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What happens to your insurance coverage when you are unable to pay your deductible or retention amount on pending claims when such payment is a condition precedent to indemnity and defense coverage under the express terms of your policy?

Under Texas law[1] and if the policy requires it, the insured must pay the deductible or retention amount despite the insured's insolvency before the insurer has any liability to defend or cover a given settlement, judgment or award against the insured. What constitutes payment of that amount, however, is subject to negotiation between the insured and the payee-claimant. Thus, the claimant may agree to accept something other than a cash payment to satisfy the deductible amount. For example, the claimant may accept a promissory note in *lieu* of the first [insert amount of deductible or retention] of his claim's settlement, judgment or award, in which case the insurer must satisfy its obligation to defend and cover the remaining amount over and above that amount

Typical policy provisions

Many policies provide for an aggregate deductible and thereafter a per claim deductible. Often, an insured may satisfy its deductible through payments of a settlement, judgment or arbitration award and certain out-of-pocket expenses such as investigation, adjustment and defense fees, costs and expenses, including attorneys' fees. Once the aggregate deductible is satisfied, generally the per-claim deductible must be exhausted before the carrier owes an obligation to indemnify or defend the pending claims. Many policies state the deductible payment as a condition precedent to the carrier's obligation to pay any amounts.

Obviously, such pay-first provision seems to conflict with important purposes of the Bankruptcy Code—allowing debtors an opportunity to reorganize or liquidate their finances and protecting the interests of creditors. *See* Bronte, Wager and Boardman, *Coverage Issues for the Insolvent Policyholder*, American Bar Association, Section of Litigation, Vol. 14, No. 2 (March/April 2004).

In an effort to avoid such conflict, many policies also contain a bankruptcy clause that provides language to the effect that "Bankruptcy or insolvency of the insured or of the insured's estate shall not relieve the carrier of any of its obligations hereunder." Such a provision, however, does not address what happens when the insured cannot make the deductible payment.

General impact of insolvency on policy's pay-first and bankruptcy clauses

Insolvent insureds have argued that the bankruptcy clause effectively excises their obligation to pay any remaining deductible amounts, and insurers have argued that neither

[1] By statute, Texas law applies to any contract of insurance payable to any Texas citizen. TEX. INS. CODE art. 21.42.

bankruptcy nor the bankruptcy clause forces them to cover what would be uncovered without the Insured's insolvency. The majority rule is that the insurer must provide coverage above the deductible amount and up to policy limits even if the policyholder cannot pay the deductible. *See, e.g., Albany Ins. Co. v. Bengal Marine, Inc.*, 857 F.2d 250, 256 (5th Cir. 1988) (La.) (under Louisiana's direct-action statute[2], held that carrier must pay claims over the per-claim deductible amount and up to the policy's limit while the debtor's un-paid deductible amount was suffered equally by policy claimants); *Columbia Casualty Co. v. Federal Press Co.*, 104 B.R. 56, 64 (Bankr. N.D. Ind. 1989) (under insurance policy and Indiana's direct-action statute, held insurer required to pay regardless of insured's insolvency); *In re: Keck, Mahin & Cate*, 241 B.R. 583, 596 (Bankr. N.D. Ill. 1999) (held law firm's E&O carrier must pay covered claims over deductible amount when law firm's Plan of liquidation granted claimants unsecured claims for the deductible-amount); *Liberty Mutual Ins. Co. v. Wheelwright Trucking Co.*, 851 So. 2d 466 (Ala. 2002) (Held insolvent insured's deductible payment viewed as a setoff in bankruptcy rather than a condition precedent to coverage); *Home Ins. Co. of Illinois v. Hooper*, 691 N.E.2e 65 (Ill. App. 1998) (Under insurance policy and Illinois' direct-action statute, insurer held liable even if insured could not pay its deductible); *but see Fidelity and Guaranty Ins. Co. v. Employers Ins. of Wausau*, 311 B.R. 288, 297 (Bankr. M.D. Fla. 2004) (Decided under Alabama law, court distinguished Wheelwright and held plain language of policy required insolvent to pay deductible in order to trigger coverage). Even the majority rule, however, does not require the carrier to cover any claim that is wholly within the deductible amount.

Potential payment obligation of other insureds

Particularly aggressive insurers in some cases have argued that additional insureds should be required to fund any shortfall in the deductible even if no claim has been raised against such other insureds. *Coverage Issues for the Insolvent Policyholder* (citing *Hartford Accident & Indem. Co. v. U.S. Natural Res., Inc.*, 897 F. Supp. 466, 473 (D. Or. 1995) (held only named insured, not an employee who was an additional insured, was obliged to pay deductible to carrier because the policy plainly referred to the "named insured's" obligation to pay); *Northbrook Ins. Co. v. Kuljian Corp.*, 690 F.2d 368, 373 (3rd Cir. 1982) (Pa. law) (affirmed district court's ruling that under the policy's plain terms both named insureds were obligated to pay deductible, even the "innocent" named insured); *In re: Keck Mahin & Cate*, 241 B.R. at 596) (under Illinois law, individual law firm partners were not required to fund the insolvent law firm's deductible amounts, even those whose conduct may have given rise to the claims) (but the court did not reveal its reasoning)).

