UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Case No. 11-15059 (MG)
MF GLOBAL HOLDINGS, LTD., *et al.*,	:	Chapter 11
Debtors.	:	Jointly Administered
In re:	:	Case No. 11-02790 (MG) SIPA
MF GLOBAL INC.,	:	
Debtor.	:	

REPLY OF THE INDIVIDUAL INSUREDS TO THE OBJECTIONS TO THEIR MOTION TO LIFT AUTOMATIC STAY AND MODIFY PLAN INJUNCTION AS TO PROCEEDS OF CERTAIN MF GLOBAL POLICIES OF DIRECTORS AND OFFICERS' LIABILITY INSURANCE

The Individual Insureds respectfully submit this reply to the Objections filed by the MFGH Plan Administrator [ECF Doc. 1964] and the Customer Representatives [ECF Doc. 1965], and the Limited Joinder in the Objections of the Plan Administrator filed by the MFGI Trustee [ECF Doc. 8176] (together, the "Objectors" and the "Objections").

Preliminary Statement

1. The Objectors do not dispute the material points on which the Motion rests:

- Any interest of MFGH and MFGI in the proceeds of the D&O Policies ("the D&O Policy proceeds") is governed by the terms of those policies.
- MFGH and MFGI have a claim to D&O coverage only if a Securities Claim is asserted against one of them, or if they advance defense costs or provide indemnification to the Individual Insureds.
- No Securities Claim has been asserted against MFGH or MFGI, and none can be brought against either of them.
- MFGH and MFGI have advanced no defense costs and provided no indemnification for any of the Individual Insureds, and the Plan Administrator and the SIPA Trustee have stated repeatedly that they do not intend to provide advancement or indemnification and that they will oppose any such requests.

2. Moreover, the Objectors do not challenge the conclusion that the D&O Policy proceeds are not estate property. MFGH tries to suggest in a footnote that it can still "reserve the right" to "challenge the . . . assertion that the D&O Proceeds are not estate property." ECF Doc. 1964 at 4 n.5. But MFGH's time to do that has come and gone. The assertion was made, MFGH did not oppose it, and thus the issue should be resolved against MFGH. Accordingly (with the potential purported exception of $15 million in policy proceeds, discussed in Section II below), MFGH and MFGI concede they have no interest in the proceeds of the D&O Policies, and those proceeds are *not* the property of either entity.

3. Because the D&O Policy proceeds unquestionably are not estate property, the Objectors struggle to find some basis for the Court to restrict the insurance companies from paying out on the insurance contracts they have with the Individual Insureds. Their attempt to do so fails, as it rests on a misapplication of the cases and on a misreading of the MFGH Plan.

4. As a fundamental matter, the Objectors' contentions rely on false assumptions.

5. *First*, the Objectors incorrectly assume that the use of D&O Policy proceeds to advance defense costs is causing harm to -- or is at least "affecting" -- MFGH and MFGI. In fact, the D&O Insurers' advancement of defense costs reduces dollar-for-dollar the indemnification claims of the Individual Insureds against MFGH and MFGI. Hence there is no harm to MFGH or MFGI at all. At the hearing on May 19, 2014, counsel for the Customer Representatives agreed with this point.[1]

6. *Second*, the Objectors incorrectly assume that MFGH and MFGI have a contractual claim to the D&O Policy proceeds. They do not, and even if they did, the Priority of Payments provision in the D&O Policies requires that the claims of the Individual Insureds for advancement of defense costs and indemnification under the Policies be satisfied first.

7. *Third*, the Objectors incorrectly assume that their interests as plaintiffs in the current lawsuits give them an interest in the D&O Policy proceeds. The Court already has

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[1] On May 19, 2014, the Court and counsel for the Customer Representatives had this exchange:

> The Court: ". . . The point I made that every dollar reimbursed for advancement -- or pa[id] for advancement or reimbursement of legal fees under the D&O policies dollar for dollar is that much less of [a] potential claim for indemnity.
>
> So I don't see any harm to MFGH when defense costs are advanced or reimbursed under the D&O policies."
>
> Mr. Entwistle: "I think that's right, Your Honor."

