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 afterward. Almost by definition, however, insolvent policyholders are unable to make these up-front 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 up-front 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. (See infra “Retrospective Premium Policies – What Happens in Bankruptcy?” for a discussion of the treatment of policies containing retrospective premium provisions.) 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 has 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

From the Editor:

Greetings! This edition of the Insurance Counselor addresses a range of insurance issues that can arise in bankruptcy proceedings. These issues are important not only for an insolvent policyholder (and of course its insurer) but also for creditors and other parties affected by a party’s bankruptcy. We hope that you find these articles of interest.

As the holidays approach, we wish you a joyous season of happiness and celebration.

Lorie Masters

Lorelie S. Masters

Lorie Masters
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 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 United States 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 deductible 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 prepetition 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. . .

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.

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.

Patricia A. Bronte is a partner with Jenner & Block LLP in Chicago and a member of the Firm’s Insurance Litigation and Counseling Practice. She advises and represents policyholders in insurance coverage matters and disputes.
Retrospective Premium Policies –
What happens in bankruptcy?

by Charlotte L. Wager and Brian C. Boardman

Introduction
Retrospective premium policies allow premiums to be adjusted over time and thereby reflect the loss experience of the policyholder. When a policyholder files for bankruptcy, the existence of retrospective policies raises several unique issues. First, is the insurer relieved from liability where the policyholder has failed to pay retrospective premiums? Second, how is an insurer’s claim for retrospective premiums classified in the bankruptcy process? This article surveys the prevailing law on these issues.

Background
Retrospective premium policies originated as a way for insurers to shift some risk to policyholders and thereby reduce costs. Generally, under such policies, the insurer charges an initial estimated premium at the beginning of each policy period, called the “deposit premium” or “standard premium.” Six months to a year after the policy expires and annually thereafter, the insurer recalculates the premium based upon the actual claims experience of the policyholder. If the policyholder has few claims, its premiums will be low (and may result in a refund); if there have been many claims, the premiums will be high. By setting premiums retroactively, based upon the policyholder’s actual loss experience, insurers can charge less up front. Retrospective premiums have been most commonly used in fields where neither the insurer nor the policyholder are able to accurately predict risks, such as comprehensive general liability and worker’s compensation. See generally Mark G. Ledwin, The Treatment of Retrospectively Rated Insurance Policies in Bankruptcy, 16 Bank. Dev. J. 11 (1999).

Retrospective premium policies originated as a way for insurers to shift some risk to policyholders and thereby reduce costs.

In addition to the benefit of reducing up-front costs, retrospective premiums provide an economic incentive for policyholders to minimize claims, for example, by maintaining a safe work environment. Conversely, however, retrospective premiums allow unscrupulous insurers to settle claims for unreasonable amounts because the policyholder ultimately pays through increased premiums. As a result, courts impose a duty upon insurers to act reasonably in settling claims and setting premiums.

Bankruptcy: Timing is Everything
When a policyholder files for bankruptcy, it may remain entitled to coverage under retrospective premium policies despite its inability to pay the ongoing retrospective premiums. The availability of such coverage depends, in part, on whether the policy constitutes an executory contract under the Bankruptcy Code. The Bankruptcy Code does not define executory contracts, but most courts have relied on Professor Countryman’s definition of an executory contract as one “under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” Vern Countryman, Executory Contracts in Bankruptcy: Part 1, 57 Minn. L. Rev. 439, 460 (1973). Thus, if a policy is executory, nonpayment of premiums by the debtor constitutes a breach of contract, allowing the insurer to cancel any remaining obligations. On the other hand, if the policy is not executory, the insurer must continue to perform (and pay claims) because the debtor has not materially breached. In addition, because of the automatic stay imposed upon the filing of a bankruptcy petition, the insurer cannot collect any prepetition debts or obtain possession of property of the estate. 11 U.S.C. § 362(a).

Under § 365(a) of the Bankruptcy Code, a debtor has the right to assume or reject executory contracts. If the contract is assumed, the third party must...
perform, and the debtor must also render its performance at full value. Section 365 is designed to give the debtor the option of assuming contracts where performance by a third party will benefit the estate, or rejecting contracts that are burdensome. Additionally, under section 365(d)(2), the other party to an executory contract may petition the bankruptcy court to order the debtor to assume or reject the contract within a specified time, thereby expediting the decision.

