

Bankruptcy Court Stays Litigation of Rescission Action against Adelphia Directors and Officers

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The United States Bankruptcy Court for the Southern District of New York has stayed the litigation of rescission issues in a declaratory judgment action brought by Adelphia's D&O insurers. *Adelphia Communications Corp., et al. v. Associated Elec. & Gas Ins. Servs., et al. (In re Adelphia Communications Corp.)*, Adv. Proc. No. 03-09580 (Bankr. S.D.N.Y. Dec. 5, 2003). The bankruptcy court also held that the coverage litigation could continue as to the remainder of the coverage issues, including whether the insurers are obligated to advance defense costs until any judicial determination that the directors and officers are not entitled to coverage.

In March and June 2002, Adelphia and its affiliate (collectively, "Adelphia") filed voluntary petitions for relief under chapter 11. Subsequently, the United States Department of Justice brought criminal charges against five Adelphia directors for conspiracy and securities fraud, the Securities and Exchange Commission sued Adelphia and five directors seeking disgorgement of ill-gotten gains and civil penalties and shareholders filed several securities lawsuits against Adelphia and its directors and officers for securities fraud.

In September 2002, several Adelphia directors and officers requested relief from the automatic stay to permit the advancement of defense costs under Adelphia's D&O policies. Thereafter, the insurers sought to rescind the policies based on fraud and brought a declaratory action against the Adelphia directors and officers. At the same time, the insurers moved for relief from the automatic stay "to the extent necessary" to name Adelphia and its affiliate as additional defendants in the declaratory judgment action. In response, Adelphia filed an adversary proceeding against the insurers seeking to enjoin the further prosecution of the coverage action grounded in either the automatic stay or the bankruptcy court's equitable powers under Section 105 of the Bankruptcy Code.

Initial Bankruptcy Court Decision

The bankruptcy court initially denied the insurers' motions for relief from the automatic stay to pursue coverage litigation against Adelphia and held that the automatic stay applied to the insurers' pending coverage litigation against Adelphia's directors and officers. The bankruptcy court, however, did grant relief from the automatic stay to five Adelphia directors to make a claim for payment or advancement of up to \$300,000 per insured for defense costs. As a predicate for its holdings, the bankruptcy court determined that the D&O

policies, which provided entity coverage for securities claims, and their proceeds were property of the bankruptcy estate.

District Court Decision

The district court vacated the bankruptcy court decision, holding that the D&O policy proceeds are not property of the bankruptcy estate. See *In re Adelphia Communications Corp.*, 298 B.R. 49 (S.D.N.Y. 2003). The court reasoned that although the D&O policies afforded entity coverage, the debtors did not have a "cognizable equitable and legal" property interest in the policies at this juncture because: (1) the debtors had not made or contemplated making any payments for which they would be entitled to indemnification coverage, and (2) no claims for entity coverage were pending. Instead, the court characterized the debtors' interest as "akin to a car owner with collision coverage claiming he has the right to proceeds from his policy simply because there is a prospective possibility that his car will collide with another tomorrow." Having determined that the automatic stay did not apply to the rescission action, the court remanded the case to the bankruptcy court to determine whether the litigation should be stayed under Section 105 of the Bankruptcy Code, a provision that has been construed liberally to enjoin suits against third parties that might impede the reorganization process.

Bankruptcy Court's Decision on Remand

With respect to the insurers' attempts to add Adelphia to the coverage action, the bankruptcy court held on remand that the automatic stay or, at a minimum, Section 105(a), would apply to enjoin such litigation or any other act by the insurers seeking to rescind the D&O policies as to Adelphia. The court reasoned that (1) the insurance policies themselves are estate property and thus the automatic stay applies; and (2) that the "destruction" of the policies or the loss of their value that would result if the insurers were successful would be detrimental to Adelphia's reorganization efforts.

Turning to the insurers' rescission claim against the Adelphia directors and officers, the bankruptcy court also held that it was appropriate to enjoin the insurers' rescission claim against the directors under Section 105(a) because the litigation "threatened to thwart or frustrate" Adelphia's reorganization efforts. The court reasoned that although Adelphia is not a party to the coverage action, it has "legitimate concerns as to possible prejudice to [it] under principles of collateral estoppel or *stare decisis*." While the court recognized uncertainty about those doctrines' possible application in subsequent litigation involving the subsidiaries, it also explained "that most courts are loath to come to a completely different decision about an identical policy involving an identically situated party." Accordingly, the risk that Adelphia might potentially be collaterally estopped was sufficient to warrant a stay of the rescission issues in the coverage action under Section 105(a).

The bankruptcy court also stayed deposition discovery under Section 105(a) for the non-rescission related aspects of the coverage action, reasoning that if the defendants being prosecuted criminally "were called upon to testify and then [they] took the Fifth Amendment, there is a risk that adverse consequences might attach not only to [those directors], but also" to Adelphia and its reorganization efforts.

Finally, the bankruptcy court held that the directors and officers could continue to litigate whether the insurers are obligated to advance defense costs unless and until there is a judicial determination of no coverage, such as a finding that they are guilty of wrongdoing. The directors and officers agreed to limit their requests for defense costs to \$300,000 per insured. (In total, 10 insureds are each seeking \$300,000 from a \$50 million insurance tower.) The court explained that the concession by directors and officers to limit the amount of defense costs that would be sought was significant because "[w]ithout it, unlimited drains on policy proceeds would have the effect of destroying the policies themselves."

Interestingly, the court acknowledged the unfairness of permitting the directors and officers to litigate "an asserted duty of the insurers to advance defense costs" without likewise permitting the insurers to litigate issues relating to rescission, but indicated that it was constrained to follow the district court's mandate and that the insurers could raise this issue in the coverage action. Moreover, in footnote 38, the bankruptcy court set forth a number of counterarguments to the district court's holding that D&O policy proceeds are not estate property that "the bankruptcy community will likely wish to consider when this issue arises next."

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