THE EFFECT OF A POLICYHOLDER'S BANKRUPTCY ON ITS INSURANCE COVERAGE: CASE STUDIES

LAURA L. SULLIVAN *
DIANA B. BROWN**
TOMMY J. ROBERTSON***

I. INTRODUCTION

There is no doubt that times are tough. One of the many unfortunate aspects of the current economic situation in the United States is an increase in bankruptcy filings. Consumers and businesses filed for bankruptcy at a pace that made 2009 the seventh-worst year on record, with more than 1.4 million bankruptcy petitions submitted.[1] This paper examines the effect of a policyholder's bankruptcy on its insurance coverage – including the effect on the insurer, the injured victim, the company's stockholders, and the policyholder corporation.

II. BANKRUPTCY OVERVIEW

A. *Overview of the Process*

The U. S. Constitution authorizes Congress to enact "uniform Laws on the subject of Bankruptcies."[2] Under this grant of authority, Congress adopted the Bankruptcy Reform Act of 1978, commonly referred to as the "Bankruptcy Code."[3] The Bankruptcy Code has been amended several times since its enactment, the most recent significant amendment being in 2005.[4] The Bankruptcy Code is the uniform federal law that governs all bankruptcy cases filed in the United States.[5]

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* J. D., M.B.A., Assistant Professor, Sam Houston State University.
** J. D., Attorney, Thompson, Coe, Cousins & Irons, LLP.
*** J. D., Assistant Professor, Sam Houston State University.

[1] *See* Mike Baker, *Bankruptcies Jump 32% to 1.4 Million in 2009*, http://www.usatoday.com/money/economy/2010-01-04-bankruptcy-2009_N.htm (last visited April 14, 2010).

[2] U.S. CONST. art. I, § 8.

[3] The Bankruptcy Reform Act of 1978 is codified in Title 11 of the United States Code.

[4] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Public Law No. 109-8, 119 Stat. 23, April 20, 2005) ("Reform Act") was effective October 17, 2005.

[5] The procedural aspects of the bankruptcy process are governed by the Federal Rules of Bankruptcy Procedure (often called the "Bankruptcy Rules") and local rules of each bankruptcy court. The Bankruptcy Rules contain a set of official forms for use in bankruptcy cases.

A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts.[6] Explaining the purpose of the bankruptcy law in a 1934 decision , the Supreme Court noted that "it gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[7] This "new opportunity" is accomplished through the central tenets of the Bankruptcy Code — the bankruptcy discharge, which releases individual debtors from liability from specific debts and the automatic stay, which prohibits creditors from pursuing the debtor to collect those debts.

B. *Types of Bankruptcy Cases*

The two types of bankruptcies most often encountered in the insurance coverage context are the chapter 7 and chapter 11 bankruptcies. Chapter 7, entitled Liquidation, contemplates an orderly, court-supervised procedure by which a trustee takes over the assets of the debtor's estate, reduces them to cash, and makes distributions to creditors, subject to the debtor's right to retain certain exempt property and the rights of secured creditors.[8] Businesses that are unable to service their debt or pay their creditors may file (or be forced by their creditors to file) for bankruptcy in a federal court under Chapter 7.[9] In most cases, a Chapter 7 filing means that the business ceases operations, that is, it "goes out of business." A Trustee is generally appointed almost immediately, and is charged with liquidating the corporate assets. Sums received from the liquidation are distributed to the creditors.

A creditor holding an unsecured claim will get a distribution from the bankruptcy estate only if the case is an "asset case" and the creditor files a proof of claim with the bankruptcy court.[10] Secured creditors, such as collateralized bondholders or mortgage lenders, have a legally enforceable right to the collateral securing their loans (or to the equivalent monetary value) which cannot be defeated by a bankruptcy filing. For this reason, fully secured creditors are not entitled to receive any distribution of liquidated assets from the Trustee. A creditor is fully secured if the value of the collateral for its loan to the debtor equals or exceeds the amount of the debt.

In a Chapter 7 case, a corporation or partnership does not receive a bankruptcy discharge — instead, the entity is dissolved. Only an individual can receive a Chapter 7 discharge.[11] Once all assets of the corporate or partnership debtor have been fully administered, the case is closed.

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[6] The Federal Judiciary, *Bankruptcy Basics*, (April 2006), http://www.uscourts.gov/bankruptcycourts/bankruptcybasics.html.

[7] Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

[8] The Federal Judiciary, *Bankruptcy Basics*, (April 2006), http://www.uscourts.gov/bankruptcycourts/bankruptcybasics.html.

[9] Chapter 7 is not limited to corporate debtors; however, individual debtors are not the focus of this paper.

[10] Often, there is little or no non-exempt property in a chapter 7 case, and, in this case, there may not be an actual liquidation of the debtor's assets. These cases are called "no-asset cases."

[11] 11 U.S.C. § 727(a)(1).

Chapter 11, entitled Reorganization, is used by commercial enterprises to re-organize their debts; a business is not required to allege or demonstrate insolvency or inability to pay debts as they arise in order to file a chapter 11 case. After filing a chapter 11 case, businesses continue to operate and repay creditors concurrently through a court-approved plan of reorganization.[12] In most cases, no Trustee is appointed, and the debtor usually has the exclusive right to file a plan of reorganization for the first 120 days after the case is filed.