A debtor in bankruptcy has an interest in maximizing its estate assets to facilitate reorganization. A debtor’s estate is worth more with its insurance policies than without, so it is in the estate’s interest to prevent an insurer from canceling its policy. Perhaps with this incentive in mind, courts have held that a debtor’s ongoing obligation to pay retrospective premiums alone is not sufficient to render the contract executory. See, e.g., In re Sudbury, Inc., 153 B.R. at 776, 781 (Bankr. N.D. Ohio 1993). Rather, most courts have found that insurance policies are only executory if there is a continuing obligation to make standard premium payments. See, e.g., In re Texscan Corp., 107 B.R. 227, 230 (B.A.P. 9th Cir. 1989).

Accordingly, determining whether a policy is executory depends in part on timing, specifically, whether: (1) the policy term expired prepetition with only retrospective premiums remaining due; (2) the policy term expired postpetition but before confirmation of a reorganization plan; or (3) the policy is ongoing, with standard premium payments still due. Each scenario requires a closer look in light of the foregoing bankruptcy principles.

Policy Expired Prepetition
A policy with ongoing retrospective premiums that expires prepetition likely is not executory. Sudbury, 153 B.R. at 778. Similarly, a debtor’s ongoing duty to cooperate under an expired retrospective premium policy does not render the contract executory. Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1046 (4th Cir. 1985). Accordingly, the debtor’s failure to pay retrospective premiums alone is not sufficient to constitute a material breach excusing performance by the insurer, and the insurer must cover losses incurred during the policy period. Beloit Liquidating Trust v. United Insurance Co., 287 B.R. 904, 906 (N.D. Ill. 2002), illustrates the point. In Beloit, the court held that a policy with ongoing retrospective premiums was not executory because it had expired prepetition and contained bankruptcy clauses that provided for continued coverage by the insurer in the event of the policyholder’s bankruptcy. The court explained: “Courts have consistently held that insurance policies where the policy coverage period has expired prior to the insured’s bankruptcy are not executory because it had expired prepetition and contained bankruptcy clauses that provided for continued coverage by the insurer in the event of the policyholder’s bankruptcy.” Id. The only remaining obligation of the debtor in Beloit was payment of retrospective premiums, and that was not enough to excuse the insurer’s performance.

Policy Expired Postpetition
If a policy expires postpetition and before the debtor has assumed or rejected it, courts likely will hold that the policy is not executory so long as all standard premiums have been paid. In this case, as with prepetition policies, the insurer will be obligated to continue covering claims insured during the policy period, even though the debtor does not pay accruing retrospective premiums. For example, in Texscan, the court held that a policy which expired five weeks after the debtor filed for bankruptcy was not executory. 107 B.R. at 230. The contract expired before either party filed a motion under 11 U.S.C. § 365(a) for assumption or rejection. In addition, the debtor had paid all standard premiums and only owed retrospective premiums. The court explained: “It is axiomatic that before 11 U.S.C. § 365 can apply a contract must exist. If a contract has expired by its own terms then there is nothing left to assume or reject.” Id.

By contrast, in In re Transit Group, Inc., 2000 WL 31940797 (Bankr. M.D. Fla. 2002), the court held that a retrospective premium policy that expired three days after the bankruptcy filing was executory, and the insurer was excused from performance. Unlike in Texscan, however, the debtor in Transit owed standard premiums, in addition to retrospective premiums, when it filed for bankruptcy. The court reasoned: “[P]ayment of the underlying premiums is an essential...
obligation under the Policies. [Debtor’s] failure to pay the premiums due under the Policies would be a material breach and would excuse [insurer’s] performance under the Policies.”

Id. at *4. Indeed, the court further observed that “the only basis for holding that an insurance policy is executory is if the insured had a continuing obligation to make premium payments under the policy.” Id. While the court did not specifically distinguish between the effect of unpaid standard premiums versus retrospective premiums, other opinions, discussed supra, suggest that it is the nonpayment of the standard premiums that renders such a policy executory.

