Effects of Bankruptcy on Insurance Policies
White Paper Accompaniment to Presentation to CNA on May 28, 2014

By John D. Hughes¹
Jonathan W. Young²
Michael B. Kind³
June, 2014

PART I

I. Does the Insurance Policy Belong to the Bankruptcy Estate?

When the owner of an insurance policy goes bankrupt, the policy becomes the property of the bankruptcy estate. This rule is rooted in the principle that a debtor’s interest in an insurance policy falls within Bankruptcy Code §541(a)(1)’s broad definition of estate property. See In re Vitek, Inc., 51 F.3d 530, 533 (5th Cir. 1995); see also In re Louisiana World Exposition, 832 F.2d 1391, 1399 (5th Cir. 1987). Courts have noted that an insurance policy can often be considered the most important asset of the bankruptcy estate. Id. Therefore, courts generally hold that a debtor’s insurance policy becomes part of the bankruptcy estate’s property upon commencement of bankruptcy proceedings.

In Vitek, hundreds of plaintiffs brought product liability suits against dental implant manufacturer Vitek and its principals, the Homsys. Vitek then filed for bankruptcy, and the trustee for the bankrupt estate sought permission from the bankruptcy court to settle with the corporation’s product liability insurance carriers. Id. at 532. The proposed settlement, which was approved by the bankruptcy court, provided that in return for paying the limits of their policies, the insurers would be protected from any third-party suits, including from the Homsys.

This part of the settlement effectively negated the insurers’ duty to defend and indemnify the Homsys. Id. The Homsys appealed the bankruptcy court’s decision, claiming that their interest in the proceeds of the policies as coinsureds barred the bankruptcy court from approving the settlement. Id.

¹ John D. Hughes is an attorney in the Insurance and Reinsurance Department of Edwards Wildman Palmer LLP. He can be reached at jhughes@edwardswildman.com.
² Jonathan W. Young is an attorney in the Restructuring and Insolvency Department of Edwards Wildman Palmer LLP. He can be reached at jyoung@edwardswildman.com.
³ Michael B. Kind is an attorney in the Restructuring and Insolvency Department of Edwards Wildman Palmer LLP. He can be reached at mkind@edwardswildman.com.
The Fifth Circuit began its analysis of the Vitek case by noting that a debtor’s insurance policy generally must be deemed an asset of the bankruptcy estate. The issue to be decided concerns the proceeds of that policy. At one extreme, when the debtor corporation owns a liability policy that exclusively covers its directors and officers, the proceeds of the D&O policy are not part of the debtor’s estate. At the other extreme, when the debtor corporation owns an insurance policy which covers its own liability to third parties, both the policy and its proceeds are property of the bankruptcy estate. When co-insureds have an interest in the proceeds of the liability policy as well, however, these distinctions are not helpful. Id. at 535. The Fifth Circuit, in order to preserve the Homsys’ claims as co-insureds, modified the bankruptcy court’s order to allow them to bring breach of good faith actions against the insurers if the insurers refused to cover them. The Court expressly refused to indicate whether those claims would have any merit, however. Id. at 538.

The Second Circuit was confronted with a similar issue in MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89 (2d Cir. 1988). In MacArthur, Johns-Manville, a manufacturer of asbestos-containing products that faced extensive liability due to thousands of products liability and negligence lawsuits, filed for bankruptcy and brought suit against its insurance carriers seeking coverage for its asbestos-related liabilities. Id. at 90. In an effort to resolve the litigation with its liability insurers, Johns-Manville and the insurers agreed to a settlement. Under the settlement, in exchange for payments into a settlement fund which the insurers contended represented their policy limits, the insurers would be protected from claims on their liability policies. Id.

Following the bankruptcy court’s approval of the settlements, MacArthur, a distributor of Johns-Manville products, appealed the court’s approval of the settlements. MacArthur claimed that it was a co-insured under several of the policies pursuant to “vendor endorsements.” Accordingly, MacArthur maintained that it was entitled to coverage for claims resulting from its sale of Johns-Manville products. Id.

The Second Circuit, after noting initially that a debtor’s insurance policy is generally the property of the estate, held that MacArthur’s rights as an insured distributor were completely derivative of, and therefore inseparable from, Johns-Manville’s rights as the primary insured. Id. at 92. As a result, the Second Circuit held that as MacArthur’s interest in the liability policies was not an independent interest but rather stemmed from Johns-Manville’s own rights, the policies, and MacArthur’s interest in them, were part of the bankruptcy estate and subject to the jurisdiction of the bankruptcy court. Id. at 93; see also In re Adelphia Communications Corp., 364 B.R. 518, 526 n.18 (Bankr. S.D.N.Y. 2007) (citing MacArthur and Louisiana World to find that D&O liability insurance policies were property of the estate because “they provide coverage the Estate can use; the Estate is worth more with them than without them; and because the policies are something that someone may pay for”).

The MacArthur court then confirmed that the bankruptcy court had the authority to insulate the insurers from any claims by MacArthur. Thus, any claims by MacArthur based on its status as a co-insured under Manville’s policies could only be asserted against the settlement fund. MacArthur, 837 F.2d at 94.

In 2009, the United States Supreme Court also addressed the settlement agreement which was the subject matter of MacArthur, finding that claims by third parties relating to insurance coverage were also enjoined by the settlement. Travelers Indemnity Co., et al. v. Bailey, 129 S.Ct. 2195 (2009). Several years after the settlement agreement, Travelers was sued by a number of plaintiffs alleging that “Travelers conspired with other insurers and with asbestos manufacturers to hide the dangers of asbestos” or that “Travelers violated common law duties by failing to warn the public about the dangers of asbestos.” Travelers moved for the Bankruptcy Court to enjoin the actions by these claimants, arguing that the third party claims constituted “Policy Claims,” which were barred under the settlement agreement.

The Bankruptcy Court found that these third party claims against Travelers arose from, or were related to, the insurance policies and therefore were barred by the settlement agreement. The district court affirmed. The Second Circuit, however, reversed; holding that the Bankruptcy Court’s order erroneously expanded the settlement order beyond the Bankruptcy Court’s subject-matter jurisdiction. In re Johns-Manville, 517 F.3d 52 (2d Cir. 2008).

The U.S. Supreme Court, however, found that the claims that Travelers sought to enjoin constituted “Policy Claims,” which were properly enjoined by the settlement agreement. Travelers Indemnity Co., et al. v. Bailey, 129 S.Ct. 2195 (2009). The Supreme Court held that the Bankruptcy Court “plainly had jurisdiction to interpret and enforce its prior orders.” Id. at 2205. The Court, however, specifically refused to address whether or not the bankruptcy court could properly enjoin claims against nondebtor insurers that are not derivative of the debtor’s wrongdoing. Id. at 2205. The dissenting justices, however, argued that the “arising out of or relating to” language in the definition of “Policy Claims” under the settlement agreement did not necessarily exclude claims by non-parties against Travelers for Travelers own wrongdoing. Id. at 2207-09. (Stephens J., dissenting). According to the dissent, interpreting the settlement agreement any other way would place it beyond the authority of the Bankruptcy Court. Id. at 2210.

The Johns–Manville case subsequently returned to the Second Circuit; In Re Johns–Manville Corp., 600 F.3d 135 (2d Cir. 2010). In this decision, the Second Circuit held that Chubb Indemnity Insurance Company was not given constitutionally sufficient notice of the 1986 Orders, so that due process absolved Chubb from following them.

The general rule that a debtor’s insurance policy is part of the bankruptcy estate is based on the principle that regardless of who may be insured under the policy, the debtor’s contractual rights under the policy itself require that the policy be included as an asset of the estate.
Consonant with this principle is the Eighth Circuit’s decision in In re Titan Energy, Inc., 837 F.2d 325 (8th Cir. 1988). In that case, Titan, the debtor, purchased third-party liability insurance for its ethanol plants, which Titan then sold to another party, Butcher Capital. Id. at 326. Butcher then claimed that the plants were defective and brought a direct action against Titan’s insurer in state court. Butcher claimed that the insurer breached its obligation to respond to Butcher’s claim under the policies purchased by Titan. Id. at 327. The insurer, in turn, brought a complaint in the bankruptcy court seeking a stay of Butcher’s state court action and seeking a declaratory judgment as to the scope of its obligations under the policies. Id.

