

Can a Bankruptcy Trustee Stop the Defense of an Insurer by Claiming Insurance Proceeds are an Asset of the Estate?

By Camille J. Iurillo and Gina M. Pellegrino

Scenario: A corporation obtains a Directors' and Officers' insurance policy ("D&O policy") to insure the officers and directors of the corporation as well as the corporation itself. The corporation ("Debtor") files for Chapter 11 bankruptcy. The Chapter 11 Trustee ("Trustee") files adversary proceedings against the officers and directors of the Debtor, alleging among other causes of actions, breach of fiduciary duty. As a result, the officers and directors of the Debtor, as insureds, report claims against the D&O policy to the insurance company ("insurer"), during the time period that the D&O policy is in effect. The insurer agrees to pay to defend. However, the Debtor, also an insured, does not report any claims against the D&O policy to the insurer. The litigation between the parties becomes protracted. Thereafter, the Trustee takes the position that the proceeds of the policy are an asset of the bankruptcy estate; since the attorneys' fees and costs are decreasing the amount available to pay on the claim, the officers and directors should be precluded from paying their attorneys from the policy proceeds. Can the Trustee preclude the defense of the insurer under a D&O policy by claiming that the insurance proceeds are an asset of the bankruptcy estate?

No, not likely under our scenario because the insurance proceeds of the D&O Policy are not an asset of the bankruptcy estate for the following three reasons.

First, in our scenario, the Debtor received its discharge in the Chapter 11 bankruptcy case. As a result, any claims that would have been covered under the D&O policy, which could have been brought against the Debtor, were discharged. One of the linchpins of determining whether policy proceeds are an asset of the bankruptcy estate is whether the Debtor has a right to the proceeds. *See, In re Scott Wetzel Servs., Inc.*, 243 B.R. 802, 804-5 (Bankr. M.D. Fla. 1999). Since any potential claims were discharged, no claims existed to bring against the D&O policy; therefore, the insurance proceeds are not an asset of the bankruptcy estate. The Court in *In re CHS Elecs., Inc.*, 261 B.R. 538, 543 (Bankr. S.D. Fla. 2001) reviewed an insurance policy which provided direct coverage for claims against the officers and directors of the corporation and the debtor corporation itself to determine whether the proceeds of the policy were assets of the estate. The Court in *CHS Elecs., Inc.* held that no basis existed for treating the insurance proceeds as an asset of the bankruptcy estate since all of the potential covered claims that could have been raised against the debtor corporation were discharged in the bankruptcy. *See, CHS Elecs., Inc.*, 261 B.R. at 543.

Secondly, if there are no claims against the Debtor that are present or reasonably foreseeable then the insurance proceeds of the D&O policy would not be an asset of the bankruptcy estate because the Debtor does not have a claim against the policy. Since no direct claims exist against the Debtor corporation then no claims exist that could compete for available coverage. *See, In re Allied Digital Technologies, Corp.*, 306 B.R. 505, 512 (Bankr. D. Del. 2004). Nevertheless, a court may determine that insurance proceeds are an asset of the bankruptcy estate, in circumstances that are distinguishable from the scenario set forth above. For example, if a debtor corporation is covered as an insured along with its officers and directors under an insurance policy and the court determines that there is a basis for a claim under the

insurance policy against the debtor corporation or such a claim is reasonably foreseeable then the court may consider whether the available insurance proceeds are an asset of the bankruptcy estate. *See, Allied Digital Technologies, Corp.*, 306 B.R. at 512-3.

Finally, it is the duty of the Trustee to collect the assets belonging to the bankruptcy estate, but the insurance policy proceeds are only collectable if the Debtor has an interest in the proceeds. *See, CHS Elecs., Inc.*, 261 B.R. at 541-2. The Trustee has no duty or right to stop the insurer from paying for the defense of the officers and directors, just because the cost of defense will decrease the amount of coverage available to pay on the claim against the officers and directors. The only insureds, from our scenario, with an interest in the D&O policy, are the officers and directors of the Debtor. The Debtor corporation has no interest in the insurance policy proceeds, as no claims exist against the Debtor corporation in the bankruptcy court. Furthermore, the Debtor corporation did not report any claims against the D&O insurance policy to the insurer; thus, the Debtor corporation has no right to the insurance proceeds of the policy.

In conclusion, the Trustee in a bankruptcy case is not always entitled to collect the insurance proceeds, as an asset of the bankruptcy estate, even if the debtor is an insured under the policy. In order for the Trustee to obtain these proceeds on behalf of the bankruptcy estate, the debtor will likely be required to show that it has an interest in the insurance policy proceeds.

Iurillo & Associates, P.A., located in downtown St. Petersburg, is comprised of **Camille J. Iurillo**, Shareholder, **Gina M. Pellegrino**, Associate, and **Sabrina C. Beavens**, as Of Counsel. **Ms. Iurillo** has been active in the St. Petersburg Bar Association for several years, including her current position as President. In addition, she is on the Executive Committee of The Florida Bar's General Practice Solo and Small Law Firm Section. **Ms. Pellegrino** joined the Firm in the summer of 2006 and is an active member of the St. Petersburg Bar Association Young Lawyers Section.

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