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'Pay First' Provisions and the Insolvent Policyholder

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When an insured entity becomes a debtor in bankruptcy, the interests of liability insurers collide with fundamental principles of the Bankruptcy Code. Most liability insurance policies require the policyholder to pay a deductible or self-insured retention ("SIR") before the insurer is obliged to pay anything. And many insurance policies require the policyholder to pay the entire claim first and to seek reimbursement from the insurer. Almost by definition, however, insolvent policyholders are unable to make these upfront payments. Indeed, in many cases, the policyholder's inability to do so in the face of a deluge of litigation was the principal cause of the insolvency in the first place.

Deductibles, SIRs and Reimbursement Policies

Liability insurance policies requiring upfront payments by the policyholder (in addition to the standard premium) take several forms, but courts tend to treat them similarly once the policyholder becomes insolvent. First, insurance policies with deductible provisions generally require the policyholder to pay the first portion of the claim, up to the deductible amount, after which the insurer pays amounts in excess of the deductible up to the limits of liability. The deductible is considered to be within the limits of liability, and the policy may provide that the insurer has no duty to defend the policyholder for claims that fall entirely within the deductible. Second, policies with SIRs may require the policyholder to shoulder all expenses, including defense costs, until the SIR is exhausted. The SIR is not considered to be within the limits of the policy, and the insurance coverage may be effectively excess rather than primary. Third, reimbursement policies provide coverage only after the policyholder become "legally obligated" to pay and has actually paid the entire amount of the claim. Nevertheless, many courts ignore these distinctions and treat deductibles, SIRs, and reimbursement provisions in virtually the same way once the policyholder becomes insolvent.

Tension Between Bankruptcy and Insurance Law

These pay-first requirements conflict with two important purposes of the Bankruptcy Code: to give the debtor breathing room to reorganize its financial obligations and to protect the interests of third-party creditors. For many debtors in bankruptcy, liability insurance coverage is the most likely source of distributions to unsecured creditors. But if the insolvent policyholder were required to pay deductibles, SIRs or the entire claim before accessing insurance policy proceeds, then its insolvency would automatically relieve the insurer of its coverage obligations — a result that most debtor-policyholders, creditors, and bankruptcy courts consider wholly unsatisfactory.

As a result, a number of states — including Arkansas, Florida, Louisiana, Maryland, Minnesota, New York, Oregon, and Virginia — have enacted legislation requiring insurance policies to contain a provision stating that a policyholder's bankruptcy or insolvency will not relieve the insurer of its obligations under the insurance policy. Consequently, many insurance policies now contain this "bankruptcy" provision. Nevertheless, the provision does not specifically address the consequences of a policyholder's failure or inability to satisfy its initial payment obligations. Insurers argue that the "bankruptcy" provision has no effect on the policyholder's obligation to fund initial losses as an absolute precondition to coverage, and that any other interpretation would impose additional obligations on them to which they never consented. Debtors argue that the "bankruptcy" provision should be construed as excising the deductible and SIR provisions from the policy altogether. Both positions may be overstated. Requiring insurers to provide

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coverage despite the debtor's failure, initially, to pay the deductible, SIR or claim need not impose additional obligations on insurers. It may force them to pay claims sooner than they would otherwise, but it does not necessarily increase their financial exposure. On the other hand, the "bankruptcy" provision probably does not eliminate the deductible or SIR provisions from the policy every time a policyholder becomes insolvent.

A few courts grappling with these issues have taken extreme positions on one side or the other. For example, a district court held that a $250,000 SIR was an absolute precondition to coverage and, because the policyholder never satisfied that precondition, the insurer's "obligations were never triggered." Similarly, the U.S. Court of Appeals for the Second Circuit held that, under the reimbursement provision of a maritime liability insurance policy, the insurer was released by the bankrupt policyholder's failure to pay the loss. In at least one case, no party raised the issue of the policyholder's insolvency, and the court simply assumed without analysis that the policyholder's satisfaction of the aggregate deductible was a necessary predicate for coverage. At the other extreme, some courts have suggested that "fronting" policies, in which the deductible is equal to the limits of liability, insure only against the risk of the policyholder's insolvency and therefore expose insurers to liability for the full amount of the deductible of an insolvent policyholder.

The Majority View

Most courts addressing this issue have taken a middle ground, however, rejecting both the "absolute condition precedent" approach advocated by insurers and the policyholders' argument that insurance should "drop down" and cover claims that fall within the deductible or SIR. These courts reason that an insurer cannot pocket premiums and then refuse coverage every time its policyholder becomes insolvent and unable to pay the deductible or SIR. Nor can a policyholder force its insurer to cover claims that fall entirely within the deductible or SIR.

Attempting to harmonize insurers' contract rights with the purposes of the Bankruptcy Code, courts usually require insurers to provide coverage in excess of the deductible or SIR, up to the limits of liability, notwithstanding the policyholder's failure to pay the deducible or SIR. *See, e.g., Albany Ins. Co. v. Bengal Marine, Inc.*, 857 F.2d 250, 256 (5th Cir. 1988); *In re Keck, Mahin & Cate*, 241 B.R. 583, 596-97 (Bankr. N.D. Ill. 1999). Courts often order these insurance payments to be made into the bankruptcy estate rather than directly to the claimants. This situation typically will leave a shortfall in the amount of the deductible or SIR that the policyholder was unable to pay. If no other sources of funding the shortfall exist, the bankruptcy court typically will determine how to apportion the insurance funds, usually by distributing them proportionately across all claims. Each third-party claimant will have a general unsecured claim against the estate for his or her share of the shortfall. If the insurer has advanced funds within the deductible or SIR under a pre-petition policy, the insurer also will have a general unsecured claim against the bankruptcy estate. Whether asserted by claimants or insurers, the shortfall is most likely to be funded by the estate at pennies on the dollar, if at all.

Other Named Insureds May Have to Fund Shortfall

Although few reported decisions discuss the issue, third-party claimants and insurers may be able to compel other solvent parties to make up the deductible or SIR shortfall. Many insurance policies identify several entities as named insureds, and sometimes other entities are not specifically named but qualify as "additional insureds" through contractual or other relationships with the principal named insured. Depending on the policy language regarding the deductible or SIR obligation, specifically named "other insureds" may be obliged to pay the deductible or SIR on behalf of the insolvent policyholder, even though the "other insured" has not asserted a claim under the policy. *See, e.g., Northbrook Ins. Co. v. Kuljian Corp.*, 690 F.2d 368, 373 (3d Cir. 1982). The same is not true, however, for additional insureds not specifically identified in the policy. In the *Keck* case, involving an insolvent law firm partnership, the individual partners were not required to fund the SIR even though their conduct may have given rise to the underlying claims.

Conclusion

Deductibles and SIRs serve as a financial incentive for policyholders to operate their businesses in a manner that minimizes the number of claims asserted against them. Once the policyholder becomes insolvent, that incentive has little or no effect. So long as the dollar amount of the insurer's exposure remains the same, requiring the insurer to pay claims sooner than it otherwise would be required to do seems an acceptable compromise between the contract rights of the insurer and the interests of third-party claimants as well as the bankrupt policyholder.

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