

Management Liability Policy Proceeds Are Property of the Debtor Estate, But Insurer Can Advance Defense Costs

February 2006

In an unpublished opinion, an Ohio bankruptcy court has held that proceeds from a "Management Liability Policy" are property of the debtor's estate. *In re Arter & Hadden, LLP, No. 03-23293*, 2005 WL 3500849 (Bankr. N.D. Ohio Nov. 29, 2005). Additionally, the court granted the motion of several directors to allow payment of attorney fees in connection with a claim brought by the bankruptcy trustee.

The policy was issued to a law firm and covered both the firm and its "Executive and Management Committee" (Committee). The policy provided coverage for "wrongful acts," which was defined as "(1) any actual or alleged act, error, omission, misstatement, misleading statement or breach of duty by an Executive Officer in connection with the conduct of the Named Insured's or any Subsidiary's business; and (2) any matter asserted against an individual Insured solely by reason of his or her status as a partner, manager, director, principal, or an officer or employee of the Named Insured or any Subsidiary."

The law firm was the subject of involuntary Chapter 7 proceedings in 2003. The underlying claim arose from the bankruptcy trustee's accusation that several members of the Committee had improperly distributed capital during insolvency and received fees. The Committee members requested that the insurer defend against the trustee's claims. Upon the insurer's request, the Committee members requested a modification of the automatic stay to allow payment of defense costs. The parties agreed to a cap on defense costs for representation in settlement talks only. The trustee subsequently settled with some of the Committee members, but filed suit against the non-settling members. The Committee then filed the current motion for payment, "as a further precautionary measure to obtain leave of court for [the insurer] to continue to pay the defense costs."

In considering this motion, the court held that the policy proceeds are property of the debtor estate. The court first observed that the automatic stay applied to "property of the estate," which is defined by 11 U.S.C. § 541 (a)(1) as "all legal or equitable interests of the debtor in property as of the commencement of the estate." As the court explained, the trustee carries the burden of showing "that the debtor has an ownership interest in property." Then, the court indicated that the burden shifts to the "party claiming the equitable interest."

In considering whether insurance proceeds are debtor property, the court stated that there is a consensus that "if a debtor does not have a direct interest in the proceeds of an insurance policy, the insurance proceeds are no longer property of the debtor estate." To make this determination, the court focused on whether "the debtor's estate is worth more with them than [sic] without them" and "whether the debtor's estate would have a right to receive and keep those proceeds when the insurer paid on a claim." Here, the court found that "the proceeds of the policy are property of the estate, since the policy expressly defines the insured entities to include both [the Committee] members and the debtor itself." The court noted that the policy did not have separate limits for individual insureds and the law firm, but instead had a single aggregate limit. As such, the court explained that "[a] debtor's interest in the proceeds requires protection from the depletion and overrides the interest of the directors and officers." The court determined that the Committee had failed to show that the proceeds were not estate property by establishing that the "entity coverage no longer provides a benefit to the estate" or was "merely hypothetical, either as a practical matter, or pursuant to the terms of the policy."

After finding that the proceeds were property of the estate, the court lifted the automatic stay to permit payment of defense fees "because the [Committee] members may suffer substantial and irreparable harm if prevented from exercising their rights to defense payments to fund their defense of the trustee's complaint." The court also concluded that any harm to the debtor by lifting the stay was "speculative" since there were no identified claims for indemnification or direct claims against the insured entity. Accordingly, the court authorized advancement and, pursuant to Federal Rule of Bankruptcy Procedure Rule 2016(a), it also required court approval of attorney fees by an application for compensation.