D&O and E&O Claims

Peggy Hunt, Moderator
Dorsey & Whitney LLP; Salt Lake City

Hon. Elizabeth E. Brown
U.S. Bankruptcy Court (D. Colo.); Denver

Andrew W. Caine
Pachulski Stang Ziehl & Jones LLP; Los Angeles

Joshua M. Hantman
Brownstein Hyatt Farber Schreck, LLP; Denver

INSURANCE ISSUES IN BANKRUPTCY

ABI ROCKY MOUNTAIN CONFERENCE

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Peggy Hunt, Moderator
Dorsey & Whitney LLP
hunt.peggy@dorsey.com

Panelists:

The Honorable Elizabeth E. Brown
United States Bankruptcy Court for the District of Colorado

Andrew Caine
Pachulski Stang Ziehl & Jones LLP
acaine@pszjlaw.com

Joshua M. Hantman
Brownstein Hyatt Garber Schreck, LLP
JHantman@BHFS.com

Table of Contents

Tab 1: General Information

OVERVIEW OF D&O INSURANCE POLICIES

A. Types of Insurance Coverage

Most D&O policies offer two types of insurance coverage: Directors and Officers Liability Coverage and Corporate Reimbursement Coverage.

1. Director and Officers Liability Coverage

Directors and Officers Liability Coverage (or "Executive Liability Coverage"), sometimes referred to as "Side-A Coverage," provides liability coverage directly to the officers and directors of a corporation for losses – including defense costs – resulting from claims asserted against them for wrongful acts, errors, omissions, or breaches of duty. Executive Liability Coverage applies where the corporation does not indemnify its directors and officers.

2. Corporate Reimbursement Coverage

Corporate Reimbursement Coverage, sometimes referred to as indemnity or "Side-B Coverage," reimburses a corporation for its losses where the corporation indemnifies its directors and officers for claims against them. Indemnification may not be permitted in all circumstances. Corporate charters or bylaws, federal or state statutes and individual agreements with directors or officers may determine whether the corporation is required, permitted or unable to indemnify.[1] In California, for example, a corporation may not indemnify its officers or directors for, among other things, intentional misconduct, acts or omissions that a director believes to be contrary to the best interests of the corporation, or acts or omissions that show a reckless disregard for the corporation. See CAL. CORP. CODE § 204(a)(10).

3. Entity Coverage

Some policies also contain a third type of coverage or endorsement to the policy, called "Entity Coverage" or "Side-C Coverage," which insures the corporation against liability for its own wrongdoing or against vicarious liability for wrongdoing by its officers or directors. While Entity Coverage expands a corporation's coverage, it may reduce the amount of coverage available to the directors and officers individually. If the policy limits are reduced, or exhausted, in resolving a claim against the corporation, there may be little or no money left to protect the officers and directors. Some scholars have argued that, in this event, the original purpose of the D&O policy – to protect the directors and officers - may be undermined in favor of the "entity coverage" provided to the corporation.[2]

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[1] *See. e.g., Slottow v. American Cas. Co. of Reading, Pa.,* 10 F.3d 1355, 1358 (9th Cir. 1993).
[2] *H. Walter Croskey*, et. al., *California Practice Guide: Insurance Litigation*, Ch. 7F-C (2006). *See Ochs v. Lipson (In re First Cent. Fin. Corp.).* 238 B.R. 9, 13 (Bankr. E.D.N.Y. 1999).

In bankruptcy cases, claims against the corporate debtor's former officers and directors are a potential source of recovery for the bankruptcy estate, especially where there is insurance coverage for the alleged wrongdoing. The ability of a trustee or creditors' committee to collect policy proceeds may be restricted, however, if there are former officers and directors competing with the corporation or with new management for the benefits of the policies. A trustee in bankruptcy (or a creditors' committee) may seek a court order that the policy and its proceeds are assets of the insolvent corporation and that the policy proceeds should be preserved for corporate creditors and other claimants.

4. Distinction Between Indemnity and Liability Policies

While "first party" indemnification insurance policy proceeds (such as fire, casualty, business interruption and similar policies) typically will inure to the benefit of the insured's bankruptcy estate, some policies relating to liability to third party claims are written as "indemnity" policies. Such policies normally require not only the determination of liability to a third party as a precondition to payment by the insurance carrier, but also the insured's actual payment of such a judgment or liability and provide for reimbursement of the insured after such payment. If the insured files bankruptcy, the debtor may never pay the covered claim (or only a portion thereof). If the debtor's failure to pay the claimant acted to preclude recovery from the insurance carrier, the insurer would avoid liability under the policy.

This may be an appropriate result from the perspective of the insurance company, especially given that indemnity policies typically have significantly lower premiums. For the injured party (and the debtor's general creditors to the extent that other assets are in the estate that can be maximized by satisfying covered claimants out of insurance proceeds), this is not an acceptable result.

Because the condition for payment to the insured under a so-called indemnity policy is payment of the third party claimant's judgment, without such payment, the debtor never would become entitled to receive the policy proceeds. As a result, it would seem that such indemnity policies should be characterized as merely a variant of third party liability policies even though written as a first party indemnity contract.

B. The Scope of Coverage

Each policy and each type of coverage within the policy will have its own retentions, deductibles, terms of coverage and exclusions. Whether coverage is available will be determined by the definition of certain terms in the policy. Some of the key terms are "claim," "wrongful act" and "loss." Although the definitions will differ between policies, the term "claim" generally defines what types of demands are covered, i.e., demands for money or specific performance. The term "wrongful act" defines what types of conduct are covered under the policy. Wrongful acts typically include breaches of fiduciary duty, negligence, errors, misleading statements or misstatements, omissions or acts by the directors or officers in the discharge of their duties.[3] Intentional, fraudulent or dishonest acts are usually

[3] *See, e.g., Olympic Club v. Interested Underwriters at Lloyd's London,* 991 F.2d 497, 500 (9th Cir. 1993); *Owens Corning v. National Union Fire Ins. Co. of Pittsburgh, PA,* 1998 WL 774109, *1 (6th Cir.

excluded from D&O coverage.[4] The term "losses" defines what types of financial harm are covered under the policy and generally includes damages, judgments, awards, settlements and defense costs. Policy exclusions may also affect which claims will be covered under the policy.

D&O insurance is typically written on a "claims-made" basis. This means that the policy will provide coverage only if a claim is made when the policy is in force, regardless of when the events that caused the claim to materialize first occurred. Claims- made policies can be further classified as either claims-made-and-reported policies, which require that claims be reported within the policy period, or general claims-made policies, which contain no such reporting requirement. If the claim is not made or reported to the insurer until after the policy has expired, coverage may be denied. Thus, the policy's notice provisions should be carefully reviewed to prevent lapse of the policy and untimely claims.

C. The Impact of Bankruptcy on D&O Policies

1. The Automatic Stay and Policy Proceeds

Under section 362(a)(3) of the Bankruptcy Code, an automatic stay is imposed as of the petition date and stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." When a company files for bankruptcy, the issue arises whether the D&O policy and its proceeds become assets of the estate subject to the protections of the automatic stay, such that they can be preserved by, or for the benefit of, the debtor and its creditors. Most courts that have addressed the issue have concluded that such policies fall within the definition of "property of the estate" as defined in section 541(a)(1) of the Bankruptcy Code and, accordingly, cannot be cancelled without violating the automatic stay.[5]

There is far less certainty among the courts, however, as to who owns the *proceeds* of the insurance policies. Some courts have held that D&O insurance policies and their proceeds are part of a debtor's estate.[6] Other courts, however, have drawn a distinction between the policy and its proceeds and held that, even if the policy is an estate asset, the

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1998); *Eglin Nat. Bank v. Home Indem. Co.*, 583 F.2d 1281, 1283 (11th Cir. 1978).

[4] *See, e.g., American Cas. Co. v. United Southern Bank*, 950 F.2d 250,254 (5th Cir. 1992).

