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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH, CENTRAL DIVISION

In re: CASTLE ARCH REAL ESTATE INVESTMENT COMPANY, Debtor.	Bankruptcy No. 11-35082 JTM Chapter 11

REPLY TO THE TRUSTEE'S OBJECTION TO THE MOTION FOR RELIEF FROM THE AUTOMATIC STAY, TO THE EXTENT APPLICABLE TO ADVANCE DEFENSE COSTS

Douglas W. Child, Kirby D. Cochran, Robert D. Geringer, William Warwick, William H. Davidson, Jeff Austin, William Grundy, and Keith Green (collectively, the "Insured Individuals" or "Movants"), by their undersigned attorneys, respectfully submit this Reply in further support of the Insured Individuals' Motion for Relief from the Automatic Stay, to the Extent Applicable, to Advance Defense Costs (the "Motion"). This Reply responds to the Objection that the Trustee filed with respect to the Insured Individuals' Motion on December 16, 2013 (the "Objection").

I. INTRODUCTION

The Trustee, D. Ray Strong, is attempting to deprive the Insured Individuals from using the proceeds of the AXIS Surplus Insurance Company Policy ("Policy" or "AXIS Policy")[1] that was purchased specifically for the Insured Individuals. The Trustee believes that he can circumvent the actual policy language to obtain the Policy's proceeds even though the debtor company, Castle Arch Real Estate Investment Company, LLC and its affiliates (the "Debtor"), was not an insured under the Policy when notice was given of potential claims against the Insured Individuals. The Policy in question only provides coverage under Insuring Agreement A, which means that it covers the insured directors, officers, and employees of the Debtor for any covered defense costs, judgments, or settlements for which the Debtor does not indemnify them. Courts across the nation have held repeatedly that similar policies are not the property of the debtor's estate because the proceeds are for the benefit of the directors, officers, and employees, not the company that employed them. *See* Motion at ¶¶ 19-20.

In the alternative, if the Court finds that the Policy is the property of the bankruptcy estate, there is cause to lift the stay and advance defense costs to the Insured Individuals. In fact, case law almost universally holds that there are situations, like the case at bar, when it is

[1] The Policy is entitled "Private Equity and Venture Captial Fund Liability Policy," a type of policy that is more commonly referred to as a D&O policy, with the policy number EAN756858/01/2010.

appropriate to lift a stay. *See, e.g.*, *In re Busch*, 294 B.R. 137, 140 (B.A.P. 10th Cir. 2003); *In re Carbaugh*, 278 B.R. 512, 525 (B.A.P. 10th Cir. 2002); *In re Curtis*, 40 B.R. 795, 799-800 (Bankr. D. Utah 1984). The Trustee's arguments to the contrary are unfounded because they fail to recognize that the automatic stay does not prohibit the Insured Individuals from seeking the advancement of defense costs from AXIS, a non-debtor.

II. ARGUMENT

A. The AXIS Policy Is Not the Property of the Debtor's Estate.

As set forth in the Motion, the AXIS Policy is not the property of the Debtor's estate because the proceeds of the Policy only cover the Debtor's directors, officers, and employees--not the Debtor. *See* Motion at ¶¶ 8-18. Regardless, even if the Debtor were an Insured Individual, which it is not, the Policy would still not be part of the Debtor's estate because of the Priority of Payments Provision of the Policy. As recognized by courts, the general rule to determine a bankruptcy estate's property interest in an insurance policy is to look to the language and scope of the insurance policy. *See, In re Allied Digital Techs., Corp.*, 306 B.R. 505, 509 (Bankr. D. Del. 2004) ("*Allied Digital*").

1. Insuring Agreement A Only Provides Coverage to Insured Individuals.

The specific and unambiguous language of the Policy makes clear that the proceeds of the Policy are only available for the Debtor's directors, officers, and employees. In Insuring Agreement A (commonly referred to as "Side A Coverage"), the Policy states that AXIS will pay all "Non-Indemnifiable Loss" in connection with "any Claim for a Wrongful Act" on behalf of any "Insured Individual" and then defines "Insured Individual" to include the directors, officers, and employees of the Debtor--but not the Debtor itself. *See* AXIS Policy III.H and End. 17 ¶ 6. In fact, Endorsement 17 makes clear that Insuring Agreement B (commonly referred to as "Side B Coverage")--the insuring agreement that provided coverage to the Debtor--is not part of the

Policy. *See* AXIS Policy End. 17 ¶ 7. Because the Debtor is not an Insured Individual, it is not entitled to the Policy's proceeds and the Policy is not the property of the bankruptcy estate.

