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NEWSLETTER

District Court Holds I v. I Exclusion Does Not Apply to Suit by Litigation Trust

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The United States District Court for the Western District of Pennsylvania has ruled that suits originally brought by an unsecured creditors committee and then assigned to a litigation trustee are not barred by the insured v. insured exclusion. *Federal Ins. Co. v. D'Aniello*, 2006 WL 3386625 (W.D. Pa. Nov. 22, 2006). The court further ruled that counts in a complaint alleging fraudulent conveyances and void preferences alleged "Loss" within the meaning of the insurance policy.

The insurers issued a primary and excess D&O policy to a company. The insured v. insured exclusion in the primary policy barred coverage for "any Claim made against any Insured Person... brought or maintained by or on behalf of any Insured." The policy stated that "Loss means the total amount which any Insured Person becomes legally obligated to pay on account of each Claim and for all Claims... made against them for Wrongful Acts for which coverage applies, including, but not limited to, damages, judgments, settlements, costs and Defense Costs. Loss does not include... matters uninsurable under the law applicable to this coverage."

The insured company initially filed a voluntary petition for bankruptcy, and the Official Committee of Unsecured Creditors (OCUC) thereafter moved for and was granted the right to pursue litigation on behalf of the estate. The OCUC then brought suit against the company's current and former directors and officers. After that suit was brought, the bankruptcy court approved the debtor-in-possession's Chapter 11 Plan and, pursuant to that plan, a litigation trust was created. The suit originally brought by the OCUC was assigned to the trust. The underlying litigation included counts seeking avoidance and recovery of certain transfers made to some of the D&Os, as well as another count seeking the recovery of property fraudulently conveyed to other D&Os.

The insurers of the company moved for summary judgment on the I v. I exclusion. The court initially considered the arguments by the D&Os that the insurer was estopped from denying coverage based upon the insured v. insured exclusion because the insurers alleged that defense for the first time upon filing the coverage action. However, the court ruled that Pennsylvania law does not permit estoppel to create coverage outside the scope of a policy's coverage and that the D&Os failed to present evidence that the insurer, with full knowledge of all the facts, effected a voluntary waiver of the insured v. insured exclusion.

Reaching the merits of the exclusion, the court stated that the issue presented "is whether the phrase 'on behalf of,' as it appears in the language of the I v. I Exclusion, means 'as representative of' or 'for the benefit of.'" The insurers argued that the litigation trust is necessarily an assignee of the policyholder as debtor-in-possession and, therefore, that the insured v. insured exclusion bars coverage for the suits brought by the litigation trust against the D&Os. The court first noted that "[i]t is apparent that [the insurer] accepted the OCUC Action for coverage.... Accordingly, the Court proceeds on the assumption that the position of [the insurer] is that the OCUC Action was not within the I v. I Exclusion, and that the exclusion was triggered only when the claims were transferred to the Trust."

The court explained that if "on behalf of" means "as representative of," the litigation trustee has brought suit on behalf of the policyholder. However, if "on behalf of" means "for the benefit of," the litigation trustee had brought suit for the benefit of creditors, and the insured v. insured exclusion would not apply. The court further opined that, before this question becomes relevant, the insurer must establish that the policyholder debtor is the same legal entity as the post-petition debtor-in-possession. If they are separate legal entities, the court reasoned that the insured v. insured exclusion could never apply, regardless of its interpretation of "on behalf of." The court then distinguished case law stating that the debtor and the debtor-in-possession are the same legal entity and ruled that, except in limited circumstances not before the court in this case, a debtor and debtor-in-possession are separate legal entities with different rights and powers.

In noting the legal distinction between the two entities, the court rejected the D&Os' further argument that the insured v. insured exclusion can only apply in circumstances where there is collusion between the parties to the underlying purpose: "Where the I v. I Exclusion applies, an absence of collusion is of no legal significance. "

The court then addressed *TIG Specialty Insurance Co. v. Koken*, 855 A.2d 900 (Pa. Commw. 2004), at length, and ruled that the decision undermined the insurer's arguments in this case. In *Koken*, the state trial court ruled that an insured v. insured exclusion applied where it encompassed policyholder's "successor," "assignee, " "trustee in bankruptcy," "debtor-in-possession" and "litigation trustee" as insureds for purposes of the exclusion. The court noted that the *TIG* case, if anything, indicated how the insurer could have drafted its own insured v. insured exclusion if it had intended the exclusion to bar coverage for a suit brought by a litigation trust.

Having ruled that the exclusion does not apply to a suit brought by a litigation trust, the court noted that, at the very least, the policyholder's interpretation is a reasonable one. As such, even if the insurer's interpretation was also
reasonable, this would render the exclusion ambiguous.

The court also addressed whether the fraudulent conveyance and preference counts sought insurable "Loss" as a matter of Pennsylvania law. Both counts sought the return of transfers made to the D&Os. The insurer relied primarily upon *Central Dauphin School District v. American Casualty Co.*, 426 A.2d 94 (Pa. 1981). In that case the Pennsylvania Supreme Court held that the return of unlawful taxes levied by a school district were not "Loss" within the meaning of the relevant insurance policy because they were "matters which shall be deemed

uninsurable under the law." The court in this case limited Central Dauphin's application to situations involving governmental entities' ultra vires acts. The court further held that, under Pennsylvania law, "an alleged public policy may be the basis of a judicial decision only in the 'clearest cases.'"