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MF Global Court Declines D&O Insurance Nanny Role

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Bankruptcy and insurance law intersected in *MF Global*[1] to illustrate a number of important concepts for unsecured creditors and bankruptcy practitioners alike. These concepts included the typical structure of insurance policies for directors and officers (D&Os), the interest of a bankruptcy estate in, and the applicability of the automatic stay to, a D&O insurance policy and its proceeds, and the ability of a bankruptcy court to use its equitable powers to impact a policy.

MF Global's insured D&Os, who were being sued in several cases alleging more than $1 billion in total damages, asked the bankruptcy court presiding over MF Global's bankruptcy to lift the automatic stay to grant them unfettered access to D&O insurance proceeds to fund their defense costs. The court granted the motion, holding that the proceeds were not property of MF Global's estate. The court's analysis focused on the D&O policies themselves, in light of the general principle that a debtor does not have greater rights in property because it filed for bankruptcy.

The *MF Global* court also declined an invitation to use its general equitable powers to serve as an overseer of D&O policy proceeds and D&O defense costs, despite the fact that defense costs of the D&O litigation had already exceeded $48 million before a single deposition had been taken. The court viewed the liquidating trustee, who himself had sued the D&Os for breach of fiduciary duties, to be in no different of a position than any other third party suing a defendant covered by a wasting policy. Therefore, the court refused to "police litigation in other courts that does not directly affect the property of the estates."[2]

Background

MF Global was formed in 2007 when Man Financial, the brokerage division of Man Group PLC, was "spun off in an initial public offering at the height of the boom in derivatives trading."[3] Since its inception, the company had been plagued with financial difficulties.[4] By the time the company filed for chapter 11 protection, allegations of misuse of approximately $1.6 billion of customer funds surrounded the company, and many were blaming the company's former D&Os.[5]

Several lawsuits were filed against MF Global's former D&Os, including former New Jersey governor and MF Global CEO Jon Corzine. The suits were brought by securities holders, commodity customers and other plaintiffs alleging violations of securities laws, the Commodity Exchange Act, the Racketeer Influenced and Corrupt Organizations Act, state consumer protection laws, breach of contract, breach of fiduciary duties and various other torts.[6] To fund their defenses in the suits, the former D&Os sought the proceeds from D&O liability insurance policies (the "D&O policies") and errors and omissions insurance policies (the "E&O policies") issued in favor of MF Global.

The bankruptcy court first addressed whether proceeds of the D&O and E&O policies were property of the estate approximately six months after MF Global filed for relief. During that time, MF Global's former D&Os had sent multiple notices to the company's insurance providers seeking payment under the policies.[7] The insurers sought a court determination that the policies' proceeds were not property of the estate or, in the alternative, relief from the automatic stay to channel the proceeds to the former D&Os.[8] In ruling on the insurers' motion, however, the bankruptcy court held that "it is unnecessary at this time to determine whether policy proceeds are property of the estates."[9] Instead, the court granted relief from the automatic stay for the former D&Os to "receive advancement or reimbursement of reasonable defense costs."[10]

The court did not initially grant the former D&Os access to the full amount of the policies' proceeds. Rather, the court set a $30 million "soft cap," which was quickly reached.[11] As a result, the former D&Os requested — and the court granted —

1 MF Global Holdings Ltd. and MF Global Finance USA Inc. filed for chapter 11 relief on Oct. 31, 2011. On Dec. 19, 2011, MF Global Capital LLC, MF Global FX Clear LLC and MF Global Market Services LLC also filed for chapter 11 relief, while MF Global Holdings USA Inc. filed on March 2, 2012. The cases are being jointly administered in *In re MF Global Holdings Ltd.*, No. 11-15059 (MG) (collectively, "*MF Global*"). *See* Disclosure Statement for the Amended Joint Plan of Liquidation Pursuant to Chapter 11 of the Bankruptcy Code at 13, *In re MF Global Holdings Ltd.*, No. 11-15059 (MG) (Bankr. S.D.N.Y. Oct. 31, 2011) [Docket No. 1092].

2 *In re MF Global Holdings Ltd.*, 515 B.R. 193, 207 (Bankr. S.D.N.Y. 2014).

3 "Jacob Bunge, MF Global: History from IPO to Bankruptcy," *Wall St. J.* (Oct. 31, 2011), *available at* blogs.wsj.com/deals/2011/10/31/mf-global-history-from-ipo-to-bankruptcy/ (last visited April 3, 2015).

