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NEWSLETTER

Proceeds of D&O Policies Not Part of Bankruptcy Estate

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In an unreported decision, a federal district court in Ohio has lifted the automatic stay of the bankruptcy code to permit litigation to proceed against two former directors and officers of a bankrupt company. *In re MCSi, Inc., Sec. Litig., No.*C-3-03-015 (S.D. Ohio Feb. 26, 2004). In reaching this result, the court held, among other things, that proceeds of D&O policies are not part of the bankruptcy estate and that, as a result, the litigation would not have a detrimental effect on the bankruptcy estate.

Various insurers issued D&O policies to a company that had been named as a defendant in seven class action lawsuits arising out of alleged violations of federal securities laws. Following the filing of the litigation, the company filed for chapter 11 bankruptcy protection. Two former officers of the company were named as co-defendants in the class action lawsuits, and the class action plaintiffs sought to lift the automatic stay so that they could proceed with the litigation against the two individuals. The two individuals argued that the stay should not be lifted because an adverse judgment might be covered under the policy, thereby having a detrimental effect on the bankruptcy estate. (The opinion did not address whether the policy provided entity coverage applicable to the securities litigation.)

The court first noted that the company had not objected to the plaintiffs' motion to lift the automatic stay, suggesting that it did not perceive any impact on the bankruptcy estate. More significantly, the court rejected the argument that an adverse judgment would impact the estate, explaining that the "proceeds of a D&O liability policy are *not* the property of the debtor" since the company does not have a direct interest in the proceeds. The court reasoned that the function of the D&O policy was to pay out proceeds only when a director or officer incurs liability. Thus, according to the court, "it is difficult to imagine any type of D&O liability policy that would permit the corporation to maintain ownership of the proceeds, as opposed to paying them directly to the successful plaintiff in an action against the director or officer." The court concluded that "any proceeds of [the policyholder's] D&O liability policy cannot be considered to inure to its pecuniary benefit and therefore may not rightly be considered property of the bankruptcy estate."

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