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BY HAGOP T. BEDOYAN AND CHRISTIAN D. JINKERSON

When Should the Proceeds of Liability Insurance Policies Be Treated as Property of the Estate?

Hagop T. Bedoyan
McCormick, Barstow, Sheppard, Wayte & Carruth, LLP
Fresno, Calif.

Christian D. Jinkerson
McCormick, Barstow, Sheppard, Wayte & Carruth, LLP
Fresno, Calif.

Hagop Bedoyan and Christian Jinkerson are partners with McCormick, Barstow, Sheppard, Wayte & Carruth, LLP in Fresno, Calif. Mr. Bedoyan heads the firm's Bankruptcy Practice Group.

As a general rule, a debtor's third-party liability insurance *policies* are "property of the estate" under § 541 of the Bankruptcy Code.[1] Insurance policies are therefore protected by the automatic stay imposed by § 362, which stays, among other things, "any act to obtain possession of property of the estate."[2]

The more complicated question is this: When should the *proceeds* of the debtor's third-party liability insurance policies be considered property of the estate?[3] As the Fifth Circuit stated in *Sosebee v. Steadfast Ins. Co.*, "We have held that while insurance policies are generally property of the estate, the proceeds of liability insurance policies, unlike first-party policies, generally are not."[4] The main rationale for holding that third-party liability insurance proceeds are not considered to be "property of the estate" is that such proceeds are usually payable to third parties and not to the debtor. This rationale was articulated in *In re Edgeworth*,[5] a case in which the Fifth Circuit ruled that the medical malpractice liability insurance proceeds of an insurance policy issued to the debtor were not property of the estate. The Fifth Circuit reasoned as follows:

> The overriding question when determining whether insurance proceeds are property of the estate is whether the debtor would have a right to receive and keep those proceeds when the insurer paid on a claim. When a payment by the insurer cannot inure to the debtor's pecuniary benefit, then that payment should neither enhance nor decrease the bankruptcy estate. In other words, when the debtor has no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate.[6]

This rationale has particular salience in light of the fact that unencumbered and nonexempt assets that are deemed to be property of the estate are ordinarily subject to the timetable of the administration of the estate, as well as administrative expenses and/or trustee's fees. As a result, the determination of whether liability insurance proceeds should be treated as property of the estate involves significant complexity.

1 *Sosebee v. Steadfast Ins. Co.*, 701 F.3d 1012, 1023 (5th Cir. 2012) ("We have held that while insurance policies are generally property of the estate, the proceeds of liability insurance policies, unlike first-party policies, generally are not."); *ACandS Inc. v. Travelers Cas. and Sur. Co.*, 435 F.3d 252, 260 (3d Cir. 2006) ("It has long been the rule in this Circuit that insurance policies are considered part of the property of a bankruptcy estate."); *Stinett v. Laplante (In re Stinett)*, 465 F.3d 309, 312 (7th Cir. 2006) ("As a general matter, insurance contracts in which the debtor has an interest at the time the petition is filed constitute property of the estate for purposes of § 541(a)."); *Amer. Bank. Ins. Co. of Florida v. Maness*, 101 F.3d 358, 362 (4th Cir. 1996) ("[D]ebtors' insurance policies clearly constitute 'interests' under § 541(a) of the Bankruptcy Code."); *In re Dow Corning Corp.*, 86 F.3d 482, 495 (6th Cir. 1996) ("Dow Corning's interest in the insurance policies at issue is property of its estate under the expansive definition set forth in 11 U.S.C. § 541(a)(1)."); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 92 (2d Cir. 1988) ("Numerous courts have determined that a debtor's insurance policies are property of the estate, subject to the bankruptcy court's jurisdiction."); *In re Titan Energy Inc.*, 837 F.2d 325, 328-29 (8th Cir. 1988) ("Though Titan's interest in the policies is somewhat attenuated, they are the named insured and we hold that the policies are property of Titan's estate under the expansive definition set forth in section 541 of the Bankruptcy Code."); *Tringali v. Hathaway Mach. Co.*, 796 F.2d 553, 560 (1st Cir. 1986) ("A products liability policy of the debtor is ... within [the statutory definition of 'property of the estate']" (quoting *A.H. Robins v. Piccinin*, 788 F.2d 994, 1001 (4th Cir. 1986)); *In re Minoco Grp. of Cos. Ltd.*, 799 F.2d 517, 519 (9th Cir. 1986) ("[L]iability policies meet the fundamental test of whether they are 'property of the estate' because the debtor's estate is worth more with them than without them.").