Unexpired Policies
Unexpired policies, where the insurer has a continuing obligation to provide coverage and the debtor has a continuing obligation to pay standard premiums, likely constitute executory contracts. In re American Med. Imaging Corp., 133 B.R. 44, 55 (Bankr. E.D. Pa. 1991). As such, if the debtor does not pay its premiums, the insurer can cancel the policy. The existence of retrospective premiums makes no difference in this analysis.

Treatment of Insurer Claims
The classification of an insurer’s claim for past due premiums may also depend on timing. Under Bankruptcy Code section 503(b)(1)(A), a creditor may file a request for an administrative expense for the “actual, necessary costs and expenses of preserving the estate” incurred postpetition. An administrative expense claim generally takes priority over all other priority and general unsecured claims, and thus has a good chance of being paid in full.

... the debtor’s failure to pay retrospective premiums alone is not sufficient to constitute a material breach excusing performance by the insurer.

11 U.S.C. § 507. Furthermore, 28 U.S.C. § 959(b) requires a chapter 11 debtor-in-possession to continue to operate its business in accordance with any applicable state laws. Maintaining adequate insurance coverage is often mandated by state law. Thus, many courts have held that an insurer is entitled to assert a priority administrative expense claim for unpaid postpetition standard premiums. See, e.g., In re Gamma Fishing Co., Inc., 70 B.R. 949, 954-55 (Bankr. S.D. Cal. 1987).

Similarly, treatment of an insurer’s claim for retrospective premiums will likely depend on when the premiums became due. Generally, retrospective premiums related to a prepetition coverage period are classified as general unsecured claims. See In re Wheeling-Pittsburg Steel Corp., 67 B.R. 620, 624 (W.D. Pa. 1986). Conversely, retrospective premiums arising under postpetition policies usually are treated as priority administrative claims. See In re MEI Diversified, Inc., 106 F.3d 829, 832 (8th Cir. 1997).

Conclusion
A debtor seeking to maximize its insurance coverage needs to promptly identify any retrospective premium policies in its insurance program and determine whether those policies are expired or current. As set forth above, this distinction may be critical to a court’s determination of the policyholder’s rights and duties and the insurer’s payment obligations. In addition, a policyholder needs to carefully monitor its premium payments, understanding that, while past due retrospective premiums may constitute general unsecured claims, standard premiums on unexpired policies likely constitute administrative expenses.

Charlotte L. Wager is a partner at Jenner & Block LLP in Chicago and a member of the Firm’s Insurance Litigation and Counseling Practice and Reinsurance Practice. She regularly represents policyholders in coverage and litigation matters. Brian C. Boardman is an associate at Jenner & Block LLP in Chicago and a member of the Insurance Litigation and Counseling Practice. Brian is a 2003 graduate of Stanford Law School.
Over ninety percent of public companies purchase “entity coverage” as part of their directors’ and officers’ (D&O) insurance policies. Entity coverage protects the company itself – as opposed to its directors and officers – against securities claims. Over the last two years, however, it would have been difficult for the director of any public company to avoid hearing that entity coverage creates an undue risk of depriving the director of D&O coverage if the company for which he or she serves files for bankruptcy. One major D&O insurer distributed a paper containing this gratuitous advice to the directors of every public company in the country. Many legal seminars and D&O coverage proposals prepared by brokers also warn of this danger. Not surprisingly, CEOs and general counsel often are questioned by their boards about D&O coverage in the event of bankruptcy.

The dire warnings find little support in bankruptcy case law. In a number of recent major bankruptcies, including Enron, courts have allowed directors and officers access to the proceeds of their D&O policies despite the presence of entity coverage. The Southern District of New York's decision in *In re Adelphia Communications Corp.*, 298 B.R. 49 (S.D.N.Y. 2003), follows this trend. Adelphia’s directors and officers were charged with fraud in numerous civil and criminal proceedings. The directors and officers sought relief from the automatic stay to access the proceeds of their D&O policies to pay for their defense of these fraud cases. Although Adelphia’s D&O policies contain entity coverage for Adelphia itself, the securities actions had been stayed as to Adelphia, and thus Adelphia had not sought reimbursement of any defense costs relating to those actions.

