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UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

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

REPLY MEMORANDUM OF LAW OF THE CHAPTER 11 TRUSTEE IN FURTHER SUPPORT OF THE STIPULATION AND ORDER BETWEEN THE CHAPTER 11 TRUSTEE AND MFG ASSURANCE COMPANY LIMITED REGARDING PAYMENT OF LOSS AND REIMBURSEMENT OF COVERED COSTS AND EXPENSES

Louis J. Freeh (the "Trustee"), the duly-appointed chapter 11 trustee of MF Global Holdings Ltd. ("MF Ltd."), MF Global Finance USA Inc., MF Global Capital LLC, MF Global FX Clear LLC, and MF Global Market Services LLC (together, the "Debtors") respectfully submits this reply memorandum of law in further support of the *Stipulation and Order Between the Chapter 11 Trustee and MFG Assurance Company Limited Regarding Payment of Loss and Reimbursement of Covered Costs and Expenses* (the "Stipulation"). In addition to the previously filed objection (the "Objections") cited in the Trustee's Memorandum of Law in Support of the Stipulation and Order (Docket No. 516) (the "Opening Brief") dated March 5, 2012, this memorandum replies to: *Response of Sapere Wealth Management, Granite Asset Management*

and Sapere CTA Fund, L.P. to the Chapter 11 Trustee and MFG Assurance Company Limited's Memoranda of Law in Support of Proposed Stipulation and Order Between the Chapter 11 Trustee and MFG Assurance Company Limited Regarding Payment of Loss and Reimbursement of Covered Costs and Expenses (the "Sapere Brief"), and *Reply Memorandum in Further Support of the MFGI Commodities Customers Objection to Proposed Stipulation and Order Between the Chapter 11 Trustee and MFG Assurance Company Limited Regarding Payment of Loss and Reimbursement of Covered Costs and Expenses* (the "MFGI CC Brief"). All signatories of the Sapere Brief and the MFGI CC Brief are collectively referred to herein as the "Objectors." In support of this reply memorandum, the Trustee represents as follows:

PRELIMINARY STATEMENT

The Objectors' opposition briefs strain to endow their allegations and asserted damages claims with the inflated power of purportedly "vested rights," transforming the entire potential proceeds of the 2011-2012 MFGA Policies into *their* property or at least the exclusive property of the MFGI estate. As of today, however, the Objectors have only alleged—not proven or prevailed on—their pending claims in bankruptcy proceedings and other courts. Here, they are asking the Court to leapfrog the judicial process by prematurely assuming both the insured entities' liability for their alleged damages and MFGA's contractual obligation to indemnify them for those damages under the MFGA 2011-2012 Policies. No matter how alarming the public disclosures of unaccounted-for MFGI customer funds may be, neither of those basic prerequisites to actual coverage under the Policies has actually been legally established.

As explained further below, the Objectors' effort to justify the denial of the *individual insureds*' claims to defense costs under the Policies fails to acknowledge critical features of the Policies at issue here and relies upon a seriously distorted analysis of applicable law. *First*, the Objectors mischaracterize the basic purpose of the 2011-2012 MFGA Policies and ignore the

primacy of the individual non-debtor insureds' present contractual right to access policy proceeds (for advancement of defense costs) over the MFGI commodity customers' contingent, prospective interest in those proceeds. *Second*, the Objectors misconstrue both the plain language of New York Insurance Law § 3420(a)(1) and the case law applying it, and erroneously attempt to elevate their desire to freeze the Policy proceeds into an enforceable legal right. In reality, applicable law lends no support to the Objectors' demand to strip the individual insureds of their contractual rights under the Policies. *Third*, the Objectors fail to acknowledge that the release of proceeds to pay defense costs under the proposed Stipulation and Order is fully consistent with the approach of bankruptcy courts in other cases involving similarly competing interests in a finite insurance pool. *Finally*, the Objectors do not have standing to object to the Stipulation as they do not possess a direct pecuniary interest in the policies or the proceeds, or they attempt to assert the rights of MFGI, which should be asserted by the SIPA Trustee. Filing a claim against the Debtors does not cure these defects. For all of the foregoing reasons, the Objectors' arguments in opposition to the Stipulation and Order should be rejected.

