

Defense Costs Advanced Under Interim Funding Agreement Deemed Property of Debtor's Estate

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The United States District Court for the Southern District of New York has affirmed a bankruptcy court's ruling that defense costs advanced by an insurer to a debtor under an Interim Fee Advancement and Non-Waiver Agreement (the Interim Agreement) were not held in trust and, therefore, constituted property of the debtor's estate. *Great Am. Ins. Co. v. Bally Total Fitness Holding Corp. (In re Bally Total Fitness of Greater N.Y.)*, 2009 WL 1684022 (S.D.N.Y. June 15, 2009).

Pursuant to the Interim Agreement, the insurer advanced defense costs subject to a reservation of the right to bring a rescission action and to seek to recoup the amounts advanced. After entering into the agreement, the insurer brought a rescission action, and the insured filed for bankruptcy. The insurer initiated an adversary proceeding seeking a declaration that the amounts it advanced under the Interim Agreement were held in implied trust and, thus, not property of the bankruptcy estate. The bankruptcy court disagreed. Upholding the bankruptcy court's ruling, the district court concluded that, under Illinois law, the Interim Agreement did not create an implied trust because there is no indication that the funds advanced were intended to be returned to the insurer. In so holding, the court noted that the insurer's reservation of the right to seek rescission did not obligate the insured to return the funds, nor did it create a contingent beneficial interest in the advanced funds.

The court also identified three factors that in its view rebutted a presumption in favor of an implied trust. First, the insurer did not require the insured to segregate the advanced funds. Second, nothing in the relationship between the insurer and the insured or in their course of dealing suggested that the Interim Agreement was intended to create an implied trust. Finally, the court noted that if the large, sophisticated insurer had intended to create a trust, it presumably would have done so expressly.