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"Insured v. Insured" Exclusion Precludes Coverage for Officers and Directors in Chapter 11 Bankruptcy Proceeding

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Debtors in a Chapter 11 reorganization may have a more difficult time recovering insurance proceeds on claims asserted against former officers and directors. *Biltmore Associates v. Twin City Fire Ins. Co.*, _ F.3d _ (9th Cir. July 10, 2009).

Most directors and officers policies exclude coverage for claims brought by one insured against another (with some limited exceptions, such as derivative claims). In *Biltmore Associates*, the Ninth Circuit held that claims for malfeasance asserted by the insured as debtor in possession of its Chapter 11 bankruptcy estate against former officers and directors still fall within this exclusion. In at least one prior instance, the Ninth Circuit had held that a reasonable person seeking coverage would not understand the trustee of a bankruptcy estate to be the same as the pre-bankruptcy insured entity for purposes of this exclusion. *See Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1117 (9th Cir. 2006).

Visitalk, an Arizona corporation, filed a Chapter 11 bankruptcy petition. As debtor in possession of the bankruptcy estate, Visitalk then sued its recently discharged officers and directors alleging they had looted the company and otherwise breached their fiduciary duties. (Visitalk claimed, for instance, that the defendants had charged grossly excessive amounts for inappropriate items such as "personal expenses, strippers, lavish trips, and gifts" of no value to the company.)

Visitalk assigned its claims to a trust as part of the bankruptcy reorganization plan, and the trust then settled with the officers and directors for $175 million in exchange for an assignment of the officers' and directors' own rights against the directors and officers liability carrier, which had denied coverage.

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The coverage lawsuit followed but never got out of the starting gate.

Affirming the district court's dismissal of the complaint outright, the Ninth Circuit held that the policy's "insured v. insured" exclusion applied. That exclusion precluded coverage for any claim "brought or maintained by or on behalf of an Insured in any capacity." (Underlining added.) The Ninth Circuit rejected decisions from across the country – including its own *Unified W. Grocers* decision (above) – that treated a pre- and post-bankruptcy entity as two separate entities. Here, the Court held, Chapter 11 specifically defined the "debtor in possession" as the "debtor" and the "debtor" as the "person . . . concerning which" the Chapter 11 case had been commenced, i.e., Visitalk. Finding no good reason to depart from the plain language of the statute, the Court found the "insured v. insured" exclusion applied.

The Ninth Circuit further noted that finding coverage would create a "perverse incentive" for the principals of a failing business "to be the dwindling treasury on a lawsuit against themselves and a coverage action against their insurers," which is among the types of "moral hazards" the "insured v. insured" exclusion is intended to avoid.

It is worthwhile to note that some policies contain an exception to the "insured v. insured" exclusion that covers precisely the risk Visitalk's former directors and officers faced: a suit by a trustee in bankruptcy. As always, the actual language of the policy is critical.

FOR ADDITIONAL INFORMATION ON THIS ISSUE, CONTACT:

Amy B. Briggs Ms. Briggs' complex business litigation practice focuses on insurance coverage and bad faith disputes. Ms. Briggs has represented numerous policyholders, including financial institutions, large real estate entities, public retirement systems throughout California, pharmaceutical and medical device manufacturers, and nonprofit organizations in coverage disputes. She has successfully litigated first- and third-party coverage and bad faith claims arising under commercial general liability, property, fiduciary liability, employers' liability, and D&O and E&O policies. She has appeared and argued before the California Court of Appeal on multiple occasions.