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Eighth Circuit Opinion Provides Potential New Coverage Defenses to Claims Asserted Against Bankrupt Insured

by John Kilgannon

When an insured files for bankruptcy protection, coverage counsel and claims handlers alike will often cringe at the notion of adjudicating claims in an unfamiliar, and often hostile, territory. There is no question that a bankruptcy proceeding can significantly amplify the risks faced by an insurer when defending an otherwise garden variety claim. However, insurers rarely appreciate that a bankruptcy filing can present a unique set of opportunities that are not available outside of the bankruptcy forum.

A compelling example of such opportunities can be gleaned from a recent decision from the United States Court of Appeals for the Eighth Circuit: *U.S. Bank National Association v. Federal Insurance Company, Old Republic Insurance Company, National Union Fire Insurance Company of Pittsburgh, Twin City Fire Insurance Company, XL Specialty Company, RLI Insurance Company*, Case No. 10-3472, --F.3d--, 2011 WL 6154998 (8th Cir. Mo. Dec. 13, 2011). The analysis adopted in the *US Bank* opinion may present insurers with expanded coverage defenses with respect to claims asserted against bankrupt insureds. While the viability of the defense will ultimately depend upon the terms of the subject policy, and controlling state law, insurers would be well advised to closely analyze this case and consider its applicability in any bankruptcy proceeding filed by its policyholder.

In many Chapter 11 bankruptcy proceedings, a claimant will seek relief from the bankruptcy court to prosecute its claims against the debtor in a non-bankruptcy forum. In the instances where the debtor may have insurance coverage for such claims, it has become commonplace for debtors and claimants to enter into a stipulation granting the claimant relief from the automatic stay[i] to prosecute its claims against the debtor. The *quid pro quo* for such cooperation is that the

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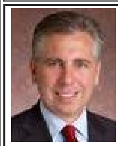

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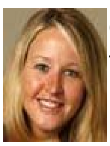

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claimant is required to limit any recovery obtained against the debtor to the extent of any available insurance proceeds. In other words, the claimant agrees to waive its right to directly recover against the debtor and the bankruptcy estate.[ii] More often than not, insurers will assume a passive role in this process and will simply be content to defend such claims once they are pursued in the non-bankruptcy forum. These stipulations are routinely approved by the bankruptcy courts as consensual agreements among the parties.

Facts In *US Bank*

The *US Bank* opinion arises out of the *Interstate Bakeries Corporation* ("Interstate")[iii] bankruptcy proceeding. Interstate, which produces *Twinkies* and *Wonder Bread*, filed for bankruptcy protection in 2004 after it suffered financial difficulties caused by accounting problems and the growing popularity of low-carb diets. In December, 2008, Interstate confirmed a chapter 11 plan of reorganization (the "Plan") and subsequently emerged from bankruptcy protection.[iv] The Plan provided for the creation of a creditors' trust ("Trust") to liquidate certain assets and to disburse the proceeds of such assets to creditors. Significantly, to fund the Trust, Interstate assigned certain claims against one of its officers, Paul Yarrick ("Yarrick"),[v] in exchange for the Trust's agreement to limit its recovery against Yarrick to any insurance proceeds that may be available under director and officer policies that named Yarrick as an insured. Stated another way, the Trust agreed to release the Interstate debtors from liability and waived any rights to seek to satisfy such claims from Yarrick's personal assets. This assignment was approved by the Bankruptcy Court as part of the Plan confirmation process.

Once this assignment of rights was consummated, the Trust commenced a lawsuit against Yarrick. Yarrick, in turn, tendered the claims to Federal Insurance Company ("Federal") which had issued a $25 Million primary D&O insurance policy ("Policy") that identified him as a named insured. Federal denied coverage for several reasons. The coverage defenses that were at the heart of the Eighth Circuit's holding were based on a strict construction of the Policy and how the Policy defined covered losses. Specifically, Federal asserted that the Policy defined "loss" to mean the "total amount which any Insured Person becomes *legally obligated to pay* on account of each Claim and for all Claims in each Policy Period…"[vi] Under this provision, Federal argued that the pre suit assignment effectuated under the Plan completely shielded Yarrick from the potential obligation to pay any future judgment in favor of the Trust. As such, there would be no compensable loss within the meaning of the Policy and hence, no insurance coverage. Federal bolstered this defense by citing an endorsement in the Policy that excluded from the definition of covered "loss" any amount "not indemnified by the Insured Organization for which the Insured Person *is absolved from payment by reason of any covenant, agreement or court order."*[vii]

After reviewing Federal's defenses, Yarrick entered into a mediated settlement agreement with the Trust that resulted in a $56 million stipulated judgment.[viii] The evidentiary record did not identify the basis for the $56 million figure other than a

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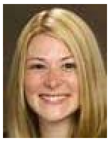

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statement in the settlement agreement that the amount was reasonable. The Trust reiterated in the settlement agreement that it would not seek to satisfy the judgment against Yarrick, or his personal assets, and would limit its recovery to available insurance proceeds. Thereafter, the Trust commenced a coverage action against Federal, and several excess insurers, seeking to recover the amount of the stipulated judgment.[ix] The insurers moved to dismiss the Trust's Complaint based on the above-referenced coverage defenses relating to the definition of covered loss under the Policy.[x] At the trial court level, the District Court held that the agreements absolving Yarrick from personal liability precluded any finding that a covered loss arose under the terms of the Policy. Significantly, in reaching this conclusion, the District Court observed that if the definition of loss had not included the language "absolved from payment by reason of any covenant, agreement or court order" it may have found that coverage was available.