The Objectors' demands are particularly suspect here, because the individuals' defense costs arise from litigation that the Objectors themselves have brought, and from which the Objectors seek to benefit. Furthermore, the Debtors' estates have a significant interest in the individuals' successful defense against these claims, which may prevent adverse judgments that could breed new claims against the estates and—given the Policies' exclusion of coverage for adjudicated knowing and willful misconduct— may ultimately maximize the insured entities' own coverage under the Policies. In short, the Stipulation and Order represent a prudent balancing of concerns affecting the Debtors' interests, and the Trustee respectfully submits that this Court should grant the relief requested.

ARGUMENT

A. The Objectors Do Not Oppose Release of Proceeds by MFGA Pursuant to Claims Under the 2010-11 Policies.

1. Neither of the Objectors' briefs lodges any objection to the proposed Stipulation and Order insofar as it relates to the 2010-2011 MFGA Policies, which insured the Debtors for a policy period that predates their October 2011 financial collapse. Nor could they. As explained in the Trustee's opening brief, only a few claims have been made against the 2010-2011 Policies, and none of those claims arise from the circumstances on which the commodity customers' alleged losses are based. Opening Br. ¶ 30. Moreover, a successful defense of these claims will likely benefit the Debtors' estates by protecting them from additional claims asserted through the bankruptcy claims process.

2. Given the absence of opposition to the continuation of coverage for ongoing claims under the 2010-2011 Policies, the Trustee respectfully submits that the Stipulation and Order should be granted as they relate to the 2010-2011 claims, and policy proceeds should be released to the full extent of any covered loss, as determined by MFGA in its capacity as insurer, for such claims.

B. The Objectors Mischaracterize the Nature of the Insurance Coverage Provided by the MFGA 2011-2012 Policies.

3. With respect to the 2011-2012 MFGA Policies, the Objectors' opposition to the Stipulation and Order hinges upon their contention that the proceeds of those Policies have been transformed into "property of the MFGI estate," solely by virtue of (a) the Objectors' assertion of claims against the MFGI estate in the SIPA liquidation proceeding and (b) their pursuit of damages claims against certain "non-debtor persons" through actions "in other courts." Sapere Br. ¶ 3; MFGI CC Br. ¶ 6. Contrary to the Objectors' argument, however, neither New

York Insurance Law § 3420(a)(1) nor applicable bankruptcy law provides any support for this contention.

4. The Objectors misconstrue the language and operation of § 3420(a)(1) of the New York Insurance Law and its application to the factual circumstances presented here. As explained further below, neither § 3420(a)(1) nor the cases interpreting that provision support the proposition that the Objectors advance—namely, that they may directly seize for themselves the total indemnity limits of the Policies merely by asserting liability claims against non-debtor individuals and bankruptcy claims against MFGI and the Debtors. Moreover, the Objectors mischaracterize the nature of the coverage provided by the Policies and the status of their bankruptcy and other litigation claims in relation to that coverage. Their arguments fundamentally depend upon erroneous assertions concerning the Policies, and it is essential at the outset to correct them.

5. To begin with, the Objectors assert incorrectly that the sole "purpose of a professional liability insurance policy"—including the 2011-2012 MFGA Policies—is to "pay the damages sustained by third-party customers of the insured entity," Sapere Br. ¶ 6. In fact, as explained in the Trustee's opening brief, the Policies extend coverage not only to the named *policyholder*, MF Global Holdings Ltd., and its subsidiary entities (including MFGI), but also to the *individual insureds*, comprising past, present and future employees, officers and directors of any insured entity. *See* Opening Br. ¶ 11 & n.4. Furthermore, the Policies do not specify any priority of entitlement to coverage proceeds or other distinction among any of the insured entities or individual insureds. Pursuant to paragraph 5.2, each Policy "is a single contract of insurance and if more than one *insured* is covered, this policy shall nevertheless be and remain a single contract of insurance for the benefit of the *insured* as joint *insured* . . . ." [*See* #1-18002-00-11

¶ 5.2; *see also* ¶ 5.2(i) ("the *policyholder* shall act for itself and for all *insureds* for all purposes") (underline added).]. Thus, the express language of the Policies eliminates the basis for the Objectors' attempt to paint the coverage rights of the *individual insureds* as subordinate or inferior to those of MFGI, its commodity customers, or the Debtors.[1]