[5] *See, e.g., A.H. Robins Co. Inc. v. Piccinin*, 788 F.2d 994, 1001 (4th Cir. 1986), *cert. denied*, 479 U.S. 876, 107 S.Ct. 251 (1986); *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) (policy that insured debtor against indemnity claims made by its officers and directors benefited debtor and constituted property of the estate because "the debtor's estate is worth more with [the policies] than without them" and that, therefore, cancellation of the policies was automatically stayed); *Nicholls v. Zurich American Ins. Group*, 244 F.Supp.2d 1144 (D. Colo. 2003) (D&O policy is considered "property of the estate" if it increases the debtor's worth or diminish its liabilities). *Cf Pintlar Corp. v. Fidelity & Cas. Co. (In re Pintlar Corp.)*, 124 F.3d 1310 (9th Cir. 1997) (distinguishing *Minoco*, concluding that directors and officers liability coverage was not "property of the estate" and that court could not enjoin insurers' state court action for declaratory relief).

[6] *See, e.g., In re Vitek*, 51 F.3d 530 (5th Cir. 1995); *In re Leslie Fay Cos., Inc.*, 207 B.R. 764 (Bankr. S.D.N.Y. 1997); *In re Sacred Heart Hosp.of Norristown*, 182 B.R. 413 (Bankr. E.D. Pa. 1995).

insurance proceeds are not property of the debtor's estate.[7] The determination as to whether proceeds of a D&O policy are included in the property of the estate is fact specific and made on a case by case basis. Those courts addressing the issue have considered the policy language, including whether the liability policy exclusively covers the directors and officers, whether the policy provides indemnity coverage or entity coverage, whether the indemnity coverage has been or will be triggered by outstanding litigation defense costs, and whether anticipated litigation expenses will exhaust the policy limits. In sum, the cases establish that whether the policy's proceeds constitute property of the estate depends primarily on whether or not the proceeds are likely to benefit the estate.

Where the policy only provides direct coverage to the directors and officers (Executive Liability Coverage), courts have generally rejected the argument that the estate has an interest in the proceeds and that use of the proceeds would violate the automatic stay. On the other hand, where the policy includes coverage for the debtor directly (Entity Coverage), the courts are more likely to find that the proceeds are estate property. The biggest split among the courts is how to treat proceeds of a policy that provides indemnity coverage (Corporate Reimbursement) but does not provide Entity Coverage. Some courts have found that indemnity coverage alone is sufficient to make the proceeds property of the estate.[8] Some courts have held that the proceeds can be estate property only if an indemnification claim has been brought against the estate, while other courts have held that indemnity coverage alone is not enough to render the proceeds estate property.[9]

2. The Stay and Third Parties

If the proceeds are property of the bankruptcy estate, the automatic stay will prohibit the officers and directors (as well as creditors with claims against a corporate debtor) from obtaining access to the proceeds without seeking relief from the court. However, the automatic stay is not unlimited. Although the scope of the automatic stay is broad, the clear language of section 362(a) of the Bankruptcy Code stays actions only against a "debtor." Nevertheless, certain courts have extended the automatic stay to non-debtor codefendants in "unusual circumstances."[10] The courts have found "unusual circumstances" where "there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect

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[7] *Louisiana World Exposition, Inc. v. Federal Ins. Co. (In re Louisiana World Exposition, Inc.),* 832 F.2d 1391, 1399 (5th Cir. 1987) (policy proceeds are not property of the estate where the policy only provides executive liability and indemnity coverage and there is no showing that indemnification payments will be made); *Houston v. Edgeworth (In re Edgeworth),* 993 F.2d 51, 56 (5th Cir. 1993); *In re CHS Elecs., Inc.,* 261 B.R. 538 (Bankr. S.D. Fla. 2001) (proceeds are not property of the estate where there is no entity coverage and there were sufficient proceeds from settlement for indemnity claims); *In re Daisy Sys. Sec. Litig.,* 132 B.R. 752 (N.D. Cal. 1991) (proceeds not property of the estate where policy provided for direct coverage of directors and officers only); *Duval v. Gleason,* 1990 WL 261364, at *5 (N.D. Cal., Oct. 19, 1990) (ruling that, although a D&O policy was property of the estate, the court was "not persuaded that the insurance policy proceeds ... necessarily constitute 'property' of the debtor policy-owner within the meaning of §541(a)(I) such that the present proceedings [against non-debtor co-defendants] must be stayed").

[8] *See e.g., Leslie Fay, supra,* 207 B.R. 764 (D&O policy, with indemnity, but not entity coverage, was property of the estate because debtor has property interest in preventing the depletion of policy limits).

[9] *See, e.g., In re Allied Digital Techs. Corp.*, 306 B.R. 505 (Bankr. D. Del. 2004).

[10] *See In re Bialac,* 712 F.2d. 426, 431 (9th Cir. 1983).

be a judgment or finding against the debtor...[A]n illustration of such a situation would be a suit against a third-party who is entitled to absolute indemnity by the debtor on account of any judgment that might result against them in the case."[11] In addition, this relationship may exist where codefendant liability is "directly attributable to the debtor." Courts have also extended the stay to non-debtor third parties where stay protection is essential to the debtor's reorganization efforts.[12]

3. Relief from Stay

When deciding whether to lift the stay, courts weigh the potential harm to the estate against the rights of the party seeking to lift the stay. For example, *In re CyberMedica*[13] concerned officers and directors of a chapter 7 corporate debtor who had been named as defendants in a proceeding brought by the trustee, and who moved for relief from stay in order to seek payment of defense costs under the debtor's D&O policy. The bankruptcy court held that proceeds available under the D&O policy, which not only provided direct coverage to the debtor's officers and directors, but also provided coverage to the debtor for indemnity and third-party claims, were property of the estate, but that cause existed to lift the automatic stay because the officers and directors "may suffer substantial and irreparable harm if prevented from exercising their rights to defense payments." The Court further held that the harm to the debtor was speculative because there presently were no claims for indemnification or entity coverage.

D. Limitations and Exceptions from Coverage

D&O policies contain a number of exclusions to coverage, including those for willful acts, false and misleading statements that violate securities laws, dishonest, fraudulent or criminal acts, and personal profit. The most typically considered exclusions are the insured vs. insured exclusion and rescission of policies.

1. Insured vs. Insured Exclusion

The insured v. insured exclusion bars coverage for claims made by an insured (e.g., the corporation) against another insured (e.g., the directors or officers). This exclusion becomes important in bankruptcy cases where a court appoints a trustee who then sues an officer or director of the debtor. The insurer may argue that the trustee, as successor in interest to the company, is an "insured" under the debtor's insurance policy. The courts are split on whether the insured vs. insured exclusion bars coverage for suits filed on behalf

[11] *A.H. Robins, supra,* 788 F.2d at 999, 1004 (relying on both the automatic stay provision and the bankruptcy court's equitable powers under 11 U.S.C. §105 to enjoin actions against non-debtor codefendants in product liability litigation because of the potential impact on the estate and the availability of insurance proceeds to satisfy the claims). *See also In re American Film Techs., Inc.,* 175 B.R. 847, 855 (Bankr. D. Del. 1994); *In re Family Health Servs.,Inc.,* 105 B.R. 937, 942-43 (Bankr. C.D. Cal. 1989).

[12] *See, e.g., In re Lazarus Burman Assocs.,* 161 B.R. 891, 899-900 (Bankr. E.D.N.Y.1993) (enjoining guaranty actions against non-debtor principals of debtor partnerships because principals were the only persons who could effectively formulate, fund, and carry out debtors' plans of reorganization); *In re Nelson,* 140 B.R. 814, 816-17 (Bankr.M.D.Fla.1992) (enjoining actions against non-debtor guarantor of corporate debtor's obligations where guarantor was debtor's president his services, expertise and attention were essential to reorganization).

[13] 280 B.R. 12 (Bankr. D. Mass. 2002).

of a bankrupt corporation (e.g., by a bankruptcy trustee or other bankruptcy representative) against its officers or directors. The vast majority of courts, however, have found the exclusion does not apply to claims brought by bankruptcy trustees.

