AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Feature

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# When a Non-Executory Insurance Policy Is Assumed: A Case Study

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In chapter 11 cases, debtors' liability insurers have often sought to enforce their interest in having deductibles, self-insured retentions or retrospective premiums paid in full — or else be relieved of their insurer obligations — notwithstanding that the insured debtor is usually insolvent and unable to fully satisfy these terms. The insurers usually lose these battles, but in a recent case before the U.S. Bankruptcy Court for the District of Delaware the insurer's interests prevailed, and for that reason, it may be instructive.

In *In re East West Resort Development V LP*,[2] the outcome was an unhappy one for the claimant seeking to recover from available insurance, although it appeared to have elevated the insurer's position beyond ordinary expectations. Yet, on the facts of the case, the bankruptcy court's ruling was entirely reasonable. An examination of the opinion and the pertinent findings in the case highlights the acute level of attentiveness that may be required of creditors in a bankruptcy case that have claims covered by insurance in order to protect the insurance's continued availability.

## Going After Available Insurance?

The lead actors in this story are a set of real estate developers, a homeowners' association and an insurer. East West Resort Development V (EastWest) and its affiliates owned and developed a set of luxury residential and commercial real estate projects in the ski resort area of Lake Tahoe, Calif. After the real estate market swooned in 2009, they filed chapter 11 petitions in Delaware in February 2010.

Homeowner and condominium associations were established for the residential developments that the debtors built; one was Iron Horse Condominium Association (IHCA). Pre-petition, IHCA concluded that some of the construction in the development was faulty. In November 2009, IHCA filed a lawsuit against two of the debtors, referred to as Iron Horse and NMP, for the construction defects. The debtors tendered the lawsuit to ACE American Insurance Co. as their commercial general liability insurance provider.[3] When the bankruptcy cases were filed, IHCA filed proofs of claim for several million dollars.

The debtors' commercial general liability (CGL) insurance policy with ACE covered damage and injuries that occurred within a four-year policy period from April 2004 to April 2008. The policy had a $2 million per occurrence insurance limit, and a $250,000 per occurrence deductible. There was a stated premium for the four-year policy, to be paid in installments over the years that the policy was in force, and it appears to have been paid.[4]

When ACE issued the CGL policy and a workers' compensation policy[5] to the debtors in 2004, EastWest and ACE entered into a related agreement, referred to as the "multi-line agreement."[6] It provided for the advance funding of applicable deductibles and any retrospective premium adjustments agreed to under the CGL and workers' compensation policies. EastWest agreed to fund a collateral account, as security to ACE, to ensure that EastWest's obligations for the deductibles and premium adjustments would be satisfied.[7]

1 The author had no involvement on behalf of any party in the principal case discussed in this article.
2 2014 WL 4537500 (Bankr. D. Del. Sept. 12, 2014) (appeals pending). This article focuses on just a portion of the court's opinion.

3 2014 WL 4537500, at *5.
4 There was no contention to the contrary.
5 ACE's workers' compensation policy for the debtors provided for retrospective premium adjustment based on payroll (employee) data, which is typical. *See* M. Ledwin, "The Treatment of Retrospectively Rated Insurance Policies in Bankruptcy," 16 *Bankr. Dev. J.* 11, 12 (1999).
6 Its full title was "Funded Multi-Line Deductible Program Agreement." 2014 WL 4537500, at *2.
7 According to ACE's May 2010 motion, which attached the CGL and workers' compensation policies, ACE was holding a "collateral account" that the debtors funded, amounting to $721,000.

