Hearing Date: March 6, 2012 at 10:00 a.m.
Objection Deadline: February 28, 2012 at 4:00 p.m.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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

OBJECTION OF SAPERE WEALTH MANAGEMENT, LLC, GRANITE ASSET MANAGEMENT AND SAPERE CTA FUND, L.P. TO MOTION OF U.S. SPECIALTY INSURANCE COMPANY FOR RELIEF FROM THE AUTOMATIC STAY, TO THE EXTENT APPLICABLE

Sapere Wealth Management, LLC, Granite Asset Management, and Sapere CTA Fund, L.P. (collectively, "Sapere") hereby objects to the *Motion of U.S. Specialty Insurance Company for Relief from the Automatic Stay, To the Extent Applicable*, dated February 8, 2012 [docket no. 428], and states as follows:

U.S. Specialty's Motion

On February 8, 2012, U.S. Specialty Insurance Company ("U.S. Specialty") filed its Motion to allow it to make payments under two liability insurance policies (the "Motion"). The first policy is Directors, Officers and Corporate Liability Policy No. 14-MGU-11-A23947 (the

"D&O Policy"), which was attached as Exhibit B to the Motion. The second policy is Fiduciary Liability Insurance Policy No. 14-MGU-11-A2394 (the "Fiduciary Policy") (collectively, the "Policies"), which was attached as Exhibit C to the Motion. In the Motion, U.S. Specialty took "no position in this case on whether the proceeds of the Policies are property of the debtors' estates," but requested that "if it is determined that the stay applies to both the Policies and their proceeds," that the court enter "an order granting relief from the stay, if applicable" for the purpose of advancing defense costs to insured persons under the Policies in connection with pending lawsuits and investigations (Motion at ¶21).

Sapere objects to the Motion because the proceeds of each Policy are part of the Holdings estate and there is no cause for relief from the automatic stay imposed by 11 U.S.C. § 362. As a creditor of Holdings, Sapere believes that the creditors and the estate is best served if Holdings estate property is preserved and used to pay off liabilities of Holdings' Chapter 11 estate and not dissipated in the defense of former directors and officers sued for allegations of unlawful conduct.[1]

Argument

1. The D&O Policy and its Proceeds are Property of The Chapter 11 Estate

As we explain, *infra*, the D&O Policy imposes on Holdings an affirmative obligation to indemnify and advance costs to its directors and officers to the fullest extent allowed by law. In the normal situation, the D&O Policy provides for only Coverage (B) payments (with no priority between B(1) and (B)(2) coverage payments), and flips to place Coverage (A) in the priority position when, despite Holdings having an affirmative contractual obligation under the Policy to

[1] Sapere and other commodities customers continue to maintain that they have a priority claim on Holdings estate assets such that the assets should not be dissipated.

pay indemnity and costs advancement to its directors and officers, Holdings cannot do so. Here, movant posits that Holdings cannot do so, self-evidently because it is an insolvent chapter 11 debtor.

Pursuant to its Insuring Agreement B(2), the D&O Policy provides for direct coverage for Holdings for securities claims; therefore, the Policy and its proceeds are part of the Holdings estate and are subject to the automatic stay. To find otherwise would allow other individual insureds under the Policy to deplete the policy proceeds, would deprive Holdings of its Side C asset and would violate the fundamental principles of bankruptcy law.

Moreover, the motion details what appear to be seven securities class actions presently pending against directors and officers of Holdings. The plaintiffs and the classes in those actions have the right to file proofs of claim against Holdings and they comprise tort-claimants against Holdings.[2] If any of Holdings' officers and directors have liability under the securities laws, then so too does Holdings. The proceeds of the D&O Policy would best benefit the debtor's estate if they were available in full to pay or settle securities claims.

Section 362(a) of the Bankruptcy Code provides for an automatic stay of any action seeking to obtain possession of and exercise control of the bankruptcy estate. Property of the estate is defined broadly under Section 541(a)(1) of the Bankruptcy Code to include "all legal or equitable interests of the debtor in property as of the commencement of the case." When a corporation becomes the subject of a bankruptcy case, its insurance policies become property of the bankruptcy estate. *See, e.g., A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1001 (4th Cir. 1986); *In re Davis*, 730 F.2d 176, 184 (5th Cir. 1984); *Johns-Manville Corp. v. Asbestos Litig. Group (In re Johns-Manville Corp.)*, 40 B.R. 219, 230-31 (S.D.N.Y. 1984). Further, it is well settled that a D&O policy owned by the debtor corporation is considered to be property of the debtor

[2] The bar date has not yet been set and tort-claimants need not yet file their claims in this Chapter 11 case.

estate. *See, e.g.*, *Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reinsurance Corp*. (*In re Minoco Group of Cos., Ltd.),* 799 F.2d 517, 519 (9th Cir. 1986).

