By Suzana K. Koch

When an Insurance Policyholder Is in Bankruptcy

When an insured files for protection under the Bankruptcy Code, there are many questions that can arise, especially if there is a claim made during the bankruptcy proceeding. This article will address some of the common issues confronting policyholders who have filed for bankruptcy protection.

Policies Become the Property of the Bankruptcy Estate

When a company files a petition for relief under the Bankruptcy Code, the company's assets become part of the bankruptcy estate. An insurance policy is property of the bankruptcy estate, even if the policy has not matured, has no cash value or is otherwise contingent. However, depending on state law and also who is named as the insured, the proceeds of the insurance policy may not be property of the bankruptcy estate. For example, a lender could be a named insured (if that is required by the company's loan documents), and in that case, the lender would be entitled to the proceeds.

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Payment of Premiums

After a company subjects itself to bankruptcy court jurisdiction by filing the petition for relief, its assets and liabilities are determined as of the filing date. The determination of responsibility for premium payments largely depends on consideration of whether such premiums are due pre-petition or post-petition.

- Did the policy term expire pre-petition but have retrospective premiums due? The debtor's failure to pay retrospective premiums may not be enough to excuse an insurer's performance in this type of instance. A debtor/insured's post-petition breach of contract for failure to pay does not void the insurer's obligations under the insurance policy.
- Does the policy expire post-petition, but before any reorganization plan has been filed and confirmed? Under these types of circumstances, an insurance policy can be considered an executory contract that a debtor in bankruptcy can assume or reject.
- Is the policy term still ongoing with standard premium payments due? If the debtor does not pay the premiums when and as due, the insurer may be able to cancel the policy.

Deductibles and SIRs

A deductible or self-insured retention (SIR) is the amount that an insured is responsible to pay under the policy for a covered claim. In a bankruptcy case, the debtor's inability to pay the deductible or SIR does not excuse the insurer from paying the claims under the policy. Instead, to the extent that the insurer has advanced costs that should have properly been paid by the policyholder as a deductible, the insurer would then have a bankruptcy claim against the insured debtor for the amount of the deductible. If it is a post-petition claim, it could be allowed as an administrative expense and has a much better chance of being repaid in full. If it is a pre-petition claim (an injury or claim that arose pre-petition), then regardless of when the insurer pays the claim and the deductible, the insurer will only have a general unsecured claim.

Bankruptcy courts have found insurers to be liable for obligations to defend and indemnify insured debtors to the extent that claims covered under the policy exceed the SIR. Insurers may attempt to require actual payment of SIR amounts, but if the debtor includes its obligation in its reorganization plan, bankruptcy courts may consider the SIR to be "satisfied." Bankruptcy courts have also consistently held that the failure of a bankrupt insured to pay an SIR will not excuse the insurer's performance under the insurance policy. Insurers may argue that they have no obligation to defend any actions or pay any claims until the debtor actually pays the SIR, but if a debtor in bankruptcy is incapable of funding a SIR, the inclusion of the SIR amount in a reorganization plan is enough to trigger the insurer's obligations.

However, in 2005, the U.S. District Court for the Western District of Texas reversed just such a bankruptcy court order.[1] In the *Pak-Mor* bankruptcy case, the plain language of the insurance policy led the district court to conclude that the language in the policy stated as "clear as daylight" that none of the insurer's obligations would attach or arise unless or until the insured paid the SIR. The district court reasoned that to require the insurer to cover the claim just because it writes liability insurance generally would be an injustice. However, the district court noted that the best approach is on a case-by-case basis in questions regarding whether or not an SIR must be exhausted by payment in order for the

1 *Pak-Mor Mfg. Co. v. Royal Surplus Lines Ins. Co.*, No. SA-05-CA-135-RF, 2005 WL 3487723 (W.D. Tex. Nov. 3, 2005).

insurer's duty to arise. Each court must examine the precise text of the policy before it.

Courts in other states have distinguished the *Pak-Mor* case based on the precise language of the insurance policies, as well as applicable state laws and public policy concerns, to prevent an insurer from avoiding indemnity obligations where an SIR has not been paid by a bankrupt insured. Courts in Louisiana, Indiana, Illinois and other states have generally found the public policy concerns to be strong enough to override policy language to the extent that an insured is obligated to perform under the insurance policy when the amounts of those obligations exceed the SIR. Consideration of state law is an often-reviewed theme in insurance coverage matters.

Insured vs. Insured

The bankrupt debtor, unless a trustee is appointed, is in possession of the bankruptcy estate. The debtor in possession (DIP) controls the estate's property, including its legal claims, and it is the DIP who has the legal obligation to pursue claims or to settle them based on the best interests of the estate. Insurance policies generally exclude coverage for claims brought by one insured against another insured, like claims against directors and officers brought by the company or on behalf of the company.

In the case of a bankrupt debtor, when claims are brought by a DIP, an official committee of unsecured creditors or a trustee, the exclusion can get murky, as the courts are split. Some courts have held that there is a sufficient identity between the pre-petition debtor and the post-petition DIP (or committee or trustee) that such claims fall within the exclusion. Other courts have disagreed because they find that the estate, committee or trustee (the "noninsured entities") are a separate legal entity distinct from the insured pre-petition debtor. In addition, the noninsured entities owe a duty to the creditors of the debtor's estate, not to the debtor itself, and noninsured entities have been found to be sufficiently adverse to the officer and director defendants that claims do not raise the appearance of collusion that otherwise might arise if the claims were brought by the insured. The analysis in making determinations on insurance coverage exclusions is highly fact-specific and depends on the language in the insurance policy.

