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Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

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Who Owns the Policy Versus Who Owns the Proceeds? The Distinction Matters During Bankruptcy

By Lorelie S. Masters and Geoffrey B. Fehling*

In this article, the authors discuss whether a debtor in bankruptcy is entitled to recover and use insurance the debtor purchased before bankruptcy or whether others are entitled to payments owed by the insurance.

One of the most important assets of a debtor's estate in bankruptcy often is insurance purchased by the debtor before bankruptcy arises, to protect the company's business, assets, and leaders. Insurance assets can be particularly key when the debtor's estate faces liabilities from mass-tort suits and claims, securities and other claims relating to management of the entity before bankruptcy. However, questions often arise about who is entitled to the insurance. Is the debtor (and its trustee) entitled to recover and use the insurance? Or, under the terms of the relevant insurance policy, or policies, are others entitled to payments owed by the insurance?

In addressing these issues, bankruptcy courts often have distinguished between ownership of the policy itself and, under the terms of the policy, the insureds who are entitled to the benefit of the "insurance proceeds." This issue typically arises with regard to liability insurance and can arise with regard to a variety of types of liability coverages, including commercial general liability (CGL) and directors and officers (D&O) liability coverage. First-party insurance, in contrast, applies to protect assets and exposures of the company, putting it outside of the reach of this issue of ownership of insurance-policy proceeds.

Thus, during bankruptcy, litigation may arise about who owns the insurance policy and who owns, or is entitled to payment of, the policy's "proceeds." Determining who owns the proceeds from a liability insurance policy often turns on interpretation of policy provisions which, when analyzed, are relevant to resolution of this issue and, thus, present classic insurance-coverage issues. D&O policies typically purchased by companies often present challenging questions because they provide different types of coverage to different entities and individuals. A primary purpose of D&O insurance, of course, is to protect individual directors and officers of the company and other individual insureds,

* The authors, attorneys with Hunton Andrews Kurth LLP, may be contacted at lmasters@hunton.com and gfehling@hunton.com, respectively.

and the existence of such insurance helps ensure that qualified people are willing to serve on company boards and as officers (and, depending on who the D&O policy defines "insured," as employees) of the company. Resolution of this issue depends on the nature of the liability faced and by whom, as well as numerous insurance factors, like the type of insurance and the policy language at issue.

WHO OWNS THE POLICY?

The bankruptcy estate is broadly defined to include "all legal or equitable interests of the debtor in property as of the commencement of the case."[1] Courts generally consider a debtor's insurance policy as part of the estate. However, owning the policy as an asset does not automatically determine who receives the proceeds. The key question typically addressed by bankruptcy courts is "whether the debtor would have a right to receive and keep those proceeds when the insurer paid on a claim."[2] If "the debtor has no legally cognizable claim to the insurance proceeds, [then] those proceeds are not part of the estate."[3] This inquiry often depends on the nature of the policy and the specific provisions governing the parties' interests in the payment of policy proceeds. Ultimately, whether the policy proceeds are considered part of the bankruptcy estate depends on the type of policy and who was intended under the insurance policy to benefit from it. Consequently, most courts distinguish between the insurance policies themselves and the proceeds from those policies.

WHO OWNS THE PROCEEDS?

Whether insurance policy proceeds are considered property of the debtor's estate depends on who is entitled to the proceeds when the insurer pays the claim. Generally, insurance proceeds paid directly to a debtor are deemed property of the estate. Examples of these "first party" coverages include collision, life, and fire policies where the debtor is the beneficiary. If the proceeds from these policies are payable to the debtor rather than a third party, they are recognized as property of the estate.[4] Conversely, policy proceeds are not considered property of the debtor's estate when they are not payable to the debtor.[5]

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[1] 11 U.S.C. § 541(a).

[2] Houston v. Edgeworth (In re Edgeworth), 993 F.2d 51, 55 (5th Cir. 1993).

[3] Id. at 56.

[4] In re Endoscopy Ctr. of S. Nevada, LLC, 451 B.R. 527, 544 (Bankr. D. Nev. 2011).

[5] In re Allied Digital Techs., Corp., 306 B.R. 505, 512 (Bankr. D. Del. 2004).

WHO OWNS D&O POLICY PROCEEDS?

The question often arises in the context of D&O insurance, which is designed to protect individual directors, officers, and other individual insureds; and, under many policies, the debtor company itself against securities claims, fiduciary breach claims, and other similar claims. Indeed, D&O insurance provides its most important protection during bankruptcy, as the debtor company's ability to indemnify individual insureds may be impaired due to financial constraints or prohibited by bankruptcy law.

D&O insurance policies typically offer three types of coverage:

- *Side A*: Covers losses arising from claims against individual directors and officers that is not indemnified by the company, either by reason of insolvency or because the company is not permitted, or chooses not, to indemnify.
- *Side B*: Reimburses the company for indemnification paid on behalf of individual directors and officers arising from claims against those individuals.
- *Side C*: Provides direct coverage to the company for securities claims and sometimes some other kinds of claims.