We agree that there has been no uniform approach used by courts to determine whether or not proceeds of a D&O policy are part of a debtor's estate. Indeed, the Second Circuit has not ruled on this issue. Courts, however, have typically looked to the policy provisions themselves and fundamental principles of insurance law and bankruptcy in reaching their decisions.

D&O policies typically provide up to three kinds of coverage against claims. Side A coverage is typically direct coverage for directors' and officers' defense and indemnity costs if the company has not agreed to indemnify them. Here, Coverage (A) corresponds to Side A coverage. Side B coverage is indirect indemnification that reimburses the insured company for indemnification and defense cost advancement payments made to officers and directors. Here, Coverage (B)(1) corresponds to Side B coverage. Side C coverage is direct coverage to the company for claims against the insured company and is often limited to certain claims against the entity, such as securities claims. Here, Coverage (B)(2) corresponds to Side C coverage.

With respect to D&O policies that provide for Side A and Side B coverage, there is no uniform approach or analysis, but courts have held that the policy proceeds are part of the estate. *In re Jasmine, Ltd.*, 258 B.R. 119, 128 (Bankr. D.N.J. 2000) (finding that the debtor's interest in indemnification proceeds of its insurance policy was sufficient to consider the entire policy and proceeds as property of the bankruptcy estate); *In re Sacred Heart Hosp. of Norristown*, 182 B.R. 413, 420 (Bankr. E.D. Pa. 1995) ("Proceeds available for the Debtor's liability exposure are not segregated from the proceeds available to the directors and officers. Thus, the Debtor is indeed an insured and has a sufficient interest in the Proceeds as a whole to bring them into the estate.").

In *In re Minoco Group of Cos., Ltd.*, 799 F.2d at 517, the court held that D&O insurance policies were property of the estate. The court reasoned that because the estate was worth more with the policies than without them, they constituted estate property. The policies insured the debtor for any indemnity claims against it by its directors and officers, as well as insuring the directors and officers against third-party claims. The court concluded that the all-inclusive purpose of § 541(a) required all property interests of the debtor, even interests which were contingent or not yet realized, to become subject to the reorganization process.

In *In re Circle K Corp.*, 121 B.R. 257 (Bankr. D. Ariz. 1990), the court held that D&O insurance policies and proceeds were property of the estate. The court reasoned that because the policies at issue were indemnity policies and not just liability policies, the debtor had a right to the proceeds. Consistent with the reasoning in *Minoco*, the estate was worth more with the policies and proceeds than without them. Those policies were "wasting" or "burning candle" policies. As the defense costs exhausted the policy limits, the estate asset was depleted and increased the debtor's exposure to third-party claims and decreased realization of the debtor's claims against the proceeds. The court stated, "[t]he fact debtor may not receive all benefits or proceeds under the insurance does not affect its current status as estate property." *Id.* at 261. Thus, the court concluded that the debtor had an interest in the proceeds rendering the proceeds property of the estate as defined in section 541.

When a debtor purchases Side A, Side B and Side C coverage, courts have held that the proceeds are part of the estate. The reasoning in these cases is that the debtor's Side C coverage overrides the interest of the directors and officers. In *In re Metro. Mortg. & Sec. Co., Inc.*, 325 B.R. 851 (Bankr. E.D. Wash. 2005), the court found that a policy's proceeds in which the debtors were named as insured, had a right to seek payment for certain claims, and had a right to

seek payment of indemnification claims that may be made by officers and directors were part of the estate. The court explained,

> The debtors and all other insureds have undivided, unliquidated interests in the identical asset, i.e., the policy proceeds. Continued diminution of those proceeds affects the debtors' interests in and rights to recover the proceeds. The stay prevents any action which affects the debtors' interests in the proceeds. This is consistent with and necessary to promote the fundamental bankruptcy principles of preserving estate property and ensuring ratable distribution to creditors.

Id. at 857.

Here, the D&O Policy provides for Side A, B, and C coverage.[3] The relevant language in the policy is as follows:

INSURING AGREEMENTS

(A) The Insurer will pay to or on behalf of the **Insured Persons Loss** arising from **Claims** first made during the **Policy Period** or Discovery Period (if applicable), against the **Insured Persons** for **Wrongful Acts**, except when and to the extent that the **Company** has paid such **Loss** to or on behalf of the **Insured Persons** as indemnification or advancement.

