

**PRESENTED AT**

**21<sup>st</sup> Annual Insurance Law Institute**

November 10-11, 2016

Houston, Texas

## **AT THE INTERSECTION OF INSURANCE LAW AND BANKRUPTCY**

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## **I. INTRODUCTION**

1. The intersection of insurance law and bankruptcy is confusing and often complex. This presentation focuses on two polar opposite circumstances.

2. First, what happens when an insured person holding a first party insurance claim files bankruptcy? This simple question or simple fact pattern can give rise to a number of bankruptcy issues including ownership of insurance proceeds and distribution of proceeds. One issue that this fact pattern does not raise is the impact of the “automatic stay. Most of the persons attending this program almost automatically link the automatic stay of 11 U.S.C. §362 (or §362 of the Bankruptcy Code) to any legal issue arising in bankruptcy. However, since this first party claim is property of the bankruptcy debtor, and thus “property of the bankruptcy estate” (*see* §541 of the Bankruptcy Code), *there* is no stay of enforcement, collection or the like. But, there will be implications where counter-claims or cross claims are being asserted.

3. On the other hand, where the bankruptcy debtor - who has purchased liability insurance coverage - faces claims made by a third party or potential third party claims, complex problems can and will appear. Of course, here the automatic stay is the first issue that must be addressed, because claims claimants may often wish to liquidate claims in non-bankruptcy forums. Or, and equally often, claims against the Debtor will be pending (even about to go to trial) in non-bankruptcy forums and the Debtor ducks into bankruptcy. In other circumstances, proceeds may be insufficient to satisfy multiple claims, and must be allocated. The most difficult are situations - like mass torts - are those in which proceeds of policies will not cover the claims of the third parties and many or all of those claims have not been liquidated or otherwise allowed.

## **II. OWNERSHIP OF PROCEEDS AND POLICIES**

4. When a bankruptcy is filed by a debtor who holds policies providing first party coverage, the policies themselves become property of the bankruptcy estate. The Bankruptcy Code, at 11 U.S.C. §541, defines “property of the estate” in terms which clearly make the policy “property of the estate.” *See In re Vitek*, 51 F. 3d 530, 533 (5<sup>th</sup> Cir, 1995), In fact, the policy may be the most important part of the estate. (*Vitek* was a third party case, and the policy was the primary source of recovery for persons injured by the Debtor’s dental device). *See also In re Louisiana World Exposition*, 832 F. 2d 1391, 1399 (5<sup>th</sup> Cir. 1987).

5. When dealing with first party claims, there is no automatic stay to contend with. The policy is property of the estate, and the person asserting the claim and entitled to policy proceeds is the estate of debtor in bankruptcy and administered by the Debtor or a trustee, depending upon the whether the case is one in which a trustee is appointed.

6. Also, because a first party claim is payable to the owner of the policy, any proceeds paid are also clearly property of the estate. (Proceeds paid on third party claims are not property of the estate; *see, e.g., In re Edgeworth*, 993 f.2d 51 (5<sup>th</sup> Cir. 1993). The *Edgeworth* debtor, a physician was facing a malpractice claim. In determining the ownership of proceeds in this third party claim, the Fifth Circuit determined that the test to determine ownership of proceeds was clearly "whether the debtor would have the right to receive and keep ... proceeds ... paid. [W]hen the debtor has no ...claim..., those proceeds are not property of the estate." *Id.* at 55-56.

7. However, even where the proceeds paid on the first party claim are clearly property of the estate, creditors may have claims to the proceeds. For example, secured creditors may have liens on insurance proceeds securing their collateral. However, this does not give such a creditor a right to collect the proceeds and apply them to the secured debt absent court authority. The claim of a creditor having an interest in first-party insurance proceeds is subject to the automatic stay. A secured creditor is entitled to "adequate protection" under Bankruptcy Code §362 (d). Often, payment of the secured creditor may be agreed. Depending on the circumstances, a Motion for Relief from the automatic stay would be filed and the agreed order entered, if necessary. If for some reason the secured creditor holding an interest in proceeds feels compelled to relief, the creditor should keep in mind that he is only entitled to "adequate protection" of the cash collateral. If the secured creditor wishes to take and apply the proceeds over the Debtor's or trustee's objections, it will need relief from the court; as discussed below.

### **III. BRIEF BANKRUPTCY PRIMER**

8. At this point, a review or primer on bankruptcy seems justified. Bankruptcy cases are filed under various "chapters" of the Bankruptcy Code:

#### **A. The Chapter Proceedings**

- Chapter 7 governs liquidation proceedings for individuals (humans) and corporations (a term that includes all business entities, such as L.L.C.'s, L.P.'s, partnerships, etc.). However, insurance companies and banks may not file under this or any chapter. Railroads may only file under this Chapter 11. In a Chapter 7 case, a trustee is appointed and takes possession of the assets. Those assets which are not exempted by law (*see* 11 U.S.C. §522) are liquidated by the Chapter 7 trustee and applied to the allowed claims in order of priority under the priority scheme of the Bankruptcy Code. *See* 11 U.S.C. §507. The Chapter 7 trustee is usually appointed from a panel of persons selected by the Office of the U.S. Trustee.

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21<sup>st</sup> Annual Insurance Law Institute session

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