Eighth Circuit Concludes No Coverage Available

The Eighth Circuit affirmed the District Court's opinion. The Court observed, as a threshold matter, that there was a split of authority as to whether an insured is "legally obligated to pay" an amount covered by an agreement not to execute against an insured. The opinion cites divergent case law on the issue of whether agreements not to execute against the insured should be interpreted as releases wholly eliminating the insured's legal obligation to pay or simply contracts providing the insured the right to sue in the event of an attempted execution. The Court went on to highlight Eighth Circuit

precedent that held that an agreement not to execute against an insured eliminated the insurer's legal obligation to pay and removed the dispute from coverage.[xi]

At bottom, the Eight Circuit's analysis hinged on the specific language in the Policy that excluded from the definition of "loss" an amount "not indemnified by the Insured Organization for which the Insured Person is absolved from payment by reason of any… agreement." Under the plain meaning of the Policy, the Court concluded it was clear that Yarrick was "absolved from payment" by virtue the terms of the assignment. In sum, the Court held that because the assignment effectively absolved Yarrick from payment, the $56 million judgment was not a *loss* that would trigger Federal's indemnification obligation as required by the plain language of the Policy. In sum, the net result of the release contained in the Plan in favor of the Interstate Debtors, and the *US Bank* Court's opinion absolving the insurers, was that the Trust was apparently left with an uncollectable $56 million judgment.

Conclusion

While the facts in *US Bank* were rather unique, a question arises as to whether the coverage defenses raised by Federal will have broader applications in the context of the claims asserted in bankruptcy proceedings. To be sure, *US Bank* provides insurers with an opportunity to broaden the scope of their coverage defenses in such situations. Indeed, a strong analogy can be drawn between the assignment of claims in *US Bank* with the typical stipulation for relief from the automatic stay in chapter 11 proceedings discussed above. In both instances, the insured/debtor, and the bankruptcy estate, are absolved from liability for the underlying claim. Indeed, the claimant waives its right to recover its claims against the debtor's assets and arguably the insured/debtor in that context is "absolved from payment" by reason of the stipulated judgment.

Accordingly, an argument can be made that stipulated motions for relief may vitiate otherwise available insurance coverage under *US Bank's* rationale. Of course, the viability and strength of the argument hinges upon, among other things, the language of the applicable insurance policy and governing state law. Nevertheless, insurers faced with defending claims in coverage court following stipulated motions for relief from the automatic stay should give serious consideration to this innovative defense and discuss its applicability with bankruptcy counsel.

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[i] Under section 362 of the United States Bankruptcy Code, a bankruptcy filing triggers an automatic stay that shields the debtor from litigation; however, creditors may seek relief from the automatic stay to liquidate their claims against the debtor.

[ii] In light of the paltry distributions that are usually made to unsecured creditors in most Chapter 11 proceedings, claimants do not consider such waivers to be a significant sacrifice. Similarly, Chapter 11 debtors typically take the position that if the claimant agrees to release its right to recover directly against the debtor, it has nothing to lose by agreeing to grant the claimant relief from the automatic stay.

[iii] *In re Interstate Bakeries Corporation, et al.,* United States Bankruptcy Court for the Western District of Missouri, Case No. 04-45814 (Jointly Administered).

[iv] Regrettably, at the time this article was being drafted, the Interstate debtors filed a second Chapter 11 proceeding, a so-called "Chapter 22," in the United States Bankruptcy Court for the Southern District of New York.

[v] The Trust alleged that Yarrick's "misdeeds" while an officer of Interstate indirectly caused Interstate to incur approximately $170 Million in losses which precipitated Interstate's financial demise.

[vi] Emphasis supplied.

[vii] Emphasis supplied.

[viii] Notably, inasmuch as this settlement apparently occurred without the insurer's consent, an argument can be made that the settlement was a "voluntary settlement" which is traditionally prohibited under the terms of most insurance policies. The Trust countered this position by arguing that Yarrick was an abandoned insured who, as a matter of law, was entitled to enter into the settlement agreement to protect himself from judgment after having been informed by Federal that there would be no coverage or defense. This argument was rejected by the Court on the grounds that Missouri state law precludes an insured from asserting the abandonment theory to secure coverage where it does not otherwise exist under the policy.

[ix] The excess policies which provided sequential layers of coverage issued by the other

defendants provided a total of $85 Million in coverage. The excess policies were allegedly "follow the form" policies; hence, no party drew a distinction between the language in the Policy and the excess policies.

[x] Federal also argued that:(i) the underlying wrongful actions did not fall within the policy period covered by the Policy; (ii) the claim by the Trust, standing in the shoes of Interstate, was in reality a claim by Interstate against its own officer, which was barred as a claim by an insured against an insured; and (iii) the assignment of the claim to the Trust violated the anti-assignment provisions in the Policy.

[xi] Interestingly, the Eighth Circuit precedent referenced by the *US Bank Court* was governed by Iowa state law where the Eighth Circuit made an "Erie guess" as to how the Iowa Supreme Court would rule. Several years later, the Iowa Supreme Court rejected the Eighth Circuit's prediction and found that coverage is available notwithstanding an agreement not to execute. Although Missouri law governed the facts in *US Bank*, the Court explained that it was not required to predict how the Missouri Supreme Court would rule in light of the specific language in the exclusion.

Back...