

Bankruptcy Court Lifts Automatic Stay to Permit Insurer to Prosecute Coverage Litigation

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The United States Bankruptcy Court for the Southern District of New York has lifted the Bankruptcy Code's automatic stay to permit an insurer to prosecute coverage litigation against a debtor's directors and officers. *In re Refco Inc.*, Case No. 05-60006 (RDD) (June 20, 2006).

Wiley Rein & Fielding LLP represents the insurer in this case. The insurer, which issued an excess D&O policy to Refco prior to its filing of a bankruptcy petition, filed a declaratory judgment action seeking a determination of coverage for several suits filed against Refco's former officers and directors. It thereafter moved the bankruptcy court to lift the automatic stay to the extent it applied in order to prosecute the coverage litigation.

The insurer argued in its motion that the stay did not apply to the coverage litigation because the proceeds of the policy were not property of the debtors' estate. As support for this argument, the insurer noted that: (1) the debtors had not made or committed themselves to making payments that would implicate the policy's indemnification or entity coverages, and their interest in the proceeds of those coverages was therefore entirely theoretical, (2) even if the debtors did one day have an interest in the proceeds of those coverages, that interest was contractually subordinated by a strong priority of payments provision to the interests of the non-debtor insureds' rights under the policy and (3) the insurer was not seeking to void the policy, but, rather, only to obtain a ruling regarding the effect of certain policy terms and conditions. The insurer also argued in its motion that even if the court were to find the stay to be applicable to the coverage litigation, it should lift the stay because the prejudice to the insurer from the continuation of the stay would exceed the prejudice to debtors from lifting the stay.

The debtors and other objectors disagreed with the insurer's position with respect to whether the policy proceeds were property of the estate and whether the stay was applicable, but argued that even if the stay did not apply, the court should extend the stay to the coverage litigation pursuant to its equitable powers under section 105 of the code. In support of this argument, the debtors argued that the result of the coverage litigation could be detrimental to any future claims that the debtors might submit under the policy, and that they therefore would have to monitor the litigation, which would distract them from their reorganization efforts. The insurer argued in response to this point that the debtors could not request an extension of the stay

through an adversary proceeding but rather must commence an adversary proceeding.

The court first held that the stay was applicable to the coverage litigation: "I believe that this lawsuit, since it does seek a construction of the insurance policy as opposed to a lawsuit that deals with proceeds of the policy (which may be a closer question), is subject to the automatic stay, in that it is clear that the policy itself is property of the estate."

The court then held that cause existed for lifting the stay because the harm that would result to the insurer from a stay of the coverage litigation exceeded the harm that would result to debtors from a lifting of the stay. With respect to the harm to the insurer, the court noted that under Illinois law, which was potentially applicable in the coverage litigation, the insurer could face arguments about adverse consequences if it did not promptly challenge the rights of the debtors' directors and officers to coverage in light of the doctrine articulated in *Wausau v. Ehlco Liquidating Trust*, 708 N.E. 2d 1122, 1138 (Ill. 1999). The court also stated that it believed that settlement discussions could occur in underlying securities litigation in the near future and found that the insurer could be prejudiced in connection with those discussions if it were not permitted to pursue a prompt adjudication in the coverage litigation of the rights of the insurer and the debtors' directors and officers under the policy.

On the other hand, the court found that the harm to the debtors from a lifting of the stay was limited for several reasons. First, the court found that the debtors' direct interests under the policy were subordinated to the interests of the debtors' directors and officers by the policy's priority of payments provision. Second, the court held that because the coverage litigation was against the directors and officers and not the debtors, the result of the litigation would not be binding on the debtors through principles of *res judicata* or collateral estoppel, and would merely have a persuasive effect on any future litigation between the debtors and the insurer. Third, the court reasoned that the directors and officers were likely to defend the coverage litigation vigorously. Finally, the court found that while the coverage litigation might result in an elimination of a potential source for satisfying claims, that result would only have an "indirect" effect on the debtors' estate, an effect that was "too remote to justify the stay remaining in place." Having concluded that the balance of the harms favored a lifting of the stay, the court did not reach the insurer's argument that debtors request for an extension of the stay under Section 105 of the code was procedurally defective.