6. Certain of these non-debtor *individual insureds* already have ripe claims for coverage of *loss* under the Policies, because they are faced with active non-stayed actions against them and are now incurring defense costs as a result. The 2011-2012 MFGA Policies expressly define *loss* to include "*defense costs,*" and specify that MFGA "shall advance" such defense costs to the insured person "prior to the final resolution of the *claim,*" subject to repayment if the claim is ultimately determined not to be covered. [*See* #1-18002-00-11 ¶ 5.8] As explained in the Trustee's opening brief, the *only* insurance claims presented to MFGA for immediate payment under the Policies to date are claims for advancement of *defense costs* by such *individual insureds*. Moreover, it is the Objectors themselves who are prosecuting these actions "in other courts" against such individuals, and who are now attempting to cut off those individuals' access to insurance proceeds needed to defend themselves against the Objectors' alleged claims for damages in those actions.

7. There is no basis for the Objectors' assertion that the defense-cost coverage provided by the MFGA 2011-2012 Policies is unnecessary or redundant, merely because (i) the D&O policy (the "D&O Policy") issued by U.S. Specialty Insurance Co. ("U.S. Specialty") for the 2011-2012 Policy Period may cover some defense costs of "the MFGI or

[1] It is therefore irrelevant whether, "as a matter of historical fact," most of the actions listed on the Open Claims Bordereaux involved customer actions in which MFGI was a named party. *See* Sapere Br. at ¶ 23. In any event, the bordereaux do not (and are not required to) document the extent to which individual insureds may have had separate counsel in such actions and have incurred covered defense costs that were advanced to those individuals by MFGA.

MFGH directors and officers," and (ii) U.S. Specialty has filed a motion for relief from the automatic stay in order to pay defense costs of those directors and officers. MFGI CC Br. ¶ 16. First, the MFGA 2011-2012 Policies provide potential defense-cost coverage not only for directors and officers but also for *any* other "past, present or future natural person employed by the *insured entity* in the ordinary course of the *services* of the *insured entity*" (¶ 2.14). This far broader category of individual insureds may encompass employees who—perhaps unlike "Jon Corzine *et al.*," as the Sapere Brief sarcastically dubs the directors and officers, *id.* ¶ 30—may not have sufficient assets to fund a vigorous defense without insurance. Second, the *scope* of coverage may be distinct even for MFGH and MFGI directors and officers under the D&O Policy and the MFGA 2011-2012 Policies, since the policies contain discrete definitions of covered conduct.[2] The existence or potential availability of D&O insurance to some individuals is therefore not germane to the issue presented here.

8. In contrast to the individual insureds' fully ripened coverage claims for advancement of defense costs, the Objectors' alleged legal claims for damages or other relief that are pending in other courts (or, more recently, against Debtors' estate in this proceeding) cannot now be characterized as "covered claims" under the Policies. *See* Sapere Br. ¶ 8 (referring to the purported "fact that commodities customers have already made covered claims"); MFGI CC Br. ¶ 3 (asserting that "[t]he [MFGA] E&O coverage . . . *covers* the class claims made by the MFGI Commodity Customers"). To the contrary—as stated in the Opening Brief, and as the Sapere

[2] The D&O Policy covers alleged wrongful acts by directors and officers "in their capacity as such," whereas the MFGA 2011-2012 Policies extends to all conduct in connection with *services* performed by the insured entity. The point here is *not* to suggest any specific difference or division of coverage under these policies: these are matters that the interested insurers may work out in the context of their respective coverage analyses and determinations in response to claims by individual insureds. To the extent that the coverages under the policies may overlap, the MFGA 2011-2012 Policies contain an "Other Insurance" clause providing that the policies' coverage "shall apply only as specifically excess over any other valid and collectible insurance or indemnity available to the *insured*." (¶ 5.12) Thus, subject to any applicable law, the MFGA 2011-2012 Policies should not be expected to pay defense costs or indemnity that the D&O Policy (or any other insurance) would be available to provide.