(B) The Insurer will pay to or on behalf of the **Company Loss** arising from:

(1) **Claims** first made during the **Policy Period** or the Discovery Period (if applicable) against the **Insured Persons** for **Wrongful Acts**, if the **Company** has paid such **Loss** to or on behalf of the **Insured Persons** as indemnification or advancement, and/or

(2) **Securities Claims** first made during the **Policy Period** or the Discovery Period (if applicable) against the **Company** for **Wrongful Acts**.

(U.S. Specialty Motion, Insuring Agreements, Ex. B).

Insuring Agreement B(2) provides Holdings with Side C coverage against "Securities Claims first made during the Policy Period or the Discovery Period (if applicable) against the Company for Wrongful acts."

[3] The Motion makes reference to two additional Insuring Agreements in Endorsement 41 of the D&O Policy. Endorsement 41 deals with Insurer's advancement of pre-claim costs. The Motion, however, only references ongoing litigation (i.e., post-claim costs) and does not discuss or provide any information about payments under Endorsement 41. Therefore, the insuring agreements in Endorsement 41 are irrelevant.

The D&O Policy has a Limit of Liability (inclusive of Defense Costs) of $25,000,000 in the aggregate for all Insuring Agreements combined. With Side A, Side B, and Side C coverage all sharing the same policy limit, Holdings has an undivided interest in the policy proceeds as its Side C coverage provides it direct coverage. If the proceeds are not protected as property of the estate, then Holdings will be deprived of its Side C and Side B proceeds. The Holdings estate has a concrete interest in preserving its Side C coverage as an asset of the estate.

U.S. Specialty's contention that the Holdings' estate's interest in the D&O Policy proceeds is "speculative" and "hypothetical" is a misplaced attempt to shoehorn the D&O Policy to comport with the analysis in *Ochs v. Lipson (In re First Cent. Fin. Corp.)*, 238 B.R. 9 (Bankr. E.D.N.Y. 1999). U.S. Specialty's reliance on *Ochs* to assert that the proceeds of the D&O Policy are property of the estate is misplaced as the holding in that case is not controlling and conflicts with fundamental principles of and bankruptcy. In *Ochs*, the D&O policy provided coverage to the debtor for indemnity payments and featured an "appendage" for entity coverage for securities claims against it. The court found that the entity coverage was "hypothetical" as there was little likelihood that securities claims would be filed against it. The court explained,

> During the eighteen months this bankruptcy case has been pending, there have been no claims filed against the Debtor which would implicate the narrow scope of the Policy's entity coverage. Indeed, no one has stepped forward to express any interest in suing the Debtor for a violation of securities laws. Nor has the Trustee intimated that any action against the Debtor is imminent or likely. We are skeptical that any individual or entity will ever emerge to assert such claims prior to the expiration of the discovery period in December, 1999.

Id. at 17-18.

Unlike the situation in *Ochs*, in this proceeding the Debtor's interest in the Side C policies is not "hypothetical." Presently, there are securities class actions filed on behalf of bondholders and stockholders of the Debtor proceeding under the caption, *In re MF Global*

Holdings Securities Litigation, Case No. 11-cv-7866 (S.D.N.Y.). Indeed, it is very likely that these securities plaintiffs will be filing proofs of claim in this proceeding. The Side C insurance proceeds that cover Securities Claims against Holdings should be preserved to maximize the value of the estate assets for the benefit of the estate's creditors, such as those who will file proofs of claim for securities law violations.

Further, U.S. Specialty should not be allowed to assert that the D&O Policy's priority of payments clause (Policy Conditions (D)(4)) gives directors and officers priority over the Holdings estate because the D&O Policy's priority of payments clause is nothing more than a fiction designed to circumvent the principles of bankruptcy law. The D&O Policy's priority of payments clause creates an incentive to race to judgment or settlement for the directors and officers so that they can exploit the limits of the D&O Policy before the Holdings estate is able to receive payment for its claims for Side C coverage. This "race" runs afoul of the equitable principles of bankruptcy law, as stated by the court in *In re Metro. Mortg. & Sec. Co.*:

> Under principles of insurance law, all entities or persons having an interest in the policy proceeds would engage in a race to judgment or settlement with the fleetest claimants realizing upon their interest while the slower claimants were deprived of their interest. Such a result is contrary to the fundamental principle of bankruptcy law that all of the debtors' interests in property are to be equitably distributed. The problem is worsened in this case by the fact that the cost of determining each claimant's interest in the policy proceeds may deplete the proceeds before all but the very fleetest claimants recover.