The Eighth Circuit held that the policies were part of Titan’s bankruptcy estate, despite the fact that Titan’s interest in the policies was “somewhat attenuated,” given Butcher’s secured interest in the proceeds of the policy as a creditor. Id. at 328; see also First Fidelity Bank v. McAteer, 985 F.2d 114 (3d Cir. 1993). Nevertheless, the Eighth Circuit also held that because Titan’s policies primarily benefited Butcher, and because no other parties had asserted claims alleging coverage, Butcher’s state court action against Titan’s insurer could proceed. Id. at 333.

Because a debtor’s contractual rights under an insurance policy become part of the bankruptcy estate, it follows that other rights of the debtor, such as the right to bring a bad faith claim against the insurer, also become property of the estate, and can therefore be asserted by the trustee of the estate. See In re Soliz, 77 B.R. 93 (Bankr. N.D. Tex. 1987). In Soliz, a tractor-trailer driver was involved in an automobile accident resulting in personal injury, property damage, and the death of another motorist. Id. at 94. The administrator of the decedent’s estate and the other two injured parties sought and won judgments against the tractor-trailer driver. Id. The driver brought suit against his insurance carrier, alleging failure to defend and bad faith claims, and then subsequently filed for bankruptcy protection. Id.

At the request of the trustee, the bankruptcy court approved a settlement between the trustee and the insurer whereby the insurer paid to the trustee a lump sum in satisfaction of all claims—a lump sum that was substantially less than the combined amounts of the judgments. Id. In deciding whether the settlement funds were the property of the bankruptcy estate, the court noted initially that the trustee succeeded to any rights to causes of action that the bankrupt previously may have had pursuant to the insurance contract. The court then went on to hold that the proceeds were part of the estate’s property because of the trustee’s succession to the debtor’s right to the cause of action for breach of the duty to defend against the insurer. Id. at 97. The fact that the rights previously held by the debtor and ultimately held by the trustee might be only contingent did not alter this analysis. See Palmer v. Travelers Ins. Co., 319 F.2d 296, 299 (5th Cir. 1963) (“whatever claim—including potential and contingent claims—that the bankrupt owns at the time of his petition, becomes a part of his estate, with title thereto in the Trustee.”).
II. Do the Proceeds of the Policy Belong to the Estate?

   a. Ownership of the policy doesn’t necessarily mean ownership of the proceeds

   While the issue of whether the policy itself becomes the property of the bankruptcy estate
   is relatively straightforward, less clear is the question of whether the proceeds of the policy also
   belong to the estate, and under what circumstances. It is well settled that while a policy may
   become estate property, that fact in and of itself has little bearing on whether the proceeds under
   the policy also become estate property.

   The Fifth Circuit was confronted with this issue in In re Louisiana World Exposition, 832
   F.2d 1391, 1399 (5th Cir. 1987). In Louisiana World, a corporation formed for the purpose of
   organizing the 1984 World’s Fair purchased directors’ and officers’ (“D&O”) policies for
   personal liabilities and expenses of its directors and officers, as well as indemnification coverage
   for the corporation itself. Id. at 1393. After the corporation filed for bankruptcy, a creditors’
   committee was formed and given the authority by the bankruptcy court to bring suit against the
   corporation, and its directors and officers. Id. at 1394.

   Ultimately the committee brought suit against various directors and officers of the
   bankrupt corporation. The committee then brought suit against the D&O insurers as well
   seeking a stay against payment of the directors’ and officers’ legal fees, claiming that such funds
   were part of the estate. Id. The Fifth Circuit held that the proceeds of the D&O coverage were
   not part of the estate, despite the fact that the bankrupt corporation had purchased the policy,
   because the policy benefited only the directors and officers, not the corporation. Therefore, the
   bankrupt corporation did not have any direct interest in the policy proceeds. Id. at 1401.

   b. Test: Does the debtor have a right to receive and keep the policy’s proceeds?

   As Louisiana World sets forth, the test in determining whether the proceeds of a policy
   belong to the estate generally depends upon whether the debtor has a legally cognizable claim to
   the proceeds. In Matter of Edgeworth, 993 F.2d 51 (5th Cir. 1993), the Fifth Circuit was faced
   with the question of whether a malpractice plaintiff seeking to pursue a lawsuit against the
   bankrupt doctor who filed for bankruptcy prior to the filing of the malpractice claim could
   collect a judgment from the proceeds of the doctor’s malpractice policy. The Fifth Circuit set
   forth the test for determining whether the policy’s proceeds could be deemed part of the estate:

   The overriding question when determining whether insurance proceeds are property of
   the estate is whether the debtor would have a right to receive and keep those proceeds
   when the insurer paid on a claim . . . In other words, when the debtor has no legally
   cognizable claim to the insurance proceeds, those proceeds are not property of the estate.
After acknowledging that the bankrupt doctor owned the malpractice policy, the Fifth Circuit drew a distinction between casualty, life and fire insurance policies, which benefit the debtor, and malpractice policies, which “will normally be payable only for the benefit of those harmed by the debtor.” Id. The Court held that since the debtor did not have a legally cognizable claim to the proceeds of his malpractice policy, the plaintiff was permitted to collect from the policy’s proceeds. Id. 4

III. Types of Insurance Policies and Their Terms

   a. Property Insurance

      1. General Rule

         Consonant with the Fifth Circuit’s distinction between property, fire, life and collision insurance on the one hand, and malpractice insurance on the other, the general rule for property insurance policies is that the proceeds belong to the estate, since the debtor would have the right to receive and keep the proceeds when the insurer paid on a claim.

         In In re Bradt, 757 F.2d 512 (2d Cir. 1985), the debtor (Bradt) bought a car with a loan from his credit union. Id. at 514. The security agreement for the loan provided that the automobile would serve as collateral for the loan, and that the security interest also included any proceeds, including insurance, stemming from the vehicle. Id. Shortly after filing for bankruptcy, Bradt was involved in an accident, and the insurer issued a check covering the repairs. Id. When Bradt attempted to deposit the check at his credit union, the credit union seized the check to cover the balance due on Bradt’s car loan. Id.

         The Second Circuit noted that at the time of his bankruptcy petition, Bradt was the legal owner of the vehicle, which therefore made the car property of the estate. Id. at 515. Furthermore, since under § 541(a)(6) of the Bankruptcy Code, “proceeds, product, offspring, rents, and profits of or from property of the estate” are also included in the estate property, the Second Circuit held that the insurance proceeds also were the property of the estate. Therefore, the credit union could not seize the insurance proceeds because they belonged to the estate. Id. at 516.

         As noted in Edgeworth, the same rationale applies to fire insurance policies. For example, in Holland America Ins. Co. v. Succession of Roy, 777 F.2d 992 (5th Cir. 1985), defendants, who had purchased fire insurance for a commercial facility, filed for bankruptcy two days before a fire destroyed the facility. Id. at 993. After several entities brought suit against the

4 At least one circuit, however, has declined to follow the test set forth in Edgeworth as being “too narrow.” See In re Focus Capital, Inc., 504 B.R. 296, 304-305 (Bankr. D.N.H. 2014) (supporting the “fundamental test” whereby insurance proceeds are property of the estate if the estate is worth more with such property than without) (citing, inter alia, In re CyberMedica, Inc., 280 B.R. 12 (Bankr. D. Mass. 2002)).
defendants, the plaintiff insurance company brought an interpleader action seeking to deny coverage and to enjoin the defendants from bringing suit to collect the policy proceeds. Id. at 994. The court held that the policy was property of the estate, thus making the requested injunction improper. “Any right to collect proceeds from the policy belonged initially to [defendants], and since liability on the policy is disputed by [the insurer], [defendants] owned a cause of action to enforce that liability.” Id. at 996. Whether subject to defeasance, defenses or liens, the fire insurance policy and any right to payment from it were property of the debtor’s bankruptcy estate. Id. See also In re Crownover, 43 B.R. 22, 24 (Bankr. E.D. Mo. 1984).