Brief acknowledges, *see* ¶ 26—the SIPA trustee of MFGI to date has not presented notice of any insurance claim for alleged losses to MFGA seeking indemnity coverage of customer losses on behalf of MFGI. As a result, MFGA to date has not made any determination as to whether any such alleged losses are in fact "covered" under those policies.

9. The Objectors cannot establish that their *alleged* damages constitute "covered" claims under the MFGA 2011-2012 Policies simply by parsing the policy language themselves and announcing, *ipse dixit*, that "[i]rrespective of the precise amount, the damages actually-incurred [*sic*] exceed $120,000,000." Sapere Br. ¶ 10. The Objectors assert that the claims they have filed with the Trustee constitute "*claims* against MFGI (an *insured*) for purposes of the Policies." *Id.* But even assuming that the Objectors' bankruptcy claims constitute a *potentially* covered "*claim*" against an *insured*, the Policies do not automatically pay whenever anyone asserts such a "*claim.*" Rather, the Policies cover only actual "*loss*," defined to include (in addition to defense costs) only adjudicated "awards" of damages, judgments or other binding orders, or final negotiated "settlements" of *claims*, against an insured. (¶ 2.19) The Objectors cannot plausibly suggest that they have such a conclusively adjudicated award of damages or judgment of liability in hand. To the contrary, no one at this juncture has been found liable for anything, and it remains to be seen whether anyone—and if so, who—ever will.[3]

10. While the Trustee understands the urgency of the Objectors' desire to secure any potential funds that conceivably might reduce their alleged losses, in light of the above the Trustee nonetheless believes that the current interest of the Debtors' estate in the

[3] In light of these facts, the Sapere Objectors' strategic last-minute filing of a claim against the Debtors' estates in this proceeding does nothing to alter the balance of legitimate interests which justifies this Court's entry of the Stipulation and Order. The Sapere Objectors need a collectible judgment; filing more bankruptcy claims, regardless of their merits, does not change the contingent and prospective nature of their interest in the policy proceeds.

proceeds of the Policies remains contingent and prospective in nature. In contrast, certain non-debtor *individual insureds* have ripe claims for defense-cost coverage under the Policies right now, and an immediate need for insurance proceeds in aid of their defense against legal claims *brought by the Objectors themselves.* The Policies' language extends unitary coverage to all covered entities and individuals as "joint *insureds*" and does not support the Objectors' demand to strip the individual insureds of their contractual rights under the Policies.

11. Where the debtor and individuals are both insureds, an insurer, in the absence of a bankruptcy filing would pay claims in the order they are presented. See, e.g., *State Farm Ins. Co. v. Credle*, 643 N.Y.S.2d 97, 98 (App. Div. 1996) ("Payments [to multiple claimants] were made on a chronological basis, and while it was arguably negligent for the [insurer] to have paid out proceeds to the first two applicants, exhausting the policy limits after [the third applicant] had filed her claim, such action did not rise to the level of 'gross disregard' so as to constitute bad faith."); *Gerdes v. Travelers Ins. Co.*, 440 N.Y.S.2d 976, 978 (Sup. Ct. 1981) ("Where . . . there is no pro rata provision in the policy, the contest of multiple plaintiffs for the limited assets of a common defendant has generally—at least in this jurisdiction—been solved in terms of chronological priority, the 'first in time, first in right' rule."). Thus, since the only claims presented for payment are against the individual directors, officers, and employees, the insurers would be paying those claims, and not hypothetical, or as-yet-unasserted claims against the entities.

12. Indeed, the Objectors themselves trumpet "the common law's 'first in time, first in right' principle," Sapere Br. ¶ 3 n.7. But they err by attempting to conflate their mere allegation or assertion of unadjudicated claims in legal proceedings with an *insured*'s notice and presentation *to the insurer* (MFGA) of a claim for indemnification of a cognizable

"loss" under the Policies. As demonstrated below, the Objectors' effort to blur this basic distinction and thereby claim "vested" rights in the policy proceeds finds no support in N.Y. Ins. Law § 3420(a)(1) or in any other applicable law.

C. The Proceeds of the 2011-12 MFGA Policies Are Not Property of the MFGI Commodity Customers or Exclusively of the MFGI Estate.

