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NEWSLETTER

Bankruptcy Court Denies Approval of Adelphia Policy Buyback Settlement

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The United States Bankruptcy Court for the Southern District of New York has denied approval of a settlement between Adelphia and its D&O insurers pursuant to which the insurers would have bought back their interests in the relevant policies issued to Adelphia for $32.5 million "with claims of others to policy proceeds... attaching to the proceeds of the sale."

I*n re Adelphia Communications Corp.*, 2007 WL 706884 (Bankr. S.D.N.Y Mar. 6, 2007). In doing so, the court held that it did not have the authority to issue a channeling injunction that would prohibit Adelphia's former directors and officers, among others, from proceeding directly against the insurers to pursue the remaining policy proceeds.

Adelphia purchased three D&O policies in 2001 that provided aggregate primary and excess coverage of $50 million. The insurers subsequently commenced a rescission action in the United States District Court for the Eastern District of Pennsylvania, arguing that the policies were void *ab initio* with respect to certain of Adelphia's former directors and officers who allegedly participated in the drafting or issuance of false and misleading warranty statements, financial documents and SEC filings. The insurers alternatively sought a declaration that no coverage existed under the policies for claims arising from Adelphia's financial collapse. The coverage/rescission action was later stayed by order of the New York bankruptcy court.

The insurers and the Adelphia debtors sought the bankruptcy court's approval for a settlement pursuant to which the insurers would buy back the remaining interests in their policies for $32.5 million. As a part of the proposed settlement, the court was to issue a channeling injunction under which any claimants, including Adelphia's former officers and directors, would not be allowed to pursue claims against the insurers under the policies. Under the proposed settlement, any such claims would instead attach to the $32.5 million proceeds of the settlement.

The bankruptcy court indicated that the policy buyback portion of the proposed settlement was appropriate because "[a] settlement with the Insurers that secures this $32.5 million, in exchange for a give-up of further recoveries from the Insurers, is plainly in the interests of the Adelphia estate" and because the sale satisfied the requirements of Section 363 of the Bankruptcy Code.

The court concluded, however, that it did not have the power to issue the channeling injunction that was a key part of the proposed settlement. In so holding, the court first noted that prior instances of the use of channeling injunctions in the insurance context did not involve D&O policies, but instead arose in the asbestos mass tort context. The court stated that each of these cases "was an asbestos case, attempting to deal with the unique problem in mass tort cases—where it is often desirable, if not essential, to tap insurance policies to help create trusts or funds to provide a funding resource for the present and future claims that must be satisfied, and where addressing issues of that character is an important, if not wholly dominant, aspect of the bankruptcy case." The court also noted that recent Second Circuit decisions have made clear that "the applicable law authorizing the use of channeling injunctions and third party releases has become increasingly restrictive, and now permits such relief only under limited circumstances—most significantly, where they are critical to the reorganization of the debtor." Here, the court reasoned that Adelphia already successfully reorganized and that securing the $32.5 million payment from the insurers was not "essential (or even important) to a successful reorganization." The court also noted that payment in full of creditors was a historical rationale for issuing channeling injunctions but that this interest would not be served here because the policy proceeds had been decreased by prior payments and would be further decreased by the discount necessary to consummate the proposed settlement. The court stated that "[p]roviding a fund of lesser size is inconsistent with the requirement that the alternate fund provide adequate protection." The court thus denied the motion for approval of the proposed settlement without prejudice.