

Liability Insurance Proceeds and Coverage Considerations When Insureds File for Bankruptcy

By Robert Given and Walker Beauchamp

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We've all seen the headlines—from Hertz to Brooks Brothers and CEC (Chuck E. Cheese's parent), many prominent companies have filed for bankruptcy protection in recent months. The total number of Chapter 11 bankruptcy filings over the first half of 2020 was up 26% compared to the first six months of 2019, and most commentators expect to see this rise in bankruptcies continue as COVID-19 further hampers economic activity.

Most practitioners with no real exposure to bankruptcy law may be aware of the general ramifications of bankruptcy proceedings. Upon a bankruptcy petition's filing, all of the debtor's property, including its contractual rights, becomes the property of its bankruptcy estate.ⁱ At the same time, a broad automatic stay of collection activity or other proceedings against the debtor is implemented.ⁱⁱ But where does this leave those with claims against the debtor for pre-petition acts or omissions that are covered under liability insurance policies? If the debtor was insured for the claims in question, would proceeds from those policies be considered estate property to be divvied up among other creditors? And might an insurer (whether primary or excess) have a defense to coverage if the insured is unable to pay an applicable deductible due to the bankruptcy proceedings?

The answer to these questions requires a careful analysis of the insurance policies in question and the law of the controlling jurisdiction. For example, determining whether proceeds of a D&O policy qualify as estate property is inherently complex because D&O policies usually cover both the corporation itself and individual directors and officers. But as a general rule, the proceeds of most standard liability policies are not considered estate property.ⁱⁱⁱ As the Fifth Circuit has explained:

Examples of insurance policies whose proceeds are property of the estate include casualty, collision, life, and fire insurance policies in which the debtor is a beneficiary. Proceeds of such insurance policies, if made payable to the debtor rather than a third party such as a creditor, are property of the estate and may inure to all bankruptcy creditors. But under the typical liability policy, the debtor will not have a cognizable interest in the proceeds of the policy. Those proceeds will normally be payable only for the benefit of those harmed by the debtor under the terms of the insurance contract.

In re Edgeworth, 993 F.2d 51,56 (5th Cir. 1993).

Because liability policy proceeds usually do not belong to the estate, bankruptcy courts are often receptive to requests to lift an automatic stay for the sole purpose of allowing a claimant to initiate or continue outside proceedings against the debtor and collect proceeds from insurance policies that

cover the resulting judgment. See *In re Calsol, Inc.*, 419 F. App'x 753 (9th Cir. 2011); *Baez v. Med. Liab. Mut. Ins. Co.*, 136 B.R. 65, 68 (S.D.N.Y. 1992); *In re Fernstrom Storage & Van Co.*, 100 B.R. 1017, 1023 (Bankr. N.D. Ill. 1989), *aff'd*, 938 F.2d 731 (7th Cir. 1991). Bankruptcy judges have considerable discretion in determining whether sufficient “cause” exists to lift the automatic stay, and the fact that the debtor’s insurer bears responsibility for defending debtor in an action outside the bankruptcy proceedings weighs in favor of lifting the stay to pursue any potentially applicable insurance proceeds. See *In re Abeinsa Holding, Inc.*, No. 16-10790 (KJC), 2016 WL 5867039, at *3 (Bankr. D. Del. Oct. 6, 2016).

If a court allows a claimant to pursue applicable debtor insurance proceeds by lifting the stay, chances are that the underlying coverage continues despite the debtor’s bankruptcy petition. In fact, most liability insurance policies expressly provide that coverage is unaffected by the insured’s bankruptcy. A recent edition of the Insurance Services Office’s CGL policy “Coverage A”, for instance, states that: “[The] Bankruptcy or insolvency of the insured or of the insured's estate will not relieve us of our obligations under this Coverage Part.” ISO Form CG 00 01 04 13 (2015). This language seems to have become commonplace in liability policies because a number of states have similar statutory mandates.^{iv}

Given the likelihood that a bankruptcy court will lift the stay for third-party claimants to pursue insurance proceeds and the fact that coverage obligations are generally not extinguished by the insured’s bankruptcy petition, both claimants and insurers will also need to consider the effect of an insured’s inability to pay deductibles or retentions required under a policy. A primary insurer tasked with settling a case may have concerns as to whether the debtor-insured’s failure to pay these amounts will affect excess coverage or duties to reinsurers, while a claimant/plaintiff may worry that the unpaid deductible or retention could present defenses to coverage. Again, resolving concerns like this requires a careful analysis of the controlling policies and case law. But as a general matter, the insured’s inability to pay deductibles or retentions will not allow an insurer to deny coverage. Rather, the insurer typically must provide coverage and seek reimbursement of the unpaid sum by filing claims against the bankruptcy estate like any other creditor.^v