Generally, D&O policy proceeds are not considered property of the debtor's estate if they benefit only the directors, officers, and individual insureds (e.g., Side A coverage only). Courts have also found that, because the debtor did not have a "direct interest" in Side A or Side B coverage proceeds, those proceeds were not property of the estate.[6]

Other courts have determined that Side B proceeds can be considered property of the debtor if the coverage limits have been or could be depleted by indemnification requests, potentially leaving the company without coverage for future indemnification demands. These courts have found that Side B insurance proceeds were property of the estate.[7] However, if the covered indemnification "has not occurred, is hypothetical, or speculative," courts may find that the policy proceeds are not property of the estate.[8]

With respect to Side C coverage, courts have found that policy proceeds from entity coverage are property of the estate.[9] This is not surprising because the

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[6] See, e.g., In re Youngstown Osteopathic Hosp. Ass'n, 271 B.R. 544, 548-550 (Bankr. N.D. Ohio 2002).

[7] In re Leslie Fay Cos., Inc., 207 B.R. 764, 785 (Bankr. S.D.N.Y. 1997).

[8] In re Allied Digital Techs. Corp., 306 B.R. 505, 512 (Bankr. D. Del. 2004).

[9] In re Sacred Heart Hosp. of Norristown, 182 B.R. 413, 420 (Bankr. E.D. Pa. 1995).

debtor can easily be said to have an interest in the proceeds as an insured under the policy. Other courts have taken a broader view, asserting that a bankruptcy estate includes any assets that enhance the value of the Estate. Thus, as long as the policy includes Side B or Side C coverage, the policy proceeds meet the "fundamental test" because the bankruptcy estate is worth more with the insurance policy than without it.[10]

TRUSTEES CANNOT SETTLE COMPANY'S LAWSUIT AGAINST FORMER CEO

One recent decision from the U.S. Court of Appeals for the Fourth Circuit, *In re Levine*, shows how disputes about ownership and control of D&O insurance claims can play out in practice. *Levine* involved a "tale of two bankruptcies and two adversary actions," where the Fourth Circuit ruled that the separate bankruptcy trustees for a debtor company and its former chief executive officer could not settle the company's fraud claims against the CEO using insurance proceeds from a D&O policy purchased by the company before bankruptcy.[11] In affirming dismissal of an adversary declaratory action addressing this issue on jurisdictional grounds, the Fourth Circuit offered insightful commentary on the purpose and intent of D&O liability policies and their treatment in bankruptcy proceedings.

First, the company's purchase of the D&O policy did not grant the company "first-party" status or standing to sue. The policy was "activated," the Fourth Circuit concluded, because the company sued the CEO. In that scenario, only the CEO was considered an insured under the policy, not the company.

Second, the trustee sought to recover defense costs in the adversary proceeding against the CEO for fraud. The trustee tried to leverage the "wasting" policy – namely, that defense costs were eroding the policy's available limits – to support his standing argument. The court ruled that the trustee's "fear" was not enough.

Third, while the insurance policy itself could be considered an asset of the estate, according to the Fourth Circuit, courts "routinely" find that, when a D&O policy provides direct coverage to the directors and officers (as was the case here), the policy proceeds are not considered property of the debtor company's estate.

Ultimately, the court emphasized that the purpose of D&O coverage is to protect individuals, like the CEO, from incurring liability as directors and

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[10] Circle K Corp. v. Marks (In re Circle K Corp.), 121 B.R. 257 (Bankr. D. Ariz. 1990).

[11] In re Levine, No. 23-1349 (4th Cir. Feb. 26, 2025).

officers of the debtor and to ensure that potential losses incurred as a result of their service in such capacities remain separate from their personal finances. Consequently, courts "regularly" recognize that the benefits provided to these individuals by D&O policies "cannot be stripped from them by a bankruptcy trustee." As a result, the trustee had no claim to the right of consent to settlement under the policy.

CONCLUSION

The Fourth Circuit's decision underscores the importance of Side A coverage to protect directors, officers, and individual insureds when an insolvent company is unable or unwilling to indemnify them for the defense costs and potential liability they face due to their service to the company.

In case of bankruptcy, Side A D&O coverage may be the only protection standing between an individual director or officer and personal exposure. For that reason, preserving scarce insurance limits for the benefit of individual insureds is paramount. This can be accomplished in a number of ways. The simplest perhaps is just buying more insurance in the form of higher limits in the company's existing "Side ABC" policy covering both the company and its directors, officers, and individual insureds. Another pathway is to purchase "dedicated" Side A-only limits, which can be used exclusively to protect individuals when the company is unable or unwilling to indemnify them or advance their legal fees and costs.

Side A-only limits are often provided automatically or with payment of additional premium in existing D&O policy forms, but often times they are better secured in entirely separate, standalone policies. Those standalone policies often provide other benefits, like fewer exclusions, more coverage, and better terms no available under traditional Side ABC forms. Working closely with experienced risk professionals, including insurance brokers, consultants, and outside coverage counsel can help companies place, renew, and modify insurance programs with an eye towards providing effective protection for insured executives and individuals that responds as expected at the point of claim. While insurance considerations are important during bankruptcy proceedings, the best time to start ensuring the effectiveness of insurance protection is long before insolvency arises.