When IHCA and the debtors came to negotiate over IHCA's proofs of claim, the resolution that they worked out seemed to be designed to facilitate IHCA's pursuit of available insurance. The settlement on IHCA's proofs of claim provided an allowed claim of $250,000 — the exact amount of the policy's deductible — and the debtors agreed to "cooperate" with IHCA in its efforts to collect from insurance.[8]

## The Expected Outcome for IHCA, and the Actual One

At this point in the tale, one would justifiably expect to learn that IHCA, as a result of the settlement, was allowed to and happily did proceed with its construction defects lawsuit, with ACE managing the defense and without otherwise being hindered by the bankruptcy case. After all, it is common — in non-mass tort cases[9] — for bankruptcy courts to approve stipulations between personal injury plaintiffs and debtors whereby the plaintiffs obtain stay relief to pursue insurance proceeds, often in exchange for giving up their claim against the debtors.[10]

However, that was not how this tale ended. What progress occurred in IHCA's construction-defect lawsuit is unclear, but evidently IHCA did not collect. When IHCA began to raise questions about a private settlement that some debtors had reached with ACE, the debtors counter-attacked.

The debtors contended that after the plan became effective, they paid $250,000 or more to ACE to satisfy the deductible upon IHCA's lawsuit from funds in the collateral account that had been established under the multi-line agreement.[11] They paid ACE because they had assumed, rather than rejected, the multi-line agreement, along with the CGL policy. Then, based on some limiting language in the IHCA proof-of-claim settlement, the debtors demanded that IHCA reimburse them upfront for the $250,000 that they had advanced to ACE (covering defense costs up to the deductible level) for the privilege of continuing its action on the construction defects. The bankruptcy court agreed and granted the debtors' motion.[12]

In part, this resulted from some awkwardly phrased terms in the proof-of-claim settlement. But more importantly, the outcome was set in motion by the much earlier determination to assume, as executory contracts, the ACE policy and the multi-line agreement. Before reviewing how they came to be assumed, some examination of the applicable law is warranted.

## Expired Policies for Which the Stated Premium Was Paid Are Not Executory

Bankruptcy courts consistently hold that an insurance policy for which the policy period expired prior to the insured's bankruptcy — and for which the initial premium was paid — is *not* an "executory contract" under § 365 of the Bankruptcy Code.[13] In other words, where the policy period expired and the basic premium was paid, the debtor's failure to complete its performance will not constitute a material breach, such as would excuse the insurer from performing its obligations under the insurance contract.[14]

An insurance policy invariably includes some continuing obligations on the part of the insured, such as the duty to cooperate with the insurer, pay deductibles, etc. However, these ongoing obligations are not so substantial that they would justify an insurer's refusal to provide the insurance for which the insured contracted. Where only one party to the contract has substantial remaining obligations, the contract is not executory; it does not need to be assumed or rejected. Rather, it is an asset of the estate.[15]

> **[A]s a structural matter, the level of vigilance within the bankruptcy system demanded of parties with actual or even potential litigation claims against debtors may simply be unreasonable.... Perhaps a stricter standard is needed before debtors can be allowed to "assume" an expired insurance policy that would otherwise be treated as a non-executory asset of the estate....**

Bankruptcy courts have held that so long as the basic premium for an insurance policy was paid pre-petition, a continuing duty on the insured's part to pay "retrospective premiums" under the policy will not justify treating the policy as executory.[16] Similarly, courts have held that an insurer cannot make a debtor's full funding of a self-insured retention to be a prerequisite for the insurer to pay upon covered claims.[17] For such debtor obligations, the insurer is often just a general unsecured creditor. Bankruptcy courts have

8 2014 WL 4537500, at *2-*3.

9 *Cf. In re Adelphia Commc'ns Corp.*, 364 B.R. 518, 528 (Bankr. S.D.N.Y. 2007) (discussing channeling injunctions in connection with insurance proceeds).

10 *See, e.g., In re Arch Aluminum & Glass Co.*, 2011 WL 6399651 (Bankr. S.D. Fla. Dec. 13, 2011). Sometimes, as IHCA did, claimants with insured claims reach agreements with debtors for an allowed claim up to the deductible or self-insured retention threshold.

11 The debtors sometimes used the term "self-insured retention" as though it and "deductible" were synonymous, but the CGL policy had a deductible, not a self-insured retention.

12 2014 WL 4537500, at *11.