The case most cited for the proposition that the insured v. insured exclusion applies is *Reliance Insurance Company v. Weis*,[14] where a chapter 11 post-confirmation committee sued the debtor's former officers, alleging breach of fiduciary duty and negligence. The former officers requested coverage from Reliance Insurance Co, which had issued a D&O policy. Reliance filed a declaratory judgment action to determine whether or not the insured v. insured exclusion applied to deny coverage. The provision stated that Reliance "shall not be liable to make any payment for loss in connection with any claim made against the directors and officers ... by or on behalf of a director and/or officer or by or on behalf the company." *Id.* at 578. The court found that the committee stood "in the shoes of the corporation," and that committee's suit against corporation's officers and directors was barred by the insured vs. insured exclusion.

Although the reasoning in *Reliance* has been followed by at least one court,[15] many subsequent decisions have reached the contrary result. For example, in *Rieser v. Baudendistel*[16], the bankruptcy court rejected the decision in *Reliance* and held that a bankrupt corporation and its trustee in bankruptcy are separate legal entities and, therefore, the chapter 7 trustee's claims against the debtor's officers and directors was not barred by the insured vs. insured exclusion. Similarly, in *Alstrin v. St. Paul Mercury Ins. Co.*[17], the Delaware District Court agreed that the insured v. insured exclusion should not apply to claims brought by a bankruptcy estate representative against the former directors and officers of the debtor where the debtor was the insured entity, because the estate representative and the debtor are separate entities. Courts reaching this result have also reasoned that that the parties intended the insured v. insured exclusion to prevent collusive suits. Because a bankruptcy trustee is not an adverse party and does not represent the interests of any party that could be a participant of a conspiracy to collude, allowing coverage raises no concerns of collusion.[18]

In *Terry v. Federal Insurance*[19], however, the bankruptcy court found that concerns of collusion could arise where a trustee is not appointed by the court but instead obtains standing by virtue of a voluntary assignment by the debtor. The debtor's plan of reorganization provided for the creation a trust. The debtor designated a trustee and transferred to the trust all claims against directors and officers. The trustee commenced an adversary proceeding against the debtor's former officers. The trustee notified the insurer

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[14] 148 B.R. 575, 582 (E.D. Mo. 1990), *affd*, 5 F 3d 523 (8th Cir. 1993), *cert. denied*, 510 U.S. 1117 (1994).
[15] *See National Union Fire Ins. Co. of Pittsburgh, PA. v. Olympia Holding Corp., et al.*, 1996 WL 33415761 (N.D. Ga.), *aff'd without opinion*, 148 F.3d 1070 (Table) (11th Cir.1998) (finding no distinction between debtor and trustee and holding that insured v. insured exclusion barred trustee's claims).
[16] *(In re Buckeye Countrymark, Inc.)*, 251 B.R. 835 (Bankr. S.D. Ohio 2000).
[17] 179 F.Supp.2d 376, 404 (D.Del. 2002).
[18] *See In County Seat Stores*, 280 B.R. 319 (Bankr. S.D.N.Y. 2002). *See also Alstrin, supra*, 179 F.Supp.2d 376; *Gray v. Executive Risk Indem., Inc., et al. (In re Molten Metal Tech., Inc.)*, 271 B.R. 711 (Bankr. D. Mass. 2002); *In re Pintlar Corp.*, 205 B.R. 945 (Bankr. D. Id. 1997).
[19] *(In re R.J. Reynolds-Patrick County Mem'l Hosp.)*, 315 B.R. 674 (Bankr. W.D. Va. 2003).

that it had made claims against the officers which might give rise to a claim for coverage under the policy. The insurer denied coverage on the grounds that the claims asserted by the trustee were excluded by virtue of the insured v. insured clause in the policy.

The policy excluded claims that are "brought or maintained by or on behalf of any Insured," including any claims that are brought or maintained by or on behalf of the debtor. The exception did not apply, however, to derivative actions brought or maintained on behalf of the debtor by persons "who are not Insured persons, and who bring or maintain the Claim without the solicitation, assistance or participation of [the Debtor]." The exception to the exception contained another exception excluding coverage for derivative actions brought with the "solicitation, assistance, or participation" of the debtor. *Id.* at 677.

In holding that the exclusion barred the trustee's claim, the court emphasized that the debtor had voluntarily assigned the claim under the confirmation plan, stating that "the determining factor is that the Trustee steps into the shoes of the Debtor by virtue of a voluntary affirmative act of the Debtor, not by the involuntary appointment of a chapter 11 trustee . . . [T]he exclusions cannot be avoided by the process of assigning the claims to another entity merely for the purpose of avoiding the exclusion." *Id.* at 678-679. The court further held that fears of collusion, while not present in cases involving bankruptcy trustees appointed by the court, did exist where the claims had been voluntarily assigned. "In a case in which the debtor voluntarily transfers the causes of action to a third party, there is the distinct possibility of collusion between the debtor and the directors and officers." *Id.* at 681.

Tab 2: Materials from *In re Centrix Financial, LLC*

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO

In re CENTRIX FINANCIAL, LLC, *et al.*, Debtors,	Bankruptcy Case No. 06-16403 EEB Chapter 11 **Jointly Administered**
CENTRIX FINANCIAL LIQUIDATING TRUST and JEFFREY A. WEINMAN in his capacity as Trustee for the Centrix Financial Liquidating Trust, Plaintiffs, v. NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA., and AIG DOMESTIC CLAIMS, INC. Defendants.	Adversary Proceeding No. 09-01150

CLOSING ARGUMENT OF DEFENDANTS NATIONAL UNION AND AIG DOMESTIC CLAIMS CONCERNING THE EVIDENTIARY HEARING ON DEFENDANTS' MOTION FOR SANCTIONS FOR SPOLIATION OF EVIDENCE

TABLE OF CONTENTS

INTRODUCTION

Spoliation sanctions are appropriate when (1) a party has a duty to preserve evidence because it knew, or should have known, that litigation was imminent, and (2) the other party was prejudiced by the destruction of the evidence. *See 103 Investors I, L.P. v. Square D Co.*, 470 F.3d 985, 989 (10th Cir. 2006); *see also EEOC v. Dillon Cos.*, 839 F. Supp. 2d 1141, 1144 (D. Colo. 2011). The uncontroverted evidence proves the destruction of a significant number of relevant documents after Centrix, its counsel, Plaintiffs, and Plaintiffs' counsel all knew that a duty to preserve had arisen, and yet took no steps to preserve the destroyed evidence. Accordingly, dismissal and/or other serious sanctions are necessary.

ARGUMENT

I. The Duty to Preserve Evidence Arose No Later Than July 2007.

The duty to preserve documents arises when a party knows or should have known "that future litigation is likely." *Cache La Poudre Feeds, LLC v. Land O'Lakes, Inc.*, 244 F.R.D. 614, 620-21 (D. Colo. 2007) ("putative litigants have a duty to preserve documents that may be relevant to pending or imminent litigation") (citing *Zubulake v. UBS Warburg, LLC*, 220 F.R.D. 212, 216 (S.D.N.Y. 2003). This obligation is especially clear in the case of a plaintiff because the plaintiff, more than any other party, has "full knowledge of the possibility of future litigation." *Sekisui Am. Corp. v. Hart*, 945 F. Supp. 2d 494, 507 (S.D.N.Y. 2013).

