wiley

NEWSLETTER

I v. I Exclusion Bars Coverage for Debtor-in-Possession's Claim Against Former Directors and Officers

August 2009

The United States Court of Appeals for the Ninth Circuit has held that an insured v. insured exclusion bars coverage for a suit by a debtor-in-possession against former directors and officers of the company. *Biltmore Assocs. v. Twin City Fire Ins. Co.*, 2009 WL 1976071 (9th Cir. July 10, 2009). The court rejected the argument that the debtor-in-possession was a different legal entity from the pre-bankruptcy company insured under the policy.

The D&O policy at issue contained an insured v. insured exclusion, which excluded coverage for "Loss in connection with any Claim made against the Directors and Officers . . . brought or maintained by or on behalf of an Insured in any capacity or by [a] security holder of the company." After two years in business, the insured filed a chapter 11 bankruptcy petition. The insured, as "debtor and debtor in possession," sued some of its recently discharged directors and officers for breaches of fiduciary duty, including financial misconduct and usurpation of corporate opportunities. The insurer denied coverage under the insured v. insured exclusion. The insured filed a chapter 11 reorganization plan, which assigned its claims against the former directors and officers to a trust established for its creditors. The trustee subsequently settled the insured's claims against four of the former directors and officers, who assigned their rights against the D&O insurer to the creditors trust. The trustee then sued the insurer.

In analyzing the applicability of the insured v. insured exclusion, the Ninth Circuit first described the history and purpose of the provision. The court distinguished liability insurance, in which a company seeks to cover the risk of a claim by a third party, from property and casualty insurance, in which a person also seeks to protect himself from the risks caused by his own negligence. The court noted that companies have traditionally purchased "fidelity bonds" to insure the company against the internal risk of employee dishonesty. The court explained that, "[b]ecause risks such as collusion and moral hazard are much greater for claims by one insured against another insured on the same policy than for claims by strangers, liability policies typically exclude them from coverage." Thus, an insured v. insured exclusion "protects . . . against collusion, and also against the risk of selling liability insurance for what amounts to a fidelity bond."

The court then turned to the question of whether the underlying claim was "brought or maintained by an Insured in any capacity." The court began by noting that the cause of action for mismanagement belonged to the corporation, which originally brought the underlying suit. Although shareholders and creditors can bring a suit for mismanagement derivatively on behalf of the corporation, the court stated that in this case the insured corporation "instigated and continued" the suit against the former directors and officers. That the claim was later assigned to the creditors' trust did not alter the court's conclusion. The court explained that, because the trustee was an assignee of the debtor-in-possession, the insured v. insured exclusion must apply to the trustee's claim to the same extent it would have applied to a claim by the corporation.

The court also rejected the argument that the insured v. insured exclusion did not apply on the grounds that the insured became a different legal entity once it entered bankruptcy. The court surveyed the treatment of the legal status of post-bankruptcy debtors in case law from around the country, including U.S. Supreme Court precedent, and concluded that, "for purposes of the insured versus insured exclusion, the prefiling company and the company as debtor in possession in chapter 11 are the same entity." Therefore, the insured v. insured exclusion operated with the same force with respect to the debtor-in-possession as it would have with respect to the pre-bankruptcy company. In so ruling, the court explicitly overruled the bankruptcy and district court opinions in *Pintlar Corp. v. Fid. & Cas. Co. of N.Y.* (In re Pintlar), 205 B.R. 945 (Bankr. D. Idaho 1997), *aff'd sub nom. Cigna Ins. Co. v. Gulf USA Corp.*, No. 97-250, 1997 WL 1878757 (D. Idaho Sept. 11, 1997).

Finally, the court rejected the argument that the insured v. insured exclusion should not apply because, as debtor-in-possession, the insured effectively brought the underlying suit as the representative of the creditors of the bankruptcy estate rather than on behalf of the corporation itself. The court explained that this argument conflated the concepts of "for the benefit of" and "on behalf of." The underlying suit brought by the debtor-in-possession may have been "for the benefit" of the creditors to the extent that they would be the ultimate beneficiaries of any money recovered, but, as a legal matter, it was brought "on behalf of the pre-bankruptcy corporation." The court stated that "[t]he alternative position would create a perverse incentive for the principals of a failing business to bet the dwindling treasury on a lawsuit against themselves and a coverage action against their insurers, bailing the company out with the money from the D&O policy if they win and giving themselves covenants not to execute if they lose. That is among the kinds of moral hazard that the insured vs. insured exclusion is intended to avoid."