2. Rights of Secured Creditors

The foregoing cases raise an additional issue: what are the rights of secured creditors when the insured files for bankruptcy? Generally, courts have held that secured creditors are only entitled to “adequate protection” and nothing more. See In re Woods, 97 B.R. 850 (Bankr. W.D. Va. 1989).

In Woods, the court was presented with the question of whether the debtor, whose vehicle was destroyed, or the lien holder of the vehicle was entitled to the insurance proceeds. Id. at 851. The Woods court noted that “a creditor whose security interest extends to insurance proceeds is only entitled to adequate protection, and is not entitled to possession of the collateral nor the insurance proceeds.” Id. at 852. See also Bradt, 757 F.2d at 516. The rationale for this rule starts with the proposition that property is still considered part of the bankruptcy estate despite the fact that it is subject to a lien or other encumbrances. Accordingly, it will not be disturbed so long as it can be shown that the creditors’ interests are otherwise protected. In re Hawkeye Chem. Co., 71 B.R. 315, 320 (Bankr. S.D. Iowa 1987).

b. Liability Insurance.

As set forth in the discussion of Edgeworth, supra, since liability insurance policy proceeds generally benefit those harmed by the debtor, they are not considered property of the bankruptcy estate. Edgeworth, 993 F.2d at 56. This principle is illustrated by medical malpractice cases. For example, in Baez v. Medical Liab. Mut. Ins. Co., 136 B.R. 65 (Bankr. S.D.N.Y. 1992), the bankruptcy court properly directed the trustee of the debtor-physician’s estate to distribute the proceeds of the physician’s malpractice policy to the injured plaintiff as the plaintiff had a vested interest in the policy proceeds. Id. at 68.

A similar result was reached by the Third Circuit in a matter involving a credit life insurance policy. First Fidelity Bank v. McAteer, 985 F.2d 114, 118-19 (3d Cir. 1993). In First Fidelity, the Third Circuit was faced with the question of whether the proceeds of a credit life insurance policy were the property of the bankruptcy estate or of the creditor beneficiary of the policy. Id. at 116. Starting with the principle that ownership of the policy does not necessarily dictate ownership of the proceeds, the First Fidelity court held that the beneficiary was entitled to
the proceeds, even though it did not own the policy. The filing of a petition in bankruptcy by the policy owner did not create in him an ownership interest in the policy’s proceeds which he did not have before the filing. Id. at 118-19.

A contrary result was reached by the First Circuit in Trignali v. Hathaway Mach. Co., 796 F.2d 553 (1st Cir. 1986). In Trignali, the court held that the proceeds of a winch manufacturer’s liability insurance policy were property of the estate. Id. at 560. Relying in large part upon the Fourth Circuit’s decision in A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir. 1986), the Trignali court reasoned that to hold otherwise would “start a race to the courthouse whenever a policy is too small to satisfy several potential plaintiffs.” Id.

The Trignali court, in its reliance on the A.H. Robins decision, however, appears to have blurred, if not erased, the distinction between the insurance policy and its proceeds. The portion of the Fourth Circuit’s decision in A.H. Robins that was quoted by the Trignali court merely states that a products liability policy is valuable property of the debtor, without distinguishing between the policy itself and its proceeds. A.H. Robins, 788 F.2d at 1001. Furthermore, other courts have criticized the Trignali decision and declined to follow its holding. See, e.g., Landry v. Exxon Pipeline Co., 260 B.R. 769, 785-90 (Bankr. M.D. La. 2001).

IV. Bankruptcy and D&O Policies

Yet another variation on the question of whether an insurance policy can be deemed part of the bankruptcy estate arises when the policy in question involves D&O insurance. The general answer to this question is that it depends upon whether the policy contains just A side and B side coverages, or also includes a C side coverage as well.

a. If the D&O policy contains only A side and B side coverages, the proceeds of the policy generally are not property of the estate.

Louisiana World, supra, posed the question of whether the proceeds of a D&O policy, which was purchased by the bankrupt corporation, could be considered the property of the bankrupt estate. Louisiana World, 832 F.2d at 1401. In Louisiana World, the creditors’ committee attempted to enjoin further payments to the directors and officers under the D&O policy, arguing that if the committee was successful in its suit against the directors and officers of the bankrupt corporation, the committee would be entitled to the proceeds of the D&O policy which would have already been diminished by reason of the payment of the directors’ and officers’ legal expenses. Id. at 1394. Despite this argument, the court held that the policy proceeds were not estate property, as they only benefited the directors and officers, not the bankrupt corporation. Id. The court therefore allowed the policy’s proceeds to be used to pay the defense costs of the directors and officers.

Contrary to Louisiana World, however, is the Ninth Circuit’s holding in In re Minoco
Group of Companies, Ltd., 799 F.2d 517 (9th Cir. 1986). In Minoco, the insurance company that issued the bankrupt corporation D&O insurance argued that the proceeds of the D&O policies were not property of the estate, as they only served to benefit the officers and directors. Id. at 519. The Ninth Circuit rejected this reasoning, holding instead that since the policies also insured the bankrupt corporation against indemnity claims by officers and directors, the policies also served to benefit the corporation. Id. at 519. The court compared the D&O policy insuring the corporation from indemnification claims by officers and directors to liability policies protecting debtors against claims by consumers. Finding “no significant distinction,” the Ninth Circuit reasoned that in both cases, the policies protected an estate’s value against diminution. Id. See also In re Benz, 2007 WL 1119893, *4 (9th Cir. Mar. 28, 2007) (recognizing that under Minoco, an insurer’s post-petition cancellation of policies violates the Bankruptcy Code “because the policies themselves are property of the estate and cancellation is an act to exercise control over property of the estate”). A more recent decision by the United States Bankruptcy Appellate Panel of the Ninth Circuit emphasized, however, that the issue before the court in Minoco was “only whether the policies were property of the estate subject to the automatic stay, not the policies’ proceeds.” Mila Inc. v. Sapp, 423 B.R. 537 (9th Cir. Bankr. 2010). In Mila, the court affirmed the bankruptcy court’s determination that Mila’s officers showed requisite cause to modify the automatic stay to obtain advancement of defense costs. In support of its decision, the court noted that the insurer’s advancement of defense costs for which the debtor was ultimately obligated to pay minimized the potential exposure of the debtor. 423 B.R. at 545 (citing Louisiana World).

b. If the D&O policy also contains C side coverage and the corporation/debtor is also a defendant, some courts have held that the policy’s proceeds are property of the estate.

In In re CyberMedica, Inc., 280 B.R. 12 (Bankr. D. Mass. 2002), the debtor, CyberMedica, and the former directors and officers of CyberMedica were sued by the bankruptcy trustee for damages resulting from alleged misrepresentations, fraudulent transfers, and breaches of duty with respect to the operation of CyberMedica. Id. at 13-14. CyberMedica purchased and maintained a D&O policy that provided direct coverage to the directors and officers, coverage to the debtor itself against indemnification claims from the directors and officers and coverage to the debtor for third-party claims against it. Id. at 14.

The directors and officers argued that they had the contractual right to have their defense costs and expenses paid by the insurer, that the policy proceeds were not property of the estate, and that the debtor did not have an interest therein since no indemnification claims had yet been filed against the estate. Id. The trustee argued that such payment would deplete the funds that would ultimately go to the estate to cover indemnification costs. Id.