Centrix was the insured under the fidelity bond. TX 3. Weinman filed this lawsuit as the successor to Centrix. *See* Amended Complaint [DKT. 22] at ¶¶ 1 and 11. Therefore, the duty to preserve first arose when Centrix and its agents knew or should have known that litigation was likely regarding Sutton's alleged bad acts. Many of the events giving rise to the preservation obligation are summarized in the timeline attached as Appendix A. Plaintiffs presented no evidence disputing this evidence or otherwise controverting that the duty to preserve arose no

later than July 2007, before documents were destroyed. The following undisputed facts confirm that Centrix and its agents and counsel knew by July 2007 that litigation regarding Sutton's acts was not just likely, but certain:

- On October 4, 2006, Hansen informed Sutton's personal attorney, Jeffrey Jonas, that "[I]nvestors will be filing a lawsuit today or tomorrow at the latest against Funds, Sutton, etc. for fraud, breach of fiduciary duty." TX 716; TR at 171:12-18 (Hansen testimony).
- On October 7, 2006, Creditors Committee counsel Michael Richman informed Craig Hansen, Centrix's lead bankruptcy counsel at the law firm of Squire Sanders & Dempsey ("Squire"), that the Creditors' Committee "intend[ed] to sue [Robert Sutton] for bad acts" and that Sutton is "a bad guy and has done bad things." Tr. of Hrg. on Mot. for Sanctions Conducted March 5 and 6, 2015 [Dkt. 272] (hereinafter "TR"), at 165:20 and 166: 14-15.
- On October 25, 2006, the Creditors Committee objected to the proposed release of Centrix's claims against Sutton, stating the claims against Sutton and others "may well prove to be the most valuable assets available for creditor recoveries." TX 55, at 3–4.
- On October 29, 2006, Jim Thomas, a Squire partner and Centrix's lead outside litigator in the bankruptcy, met with Hansen, Centrix Chief Restructuring Officer Tim Boates, Centrix General Counsel Scott Roswell to discuss the obligation to preserve documents. *See* TX 706; TR at 240:19 - 242:21. Although Centrix's outside counsel (Thomas and Hansen), inside counsel (Roswell), and CRO (Boates) all recognized their preservation duty, none of them took any steps to preserve their own relevant documents.
- On November 26, 2006, Thomas briefed a team of Squire attorneys on Centrix, telling them Sutton "[r]an the business fraudulently" and that, "[a]t end the day he will be sued personally by parties." TR at 244:9-15; *see also* TX 697, at 4 (S. Ballin notes of meeting).
- In January 2007, Centrix's bankruptcy attorneys negotiated a Tolling and Standstill Agreement with the Creditors Committee and others, in which the parties agreed to preserve all documents pertaining to claims against Sutton. *See* TX 719 and 720. In a February 1, 2007 email, Michael Richman, the Foley & Lardner ("Foley") partner who served as lead counsel to the Committee of Unsecured Creditors, told Centrix's bankruptcy attorneys at Squire that "Docs and info should be preserved, period." *Id.*
- Hansen testified that during his involvement with Centrix the Creditors Committee counsel wanted to be in "control" of the Centrix estate claims against Bob Sutton because the creditors would be the eventual beneficiary of such litigation. TR at 166:6 - 166:18.
- On February 6, 2007, as part of the approval of the sale of Centrix assets, this Court ordered that Centrix's books and records be preserved. TX 2001.[1] At this point, Tim Boates was the CRO of Centrix and was functioning as the CEO. *See* TR at 85:25 -

[1] This stipulated exhibit is in Plaintiff's book of exhibits for the Spoliation Hearing.

90:21. He knew that he had conducted all of his work for Centrix using his personal computer and his personal AOL account, rather than a Centrix email address that would go through the Centrix server). *See* TR at 93:12 - 94:11 (re use of personal laptop) and 100:4-10 (re use of personal AOL account). Despite these facts, Boates took no steps to back up or otherwise preserve his documents. *See* TR at 112:13 - 113:1. And despite the court's order, none of Centrix's inside or outside lawyers ever instructed Boates to preserve his documents. *See* TR at 91:2 - 92:9; 95:6-17.

- On February 7, 2007, Lyndon insurance company filed a lawsuit against Centrix and Sutton alleging various bad acts by Sutton. TX 47.
- On March 14, 2007, Everest insurance company filed a lawsuit against Sutton and other Centrix insiders alleging similar bad acts by Sutton. TX 46.

By the Spring of 2007 Centrix and its agents were trying to develop a claim against National Union under the fidelity bond. This activity reinforced the obligation to preserve documents -- particularly those pertaining to purported discovery of wrongdoing by Sutton -- because such "discovery" is a critical element in any fidelity bond claim. *See Block v. Granite State Ins. Co.*, 963 F.2d 1127, 1127 (8th Cir. 1992); *Driskill v. El Jamie Marine, Inc.*, Civ. A. No. 87-4136, 1988 WL 93606, at *2 (E.D. La. Sept. 7, 1988). The following events reinforced the document preservation obligation:

- On March 15, 2007, after the sale of the Centrix assets, Squire communicated with the Centrix General Counsel (Scott Roswell) to send letters to former Centrix employees telling them of the obligation to preserve their Centrix-related documents. TX 668, at 2. Although Centrix understood that these instructions needed to be sent to former employees, the same instructions were not delivered to Boates or the lawyers themselves.
- In early April 2007, Squire, Boates and Larry Bass of Holme Roberts & Owen ("HRO"), who had taken over the lead role as bankruptcy counsel for Centrix, engaged in a long email exchange scheduling and discussing the agenda for an upcoming meeting among them in Chicago, which appears to have taken place on May 14, 2007. *See* TX 1043, at 797-800. During this exchange, on April 30, 2007, Roswell emailed Bass, with a cc to Boates, stating, "One agenda I suggest we cover is document retention." *Id.* at 797.
- On May 4, 2007, Creditors Committee counsel sent Bass a letter in anticipation of the May 14 meeting, stating that she also wanted "to discuss a protocol to ensure that all documents are preserved for our review." TX 669; *see also* TR at 302:4-8. Despite this letter and Roswell's similar desire to discuss document preservation at the Chicago meeting, there was no effort by Centrix, its counsel, or the Creditors Committee to develop such a protocol or to otherwise preserve relevant documents. *See* TR at 369:2-5 (Weinman admitting that he was unaware of any protocol being implemented); TR at

302:11-25 (Bass admitting receiving "protocol" letter, and stating that HRO never received a document hold request).

- On May 16, 2007, Boates filed a Notice of Claim with National Union under the fidelity bond. *See* TX 2; TR at 332:1-14. Boates testified that he understood that he had a preservation obligation arising from his assertion of the fidelity bond claim, but neither Boates nor Bass took any steps to preserve their documents.
- By May 2007, Bass testified that the Creditors Committee counsel was firmly in control of the claim against National Union under the fidelity bond. TR at 314:22-315:13. The billing records show that there was substantial communication between Bass, Boates, and Creditors Committee counsel about filing the claim with National Union, as well as the subsequent preparation of the Proof of Loss. As described below, none of these emails were preserved or produced by Centrix in this case.
- In July 2007, Creditors Committee counsel confirmed to Bass that they would handle Centrix's claim against National Union on a contingent fee basis and that Centrix should "put the entire case but for the litigation on freeze while we attempt to gain more resources through litigation." *See* TX 672.

When Jeffrey Weinman was appointed as Trustee in May 2008, he assumed both retroactive and prospective discovery obligations. First, as discussed below, Weinman assumed responsibility for all of Centrix's spoliation up to that point, because a trustee takes "possession and control of a lawsuit encumbered by [the debtor]'s misconduct and, as successor-in-interest, [is] subject to sanction for that misconduct." *Ehrenhaus v. Reynolds*, 965 F.2d 916, 920 (10th Cir. 1992). Second, and independently, when Weinman became Trustee (and again when he later became a plaintiff in this action), he became the Trust's managing agent and assumed his own "*continuing* duty to exercise reasonable efforts to preserve and produce [relevant] documents." *Lewis v. ASAP Land Exp., Inc.*, Civ. A. No. 07-2226, 2009 WL 2580315, at *2 (D. Kan. Aug. 20, 2009) (emphasis added).[2] His failure to perform that duty contributed mightily to the destruction of documents by Squire and HRO in the second half of 2008, and to the destruction of Tim Boates' emails in 2009, a year *after* Weinman was appointed.

[2] *Accord LaJocies v. City of N. Las Vegas*, No. 08-CV-00606, 2011 WL 1630331, at *2 (D. Nev. Apr. 28, 2011) (awarding spoliation sanctions for party's breach of "continuing duty to preserve" evidence during litigation).

