

ALERT

Insured Versus Insured Exclusion Inapplicable to Action by Bankruptcy Trustee and Bankruptcy Exclusion Deemed Unenforceable

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The Appellate Court of Illinois, First District, Third Division, applying Indiana and federal law, has held that neither a bankruptcy nor an insured versus insured exclusion applied to bar coverage for claims brought by a bankruptcy trustee. According to the court, the bankruptcy exclusion is unenforceable because coverage arises from a policy that is a property interest of the debtors, and that property interest is protected under Section 541 of the Bankruptcy Code. The insured versus insured exclusion did not apply, the court held, because the policyholder and a court-appointed trustee "working on behalf of creditors and under the authority of the bankruptcy court, . . . are not the same entity for purposes of the insured versus insured exclusion." *Yessenow v. Executive Risk Indemnity, Inc.*, 2011 WL 2623307 (Ill. App. Ct. June 30, 2011).

The policyholder, an operator of for-profit, physician-owned, healthcare practices, owned a hospital. Both the policyholder and its hospital declared bankruptcy. The court-appointed trustee in the hospital's bankruptcy proceeding filed lawsuits against several of the policyholder's former directors, which were tendered to the insurer. The insurer denied coverage based on insured versus insured and bankruptcy exclusions. The former directors then filed a coverage action. On partial motions for summary judgment, the trial court held that the insured versus insured exclusion did not apply and that, although the plain language of the bankruptcy exclusion barred coverage, the bankruptcy exclusion was unenforceable.

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In affirming the trial court's ruling, the appellate court first determined that the former directors had standing to challenge the bankruptcy exclusion under the Bankruptcy Code. Under Section 541(c), "an interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law" The court explained, "although coverage inures to the benefit of plaintiffs, it arises from the [] policy which has become a property interest of . . . the debtors. Therefore, that property interest is protected by section 541(c) and because any benefit to the estate will be realized only if plaintiffs may seek coverage under it, they have standing to challenge the exclusion." Because the bankruptcy exclusion is conditioned on the commencement of a bankruptcy case, the court held the exclusion unenforceable.

The appellate court also agreed with the trial court's conclusion that the insured versus insured exclusion did not apply. In reaching its conclusion, the court distinguished the Ninth Circuit's opinion in *Biltmore Associates, LLC v. Twin City Fire Insurance Co.*, 572 F.3d 663 (9th Cir. 2009), in which the insured versus insured exclusion was deemed applicable because the debtor in possession was found to be the same entity as the pre-bankruptcy corporation. Here, the appellate court stressed that the lawsuits were brought by a court-appointed trustee, who is "acting with the imprimatur of the court," not a debtor in possession, and that there was no evidence of collusion, as there was in *Biltmore*. The court therefore concluded that "where a court appointed trustee is working on behalf of creditors and under the authority of the bankruptcy court, . . . the trustee and the debtor [] are not the same entity for purposes of the insured versus insured exclusion." The court also determined that the court-appointed trustee was not precluded from recovery under the imputation doctrine, finding that he "is a distinct entity from the prefiling [policyholder] who is working on behalf of the [policyholder]'s creditors, not on behalf of the [policyholder]."