Tr., May 19, 2014, at 77:15-22. Counsel for MFGH also agreed with the Court's statement that "[e]very dollar that they [the Individual Insureds] get reimbursed on their defense costs from the policies is $1 less on indemnity claims." *Id.* at 70:10-18.

ruled that the law does not permit an objector to interfere with an insured's contractual right to advancement and indemnification merely because the objector wishes either (1) to preserve a wasting policy to satisfy a potential judgment in litigation against the insured; or (2) to gain a tactical advantage in litigation:

> 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.
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> *In re MF Global Holdings Ltd.*, 469 B.R. 177, 196 (Bankr. S.D.N.Y. 2012)

(quoting *In re Allied Digital Technologies Corp.*, 306 B.R. 505, 512-13 (Bankr. D. Del. 2004), and citing *In re Beach First Nat'l Bancshares, Inc.*, 451 B.R. 406, 411 (Bankr. D.S.C. 2011), and *In re First Cent. Fin. Corp.*, 238 B.R. 9, 21 (Bankr. E.D.N.Y. 1999). Other courts have held exactly the same way. *See, e.g.*, *In re Hoku Corp.*, No. 13-40838-JDP, 2014 WL 1246884, at *4 n.10 (Bankr. D. Idaho March 25, 2014); *In re CyberMedica, Inc.*, 280 B.R. 12, 18 (Bankr. D. Mass. 2002).

8. The Objectors make two legal arguments, both of which rest on the above erroneous assumptions and cannot be sustained. First, even though the D&O Policy proceeds are not the property of MFGH or MFGI, the Objectors ask the Court to continue to restrict the use of those proceeds, purportedly under some combination of Section 105(a) of the Bankruptcy Code and the injunction contained in the confirmed Liquidation Plan of MFGH. Second, the Objectors say that because MFGH has created a $15 million reserve for the indemnification claims of three

Individual Insureds, $15 million of D&O Policy proceeds somehow has become the property of MFGH. As we show below, neither of these points has merit.[2]

I. THE COURT NO LONGER HAS ANY BASIS TO REGULATE USE OF THE D&O POLICY PROCEEDS

A. Section 105(a) Does Not Authorize the Action MFGI Wants the Court to Take

9. Code Section 105(a) provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. . . ." This section "does not allow the bankruptcy court 'to create substantive rights that are otherwise unavailable under applicable law.'" *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142 (2d Cir. 2005) (quoting *In re Dairy Mart Convenience Stores, Inc.*, 351 F.3d 86, 92 (2d Cir. 2003)). Indeed, the Second Circuit "has long recognized that 'Section 105(a) *limits* the bankruptcy court's equitable powers.'" *In re Dairy Mart*, 351 F.3d at 91-92 (quoting *FDIC v. Colonial Realty Co.*, 966 F.2d 57, 59 (2d Cir. 1992)) (emphasis added). It grants power only to "carry[] out the provisions of the Bankruptcy Code rather than to further the purposes of the Code generally, or otherwise to do the right thing." *Id.* (quoting 2 Collier on Bankruptcy ¶ 105.01[1]). "It does not 'authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.'" *Id.* (quoting *United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986)).

[2] The Objectors also complain about the parties' inability to resolve among themselves the issues raised by the Motion. Without going into the substance of the discussions, we have attempted to negotiate with counsel for MFGH and for the MFGI Trustee about these issues, and indeed thought we had reached an agreement with MFGH several weeks ago to resolve the issues presented by this Motion, but MFGH declined to go forward with that agreement. The discussions with the MFGI Trustee are continuing, but those relate only to the errors and omissions ("E&O") policy, which is not the subject of this Motion. MFGI also complains that the Individual Insureds have not resolved the issue of allocation between the D&O and E&O insurance towers. But we have never been a part of the negotiations concerning the allocation of defense costs between the different towers of insurance, and do not know the status of those negotiations.

