

## **A Common-Sense Approach To D&O Policy Exclusions**

Law360, New York (July 27, 2011) -- Directors and officers are most in need of insurance coverage when their companies enter bankruptcy. It is no surprise, then, that this is precisely the point when directors and officers insurance policies typically do their best to let insurers off the hook. A recent opinion by an Illinois appellate court, however, thwarted just such an attempt, and afforded two former directors the coverage to which they were entitled.

In *Yessenow v. Executive Risk Indemnity Inc.*, 2011 Ill. App. (Ill. App. 1st Dist. June 30, 2011), the D&O insurer denied coverage for a claim by the trustee against two directors of a bankrupt company, relying on two commonly invoked exclusions: a bankruptcy exclusion and the insured versus insured exclusion. The trial court granted summary judgment to the directors on these issues and the appellate court affirmed.

### **The Bankruptcy Filings and the Follow-On Lawsuits**

Jeffrey Yessenow and Vijay Patel were physicians and former directors of iHealthcare Inc. They were insured under a D&O insurance policy issued by Executive Risk Indemnity Inc., entitled "Diversified Healthcare Organization Directors and Officers Liability Insurance Policy."

In January 2007, Heartland Memorial Hospital LLC, which was owned by iHealthcare, was placed into an involuntary bankruptcy by several creditors. Heartland was managed by a committee of iHealthcare's directors. In March of 2007, iHealthcare filed Chapter 11, and the two cases were consolidated.

The bankruptcies resulted in five lawsuits. Specifically, in February 2009, the Heartland trustee commenced two adversary proceedings against Yessenow and Patel (and several other former directors of iHealthcare). Three additional adversary proceedings were also filed against Yessenow and Patel, one by iHealthcare in its bankruptcy proceeding alleging mismanagement and self-dealing and two by other former directors of iHealthcare.

## Coverage for the Claims

Yessenow and Patel submitted timely notice of each of the five lawsuits to Executive Risk seeking coverage under the D&O policy, and Executive Risk denied coverage for all of them. Yessenow and Patel ultimately filed a complaint against Executive Risk, seeking a declaration that the policy provided coverage for the lawsuits.

Yessenow, Patel and Executive Risk moved for partial summary judgment on coverage issues. Yessenow and Patel sought a declaration that the D&O policy required Executive Risk to provide a defense in one of the underlying actions filed by the trustee in the Heartland bankruptcy, which alleged that they had mismanaged the corporation and breached their fiduciary duties. Executive Risk filed a cross-motion for summary judgment seeking a finding that the D&O policy did not afford coverage for the trustee's action, as well as the other four underlying actions.

The court concluded that neither the bankruptcy nor the insured versus insured exclusion precluded coverage, granted judgment to Yessenow and Pate and found that Executive Risk was obligated to defend them in the adversary proceeding commenced by the trustee. The decision on appeal in Yessenow addressed coverage for the claim by the trustee of iHealthcare against Yessenow and Patel, and applied Indiana law.

## The Bankruptcy Exclusion

Executive Risk first argued that the policy's bankruptcy exclusion, which was relatively detailed, barred coverage. The trial court disagreed, and deemed the exclusion unenforceable under section 541(c) of the Bankruptcy Code.

The appellate court first examined Executive Risk's argument that Yessenow and Patel, as nondebtors, lacked standing to challenge the validity of the exclusion under the Bankruptcy Code. On this point, the court examined section 541(c)(1), which states in relevant part:

"Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2) or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law[.]" Id. at \*12.

Executive Risk asserted that this section did not apply because Yessenow and Patel were not the debtors, and thus should not be afforded the protections of the Bankruptcy Code. The court, however, found that the policy itself was property of the bankruptcy estate, and therefore subject to the provisions of the Bankruptcy Code.

On this point, the court noted that although coverage inured to the benefit of Yessenow and Patel, "it arises from the D&O policy which has become a property interest of iHealthcare and Heartland, the debtors. Therefore, that property interest is protected by section 541(c) and because any benefit to the estate will be realized only if [Yessenow and Patel] may seek coverage under it" they had standing to challenge the exclusion. Id. at \*13.

The trial court had found the exclusion unenforceable because it “render[ed] the policy useless.” *Id.* at \*14. On appeal, Executive Risk asserted that the trial court had erred, and pointed to two decisions in which the courts did apply bankruptcy exclusions: *Lexington Insurance Company v. American Healthcare Providers*, 621 N.E.2d 332 (Ind. Ct. App.1993); and *Coregis Ins. Co. v. American Health Foundation*, 241 F.3d 123 (2d Cir. 2001).

Although both cases involved different exclusionary language, the Yessenow court did not address that issue. Rather, the court found those cases inapplicable because they concerned appointment of receivers under state statutes, and concluded that because the bankruptcy exclusion was conditioned on the commencement of bankruptcy case, the trial court did not err in finding the exclusion unenforceable under section 541(c).

### **The Insured Versus Insured Exclusion**

Executive Risk also disclaimed coverage on the basis of the insured v. insured exclusion, which purported to preclude coverage for claims “by or on behalf of, or in the name or right of, the Company or any Insured Person,” except that this would not apply to:

- any derivative action by a security holder of the Company on behalf of, or in the name or right of, the Company, if such action is brought and maintained independently of, and without the solicitation of, the Company or any Insured Person.
- any Claim in the form of a crossclaim, third party claim or other claim for contribution or indemnity by an Insured Person which is part of or results directly from a Claim which is not otherwise excluded by the terms of this Policy; or
- any Claim for an Employment Practices Wrongful Act. 2011 Ill. App. at \*4.

The trial court found this exclusion ambiguous, and construed it in favor of coverage. On appeal, Executive Risk argued that the exclusion was not ambiguous, but rather that its plain language barred coverage for the claim because a postpetition complaint brought by the trustee was “one brought ‘by or on behalf of or in the name or right of the Company or an Insured Person.’” *Id.* at \*21.

Although the trial court had found ambiguity because of contrary court decisions interpreting the exclusion, Executive Risk relied on *Biltmore Associates LLC v. Twin City Fire Insurance Company*, 572 F.3d 663 (9th Cir. 2009), which had found that an insured versus insured exclusion precluded coverage for a claim by a trustee of a creditors’ committee.

The appellate court in Yessenow did not address the split in case law on insured versus insured exclusions. Rather, it found that Biltmore had denied coverage because the purpose of the exclusion was to prevent collusion between the debtors and the company, which was an issue in Biltmore.

The Yessenow court did not see a possibility of collusion in the case before it, and found that the insured versus insured exclusion did not apply, noting: “[a] court-appointed trustee, unlike a debtor-in-possession, is acting with the imprimatur of the court, reducing the fear of collusion.” 2011 Ill. App. at \*25-6. Ultimately, Yessenow stated that the trustee was “a distinct entity from the pre-filing hospital who is working on behalf of the hospital’s creditors, not on behalf of the hospital.”

## Conclusion

Insurers' arguments to preclude coverage under bankruptcy and insured versus insured exclusions are frequently overly formulaic and divorced from the business realities and practicalities of bankruptcy proceedings. Yessenow is a welcomed, common-sense judicial approach to these two D&O policy exclusions, both of which are often invoked in the bankruptcy context.

Creditors committees, insured directors and officers, and insolvent policyholders generally, can applaud and feel emboldened by Yessenow's favorable outcome and sensible approach to complex insurance coverage issues.

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