

# Adelphia D&O Policies Are Property of Bankruptcy Estate; Coverage Litigation against Directors and Officers Stayed

---

November/December 2002

A New York bankruptcy court recently denied several D&O insurers' motions for relief from the automatic stay to pursue coverage litigation against Adelphia Communications Corp. (ACC) and Adelphia Business Solutions, Inc. (ABIZ). *Adelphia Comm. Corp., et al. v. Associated Elec. & Gas Ins. Servs. Ltd., et al. (In re Adelphia Comm. Corp.)*, Nos. 02-41729, 02-03282 & 02-11389, 2002 WL 31557175 (Bankr. S.D.N.Y. Nov. 15, 2002). The court also stayed the insurers' pending coverage litigation against ACC's directors and officers. The bankruptcy court, however, did grant relief from the automatic stay to five ACC directors to make a claim for payment or advancement of up to \$300,000 per insured for defense costs. As a predicate for its holdings, the bankruptcy court determined that the D&O policies at issue, which provided entity coverage for securities claims to ACC and ABIZ, and their proceeds were property of the bankruptcy estate.

In March and June 2002, ABIZ and ACC, respectively, filed voluntary petitions for relief under chapter 11. Each entity continues to operate its businesses as a debtor in possession. Subsequently, in July 2002, the U.S. Department of Justice brought criminal proceedings against five Adelphia directors for conspiracy and securities fraud. The Securities & Exchange Commission also instituted a civil action against ACC and five directors seeking disgorgement of ill-gotten gains and civil penalties. Several civil lawsuits have also been filed against ACC and its directors and officers for securities fraud. In September 2002, several directors and officers of ACC requested relief from the automatic stay to permit payment or advancement of defense costs under ACC's and ABIZ's D&O policies. Thereafter, the insurers sought to rescind the policies based on fraud as to the directors and officers of ACC and ABIZ and brought a declaratory action against them. At the same time, the insurers filed a motion in the bankruptcy proceedings seeking relief from the automatic stay "to the extent necessary" to name ACC and ABIZ as additional defendants in the declaratory action. In response, ACC filed an adversary proceeding against the insurers seeking to enjoin the further prosecution of the coverage litigation pursuant to the automatic stay or, in the alternative, pursuant to the bankruptcy court's equitable powers under Section 105(a) of the bankruptcy code.

As an initial matter, the court concluded that under the circumstances of this case the automatic stay did apply to the insurance proceeds and relief from the stay was required to draw down on these proceeds. The court first noted that the policies themselves were property of the estate. Accordingly, the court denied the insurers'

request for relief from the stay, reasoning that if the insurers were successful, "the policies they issued would come to an end and would from the perspective of the two chapter 11 estates be destroyed." The court also held that the automatic stay applied to the directors' request for access to the proceeds of the insurance policies. Although the court recognized that other jurisdictions have held that the proceeds of a D&O policy are not property of a bankruptcy estate, relying on *In re Cybermedica, Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002), the court found that the proceeds of the instant policies were property of ACC's and ABIZ's bankruptcy estates. The court reasoned that the corporations had a "material interest" in the proceeds of the D&O policies for their "own economic exposure" and that the estate is worth more with the D&O policies because the policies provided reimbursement and entity coverage to ACC and ABIZ. Moreover, the court focused on the fact that the maintenance of D&O insurance is essential to ACC's and ABIZ's attempt to reorganize because if the insurance was exhausted, then ACC's and ABIZ's ability to retain and attract directors and officers would be significantly impaired.

Having decided this threshold issue, the bankruptcy court refused the insurers' request to lift the automatic stay and held that the coverage litigation, including litigation against only the directors and officers, is stayed, subject to reconsideration at the conclusion of the criminal proceedings. The court found that the issues in the coverage action are largely duplicative of those in the criminal prosecution. Thus, allowing the coverage litigation to proceed could potentially prejudice ACC and ABIZ because of the possibility that the directors being prosecuted might invoke their Fifth Amendment rights and that there could be questions of issue preclusion. Moreover, the court reasoned that the coverage litigation, along with all pending civil litigation, would likely be stayed on motion of the U.S. Attorney. Balancing all the relevant factors, the court determined that the prejudice to ACC and ABIZ outweighed the directors' need to litigate their entitlement to defense costs and the insurers' attempt to rescind their policies. The court did recognize, however, that "the insurers may not be criticized for failing to make payments on the D&O policies here after they have attempted, in good faith, to litigate their duty to do so."

The court, however, did grant relief to the five ACC directors to seek payment or advancement of \$300,000 in defense costs per insured. Relying on *Ochs v. Lipson (In re First Central Financial Corp.)*, 238 B.R. 9 (Bankr. E.D. N.Y. 1999), the court reasoned that "at its core," a D&O policy is a "safeguard of officer and director interests and not a vehicle for corporate protection" even where the policy provides for entity coverage. Nonetheless, the court only granted relief to the five directors to seek \$300,000 in defense costs per insured to preserve the proceeds of the policies for the potentially conflicting claims of coverage by the directors, the outside directors, ACC and ABIZ.

For more information, please contact one of WRF's Professional Liability Attorneys at 202.719.7130.