In short, reasonable efforts to comply with the obligation to preserve documents should have included meeting with key witnesses -- such as Boates, who submitted the fidelity bond claim (TX 2, 10), the attorneys at Squire who participated in investigating Sutton's alleged bad acts (TX 284, 706), and Larry Bass, who assisted Boates in asserting and prosecuting the fidelity bond claim -- and ensuring that they preserved relevant documents. *Zubulake v. UBS Warburg LLC*, 229 F.R.D. 422, 432 (S.D.N.Y. 2004); *Cache La Poudre Feeds*, 244 F.R.D. at 629. But it is undisputed that no one took any steps, at any time, to preserve critical documents, and that as a result countless documents were destroyed after July 2007 and even more after May 2008.

II. It Is Undisputed That Substantial Relevant Evidence Was Permanently Lost and Destroyed by Boates, Squire, and HRO.

According to Plaintiffs, Boates and Centrix's lawyers at Squire and HRO played a critical role in uncovering the alleged bad acts of Bob Sutton, which comprise the losses alleged in this case. *See* TX 865, at 6, and TX 1006, at 2. Yet, relevant and critical evidence from all of these key players was destroyed because neither Centrix nor Plaintiffs made any effort to ensure that their documents be preserved.

A. Critical Documents on Boates' Computer Were Destroyed in 2009.

Tim Boates was Centrix's CRO, and functional CEO, from before Centrix's bankruptcy filing until confirmation of the liquidation plan in May 2008. *See* TR at 85:25 - 90:21. Plaintiffs describe Boates as "one of the most important if not the most important witness in the case." *See In re: Centrix Financial, LLC, et al.*, Case 1:09-cv-01542 (D. Colo.), Pl.'s Mtn. to Adjourn June 8 Trial Date (1/29/15) [Dkt. No.99]. It was Boates who submitted the Notice of Claim to National Union in May 2007, and executed the sworn affidavit for the Proof of Loss in January 2008, detailing Centrix's claim. *See* TX 2 and TX 10. Plaintiffs also contend that Boates was involved in discovering the alleged loss under the fidelity bond on March 17, 2007. *See* TX 865,

at 6. National Union vigorously disputes Boates' purported "discovery date," and contend that if discovery occurred before March 17, 2007, Plaintiffs' claim under the Bond fails. *See FDIC v. St. Paul Cos.*, 634 F. Supp. 2d 1213 (D. Colo. 2008).

Given Boates' key role at Centrix and pervasive involvement in the fidelity bond claim, his emails are self-evidently critical to this case. In particular, National Union has no other way to conclusively prove that the March 17, 2007, date is a fiction, created after the fact. But most of Boates' emails are gone, because Boates used his personal laptop computer and personal AOL email account for Centrix business (not a Centrix email address that would go through the Centrix server), *see* TR at 93:12 - 94:11; 100:4-10; *see also* TX 1043, never backed up his computer or emails, *see* TR at 112:13 - 113:1, and, as discussed below, lost all of his emails and other Centrix records due to a computer virus.

It is undisputed that no one -- not Centrix's counsel, not Weinman, and not Weinman's lawyers -- ever took any steps to ensure that Boates' own documents were preserved. *See* TR at 95:6-17; 108:4-9. Boates admitted that he never received any type of litigation hold notice, formally or informally. *Id.* Furthermore, neither Plaintiffs nor their counsel did anything from May 2008 forward to preserve Boates' emails and other electronic documents. *Id.*

Boates testified that in February 2009, more than six months after Weinman was appointed as Trustee and only a month before Plaintiffs filed this lawsuit, the laptop that Boates used while working for Centrix was infected with a computer virus. *See* TR at 97:5-19. At that time, Boates was working as a consultant for Centrix's successor, Flatiron, and asked a Flatiron IT employee to look at his computer when the screen froze. *See* TR at 97:15-19. Although the employee was able to recover some of Boates' personal financial documents, according to Boates, he did not recover anything else. *See* TR at 98:16 - 99:21. Boates decided not to seek

further IT assistance to see what could be saved from his computer. *See* TR at 103:5-9. Instead, he "donated" his laptop to a "destruction service" in June 2009, three months after Plaintiffs filed this lawsuit. TR at 104:2-19. Because Boates never backed up his hard drive, every Centrix email and document saved locally on his computer was irretrievably lost. *See* TR at 99:22-25, 100:18 - 102:1, 102:24 - 103:4.

Weinman suggested at the evidentiary hearing that Boates' emails were actually preserved somewhere because his hard drive was somehow included with documents retained by Centrix or Flatiron. *See* TR at 378:18 - 379:4. This contention is flatly contradicted by Boates' own testimony that he never backed his computer up and lost all of his electronic data concerning Centrix due to the virus and later destruction of his computer. *See* TR 112:13 - 113:1; 99:22-25; 100:18 - 102:1; 102:24 - 103:4. Indeed, Weinman himself conceded that Boates was able only to retrieve limited personal information from his computer, *see* TR 379:24 - 380:3, that Boates had been unsuccessful in retrieving emails through AOL, *see* TR 380:4-6, that Boates had not suggested that he had retrieved his emails from Flatiron, *see* TR 380:7-9, and that he really didn't know whether Boates' emails were ever included in the materials that Boates transferred to Flatiron in 2007, *see* TR 380:10-14.

Plaintiffs also suggested that Boates' emails were largely preserved because he included a Centrix employee on his communications. The evidence also disproves this contention. [3] Boates acknowledged sending "easily 20 emails a day" during the active period of the bankruptcy, *see* TR at 94:15 - 94:25, yet discovery from all sources yielded only 426 total emails authored by Boates during his nearly two years working with Centrix, fewer than one email per day. *See* TX

[3] Plaintiff likewise suggested that Boates produced significant hard copy materials related to his engagement at Centrix. To the contrary, that production included a total of 21 pages of hard copy documents. *See* TR at 110:9 - 111:18; TX 1002.

1046 and Appendices B and C.[4] There is not a single day during Boates' two year Centrix engagement for which discovery has yielded 20 emails that he authored. *See id.* Indeed, the highest one day total is 12, on November 14, 2006. *See id.* The next highest daily total is 10 (October 5, 2006). *See id.* For the vast majority of the two year period discovery has yielded zero emails authored by Boates. *See id.* And perhaps most importantly, from the period March 17, 2007, when Boates allegedly discovered the loss, to the end of his Centrix engagement nearly 15 months later, discovery has yielded only 22 emails, none of which deal with his alleged discovery, the filing of the notice, or the filing of the Proof of Loss. *See* TX 1046 and TX 1043 and Appendices B and C.

In addition, emails to or from Boates to Craig Hansen or Chris Johnson at Squire or Larry Bass at HRO, and not copied to anyone else, would have been lost because they never passed through a Centrix server and because the lawyers also destroyed their emails. *See infra.* Boates admitted that he had significant communications with these attorneys, *see* TR, at 86:23 - 87:9, but no emails remain between just these key players. The evidence also shows that Boates sent countless emails to non-Centrix people, *see* TX 1046 (showing 78 emails to non-Centrix employees), contrary to his assertion that he would have included a Centrix employee on "substantially all" of his emails. *See* TR at 91:24. National Union obtained a small number of Boates' emails to or from certain third parties whose emails still were preserved five years after their Centrix engagement, but the key players at Squire and HRO all deleted their emails, as many third parties likely did, at least in part.

In short, Plaintiffs cannot seriously dispute that Boates' emails were destroyed and that National Union will never know the full extent of Boates' communication about his alleged

[4] Appendices B and C are visual aids that summarize in tabular and graphical form the data included in TX 1046.

"discovery" of the losses or the claim he asserted for Centrix under the fidelity bond. Similarly, the evidence proves the documents were lost forever because Plaintiffs and their counsel took none of the legally required steps to preserve Boates' documents after May 2008. *Zubulake*, 229 F.R.D. at 432 (plaintiff had an obligation to "oversee compliance with the litigation hold, monitoring the party's efforts to retain and produce the relevant documents"). Had Plaintiffs made any effort to check in with Boates at any point prior to February 2009, Boates' documents would never had been destroyed and would be available to National Union today. *See* Appendix D (summary timeline of Boates' document destruction).