Earlier this year, the bankruptcy court allowed Adelphia's directors and officers limited access to the D&O policy proceeds, but held that those proceeds were assets of Adelphia's bankruptcy estate because of the presence of entity coverage in Adelphia’s D&O policies. In reversing the bankruptcy court, the district court offered even more protection to directors and officers seeking coverage under D&O policies. The district court held that the proceeds of the D&O policies are not even property of the estate. According to the district court, because Adelphia had not yet made any payment that would entitle it to entity coverage “[c]laiming [Adelphia] now [has] a property interest in those proceeds makes no sense at this juncture.”

The *Adelphia* decision assists in dispelling the unwarranted fear that the presence of entity coverage will deprive directors and officers of their D&O insurance protection if their company files for bankruptcy.

Timothy W. Burns is a partner at Jenner & Block LLP in Chicago. He is Co-Chair of the Insurance Coverage Litigation Committee of the American Bar Association and co-author of “Directors and Officers Liability: Prevention, Insurance and Indemnification” (Law Journal Press 2000).
Introduction
A Policyholder/Debtor with Comprehensive General Liability ("CGL") insurance has a strategic decision to make: Should the Policyholder/Debtor protect and preserve its insurance for post-bankruptcy claims, or seek to maximize the insurance proceeds available to satisfy third-party claims? Although the Policyholder/Debtor cannot dictate how its policies are treated during the bankruptcy proceeding, without determining a strategy the Policyholder/Debtor cannot hope to influence the outcome. This article addresses the situation where a Chapter 11 Policyholder/Debtor faces third-party environmental claims. Although this area of law is still developing and varies from one jurisdiction to another, the Policyholder/Debtor should consider certain key issues when determining its strategy for dealing with its CGL insurers.

Determining Whether Insurance Proceeds Are Part of the Policyholder/Debtor’s Estate
One of the threshold issues to be determined in a bankruptcy proceeding is whether or not the proceeds of the CGL policies are property of the bankruptcy estate. The distinction may be critical because in some circumstances, the Policyholder/Debtor may prefer those proceeds to be distributed to the general creditors, but in other circumstances, the Policyholder/Debtor may prefer that the policy proceeds not be treated as property of the estate. If the proceeds of an insurance policy are property of the estate, then the proceeds will be distributed among all unsecured creditors based upon the creditors’ priority. If, however, the proceeds of the insurance policy are not property of the estate, then the third-party claimant will seek to recover the insurance proceeds directly.

The Bankruptcy Code defines property of the estate as “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. § 541(a)(1)(2000). Property usually includes all proceeds from property of the estate. The debtor’s insurance policies are generally considered property of the estate. Whether the proceeds of those policies are part of the Policyholder/Debtor’s estate, however, depends on what law applies. If a state law codifies whether the insurance proceeds belong to the policyholder or claimant, the bankruptcy court will apply that law. For example, under New York statute, the proceeds of an insurance policy vest in the claimant, not the policyholder, at the time of bankruptcy. Therefore, the claimant who is injured prepetition receives compensation for that injury from the policyholder’s insurance and the proceeds are not property of the estate. Where no statute codifies the policyholder or claimant’s legally recognized interest in the insurance proceeds, bankruptcy courts look to the nature of the insurance policy to determine whether the Policyholder/Debtor or the claimant has an interest in the proceeds. If the Policyholder/Debtor would be entitled to receive the proceeds, then the insurance policy is treated as property of the estate.

If the Policyholder/Debtor’s strategy is to have the policies survive the bankruptcy, it should take the position that claimants have a direct claim on the policy proceeds. If those claimants do not exhaust the policy limits, the policy will survive the bankruptcy. On the other hand, if the Policyholder/Debtor wants the policy proceeds distributed to creditors, it should take the position that claimants have no direct right to policy proceeds, thus the policy proceeds become part of the bankruptcy estate.