The court held that the proper test for determining whether D&O policy proceeds belonged to the estate was to determine whether the estate would be worth more with the
proceeds than without them. Id. at 17. Applying the test, the court held that the proceeds were part of the estate, reasoning that the estate would be worth more with the proceeds insofar as they would protect the estate against indemnity claims. Id. See also In re Adelphia, 285 B.R. 580, 593 (Bankr. S.D.N.Y. 2002) (rev’d 298 B.R. 49) (S.D.N.Y. August 25, 2003). (On remand, the Bankruptcy Court enjoined the declaratory judgment action commenced by Adelphia’s insurers with respect to rescission and discovery issues, but rested its decision on Bankruptcy Code Section 105(a) rather than Section 362. 2003 WL 22945634 (Bankr. S.D.N.Y. Dec. 5, 2003)).

In In re Eastwind Group, Inc., 303 B.R. 743 (Bankr. E.D. Pa. 2004), the court concluded that proceeds of a D&O policy providing coverage to the directors and officers as well as entity coverage for securities claims were property of the estate where securities laws violations were asserted both against the directors and officers and the debtor.

Conversely, in In re First Central Financial Corp., 238 B.R. 9, 12 (E.D.N.Y. 1999), the court found that proceeds from a D&O policy which provided coverage to the debtor for claims against it in addition to providing coverage for claims against directors and officers of the debtor would not always be considered property of the estate. Here First Central Financial, the debtor, purchased a D&O policy that provided direct coverage to the directors and officers, coverage to the debtor against indemnification claims from the directors and officers, and an endorsement to the policy which provided coverage to the debtor in the event it was sued for violations of securities laws. Id. at 14.

The trustee contended that the entity coverage included in the policy required that the proceeds be treated as property of the estate. Id. at 16. Rejecting the trustee’s position, the court held “the mere appendage of entity coverage to this Policy by way of a rider, providing the Debtor with protection from securities claims does not provide sufficient predicate, per se to metamorphose the proceeds into estate property.” Id. at 17.

The court recognized that there might be situations where the proceeds would be considered property of the estate, such as where claims against the debtor threatened to exhaust insurance proceeds and thereby jeopardize estate assets over and above the policy limits. Id. Because the court concluded that there was no danger to the estate assets in this case, the court declined to exercise its right to enjoin the officers and directors from attempting to obtain coverage under the D&O policy. Id. at 21.

More recently, the Bankruptcy Court for the Southern District of Florida in In re Laminate Kingdom, LLC, 2008 WL 1766637, No. 07-10279-BKC-AJC (Bankr. S.D. Fla. March 13, 2008), held that a D&O policy was not an asset of the estate and granted Carolina Casualty Insurance Company’s motion for relief from automatic stay to permit it to advance and/or pay defense costs incurred against directors and officers of the debtor. The court found that due to the policy language, which provided specifically that proceeds of the policy must first be used to pay non-indemnifiable loss, the estate only had a contingent interest in the proceeds. Id. at *3.
Therefore, the court noted that the payment of the directors and officers legal fees did not diminish the protection afforded to the estate. Id. The court held that even if the policy proceeds were considered property of the estate, cause would exist to grant stay relief because “at its core, a D&O policy remains a safeguard of officer and director interests and not a vehicle for corporate protection.” Id. at *4 (quoting In re First Central Financial Corp., discussed supra). See also In re Refco Inc., Order Granting Mot. Sum. J., No. 05-60006(RDD) March 27, 2006 (granting insurer’s motion for relief from automatic stay to permit it to advance costs incurred against directors and officers under a D&O policy); In re Arter & Hadden, LLP, 335 B.R. 666 (Bankr. N.D. Ohio 2005)(although holding that D&O policy proceeds were property of the estate because the policy expressly defined the insured entities to include both directors and officers as well as the debtor, the court lifted the automatic stay because it found the directors and officers may “suffer substantial and irreparable harm if prevented from exercising their rights to . . . fund their defense.”); In re Boston Regional Medical Center, 285 B.R. 87 (Bankr. D. Mass. 2002)(granting limited relief from stay for purpose of allowing insurer to make limited payments with D&O policy proceeds on directors’ and officers’ behalf for expert witness fees)).

Accordingly, in these types of situations, the automatic stay generally will have to be modified in order for the insurer to advance defense costs for the benefit of the director and officer defendants.

V. Bankruptcy of Primary Insurer and “Drop Down” of Excess Coverage

a. General Rule: Requirement for “drop down” of excess coverage hinges on the wording of the excess insurance policy.

When faced with situations in which the underlying insurer files for bankruptcy, courts have been reluctant to require the excess insurer to “drop down” its coverage limits unless the excess policy contains specific language anticipating the possibility of the primary insurer’s insolvency, or unless the language in the policy is so ambiguous as to the excess insurer’s coverage that policy considerations dictate that the ambiguity be resolved in favor of the insured. Couch on Insurance 3d, §§ 6:35-36.

1. Excess policy language expressly forbids “Drop Down” coverage: courts will generally uphold such express exclusions of “Drop Down” coverage.

Gibson v. Kreihs, 538 So.2d 1057 (La. Ct. App. 1989), provides a good example of the language in an excess insurance contract required to protect against the excess insurer’s duty to “drop down.” In Gibson, the excess policy provided:
In the event there is no recovery available to the insured as a result of the bankruptcy or insolvency of the underlying insurer, the coverage hereunder shall apply in excess of the applicable limit of liability [$1,000,000] specified in the Schedule A.

Id. at 1059. The insured, Buck Kreihs Co., and the primary insurer were sued for damages sustained in a three car collision allegedly due to the negligence of Louis F. Kreihs. Id. at 1058. While the suit was pending, the insured’s primary automobile liability policy carrier became insolvent. Id. After the primary insurer’s insolvency, the claimants amended their complaint to include the Louisiana Insurance Guaranty Association (“LIGA”), and the excess insurer. Id.

The excess insurer moved for summary judgment on the grounds that the claimants sought damages of less than $1,000,000, and the excess insurer was not obligated to provide coverage unless the loss exceeded that amount. Id. The Louisiana Court of Appeals upheld the lower court’s determination that the excess insurer’s sole obligation was to provide coverage up to its policy’s limit in the event that a judgment of over $1,000,000 was rendered against the insured. Id. The court based its decision on the fact that the policy provided that the excess insurer was liable “only for the ultimate net loss in excess of the applicable limits of the [primary insurer] policy listed in Schedule A.” Id. at 1059 (emphasis added). In addition, the court held that the policy “unquestionably” did not “drop down” due to the insolvency of the primary insurer because of the specific language relating to the insolvency of the primary insurer, noted above. Id. at 1060.

Similarly, in Louisiana Ins. Guaranty Assoc. v. International Ins. Co., 551 So.2d 50 (La. Ct. App. 1989), the excess insurance policy in question provided, in relevant part, that:

In the event there is no recovery available to the insured as a result of the bankruptcy or insolvency of the underlying insurer, the coverage hereunder shall apply in excess of the applicable limit of liability.

Id. at 52. Accordingly, the court held that the excess insurer’s policy did not “drop down,” and that therefore the excess insurer only would have to provide coverage above the insolvent primary insurer’s limit. Id. See also Huggins v. Gerry Lane Enterprises, Inc., 2006 WL 3103493, No. 2005 CA 2665 (La. App. Nov. 3, 2006) (upholding a clearly worded “anti drop down provision” that “clearly expresses that the parties never intended that coverage provided by the … policy would “drop down” in the event of the insolvency of the underlying scheduled insurer”), aff’d at 957 So. 2d 127; Massachusetts Bay Transportation Authority v. Allianz Insurance Company Inc., 413 Mass. 473, 597 N.E.2d 439 (Mass. 1992) (holding that excess insurer was not required to “drop down” due to the insolvency of an underlying insurer where the policy only provided coverage excess of the commitment made by the underlying insurer, and because the policy made clear that coverage was not adjustable downward in response to the insolvency of the first-level excess carrier).
2. Policy Language is Silent on “drop down” Coverage

Whether an excess insurer is required to “drop down” when the policy at issue does not contain specific language expressly prohibiting “drop down” coverage is a more difficult analysis.

i. **Majority Rule:** The absence of language expressly excluding “drop down” coverage does not create sufficient ambiguity in an excess policy to require the excess insurer to provide “drop down” coverage.