10. The Objectors identify no substantive provision of the Code that Section 105(a) would serve to implement here, and there is none. In other circumstances, it might have been Section 362, the automatic stay provision, but because the D&O Policy proceeds are not the property of MFGH or MFGI, Section 362 has no application here.

11. With no substantive provision of the Bankruptcy Code for them properly to rely on, the Objectors' sweeping theory cannot be correct. On their theory, if an MF Global Individual Insured owned another insurance policy, one that had not been obtained by MFGH, and the policy provided coverage for the claims being brought against that Individual Insured here, the Court would be authorized to restrict the use of proceeds from that insurance policy in order to make sure that more of the proceeds would remain available to satisfy potential judgments in favor of the MF Global entities or creditors. That is not the law.

12. The Objectors have not cited a single case in which a court limited the access of defendant directors and officers to the insurance coverage that had been obtained for their benefit. In each cited case, the court stayed a separate lawsuit that threatened to drain the coverage. And in two of those cases, the insurance proceeds at issue had been determined to be property of the estate. *See In re Sacred Heart Hosp. of Norristown*, 182 B.R. 413 (Bankr. E.D. Pa. 1995); *In re Rusty Jones, Inc.*, 124 B.R. 774 (Bankr. N.D. Ill. 1991). Here, with the D&O Policy proceeds not property of MFGH or MFGI, neither of these cases has any application.[3]

[3] Other cases cited by the Objectors are inapposite because they address only the limited issue – not presented here – of whether a bankruptcy court possesses subject matter jurisdiction over a separate civil action that is related to the bankruptcy proceeding. *See Parmalat Capital Fin. Ltd. V. Bank of Am. Corp.*, 639 F.3d 572, 579 (2d Cir. 2011); *Pacor, Inc. v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984); *Fed. Ins. Co. v. Sheldon*, 167 B.R. 15, 19-20 (S.D.N.Y. 1994); *In re 610 W. 142 Owners Corp.*, 219 B.R. 363, 370-71 (Bankr. S.D.N.Y. 1998); *Fried v. Lehman Bros. Real Estate Assocs. III, L.P.*, 496 B.R. 706, 709-10 (S.D.N.Y. 2013); *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. P'ship*, 2004 U.S. Dist. LEXIS 8168, at *7-8 (S.D.N.Y. May 6, 2004); *Macarthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 92 (2d Cir. 1988). None of these cases considers the question whether a bankruptcy court has the authority to restrict the use of insurance proceeds to cover defense costs when those proceeds are not property of the debtor.

13. Only two of the Objectors' cited cases involve an insurance policy that was held *not* to be property of the estate, but neither case supports the relief the Objectors seek, as they again both involve requests to enjoin separate lawsuits.

14. In *In re Adelphia Commc'ns Corp.* 302 B.R. 439 (Bankr. S.D.N.Y.), *on remand from In re Adelphia Commc'ns Corp.*, 298 B.R. 49 (S.D.N.Y. 2003), the Bankruptcy Court had initially enjoined non-bankruptcy coverage litigation concerning insurance proceeds which had been found to be property of the estate. On appeal, the District Court determined that the insurance proceeds were *not* property of the estate, and it remanded the matter to the Bankruptcy Court for a further determination of whether an injunction was proper. On remand, the Bankruptcy Court held that in light of the District Court's ruling that the policy proceeds were not property of the estate, an injunction of separate coverage litigation concerning those proceeds was not proper. This ruling supports the Individual Insureds, not the Objectors.[4]