The plan will classify the types of outstanding claims and propose a resolution for them. Generally, claims consist of administrative claims (claims incurred after the case is filed); certain priority claims (designated by Congress for special treatment under the Bankruptcy Code); secured claims (claims for which property of the debtor serves as collateral); unsecured claims; and equity. Under Chapter 11, a debtor has the opportunity to restructure its secured debt payments; to pay tax obligations over time; to sell unneeded assets; to pay unsecured claims at a discount, and to have claims determined by the court. The debtor can also terminate burdensome contracts and leases, recover assets, and rescale its operations in order to return to profitability. Under chapter 11, the debtor normally goes through a period of consolidation and emerges with a reduced debt load and a reorganized business.[13]

Creditors are then given a chance to vote on the plan. Depending on the size of the case, a creditor's committee may be formed to streamline the process.[14] If the requisite number of creditors vote in favor of the plan and the plan otherwise complies with the requirements of the Bankruptcy Code, the plan is "confirmed" by the Court. Once the plan is confirmed, the debtor is responsible for making payments and otherwise performing its obligations under the plan.

C. *Fundamental Bankruptcy Concepts*

1. What Constitutes "Property of the Estate"

The filing of a bankruptcy petition creates an estate, which consists of "all legal and equitable interests of the debtor in property as of the commencement of the case" and "proceeds . . . of or from property of the estate," as well as well as certain property acquired by the debtor or the estate post-petition.[15] Section 541 is interpreted to "include all kinds of property, including tangible or intangible property, causes of action . . . and all other forms of property currently specified in section 70a of the Bankruptcy Act."[16]

Although bankruptcy courts have interpreted the scope of § 541 very broadly, non-bankruptcy law (*i.e.*, property law) determines the nature and extent of a debtor's interest in property.[17] A debtor's insurance policies are generally considered

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[12] 11 U.S.C. §101 *et seq*.
[13] The Federal Judiciary, *Bankruptcy Basics*, (April 2006), http://www.uscourts.gov/bankruptcycourts/bankruptcybasics.html.
[14] A creditor's committee is usually composed of the largest creditors of the debtor.
[15] 11 U.S.C. § 541(a)(1), (6), (7).
[16] United States v. Whiting Pools, Inc., 462 U.S. 198, 204-05 & n. 9 (1983).
[17] Butner v. United States, 440 U.S. 48, 55, 99 S.Ct. 914, 918, 59 L.Ed.2d 136 (1979).

property of the estate.[18] However, whether the proceeds of a particular insurance policy are property of the estate depends on the nature of the policy.[19] Policy proceeds have been held to constitute estate property where "the debtor would have a right to receive and keep those proceeds when the insurer paid on a claim."[20] Furthermore, where the debtor is the named insured and would be entitled to keep the insurance proceeds, such proceeds often have been found to constitute property of the estate.[21] However, where the policy proceeds are payable to a third party, and the debtor has no claim to the proceeds, the proceeds will likely not be considered part of the estate.[22]

Fundamentally, the "property of the estate" concept determines whether the bankruptcy court will control the distribution of the proceeds. If the available proceeds are the property of the estate, the court will control the distribution of the proceeds. Additionally, whether the insurance proceeds are the property of the estate also affects the impact of the automatic stay provisions. If the insurance policy proceeds are property of the estate, any action to recover the proceeds would be stayed unless and until the automatic stay is lifted.

2. Jurisdiction Issues

(a.) Related and Core Jurisdiction

Although technically filed in the district court, all bankruptcy cases and all proceedings arising in, under, or related to Title 11 are automatically transferred to the bankruptcy court in that district pursuant to standing orders of reference.[23] The jurisdiction of a bankruptcy court is Bankruptcy jurisdiction is limited to the specific grant found in 28 U.S.C.§ 1334, which provides in part: "the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under Title 11 or arising in or related to cases under Title 11."

Bankruptcy courts are permitted to render final judgments only in "core proceedings."[24] As a general proposition, core proceedings are meant to include those types of matters that are at the very heart of the bankruptcy process.[25] Although section 157(b) does not define the term "core," it does provide a non-exhaustive list of core proceedings, including, among others, matters concerning the administration of the estate; the allowance or disallowance of claims against the estate or exemptions from property of the estate; counterclaims by the estate against persons filing claims against the estate; orders in respect to obtaining credit; orders to turn

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[18] In re Edgeworth, 993 F.2d 51, 55 & n. 13; Am. Bankers Ins. Co. of Fla. v. Maness, 101 F.3d 358, 362 (4th Cir. 1996).
[19] H. Jason Gold & Valerie Morrison, *Overview of Bankruptcy for the Insurance Professional*, 2002; Grillo v. Zurich Ins. Co., 170 B.R. 66, 69 (S.D.N.Y. 1994).
[20] Houstono v. Edgeworth (In re Edgeworth), 993 F.2d 51, 55 (5th Cir. 1993).
[21] In re Equinox Oil Co., No. 01-30747 2002 WL 1733151 (5th Cir. Aug. 12, 2002).
[22] In re Edgeworth, 993 F.2d at 55-56.
[23] Title 28 U.S.C. § 157(a) allows the district courts to refer matters that fall within the scope of § 1334 to the bankruptcy courts.
[24] Wood v. Wood (In re Wood), 825 F.2d 90, 97 (5th Cir. 1987).
[25] *See* Gold & Morrison, *supra* note 19.

over property of the estate; proceedings to determine, avoid, or recover preferences; motions to terminate, annul, or modify the automatic stay; proceedings to determine, avoid, or recover fraudulent conveyances; determinations as to the dischargeability of particular debts; objections to discharges; and determinations of the validity, extend, or priority of liens; confirmation of plans.

