or trusts that are established pursuant to a confirmed plan of reorganization. In these actions, a debtor, or its representative, commences an adversary proceeding against the recipient of the payment seeking to avoid and recover the payment for the benefit of the bankruptcy estate. Defendants facing "preference actions," referred to as "preference defendants," do have recourse in this process. Indeed, the Bankruptcy Code outlines several affirmative defenses that may be invoked to avoid preference liability. *See generally*, 11 U.S.C. §547 (c)(1); 11 U.S.C. §547 (c)(2); 11 U.S.C. §547 (c)(4).

The Conflict Between Policy Terms and Chapter 11 Plans of Reorganization

Perhaps the biggest threats that insurers must navigate in Chapter 11 proceedings arise from plans of reorganization. The "Chapter 11 reorganization plan" is the vehicle that enables a debtor to exit bankruptcy. In effect, the plan serves as a contract between a debtor and its creditors that governs their business relationship and specifies the recovery that creditors will receive if the bankruptcy court confirms the plan. A number of provisions embedded in most Chapter 11 plans will permanently impair an insurer's contractual rights and relieve a debtor/insured of its contractual obligations. In light of these significant concerns, an insurer must act to ensure that it avoids the untenable situation of having to honor contractual obligations to continue to indemnify and defend a debtor/insured while losing the ability to enforce the insured's reciprocal contractual obligations.

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Claims Resolution Procedures

For example, Chapter 11 plans typically vest a debtor with the *exclusive* right to object to resolve claims that insurance may cover. Often, particularly regarding smaller claims, a debtor is not required to seek court approval of a settlement between the debtor and claimant. This effectively excludes the insurer from the claims adjudication process altogether and, in addition to impairing its contractual right to control the investigation, defense, and settlement of claims, may require the insurer to satisfy settled or adjudicated claims. The insurer loses the ability to ensure that an appropriate and vigorous defense is asserted against such claims and may be forced to satisfy meritless claims that the tort system would have dismissed. Further, insofar as a bankruptcy court has sanctioned this settlement process under a court-approved plan of reorganization, the sanctioned plan would jeopardize an insurer's ability to raise coverage defenses to counteract these impaired contractual rights.

Discharge and Injunction

Furthermore, Chapter 11 plans of reorganization include expansive discharge and injunction provisions that effectively discharge and enjoin any claims against a debtor in consideration for a distribution under the plan. These provisions present a significant risk to insurers in that they may relieve a debtor/insured from its non-monetary obligations, such as the duty of cooperation, as well as from monetary obligations that the debtor owes to the insurer under an insurance policy. Again, when a plan of reorganization does not include language that either affirms the debtor/insured's commitment to adhere to the insurance policies, either by assuming the policies or expressly agreeing to remain bound by their terms, these discharge and injunction provisions would convert the policy into a one-sided arrangement that would relieve the debtor insured of all obligations, and an insurer would remain obligated to defend and indemnify.

Substantive Consolidation

When several related companies file for bankruptcy, the related entities may file a joint Chapter 11 plan that substantively consolidates the various entities. In other words, the debtors are treated as a single entity, and all of the debtors' assets and liabilities are aggregated for purposes of structuring distribution to creditors. Substantive consolidation presents a unique risk to insurers. Indeed, even when the policies involved do not name all of the debtors as insureds, substantive consolidation presents the risk that an insured still must satisfy claims against a debtor that was not a named insured under the insurer's policy.

Acceleration of Indemnification Obligations

Insurers must also be mindful of legal precedent that could have a dramatic effect on insurers' coverage obligations. Indeed, several courts have held that confirmation of a Chapter 11 plan authorizes the acceleration of an insurer's indemnification obligations even though the underlying claims for which coverage was sought were not adjudicated on the merits. In analyzing these cases, it is important to remember that insurance policies are contracts of indemnity that require an insurer to indemnify the policyholder for amounts paid to settle a claim, with the insurer's consent, or to satisfy a judgment after a trial. Historically, Chapter 11 debtors, and other parties seeking to access insurance proceeds, have attempted to use the Chapter 11 plan of reorganization confirmation process to alter these contractual principles.

For example, in *UNR Industries, Inc. v. Continental Cas. Co.*, 942 F.2d 1101 (7th Cir. 1991), one of the first mass asbestos bankruptcy cases, the plan of reorganization created a trust to liquidate and pay asbestos claims. The plan proponents, which included the debtor and representatives of the asbestos claimants, fixed the value of the asbestos claims in the plan at $254 million. After the bankruptcy court confirmed the plan, the plan proponents argued that the plan constituted a "settlement" or "judgment" that obligated insurers to pay that inflated amount without any independent coverage determination or adjudication of the underlying claims. Significantly, the United States Court of Appeals for the Seventh Circuit held that the plan was tantamount to a judgment or settlement against the debtor/insured for $254 million on the asbestos claims. *Id.* at 1104–05. ("This bankruptcy reorganization was a judgment or settlement and so triggers [the insurer's] insurance obligations"). The court ruled that the valuation of claims was binding on the insurer because it had the opportunity to participate in the confirmation proceedings.