15. *Megliola v. Maxwell*, 293 B.R. 443 (N.D. Ill. 2003), is likewise not helpful to the Objectors. It involved a shareholder action asserting against officers of the debtor certain claims that were identical to claims asserted by the trustee in an adversary proceeding against the same officers. The court enjoined the shareholder action, because "both [the third-party plaintiff and the debtor] [are] pursuing the same dollars from the same defendants to redress the same harms." *Id.* at 448 (quoting *Fisher v. Apostolou*, 155 F.3d 876, 880 (7th Cir. 1998)). *Megliola* did not restrict the ability of the defendants in the continuing adversary proceeding to use the insurance proceeds to defend themselves in that suit. Thus if *Megliola* has any relevance here at

[4] The bankruptcy court in *Adelphia* noted, in dicta, that it need not address the issue closest to the one the Objectors seek to press here, namely, whether the court would have the further power to regulate the use of those proceeds if faced with "unlimited drains on policy proceeds" that "would have the effect of destroying the policies themselves." 302 B.R. at 452. Notably – and unlike the situation here – the court's comments on this issue were aimed at the insurance policies themselves (as opposed to the proceeds), which the court found to be an asset of the estate protected by Section 362(a) because the debtor in that case needed the policies to remain in effect (and thus not be "drained") to cover its directors in the reorganized entity. *Id.*

all, it is to suggest, as MFGH acknowledges (ECF Doc. 1964 at 8 n.9), that the Court could enjoin some of the litigation against the Individual Insureds, such as the securities class action or even one of the overlapping and duplicative trustee actions. No such relief is requested here. Instead, the Objectors' sole aim is to gain a tactical advantage in this litigation by "protect[ing] the amount [they] may receive in [their] suit[s] against the directors and officers while limiting coverage for the defense costs of the directors and officers" – a tactic this Court has already found to be improper. *In re MF Global Holdings Ltd.*, 469 B.R. at 196.

B. The Plan Injunction for MFGH Does Not Authorize Any Continuing Restrictions on the Use of D&O Policy Proceeds

16. MFGH also purports to find authority for its request in Section XI(D), the Injunction in its confirmed Plan of liquidation. In particular, MFGH relies on two provisions of the Injunction: Section XI(D)(i), which it says "enjoin[s] actions 'against or affecting the Protected Parties,'" and Section XI(D)(vi), which "enjoins 'any actions to interfere with the implementation or consummation of the Plan.'" Again, however, neither provision says what MFGH wants it to.

17. Section XI(D)(i) provides in pertinent part:

> [A]ll Entities (other than the Debtors) who have held, hold or may hold Claims against or Interests in any or all of the Debtors . . . , are permanently enjoined, on and after the Effective Date, *solely with respect to any Claims or Interests that are treated pursuant to this Plan*, from (i) commencing, conducting, or continuing in any manner, directly or indirectly, any suit, action, or other proceeding of any kind (including, without limitation, any proceeding in a judicial, arbitral, administrative or other forum) *against or affecting the Protected Parties or the property of the Debtors*.

(Emphasis added). When Section XI(D)(i) refers to an "action," it plainly means a lawsuit or other formal proceeding "with respect to any Claims or Interests that are treated pursuant to this Plan." This provision has no application whatsoever to the Individual Insureds' use of D&O

Policy proceeds for payment of their defense costs. Moreover, even if the word "action" were not limited to formal proceedings with respect to Claims, the action would have to be "against or affecting the Protected Parties or the property of the Debtors." But the D&O Policy proceeds are not "property of the Debtors." Because the use of those proceeds reduces dollar-for-dollar the indemnification claims of the Individual Insureds, the use of those proceeds does not harm, or even "affect," the Debtors.

18. Section XI(D)(vi), which bars "actions to interfere with the implementation or consummation of this Plan," gives no more help to MFGH. Even if the word "action" is read as broadly as the Objectors would like, the D&O Policy proceeds are not "property" of MFGH within the meaning of the Plan, and the Plan makes no provision for the disposition of the D&O Policy proceeds. Consequently, the use of the D&O Policy proceeds for the payment of defense costs does not "interfere with the implementation or consummation of" the Plan. Moreover, use of the D&O Policy proceeds is not an action "with respect to any Claims or Interests that are treated pursuant to this Plan."

