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NEWSLETTER

Policy Proceeds Not Property of Bankruptcy Estate Because Payment of Proceeds Would Not Affect Estate Assets

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The United States Bankruptcy Court for the District of Delaware has held that policy proceeds were not part of the insured entity's bankruptcy estate because previous entity claims were dismissed with prejudice, it was highly speculative that the bankruptcy trustee would approve indemnification of directors and officers, and the policy's priority of payment provision provided that entity coverage was only available after payment of proceeds for direct coverage to insured persons. *In re Downey Fin. Corp.*, 428 B.R. 595 (D. Del. Bankr. May 7, 2010). The court also held that, even if the policy proceeds were part of the bankruptcy estate, good cause existed to lift the automatic stay to pay for the defense expenses of the directors and officers.

The insured entity was the corporate parent of a financial institution regulated by the Office of Thrift Supervision (OTS). In May and June 2008, two securities class actions were filed against the insured entity and three of its officers. In June 2008, two derivative class actions were filed against the directors and officers of the insured entity, and the insured entity was named as a nominal defendant in that suit. In November 2008, the primary subsidiary of the insured entity was closed by OTS, and the Federal Deposit Insurance Corporation (FDIC) was appointed as receiver. Shortly thereafter, the insured entity filed for chapter 7 bankruptcy. The securities class action was dismissed with prejudice in June 2009, but the derivative actions continued. The insured entity was indemnifying the directors and officers actions until it filed for bankruptcy protection. The directors and officers therefore sought direct coverage under the policy for the payment of defense expenses.

The bankruptcy court first addressed whether the policy proceeds were property of the insured entity's bankruptcy estate by determining whether the "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." The court held that the policy's entity coverage for securities claims did not protect the bankruptcy estate from a diminution in assets. No securities actions were pending against the entity because the previous securities actions were dismissed with prejudice and the related proofs of claim were withdrawn. The court also held that the entity had not made any indemnification payments to the directors and officers that would be covered by the policy, so any payment of the policy proceeds would not deplete the amount available to reimburse the bankruptcy estate for indemnification of the directors and officers. The court reasoned that the possibility of

indemnification was hypothetical or speculative because the estate would need to pay $400,000 to satisfy the retention before indemnification coverage would be available, the insured persons had not requested indemnification since the entity filed for bankruptcy, the trustee did not indicate that he planned to indemnify the directors and officers, and the directors and officers missed the deadline to file a proof of claim for their defense expenses. To the extent the entity had any interest in the policy proceeds, the court held that the policy's priority of payment provision provided entity coverage only after payment of direct coverage to the directors and officers. The court opined that, if it held the policy proceeds were property of the estate, the insured entity would have greater rights under the policy than before the bankruptcy.

Next, the bankruptcy court held that, even if the policy proceeds were part of the bankruptcy estate and subject to the automatic stay, good cause existed to lift the stay. First, the court held that lifting the automatic stay would not cause great prejudice to the bankruptcy estate. The directors and officers were seeking relief from the stay to pay only about $900,000 in defense costs when the policy's limit of liability was $10 million. Second, the hardship to the directors and officers outweighed the harm to the bankruptcy estate because the harm to the bankruptcy estate for lifting the stay was hypothetical and not lifting the stay would force the directors and officers to pay almost $900,000 "out of their own pockets." Finally, the court held the directors had a clear probability of success on the merits because the securities class actions were dismissed with prejudice and the derivative actions would also likely be dismissed since they were based on the same facts as the securities actions.

The court then rejected the FDIC's contention that the directors and officers were barred from coverage because they did not file a proof of claim. The court noted that, since the directors and officers were seeking direct coverage from the insurer instead of indemnification from the bankruptcy estate, the failure to file a proof of claim did not bar recovery of their defense expenses.