4 For instance, approximately seven months after its formation, "[a] trader in MF Global's Memphis, Tenn., office sustain[ed] a $141.5 million loss after making unauthorized wheat trades, sending shares down 28%." *Id.*

5 Nick Brown, "MF Global Commodity Trader Customers to Get All Their Money Back," Reuters (Nov. 5, 2013), *available at* www.reuters.com/article/2013/11/05/us-mfglobal-bankruptcy-idUSBRE9A41BN20131105 (last visited April 3, 2015).

6 *In re MF Global Holdings Ltd.*, 469 B.R. 177, 181 (Bankr. S.D.N.Y. 2012).

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.*

11 *MF Global*, 515 B.R. at 196.

an increase in the soft cap to $43.8 million.[12] When this cap was reached, the former D&Os brought an action to access all of the proceeds of the D&O, but not the E&O, policies.[13]

D&O Proceeds Are Not Property of the Estate

In determining whether MF Global's D&O policies were property of the estate, the court first held that "it is well-settled that a debtor's liability insurance is considered property of the estate."[14] However, "courts disagree over whether the *proceeds* of a liability insurance policy are property of the estate."[15] When a policy "only provides direct coverage to a debtor, courts generally rule that the proceeds are property of the estate."[16] On the other hand, when a policy covers D&Os exclusively, "courts have generally held that the proceeds are not property of the estate."[17] When a policy covers both D&Os and the company, the Bankruptcy Code provides little guidance. In such situations, courts have held that "the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent [that] the policy actually protects the estate's other assets from diminution."[18]

MF Global's D&O policies covered both the company and the company's former D&Os. The company obtained both a primary D&O policy with coverage of up to $25 million and excess D&O policies providing up to an additional $200 million in coverage before its bankruptcy.[19] All of the policies were in the same format, containing the standard three insuring agreements, known as A-Side, B-Side and C-Side (or entity coverage).[20] A-Side policies provide coverage directly to D&Os when they are personally liable and when indemnification from the company is either not provided for by contract, not permitted by law or not available due to insolvency.[21] B-Side policies are indemnification policies that provide reimbursement to the company after the company indemnifies a D&O.[22] C-Side policies provide coverage directly to the company for its liability for securities claims.[23]

These policies are often combined in a single policy and may provide a priority waterfall in which the insurer will fund different policy components in a pre-established order.[24] MF Global's D&O policies contained such a priority-of-payment provision, providing that the A-Side coverage afforded to the D&Os must be paid before the payment of any loss to debtors for indemnification obligations (B-Side) or for losses resulting from securities claims against debtors (C-Side).[25]

MF Global arguably had a legal or equitable interest in the proceeds of the policies because the company could assert a claim against the D&O policies. This would render the proceeds as property of the estate under 11 U.S.C. § 541, which includes "all legal or equitable interests of the debtor in property as of the commencement of the case." However, MF Global could assert a claim against the D&O policies in only two specific instances: (1) if a party lodged a securities claim against MF Global, or (2) if MF Global was forced to indemnify its D&Os.[26]

As for the first instance, no party had instituted a "securities claim," as defined in the D&O policies, against MF Global and the statute of limitations to assert that such a claim had expired, meaning that it was extremely unlikely that MF Global would seek coverage under its C-Side policy.[27] As for the second instance, several former D&Os had sought indemnification from MF Global. The company could assert a $13.06 million claim against the B-Side policy if it were forced to indemnify these individuals.[28] However, the company had not indemnified any individual D&Os and did not intend to do so in the future.[29] Further, any indemnification would be subject to the priority-of-payment provision, meaning that MF Global would only be entitled to proceeds from the policy after the individual D&Os received their defense costs. By the time that MF Global sought indemnification, there likely would not be any funds left to reimburse the company.

Despite these observations, the court withheld the amount of MF Global's potential claim for indemnification against the D&O policies. The court held that "it is premature to label a payout [as] purely hypothetical," and that the former D&Os would "not be prejudiced by establishing a $13.06 million reserve in light of the substantial unused amounts available under the D&O Policies."[30] Accordingly, the court granted the former D&Os access to all but $13.06 million of the D&O policies.