325 B.R. at 857.

Basically, the D&O Policy's priority of payments clause provides that the Side A coverage will be paid out to the officers and directors prior to any payments to the Debtor for Side C coverage. This creates an incentive for the insured officers and directors receiving Side A coverage to deplete the proceeds as quickly as possible so that only they will receive the full benefit of the policy limit. Under this provision, by the time the Holdings has a claim for Side C

coverage, the policy limits would be exhausted and Holdings' estate would be deprived of any proceeds. This scheme to circumvent the Section 362 stay violates the fundamental principle of bankruptcy law that "all of the debtors' interests in property are to be equitably distributed." *Id.*

As one commenter noted, bankruptcy courts should reject "priority of payment" provisions and "uphold the [Bankruptcy] Code's equitable approach" and "reject attempts to circumvent the bankruptcy priority scheme" as "[s]uch provisions are comparable to contracts in which one party contracts not to be sued" and are "unenforceable." Elina Chechelnitsky, *D&O Insurance in Bankruptcy Just Another Business Contract*, 14 Fordham J. Corp. & Fin. Law 825 (2009). Therefore, the court should not permit U.S. Specialty to rely on the D&O Policy's priority of payment provision to evade the stay under Section 362.

Making matters worse, here, in another too-clever-by-half gimmick, Holdings' management and the insurer, U.S. Specialty, tried to use a "flip" provision in a liability insurance policy unsuccessfully to change the normal priority of payment in an effort to circumvent 11 U.S.C. § 365(e)(1).

Pursuant to Endorsement 40(2) of the Policy, Holdings agrees that: "The **Company** [Holdings] agrees to advance, pay and indemnify **Loss** to or on behalf of the **Insured Persons** to the fullest extent permitted by law."[4]

Insuring clause 4(B) provides that the Insurer will cover the Company (Holdings) for its securities laws liability (Coverage B(2)) and for its indemnity/defense-cost advancement to its

[4] According to the Insurer, Holdings has not performed this obligation. (According to the movant's papers, Holdings is not indemnifying or advancing costs to its officers and directors.) The Insurer also owes yet-performed obligations, including the obligation to indemnify Holdings for securities laws claims under Coverage B. The insurance policy is an executor contract between Holdings and the Insurer. *See also Gen. Motors Acceptance Corp. v. Rose (In re Rose)*, 21 B.R. 272, 275-77 (Bankr. D. N.J. 1982) (Section 365(e)(1) also applies to non-executory contracts).

directors and officers (Coverage B(1)), in no particular priority. Coverage (B) makes the proceeds of the insurance policy assets of Holdings' Chapter 11 estate.

Insuring clause 4(A) provides that *only* if Holdings does not indemnify/advance costs to its officers and directors, then insurance coverage will flip, so that the Coverage B (which benefits Holdings) ceases and upon flipping (and only then) instead covers the directors and officers (Coverage A).[5] The insurer now posits that this "flip" provision either takes the insurance proceeds out of Holdings' Chapter 11 estate or is "cause" to lift the Section 362 stay. However, that could scarcely be further from the truth.

Here, the coverage putatively flipped from Coverage B to Coverage A only because Holdings became unable to pay its debts when due (i.e., insolvent) and filed for liquidation under Chapter 11. Until then, Coverage B took precedence over Coverage A. In the "real world" sense, the "flip" provision in clause 4 putatively operated only because Holdings became insolvent, filed for relief under Chapter 11 and then saw its directors and officers sued in class actions for securities laws violations.

Facially, the "flip" provision in the D&O policy, which purportedly modifies the obligations under the insurance contract to switch from Coverage (B) (which benefits Holdings' Chapter 11 estate) to coverage (A) (which benefits only Holdings' pre-petition directors and officers), violates 11 U.S.C. § 365(e)(1).[6] The only theoretical argument that the insurance's

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[5] As noted earlier, Endorsement 40 requires Holdings to indemnify its directors and advance their costs "to the fullest extent permitted by law." Coverage A does not apply "when and to the extent that the Company has paid such Loss to or on behalf of the Insured Persons as indemnification or advancement." Thus, so long as the law permits the Company (i.e., Holdings) to indemnify or advance costs to or for its directors and officers, Coverage A cannot apply. Only because Holdings became insolvent and filed under Chapter 11 has Holdings not complied with endorsement 40.

