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NEWSLETTER

D&O Policy Proceeds Are Not Property of Estate Where Indemnification Has Not Occurred

April 2004

The United States Bankruptcy Court for the District of Delaware has held that when a D&O policy provides a debtor corporation with indemnification coverage, but that indemnification is uncertain or has not occurred, the proceeds are not property of a bankruptcy estate. *In re Allied Digital Tech. Corp.*, 2004 WL 504268 (Bankr. D. Del. Mar. 16, 2004).

The insurer issued a D&O policy that provided direct coverage to the individual directors and officers of the insured company, corporate reimbursement coverage to the company for amounts paid as indemnification to the directors and officers and entity coverage for securities claims. After the corporation filed for bankruptcy, the trustee filed an adversary proceeding against the corporation's directors and officers seeking $62 million in damages. The directors and officers sought an order allowing reimbursement of their defense costs under the D&O policy. The trustee objected on the grounds that proceeds of the policy were part of the bankruptcy estate, and that the automatic stay therefore barred distribution of these proceeds.

In rejecting the trustee's argument, the bankruptcy court explained that the general rule that a debtor's liability policy is property of the bankruptcy estate does not always apply with respect to policy proceeds. Instead, the court explained that in cases involving policy proceeds, courts look at the specific language of the policies and who is listed as an insured. The bankruptcy court identified four potential scenarios:

- First, 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.
- Second, in cases where a policy provides only direct coverage to a debtor, the court concluded that the proceeds are property of the estate.
- Third, 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."

- Fourth, 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 court concluded that the last scenario applied in this case. The court found that policy provided: (1) direct coverage to the individual defendants for "real" claims and defense costs and (2) indemnification coverage to the corporation for amounts paid to the directors and officers. However, such payments were "hypothetical" at this point since the company had not paid any defense costs. In addition, the trustee had not shown that any securities claims were viable, such that there would be direct coverage for the corporation. Therefore, the directors and officers were entitled to their bargained-for right to coverage for liability and defense costs. The court viewed the trustee as "no different than any third party plaintiff" since his concern was only that the payment of defense costs might affect his ability to recover under the D&O policy as a plaintiff rather than protecting a potential defendant.

Although it was not necessary to the outcome, the court further suggested that even if the proceeds of the policy were part of the bankruptcy estate, the automatic stay should be lifted because the directors and officers had shown that they would be unable to conduct a worthwhile defense of the trustee's claim absent funding from the policy.

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