Some policies do not expressly make other insureds obligated parties to the Policies. It seems that if the other insureds are not identified as parties to the insuring agreement, they should not be obligated to pay the deductible. *See, e.g., Continental Casualty Co. v. Campbell Design Group, Inc.*, 914 S.W.2d 43, 44 (Mo. Ct. App. 1996) (professional liability insurer could collect deductible from named insured but not from corporate officers who were other insureds because they were not party to the insuring agreement).

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[2] A statute that expressly permits a claimant to file suit directly against an insured's carrier to seek payment of his claim against the insured, including when the insured is insolvent.

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Texas case dealing with insolvency and a policy's first-pay and bankruptcy provisions

In Texas, a federal court held that as a matter of law, an insurer's obligations are not triggered until the insolvent insured first satisfies its deductible. *Pak-Mor Manuf. Co. v. Royal Surplus Lines Ins. Co*., 2005 WL 3487723 (W.D. Tex. Nov. 3, 2005). Pak-Mor filed suit against Royal, seeking a declaratory judgment that Royal's coverage obligations persisted in spite of Pak-Mor's inability to pay its self-insured deductible amounts. Royal filed a motion for summary judgment, arguing that it was relieved of any obligation to pay because Pak-Mor was unable to pay its self-insured retention (SIR). The bankruptcy court below held that "Royal must satisfy its policy obligations once a tort claimant proves his claim is greater than the SIR amount." On appeal, the federal district court held that the plain language of the insurance contract that payment of the deductible was a condition precedent to the carrier's liability. The policy provided:

> Notwithstanding any provisions of the policy or any endorsements to the contrary, it is a condition precedent to the company's liability under this policy that the insured, and no other person, insurer or organization for or on behalf of the insured, makes actual payment of the "Retained Limit". Any of our obligations under the policy shall not attach or arise unless or until the insured alone, and no other person, insurer or organization for or on behalf of the insured, pays the amount of the "Retained Limit". . . .

Id. at *2. Applying Texas state law rules of construction, the Court concluded the policy unambiguously required the insured to pay its deductible before coverage would attach. *Id*. at *3. The Court distinguished cases following the majority rule, finding that "such decisions were virtually compelled by applicable statutes in those states that required insurers to assume liability in the bankruptcy context just as they would outside the bankruptcy context regardless of what the policies themselves said." *Id.* at *6. The Court also found its holding to be consistent with the equitable policies of bankruptcy and also consistent with the bankruptcy clause within the policy, which expressly provided the retained limit requirement applied even if the insured was insolvent or bankrupt. *Id.* at *3-*4.

Still, the Texas federal court in *Pak-Mor* offered the insured some relief. The Court held that the insured "may satisfy the self-insured deductible by making its payment in whatever form it wants" subject to the claimant-payee's consent. *Id*. at *6, n. 49. For example, the Court stated that if the insured "issues a promissory note to its [claimant] in the sum of [the insured's retained limit], which note is not dischargeable in bankruptcy and which note is shown to be a creditable obligation," then the bankruptcy court would be within its power to find the insured's deductible requirement was satisfied. *Id.* at *7. Then, the insurer is obligated to pay amounts above the deductible amount and up to the limits of the policy. *Id.*

It should be noted that none of the cited cases arose exclusively outside the context of a bankruptcy, which seems to make sense. If all, or all but nominal creditors, and the insured's carrier amicably resolve claims and disputes to allow an orderly liquidation, no lawsuit need be filed. If, however, the carrier does not cooperate or at least three creditors with the ability and incentive to force the insured into involuntary bankruptcy, then bankruptcy and/or a lawsuit almost certainly will ensue.

Example case

A Chicago insured firm tried to wind-down its almost 100-year existence and liquidate outside of bankruptcy, but five trade creditors filed an involuntary proceeding under Chapter 7 of the Bankruptcy Code. *In re: Keck, Mahin & Cate*, 241 B.R. at 586. At the firm's request, the case converted to chapter 11 with a plan of liquidation, which plan was objected to by only one former partner and one of the firm's insurance carriers. The carrier urged that it was not obligated to provide any coverage for the pending claims, or to defend the firm, until the firm or its partners first paid its $1,000,000 per claim deductible. The bankruptcy court disagreed.

The bankruptcy court concluded that the Plan's grant to the claimants of an unsecured general claim for the deductible amount was sufficient value to satisfy the policy's requirement, and the carrier was required to cover those claims, once reduced to settlement, judgment or award, over the deductible amount and up to the policy's limits. The Plan also provided that the plan administrator—not the carrier—would defend the law firm in the pending malpractice matters. So, the carrier's obligation was no greater in bankruptcy than had the firm been solvent. The court further concluded that those claimants who settled for less than the remaining deductible would receive a larger distribution; in this way, lower, reasonable settlements were encouraged.

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