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FIFTH CIRCUIT ADDS NEW CONSIDERATION IN DECIDING WHETHER POLICY PROCEEDS ARE PROPERTY OF THE DEBTOR'S BANKRUPTCY ESTATE: AND HOW IT COULD IMPACT INSURERS UNINTENDED WAYS

IN RE OGA CHARTERS, L.L.C., — F.3D — (5TH CIR. 2018), 2018 WL 4057525

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On August 24, 2018, the Fifth Circuit Court of Appeals issued a decision that will alter the analysis of whether proceeds of an insurance policy issued to an insured who files bankruptcy are property of the bankruptcy estate under 11 U.S.C. § 541. The results-oriented decision produced a more equitable outcome for the debtor's many creditors, but it may lead to unintended consequences that could wreak havoc on insurers.

The Facts: OGA Charters, LLC ("OGA") operated a charter bus service. While on a route to a casino in Eagle Pass, Texas, one of its buses was involved in a single-vehicle rollover crash that killed nine passengers and injured more than 40 others. OGA had a single relevant insurance policy that provided $5 million of liability coverage for "covered autos." A small group of claimants quickly entered a settlement with the insurer that would have exhausted limits, leaving the remaining claimants with possible recourse only against OGA's very limited other assets. The total claims asserted by the accident victims exceeded $400 million.

Faced with a prospect of no recovery on their claims, a group of the non-settled claimants filed an involuntary bankruptcy petition against OGA and initiated an adversary proceeding asking the bankruptcy court to enjoin the insurer from paying the pre-bankruptcy settlement. The non-settled claimants argued the proceeds were property of the OGA bankruptcy estate that must be equitably distributed to all claimants. The Bankruptcy Court held the proceeds were property of the estate, and a direct appeal was taken to the Fifth Circuit.

Historical Treatment of Policies and Proceeds: It is well known that insurance policies issued to a debtor are considered property of the estate, but the treatment of proceeds is another matter. In the Fifth Circuit the latter question has historically been resolved by asking who owns—or is entitled to receive—the proceeds when a claim is paid. *See, e.g., In re Louisiana World Exposition, Inc.*, 832 F.2d 1391 (5th Cir. 1987) (proceeds of policies purchased by the debtor but providing coverage for its directors and officers were not property of the estate.). Where the debtor has no right to receive and retain the proceeds of the policy, the proceeds are not property of the estate. *In re Edgeworth*, 993 F.2d 51 (5th Cir. 1991). Proceeds of first party policies and coverages are generally considered property of the estate, while proceeds of liability policies generally are not.

From a bankruptcy perspective, the purpose of asking who is entitled to retain the proceeds is to determine whether those proceeds might enhance or deplete the debtor's estate. If paying the proceeds would neither enhance or deplete the estate—as would occur when proceeds of a liability policy are paid to a third-party claimant—the proceeds are not property of the estate under 11 U.S.C. § 541.

While the question of who is ultimately entitled to policy proceeds is sometimes complicated by the particular circumstances, for instance when a policy provides both first party and third party coverage, the answer has typically been predictable. That may no longer be the case after *In re OGA Charters*.

The holding: The Fifth Circuit acknowledged the policy at issue in *OGA Charters* was a liability policy whose proceeds could not be retained by the Debtor. Historically, this would lead one to conclude the proceeds were not property of the estate, leaving the insurer free to perform under the settlement and exhaust its limits unimpeded by the Bankruptcy Code's automatic stay provisions.[1] Here, however, the Fifth Circuit held that because the amount of claims far exceeded OGA's coverage limits, OGA had "an equitable interest" in having the proceeds applied to satisfy as many of the pending claims as possible. The proceeds were property of the estate subject to the bankruptcy policy of equitable distribution among creditors, notwithstanding the fact that OGA would never be entitled to retain any of the proceeds.

How this holding could impact insurers: We believe this holding could have a number of unintended consequences for insurers. Some of those include the following:

- Limitation on insurer's right to enter reasonable settlements: It has long been the law in Texas that an insurer faced with multiple claims and inadequate limits may enter into reasonable settlements with fewer than all claimants even though those settlements exhaust limits. *Texas Farmers Ins. Co. v. Soriano*, 81 S.W.2d 312 (Texas 1994). *OGA Charters* appears to limit the protections and rights afforded by *Soriano* to expand a debtor's property interests beyond what applicable state law otherwise provides.[2]
- Possible exposure to significant defense costs: Under *Soriano*, an insurer could exhaust limits through reasonable settlements and by doing so end its obligation to provide a defense of other covered claims. Under *OGA Charters*, an insurer may be denied the right to exhaust its limits, remaining obligated to provide a defense of all pending claims. This risk is exacerbated by the fact that bankruptcy courts lack jurisdiction to adjudicate personal injury and wrongful death claims. Those claims must be tried in the district court where the bankruptcy case is pending or where the claims arose. 28 U.S.C. § 157(b)(5). A debtor's plan of reorganization or liquidation might provide that the policy proceeds will be paid into a trust for the benefit of the injured claimants, but those claimants retain their right to a jury trial if they do not consent to the plan's claim-valuation procedures. Whether the insurer remains obligated to provide a defense for those claims is unclear under *OGA Charters*.
- *Stowers* implications?: If an insurer accepted a prepetition *Stowers* demand, and a bankruptcy was filed before the payment was made, it would appear the intervening bankruptcy in circumstances similar to *OGA Charters* should protect the insurer where the bankruptcy court concludes the proceeds are property of the estate. This outcome is, however, far from clear. In 2001, the Fifth Circuit in *In re Davis*[3] held that a *Stowers* claim did not become part of the debtor's bankruptcy estate where the bankruptcy occurred

years before the final judgment in excess of limits was entered,[4] the debtor received his discharge prior to entry of the final judgment, and the debtor had no assets available to pay claims in the bankruptcy—meaning the debtor-insured was not harmed by the excess judgment so no *Stowers* claim arose. However, the concurrence in *Davis* recognized the answer may be different where a portion of the debtor's assets are used in the bankruptcy case to pay the excess judgment.

- Avoidance action liability: If a liability insurer pays policy limits to resolve one or more claims against an insured, leaving other pending claims without coverage, and the insured later files bankruptcy, the *OGA Charters* holding could give rise to avoidance actions by a creative debtor, committee or trustee. A fundamental requirement of any bankruptcy avoidance action is that the debtor have an interest in the assets that were transferred. When faced with multiple claims and insufficient limits, *OGA Charters* now creates in the insured-debtor a property interest in liability policy proceeds. Such avoidance actions could ultimately expose the insurer to liability well in excess of its policy limits.

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[1] In these circumstances, it is nonetheless advisable to seek relief from the automatic stay, to the extent it applies, out of an abundance of caution. *OGA Charters* makes this particularly true when there are multiple claims exceeding limits.

[2] Bankruptcy Code § 541, which defines property of a debtor's bankruptcy estate, does not create property interests that do not otherwise exist. It merely recognizes and enforces whatever property interests the debtor may have as of commencement of the bankruptcy case. *OGA Charters* appears to go beyond § 541 by recognizing an "equitable" interest in property that does not otherwise exist under Texas law.

[3] *In re Davis*, 253 F.3d 807 (5th Cir. 2001).

[4] A *Stowers* claim accrues upon entry of a final judgment in excess of limits.