Christine A. Picker is a partner at Jenner & Block LLP in Chicago. Ms. Picker represents policyholders in insurance coverage and litigation matters. She also practices in the firm’s Environmental, Energy and Resources Group. Patricia L. Boye-Williams is an associate at Jenner & Block LLP. She practices in the firm’s Environmental, Energy and Resources Group.
Different Types of Environmental Claims

The type of environmental claim may impact a creditor’s entitlement to insurance policy proceeds. The two types of environmental claims are: private claims asserted by landowners or others who claim to have suffered property damage or personal injury, and government claims for remedial measures and/or cleanup costs. Private claims receive the least priority when distributing the property of the debtor’s estate and are classified as general unsecured claims. If a private environmental claimant has a claim against the Policyholder/Debtor, estate funds will be distributed first to secured creditors, next to satisfy administrative claims incurred during the bankruptcy proceedings, and only then will any remaining funds be distributed pro rata to all unsecured claimants. Where a claimant does not have a direct interest in the policy proceeds such that those proceeds become property of the estate, then the proceeds may be intermingled with other estate funds distributed to the unsecured creditors.

Usually, unsecured private claims against a debtor in bankruptcy are stayed by the automatic stay provision of the Bankruptcy Code. An exception to the rule exists if the insurer is obliged to cover all costs of defending the environmental claim, in which case the claim would not be stayed. In this circumstance, the claimant may litigate the claim to judgment but cannot enforce that judgment.

Governmental environmental claims fall into three categories. First, a federal or state government is permitted “to enforce [its] police and regulatory power” by either commencing an action against the Policyholder/Debtor or enforcing a previous non-monetary judgment. 11 U.S.C. § 362(b)(4) (2003). Commonly, this occurs when a government has issued an injunction in an effort to remedy or prevent imminent environmental harm. These injunctions are not stayed under the Bankruptcy Code, even when the debtor must incur costs to comply with the injunction. In these circumstances, it is unlikely that the insurance proceeds will be necessary to fund the compliance with an injunction, because the Policyholder/Debtor will have access to operating funds which the bankruptcy court will approve for use in responding to the government’s claim.

The second type of government claim is one seeking money damages for a prepetition event or condition, for example, where the government seeks to recover oversight costs under the Comprehensive Environmental Recovery Compensation and Liability Act (“CERCLA” or “Superfund”) or to impose a penalty on the Policyholder/Debtor for violating the Clean Water Act. For this type of claim, courts determine whether the government action relates more to its “pecuniary interest in the debtor’s property” or whether the government is acting pursuant to its “public policy interest in the general safety and welfare” of the public. United States v. Nicolet, Inc., 857 F.2d 202, 209 (3d Cir. 1988). If the government action relates more to its pecuniary interest, most courts hold the government can pursue its claim. However, if a court enters a money judgment for past wrongful acts of the Policyholder/Debtor, the government cannot enforce such judgment. In these situations, if the government tries to enforce its monetary judgment, the government is treated like any other private creditor. If the government has a direct claim to the policy proceeds, it will be compensated with those proceeds. On the other hand, where no creditor has a direct claim to the policy proceeds, the policy proceeds are intermingled with the

If the proceeds of an insurance policy are property of the estate, then the proceeds will be distributed among all unsecured creditors based upon the creditors’ priority.
other estate funds, and the government claimant is compensated like the other unsecured creditors.

The third type of government environmental claim is an administrative expense. Unlike the second type of government claim addressed above, administrative expenses are incurred after the filing of the bankruptcy petition. These costs are given priority and are paid out of the Policyholder/Debtor’s estate before any other unsecured claim. A claim qualifies as an administrative expense if it is a necessary and actual cost of preserving the estate. Courts interpret this requirement to mean that a cost must be definite and reasonable, and it must benefit the estate. Remedying a violation of an environmental law is considered to be a benefit to the estate. Because a Chapter 11 Policyholder/Debtor does not have the option of disobeying environmental laws, postpetition costs to comply with these laws qualify as administrative expenses deserving priority under the Bankruptcy Code. In these circumstances, it is likely a Policyholder/Debtor would use operating funds, as opposed to insurance policy proceeds, to remedy the noncompliance. This is especially the case because, in most circumstances, noncompliance with environmental laws will not trigger coverage under the CGL policies.