Even where a proceeding is not core, the bankruptcy courts have jurisdiction under 28 U.S.C. § 1334 to hear proceedings that are "related to" the bankruptcy case.[26] The most common test for whether a proceeding is "related to" the bankruptcy case, is "whether the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy."[27] Bankruptcy courts have no jurisdiction over proceedings that have no effect on the debtor.[28]

(b.) Withdrawal of Reference

The district court may withdraw the reference to the bankruptcy court of any matter for cause.[29] The following factors have been deemed applicable in determining whether cause exists for withdrawal of the reference: (1) judicial economy; (2) whether withdrawal would promote uniformity of bankruptcy administration; (3) reduction of forum shopping mad confusion; (4) conservation of debtor and creditor resources; (5) expedition of the bankruptcy process; and (6) whether a jury trial has been requested.[30] The most common reason to withdraw the reference is where a party is entitled to a jury trial in a non-core matter, due to the fact that the bankruptcy court is prohibited by the 7th Amendment to the United States Constitution from conducting a jury trial absent the consent of the parties.[31]

(c.) Insurance Matters and Bankruptcy Jurisdiction

Most pre-petition insurance coverage matters are considered non-core, related proceedings.[32] However, if a coverage dispute or claim arises post-petition, such action may be considered a core proceeding if it concerns the administration of the estate in bankruptcy.[33] In addition, a few courts have held that a coverage dispute concerning a pre-petition insurance policy was a core proceeding where the coverage was essential to the debtor's reorganization.[34]

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[26] Celotex Corp. v. Edwards, 514 U.S. 300, 308 (1995).
[27] Pacor, lnc. v. Higgins, 743 F.2d 984 (3d Cir. 1984).
[28] Celotex Corp., 514 U.S. at 308.
[29] 28 U.S.C. § 157(d).
[30] Official Comm. Of Unsecured Creditors v. TSG Equity Fund L.P. (In re Envisionet Computer Servs., lnc.), 276 B.R. 1, 4 (D. Me. 2002).
[31] *See* M. Sobel lnc. v. Weinstein (In re Weinstein), 237 B.R. 567 (Bankr. E.D.N.Y. 1999).
[32] *See* U.S. Brass Corp. v. Cal. Union lns. Co. (In re U.S. Brass Corp.), 110 F.3d 1261, 1268 (7th Cir. 1997).
[33] 28 U.S.C. § 157(b)(2)(A).
[34] Celotex Corp. v. AIU lns. Co. (In re CelotexCorp.), 152 B.R. 667 (Bankr. M.D. Fla. 1993).

(d.) Removal and Remand

One of the benefits of filing for bankruptcy is that it suspends piecemeal litigation against the debtor and its assets in different courts and centralizes litigation in a single, coordinated forum. To that end, the debtor and anyone who is involved in litigation with the debtor are permitted to "remove," or transfer, litigation pending in state or other federal courts to the bankruptcy court. Removal requires only that the litigant file a notice of removal with the state or federal court in which an action involving the debtor is pending within a statutorily prescribed period.[35] Under 28 U.S.C. § 1452(a), any "party may remove any claim or cause of action in a civil action other than a proceeding before the U. S. Tax Court or a civil action by a governmental unit to enforce such governmental unit's police or regulatory power, to the district court for the district where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title." This means that a party named in a state court action can, as of right, remove the action or any claim over which the bankruptcy court would have "related to" jurisdiction to the district court in that area. Upon removal, the action would be transferred to the bankruptcy court if the related bankruptcy case is pending in the relevant district. Certain actions, however, may not be removed to the bankruptcy court. These include non-civil actions (*e.g*., criminal, administrative and arbitration proceedings), tax court proceedings, certain governmental proceedings and claims or causes of action over which the district court does not have jurisdiction.[36]

Under certain circumstances, a bankruptcy court can transfer, or "remand," removed litigation to the court from which it came. Conferred with broad discretion, the court may remand a removed "claim or cause of action on any equitable ground."[37] Courts will consider several factors in determining whether equity requires remand, including:

a. Duplication or uneconomical use of judicial resources;
b. Any adverse affect on the administration of the estate;
c. Issues of State law that are better addressed by State courts;
d. Consideration of comity;
e. Any prejudice to unresolved parties;
f. Possibility of inconsistent results absent remand; and
g. Expertise of the court where the action originated.[38]

Despite the foregoing list of factors, the decision on remand does not involve a "formulaic balancing of the equities."[39] In *Landry v. Exxon Pipeline Co.*, the bankruptcy court remanded a removed action to recover against a debtor's insurance