Courts agree that when a policy only provides direct coverage to directors and officers, "the proceeds of the insurance policy are not property of the bankruptcy estate because the proceeds are payable to the directors and officers not the estate." *Allied Digital*, 306 B.R. at 510; *see also In re Louisiana World Exposition, Inc.*, 832 F.2d 1391 (5th Cir. 1987) ("*Louisiana World*").[2] In *Allied Digital*, the Trustee brought a proceeding against the debtor's former directors and officers seeking damages in excess of $62 million in connection with a leveraged buyout. *Id.* at 507. The directors and officers argued that because Insuring Agreement A of the Policy provided them with direct coverage for non-indemnifiable defense costs and settlements in connection with the claim brought by the Trustee, that the policy was not property of the estate. *Id.* at 508. The Trustee argued that because Insuring Agreement B of the policy provided the debtor company with coverage for all indemnification of its directors and officers, that the insurance proceeds passed to the bankruptcy estate. *Id.* at 509.

The *Allied Digital* court agreed with the directors and officers and held that even though the policy provided indemnification to the debtor for funds paid to the directors and officers arising out of a covered loss, the insurance policy was not part of the estate. The court reasoned that

> [t]he Trustee's real concern is that payment of defense costs may affect his rights as a plaintiff seeking to *recover from* the D & O Policy rather than as a potential defendant seeking to be *protected by* the D & O Policy. In this way, Trustee is no different than any

[2] As discussed at the end of this section, none of the cases cited by the Trustee actually support its position that the Policy's proceeds are part of the bankruptcy estate. In contrast, there are several cases across the country in addition to those already cited in the main body of this brief that support the Insured Individuals' position. *See, e.g., In re Reliance Grp. Holdings, Inc. Sec. Litig.*, No. 00-CV-4653, 2004 WL 943545 at *11-12 (S.D.N.Y Apr. 30, 2004) (holding that there was no basis to conclude that a Side A policy or its proceeds are the property of the estate because they only benefit the directors and officers); *In re Imperial Corp. of Am.*, 144 B.R. 115, 118-19 (Bankr. S.D. Cal. 1992) (holding that direct coverage to the directors and officers was not the property of the estate).

> third party plaintiff 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.
>
> The bottom line is that the Trustee seeks to protect the amount he may receive in his suit against the directors and officers while limiting coverage for the defense costs of the directors and officers. This is not what the directors and officers bargained for. In bringing the action against the directors and officers, the Trustee knew that the proceeds could be depleted by legal fees and he took that chance. The law does not support the Trustee's request to regulate defense costs.

Id. at 513. The court went as far as to create a bright-line rule that when a liability insurance policy "only provides direct coverage to the directors and officers the proceeds are not property of the estate." *Id.* at 512.

Just as in *Allied Digital*, the Trustee in this case is similar to a third-party plaintiff, making demands of the Debtor's former directors, officers, and employees in the hopes of obtaining the AXIS Policy's proceeds. This is evident from the fact that the Trustee's Objection used a potential $950,000 settlement with Douglas Child, one of the debtor's former employees, as a supporting reason for why the AXIS Policy is supposedly the property of the estate. The Trustee has no direct claim against the Policy (or its proceeds) and can only assert a claim if an Insured Individual (one of the directors, officers, or employees) makes a claim.

Although it is understandable that the Trustee would seek to obtain monies from any potential source, the Trustee cannot transform the Policy into part of the Debtor's estate simply because the directors, officers, and employees are entitled to coverage for a potential settlement with the Trustee. Indeed, as the Fifth Circuit described "[o]ne having a pending, unadjudicated tort claim against another does not--whether or not the claimant is bankrupt--thereby have a property interest in liability proceeds payable to the defendant; but the defendant *does* have a property interest, recognized in bankruptcy, in such proceeds." *Louisiana World*, 832 F.2d at

1399. In bankruptcy, the estate's "legal and equitable interests in property" does not rise any higher than the "legal and equitable interests" of the Debtor. *In re Gagnon*, 26 B.R. 926, 928 (Bankr. M.D. Pa. 1983).

In contrast to the situation in *Allied Digital*, where the policy provided direct coverage to the directors and officers (i.e. Side A coverage) and also provided coverage to the debtor for indemnifying the directors and officers (i.e. Side B coverage), the AXIS Policy does not provide indemnification coverage to the Debtor. Instead, the AXIS Policy only provides Side A Coverage, meaning direct coverage to the Debtor's directors, officers, and employees. This means that the Policy is not the property of the bankruptcy estate under *Allied Digital's* bright-line rule.

