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Do "Insured vs. Insured" Exclusions Apply to Assignees in Assignments for the Benefit of Creditors?

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"Insured vs. insured" clauses in corporate insurance policies have received a good deal of attention recently in bankruptcy cases. Insured vs. insured clauses are exclusions that preclude directors' and officers' insurance coverage when the dispute is between the corporation and its directors or officers. These exclusionary clauses became prominent after a wave of litigation in the 1980s in which corporations attempted to recoup operational losses by filing claims against the director & officer policies.[3] Thus, insured vs. insured exclusions are commonly thought to serve the purpose of preventing collusive litigation that results in insurance companies making up for a company's operational losses.[4]

For a reasonably healthy company that is operational, the insured vs. insured exclusion is perfectly easy to understand. But what happens when the company runs into financial trouble (or, as we have seen in recent years, the company is doomed by the misdeeds of its insiders) and enters into some form of formal insolvency proceeding? Is the person responsible for conducting the liquidation or rehabilitation of that business, whether it be a bankruptcy trustee, receiver or assignee for the benefit of creditors, an "insured" under the exclusion, or is that person sufficiently distinct such that any harm done to the company by its directors or officers is covered by the insurance policy?

The law is not completely settled, but the emerging rule is that the exclusion does not apply to bankruptcy trustees.[5]

In an early decision on the insured vs. insured issue, the court in *Reliance Insurance Co. v. Weis*[6] presented what is now the minority view in bankruptcy. In *Reliance Insurance,* an entity called the plan committee was designated by the debtor's chapter 11 liquidation plan to effectuate the liquidation. After an investigation, the plan committee's representative commenced an action against former officers of the debtor, alleging breach of fiduciary duty and negligence, and seeking recovery of more than $50 million in actual and punitive damages. The former officers' insurer, Reliance, filed a declaratory judgment action on the question of whether the litigation was excluded from coverage. Examining the language of the policy, the liquidating plan and the Bankruptcy Code, the court concluded: "For purposes of this litigation, there is no significant legal distinction between [the debtor] and the bankruptcy estate."[7] The Eighth Circuit Court of Appeals affirmed the *Reliance Insurance* case without opinion.[8] The Eleventh Circuit similarly affirmed a lower-court decision that reached the same conclusion.[9]


Geoffrey L. Berman

The majority of courts have since disagreed with the *Reliance Insurance* holding, recognizing that there are important legal distinctions between bankruptcy debtors and the trustees charged with the administration of those debtors' estates. In *Reiser v. Baudendistel (In re Buckeye Countrymark Inc.),*[10] where the chapter 7 trustee filed a complaint against the debtor's former directors along similar lines as in *Reliance Insurance,* the court stated:

> First and foremost, a bankruptcy trustee is a separate legal entity that neither represents the debtor nor owes the debtor a fiduciary obligation. Instead, the trustee's responsibility is to the bankruptcy estate that he or she represents. As such, the trustee and the debtor often take adversarial positions. In these respects, the trustee and the debtor are neither the same entity nor alter egos of each other.[11]

The court in *Cohen v. National Union Fire Insurance Co. (In re County Seat Stores Inc.)*[12] echoed the reasoning expressed in the *Buckeye Countrymark* case, adding that

> It is exactly this status of the trustee as a statutory invention, with powers that far exceed those of a corporation or debtor-in-possession, that affords him dissimilar treatment from that afforded others, including debtors-in-possession. Simply stated, a bankruptcy trustee charged with a statutory duty and endowed with special statutory powers is an independent and disinterested entity, separate and distinct from the debtor as well as the pre-petition company, and as such does not strictly "stand in the shoes" of the debtor. Nor does he assume the identity of the debtor.[13]

In addition, the policy behind insured vs. insured exclusions—preventing collusive lawsuits—is not implicated when a bankruptcy trustee pursues causes of action against the debtor's pre-petition officers and directors.[14]

As stated, the *Buckeye Countrymark* and *County Seat Stores* cases represent what is emerging as the majority rule in bankruptcy cases.[15] Moreover, these bankruptcy decisions are in accord with a line of cases from the analogous context of insolvent banks and federal FDIC receivers. The majority of courts considering whether an

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3 *See, e.g., Township of Center v. First Mercury Syndicate,* 117 F.3d 115, 119 (3d Cir. 1997).