2 11 U.S.C. § 362(a)(3).

3 *Compare In re Caribbean Petroleum Corp.*, 580 Fed. App'x. 82, 88 (3d Cir. 2014) ("[I]nsurance policies are considered part of the property of a bankruptcy estate.... With limited exceptions, so are the rights to insurance proceeds" (internal citations omitted)), *with Sosebee v. Steadfast Ins. Co.*, 701 F3d at 1023 ("We have held that while insurance policies are generally property of the estate, the proceeds of liability insurance policies, unlike first party policies, generally are not."); *In re Pintlar Corp.*, 124 F.3d at 1313-14 (9th Cir. 1997) (liability insurance proceeds deemed not property of estate because "a judgment involving third parties does not have a sufficient potential impact on the value of the estate to fall under the Bankruptcy Code's stay provision").

4 701 F.3d 1012, 1023 (5th Cir. 2012).

5 993 F.2d 51, 56 (5th Cir. 1993).

6 *Id.* at 55-56.

The case of *In re OGA Charters LLC*[7] elucidates an analysis for determining when liability insurance proceeds should be treated as property of the estate. In this case, a charter bus owned by OGA Charters LLC rolled over while traveling on a highway in southwest Texas on May 14, 2016. The accident killed nine passengers and injured more than 40 others, and resulted in numerous personal injuries, wrongful deaths and survival claims against OGA.[8] At the time of the accident, OGA had a commercial auto insurance policy that provided liability coverage subject to an aggregate policy limit of $5 million, but the total amount of the accident-related claims against OGA exceeded $400 million.[9] OGA had only one other known creditor, with a claim for less than $9,000.[10]

The massive scale of the OGA accident gave rise to a "race to the courthouse" dynamic among the numerous plaintiffs in which a "small group of victims and their representatives (the 'Settled Claimants') quickly entered into settlements with [OGA's liability insurer] that — if valid and enforceable — would exhaust the $5 million in liability coverage."[11] As a result, "the victims without settlements (the 'Unsettled Claimants') filed an involuntary [chapter 7] bankruptcy petition against OGA" and sought a determination of whether the insurance proceeds were "property of the estate" under 11 U.S.C. § 541. The unsettled claimants/petitioning creditors also sought an injunction from the bankruptcy court against the distribution of the liability insurance proceeds to the settled claimants.[12] The bankruptcy court determined that under the circumstances of the *OGA* case, the proceeds of its liability insurance policy were property of the estate, therefore it granted a preliminary injunction enjoining the liability insurer from paying out any policy proceeds.[13]

The Fifth Circuit subsequently affirmed the bankruptcy court's ruling that the proceeds of the liability insurance policy were property of the bankruptcy estate under the "limited circumstances" of the *OGA* case. The Fifth Circuit opined that "where a siege of tort claimants threaten the debtor's estate over and above the policy limits, we classify the proceeds as property of the estate."[14] The Fifth Circuit pointed out that because in the *OGA* case more than "$400 million in related claims threaten[s] the debtor's estate over and above the $5 million policy limit," the debtor had an "equitable interest ... in having the proceeds applied to satisfy as much of those claims as possible."[15]