[35] 28 U.S.C. § 1452(a).
[36] The Federal Judiciary, *Bankruptcy Basics*, (April 2006), http://www.uscourts.gov/bankruptcycourts/bankruptcybasics.html.
[37] 28 U.S.C. § 1452(b).
[38] Baxter Healthcare Corp. v. Hemex Liquidation Tr., 132 B.R. 863, 867-68 (N.D. Ill. 1991).
[39] Landry v. Exxon Pipeline Co., 260 B.R. 769, 802 (Bankr. M.D. La. 2001).

policy on an environmental tort cause of action.[40] The bankruptcy court noted, among other things, that the state tort action would have little effect on the estate, would not interfere with the debtor's rights under the Bankruptcy Code, was entirely grounded in state law, and did not involve disposition of property of the estate.[41] Consequently, remand was proper.[42]

(e.) Abstention

A related concept – "abstention" − involves the bankruptcy court's determination not to hear a case because another forum is more appropriate. The following elements must be established to mandate abstention under 28 U.S.C. § 1334(c)(2): (1) the motion for abstention must be timely; (2) the underlying proceeding must be based on a state law claim; (3) the proceeding must be related to a bankruptcy case; (4) the proceeding could not have been brought in federal court absent the bankruptcy; and (5) the suit must be one that can be timely adjudicated in state court.[43] Courts disagree on the issue of whether the state proceeding must actually have been pending at the time of bankruptcy.[44]

Even if the court is not required to abstain under 28 U.S.C. § 1334(c)(2), abstention still may be appropriate, and the court may abstain pursuant to 28 U.S.C. § 1334(c)(1).[45] Permissive abstention applies to both core and non-core matters and is proper if the court finds that abstention is appropriate "in the interest of justice, or in the interest of comity with State Courts or respect for State law."[46] Permissive abstention is a narrow doctrine.[47] Bankruptcy courts examine a number of factors in determining whether to abstain, including:

a. The effect of abstention on the efficient estate administration;
b. The extent to which state law issues predominate;
c. The difficulty or unsettled nature of state law issues;
d. The presence of related state court proceedings;
e. Jurisdictional basis, if any other than 28 U.S.C. § 1334;
f. The degree of relationship to the bankruptcy proceeding;
g. The ability to sever state claims or bankruptcy matters to allow judgments to be entered in state court and enforced in bankruptcy;
h. The substance rather than form of the asserted "core" proceeding;
i. The burden of the bankruptcy judge's docket;
j. The likelihood that the party commencing the proceeding in bankruptcy court is forum shopping;

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[40] *Id.* at 802-03.
[41] *Id.*
[42] *Id.*
[43] In re Riverside Nursing Home, 144 B.R. 951 (S.D.N.Y 1992).
[44] *Compare* In re The Bible Speaks, 65 B.R. 415 (Bankr. D. Mass. 1986), *with* World Solar Corp. v. Steinbaum (In re World Solar Corp.) 81 B.R. 603, 612 (Bankr. S.D. Cal. 1988).
[45] 28 U.S.C. § 1334(c)(1).
[46] *Id*.
[47] Eastern Airlines, Inc. v. Int'l Assoc. of Machinists & Aerospace Workers (In re Ionosphere Clubs, Inc.), 108 B.R. 951, 954 (Bankr. S.D.N.Y. 1989).

k. The existence of a fight to a jury trial; and
l. The presence of non-debtor parties in the proceedings.[48]

Although no single factor is necessarily decisive, and the issue is examined on a case-by-case basis, the most important factor appears to be whether unsettled state law issues predominate.[49]

3. Standing Of Insurers As "Parties In Interest"

The Bankruptcy Code states that "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under [chapter 11]."[50] The purpose of this provision is to ensure "that anyone who has a legally protected interest that could be affected by a bankruptcy proceeding is entitled to assert that interest with respect to any issue to which it pertains."[51]

Standing to object to the confirmation of a reorganization plan is granted to any "party in interest," which has been construed broadly to encompass anyone with a "practical stake in the outcome of the proceedings."[52] How the bankruptcy courts interpret the extent of an insurer's "interest" in a plan, and hence its standing to object, is a matter that is determined on a case by case basis. Standing can be a critical issue, especially where the bankruptcy plan and confirmation order are later determined to constitute a judgment or binding settlement.[53]

Nevertheless, the state of the law on insurer standing to be heard on confirmation of a plan or approval of a settlement is not settled. In some cases, insurers have been held by some courts to be parties in interest under § 1109(b) and § 1128 (b) to object to confirmation of a plan.[54]

4. The Automatic Stay

A stay of creditor actions automatically goes into effect when the bankruptcy petition is filed.[55] The automatic stay has been described by the United States Supreme Court as "one of the fundamental debtor protections provided by the bankruptcy laws." *Midlantic National bank v. New Jersey Dept. of Envtl. Prot.* 474

