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NEWSLETTER

D&O Policy Proceeds Are Property of Bankruptcy Estate, but Directors Obtain Reimbursement of Defense Fees

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A bankruptcy court in Massachusetts granted two directors' motion to lift the automatic stay in order to obtain payments from a directors and officers liability insurer for defense fees incurred in an action brought by a Chapter 7 trustee. *In re Cybermedica, Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002). The bankruptcy court found that the D&O policy at issue was property of the bankruptcy estate because it provided entity coverage but ruled that there was cause to lift the automatic stay to permit the directors to seek payments for defense fees.

A bankruptcy trustee brought suit against several directors of Cybermedica, Inc. and a hospital, seeking the return of the proceeds from several alleged fraudulent transfers from Cybermedica to the hospital and damages for asserted misrepresentations, breach of fiduciary duty, and deceptive and unfair trade practices. The directors sought coverage for the trustee's action, including payment of defense costs, under a directors and officers liability policy that provided direct coverage to the directors and officers as well as indemnification and entity coverage to Cybermedica. The insurer, Certain Underwriters at Lloyd's, London, agreed to pay the directors' defense costs; however, the trustee opposed the distribution of the D&O policy proceeds. Accordingly, the directors filed a motion to lift the automatic stay to permit them to seek payments for defense costs under the policy. The bankruptcy court granted the motion.

The court first held that the policy and its proceeds constituted property of the bankruptcy estate. The court reviewed the relevant case law and observed that the majority view is that the policy is the property of the estate. It also noted that courts disagree regarding whether the policy's proceeds are property of the estate. The court distinguished the case law, such as *Louisiana World Exposition, Inc. v. Federal Ins. Co.* (*In re Louisiana World Exposition Inc.*), 832 F.2d 1391, 100-1401 (5th Cir. 1987), that holds that the proceeds of a D&O policy are not the property of the estate on the ground that the policies in those cases did not provide entity coverage to the debtor. The court reasoned that the proceeds of the policy at issue were the property of debtor's bankruptcy estate because the policy provided direct coverage to the debtor and thus the estate would be worth more with the policy proceeds included therein.

Having determined that the policy proceeds were property of the estate and that the automatic stay applied, the court determined that cause existed to grant the directors relief from the automatic stay. The court reasoned that the directors would be irreparably harmed if they were not permitted to exercise their contractual right to payment of defense costs. The court also acknowledged that any prejudice to the debtor was speculative because the debtor had made no claim for indemnification or entity coverage. Moreover, the court rejected the trustee's argument that there may be indemnification claims in the future, opining that the claims for which the insurer would be paying defense costs would be the same claims for which the directors would seek indemnification from the debtor. Thus, the insurer's payment of defense costs would minimize the potential exposure of the debtor. Lastly, the court rejected the trustee's argument that the personal profit and dishonesty exclusions would ultimately bar coverage under the D&O policy for defense fees and losses. The court refused to decide the coverage issues raised by the trustee, indicating that the insurer's payment of defense fees would be at its own peril.