4 *See, e.g., Level 3 Communications Inc. v. Fed. Ins. Co.,* 168 F.3d 956, 958 (7th Cir. 1999). The *Level 3 Communications* court noted a second purpose of the insured vs. insured exclusion; in addition to those that are collusive, the exclusion serves to prevent "suits arising out of those particularly bitter disputes that erupt when members of a corporate, as of a personal, family have a falling out and fall to quarreling." *Id.*

5 There is some authority that chapter 11 debtors-in-possession (DIPs) are also outside the scope of the insured vs. insured exclusion. *See Cigna Ins. Co. v. Gulf USA Corp.,* 1997 U.S. Dist. LEXIS 23816 (D. Idaho Sept. 11, 1997). The DIP, however, presents a much closer call than the trustee, because if pre-petition management continues to operate the debtor, the possibility of a collusive suit is present.

6 148 B.R. 575 (E.D. Mo. 1992).

7 *Id.* at 583.

8 *Reliance Ins. Co. v. Weis,* 5 F.3d 532 (8th Cir. 1993).

9 *Nat'l. Union Fire Ins. v. Olympia Holding Corp.,* 148 F.3d 1070 (11th Cir. 1998), *aff'g., without opinion, Nat'l. Union Fire Ins. v. Olympia Holding Corp.,* 1995 U.S. Dist. LEXIS 22369 (N.D. Ga. Sept. 18, 1995).

10 251 B.R. 835 (Bankr. S.D. Ohio 2000).

11 *Id.* at 841 (citations omitted).

12 280 B.R. 319 (Bankr. S.D.N.Y. 2002).

13 *Id.* at 326 (citations omitted). Because the *County Seat Stores* court views a trustee's powers as exceeding those of a DIP, one could argue that the court would give an insured vs. insured exclusion full force in chapter 11 cases in which no trustee has been appointed. There are no decisions citing *County Seat Stores* in this regard, however, and there is some authority that a chapter 11 DIP is sufficiently distinct from the pre-petition debtor so as to remove the former from the insured vs. insured exclusion. *See, e.g., Cigna Ins. Co. v. Gulf USA Corp.,* 1997 U.S. Dist. LEXIS 23816 (D. Idaho Sept. 11, 1997).

14 *Sphinx Int'l. v. Nat'l. Union Fire Ins. Co.,* 226 F. Supp. 2d 1326 (M.D. Fla. 2002), takes a more detailed look into whether collusive purpose must be shown or, on the other hand, whether the exclusion would be inoperative in other, non-collusive circumstances. A collusive suit by a chapter 7 bankruptcy trustee is highly unlikely, but the issue could arise in chapter 11 when the company continues to operate as a DIP.

15 *See, also, Alstrin v. St. Paul Mercury Ins. Co.,* 179 F. Supp. 2d 376 (D. Del. 2002) (following *Buckeye Countrymark*); *Gray v. Exec. Risk Indem. Inc. (In re Molten Metal Tech. Inc.),* 271 B.R. 711 (Bankr. D. Mass. 2002); *Hurley v. Columbia Gas Co.,* 297 F. Supp. 268 (D. Del. 1997) (denying declaratory judgment on applicability of insured vs. insured exclusion because identity of plaintiff was unknown); *Pintlar Corp. v. Fidelity and Cas. Co. (In re Pintlar Corp.),* 205 B.R. 945 (Bankr. D. Idaho 1997) (exclusion not applicable to trustees of litigation trust).

Suggested Reading

Clear Proof

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Dutch Colson is a private eye who has moved with his wife Lauraine to the Upper West Side of Manhattan: he to establish his practice, she to become the executive chef of a new restaurant. In ABI member **David Paul Miller**'s new novel, *Clear Proof,* Dutch narrates for us the tale of his three-year involvement with Robbie Lawrence and his family. Robbie is profligate, spoiled and rich. His family consists of his mother; his father, a successful Midwestern urologist; his mother's second husband Raoul Sank, a French general and author; Gen. Sank's son Henri, who has been adopted by Robbie's mother thereby becoming Robbie's half step-brother; and Marie, the Broadway actress with whom both Robbie and Henri share a physical and perhaps romantic relationship. This is not your average dysfunctional American family unit.