[6] 11 U.S.C. 365(e)(1) states in pertinent part:

> (e) (1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, *an executory contract* or unexpired lease of the debtor *may not be* terminated or *modified*, *and any right or obligation under such contract* or lease *may not be* terminated or *modified*, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on--

"flip" clause did not violate Section 365(e)(1) is the far-fetched notion that one might hypothesize that there might have existed a theoretical circumstance (which did not occur here) whereby the law would forbid Holdings to indemnify/advance costs to its officers and directors, even though insurance law would have allowed their misconduct to be insured.

That ephemeral pretense does not save the "flip" provision from contravening Section 365(e)(1). The flip occurred because Holdings was insolvent, filed for protection under Chapter 11 and could then not indemnity/advance costs to its pre-petition directors and officers. It is obvious that the purpose of the flip provision was to alter how insurance coverage operates in insolvency and bankruptcy. "The broad language of section 365(e) is intended to address provisions in contracts or leases that lead to the same effect as a clause triggered by bankruptcy, without mentioning bankruptcy." 3 COLLIER ON BANKRUPTCY ¶ 365.08[1] (16th ed. 2011); 2 COLLIER BANKRUPTCY MANUAL ¶ 365.08[1] (3rd ed. rev. 2011); *see, e.g., In re B. Siegel Co.*, 51 B.R. 159 (Bankr. E.D. Mich. 1985); *In re Garnas*, 38 B.R. 221 (Bankr. D.N.D. 1984). Additionally, the movant proffered no evidence that Holdings' shareholders knowingly approved the self-dealing "flip" provision whereby the insurance coverage for Holdings' liability for securities laws violations flipped post-petition to diminish the protection of the corporation in favor of protecting its pre-petition directors and officers or that the flip provision was fair to Holdings. *See* Del. Corp. Code § 144. The flip provision is invalid as a breach of the directors' fiduciary duty owed to Holdings.

Each Holdings officer (including whoever procured this insurance policy) has the same fiduciary duty to Holdings. *See, e.g., Gantler v. Stephens*, 965 A.2d 695, 708-09 n.37 (Del.

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;
(B) the commencement of a case under this title; or
(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.
(emphasis added)

2009). An officer's self-dealing so as to arrange to include a flip clause in liability insurance protecting Holdings against securities laws liability so that coverage would instead flip to protect the officers and theirs cronies instead of Holdings is a likewise breach of fiduciary duty.

Moreover, even if one were to pretend, for argument's sake only, both that Section 365(e)(1) does not reach these shenanigans and that fiduciary principles do not render them void, the equity principles that underlie the Bankruptcy Code void this flip provision as inequitable and against public policy.

2. The Proceeds of the Fiduciary Policy are Property of the Chapter 11 Estate

The movants provide only sketchy information about the Fiduciary Policy. That Policy covers employee plan sponsors and other insured persons. The motion identifies no plans but concedes that Holdings is a Sponsor Organization. Other insured persons are the officers and employees who administer the sponsored plans. Because Holdings is an insured, the proceeds of the Fiduciary Policy are property of the Chapter 11 Estate for the same reason that the proceeds of the D&O Policy are estate property.

3. There is No Cause under Section 362(d) of the Bankruptcy Code to Lift the Stay.

Substantial harm to the Holdings estate would result if the Section 362 stay were lifted to allow the proceeds of the D&O Policy to be depleted. Holdings has direct liability coverage under the D&O Policy for securities claims and the proceeds should be protected by the Section 362 stay. As stated by the court in *In re Metro. Mortg. & Sec. Co.*, 325 B.R. 851, 857 (Bankr. E.D. Wash. 2005), "the stay prevents any action which affects the debtors' interests in the proceeds. This is consistent with and necessary to promote the fundamental bankruptcy principles of preserving estate property and ensuring ratable distribution to creditors." Because Holdings and the insured have undivided, unliquidated interest in the policy proceeds, the stay should remain in place at this time.

With respect to the Fiduciary Policy, movant has provided insufficient information to constitute cause for lifting the stay. Movant has not identified why it proposes to make payments or to whom. Accordingly, the stay should not be lifted in respect of the Fiduciary Policy.

Conclusion

For the foregoing reasons, the Court should deny the motion of U.S. Specialty and should grant such other and further relief as may be just and proper.

Dated: February 28, 2012
New York, New York

Respectfully submitted,

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