*Metropolitan Leasing, Inc. v. Pacific Employers Ins. Co.*, 633 N.E.2d 434 (Mass. App. Ct. 1994) provides a good illustration of the majority rule that the absence of language excluding “drop down” coverage does not dictate that the excess insurer is obligated to provide such coverage. In *Metropolitan*, the Appeals Court of Massachusetts held that “a mere failure of the excess policy to deal with the consequences of insolvency does not, by itself, create ambiguity.” *Id.* at 437.

In *Metropolitan*, the lower court determined that there was ambiguity in the policy of a third-level excess policy due to a clause in the contract, which provided:

In the event of cancellation or termination of the primary insurance, this certificate, to the extent of such cancellation or termination, shall cease to apply at the same time without notice to the Insured.

*Id.* at 436. The court of appeals explained that the lower court had erroneously compared this language to other cases in which the policies actually provided for “drop down” in certain situations. *Id.* The language in the Pacific policy, however, actually contemplated that coverage would “cease to apply” in the event of cancellation of the underlying policy. *Id.* at 438.

The Plaintiffs also argued that the fact that the third excess insurer had “follow form” language in its policy meant that it must “drop down” if the underlying policy “dropped down.” *Id.* at 439. The appeals court, however, explained that “‘following form’ language means only that the policy covers the same risks as the underlying insurer, and has nothing to do with the excess policy’s lower limits or the events which trigger its applicability.” *Id.*

In *Alaska Rural Elec. Co-op Ass’n, Inc. v. INSCO Ltd.*, 785 P.2d 1193 (AK 1990), the excess policy did not expressly provide for the bankruptcy or insolvency of the primary insurer, but the Supreme Court of Alaska held that the excess insurer was not obligated to “drop down” because insolvency of the primary carrier was not “one of the risks considered in determining an excess carrier’s premium.” *Id.* at 1194. In *Alaska*, the excess policy had a clause regarding “other insurance” which stated:
If other valid and collectible insurance, which is written by another insurer is available to the Insured covering a loss also covered by this policy, other than insurance that is in excess of this policy, the insurance afforded by this policy shall be in excess of and shall not contribute with such other insurance.

Id. at 1196. The plaintiffs argued that because the primary policy was not “valid and collectible,” the excess insurer should “drop down.” Id. The court specifically noted that the “other insurance” clause in the excess policy did not apply to the underlying insurer, and the “valid and collectible” language was therefore not relevant to the determination of whether or not the excess insurer should “drop down” due to the underlying insurer’s insolvency. Id. See also Pacific Coast Building Products, Inc. v. AIU Ins. Co., 2008 WL 4927351 (9th Cir. 2008) (holding that policy provision requiring underlying insurance to be exhausted compelled application of horizontal exhaustion rule); Cadwell Freight Lines, Inc. v. Lumbermens Mutual Cas. Co., 947 So.2d 948 (Miss. 2007) (holding excess insurer has no duty to drop down to provide primary coverage unless the policy expressly provides for such coverage).

ii. Minority Rule: Ambiguous excess policy language regarding “collectible” primary policy should be construed against the excess insurer with the result being that the excess policy should “drop down.”

In contrast to the holdings in Metropolitan and Alaska, some courts have applied the well-settled principle that ambiguities in insurance contracts should be resolved in favor of the insured to justify finding “drop down” coverage. The vast majority of cases finding such ambiguities involve umbrella policies; however, there have been a small number of cases involving pure excess policies.

For example, in Alabama Ins. Guar. Ass’n v. Magic City Trucking Service, Inc., 547 So.2d 849 (Ala. 1989), the Supreme Court of Alabama held that the excess policy in question was ambiguous with regard to whether the excess coverage was required to “drop down” when the primary insurance was not collectible, and the excess policy was ambiguous in its definition of the term “collectible insurance.” Id. at 853. The policy contained the following language:

(a) Underlying limit—an amount equal to the limits of liability indicated beside the underlying insurance listed in the schedule of underlying insurance, plus the applicable limits of any other underlying insurance collectible by the insured

In this case, both the primary and excess insurers were declared insolvent, and the claimants sought to have the Alabama Insurance Guaranty Association, which was standing in the shoes of the excess carrier, “drop down” to provide primary coverage due to the primary insurer’s bankruptcy. Id. at 850. The court held that the excess insurer’s policy should be
interpreted as requiring the carrier to “drop down” to provide indemnity to the extent that the insolvent primary insurer’s estate did not because of the well settled principle that ambiguities in insurance contracts should be interpreted in favor of the insured. Id. at 855. The court relied upon the opinion of the Massachusetts Supreme Judicial Court in Gulezian v. Lincoln Ins. Co., 506 N.E.2d 123 (Mass. 1987), in which the court held that an umbrella policy must drop down to cover when the primary insurer was insolvent. See also Coca Cola Bottling Co. of San Diego v. Columbia Cas. Ins. Co., 11 Cal. App. 4th 1176 (1992) (holding that excess insurer was required to “drop down” because “amount recoverable” language in policy was ambiguous).

b. Effect of insolvency of Insured when policy contains Self-Insured Retention: Is the Insurer required to “drop down” and pay the retention?

Generally, where an insurance policy provides for the first layer of coverage to be a self-insured retention (“SIR”), the insurer excess to the SIR is not required to “drop down” and pay the SIR where the insured becomes insolvent. See, e.g., Kleban v. National Union Fire Ins. Co. of Pittsburgh, 771 A.2d 39 (Pa. Super. Ct. 2001); Home Ins. Co. of Illinois v. Hooper, 691 N.E.2d 65, (Ill. App. 1998). In Home Ins., the Appellate Court of Illinois treated the issue similarly to that of an excess insurer where the primary insurer becomes insolvent and held that because there was no “drop down” provision in the policy, the coverage should begin where the unpaid underlying insurance left off. 691 N.E.2d at 70.

Similarly, in Kleban the court held that the insurer was only required to pay the amount of the judgment in excess of the SIR. 771 A.2d at 43-44. “The self-insured retention is therefore not an amount that is owed by the Debtor to [the insurer] but, rather, represents the threshold of [the insurer’s] liability to the [insured].” Id. at 43 (quoting Amatex Corp. v. Aetna Casualty & Sur. Co., 107 B.R. 856, at 872 (E.D. Pa. 1989)). The court further held that the SIR was not exhausted by the insurer’s payment of defense costs. Id. at 43.

In both Home Ins., and a subsequent case applying Illinois law, In re Vanderveer Estates Holding, LLC, 328 B.R. 18 (Bankr. E.D.N.Y. 2005), the courts held that the failure of the insured to actually pay the SIR, however, did not relieve the insurer of its obligation under the policy. Both decisions were primarily based upon an Illinois statute, Ill. Ins. Code, Chapter 215, § 5/388, which provides that all insurance policies must include a provision stating that the insolvency of the debtor will not relieve the insurer of its duty under the policy. The courts held that although the policies made payment of the SIR a condition precedent to the payment of policy proceeds, enforcing this provision would be directly contrary to § 5/388.

Some commentators have suggested that a SIR and a deductible differ in that an insurer may be required to “drop down” and pay an insured’s deductible when an insured declares bankruptcy, while an insurer excess to a SIR would not be required to “drop down.” See Ostrager & Newman, Handbook on Insurance Coverage Disputes § 13.13[a] (2008). Some courts, however, have treated SIRs and deductibles as nearly synonymous. See In re Grace
Industries, Inc., 341 B.R. 399 (E.D.N.Y. 2006) (aff’d 409 B.R. 275) (relying heavily upon a case involving a deductible to hold that even in the absence of a statutory provision, the failure of an insolvent insured to pay its SIR may not relieve the insurer of its obligations under the policy); Kleban, 771 A.2d at 43 (“Self insurance is best compared to the familiar ‘deductible’ amount referenced in most insurance policies.”).