The Fifth Circuit further reasoned that by making the insurance proceeds property of the estate and subject to the standard claims-administration process in bankruptcy, the bankruptcy court could provide oversight over the "allocation of the proceeds among claimants" and assure an "equitable distribution" of the insurance proceeds.[16] The reasoning of the *OGA* case was followed in *Roe v. Catholic Charities Archdiocese of New Orleans*, which held that "*OGA Charters* and its rationale control the outcome of this case ... the Court holds that the proceeds of these policies constitute property of the debtor's bankruptcy estate."[17]

Takeaways

The *OGA* case illustrates that three main factors should be used in determining whether third-party liability insurance proceeds are property of the estate: (1) whether the amount of the tort claims against the debtor exceeds the debtor's liability policy limits; (2) whether there are multiple separate claimants with claims covered by one or more liability insurance policies of the debtor; and (3) whether one or more claimants files with the bankruptcy court a request that the liability policy proceeds be treated as property of the estate. With respect to the equitable distribution of the policy proceeds, the bankruptcy court in *In re Mahoney Hawkes LLP*[18] offered a novel approach. In separately classifying the unsecured claims of the tort claimants as, "in effect, multiple secured creditors having claims against a single fund," the court noted:

> [T]he proceeds of the Policy are property of the estate.... This holding, however, is not dispositive of the issue of separate classification. After holding that the proceeds of a liability policy were property of the estate, the First Circuit [in *Tringali*] went on to state that what comes into the estate from such a policy is a 'debtor's right to have the insurance company pay money to satisfy one kind of debt—debts accrued through, for example, the insured's negligent behavior.'... It was not suggesting that the proceeds of a liability policy become part of the general fund available for distribution to all creditors.... *The malpractice claimants have the right to receive some property of the estate that general unsecured creditors cannot receive. They are, in effect, multiple secured creditors having claims against a single fund.*[19]

The *OGA Charters* case did not address the issue of the how to structure the distribution of liability policy proceeds to the tort claimants from the bankruptcy estate. As a practical matter, that issue did not present a significant challenge because the tort claimants constituted substantially all of the creditors of OGA's chapter 7 estate. However, in most cases, the issue of how to distribute third-party liability insurance proceeds only to creditors holding claims against those proceeds is an important one. We suggest, along the lines of the reasoning of the court in *In re Mahoney Hawkes LLP*, that to the extent that tort claimants have similar claims, such claims be treated as a separate class of secured or priority claims with the same level of priority, or on a *pari passu* basis, to best address the "race to the courthouse" problem first identified in *Tringali*[20] and well-illustrated in *OGA*.[21]

7 901 F.3d 599 (5th Cir. 2018).
8 *Id.* at 601.
9 *Id.*
10 *Id.* at 602.
11 *Id.* at 601.
12 *Id.*
13 *Id.*
14 *Id.* at 604.
15 *Id.*
16 *Id.* (citing 3 *Collier on Bankruptcy* ¶ 362.03 (16th ed)).
17 Case No. 20-1829, 2020 WL 6042327 * 4 (E.D. La. Oct. 13, 2020) ("*OGA Charters* and its rationale control the outcome of this case ... the Court holds that the proceeds of these policies constitute property of the debtor's bankruptcy estate.").
18 289 B.R. 285, 295 (Bankr. D. Mass. 2002).
19 *In re Mahoney Hawkes LLP*, 289 B.R. at 295 (emphasis added) (citations omitted).
20 *Tringali, supra*, at 796 F.2d at 560.
21 *OGA, supra.*

Conclusion

This article highlighted the apparent circuit split regarding the "liability insurance policies vs. liability insurance proceeds" dichotomy as it pertains to "property of the estate" in bankruptcy. It also suggests that the *OGA* case provides a helpful framework for determining when third-party liability insurance proceeds should be treated as property of the bankruptcy estate. The suggested framework aims to clarify when third-party liability insurance proceeds should be treated as property of the estate such that practitioners can more easily navigate those waters, and to show that under certain circumstances, the bankruptcy process can be helpful to tort claimants. abi

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