An equally notorious bankruptcy case that is well known to insurance counsel is *Fuller-Austin Insulation Co. v. Highlands Ins. Co.*, 135 Cal. App. 4th 958, 38 Cal. Rptr. 3d 716 (2d Dist. 2006). In *Fuller-Austin*, the insured negotiated a prepackaged bankruptcy, known as a "pre-pack," with representatives of most of the asbestos claimants before it filed for bankruptcy protection. The pre-pack included claims resolution procedures that required the bankruptcy court to determine the aggregate amount of both existing and future asbestos liabilities. Certain of the insurers objected to the plan and asserted that they were entitled to participate in the bankruptcy case as well as the claims valuation proceedings. Afterwards, the debtor/insured revised the plan to include an "insurance neutrality" provision that all claims and defenses of the insurers would be unaffected by the plan and that all rights and obligations would be determined in a related coverage action. Based on those revisions, the bankruptcy court ruled that the insurers lacked standing to participate in the bankruptcy proceeding. *Id.* at 971.

> Several courts have held that confirmation of a Chapter 11 plan authorizes the acceleration of an insurer's indemnification obligations.

After the plan was confirmed, the parties resumed a coverage action that was pending when the bankruptcy case was filed. In that action, the insured took the position that the confirmed plan was a final adjudication that established the insured's liability to the asbestos claimants and obligated the insurers to pay the full liquidated value of the asbestos claims. *Id.* at 972. Incredibly, it took that position despite the representations that it made in the plan regarding the reservation of the insurers' rights. The coverage court agreed with the insured and ruled that the bankruptcy proceedings, from which the insurers were excluded, constituted an actual trial, or at a minimum a settlement, of the insured's liability. *Id.* Perhaps even more disturbing was the trial court's conclusion that the liabilities established under the confirmed plan triggered coverage under the insurance policies. Fortunately for the insurers, most of the trial court's holdings were reversed on appeal. *Id.* at 1006.

While commentators have widely criticized both *UNR* and *Fuller-Austin*, acceleration remains a significant concern. Whether in the context of claims resolution procedures or a Chapter 11 plan, insurers must be aware of the risk that an insured or a claimant may raise an argument that an insured's liability, and in turn the insurer's coverage obligations, were adjudicated in the context of the bankruptcy proceeding and that the insurer is obligated to pay the estimated or accelerated liability. *Id.*

Liquidating Chapter 11 Plans

In some situations a Chapter 11 debtor will transition to liquidation mode for a variety of reasons. In these cases, a debtor may file a plan that would liquidate of all of the debtor's assets completely and distribute the proceeds of those assets to creditors. Often, a liquidating trust is established to facilitate this process after the plan is confirmed. The liquidating plan may also assign insurance policies, insurance proceeds, or both to a trust. Based on such assignments, the liquidating trustee may seek to secure coverage under the assigned policies and use the recoveries from those assigned policies to pay claims against the debtor

To be sure, insurers face a number of pitfalls when a debtor/insured commences liquidation proceedings. First and foremost, if an insured goes out of business and terminates its employees, an insurer may have a difficult time securing the insured's cooperation in defending claims. For that matter, unless protective measures are taken, the insurer may not even have the ability to receive notice of any claims that may be entitled to coverage. Indeed, after the company "goes dark," there will be no employees available to assist the insurer in investigating the factual basis and defenses to any claims, assemble relevant documents, or provide testimony to support a defense. Nor will the insurer have a way to ensure that the insured preserves relevant documents.

In short, failing to act during the confirmation process may compel an insurer to defend claims, and ultimately indemnify an insured, even though the insured (1) has ceased operating, (2) has failed to preserve relevant documents; and (3) has failed to retain employees or any representatives with knowledge of relevant facts who could testify in the defense of those claims.

Chapter 7 Proceedings

A Chapter 7 proceeding is the alternative to the corporate Chapter 11 case. The chief distinction between these types of proceedings is that a Chapter 7 proceeding simply liquidates a debtor's assets. Immediately upon filing a Chapter 7 petition, a debtor's business operations cease, and a Chapter 7 trustee is appointed to marshal the debtor's assets and liquidate any unencumbered assets for the benefit of the debtor's creditors.

As with liquidating Chapter 11 cases, Chapter 7 proceedings present significant obstacles that insurers must navigate. In Chapter 7 cases, an insured will close its doors and terminate its employees. Thus, if there are any pending claims for which coverage was sought, or if claims arise in the future, there is no "insured" available to perform the contractual obligations under the policies. Employees will not be available to provide notice of claims to the insurer or assemble relevant documents that are crucial to the defense of the claims. Nor are there employees readily available to provide background information or testimony at trial. While the Chapter 7 trustee may agree to perform some of these functions, or at least retain documents, his or her knowledge of the factual history of the entity in general, and the tendered claim in particular, will be very limited. Indeed, the insurer may find that a stranger to the policy—the Chapter 7 trustee —would tender claims for coverage but would not have a contractual obligation to cooperate in the defense of those claims.

Conclusion

Without question a policyholder's bankruptcy filing dramatically alters the relationship between an insurer and the insured. Insurers, acting in concert with bankruptcy counsel, must remain vigilant throughout the bankruptcy process—from the date of the bankruptcy filing through confirmation of the plan of reorganization—to protect their contractual rights and ensure that policyholders remain bound to perform their contractual obligations. Failing to take appropriate action will expose an insurer to the significant risk that the insurance policy will be converted into a one-sided agreement leaving the insurer bound to defend and indemnify tendered claims without the insured's assistance and cooperation. IDQ