VI. Conclusion

From the foregoing, the general rule clearly is that an insured’s liability policy becomes property of its bankruptcy estate. Whether the proceeds of that policy become property of the bankruptcy estate as well depends upon whether those proceeds would have benefited the bankrupt, absent bankruptcy, or a third party. In the former case, the proceeds of the policy will be deemed assets of the bankruptcy estate as well, and subject to the control of the bankruptcy court. In the latter case, most (but not all) courts hold that the proceeds of the policy belong to the third party to whom they are payable under the policy.

Whether an excess liability policy’s coverage will “drop down” in the event of the primary insurer’s insolvency depends upon the language of the excess policy. Some courts are more demanding than others as to how explicit the language of the excess policy must be in order for “drop down” to be avoided.
PART II

VII. Preclusive Effect of a Proof of Claim

Insurers have routinely made the argument that a creditor’s filing of a proof of claim in a bankruptcy proceeding, or its failure to do so, has a preclusive effect on subsequent attempts to reach and recover from available insurance. The following section addresses two common scenarios arising with respect to proofs of claim: a creditor’s failure to file a proof of claim; a claim filed, but subsequently disallowed by the bankruptcy court; and a claim allowed during the course of the bankruptcy proceedings. A third scenario; the effect of a creditor’s failure to file a proof of claim, will be addressed in the next section.

Pursuant to section 501 of the Bankruptcy Code, a creditor may file a proof of claim, which, if allowed, permits the creditor to share in distributions of the bankruptcy estate. 11 U.S.C. § 501(a); Int’l Business Machines v. Fernstrom Storage & Van Co., 938 F.2d 731, 733 (7th Cir. 1991) (“Section 501(a) of the bankruptcy code allows, but does not require, creditors of the bankruptcy estate to file proofs of claim.”).

The filing of a bankruptcy petition gives rise to the automatic stay which is designed to protect property of the bankruptcy estate from the reach of third parties. See 11 U.S.C. § 362. As we have seen, this property may include certain insurance policies and even the proceeds of those policies. Upon confirmation of a plan of reorganization by the debtor, and a subsequent discharge of prepetition indebtedness, the automatic stay is replaced with a permanent injunction under section 524(a), which prohibits third parties from pursuing the debtor for the discharged debt. 11 U.S.C. § 524(a). Essentially, section 524(a) precludes third parties who held prepetition claims against the debtor from holding the debtor liable for such conduct after a discharge is granted.

In order to participate in any recovery, a creditor must timely file a proof of claim. When a creditor files a proof of claim, but that claim is disallowed during the course of the bankruptcy proceedings, whether a creditor may seek to hold an insurer liable is open for debate. Initially, a proof of claim is deemed allowed unless a party in interest objects. 11 U.S.C. § 502(a); EDP Med. Computer Sys. v. United States, 480 F.3d 621, 626 (2d Cir. N.Y. 2007). It has widely been held that the allowance or disallowance of a claim is considered a final judgment for purposes of res judicata.5 In re Los Gatos Lodge, Inc., 278 F.3d 890, 894 (9th Cir. 2002) (“Proofs of claims themselves are not final judgments giving rise to res judicata, but the bankruptcy court’s allowance or disallowance of a proof of claim is a final judgment.”); Siegel v. Federal Home

---

5 However, no preclusive effect is given to a disallowed proof of claim when the debtor’s bankruptcy case is dismissed without discharge. Mirzai v. Kolbe Foods, Inc. (In re Mirzai), 271 B.R. 647, 652 (C.D. Cal. 2001).
Interpreting the disallowance of a claim as extinguishing the underlying debt on which the insurer could be liable, some courts bar creditors whose claims have been disallowed from commencing actions against the debtor’s insurer. See Bursch v. Beardsley & Piper, 971 F.2d 108, 114 (8th Cir. 1992).

Where a claim is discharged, the debt is recognized in bankruptcy -- that is, allowed -- but the debtor is relieved of responsibility for it. Because this relief is limited to the debtor, a party derivatively liable for the debt, such as an insurer, remains responsible. . . . Where a claim is disallowed, however, the debt is not recognized and the creditor is unable to share in any distribution of the debtor’s assets. . . . In this situation, an insurer cannot be derivatively liable for the debt because the debtor was never principally liable for it.

Id. at 114.

Conversely, even where a claim is disallowed by the bankruptcy court, other courts permit the claimant to proceed nominally against the debtor to collect available insurance proceeds. See Hawxhurst v. Pettibone Corp., 40 F.3d 175, 179 (7th Cir. 1994). In Hawxhurst, the Bankruptcy Court entered an order disallowing personal injury claims for which no proof of claim was filed. As the holder of a disallowed claim, the claimant was precluded from sharing in distribution of the assets of the bankruptcy estate. Notwithstanding such disallowance, the Seventh Circuit held that res judicata did not bar the claimant from proceeding nominally against the debtor, as the cause of action against the debtor in the bankruptcy court was not the functional equivalent of the subsequent action against the debtor and its insurer. Id. at 180 (“Permitting a suit to obtain a declaration of liability against a debtor is not equivalent to authorizing the recovery of a barred claim in a bankruptcy proceeding”). Moreover, the Circuit Court found that it would be hard to reach a conclusion to the contrary, given that the claimant was not even required to file a proof of claim in the bankruptcy court in order to proceed against the debtor’s insurers in a later action. Id.

In understanding the conflicting decisions, it is important to distinguish between disallowance of a claim on the merits, as opposed to procedural disallowance. The doctrine of res judicata applies when an action has been previously adjudicated on the merits. See Hawxhurst, 40 F.3d at 180 (“In order for res judicata to apply, there must be (1) a final judgment on the merits in a prior action; (2) identity of the cause of action in both the prior and subsequent suits; and (3) identity of the parties or privies in these suits.”). While an order disallowing a

---

6 But see In re Santry, 481 B.R. 824, 830 (Bankr. N.D. Ga. 2012) (noting that some courts have criticized the holding in Siegel and that other circuits follow different rules with respect to the res judicata effect of the allowance of a proof of claim).
claim is generally viewed as res judicata, the case may be different when, as in Hawxhurst, the
claim was disallowed on procedural grounds as untimely, and therefore, the Bankruptcy Court
never adjudicated the claim on the merits. See U.S. v. Coast Wineries, Inc., 131 F.2d 643, 648-
49 (9th Cir. 1942) ("[T]he distinction must be noted between disallowance of a claim because the
creditor had a nonprovable debt and disallowance because he had no debt at all. Disallowance
on the former ground decides nothing as to the merits of the claim.").

With respect to claims which have been allowed by a bankruptcy court, while hardly a
universal rule, one court has held that such allowance does not bind the debtor’s insurer in a

A liability insurer has no obligation to appear in bankruptcy court on its own
behalf and in its own name to object to a claim against an insured debtor. An
insurer’s obligation under a liability insurance policy is to defend and indemnify
the insured in accordance with the provisions of the policy. If the insured elects
to not oppose or defend against a bankruptcy claim and the bankruptcy trustee
agrees with the claimant that the claim should be allowed, the insurer has no
obligation to object to the claim on its own behalf.

Id. at 165-66; see also First Fidelity Bank v. McAteer, 985 F.2d 114, (3d Cir. 1993) (where the
amount of a debt owed to a creditor was crammed down in the debtor’s plan, the Third Circuit
held that “the creditor remains free to collect the full amount of the original obligation from any
non-debtor party such as a guarantor or insurer”).