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[48] *Id.*
[49] Maggio v. Touche Ross & Co. (In re Oliver's Stores, Inc.), 107 B.R. 40, 43 (D. N.J. 1989).
[50] 11 U.S.C. § 1109(b).
[51] In re Keck, Mahin & Cate, 241 B.R. 583, 596 (Bankr. N.D. Ill. 1999) (quoting *In re James Wilson Assocs*., 965 F.2d 160, 169 (7th Cir. 1992)).
[52] In re Amatax Corp., 755 F.2d 1034, 1041-42 (3d Cir.1985); 11 U.S.C. § 1128(b).
[53] *See*, *e.g.*, Fuller-Austin Insulation, No. 98-2038-JJF, 1998 U.S. Dist. LEXIS 18340, *1 - *3 (D. Del. Nov. 10, 1998); Fuller-Austin Insulation Co. v. Fireman's Fund Ins. Co., No. BC 116835, 2002 WL 398672, at * 19-25 (Cal. Sup. Ct. 2002), *rev'd in part,* Fuller-Austin Insulation Co. v. Highlands Ins. Co., 135 Cal. Ct. App. 4th 958 (2006).
[54] *See, e.g.*, In re Keck, Mahin & Cate, 241 B.R. 583, 596 (Bankr. N.D. Ill. 1999).
[55] 11 U.S.C. § 362(a). The filing of a petition, however, does not operate as a stay for certain types of actions listed under 11 U.S.C. § 362(b).

U.S. 494, 503 (1986). The stay applies to all property in which the debtor has an interest, regardless of possession or title, and is intended to preserve the status quo.[56] The automatic stay provides a period of time in which all judgments, collection activities, foreclosures, and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the filing of the bankruptcy petition.[57] The stay provides a breathing spell for the debtor, during which negotiations can take place to try to resolve the difficulties in the debtor's financial situation.[58] As a general rule, actions prosecuted in violation of the stay are void and without effect, even if the entity that violated the stay had no knowledge or notice of the bankruptcy proceeding or the automatic stay.[59]

Under specific circumstances, the secured creditor can obtain an order from the court granting relief from the automatic stay. For example, when the debtor has no equity in the property and the property is not necessary for an effective reorganization, the secured creditor can seek an order of the court lifting the stay to permit the creditor to foreclose on the property, sell it, and apply the proceeds to the debt.[60]

Where the automatic stay applies to insurance policy proceeds in which the debtor has an interest, most courts hold that, where a third-party claim is covered by an insurance policy, the automatic stay should be lifted and the claim allowed to proceed outside the bankruptcy case.[61] Courts look to a variety of factors to determine whether the stay should be lifted and litigation should be permitted to continue in another forum. Some of these factors include whether the action primarily involves third parties, whether the debtor's insurer has assumed has assumed full responsibility for the defense of the action, whether relief would result in a partial or complete resolution of the issues, and the strength of the connection with or interference with the bankruptcy case.[62]

III. CASE STUDIES – INSURANCE COVERAGE IMPLICATIONS OF THE INSURED'S BANKRUPTCY

A. *Pak-Mor*

In *Pak-Mor Mfg. Co. v. Royal Surplus Lines Ins. Co.*, the bankruptcy court considered the impact of the bankrupt insured's inability to satisfy its insurance policy's self-insured retention.[63] Royal insured Pak-Mor under a commercial general

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[56] Darrel M. Seife, *Bankruptcy Proceeding's Impact on Coverage Litigation and Claims Management,* For the Defense*,* February 2002.
[57] There are statutory exceptions. 11 U.S.C. § 362 (a).
[58] Notes of the Committee on the Judiciary, Senate Report No. 95-989 (1978).
[59] 9A AM. JUR. 2d *Bankruptcy* § 1544, at 390 (1991).
[60] 11 U.S.C. § 362(d).
[61] *In re Sonnax Indus. Inc.,* 907 F.2d 1280, 1286 (2nd Cir. 1990) (citing Collier on Bankruptcy and summarizing caselaw under section 362).
[62] *Id.*
[63] *Pak-Mor Mfg. Co. v. Royal Surplus Lines Ins. Co.*, No. SA-05-CA-135-RF, 2005 WL 3487723 (W. D. Tex. 2005) (not designated for publication).

liability insurance policy.[64] During the Royal policy period, a garbage collector was injured when he slipped off the truck and was run over by it.[65] The garbage collector sued Pak-Mor, alleging that the step from which he slipped was improperly designed.[66] Approximately two weeks later, Pak-Mor filed for bankruptcy protection.[67]

Pak-Mor filed a declaratory judgment action against Royal in the bankruptcy court, alleging that Royal was obligated to indemnify Pak-Mor, despite Pak-Mor's inability to satisfy the policy's self-insured retention.[68] The bankruptcy court held that Royal was obligated to indemnify Pak-Mor; Royal appealed.[69] The appellate court reversed, holding that Royal was not obligated to pay any sums under its contract of insurance due to Pak-Mor's failure to satisfy its self-insured retention, the payment of which was a condition precedent to coverage based upon the following policy language: "Notwithstanding any provisions of the policy or any endorsements to the contrary, it is a condition precedent to the company's liability under this policy that the insured, and no other person, insurer or organization for or on behalf of the insured, makes actual payment of the 'Retained Limit'.[70] Any of our obligations under the policy shall not attach or arise unless or until the insured alone, and no other person, insurer or organization for or on behalf of the insured, pays the amount of the 'Retained Limit'. . . ."[71]

Weighing the equities, the court noted:

> The reasoning must start with the candid acknowledgment that there is an equitable problem here that cries out for a solution. As Pak-Mor notes, relieving insurers of liability in the bankruptcy context leaves 'third party plaintiffs . . . no means of recovery in the event that they are successful despite the fact that the insured [defendants] took the precaution of obtaining insurance to cover such losses such as those the claimants have suffered.' And this is a tragic position for plaintiffs to be in. Having endured suffering and having finally won a favorable judgment from the courts, it is unfair for them to get nothing because culpable defendants throw up their arms in insolvency and insurers quietly exit through the back door. This is an injustice, and something ought to be done about it. The solution, however, does not lie in judicially compelling an insurer to pay plaintiffs the amount they are due, contrary to contractual obligations.[72]

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[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] Pak-Mor Mfg. Co., 2005 WL 3487723 at *3.