David Peress

Dutch's story begins with the news that Gen. Sank has been murdered, thrown off a subway platform into an oncoming train. Dutch had previously come into contact with Gen. Sank when he was retained by Robbie's father to sort out a spat between Robbie and his stepbrother that threatened to get Robbie expelled from college. Robbie is indicted for the murder and turns to Dutch to help him and his lawyer sort out the facts. Dutch undertakes the assignment and in the process becomes a sort of surrogate parent and guardian angel for Robbie.

Bad luck seemingly follows Robbie and his family. Following his acquittal in connection with Gen. Sank's murder, Robbie's father is killed in a mysterious boating accident, and later Robbie's mother dies when she falls from her hotel room window. In each case, Dutch is called upon to uncover the evidence that exonerates Robbie—or does it? Is Robbie an unwitting victim of circumstance, or does he bear a more nefarious connection to these events?

As a narrator, Dutch is spare in his use of adjectives. His narrative style is to simply relate the various facts and events as they unfold and become known to him. He lets readers decide for themselves what the motivations of the various players are. Mr. Miller, through Dutch, is at his best when relating the details of the various trials that follow each untimely death. Dutch repeats all of the key testimony, evidentiary rulings, motion practice, jury instructions and eventual verdicts. Reading Dutch's description of each trial, I felt as if I was watching a time-compressed replay of a trial on "Court TV."

Befitting a novel written by an ABI member, Robbie's troubles are not limited to being the prime suspect in several homicides. He also manages to bankrupt himself and ends up being indicted for bankruptcy fraud for failing to disclose a preferential transfer to a loan shark. At one point in the novel, Dutch observes: "He (Robbie) was a weasel, a selfish brat, a threat—not a solution—to his creditors. Life was a game, a bowl full of cherries about to turn rotten." Ultimately, Robbie becomes a threat to Dutch as well.

Mr. Miller's novel is an engaging read. In the tradition of other private investigator noir novels, Dutch's narration is spare and concise. One might hope for a little more character development and analysis on the motivations of the players in Robbie's world. Perhaps Dutch views analysis of that sort as being the reader's responsibility. His responsibility is to provide the clear proof. We are provided the opportunity to act as the jury and thereby charged with the responsibility for providing our own answers concerning the motivations of the victims and the accused. ■

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law will stand as an obstacle to the reorganization. Under this analysis, implied preemption may not be effective to override state law unless compliance would make the reorganization impossible. Outside the Ninth Circuit, debtors will press for a broader standard of express preemption under §1123, but they should be prepared to address the policy questions inherent it trying to reconcile federal bankruptcy law and competing state regulation. ■

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insured vs. insured exclusion applies to FDIC receivers have answered in the negative.

That the FDIC receiver does not merely "stand in the shoes" of an insolvent bank has been recognized at law for half a century.[16] Like the bankruptcy trustee, the FDIC receiver is imbued with statutory powers not held by the insolvent bank, and its interest in a suit against officers and directors is genuinely adverse, thus falling outside of the need for protection against collusive suits. As the court in *American Casualty Co. v. Sentry Fed. Sav. Bank*[17] summarized: "The weight of opinions concerning 'insured vs. insured' exclusions in the receivership context side with the *American Casualty* cases and the *Branning* decision by allowing coverage when receivers sue the former directors and officers of a failed institution."[18]

Given the authority developed in the analogous contexts of bankruptcy trustees and FDIC receivers,[19] the logical question is whether the same result should be obtained when an insolvent corporation elects to use state law to effect its liquidation and enters into an assignment for the benefit of creditors (ABC). Credible arguments exist on either side of the issue, but, deriving from the bankruptcy and FDIC cases,[20] the correct answer appears to be that the exclusion does not apply.

The controversy lies in the fact that an ABC assignee is simultaneously a creature of statute and contract. On the one hand, an assignment for the benefit of creditors is just that—an assignment, and assignments generally are matters of contract. It is black-letter law that an assignee succeeds to no greater rights than those held by the assignor. An ordinary contract assignee is undoubtedly bound by insurance policy exclusions, including insured vs. insured clauses. The plaintiff in *Niemuller v.*

16 *American Casualty Co. v. FDIC,* 713 F. Supp. 311 (N.D. Iowa 1988), *citing D'Oench, Duhme & Co. v. FDIC,* 315 U.S. 447 (1942).

17 867 F. Supp. 50 (D. Mass. 1994).