13. Section 3420(a)(1) states: "[T]he insolvency or bankruptcy of the person insured, or the insolvency of the insured's estate, shall not release the insurer from the payment of damages for injury sustained or loss occasioned during the life of and within the coverage of such policy or contract." N.Y. Ins. Law § 3420(a)(1) (Consol. 2012). This is contrary to the common law rule under which the insurer would not be liable to a bankrupt insured when the insured was unable to pay the injured party. Because § 3420(a)(1) is "in derogation of the common law . . . , [it] must be strictly construed." *Royal Indem. Co. v. Travelers' Ins. Co.*, 280 N.Y.S. 485, 488 (App. Div. 1935), aff'd, 270 N.Y.S. 574 (1936) (construing former section 109 of the Insurance Law, a predecessor to section 3420). The plain language of § 3420(a)(1) restricts its application to "insolvency or bankruptcy *of the person insured*" (emphasis added).

14. By its plain terms, § 3420(a)(1) does not fully address a situation such as here, in which the Policies insure multiple entities and thousands of individual employees, officers and directors, and only some of the insured entities are insolvent or bankrupt. Consequently, the text of the statute facially does not support the Objectors' interpretation with respect to the rights of non-debtor insureds to the Policies' proceeds.

15. With respect to the debtor *insured*, Holdings, judicial interpretations of § 3420(a)(1) do not support Objectors' argument. The Objectors' heavy reliance on the *Merchants' Mutual*, *Baroff* and *Baez* decisions is misplaced. In all three cases, the liability of the insured was already admitted or established by the time the insurance proceeds were pursued by

the injured party. *See Merchants Mut. Auto. Liab. Ins. Co. v. Smart*, 267 U.S. 126, 128 (1925); *Am. Bank & Trust Co. v. Davis (In re F.O. Baroff Co.)*, 555 F.2d 38, 40 (2d Cir. 1977); *Baez v. Med. Liab. Mut. Ins. Co.*, 136 B.R. 65, 66 (S.D.N.Y. 1992). Indeed, it has been noted of *Baroff* that "the Court of Appeals' interpretation of the bankruptcy provision only applies when the injured party sues the bankrupt for insurance money paid to the bankrupt *on admitted liability*. Plaintiff's reliance on *Baroff* . . . when *the insured's liability is not established*, cannot be sustained." *Freed v. U.S. Aviation Underwriters, Inc.*, 82 B.R. 9, 12 (S.D.N.Y. 1987) (emphases added).

16. The seminal New York case regarding the scope of § 3420(a)(1)'s predecessor statute, cited by Objectors and the *Baroff* court, is premised on liability of the insolvent insured being conclusively established *before* an insurer becomes liable to an in-fact injured party. *See Coleman v. New Amsterdam Cas. Co.*, 247 N.Y. 271, 275 (1928) (Cardozo, C.J.) ("The effect of the statute is to give to the injured claimant . . . the same relief that would be due to a solvent principal seeking indemnity and reimbursement *after the judgment* has been satisfied. The cause of action is no less but also it is no greater." (emphasis added)). Here, neither Holdings nor MFGI has admitted liability, and the liability of any of the individual insureds has not been established. The Objectors would have § 3420(a)(1) give them "greater" rights by eliminating the requirement that liability be established. As the above cases make clear, the statute simply does not confer such rights. The Objectors' argument under § 3420(a)(1) therefore fails.

17. The Objectors' argument also fails because the *individual insureds* who are presently claiming advancement of defense costs under the 2011-2012 MFGA Policies are not in bankruptcy, nor have they been shown to be insolvent. Section 3420(a)(1) applies only if the "person insured" is insolvent or bankrupt, and only to the extent of the insolvent insured's

interest in the proceeds. *See Baez*, 136 B.R. at 68 (only the "*insured bankrupt* . . . is divested of *his interest* in the proceeds of the policy . . . ." (emphases added)). The non-debtor individual insureds retain an independent property interest in the policy proceeds in respect of their covered defense costs; the bankrupt insured entities' do not have an interest in those particular proceeds, as they are for the benefit of the *individual insureds* only. Thus, the *insured entities*' bankruptcy is of no consequence under § 3420(a)(1) as it relates to the individual insureds' defense costs, and § 3420(a)(1) gives the Objectors no rights in those particular proceeds.