B. Craig Hansen and Chris Johnson Intentionally Deleted Their Centrix Emails in Late 2007 / Early 2008, and Squire Intentionally Deleted Countless More Centrix Emails from Other Attorneys in September or October 2008.

Centrix hired Squire in June 2006. Craig Hansen was the lead bankruptcy counsel for Centrix, Chris Johnson was lead corporate attorney, and James Thomas was the lead litigator in the bankruptcy. Squire continued working for Centrix through approximately April or May 2007. *See* TX 1047 at 1, 21; TX 712 at 59. The Squire attorneys, including Hansen, Johnson, and Thomas, are additional "key players" in this lawsuit due to their involvement in matters that go to the heart of the issue of discovery of the alleged loss and investigations into Sutton's alleged wrongdoing. *See* TX 284 & 706 (investigating Universal, Lyndon, and Founders issues). Hansen also discussed with Creditors' Committee counsel both the release of claims against Sutton and, relatedly, potential legal actions against Sutton. *See, e.g.*, TR at 158:5 - 159:7. Plaintiffs have maintained that the investigations of Sutton and other Centrix insiders by attorneys at Squire, including Hansen and Thomas, contributed to the process of discovering the losses that are the basis of this lawsuit. *See* TX 865, at 6, and TX 1006, at 2.

During the bankruptcy, Hansen and Johnson had a practice of moving Centrix-related emails to a "Centrix" folder each created in Outlook. *See* TR at 181:14 - 182:18. In 2008, or

possibly late 2007, Hansen and Johnson affirmatively and intentionally deleted their Centrix email folders, destroying every email they had retained related to this case. Wall Dep. at 42:25 - 43:25; TX 714; *see* TR at 185:21 - 186:2 (Hansen testimony). Then, in September or October 2008, five months after Weinman became Trustee, Squire implemented a new email destruction policy that automatically deleted all emails in any custodian's Inbox or Sent folder that was more than one-year old. *See* Wall Dep. at 24:5 to 25:17. Thus, for all other Squire custodians who had not separately foldered their emails (including all their sent emails), all Centrix-related emails were destroyed in September or October 2008.

The Squire attorneys testified that they did not understand that they were potential witnesses or that they had discoverable materials because no one at Centrix (including its General Counsel Scott Roswell) or the Creditors Committee (who were purportedly "controlling" the claims associated with Sutton's alleged bad acts) so informed them. TR 185:21–186:2; 250:12-23. Furthermore, neither Plaintiffs nor their counsel instructed the Squire attorneys to preserve their documents after Weinman was appointed in May 2008. TR at 185:21 - 186:2. Had Centrix or Plaintiffs taken the required steps to ensure that Squire attorneys preserved their documents, those documents would not have been destroyed and would be available today. *See* Appendix E (summary timeline of Squire document destruction).

C. HRO Intentionally Deleted Emails On a Rolling Basis 215 Days After They Were Sent or Received.

HRO was engaged as local bankruptcy counsel to Centrix in September 2006 and served as lead bankruptcy attorneys from shortly after the asset sale in mid-February 2007 until the confirmation of the liquidating plan in May 2008. *See* TR at 265:15 - 269:12; *see also* TX 852, at 233. Larry Bass was the lead attorney for HRO and is another "key player" in this lawsuit because he was involved in many of the critical events -- the purported discovery of the losses in

March 2007, the Notice of Claim to National Union under the fidelity bond in May 2007, and the filing of the sworn Proof of Loss in January 2008. TX 2, 10.

At the time of HRO's engagement with Centrix and through 2009, HRO's email system permanently deleted emails in an attorney's inbox and sent folder after 215 days. *See* Robinson Dep. at 21:18 to 22:24 (testifying that email would reside in inbox/sent mail for 150 days, in deleted items for another 30 days, be on backup tape for 5 weeks, and then irretrievably deleted); *id.* at 46:9-17. During its Centrix engagement and thereafter, HRO did not impose any litigation hold for documents pertaining to its Centrix representation. *See* Buhler Dep. at 84:16-25, 91:19 to 92:7, 101:3-19. Therefore, Centrix-related emails were destroyed in the ordinary course 215 days after their creation, beginning in July 2007 and continuing into early 2009.

As a result, National Union has obtained only a very few emails authored by Bass. TX 1048 (showing only 195 such emails). Most of those were produced not by HRO, but by other parties. *Id.* (107 of the 195 Bass-authored emails produced came from parties other than HRO).[5] Of course, because Boates and the Squire attorneys all destroyed their emails, National Union will never know the full extent of the deleted emails to or from Bass. But the HRO billing records discussed below give a small window into emails that we know were destroyed and relate directly to the central issues in the case. *See infra* at pp. 17.

Although Bass was involved in submitting the Notice of Claim to National Union in May 2007 and the Proof of Loss in January 2008 (and billing records prove that Bass had numerous emails about both), no emails to or from Bass on those subjects were produced. Notably, Bass's emails pertaining to the Proof of Loss submitted to National Union on January 15, 2008, would have been available on the HRO system in May 2008, when Weinman was appointed Trustee.

[5] The absence of emails from Bass in the productions is not surprising given that his practice was to only print certain emails to place them in a physical file. *See TR* at 326:8 - 327:5.

But they were later destroyed because Plaintiffs and their counsel did nothing to satisfy his independent obligation to reach out to Bass or other attorneys at HRO to instruct them to preserve their documents. *See* TR 306:1–22 (Bass); 393:19–23 (Weinman); *see also* Buhler Dep. at 91:19 to 92:7.

The Creditors Committee's counsel (Ms. Uetz) had sent a letter to Bass on May 4, 2007, expressing a desire "to discuss a protocol to ensure that all documents are preserved for our review." TX 669. HRO and Bass did not read that letter to be a preservation request directed at HRO. *See* TR at 304:1-8 and 305:21-25. Moreover, neither the Creditors Committee counsel nor Plaintiffs ever followed up with any "protocol" to ensure that HRO documents were preserved for review or informed Bass that he was a potential fact witness in the case. *See* TR at 369:2-5 (Weinman admitting that he was unaware of any protocol being implemented); TR at 302:4-25 (Bass admitting receiving "protocol" letter, and that HRO never received document hold request). Accordingly, HRO took no steps to preserve its own emails relating to Centrix, and many were destroyed in the ordinary course 215 days after creation, including after Weinman became the Trustee. *See* Buhler Dep. at 84:16-25, 101:3-19; *see* Appendix F (summary timeline of HRO document destruction).

III. National Union Has Been Prejudiced by the Wide-Ranging Document Destruction

"Destroying the best evidence relating to the core issue in the case inflicts the ultimate prejudice upon the opposing party." *Computer Assocs. Int'l v. Am. Fundware*, 133 F.R.D. 166, 169–70 (D. Colo. 1990).[6] While the full extent of the spoliation in this case will never be known, the destruction by Boates, Squire, and HRO was pervasive and encompassing. National

[6] *See also Arista Records, L.L.C. v. Tschirhart*, 241 F.R.D. 462, 465 (W.D. Tex. 2006) (same, with respect to destruction of computer hard drive); *In re Quintus Corp.*, 353 B.R. 77, 93 (Bankr. D. Del. 2006) (issuing "the most severe sanction of judgment" for prejudice caused by destruction of evidence that "goes to the heart of" opponent's suit).

Union's burden of proving prejudice must be understood in light of the reality that no one will ever know the full extent of the evidence destroyed. *See Phillips Elec. N. Am. Corp. v. BC Tech.*, 773 F.Supp.2d 1149, 1199 (D. Utah 2011) (noting that the extent of the spoliation made it difficult to determine "the full scope of [the spoliator's misconduct] and has impeded the [plaintiff's] ability to obtain evidence relevant to the claims and defenses at issue in this case").