18 *Id.* at 59, *quoting* Palmore, Melanie K., "Insured vs. Insured Exclusions in Director and Officer Liability Insurance Policies: Is Coverage Available when Chapter 11 Trustees and Debtors-in-possession Sue Former Directors and Officers?," 9 Bankr. Dev. J. 101, 118 (1992).

19 Although beyond the scope of this article, it should be noted that there is a corollary body of caselaw with respect to "regulatory exclusions" and FDIC receivers. Although there is some disagreement among the courts, most appeals courts that have addressed the validity of regulatory exclusions have held that they are enforceable. *See Id.* at 53-54.

20 Obviously federal law does not control state court decisions, but it is certainly appropriate to use federal law as persuasive precedent in a jurisdiction that has not addressed the issue or to present a good-faith argument that controlling authority is either distinguishable or wrongly decided. Such use of persuasive precedent is actively encouraged in some courts. *See, e.g., Blonder v. Cumberland Eng'g.,* 71 Cal. App. 4th 1057, 1061 (1999) (state preference statute should be interpreted in accordance with analogous Code §547).

National Union Fire Insurance Co.[21] tried without success to convince the court that a contrary result was warranted. As the *Niemuller* court stated:

> The extant case before me, in contrast [to the FDIC cases], involves ordinary assignees who are continuing an action brought by their assignors. As noted previously, and in no way undermined by the regulatory case cited by *Niemuller,* ordinary assignees have neither independent claims nor any greater rights than their assignors.[22]

However, an ABC assignee is not an "ordinary" assignee. Here, again, the *Niemuller* decision is instructive:

> The primary and determinative distinction between the entities involved in [the FDIC] cases and the assignees in the instant case is that the assignees in the cases noted by plaintiff are statutorily created entities charged by federal or state law with the obligation to pursue certain claims, including claims of other interested parties such as creditors. Thus, the rights and claims brought by these statutory entities are not analogous to those of an ordinary assignee.[23]

But for the fact that an ABC assignee is created by contract, this description seems to apply with full force to assignments for the benefit of creditors, particularly in states where the procedure is largely governed by statute and supervised by the courts.[24] Even in states such as California, where there are few statutory provisions expressly governing assignments and court involvement is minimal, ABC assignees are afforded rights not generally available:

> Specifically, the [ABC] assignee usually has the rights of a lien creditor under Uniform Commercial Code §9-301 [now §9-309], so that unperfected security interests fail against the rights of the assignee. Additionally, some states give an assignee the right to void writs of attachment and temporary protective orders granted within the 90 days immediately prior to the making of the assignment, separate and distinct from the ability to recover on preferential transfers. Finally, the assignee holds the property of the debtor "*in custodia legis,*" or in trust for the creditors of the estate and not for its own account.[25]

21 1993 U.S. Dist. LEXIS 18476 (S.D.N.Y. Dec. 30, 1993).
22 *Id.* at *12.
23 *Id.* at *9-10.
24 *See, e.g.,* Fla. Stat. §§727.101-727.116.

Thus, if the inquiry rests on the rights and duties of the ABC assignee, the majority lines of cases in the bankruptcy and FDIC receivership contexts seem readily applicable. From this perspective, it is clear that an ABC assignee does not merely step into the debtor/assignor's shoes and would not be bound by an insured vs. insured exclusion.

[I]t appears that whether an ABC assignee is bound by an insured vs. insured exclusion will depend on the perspective of the decision-maker.

Nevertheless, the voluntary, contractual nature of an assignment for the benefit of creditors presents a formidable argument with which the ABC assignee must reckon, as was seen in the bankruptcy case of *Terry v. Federal Insurance Co. (In re R.J. Reynolds-Patrick Country Memorial Hospital Inc.).*[26]

25 Berman, Geoffrey L., *General Assignments for the Benefit of Creditors: A Practical Guide,* 2 American Bankruptcy Institute (2000).
26 2003 Bankr. Lexis 1481 (Bankr. W.D. Va. Aug. 15, 2003).

In *Terry,* the plaintiff was administering a trust created pursuant to the debtor's confirmed chapter 11 plan, which included prosecuting claims against officers of the debtor. Although not mentioned in the decision, it is unlikely the trust was being administered for any reason other than the benefit of the creditors. In many respects, the facts of Terry are not dissimilar from those of *Reliance Insurance,* discussed above, although the *Terry* court did not specifically indicate whether the plan transferred all of the debtor's assets with an intended full liquidation of those assets.