19. Because these provisions of the Plan Injunction do not reach the D&O Policy proceeds, they do not authorize the restrictions the Objectors seek.

II. NONE OF THE D&O POLICY PROCEEDS IS THE PROPERTY OF MFGH OR MFGI

20. In its motion to estimate the value of certain director and officer indemnification claims [ECF Doc. 1907], MFGH asked the Court to estimate the maximum allowable amounts for the indemnification claims of Bradley Abelow, Jon Corzine, and Henri Steenkamp at $5 million each. The purpose of the motion was to permit MFGH to create a reserve of $15 million on account of those indemnification claims and to enable MFGH to distribute other funds to creditors immediately. But throughout the estimation motion, MFGH

stated that the indemnification claims of all three of these Individual Insureds should be disallowed. (*See*, *e.g.*, ECF Doc. 1907 at 19-22). Nowhere in the estimation motion did MFGH suggest that it had any intention of ever making any payment to these Individual Insureds on their indemnification claims. The estimation motion is consistent with the prior representations of both MFGH and MFGI that they would not advance defense costs or provide indemnification to the Individual Insureds.[5]

21. Messrs. Abelow, Corzine and Steenkamp did not object to the estimation motion, thus allowing the reserve to be set. But that does not convert $15 million of D&O Policy proceeds into property of MFGH or MFGI. When a "liability policy provides the debtor with indemnification coverage but indemnification either has not occurred, is hypothetical, or speculative, the proceeds are not property of the bankruptcy estate." *Allied Digital*, 306 B.R at 512; *accord In re First Cent. Fin. Corp.* 238 B.R. 9, 17 (Bankr. E.D.N.Y. 1999). The creation of the reserve does not make any claim by MFGH for indemnification coverage under the D&O Policies any less speculative today than it always has been. The Plan Administrator and the SIPA Trustee still have not advanced any defense costs or indemnified the Individual Insureds for any settlements or judgments. They continue to insist that they will never do so.

22. As discussed above (at Paragraph 5), the use of the D&O Policy proceeds to pay defense costs continues to reduce on a dollar-for-dollar basis the amounts that MFGH and MFGI could ultimately be responsible for under their indemnification agreements with the Individual Insureds. By contrast, any indemnification that would be paid (over the objections of MFGH and MFGI) from the $15 million reserve will *not* give MFGH and MFGI a dollar-for-dollar claim on the D&O Policies. The Individual Insureds will have indemnification claims for

[5] *See* ECF Doc. 1956 at 13 and n. 8.

defense costs not covered by the D&O Policies, and paying those will not give MFGH and MFGI any claim to the policy proceeds.

23. In addition, MFGH and MFGI must satisfy a $2.5 million retention before their indemnification of insured defense costs is covered by the D&O Policies. For these reasons as well, MFGH and MFGI are better off if insured defense costs are paid directly by the carriers under the D&O Policies than they would be if they paid them under their indemnification obligations and sought coverage under the D&O Policies.

24. MFGH concedes, as it must, that in accordance with the cases cited at Paragraph 22 of its Objection, the debtor *must actually make payment* on a director or officer's indemnification claim in order for that claim to give a debtor an interest in a D&O insurance policy. But MFGH and MFGI do not intend to make payment. MFGH contends that merely reserving $15 million should satisfy the Court's statement at the last hearing that MFGH would have a "claim under the D&O" if payment were to be made. However, the full colloquy (which MFGH has only excerpted) reveals the fallacy of this contention.

> The Court: "If and when -- *if you pay a penny on indemnification claims, fine*, you have a claim under the D&O. Are you going to pay any of the indemnification claims?"
> Mr. Bennett: "Your Honor, *I hope not. We intend to object to them*, but there remains today the possibility that we will."

Tr., May 19, 2014, at 70:3-8 (emphasis added).

Conclusion

For these reasons and those stated in their prior papers, the Individual Insureds respectfully request that the Court grant the Motion in all respects.

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