7 However, outside of the insurance context, courts have held that proofs of claim allowed as uncontested constitute
final judgment for purposes of res judicata. EDP Medical Computer Systems, Inc., 480 F.3d at 625-26 ("Res
judicata does not require the precluded claim to actually have been litigated; its concern, rather, is that the party
against whom the doctrine is asserted had a full and fair opportunity to litigate the claim.").

[W]e see § 502(a) as a recognition of the fact that people can raise objections and litigate them, if
they see something wrong with a claim, but if they do not, the claim will be treated in all respects
as a claim allowed by the court itself. In short, the validity of the claim has been determined on
the merits, and attacks upon it that ‘could have been asserted’ cannot be raised in later
proceedings.

Siegel, 143 F.3d at 530 (quoting Robertson v. Isomedix, Inc. (In re Intl. Nutronics), 28 F.3d 965, 969 (9th Cir.
1994)); But see County Fuel Co., Inc. v. Equitable Bank Corp., 832 F.2d 290, 292 (4th Cir. 1987) (finding it
“doubtful that the ‘automatic allowance’ under 11 U.S.C. § 502(a) of a claim not objected to constitutes a ‘final
judgment’ of the type that gives rise to ‘bar’ or ‘claim preclusion’ under strict res judicata principles.”). It is unclear
whether an insurer is a party in interest with standing to object to a claim in the debtor’s bankruptcy proceeding. If
the insurer was not given an opportunity to object, then it likely would not be deemed to have had “a full and fair
opportunity to litigate the claim.” EDP, 480 F.3d at 626.
In summary, the failure of a party to file a proof of claim in the bankruptcy proceedings will not preclude the party from filing a subsequent action against the debtor, nominally, in order to pursue recovery from available insurance proceeds. The law is considerably less clear with respect to claims allowed and disallowed during the course of the bankruptcy proceedings. Regarding such claims, the chief consideration is whether the claim was adjudicated on the merits, or whether it was allowed or disallowed as a matter of procedure. In the case of the former, the insurer will have a significantly more persuasive argument that a subsequent action against the debtor and insurer should be barred by the doctrine of res judicata.

VIII. Discharge, Post-Confirmation Injunctions and Non-Debtor Releases

The discharge and injunction provisions of the Bankruptcy Code form the keystone of the “fresh start” granted to a reorganized debtor under Chapter 11. First, Section 1141(d)(1) of the Bankruptcy Code provides, among other things, that the confirmation of a plan “discharges the debtor from any debt that arose before the date of such confirmation.” 11 U.S.C. § 1141(d)(1). In addition, Section 524(a) provides, in part, that a discharge granted in a bankruptcy case:

(1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under [Section 1141 of the Bankruptcy Code], whether or not discharge of such debt is waived; [and]

(2) operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived; . . . .


These provisions, by their terms, only apply to the debtor, and only apply in the context of confirming a plan of reorganization. Furthermore, Section 524(e) of the Bankruptcy Code specifically provides that “discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.” 11 U.S.C. § 524(e). Accordingly, the discharge and injunction granted to a debtor under a chapter 11 plan do not prevent the debtor’s creditors from seeking recovery against related parties, such as directors, officers, shareholders, guarantors, sureties, or joint-tortfeasors—or the debtor’s insurers. Stated differently, “[a] discharge in bankruptcy does not extinguish the debt itself, but merely releases the debtor from personal liability for the debt. Section 524(e) specifies that the debt still exists and can be collected from any other entity that might be liable.” Id.; Bituminous Ins. Co. v. Chapman (In re Coho Resources), 345 F.3d 338, 342-43 (5th Cir. 2003) (“The discharge and injunction . . . are expressly designated to protect only the debtor’’); Green v. Welsh, 956 F.2d 30, 35 (2d Cir. 1992).
Courts have held uniformly that the debtor’s discharge does not affect an insurer’s liability as to third parties. Id. ("§ 524 permits a plaintiff to proceed against a discharged debtor solely to recover from the debtor’s insurer."); In re Shondel, 950 F.2d 1301, 1306 (7th Cir. 1991) ("On its face, the provision prevents suits and renders judgments void only with respect to the ‘personal liability’ of the debtor; it does not preclude a determination of the debtor’s liability on the basis of which indemnification would be owed by another party."); In re Doar, 234 B.R. 203, 204 (Bankr. N.D. Ga. 1999) ("Bankruptcy law is clear and nearly unanimous that § 524(e) does not prevent a creditor from maintaining a debtor, nominally, in a state court action for the purposes of establishing liability as a prerequisite to proceeding against a debtor’s liability insurer."); In re Jason Pharmaceuticals, Inc., 224 B.R. 315, 322 (Bankr. D. Md. 1998); In re Greenway, 126 B.R. 253, 254 (Bankr. E.D. Tex. 1991); Lightowler v. Continental Ins. Co., 255 Conn. 639, 645-46 (2001); Arreygue v. Lutz, 69 P.3d 881, 884 (Wash. Ct. App. 2003); see also 4 Collier on Bankruptcy ¶ 524.05 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.) ("It is generally agreed that the debtor’s discharge does not affect the liability of the debtor’s insurer for damages caused by the debtor and that the creditor may seek to recover from the insurer.").

Thus, even where a party has failed to file a proof of claim in a debtor’s bankruptcy case, courts have held that the party may still pursue a state court action against the debtor, nominally, to recover against insurance policy proceeds. See Edgeworth, 993 F.2d at 55; Jet Florida Systems, Inc., 883 F.2d 970 at 976 ("[P]ursuant to section 524(e), a plaintiff may proceed against the debtor simply in order to establish liability as a prerequisite to recover from another, an insurer, who may be liable."); Fernstrom, 938 F.2d at 734 (because “the creditor holding the claim for which no proof was filed has agreed that all it [would] seek from the debtor is a determination of liability”, the creditor was permitted to proceed in its district court suit against the debtor); Coho, 345 F.3d at 343 (explaining that, while a party’s failure to file a proof of claim barred his claims against the debtor personally, “it does not affect his claims against non-debtors, such as general liability insurers”); Patronite v. Beeney (In re Beeney), 142 B.R. 360, 363 (B.A.P. 9th Cir. 1992) (holding that a party who failed to file a proof of claim may pursue litigation against the debtor so long as any judgment obtained will not be enforced against the debtor or his property); Doar, 234 B.R. at 205 (finding the non-filing of a proof of claim “irrelevant to the issue of whether a creditor may pursue a debtor’s liability insurer after a discharge order has been entered in the debtor’s bankruptcy case except to the extent that an ultimate judgment of liability against a debtor’s liability insurer would have to be reduced to the extent that the creditor received a distribution on its claim in the bankruptcy case”).

---

8 The Sixth Circuit, however, holds to the contrary. In Citibank, N.A. v. White Motor Corp. (In re White Motor Credit), the Sixth Circuit barred tort plaintiffs who failed to file a proof of claim in the bankruptcy proceedings from maintaining an action against the debtor nominally in order to collect from the debtor’s insurers. 761 F.2d 270, 275 (6th Cir. 1985). Although the case remains good law in the Sixth Circuit, the decision has been widely criticized by other circuit courts. See, e.g., Jet Florida Sys., 883 F.2d at 973; Shondel, 950 F.2d at 1307-08; Green, 956 F.2d at 34 (declining to follow White Motor Credit).
However, section 105(a) of the Bankruptcy Code—reflecting the bankruptcy courts’ origins as courts of equity—provides that a bankruptcy court “may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a); see also United States v. Energy Res. Co., 495 U.S. 545, 549 (1990) (“These statutory directive are consistent with the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships.”). Furthermore, Section 1123(b)(6) of the Bankruptcy Code provides that a plan of reorganization may “include any other appropriate provision not inconsistent with the applicable provisions of this title.” 11 U.S.C. § 1123(b)(6).

