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NEWSLETTER

Claims against Debtor's Former Officers Brought by Litigation Trustee Barred by Insured v. Insured Exclusion

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A Virginia Bankruptcy Court has held that an insured v. insured exclusion bars coverage for claims against the debtor's former officers made by a litigation trustee handling a trust to whom a debtor-in-possession assigned its claims against its former directors and officers. *Terry v. Federal Ins. Co., et al., (In re R.J. Reynolds-Patrick County Mem. Hosp., Inc.*) (Bankr. W.D. Va. Aug. 15, 2003).

As a part of its reorganization plan, the debtor-in-possession created a trust, to which it assigned all of its claims against its former directors and officers, and designated a trustee to manage the trust. Following confirmation of the plan, the trustee filed an adversary proceeding against two former officers of the debtor. Thereafter, the trustee notified the debtor's D&O insurer of the claim. The insurer denied coverage based on the insured v. insured exclusion, which barred coverage for all claims "brought or maintained by or on behalf of any Insured," including derivative claims brought or maintained with "the solicitation, assistance or participation" of an insured. Coverage litigation followed.

The bankruptcy court held that the insured v. insured exclusion barred coverage for the trustee's claims for two reasons. First, the court held that the claims were "brought by or on behalf of" the debtor because the trustee brought the claims as contractual assignee of the debtor. The court reasoned that the debtor voluntarily assigned its claims against its former officers through the reorganization plan and as such the trustee stood in the shoes of the debtor in suing the former officers. Moreover, the court determined that a debtor could not assign a claim to a third party to circumvent an exclusion in its D&O policy.

In rejecting the trustee's arguments, the court distinguished recent cases, such as *In re Molten Metal Technology, Inc.*, 271 B.R. 711 (Bankr. D. Mass. 2002), and *In re County Seat Stores*, 280 B.R. 319 (Bankr. S.D.N. Y. 2002), that have held that an insured v. insured exclusion does not apply to claims brought by chapter 11 trustees. The court reasoned that in those other cases, the appointment of the chapter 11 trustee and accompanying assignment of claims was involuntary and was not done for the purpose of avoiding the application of the insured v. insured exclusion. Here, by contrast, a debtor-in-possession outside the control of a trustee voluntarily assigned the claims. The court also reasoned that a chapter 11 trustee and a pre-petition debtor or debtor-in-possession are distinct entities as the former is appointed by the court and is a statutory

creation. In contrast, the trustee in the instant case was merely an assignee of a debtor-in-possession whose rights arose by virtue of the provisions of the reorganization plan. The court opined that where a debtor voluntarily assigns its claims to a third party, there is a potential for collusion between the debtor and its directors and officers, a result insurers attempt to avoid by including an insured v. insured exclusion in their policies.

Second, the bankruptcy court also held that the insured v. insured exclusion applied because the trustee's claims were brought or maintained with "the solicitation, assistance or participation" of the debtor. The court reasoned that even if the trustee was acting as the agent of the creditors and not the assignee of the debtor, there would be no coverage under the exclusion because the debtor, through the reorganization plan: (1) "solicited" the action against the former officers by creating "a legal entity to sue on behalf of the creditors" and (2) "assisted" in the prosecution of the action by voluntarily assigning the claims to the trustee.

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