18. The Objectors' attempt to transform their contingent and prospective interest into so-called "vested rights" is similarly without foundation. The Objectors appear to have taken the term "vested rights" from language in the *Merchants Mutual* and *Baez*. (*See* Commodity Customers' Reply Mem. at 9, Docket No. 573.) Unfortunately for the Objectors, they take the term out of context and misunderstand the situation under which an injured party has "vested" rights. Such a party's rights to insurance proceeds may be considered "vested" in the injured party only when the insolvent or bankrupt insured's actual liability has been conclusively established. *See Merchants' Mutual*, 267 U.S. at 131 ("But the clause becomes operative only in the event of the insolvency or bankruptcy of the insured . . . . The title to the indemnity passes out of the bankrupt or insolvent person and vests in him in whom the contract and the state law declares it should vest."); *Baez*, 136 B.R. 68 ("[U]pon filing of a bankruptcy petition, the insured is divested of his interest in the proceeds of the policy to the extent that those proceeds are needed to compensate the injured party, which proceeds at that point vest in the injured party."). The so-called "vesting" does not occur simply because the Objectors wish it to: the Objectors first must establish through legal processes that the insolvent insured is actually liable to them. Because the Objectors have not made—and cannot make—this showing

with respect to any insured under the Policies, they have no "vested" rights in the Policies' proceeds.[4]

19. Even were the Objectors to obtain a judgment of liability against the *individual insureds* (this is presumably the goal of their parallel actions for which they aim to deny the individual insureds' defense costs), § 3420(a)(1) would still have no operative effect with respect to that judgment, unless and until the individual insureds became insolvent or bankrupt. If that condition were met, and the individual insured failed to satisfy the judgment, § 3420(a)(2) would give the Objectors a right to pursue the *insurer—i.e.*, MFGA—directly for that amount in some circumstances. *See* N.Y. Ins. Law § 3420(a)(2) (allowing holder of an unsatisfied "judgment against the insured" to proceed "against the insurer under the terms of the policy or contract for the amount of such judgment . . . ."); *see also Merchants Mut.*, 267 U.S. at 130 ("It provides that the subrogation shall take place only when the insured proves insolvent or bankrupt, and leaves the injured person to pursue his judgment against the insured if solvent . . . ."); *Baroff*, 555 F.2d at 43 ("[I]n the event that the injured claimant has procured a judgment against a bankrupt insured, he may . . . proceed directly against the insurer."). But New York law does not allow the Objectors to put the cart before the horse: first they must prove liability and then obtain an actual, collectible judgment, which they have not done.

20. Nor does federal bankruptcy law operate to "vest" rights in the Objectors that New York law does not grant. It is axiomatic that, unless there is a specific provision in the Bankruptcy Code, property interests (such as insurance proceeds) will be governed by state law. *See Butner v. United States*, 440 U.S. 48, 55 (1979) (holding that, "[u]nless some federal interest

[4] There is no basis for the Objectors' assertion that "loss" under § 3420(a)(1) does not include defense costs. To the contrary, § 3420(a)(2) makes plain that any rights conferred by this provision must be asserted "under the terms of the policy or contract," *see* ¶ 19 *infra*, and the Policies here indisputably define *loss* to <u>*include*</u> "*defense costs*.

requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding" because bankruptcy law requires "[u]niform treatment of property interests by both state and federal courts"). The Objectors fail to cite any provision of the Bankruptcy Code that purportedly dictates a different result from that directed by New York law.

21. To the contrary, the only authorities cited to suggest that bankruptcy law affords them rights in the proceeds that New York does not are the Code's general grant of equitable power in § 105(a), and a case recognizing the code's general policy on "equality of distribution among creditors." (*See* Sapere Reply Mem. at 13–14, Docket No. 574.) Such general provisions do not give rise to any "federal interest requir[ing] a different result" from New York law, and are nothing more than red herrings. The Objectors simply wish to create a right to proceeds out of whole cloth, without any support in the Bankruptcy Code.