Lastly, the cases cited by the Trustee do not support the Trustee's argument that the AXIS Policy's proceeds are part of the bankruptcy estate. First, in *In re Metropolitan Mortgage & Securities Co., Inc.*, the court specifically held that when the debtors are not insureds under the policy, the debtors have no "right or claim to any of the policy proceeds" and the "debtors hold no legal interest in the proceeds." 325 B.R. 851, 854, 857 (Bankr. E.D. Wash. 2005) ("*Metropolitan Mortgage*"). It is unclear why the Trustee believes this case supports his claim to the Policy's proceeds because the Debtor is not an insured under the AXIS Policy and *Metropolitan Mortgage* holds that in such situations, the debtor has no legal interest in the policy proceeds.

Similarly, *In re the Circle K Corporation* does not support the Trustee's argument. 121 B.R. 257 (D. Ariz. 1990) ("*Circle K*"). In *Circle K*, the debtor was an insured entity under the policy and, in certain circumstances, the debtor could make a claim for reimbursement for indemnifications expenses paid to its directors and officers under the policy's indemnification

coverage (Side B coverage). *See id.* at 261. The court reasoned that when a policy only provides liability coverage to the director and officers, and no indemnity coverage to the debtor, the policy proceeds are not part of the estate. *See id.* at 259-60 (citing *Louisiana World*, 832 F.2d at 1398-1401). In contrast to the situation in *Circle K*, the AXIS Policy does not provide indemnity coverage to the Debtor because it is a liability policy, or Side A policy. *See* AXIS Policy, End. 17 (removing indemnification coverage for the Debtor). Indeed, the title of Insuring Agreement A is "Individual Management Liability." *See id.* at I.A. Thus, under the reasoning in *Circle K*, the Policy is not part of the bankruptcy estate because it provides liability coverage, not indemnification coverage. Even further, in contrast to the debtor in *Circle K*, the Debtor in this case is not an insured under the Policy and is not entitled to any of the Policy's proceeds.

2. Even if the Policy Covered the Debtor Directly Under Insuring Agreement B, Which it Does Not, the Policy's Priority of Payments Provision Evidences that the Policy Proceeds Belong to the Directors, Officers, and Employees.

Even if the Debtor were an insured under the Policy, which it is not, the Policy would still not be part of the Debtor's estate. The Policy provides that when there are competing claims for coverage under different insuring agreements, the Policy first responds to claim made under Insuring Agreement A. This provision does not apply in this instance because the Policy only has one insuring agreement, Insuring Agreement A, but to the extent the Trustee is arguing that there is coverage under another insuring agreement, the Policy language makes it clear that the intent of the policy is to cover directors and officers first. The Policy states:

> In the event of Loss arising from a Claim or Claims for which payment is due under the provisions of this Policy, then the Insurer shall first, pay such Loss for which the Policyholder does not indemnify an Insured Individual and for which coverage is provided under Section I. Insuring Agreement A of this Policy.

AXIS Policy V.E. This means that even if the Debtor were entitled to coverage under Insuring Agreement B, which it is not, the Policy's proceeds would go to the Debtor's directors, officers,

and employees first. The meaning of this provision is unmistakable, it evidences the fact that the proceeds of the Policy are not the property of the bankruptcy estate because the proceeds are always given to the Insured Individuals when coverage is provided under Insuring Agreement A. *See, e.g.*, *In re Allied Digital Techs. Corp.*, 306 B.R. at 509. The Trustee has already admitted that the Debtor's directors, officers, and employees are Insured Individuals under the Policy. *See* Objection at 9. Even further, the Trustee admitted in its Objection that the defense costs of the Debtor's directors, officers, and employees would likely exhaust the entire $1 million in limits. *See id.* at 19-20. Therefore, even if the Policy did provide coverage to the Debtor, which it does not, the Policy would be exhausted by payments made under Insuring Agreement A to the Debtor's directors, officers, and employees for defense costs and/or settlement expenses.

B. The Debtor Is Not an Insured Under the AXIS Policy.

The Trustee argues that because the Debtor was an insured party under the terms of the AXIS Policy when the Debtor filed for Chapter 11, the Policy is the property of the estate. This argument fails because the policy proceeds at issue are subject to the policy terms and conditions effective starting January 20, 2012--the day the Policy was amended to eliminate all coverage for the Debtor under Insuring Agreement B.

