

D&O Proceeds Not Part of Bankruptcy Estate Where Policy and Discovery Periods Expire without Securities Claim Being Tendered

October 2004

The U.S. Bankruptcy Court for the Eastern District of Tennessee has held that a debtor had no interest in the proceeds of a D&O policy that provided entity coverage because the policy and discovery periods had expired without the insurer receiving any notice of a claim or demand against the debtor regarding a securities claim. *In re Medex Regional Labs., LLC*, 2004 WL 2106615 (Bankr. E.D. Tenn. Aug. 25, 2004).

The insurer issued a D&O policy to a limited liability company. The policy provided entity coverage to the company for securities claims. After the company filed for bankruptcy under chapter 11, a committee of unsecured creditors filed a complaint against the directors and officers of the company, alleging various causes of action, including breach of fiduciary duty, duty of care and loyalty, breach of contract and negligence. Upon tender, the insurer agreed to indemnify the directors and officers for their defense costs, subject to approval from the bankruptcy court. The directors and officers then filed a motion seeking a determination that the insurance proceeds were not part of the company's bankruptcy estate. Alternatively, the directors and officers argued that the insurance proceeds were excluded from the automatic stay of the Bankruptcy Code and therefore could be paid to them.

The bankruptcy court noted that "[a]lthough the courts readily agree that directors' and officers' insurance policies themselves are property of a debtor's estate, there is more discord regarding the question of whether proceeds of such policies constitute estate property." It explained that the determination as to whether the proceeds of a policy are property of the estate depends on the terms of the policy. The bankruptcy court adopted the approach of *In re Allied Digital Technologies Corp.*, 306 B.R. 505, 512 (Bankr. D. Del. 2004), concerning the treatment of D&O policy proceeds in bankruptcy. The court in that case identified four potential scenarios:

1. In cases where a policy provides only direct coverage to directors and officers, the court stated that the proceeds are not property of the estate.

2. In cases where a policy provides only direct coverage to a debtor, the court concluded that the proceeds are property of the estate.

3. In cases where a policy provides direct coverage to the directors and officers, and direct or indemnification coverage to the debtor, the court explained that the proceeds are property of the estate "if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution by providing indemnification coverage for a pending claim."

4. In cases where a policy provides the debtor with coverage, but the coverage "either has not occurred, is hypothetical, or speculative," the proceeds are not property of the estate.

The Tennessee bankruptcy court concluded that the fourth scenario applied in this case. Although the policy afforded entity coverage for securities claims, the policy period and discovery period had expired without any securities claim being made. The court therefore concluded that "the Debtor no longer enjoys any direct 'entity coverage' under the Policy. As in the *Allied Digital Technologies Corporation* case, by virtue of the adversary proceeding filed by the Committee, the Movants face 'real' defense costs, while the Debtor faces 'hypothetical' indemnification costs." The court therefore concluded that, in these circumstances, "the Policy Proceeds are not property of the Debtor's bankruptcy estate," and that insurer could therefore advance defense costs without running afoul of the automatic stay of the Bankruptcy Code.

For more information, please contact us at 202.719.7130.