22. Indeed, with respect to the Objectors' concerns about *defense costs* for the *individual insureds* depleting proceeds under the Policies, it should be noted that the Objectors have themselves caused defense costs to be incurred by initiating many of the underlying suits against the *individual insureds*. (*See* Chapter 11 Trustee's Mem. of Law ex. B, Docket No. 516.) If Objectors were serious about minimizing defense costs and avoiding depletion of the Policies' limits, they could have asked this Court to stay or enjoin all actions against the *individual insureds*, thereby ensuring that defense costs would not deplete the policy proceeds. *See Circle K Convenience Stores, Inc. v. Marks (In re Circle K Corp.)*, 121 B.R. 257, 262 (Bankr. D. Ariz. 1990) (citing *Johns-Manville Corp. v. Asbestos Litig. Grp. (In re Johns-Manville Corp.)*, 26 B.R. 420, 428–31 (Bankr. S.D.N.Y. 1983)). In *Circle K*, the court expressly noted that "the deposition or trial testimony of debtor's senior executives may be used against the company subsequently," and that "continued prosecution of [other litigation against individual insureds]

affects debtor's property interests in a valuable estate asset in violation of the automatic stay." *Id.* at 261–62. Rather than pursuing this course, the Objectors are now attempting to monopolize the entirety of the Policies' proceeds for themselves to the exclusion of the *individual insureds*, without establishing liability or following the strictures of applicable law. At the same time, they seek to give themselves an advantage in the underlying suits against those very *individual insureds*, by denying them the advancement of defense costs to which they are entitled under the Policies. This Court should not countenance such a result.

D. The Release of Some Policy Proceeds to *Individual Insureds' Defense Costs* Is Consistent With the Approach of Other Bankruptcy Courts in Similar Circumstances.

23. As discussed above, the Policies here insure both not only bankrupt *insured entities* but also numerous non-debtors, who also have a protected contractual interest in the proceeds of the Policies. Moreover, because the Policies do not have any language dictating priority of payment between one class of *insureds* over another, the non-debtors' rights are on par with those of the Debtors and MFGI (even assuming it had made a claim to MFGA). When confronted with this situation of debtor and non-debtor co-insureds, courts have recognized that the debtor's bankruptcy does not eliminate the contractual rights of non-debtor co-insureds in favor of the claims of the debtor's creditors. *See Metro. Mortg. & Secs. Co. v. Cauvel (In re Metro. Mortg. & Secs. Co.),* 325 B.R. 851, 857 (Bankr. E.D. Wash. 2005) ("The debtors and all other insureds have undivided, unliquidated interests in the . . . the policy proceeds.").

24. As discussed in the Opening Brief, the Trustee believes that the proceeds of the Policies are not estate property, and we do not repeat that argument here. (*See* Opening Brief at 13). More important is the need to recognize, which the Objectors do not, that the rights of the non-debtor co-insureds cannot be trampled over simply because the alleged shortfall of MFGI customer funds potentially may exceed the full indemnity limits of the Policies. While the

Objectors may wish to use this alleged shortfall as a "trump card" to run roughshod over the established contractual rights of the non-debtor co-insureds, the Bankruptcy Code does not license this result, and this Court should not endorse it. *See In re Petters Co.*, 419 B.R. 369, 378 (Bankr. D. Minn. 2009) ("There is nothing divine about the estate's status as an insured and prospective claimant; the universe of other claimants has the same status under non-bankruptcy law.").

25. Indeed, regardless of whether courts treat insurance proceeds as property of the estate requiring relief from the automatic stay, in cases where both the debtor and non-debtors are co-insureds, courts across the country favor providing a reasonable portion of proceeds to the non-debtor insureds for payment of defense costs. *See, e.g., Adelphia Commc'ns Corp. v. Associated Elec. & Gas Ins. Services Ltd. (In re Adelphia Commc'ns Corp.),* 285 B.R. 580, 600 (Bankr. S.D.N.Y. 2002); *see also, Groshong v. Sapp (In re Mila, Inc.),* 423 B.R. 537, 545 (B.A.P. 9th Cir. 2010); *In re Beach First Nat'l Bancshares, Inc.*, 451 B.R. 406, 411–12 (Bankr. D.S.C. 2011); *In re Downey Fin. Corp.*, 428 B.R. 595, 610 (Bankr. D. Del. 2010); *In re Petters Co.*, 419 B.R. at 379; *In re Arter & Hadden, L.L.P.*, 335 B.R. 666, 674 (N.D. Ohio 2005); *In re Allied Digital Techs. Corp.*, 306 B.R. 505, 513–14 (Bankr. D. Del. 2004);*Exec. Risk Indem., Inc. v. Boston Reg'l Med. Ctr. Inc. (In re Boston Reg'l Med. Ctr. Inc.),* 285 B.R. 87, 98 (Bankr. D. Mass. 2002); *In re CyberMedica, Inc.*, 280 B.R. 12, 18 (Bankr. D. Mass. 2002);.