13 *See, e.g., Beloit Liquidating Trust v. United Ins. Co.*, 287 B.R. 904, 906 (N.D. Ill. 2002); *In re Ames Dep't Stores Inc.*, 1995 WL 311764, at *3 (S.D.N.Y. 1995); *In re Firearms Import and Export Corp.*, 131 B.R. 1009 (Bankr. S.D. Fla. 1991); *In re Fed. Press Co.*, 104 B.R. 56, 65-66 (Bankr. N.D. Ind. 1989). *See also* M. Anderson, "The Creditor That Is Always There — The Insurance Company," 17 *Norton J. Bankr. L. & Prac.* 4, § II (July 2008) ("Courts have held generally that unexpired insurance policies are executory contracts.").

14 *See In re Grace Indus. Inc.*, 341 B.R. 399, 402 (Bankr. E.D.N.Y. 2006), *aff'd as modified, Admiral Ins. Co. v. Grace Indus. Inc.*, 409 B.R. 275 (E.D.N.Y. 2009) (for purposes of § 365, "debtor's payment of the initial policy premium constitutes substantial compliance with its contractual obligations"). This standard for determining whether a contract is executory for purposes of § 365 derives from a 1973 article by Prof. Vern Countryman.

15 Courts' rationales on this proposition vary. *See, e.g., In re Vanderveer Estates Holding LLC*, 328 B.R. 18, 24 (Bankr. E.D.N.Y. 2005); *Pinnacle Pines Cmty. Ass'n. v. Everest Nat. Ins. Co.*, 2014 WL 1875166, at *5 (D. Ariz. May 9, 2014).

16 *See, e.g., In re Grace Indus. Inc.*, 341 B.R. at 403; *Beloit Liquidating Trust*, 287 B.R. at 906; *In re Sudbury Inc.*, 153 B.R. 776, 778 (Bankr. N.D. Ohio 1993); *Fed. Press Co.*, 104 B.R. at 65-66 ("[I]f an insurance contract is expired at the time of the filing of the debtor's petition ... and the debtor has only the duty to pay for retrospective premiums, the contract is not executory."); *In re Placid Oil Co.*, 72 B.R. 135, 137-38 (Bankr. N.D. Tex. 1987).

17 *See, e.g., In re FF Acquisition Corp.*, 2010 WL 1027405 (Bankr. N.D. Miss. March 18, 2010), *denying reconsideration of In re FF Acquisition Corp.*, 422 B.R. 64, 67 (Bankr. N.D. Miss. 2009) ("[B]ankruptcy courts ... have consistently held that the failure of a bankrupt insured to fund a self-insured retention will not excuse the insurer's performance under the insurance policy.").

rejected insurers' contentions that the presence of a separate agreement between insurer and debtor for the funding of premiums or deductibles — such as what ACE had with the debtors — requires any different result on the issue.[18] Lastly, in reviewing an insurance policy's status as non-executory, courts sometimes consider the presence of a standard clause in the policy (required in some states), referred to as the "bankruptcy clause." It provides that the bankruptcy or insolvency of the insured or its estate will not relieve the insurer of its obligations under the policy.[19] The ACE policy had such a clause.

The determination that an insurance contract is not executory is critical. If the debtors were forced to assume insurance policies, and cure all defaults, in order to gain the benefits of the insurance that they purchased, the economics of insurance would substantially shift.[20] The parties that suffered injuries or property damage that were caused by a bankrupt debtor would largely lose the benefits of the policies that the debtors had purchased, so long as the debtors could not pay in full such additional costs as outstanding retrospective premiums, deductibles or self-insured retentions. As one court stated:

> [The insurers] seek to have these obligations characterized as executory under section 365 so as to obtain administrative expense priority for their retroactive premium claims. But whether or not the Insurers' claims … are entitled to administrative priority should depend upon whether [they] qualify for such priority under section 503 of the Bankruptcy Code.[21]

Under these principles, one would expect the ACE CGL policy to have been deemed non-executory. It was a general liability policy that expired pre-petition, and the basic premiums had been paid. The policy included a standard bankruptcy clause, and had it been treated as a non-executory asset, an assumption of the multi-line agreement would have been unlikely. However, it was not.