In the alternative, the Trustee claims that this Policy change was made without notice, but the Trustee fails to allege that notice was required. Notably, the Trustee does not cite any authority to demonstrate that notice was required. Indeed, this is because notice is not necessary and no case law exists that would require notice. Moreover, the changes to the Policy were bound on January 19, 2012, not March 23, 2012 as the Trustee suggests. The March 23, 2012 date is when AXIS finalized Endorsement 17 with the terms that had been previously negotiated and bound on January 19, 2012, the day before the Policy expired. This means that the changes

to the Policy were made prior to February 14, 2012, when the Official Committee of Unsecured Creditors for the Debtor filed its Motion for Appointment of a Chapter 11 Trustee.

Additionally, the Trustee's Objection seems to unfairly imply some nefarious reason behind why the Policy was amended to exclude Insuring Agreement B and reduce the Policy's limits to $1 million. The unfortunate truth is that when the January 20, 2012 expiration date arrived--the day the Policy was set to expire[3]--the Debtor was bankrupt and AXIS was not willing to renew the Policy with the same terms. Accordingly, the directors and officers managing the estate decided to purchase the only prospective coverage offered by AXIS at the time, which was a one-year renewal for $25,000 in premium that removed Insuring Agreement B, reduced the limits to $1 million, and only provided insurance coverage to the Debtor's directors, officers, and employees.

C. In the Alternative, the Court Should Lift the Stay or Modify the Plan Injunction and Authorize the Payment of Defense Costs.

As more fully set forth in the Motion, if the Court determines that the AXIS Policy is the property of the estate, the Court should modify the plan injunction to authorize payment of defense costs to the Debtor's former directors, officers, and employees. *See* Motion ¶¶ 21-26. The Trustee's objections to the contrary are based in its desire to secure funds from a Policy that does not even list the Debtor as an Insured Individual.

The Trustee argues that the Motion should be denied because there no longer is an automatic stay under Bankruptcy Code § 362, but an injunction under the Trustee's Plan of Liquidation dated February 25, 2013, and confirmed by the Court on June 7, 2013, pursuant to Bankruptcy Code § 1141. This is a distinction without a difference. Just as the automatic stay does not protect non-debtors, an injunction under Bankruptcy Code § 1141 does not prohibit the

[3] *See* Endorsements 15 and 16, which extended the Policy Term one month, to January 20, 2012 for $5,950 in premium.

Movants from seeking the advancement of defense costs from AXIS, a non-debtor. *See*, 11 U.S.C. § 524(e) ("the discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt"); *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Porter Hayden Co.*, 408 B.R. 66, 73 (D. Md. 2009) (bankruptcy plan's discharge injunction did not eliminate insurer's obligations to asbestos claimants).

Moreover, the Court may (and should in this instance) modify the plan injunction for the same reasons articulated in the Motion—"cause" exists for relief from the plan injunction based on the application of the *Curtis* factors to the facts of this case. Courts apply the same *Curtis* factors which apply to a request for relief from the automatic stay to a request to lift or modify Chapter 11 plan injunctions. *See In re Worldcom, Inc.*, 2007 WL 841948, *5 (Bankr. S.D.N.Y. Mar. 12, 2007).

This is not a circumstance involving an operating company undergoing a true reorganization where, arguably, allowing the Movants to access the Policy would affect the Debtor's premiums or ability to obtain coverage for officers and directors going forward. Instead, the Plan is a liquidating plan and, accordingly, there will be no renewal of the Policy and, notably, the Debtor is not even entitled to a discharge. *See* Bankruptcy Code § 1141(d)(3) (providing that non-individual debtors do not receive a discharge upon plan confirmation if the debtor does not engage in business after consummation of the plan).

Lastly, if the Court determines that the AXIS Policy is the property of the estate, the Court should not allow the Trustee to interfere with defense or settlement payments. Specifically, the Court should not permit the Trustee to have access to the invoices or other requests for reimbursement, which would likely contain privileged information. This would be highly prejudicial to the directors, officers, and employees because the Trustee is the entity

demanding that the Insured Individuals settle claims against the Debtor's creditors. Likewise, the Court should not allow the Trustee to prohibit AXIS from making any disbursements without providing the Trustee with ten days written notice "of the amount it intends to pay, as well as identifying the specific costs that it intends to pay." The proceeds, as demonstrated earlier, belong to the directors, officers, and employees, not the Debtor.

III. CONCLUSION

WHEREFORE, for the foregoing reasons, the Insured Individuals respectfully request that this Court grant the Proposed Order attached to the Motion and reject the Trustee's Objections to the advancement of defense costs under the AXIS Policy.

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Respectfully submitted,

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