Unsurprisingly, parties involved in a debtor’s chapter 11 case or in the negotiation of the plan of reorganization—including the debtor’s insurers—have frequently sought to have the bankruptcy court approve releases of these third-party claims, and to have the bankruptcy court’s equitable powers extended to enjoin parties holding claims against the debtor from asserting those claims, or even related claims, against the non-debtor parties whose liability arises from their relationship with the debtor.

First, some bankruptcy courts have approved releases of claims against non-debtor third parties in the context of approving settlement agreements with the debtor. See, e.g., McArthur Co. v. Johns-Manville Corp., 837 F.2d 89 (2d Cir. 1988). In certain circumstances, these settlements have also enjoined claimants from bringing suits against the non-debtor, third-party releasees, where the claims are derivative of the debtor’s own claims that are being settled. See, e.g., In re Energy Corp., Inc., 886 F.2d 921, 929 (7th Cir. 1989) (“The power of the court under [section 105(a)] . . . includes the power to issue an injunction enjoining third parties rom pursuing actions which are the exclusive property of the debtor estate and are dismissed pursuant to a settlement agreement.”).

Second, the debtor’s plan of reorganization and bankruptcy court’s order confirming the plan may enjoin suits against non-debtor parties, including insurers. See, e.g., Menard-Sanford v. Mabey (In re A.H. Robins Co., Inc.), 880 F.2d 694 (4th Cir. 1989).

9 While some bankruptcy court orders only provide for releases of third-party claims against non-debtors and others include both release and injunction provisions, the distinction between the two is one of degree rather than kind—as both effectively discharge a claimants ability to recover against the non-debtor party releasee.

10 A number of courts have also held that a debtor may seek to have a bankruptcy court may enjoin suits against non-debtor parties prior to the confirmation of a plan by commencing an adversary proceeding in the bankruptcy case. See, e.g., In re A.H. Robins Co., 788 F.2d 994 (4th Cir. 1986). However, courts have unanimously recognized that this type of injunction is preliminary only, and that a permanent injunction may issue, if at all, only pursuant to a plan of reorganization. In re Excel Innovations, Inc., 502 F.3d 1086, 1095 (9th Cir. 2007) (noting that the “maximum injunctive relief” the bankruptcy court was empowered to order an injunction through confirmation of a plan); see also In re Calpine Corp., 365 B.R. 401, 409 (S.D.N.Y. 2007) (“A request by a debtor for an injunction under section 105(a) pending confirmation of the debtor’s plans for reorganization is regarded as a request for preliminary injunction.”).
A. Need for Jurisdictional Basis

As an initial matter, however, it should be noted that, in each case, the bankruptcy court must find that approving the releases or entering the injunction protecting the non-debtor party will have an impact on the debtor’s estate. See generally Celotex Corp. v. Edwards, 514 U.S. 300 (1995) (holding that bankruptcy courts have no jurisdiction where matters do not effect on the debtor or its estate). Thus, where the debtor has an interest in insurance proceeds, bankruptcy courts will generally find they have jurisdiction. See, e.g., MacAurthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.), 837 F.2d 89, 90-91 (2d Cir. 1988); In re Dow Corning Corp., 198 B.R. 214, 244-47 (Bankr. E.D. Mich. 1996). On the other hand, courts have generally recognized that they do not have jurisdiction to release non-debtor parties or enjoin claimants where the proceeds of the insurance policies at issue are not property of the estate. See, e.g., In re Elsinore Shore Assoc., 91 B.R. 238, 253 (Bankr. D.N.J. 1988) (distinguishing Johns-Manville on the basis that the claims at issue were against policies that were property of the debtors’ estates).

B. Bases for Releasing and Enjoining Third-Party Claims

Whether pursuant to a settlement agreement or a plan of reorganization, most jurisdictions appear to apply a similar standard. The issue revolves around whether and to what extent Sections 105(a) and 524(e) grant bankruptcy courts discretion to grant non-debtor third parties releases or enjoin claimants from pursuing claims against them. In the Second, Third, Fourth, Sixth, and Seventh Circuits, the Courts of Appeal have all held that bankruptcy courts have the power under 105(a) to issue permanent injunctions or third-party releases under certain circumstances. See, e.g., In re Metromedia Fiber Networks, Inc., 416 F.3d 136 (2d Cir. 2005) (requiring “unique circumstances”); In re Drexel Burnham Lambert Group, Inc., 960 F.2d 285 (2d Cir. 1992); In re Continental Airlines, Inc., 203 F.3d 203 (3d Cir. 2000); In re A.H. Robins, Inc., 880 F.2d 694 (4th Cir. 1989); In re Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002); In re Airadigm Comm., Inc., 519 F.3d 640, 655 (7th Cir. 2008). As the Third Circuit recently observed, “several courts have concluded that trusts and channeling injunctions may be authorized under § 105(a) and § 1123(b)(6) of the Bankruptcy Code to address . . . mass tort liabilities where a trust and channeling injunction would pay ‘an important part in the debtor’s reorganization plan.’” In re Global Indus. Techs., Inc., 645 F.3d 201, 206 (3d Cir. 2011) (quoting SEC v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 960 F.2d 285, 293 (2d Cir. 1992) and citing Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2002) (authorizing channeling injunction to address silicone breast implant claims); Menard-Sanford v. Mabey (In re A.H. Robins Co.), 800 F.2d 694 (4th Cir. 1989) (authorizing a channeling injunction for Dalkon Shield birth control device claims).

Thus where an insurer has agreed to contribute funds to satisfy claims against the debtor (which the insurer might otherwise need to defend with the debtor as the “nominal” defendant),
bankruptcy courts have imposed “channeling injunctions” that direct all litigation related to claims against the debtor (even claims that are, in the first instance, brought against the insurer with the debtor as a nominal defendant) be handled through the bankruptcy court and satisfied from the debtor’s marshaled assets (usually in the form of a creditor trust established pursuant to the debtor’s plan). See, e.g., Kane v. Johns-Manville Corp. (In re Johns-Manville Corp.), 843 F.2d 636 (2d Cir. 1988) (approving plan where insurance proceeds were contributed to a creditor trust and the bankruptcy court entered a channeling injunction directing all asbestos-related claims be asserted against the creditor trust established pursuant to the plan of reorganization). While never having addressed the issue directly, the First Circuit appears to have sided with the pro-release and injunction courts. See Monarch Life Inc. Co. v. Ropes & Gray, 65 F.3d 973, 980 (1st Cir. 1995). Courts in the Eighth and Eleventh Circuits have also appeared to side with the pro-release and injunction courts. See In re Munford, Inc., 97 F.3d 449 (11th Cir. 1994) (approving third-party, non-debtor releases in settlement agreement); In re Master Mortgage Inv. Fund, Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994) (noting that Section 524(e) does not restrict a bankruptcy court’s power on its face).

On the other hand, the Ninth and Tenth Circuit Courts of Appeal read Section 524(e) as precluding a bankruptcy court from granting third party releases and injunctions unless specifically authorized under the Bankruptcy Code. See In re Lowenschuss, 67 F.3d 1394 (9th Cir. 1995); In re Western Real Estate Fund, Inc., 922 F.2d 592 (10th Cir. 1990) (temporary, but not permanent, injunctive relief may be granted). The Fifth Circuit also appears to side with the Ninth and the Tenth, holding that while temporary injunctions may be allowed, Section 105(a) may not be used to impose a permanent third-party injunction or releases. See In re Zale Corp., 62 F.3d 746, 761 (5th Cir. 1995).

Finally, in light of the various approaches to channeling injunctions applied by different courts, and cognizant of the special difficulties created by the asbestos-related litigation and resulting bankruptcy cases in the 1980s and 1990s, Congress enacted Section 524(g) as part of the 1994 amendments to the Bankruptcy Code. Section 524(g) specifically clarifies, building on the developed case law cited above, that bankruptcy courts may establish claims trusts and channeling injunctions to deal with asbestos claims as part of a Chapter 11 plan of reorganization, so long as the plan and the trust meet certain statutory requirements.