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NEWSLETTER

Ds & Os of Parent Corporation Not Insured; Cancellation of Policy Does Not Violate Bankruptcy Automatic Stay

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A federal district court, applying Colorado law, held that the directors and officers of a policyholder company's parent corporation were not entitled to coverage for a claim because they were not "Insured Persons" under the company's D&O policy and because the personal profit exclusion barred coverage. *See Nicholls, et al. v. Zurich Am. Ins. Group, et al.,* No. CIV.A.01-WY1687CBOES, 2003 WL 354686 (D. Colo. Feb. 7, 2003). The court also held that cancellation of the bankrupt company's D&O policy for nonpayment of premiums did not violate the automatic stay under Section 362(a)(3) of the Bankruptcy Code.

Prior to the chapter 7 bankruptcy of the policyholder company and its parent corporation, the policyholder acquired a D&O policy from the insurer through two insurance brokers. The declarations and the definitions in the policy provided that the company, and not the parent, was the insured. The policy also contained a personal profit exclusion that barred coverage for "any Claim made against any Insured Person:...based upon, arising out of, or attributable to such Insured Person gaining in fact any personal profit, remuneration or advantage to which such Insured Person was not legally entitled."

An insurance premium financing entity funded the premium in return for nine monthly payments and the express authority to cancel the policy upon nonpayment. Subsequent to its bankruptcy, the company failed to remit a required payment. The financing entity canceled the policy and the insurer refunded the unearned premium. The bankruptcy trustee brought an adversary proceeding against four individuals who were directors and officers of both the company and its parent corporation, alleging that they unlawfully sold their personal shares of parent corporation stock under the guise of a private placement and pocketed the proceeds. The carrier denied coverage for the claims. Coverage litigation ensued.

The court held that the policy did not afford coverage for the adversary proceeding because the directors and officers of the parent corporation were not "Insured Persons" under the policy. The court reasoned that because the policy provided coverage for wrongful acts of the directors and officers of the company and its subsidiaries, wrongful acts committed by the directors and officers of the company's parent corporation did not fall under the policy's insuring clause. The court rejected the trustee's argument that the insurer should be estopped from arguing that the directors and officers were not "Insured Persons" because the insurer did not

make such an assertion when it declined to defend them in the adversary proceeding. The court reasoned that estoppel did not apply because the bankruptcy trustee "could not have been 'ignorant of the true facts' surrounding the denial of insurance coverage," and because "equitable estoppel cannot be asserted to bring within the scope of an insurance policy risks that are not covered by the policy." The court also rejected the trustee's argument that the parent corporation was an insured because someone had crossed out the name of the company on the renewal policy application and had inserted the parent corporation's name. The court noted that the insurer did not require a renewal application and the application was not part of the policy. Additionally, the court reasoned that the insurance binder issued by the insurer "clearly identified" the company, rather than its parent corporation, as the insured, and that the company had responded to the binder not by objecting, but by financing the renewed policy.

The court additionally found that even if the parent corporation was an insured under the policy, the policy's personal profit exclusion would bar coverage for its directors and officers. The court reasoned that the amended complaint inescapably alleged that the directors and officers received all of the proceeds from the sham stock transaction...allegations that fell entirely within the personal profit exclusion.

The court also held that the cancellation of the bankrupt company's D&O policy did not violate the automatic stay under Section 362(a)(3) of the Bankruptcy Code. In so holding, the court relied heavily on *In re Trigg*, 630 F.2d 1370 (10th Cir. 1980), in which the Tenth Circuit held that a "contract that provides for termination on default of one party may terminate under ordinary principles of contract law even if the defaulting party has filed a petition under the Bankruptcy Act." Reasoning that the company "failed to satisfy its contractual obligations" to make the required payments and the contract terminated by its own terms, the court concluded that it was "powerless to rewrite [the] terms" of the D&O Liability Policy to prevent its termination.

Finally, the court held that the insurance brokers and financing entity could not be liable under common law theories for canceling the policy. The court held that the financing entity was not liable for unjust enrichment since it refunded the full amount of the unearned premium to the company and clearly informed the company that the policy was canceled and not in force. The court held that any claims against the brokers for their failure to secure insurance for the parent corporation were moot because the personal profit exclusion precluded coverage in any event.

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