The central thrust of Plaintiffs' presentation at the hearing was that National Union is complaining that certain parties did not produce duplicate copies of emails that were in fact produced by other parties. On that basis and on the basis of the millions of pages of records that have been produced, Plaintiffs deny that National Union has been prejudiced by the wholesale destruction of documents that undeniably occurred here. While the "duplicates" issue alluded to by Plaintiffs confirms that thousands of emails were in fact destroyed by Boates, Squire and HRO, Plaintiffs' argument ignore the real basis of National Union's motion. Specifically, National Union has identified many specific, critical documents whose past existence (but not contents) are proven by testimony from witnesses, references in attorney billing records or other exhibits. National Union also proved the absence of emails on entire subject areas that are critical to National Union's defenses, despite witness testimony confirming that there once existed emails concerning those topics. The destroyed documents go to the very heart of some of the primary defenses in this case -- whether Centrix discovered the losses during the Bond Period, whether Centrix complied with the Bond's notice requirements, and whether Plaintiffs filed their lawsuit within the Bob's time limitation. Given those realities, Plaintiffs' focus on the duplicates issue and millions of pages of other largely irrelevant documents is entirely misplaced.

The nature of the evidence lost to history because of spoliation is perhaps best revealed by an analysis of Larry Bass's email message to Foley partner Michael Richman, a portion of

which is preserved in TX 666 because it was cut and pasted into a message that Bass later printed and put in his paper file. In the original, destroyed email, Bass stated his position that a claim could not be brought under the fidelity bond because such a claim would not be timely:

> It appears that there are no timely claims that can be made against the debtors' E&O or other insurance policies. . . . If you [Richman] or the Committee feel strongly to the contrary based on your review of the policies I provided you when we met in Phoenix, we'd be pleased to discuss the issue on tomorrow morning's call, but otherwise I just wanted to let you know of the planned non-renewal.[7]

TX 666. This document sits at the center of the issues of discovery and notice, which are among National Union's most important defenses in this case. Bass's email suggests that he analyzed the fidelity bond to determine whether a timely claim could be made. It suggests that the issue of timeliness of a fidelity bond claim was a topic that may have been addressed in a meeting in Phoenix on March 15, 2007. TX 835, at 24-25. It suggests that Bass had later discussions with Boates, the Creditors' Committee and Foley regarding how and, if so, why claims under the fidelity bond are timely. In fact, on March 16, 2007, the day after the Phoenix meeting, Mr. Bass's own billing records prove that he had an "email exchange with T. Boates re outcome of meeting with Lyndon and Committee," TX 835, at 25, but that "email exchange" was destroyed forever by both Boates and Bass, and thus had never been produced.

Written evidence on each of these issues is highly probative on the central issue in the case. Yet, at his deposition Bass had absolutely no recollection of the "no timely claims" email and only a vague recollection of discussion with Centrix regarding cancellation of the fidelity

[7] The substance of the email confirms that Bass's reference to "no timely claims" under "other insurance policies" included the fidelity bond. The email states that canceling the policies would allow the estate to recover close to $100K in insurance premium refunds. *See* TX 666 at 1. The same exhibit shows that there were 5 separate policies, including the Financial Institution Bond (i.e., the fidelity bond) that, if cancelled, would equal $100,000 in refunds. *See id.* at 2-3. The fidelity bond comprised $47,412 of that total. *See id.* at 2.

bond and return of unearned premiums.[8] *See* TR at 284:20 - 288:18. National Union, in turn, has no other written evidence or testimony regarding the actual date of this email from Bass to Richman (other than it was after the March 15, 2007 meeting held in Phoenix). It has no other written evidence or testimony regarding whether there was more text in this email other than what was cut and pasted. It has no other written communications back and forth between Bass, Boates, or Richman on this issue. And, it has no other written testimony or evidence regarding any discussions at the Phoenix meeting regarding claims under the fidelity bond. In short, based on the surviving fragment of Bass's email we know critical issues were discussed and debated in March and April 2007, but because of the destruction of those emails and Bass's uncertain memory we will never know what the discussion was, or why Bass articulated an opinion that is directly contrary to Plaintiffs' central claim in this case.

National Union contends that "discovery" under the fidelity bond occurred at the latest in the fall of 2006. By the spring of 2007, National Union contends that the lawyers involved in the bankruptcy proceeding, including Bass and various Foley attorneys, were addressing whether notice under the fidelity bond would be timely and, if not, how they could develop a theory to survive a defense of untimeliness. The Phoenix meeting referred to in Bass' email occurred two days before Boates' alleged discovery on March 17, 2007. TX 835, at 24-25. Bass and Boates had an email exchange (now destroyed) on March 16, 2007, regarding the outcome of the Phoenix meeting. TX 835, at 25. Bass' "no timely claims" email indisputably came after the

[8] Bass' memory of the Centrix bankruptcy was, at best, extremely limited. *See* TR at 270:13-15 (stating that with respect to his Centrix engagement, "I'll stipulate that I will fail that [memory] test miserably"); see, e.g., other excerpts from Bass showing a lack of recall regarding critical events during Centrix bankruptcy proceedings: TR at 273:1-6; 276:9-14; 279:7-10; 280:6-12; 280:13-21; 282:9-16; 283:22-25; 285:8-12; 288:2-5; 292:5-8; 338:15-339:1; 295:17-24; 296:18-297:2; 299:15-300:21; 312:11-19; 312:25-313:12; 313:25-314:21; 315:14-316:14; 318:18-23; 319:14-19; 334:3-13; *see* also Bass Dep. at 74:8-12; 74:18-19; 83:10-17; 83:18-23; 84:7-15; 85:9-18; 86:16-87:12; 90:21-91:6; 149:5-24; 151:13-20; 152:1-21; 171:10-20; 225:21-226:8; 226:23-227:25; 255:10-22.

meeting in Phoenix. These facts suggest that Boates did not, in fact, make any discovery on March 17, 2007. Instead, what appears to have happened is that the lawyers held a meeting in Phoenix on March 15, 2007 and then or thereafter concocted a scheme to bring a claim under the fidelity bond, even though they believed there were "no timely claims." The destruction of evidence by Boates and Bass ensures that National Union will never know.

At the hearing, National Union put on substantial, uncontroverted evidence of a number of other relevant documents that were destroyed, including:

1. **Squire report providing factual background regarding an investigation into potential claims against Sutton, including the facts and law supporting such claims.**

Evidence of Spoliation: Bass testified that Squire prepared such a report, which he reviewed and which detailed claims against Sutton. *See* TR 298:22 - 299:3; 328:6-23.

Materiality and Prejudice to National Union: This report likely would confirm that Squire and Boates knew the details of the potential claims against Sutton long before Plaintiffs claim and that Sutton would be sued for fraud.

2. **Squire memorandum regarding insurance policies.**

Evidence of Spoliation: Squire billing records show that K. Singer billed 25 hours from 8/22-24/2006 as follows: "Research and analyze case law regarding insurance policies and assumption and assignment under the bankruptcy code" and "draft memorandum regarding research results." TX 1016 at 45-47. This memo has never been produced.

Materiality and Prejudice to National Union: This memorandum likely would show that Squire knew about the fidelity bond in August 2006 and might have analyzed what Squire knew at that time about the relationship between the bond and Sutton's alleged misconduct.

3. **"Roswell Summary" concerning deponents from November 22, 2006.**

Evidence of Spoliation: Stephanie Niehaus (Squire) printed out an email from Thomas (Squire), which stated, "Resending the Roswell summary on the deponents." TX 1000. Niehaus did not print out the summary, and the second page of the email is missing.

Materiality and Prejudice to National Union: This summary likely would confirm that Squire and Centrix General Counsel (Roswell) knew that Sutton would ultimately be sued for fraud, *i.e.*, that there was more than just a mere suspicion. In addition, just days after sending this summary of Centrix deponents from Roswell, Thomas described Sutton as having "run the business fraudulently." TR at 244:9-15; *see also* TX 697, at 4 (S. Ballin notes of meeting).

4. Initial Everest complaint sent March 9, 2007 from Thomas (Squire) to Roswell, Boates, Hansen and other Squire attorneys.

Evidence of Spoliation: Email attached a draft of the Everest complaint 5 days before the complaint was actually filed. *See* TX 688; Hansen Dep. at 168:3-8; 169:9-18:171:2-7.[9] The attachment has never been produced.