Accordingly, the court held that the unambiguous text of the insurance policy compelled the conclusion that Pak-Mor must pay the self-insured retention before Royal had any obligation to indemnify Pak-Mor.[73]

B. *Amatex*

In *Amatex Corp. v. Stonewall Insurance Co*., Amatex requested approval of a bankruptcy plan and the creation of two trusts proposed by the debtor in the plan for the benefit of asbestos claimants.[74] Amatex then sought an order from the court requiring its products liability insurers to pay the policies' remaining limits into the two trusts for the benefit of asbestos claimants.[75] The bankruptcy court declined to issue such an order, and granted summary judgment in favor of the insurers, holding that the insurers could not be compelled to transfer the balance of the limits of their policies into the trusts for the benefit of future asbestos claimants.[76]

An appeal followed, in which the appellate court ultimately agreed that the bankruptcy court could not compel insurers, contrary to the terms of the insurance policies, to make lump-sum payments to the debtor for liabilities that the debtor contended would become due and payable to it under the liability insurance policies.[77] Specifically, the court ruled that a bankruptcy court cannot, by exercise of its equitable powers, create rights that are not otherwise available under the policies of insurance.[78] In so holding, the court rejected the argument that an insurer can be liable for future, contingent liabilities:

> The estimates represent only the *possibility* that the policies would be triggered. As the insurers point out, there has been no estimate as to whether any of the insurance coverage under the various insurance policies would be triggered by the pending or future asbestos claims. This court finds that, despite the likelihood that the policies would be triggered, and even the high probability that the policies would be exhausted, the debtor has no property interest in the insurance until the debtor is legally obligated to pay damages which fall under the definitions contained in the policies.[79]

The court also rejected the policyholder's argument that a settlement including policy proceeds in lump-sum would be more fair to all claimants, reduce the transaction costs of case by case litigation, and avoid the extensive litigation over

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[73] *Id.*
[74] Amatex Corp. v. Stonewall Insurance Co., 102 B.R. 411 (E.D. Pa. 1989), *aff'd* 908 F.2d 964 (3d Cir. 1990).
[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] *Id.* at 414.
[79] *Id.* (emphasis in original).

coverage issues.[80] Considering the arguments, the court explained that, "[a]lthough these arguments have some merit as a practical matter, and would therefore strongly suggest that a settlement would be the best for all parties, it does not change the legal powers of the bankruptcy court or the legal entitlement of the debtor."[81]

C. *UNR*

The United States Court of Appeals for the Seventh Circuit disagreed and arrived at a different solution to a similar problem in *UNR Industries, lnc. v. Continental Casualty Co*.[82] UNR was faced with 105,000 asbestos claims and was spending more than a $1 million dollars a month in legal expenses.[83] The bankruptcy court approved a reorganization under which UNR transferred a majority of its stock to a trust for the exclusive benefit of the asbestos victims.[84] On appeal, the court held that the bankruptcy reorganization plan constituted a "judgment" or "settlement" triggering the insurers' duty to indemnify.[85] The court reasoned that the reorganization required the policyholder to pay a sum certain in satisfaction of the asbestos claims, in exchange for which the asbestos claims would "be fully settled and satisfied" by the distribution of UNR's stock to the Trust.[86] In addition, the court reasoned that the order confirming the reorganization was final and appealable.[87] Thus, the court concluded, that UNR had suffered an adverse judgment, resulting in a "loss" within the meaning of the policy.[88]

The court rejected the insurer's argument that the bankruptcy plan did not bind them because of the "no action" clause in the policies.[89] The insurers contended that UNR failed to satisfy policy conditions in proposing and seeking confirmation of its bankruptcy reorganization plan, and made voluntary payments in violation of the policy conditions.[90] The court, considering this argument, noted that, even assuming for the moment that the reorganization order was not a "judgment" but only a "written agreement," the "no action" clause would bar suit because the insurers were not parties to the agreement.[91] However, without dispute, the insurers had notice of the bankruptcy reorganization and opportunity to participate.[92] Further, the court held, the valuation of asbestos claims in the reorganization was

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[80] *Id.*
[81] *Id.*
[82] UNR Indus., lnc. v. Cont'l Cas. Co., 942 F.2d 11.01 (7th Cir. 1991).
[83] *Id.*
[84] *Id.*
[85] *Id.* at 1104-05.
[86] *Id.*
[87] *Id.*
[88] *Id.* at 1105.
[89] *Id.*
[90] *Id.*
[91] *Id.*
[92] *Id.*

reasonable.[93] In combination, according to the court, these factors would establish that any "no action" rights of the insurers were waived.[94]

D. *Fuller-Austin*

In *Fuller-Austin Insulation Co. v. Fireman's Fund Insurance Co*., the insurers contested whether an approved bankruptcy plan constituted a "legal obligation to pay damages" as required by their respective liability policies' insuring agreements.[95] During the approval phase of the proposed bankruptcy plan, the insurers sought to participate in the bankruptcy proceedings and object to the bankruptcy plan.[96] In response to the insurers' objections, Fuller-Austin inserted text protecting the insurers' rights in the coverage action.[97] Because the next text purported to protect the insurers' rights, the bankruptcy court held that the insurers lacked standing to object to confirmation, reasoning that the insurers' rights were not affected by it.[98] The plan was approved.