Court Declines to Oversee D&O Proceeds and Defense Costs

Whether the D&O policies' proceeds were property of the estate was not seriously in dispute. MF Global's plan administrator conceded that the former D&Os were "entitled to pay for the adequate defense of their interests."[31] The real concern stemmed from the rate at which the former D&Os were consuming the proceeds, with more than $48 million in defense costs and expenses having been incurred without a single deposition.[32] To curb the rate at which the proceeds were being used, MF Global's plan administrator and other interested parties asked the court to continue to exercise oversight of the proceeds. In support of their request, the parties relied on 11 U.S.C. § 105(a), which permits a court to issue "any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[33] The court rejected this request, holding that the parties had not identified case law or plan language that permitted — much

12 *Id.*
13 The former D&Os sought only the proceeds of the D&O policies because the D&O policies, unlike the E&O policies, contained a priority-of-payment provision. *Id.* at 202. Further, MF Global had pending claims against the E&O policies but only hypothetical or speculative claims against the D&O policies. *Id.* Although the former D&Os likely had some interests in the proceeds of the E&O policies, their interests in the proceeds of the D&O policies was much clearer.
14 *Id.* (citations omitted).
15 *Id.* (citations omitted) (emphasis added).
16 *Id.* (citations omitted).
17 *Id.* (citations omitted).
18 *Id.* at 203 (citations omitted).
19 *Id.* at 198.
20 *Id.*
21 Richard L. Epling, Brandon R. Johnson and Kerry A. Brennan, "Intersections of Bankruptcy Law and Insurance Coverage Litigation," 21 *Norton J. Bankr. L. & Prac.* 103, 108 (2012).
22 *Id.*
23 *Id.*
24 *Id.*
25 *In re MF Global Holdings Ltd.*, 515 B.R. at 198.
26 *Id.* at 199.
27 *Id.* at 199, 203.
28 *Id.* at 203.
29 *Id.*
30 *Id.*
31 *Id.* at 200.
32 *Id.* at 196.
33 *Id.* at 204.

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less compelled — continued court oversight of the D&O policy proceeds.[34]

In reaching its conclusion, the court noted that while § 105(a) is broadly construed, it does not give a court the authority to create substantive rights that are otherwise unavailable under applicable law.[35] Further, a court can only issue an order under § 105(a) that would enforce or carry out the Code's provisions, and there is no specific Code provision that ongoing oversight of the D&O proceeds would enforce.[36] Therefore, the court held that "[i]t would be fundamentally unfair to allow the litigation to proceed while denying the [D&Os] coverage for defense costs."[37]

The court also dismissed the movants' argument that continued court oversight of the D&O insurance proceeds was appropriate because the payment of defense costs reduces potential recoveries in the underlying lawsuits, including by the liquidating trustee. In so holding, the court stated that the "[t]rustee is no different than any third party suing defendants covered by a wasting policy. No one has suggested that such a plaintiff would be entitled to an order limiting the covered defendants' rights to reimbursement of their defense costs."[38] Accordingly, "the Court [did] not believe [that] the law supports the placing of the bankruptcy court as the overseer of defense costs."[39]

34 *Id.* at 207-08.
35 *Id.* at 204.
36 *Id.*
37 *Id.* at 205.
38 *Id.* (quoting *In re Allied Digital Techs. Corp.*, 306 B.R 505, 512-13 (Bankr. D. Del. 2004) (authorizing payment-of-defense costs under D&O policy over objection of trustee who sought to preserve policy proceeds to satisfy his own claims against insureds)).
39 *Id.* at 207.

Conclusion

MF Global is a big loss for the typical unsecured creditor, but the decision is likely consistent with the Bankruptcy Code. Section 541(a)(1) provides that property of the estate must consist of "all legal or equitable interests of the debtor in property as of the commencement of the case." Most courts agree that "[i]nsurance policies and debtors' rights under insurance policies ... are property of the estate,"[40] but a debtor has no greater rights under a contract in bankruptcy than outside of bankruptcy.[41] If the proceeds of an insurance policy cannot flow to the debtor, or can only flow to the debtor in limited circumstances, most, if not all, of the proceeds are not properly considered estate property.

Whether proceeds of an insurance policy flow to the debtor depends on the policy's language. *MF Global* does not stand for the proposition that D&O insurance policy proceeds are never property of the estate; that determination depends on the language of the policy. Therefore, an unsecured creditor's strategy in handling a D&O policy issue will be dependent on the facts of each case. In cases such as *MF Global*, where a company and its D&Os are covered by a wasting insurance policy, unsecured creditors may be incentivized to settle quickly to prevent D&Os from consuming insurance proceeds to the detriment of the bankruptcy estate. abi

40 5 *Collier on Bankruptcy* ¶ 541.10 (Alan N. Resnick and Henry J. Sommer eds., 16th ed.).
41 *See, e.g., White Motor Corp. v. Nashville White Trucks Inc. (In re Nashville White Trucks Inc.),* 5 B.R. 112, 117 (Bankr. M.D. Tenn. 1980) ("The Code does not, however, grant the debtor in bankruptcy greater rights and powers under the contract than he had outside of bankruptcy.").