In holding the insured vs. insured exclusion applicable to the plan trustee, the court focused on the contractual nature of the plan itself, and described the transfer of assets to the plan trust, the actions against the debtor officers in particular, as having been voluntarily assigned. According to the court:

> The provision in the plan that transferred any claims against [the officers] from the debtor to the trust, and the trustee, constituted a voluntary assignment of claims by contract. An assignee steps into the shoes of the assignor and takes the

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further demonstrates that the new value infusion is not warranted. After the election, the principals would have to contribute even more money than originally anticipated, since there is no more value that can be extracted from the enterprise. That additional contribution would be far in excess of any reasonable assessment of the "equity" based on the debtor's enterprise valuation.

Second, the required balloon payment at the end of three years ($4,851,450.54) far exceeds the value that could be obtained upon refinancing (.75 x $5.15 million, or $3,862,500, could be raised). The collateral would have to be worth at least $6,468,600.72 ($4,851,450.54 ÷ .75) in three years to finance such a balloon payment. The debtor would have to increase its estimate of the expected future enterprise value by more than 25 percent. Such a dramatic increase would be difficult to justify.

The debtor could propose a payment stream that might satisfy both the §1111(b) allowed claim test and the NPV test. For instance, the debtor could propose to fully amortize the secured claim over 15 years (the entire useful life of the enterprise) at a 100 percent loan-to-value ratio and argue that the interest rate should still be 11.5 percent and that the discount rate should be 11 percent. As that proposal deviates from generally accepted lending practices, however, it is not reasonable to expect that the entire enterprise risk would be imposed upon the secured claimant while, at the same time, maintaining the secured claimant's rate of return at a level corresponding to that of a standard secured obligation. Obviously, the interest rate provided would have to be increased, which would inflate the monthly plan payments. In addition, the discount rate would have to be adjusted to reflect the increased risk associated with the over-leveraged financial profile. The corrected rates would have the effect of either increasing the monthly payments beyond the debtor's ability to pay, or reducing the net present value of the payment stream such that the NPV test is not satisfied.

Conclusions

Generating and comparing the §1111(b) premium and the bifurcated claim unsecured recovery element enables a secured creditor to evaluate which recovery stream will yield the greatest economic benefit. It also reveals shortcomings in the debtor's valuation and feasibility analyses. This framework can be used to analyze variations in amortization and payout assumptions, thereby enabling the secured creditor to make the most appropriate decision regarding §1111(b) under any set of variables. Accordingly, this analysis dispels the common view that the §1111(b) election should be utilized only to capture potential appreciation in collateral. ■

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> assignment subject to all prior equities between previous parties, and his situation is not better of (sic) the assignor.[27]

The court indicated that had it appointed Terry as a chapter 11 trustee, a move that is usually accomplished over the debtor's objection, the outcome could very well have been different. Thus, in the court's view, the decisive factor was the fact that the debtor voluntarily assigned claims against the officers through a plan that the debtor itself drafted and filed. In other words and without stating so directly, the *Terry* court treated the plan as if it were a contract of assignment for the benefit of creditors.

Some of the *Terry* reasoning is flawed in certain respects. For example, the court expresses concern that the type of plan confirmed by the debtor left open the possibility of collusion, the very concern that gave rise to insured vs. insured clauses in the first place. But in this regard, the court downplayed its own power to ensure that a plan trustee is disinterested under well-established bankruptcy principles, let alone its authority to approve the proposed plan.

More important to the ABC assignee, however, is that the *Terry* decision nowhere fully examines the role the plan trustee was to play. Functionally, the plan trustee was not a mere assignee of the debtor, but was charged with the administration of assets for the benefit of creditors, a responsibility that is accompanied by a fiduciary duty to the creditors. When viewed in terms of his duties, rather than the debtor's role in his appointment, the plan trustee in *Terry* is not altogether different from the trustees in *Buckeye Countrymark* and *County Seat Stores*, and FDIC receivers.

In sum, it appears that whether an ABC assignee is bound by an insured vs. insured exclusion will depend on the perspective of the decision-maker. If the contractual nature of the assignment for the benefit of creditors is given emphasis, then the exclusion will likely apply. On the other hand, an analysis of the unique, and often statutorily mandated, duties of the ABC assignee, when contrasted with an "ordinary" contract assignee, can—and should—serve to remove the ABC assignee from the exclusion. ■

[27] *Id.* at *9.