Subsequently, the trial court in the insurance coverage lawsuit which was being prosecuted concurrently, concluded that the bankruptcy plan constituted a judgment through which Fuller-Austin was "legally obligated to pay" amounts as "damages," thus triggering the insurers' duty to indemnify.[99] The court rejected the insurers' arguments that Fuller-Austin's obligations under the bankruptcy resulted from a settlement to which the insurers had attempted to object.[100] Further, the court held that Fuller-Austin's insurers were obligated to pay the full amount established by the federal court with respect to each asbestos claim, notwithstanding the fact that Fuller-Austin could only pay a percentage of the values because of its bankrupt status.[101]

The insurers appealed these rulings. On appeal, the court held that the bankruptcy confirmation proceedings did not amount to a judicial finding that the insured was actually liable in the agreed amount because (1) there was no contested evidentiary hearing to determine the insured's liability, (2) the settlement resulted from negotiation rather than fact-finding, and (3) the purpose of a good faith determination is to ensure that the settling tortfeasor pay no less than its proportionate share of liability, while the insurer's concern is that the insured pay no more than its share.[102] The appellate court held that the key purpose of the bankruptcy court's findings was to ascertain the plan's good faith and reasonableness

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[93] *Id.*
[94] *Id.*
[95] Fuller-Austin Insulation Co. v. Fireman's Fund Ins. Co., No. B C 116835, 2002 WL 398672 (Cal. Super. Ct. Feb. 26, 2002), modified (August 6, 2002) (not designated for publication).
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] Fuller-Austin Insulation Co. v. Highlands Ins. Co., 135 Cal. App. 4th 958 (2006) (citing Wolkowitz v. Redland Ins. Co., 112 Cal. App. 4th 154 (2003)).

as to the asbestos claimants.[103] In fact, the appellate court noted that the bankruptcy court "intentionally did not address the Plan's fairness to [the insurers], as it found that they were 'not directly and pecuniarily affected' by the Plan."[104]

Further, the appellate court found that the bankruptcy plan confirmation was a settlement, the effect of which the insurers could challenge on retrial.[105] The appellate court reversed the lower court's decision to the extent it held that the insurers had waived all rights under their policies to object to the reasonableness of the settlement afforded by the bankruptcy confirmation.[106] The court also over-ruled the determination that Fuller-Austin would "be entitled to present evidence to a jury regarding its aggregate asbestos liability- *i.e*., the present liability of Fuller-Austin to pay pending and future asbestos claims," and that the jury's valuation would be binding on the insurers.[107] The court explained that, while the trial court relied upon the *UNR* decision in making its ruling, *UNR* relied on a bankruptcy court valuation that was based on a finite sum that would be used to settle identifiable asbestos claims. The *Fuller-Austin* court concluded that it could not find any authority, and it would not create any, that would allow a jury to estimate the aggregate sum of an insured's liability for pending and potential future asbestos claims for the purpose of accelerating its insurers' obligations.[108]

IV. THE COVERAGE IMPLICATIONS OF A BANKRUPT INSURED

A. *Bankruptcy Court's Actions Should Not Affect the Rights of the Respective Parties under Contracts of Insurance*

The approval of a policyholder's proposed bankruptcy plan should not change the rights of the insurers or the scope of coverage under policies of insurance. The policyholder's bankruptcy should not alter the terms and conditions of insurance contracts purchased by the insured and underwritten by insurers. The insurers' rights under their insurance policies should not be affected by bankruptcy proceedings, especially where the insurers had no opportunity to participate in the bankruptcy proceedings.[109]

It is hornbook law that if the language of a contract is clear and unambiguous, it governs.[110] Moreover, courts may not rewrite an insurance contract to expand coverage beyond that agreed to by the parties to the contract.[111] Based upon these doctrines, most courts correctly hold that the extent of a bankrupt estate's interest in an insurance policy is expressly limited by the contractual provisions within that

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[103] *Id.*
[104] *Id.* at 980.
[105] *Id.* at 982.
[106] *Id.*
[107] *Id.* at 991.
[108] *Id.*
[109] *See* Laura Foggin & Karalee Morell, *Distinctive Coverage Issues for the Bankrupt Insured*, 2002
[110] Brown v. Palatine Ins. Co., 35 S.W. 1060 (Tex. 1986).
[111] Alvarado v. Pilot Life Ins. Co., 663 S.W.2d 108 (Tex. App. 1983).

policy.[112] Thus, "the owner of an insurance policy cannot obtain greater rights to the proceeds of that policy than he would have under state law by merely filing a bankruptcy petition."[113]

Similarly, where an insurance policy requires the payment of a self-insured retention, courts should not rewrite the policy. A policyholder's decision to file for bankruptcy protection does not change the terms of the insurance contracts it purchased. Courts should not retroactively alter an insured's rights to coverage and the risks assumed by the insurers under an insurance contract because of the policyholder's financial difficulties.