Insurance Policy Buybacks

Insured policyholders and insurers can enter into an agreement whereby the insurer "buys" its insurance policy back, otherwise called a "buyback agreement." These buyback agreements can operate as a type of settlement in an insurance coverage dispute. The insurer offers the insured a lump sum in exchange for an agreement to annul or cancel the insurance policy, typically after there has been a loss or some other policy-triggering event.

There are variations on that general theme where, for example, there could be an environmental carve-out and only the environmental piece is bought back, leaving the remainder of the insurance policy in place. The same can be done with other specific policy exclusion items such as litigation. However, in the case of a whole policy buyback, the insurance policy itself is either cancelled or rescinded. The mutual release of the rights of the parties is sufficient consideration for the buyback agreement.[2]

Policy cancellations are prospective only and do not extinguish liabilities that have already accrued, and policy rescissions are retroactive.[3] There are obvious public policy concerns if there has been a policy-triggering event and claims have been made, and then efforts are made to rescind the insurance coverage on a retroactive basis. Some states have enacted statutes that attempt to limit retroactive buyback agreements. These state laws can pre-empt federal bankruptcy law in such a way as to derail a debtor's efforts to reorganize or liquidate in an orderly fashion.

In bankruptcy, debtors have looked to buyback agreements as a source of funding for distributions pursuant to plan confirmation and/or liquidation. In the case of *Caribbean Petro Corp.*, one of Caribbean Petro's litigation co-defendants objected to the use of insurance policy buyback funds for creditors other than those who were tort claimants.[4] Caribbean Petro filed its bankruptcy petition following an enormous fire and explosion that resulted in personal injuries and property damage at its Puerto Rican facility. Caribbean Petro's insurer bought back its insurance policy for $24 million, a settlement that was approved by the bankruptcy court. In the fire-related litigation, one of Caribbean Petro's co-defendants was Intertek USA Inc.

Intertek objected to the buyback settlement after the order was entered approving the buyback agreement and after the plan and confirmation order were entered. Intertek argued, in part, that Puerto Rican statutes required that the $24 million could only be distributed to the personal-injury claimants, not any other general unsecured creditor, as the plan allowed. Intertek argued that Puerto Rico is a direct-action jurisdiction, so proceeds of liability policies do not become property of the estate (and thus, are available to general creditors), but must be paid on behalf of the insured.

The bankruptcy court decided the issue on the lateness of Intertek's objection, holding that the provisions of a confirmed plan bind the debtor and each creditor. The bankruptcy court went so far as to cite *In re Bryant:*[5] Even a plan that could not be confirmable due to provisions that do not conform to applicable law will be given effect if an objection is not raised prior to entry of the confirmation order. Had Intertek been more timely, the outcome could have been very different for the debtor.

There is a similar cautionary tale in the *Allied Products* bankruptcy case, wherein state law intervened.[6] Allied Products entered into a buyback agreement as part of its liquidation, but the injured parties were not originally given notice of the global buyback settlement at the bankruptcy court level. After the bankruptcy judge ordered notice, several claimants objected, in part based on the grounds that the buyback proceeds were intended for the general use of the estate, rather than for the payments of claims that are covered by the policies, as required by state law. The bank-

2 *In re SeaQuest Diving LP*, 579 F.3d 411 (5th Cir. 2009).
3 *See, e.g., Douglass v. Nationwide Mut. Ins. Co.*, 913 S.W.2d 277, 279 (Ark. 1996).
4 *In re Caribbean Petro. Corp.*, No. 10-12553(KG), 2013 WL 950361 (Bankr. D. Del. March 11, 2013).
5 *In re Bryant*, 323 B.R. 635, 639 (Bankr. E.D. Pa. 2005).
6 *Allied Prods. Corp. v. ITT Indus. (In re Allied Prods. Corp.)*, No. 03-C-1361, 2004 WL 635212 (N.D. Ill. March 31, 2004).

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ruptcy court agreed, but on appeal, the district court held that Illinois state law maintains the interests of a debtor in an insurance contract by preventing an insurer from terminating or modifying such rights and, by extension, the rights of the parties whom the insured has injured. State law played a key role in the denial of Allied Product's motion to sell its insurance policy.

After significant personal-injury litigation arising from the sale of consumer gas cans, Blitz U.S.A. Inc. filed its chapter 11 petition in November 2011.[7] Following a sale of substantially all its operating assets in July 2012, Blitz entered into a buyback agreement with its insurers. The sale of the insurance policies back to the insurers was proposed to be free and clear of all liens, claims and encumbrances. The proceeds of the sale would be used, in part, to fund a trust for personal-injury claimants, and the terms surrounding this settlement would be conditioned upon the entry of a bankruptcy court order confirming the plan.

7 *In re Blitz U.S.A. Inc.*, No. 11-13603 (PJW), 2014 WL 2582976 (Bankr. D. Del. Jan. 30, 2014).

In the *Blitz* case, the insurers paid more than $137 million. The parties spent more than a year in mediation, which involved the majority of the personal-injury claimants as well as the official unsecured creditors' committee, provided ample notice in a transparent process, and offered much in the way of testimony and evidence in support of the buyback agreement. As a result, the Blitz plan was confirmed, providing a certain pool of funds for recovery in a situation where the many and varied layers of insurance coverage could have made recovery very difficult and tenuous.

Coverage determinations when an insured has filed for bankruptcy protection are case-specific. The intersection of bankruptcy and insurance issues can be complex, as evidenced by the examples in this article. Understanding key complex coverage issues on the state law level, as well as its interplay with the Bankruptcy Code, can mean the difference between a successfully and unsuccessfully confirmed plan. abi

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