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NINTH CIRCUIT RULES THAT D&O POLICIES' "INSURED VERSUS INSURED" EXCLUSION APPLIES TO DEBTORS-IN-POSSESSION AND ASSIGNEE CREDITORS DURING BANKRUPTCY PROCEEDINGS

In *Biltmore Assocs., LLC v. Twin City Fire Insurance Co.*, 2009 WL 1976071 (9th Cir. July 10, 2009), the United States Court of Appeals for the Ninth Circuit applied the “insured versus insured” exclusion, common in directors’ and officers’ insurance policies (“D&O insurance”), to prevent a creditors’ trust from collecting on a D&O insurance policy under a claim assigned to it from a debtor-in-possession. The Ninth Circuit held that a post-bankruptcy debtor-in-possession should be treated as the same entity as a pre-bankruptcy corporation for purposes of the D&O insurance policy. Because the underlying claim was brought by the debtor-in-possession against directors and officers of the company, the “insured versus insured” exclusion prevented any assignee of the debtors’ claim against the insurance company from collecting. The court held that the trustee of the creditors’ trust stood in the debtor’s shoes for the purposes of the action and, because the debtor-in-possession was still an insured under the D&O policy, the trustee could not collect on the claim.

In *Biltmore*, Visitalk, an Arizona corporation, carried D&O insurance which contained a standard “insured versus insured” exclusion, which excludes insurance coverage in situations where a claim is brought against an insured by another insured under the policy. Visitalk later filed for bankruptcy protection and, as debtor-in-possession, sued four former directors and officers for breach of fiduciary duties. As part of its Chapter 11 reorganization, Visitalk assigned those claims to its creditors’ trust. Biltmore Associates LLC, as trustee of the creditors' trust agreed to settle the claims against the directors and officers, and as part of that settlement was assigned the insureds’ rights against the D&O insurers. The district court dismissed Biltmore's case against Twin City Fire Insurance, the insurers, and the Ninth Circuit affirmed the dismissal, though on different grounds.

The Ninth Circuit held that the creditors could not collect from the insurance company under the policy because they stood in the shoes of the debtor-in-possession, which was still an insured for purposes of the “insured versus insured” exclusion. The court held that the exclusion still applied to the creditors’ trust for three primary reasons. First, the ultimate recipient of the funds collected from the underlying action was irrelevant. The court stated, “[t]hat the creditors rather than the shareholders will get whatever money the insurer pays does not avoid the exclusion.” Second, the court noted that the creditors had no independent claim against the insurers because they were not insured under the policy and thus had no contractual rights. Third, the court observed that the underlying claim was “instigated and continued” by Visitalk and

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affirmed that the "assignee of a claim against an insurance company can have no stronger claim than the assignor who assigned the claim." Because the creditors were not an insured, they had to step into the insured's shoes in order to bring the claim. Once they did that, according to the court, the "insured versus insured" exclusion applied.

The most significant aspect of the Ninth Circuit's decision was its holding that, for purposes of the "insured versus insured" exclusion, a debtor-in-possession during bankruptcy proceedings is treated as the same entity as the pre-bankruptcy corporation. Biltmore argued that the Visitalk which brought the underlying claim against the directors and officers was different from the Visitalk which was an insured corporation under the D&O policy. The court disagreed. It noted several cases that considered post-bankruptcy entities as different from pre-bankruptcy entities for purposes of the exclusion, but also several cases that treated the entities as one. Moreover, the court could find no case dealing with a post-bankruptcy debtor-in-possession and its relation to the pre-bankruptcy entity. It concluded that "Visitalk, the debtor in possession, is the same person for bankruptcy purposes as Visitalk, the pre-bankruptcy corporation."

The courtconceded that suits by debtors-in-possession are for the benefit of their creditors, but ruled that under the terms of the insurance policy the corporation was an insured even as a debtor-in-possession. A large factor in the court's decision was concern about collusion between a debtor and its officers and directors. It did not want companies, as debtors, to be able to collect money from a D&O insurance carrier simply by filing for bankruptcy and filing a claim against directors and/or officers. The opinion speculated on the possibility that such filings and claims may be made simply to pay off existing creditors, as the insurance collection would provide large proceeds with which to satisfy debts.

This decision highlights the potential risk to officers and directors when their company goes bankrupt. Not only do they face difficulty in enforcing indemnification rights against an insolvent corporation, the insured versus insured exclusion may preclude coverage under D&O insurance policies in the event the debtor or an assignee asserts claims against the officer or director. The potential individual insured will want to seek changes in policy language to protect their right to D&O insurance for noncollusive claims when the company is in bankruptcy.

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