In sum, when the insurance proceeds are part of the bankruptcy estate, the type of environmental claim dictates whether those proceeds are used to pay the claim. Government environmental claims arising from the government’s use of its police or regulatory powers, and those government claims treated as administrative expense, will most likely not be funded by insurance proceeds. On the other hand, government environmental claims seeking a monetary recovery and private claims will be funded from the bankruptcy estate, which will include insurance policy proceeds.

**The Policyholder/Debtor should provide notice of the bankruptcy to as many would-be environmental claims as possible.**

Because the Policyholder/Debtor can face these kinds of pre-bankruptcy environmental claims post-bankruptcy, but the Policyholder/Debtor’s CGL policies may have been distributed as property of the estate as part of the bankruptcy, an important question arises. How should the Policyholder/Debtor manage the liability for these surviving pre-bankruptcy environmental claims? One approach is to limit the number of pre-bankruptcy claims asserted post-bankruptcy. To achieve this, the Policyholder/Debtor should provide notice of the bankruptcy to as many would-be environmental claimants as possible. For example, if the Policyholder/Debtor knows a government agency or private party has investigated a site and tried to link the Policyholder/Debtor to the site, the Policyholder/Debtor

---

*continued on page 12*
Federal Court in Illinois Protects Claimants in Bankruptcy Case
by Brian C. Boardman

The United States District Court for the Northern District of Illinois recently rejected a debtor’s attempt to sell its liability insurance policies back to its insurers in order to obtain funds for the general use of the estate. The court held that the debtor could not do so unless it provided adequate protection to claimants who had protectable interests in the insurance policies’ proceeds. In re Allied Prods. Corp., 288 B.R. 533 (Bankr. N.D. Ill. 2003). Allied Products had moved for approval under 11 U.S.C. § 363 of a plan to sell most of its liability insurance policies back to its insurers for $3.5 million. The funds were to be maintained for the general use of the estate, rather than for payment of claims that were covered under the policies. The court ordered the debtor to give notice to potential policy claimants. In response, several claimants – including ITT Industries, Inc. – objected.

The court found that Illinois law and the insurance policies themselves conferred on the claimants a right to payment from the insurers. The court noted that public policy in Illinois, like most states, prohibits an injured party from recovering against an insurer without first proceeding to judgment against the policyholder. Id. at 536-37. However, once a judgment is obtained, an injured party can proceed directly against the insurer. Id. at 537. The court relied specifically on 215 ILCS § 388 (2002), which provides, inter alia, that “no policy of insurance against liability . . . shall be issued . . . unless it contains . . . a provision that the insolvency or bankruptcy of the insured shall not release the company from the payment of damages for . . . loss . . . and stating that in case a certified copy of a judgment against the insured is returned unsatisfied . . . , then an action may be maintained by the injured person . . . against such company under the terms of the policy . . . .” See also Home Ins. Co. v. Hooper, 294 Ill. App. 3d 626 (1998) (insurance company required to make direct payment to policy claimant where policyholder was in bankruptcy and could not pay self-insured retention). In addition, the court relied on several decisions by the United States Court of Appeals for the Seventh Circuit which held that a debtor discharged in bankruptcy is nevertheless subject to suit by claimants under liability insurance policies, for the purposes of obtaining a judgment that may be enforced against the insurer that issued the policy. 288 B.R. at 538.

Accordingly, because the claimants who objected to the debtor’s sale of its liability insurance policies had a protectable interest in payment under the policies, and because the proposed sale did not adequately protect the claimants’ interests, the court denied the debtor’s motion to sell the policies.
Another approach to managing environmental liabilities not discharged in the bankruptcy is to utilize financial options that can help minimize the impact of these liabilities. First, it may be time to purchase one of the new environmental insurance products that addresses environmental contamination. For example, clean-up cost cap insurance could provide the Policyholder/Debtor with a cap on the total cost to remediate known contamination. This type of insurance protects the Policyholder/Debtor from cost overruns that frequently accompany environmental cleanups. Obtaining this type of insurance may be more difficult post-bankruptcy, which could result in higher premiums or more onerous disclosures during the application process.

As an alternative to insurance, the Policyholder/Debtor can “out-source” its liability to one of several companies that assume these liabilities at a set price. The Policyholder/Debtor pays to get rid of the liability, but avoids the risks and transaction costs associated with environmental claims.