This outcome is especially likely in the case of deductible obligations.^{vi} Deductible provisions generally set a sum that the insured is responsible for *reimbursing* the insurer, while self-insured retention provisions typically require full payment of a retention amount before the insurer’s coverage obligations are even triggered.^{vii} Despite this difference, many courts have refused to distinguish between deductible and self-insured retention obligations, holding that an insurer must provide full liability coverage regardless of whether the debtor is unable to pay the deductible or retention:

[W]here ... an insured debtor has paid the policy premium in full, the insurance policy is not an executory contract for purposes of § 365 of the Bankruptcy Code, even where the debtor has continuing obligations, such as the payment of a self-insured retention, a deductible, or a premium. Failure of the debtor to perform these continuing obligations does not excuse the insurer from performance under the contract, but gives rise to an unsecured claim by the insurer for any damages incurred by reason of the debtor's breach of the policy.

In re Vanderveer Estates Holdings, LLC, 328 B.R. 18, 25 (Bankr. E.D.N.Y. 2005).^{viii}

Other courts, however, have considered payment of retentions as a condition-precedent to coverage on the basis that a plain reading of the insurance policy dictates that result.^{ix} These courts have found

that, where a debtor-insured cannot pay a retention due to bankruptcy, the insurer has no coverage obligations. This underscores the importance of a careful analysis of relevant policy language and case law wherever bankruptcy and insurance matters intersect. While liability coverage is ordinarily unaffected by an insured's bankruptcy or insolvency, there are important exceptions or caveats that counsel should carefully assess when moving to lift an automatic stay on a plaintiff's behalf or advising a primary insurer faced with defending and/or paying for claims against an insured who files for bankruptcy.

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To discuss this further, please contact:

[Robert Given](#) at (205) 458-5308 or rgiven@burr.com, [Walker Beauchamp](#) at (205) 458-5126 or wbeauchamp@burr.com, or the Burr & Forman attorney with whom you normally consult.

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ⁱ 11 U.S.C. § 541.

ⁱⁱ 11 U.S.C. § 362(a)(1) (covering “the commencement or continuation ... of a[n] ... action or proceeding against the debtor ... to recover a claim against the debtor that arose before the [petition]”).

ⁱⁱⁱ There are important exceptions to this general rule, such as in the mass-tort setting or when claims are sure to exceed policy limits. *See, e.g., MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 91 (2d Cir. 1988); *In re Equine Oxygen Therapy Res., Inc.*, No. 14-51611, 2015 WL 1331540, at *1 (Bankr. E.D. Ky. Mar. 20, 2015).

^{iv} *See, e.g.*, 215 Ill. Comp. Stat. Ann. 5/388 (“No policy of insurance against liability or indemnity... shall be issued or delivered in this State ... unless it contains in substance a provision that the insolvency or bankruptcy of the insured shall not release the company from the payment of damages for injuries sustained or death resulting therefrom, or loss occasioned during the term of such policy....”).

^v The insurer may assert an administrative-expense claim in this situation if it pays a claim for a post-petition loss, but payment for covered pre-petition injuries give rise to general unsecured claims against the estate. *See In re Eli Witt Co.*, 213 B.R. 396 (Bankr. M.D. Fla. 1997).

^{vi} *E.g., In re Int'l Fibercom, Inc.*, 311 B.R. 862, 866 (Bankr. D. Ariz. 2004), *aff'd*, 503 F.3d 933 (9th Cir. 2007).

^{vii} *Self-Insured Retention*, BLACK'S LAW DICTIONARY (11th ed. 2019) (“The amount of an otherwise-covered loss that is not covered by an insurance policy and that usually must be paid before the insurer will pay benefits.”).

^{viii} *See also In re OES Envtl., Inc.*, 319 B.R. 266 (Bankr. M.D. Fla. 2004); *In re Fed. Press Co., Inc.*, 104 B.R. 56 (Bankr. N.D. Ind. 1989).

^{ix} *In re Kismet Prod., Inc.*, No. 04-25167, 2007 WL 6872750, at *10 (Bankr. N.D. Ohio Aug. 28, 2007); *In re Apache Prod. Co.*, 311 B.R. 288, 298 (Bankr. M.D. Fla. 2004).