## Under the Radar

After the debtors filed their proposed plan documents, ACE filed a motion asking the bankruptcy court to direct the debtors to assume or reject what they called an "executory insurance policy" and "related agreements." The main "related agreement" was the multi-line agreement. The motion defined the phrase "executory insurance policy" to refer *not* to the entire CGL policy, but rather to one component (an endorsement) within it. ACE also sought approval to use the collateral account funds to satisfy the debtors' commitments to pay deductibles or adjusted premiums.

Not long after, the debtors filed a schedule of those executory contracts that they proposed to assume under the plan. Their schedule included *both* the ACE CGL policy and the multi-line agreement; their reasoning was not supplied. Even ACE in its motion had not characterized the entire CGL policy as executory. No party objected to the debtors' scheduling of the CGL policy and the related multi-line agreement as executory. (ACE filed objections, but only as to whether the scheduled cure amount could be deducted from the collateral account.) In June 2010, the bankruptcy court's plan-confirmation order approved their assumption.

The debtors' disputes with ACE on the handling of the cure amount and related matters were resolved 10 months later, with a proposed, agreed-to order that the bankruptcy court approved. Under the agreed-to order, the ACE policy and the multi-line agreement were assumed and assigned to debtor NMP, which agreed to replenish the collateral account as the multi-line agreement provided.

Thus, the expired ACE insurance policy and the related agreement to fund the deductibles came to be assumed, without fanfare. No other interested parties — not a homeowner's association or anyone else — weighed in. Effectively, it went "under the radar."

## Too Much to Ask?

The treatment of the policy and agreement as executory contracts to be assumed by the debtors set in motion the rest of the outcome in the court's decision. In the court's ruling against IHCA, the debtors' joint assumption of the ACE policy with the multi-line agreement was a predicate on which the rest of the analysis followed. Hypothetically, the court could have revisited that decision[22] if it had been asked to, but it would have been well within its discretion not to do so, as it had been roughly two years since the bankruptcy case had been closed.

It is not known whether IHCA spotted the problem with the debtors' scheduling of the ACE policy as an executory contract to be assumed; to have done so would have required quite a high level of monitoring in the case.[23] Nonetheless, and certainly in retrospect, objection was warranted to the debtors' scheduling of the CGL policy as an assumable executory contract.

However, it is also possible that, as a structural matter, the level of vigilance within the bankruptcy system demanded of parties with actual or even potential litigation claims against debtors may simply be unreasonable. As the Bankruptcy Code is being examined afresh, these interests should be considered as well. Perhaps a stricter standard is needed before debtors can be allowed to "assume" an expired insurance policy that would otherwise be treated as a non-executory asset of the estate, or to shift liability insurance proceeds away from creditors with covered claims. abi

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18 *See, e.g., In re Sudbury*, 153 B.R. at 777 (policies non-executory, regardless of parties' concurrent premium agreement for funding retrospective premiums); *In re Placid Oil Co.*, 72 B.R. at 136-37.

19 *See, e.g., Rosciti v. Ins. Co. of Pa.*, 659 F.3d 92, 98-99 (1st Cir. 2011); *Pinnacle Pines*, 2014 WL 1875166, at *5.

20 *See* 11 U.S.C. § 365(b)(1).

21 *In re Sudbury*, 153 B.R. at 780-81.

22 *Cf. In re Int'l Fibercom Inc.*, 503 F.3d 933 (9th Cir. 2007) (affirming bankruptcy court's decision to limit prior order, which approved assumption of workers' compensation insurance policy as executory, where court later concluded that the assumption order violated § 365 because it allowed assumption of non-executory contract).

23 *Cf. In re Caribbean Petroleum Corp.*, 580 Fed. App'x. 82 (3d Cir. 2014). In *Caribbean*, the debtor's plan diverted some of the available liability insurance proceeds to pay administrative or general unsecured creditors; a creditor's later objections to the treatment of the insurance proceeds, in part on due process grounds, were unsuccessful.