B. *Insuring Agreement's Requirement of a "Legal Obligation" to Pay "Damages" is Not Satisfied by a Bankruptcy Plan's Treatment of Future, Contingent Liabilities*

Most insuring agreements, particularly those in liability insurance contracts, extend coverage only for amounts that the policyholder is "legally obligated" to pay "as damages." To obtain funding for future, contingent claims, some policyholders facing bankruptcy have argued, like UNR and Fuller-Austin, for courts to ignore the plain language of their policies.[114] These policyholders seek – without their insurers' consent and without paying the insurers a premium to compensate for the extra risk - to treat their policy limits as a line of credit, in effect forcing insurers to finance their bankruptcy reorganization and indemnify them for costs associated with future, contingent claims that may or may not ever materialize.[115]

1. A Policyholder Is Not "Legally Obligated to Pay" Amounts In Relation To Claims Which May Never Be Brought

A liability insurer contracts to indemnify its policyholder under prescribed circumstances and conditions for third-party claims for damages that the policyholder has a "legal obligation" to pay.[116] An insurer does not agree to indemnify a policyholder for any expenditures that it might incur in anticipation of unrealized or potential future third-party claims.[117] The phrase "legally obligated to pay as damages" imposes a specific prerequisite for coverage.[118] Until a third party actually claims that it has suffered a loss, there is simply nothing for which the insured is "legally obligated" to pay "as damages." In the absence of a current claim or demand that creates a legal obligation, coverage is precluded. Liability policies do not provide coverage for contingent liabilities, and this is one reason why liability insurance contracts do not - and should not - apply to the extent that a bankruptcy

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[112] *See, e.g.* In re Jones, 179 B.R. 450, 455 (Bankr. E.D. Pa. 1995).
[113] *Id.* at 455.
[114] *See*, Fuller-Austin Insulation Co. v. Fireman's Fund Ins. Co., and UNR Indus., lnc. v. Cont'l Cas. Co., discussed in detail in Part III, *supra.*
[115] *See* Foggin & Morell, *supra* note 109.
[116] *Id.*
[117] *Id.*
[118] Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co., 387 S.W.2d 22, 25 (Tex. 1965).

plan addresses only future, contingent claims that are neither certain to be made nor certain to result in an insured's liability.

As the United States Court of Appeals for the First Circuit correctly recognized in a non-bankruptcy context, the mere possibility of "indefinite and unfocused" future claims cannot trigger an Insurer's obligations under a third-party liability policy.[119] To "read the contract so liberally would effectively rewrite it, producing a very different type of agreement than the parties bargained for or reasonably could have expected."[120]

2. A Policyholder's Settlement With A Claimant Made Without the Insurer's Consent Does Not Constitute "Damages"

In addition to the insurance contract requirement that the policyholder be "legally obligated to pay," the relevant legal obligation must be paid "as damages." All requirements must be satisfied before an insurer's duty to indemnify is triggered. A policyholder's settlement with a claimant, made without an adversary proceeding and without the insurer's agreement, does not qualify.[121]

With regard to policyholder bankruptcies, many bankruptcy plans purport to be "global settlements." A bankruptcy court's approval of that "settlement" does not constitute an adjudication of a lawsuit resulting in "damages."[122] Where there is no specific claim being adjudicated in a lawsuit against the policyholder, "the duty to indemnify cannot arise because 'damages,' i.e., money ordered by a court, cannot be fixed in their amount since they have not been sought in the first place."[123]

C. *A Bankruptcy Plan Creating a Claims Resolution Procedure for Future Claims Is Not a "Judgment" For a Fixed Amount*

Where a bankruptcy plan creates a procedure for the future resolution of claims involving a policyholder, no "judgment" for a fixed amount is established against the policyholder.[124] Such a plan does not establish a present legal obligation to pay, and does not fix the policyholder's liability in the amount of any particular claim.[125] Because such a plan merely creates a procedure for the settlement of future claims, there are no actual claims or current liabilities that trigger insurance coverage.[126] In other words, where a bankruptcy plan only establishes a future claims resolution procedure, no "judgment" results. In such a circumstance, there is no adversarial process, and, ultimately, no judgment is entered against the policyholder. Consistent with this rationale, some courts have recognized the

[119] Ryan v. Royal Ins. Co. 916 F.2d 731, 743 (lst Cir. 1990).
[120] *Id.*
[121] Certain Underwriters at Lloyd's London v. Superior Court (-Powerine), 24 Cal. 4th 945 (2001).
[122] *See* Foggin & Morell, *supra* note 109.
[123] Powerine, 24 Cal. 4th at 968.
[124] *See* Foggin & Morell, *supra* note 109.
[125] *See,* Fuller-Austin Insulation Co. v. Highlands Ins. Co., 135 Cal. App. 4th 958 (2006); *supra* Part III (discussing the case in detail).
[126] *Id.*