26. In each of the above cases, the court recognized non-debtor individual insureds' contractual rights to payment of defense costs out of the proceeds of policies—notwithstanding policy provisions that also gave the debtor insured rights to proceeds—and granted access to such proceeds at least to some reasonable extent. Moreover, although much of the case law addresses D&O policies, these principles are equally applicable to the E&O policies at issue here. *See In re Metro. Mortg. & Sec. Co.*, 325 B.R. at 853–54, 857 (analyzing D&O and

E&O policies under the same framework). There is nothing inherent in the terms of a D&O or E&O policy that would dictate a contrary result—for *any* insurance policy, a court must examine "the language and scope of the specific polic[y] at issue." *In re Downey Fin. Corp.*, 428 B.R. at 603.

27. Here, the Policies clearly militate in favor of permitting the release of proceeds to the individual insureds, subject to monitoring or other reasonable conditions to be determined by the Court. Accordingly, the Trustee respectfully submits that the relief requested by the Trustee here should be granted.

E. The Objectors Lack Standing to Object to the Stipulation.

28. As to the Objectors' standing, the Court must determine whether the Objectors have standing to object to this specific stipulation. Regardless of whether the Objectors have filed a proof of claim in this case, they must show that their pecuniary interest is directly affected by the stipulation. For two reasons, the Objectors cannot.

29. First, under *Innkeepers* and the other cases cited by the Trustee in his Opening Brief,[5] a party must show a direct pecuniary interest in the proceeding to be heard on a particular matter, otherwise courts have "limited 'party in interest' standing where a party's interest in the proceeding is not a direct one."[6] Here, the Objectors do not have a direct interest in the policies because they do not have any right to payment under the terms of the policies.

[5] *In re Innkeepers USA Trust*, 448 B.R. 131, 141 (Bankr. S.D.N.Y. 2011); *In re St. Vincent's Catholic Med. Ctrs of N.Y.*, 429 B.R. 139, 151 (Bankr. S.D.N.Y. 2010); *Krys v. Official Comm. of Unsecured Creditors of REFCO, Inc.* (*In re Refco Inc.*), 505 F.3d 109, 117 n.9 (2d Cir. 2007); *Roslyn Savs. Bank v. Comcoach Corp. (In re Comcoach Corp.)*, 698 F.2d 571, 573 (2d Cir. 1983).

[6] *In re Innkeepers USA Trust*, 448 B.R. at 141.

30. Second, under *Refco*, and the cases cited therein, cited in the Trustee's Opening Brief,[7] "party-in-interest standing under *§ 1109(b)* does not arise if a party seeks to assert some right that is purely derivative of another party's rights in the bankruptcy proceeding."[8] Here, the Objectors attempt to assert rights belonging to MFGI, as a co-insured under the policies. These rights would be properly asserted by the SIPA Trustee.

CONCLUSION

For the reasons explained above and in the Trustee's Opening Brief, the Debtors' interests in the proceeds of the Policies are too uncertain and remote to deny the individual insureds access to the Policies for advancement of defense costs. The Trustee respectfully submits that any concerns about depletion of the Policies should be address, not by cutting off the individual insureds' rights entirely, but rather through adoption of a staged stay relief program and other reasonable monitoring or controls that this Court deems appropriate.

[7] *In re Refco, Inc.*, 505 F.3d at 117 n.9; *In re Ionoshpere Clubs, Inc.*, 101 B.R. 844, 850-51 (Bankr. S.D.N.Y. 1989); *In re Comcoach Corp.*, 698 F.2d at 573.

[8] *In re Refco, Inc.*, 505 F.3d at 117 n.9 2d Cir. 2007.

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