Materiality and Prejudice to National Union: This draft likely would show that discovery occurred prior to March 17, 2007.

5. Emails among Boates, Bass and Foley in March 2007 regarding activities around the time of the alleged discovery and in May 2007 regarding Notice of Claim.

Evidence of Spoliation: HRO billing entries in March 2007, around the time of the alleged discovery of the losses, include references to "email exchange with T. Boates" re "Meetings at Squire Sanders ... re transition issues, plan, claims, Lyndon litigation, etc.," "email exchange with T. Boates re outcome of meeting with Lyndon and Committee," "Email exchange with T. Boates re wind-down issues" and "Email exchange with T./ Boates" and Foley" re "status, etc." TX 835, at 25. Similarly, HRO billing records for 5/15/07 and 5/16/07 evidence email correspondence between Bass, Boates, and Foley re: "notice of claim (Financial Institution Bond)" and "claims v. bonding company and finalize notice of claim." TX 835 at 112. Foley billing records for 5/15/07 and 5/16/07 identify "email from L. Bass attaching revised notice of claim" and "email from L. Bass on notice of claim" and related response. TX 834 at 31. None of these emails have been produced.

Materiality and Prejudice to National Union: Communications around the time of the alleged discovery and concerning the notice of claim likely would show the perceptions of Boates, Bass, and Foley as to the timeliness of the notice and the creation of Boates' fictional discovery of the alleged loss in March 2007.

6. Emails in January 2008 regarding Proof of Loss

Evidence of Spoliation: HRO billing records for 1/11/08, 1/13/08, 1/15/08, 1/16/08, and 1/22/08 prove that there were communications between Bass, Boates, Uetz and other Foley attorneys re: "fidelity bond proof of loss", "AIG proof of loss," "revised proof of loss (fidelity bond)," and "AIG stipulation." TX 852 at 98. Foley billings records for 1/11/08 and 1/13/08 also reflect communications between Bass, Uetz, and other Foley attorneys re: "fidelity bond policy provisions" and "proof of loss and appendix thereto." TX 847 at 26. None of these emails have been produced.

Materiality and Prejudice to National Union: Communications regarding the notice likely would show the perceptions of Boates, Bass, and Foley as to the propriety of the items to include in the proof of loss and its timeliness.

[9] Citations to "Hansen dep." Refer to testimony from sections of Hansen's deposition designated for the Court's review but not included in the video played during the hearing.

7. Emails re: Analysis of Insurance Issues and Bonds

Evidence of Spoliation: Foley billing record for 2/28/07 prove that there was correspondence with Hansen regarding analysis of insurance issues and bonds. *See* TX 715; TR at 145:21 - 146:17; 148:14-20 (stating that he has no recollection of the substance of that correspondence). None of these emails have been produced.

Materiality and Prejudice to National Union: Records would likely show cognizance of bond and potential claims against Sutton more than 60 days before Centrix filed its initial notice.

The record also confirms the absence, and probably destruction, of a wide range of other relevant emails concerning topics that the evidence shows were the subject of email traffic, but with respect to which few if any emails have been produced. For example, the evidence shows that the fidelity bond was one of eight insurance policies that were specifically cited by Centrix in a first day motion seeking the Court's authority to continue paying premiums. TX 539 at 9. Although Hansen admitted that it is "unusual" to include insurance issues in a first day pleading, Hansen Dep. at 22:10-23:9, he has no recollection of why this first day motion was brought, *see id.* at 22:10-24; 24:14-25. And not a single email has surfaced explaining why the fidelity bond was included in the motion, who brought the fidelity bond to the attention of the Squire lawyers who filed the motion, or whether anyone considered, in September 2006 (when the first day motions were filed) whether a claim had already arisen under the fidelity bond. Other obvious gaps in the email record on critically important topics include:

Topic: Sutton release (Nov. 2006 and Dec. 2006)

Evidence of Spoliation: Boates testified that there would have been significant email traffic on this subject because it was hotly contested. *See* TR 113:25 - 115:4; *see also* TR162:12-18 (noting that there was a significant confrontation between Sutton's attorneys and Creditors' Committee regarding release); TR 233:16 - 234:3 (stating that there was discussion with Boates re: claims that could be brought against Sutton). There are only a handful of Hansen-authored emails from November and December 2006, *see* TX 1047 at 19 and TX 1044, and only one makes even a passing reference to the release issue, *see* TX 1044 at 681. Likewise, Of the small number of surviving Boates emails from the same two months, *see* TX 1046, only one makes a passing reference to Sutton's motion to enforce the APA in a manner that would secure him a release, see TX 1043, at 489.

Materiality and Prejudice to National Union: Emails on this topic likely would show Squire's and Boates' knowledge of Sutton's alleged fraudulent acts at a time much earlier than they claim.

Topic: Alleged discovery of loss by T. Boates (3/17/2007)

Evidence of Spoliation: There are no emails from Boates on 3/17/2007, the day he claims to have discovered that Centrix had a $20 million claim under the fidelity bond. In addition, there are no emails at all in March 2007 related to the purported discovery of the fidelity bond claim. *See* TX 1046 at 25; *see also* TX 1043 at 711.

Materiality and Prejudice to National Union: A complete record of Boates' email traffic likely would show definitively that Boates, in fact, discovered nothing on or after March 17, and thus would confirm that Plaintiffs' discovery theory is a fiction.

Topic: Notice to National Union (5/16/2007)

Evidence of Spoliation: There are no emails from Boates on 5/16/2007, the day Boates gave notice to National Union (or during the period 5/8 to 5/21), and no emails from Boates in May 2007 about giving notice to National Union at all. *See* TX 1046 at 26. Similarly, there are no emails from Bass on 5/16 (or during the period 5/12 to 5/21), and only a few emails from Bass in May 2007 (none relate to notice). *See* TX 1048 at 7.

Materiality and Prejudice to National Union: This topic likely would show discussions between Boates, Bass, and Foley regarding the timeliness of the notice under the Bond. Bass testified that he has no recollection of any conversation with Foley regarding the "elements of a claim under the National Union fidelity bond, what such a claim might consist of, what technical requirements might be associated with that sort of claim." TR 338:20 - 339:1.

Topic: Proof of loss (1/15/2008)

Evidence of Spoliation: Boates testified that there would have been emails to develop the Proof of Loss under the fidelity bond (TX 10) in January 2008. *See* TR 109:4-10. But, once again, there are no emails from Boates in January 2008 (or any other time) regarding the Proof of Loss. *See* TX 1046. Of the three surviving Bass emails from January 2008, *see* TX 1048, at 8, none were written on January 15 and none relate to the Proof of Loss, *see* TX 1045 at 399 - 403.

Materiality and Prejudice to National Union: This topic likely would show discussions between Boates, Bass, and Foley regarding timeliness of the proof of loss.

In short, the widespread destruction of these documents will, absent severe sanctions, deprive National Union of the opportunity to show, with contemporaneous records, what really happened here.

IV. Plaintiffs Stand in the Shoes of Centrix and Are Subject to Sanctions for Centrix's Discovery Abuses, as Well as Their Own.

Plaintiffs assert that they should be held blameless because the documents were destroyed by third parties, rather than Centrix or plaintiffs themselves. For two independent reasons, Plaintiffs are mistaken. First, as shown above, many of the documents in question, including in particular all of Boates' emails, were destroyed after Weinman became Trustee and failed, with his counsel, to fulfill his preservation obligations. Second, it is well established that a bankruptcy Trustee takes the claims of the debtor subject to the debtor's own discovery abuses, and is therefore subject to sanctions for the debtor's actions:

> Because the trustee's interest is no greater than that of the debtor, the trustee took possession and control of a lawsuit encumbered by [the debtor]'s misconduct and, as successor-in-interest, was subject to sanction for that misconduct. Although the sanction now affects parties other than the one who engaged in the wrongful conduct, the nature of the property interest transferred cannot be altered.

Ehrenhaus v. Reynolds, 965 F.2d 916, 920 (10th Cir. 1992). [10]

It is immaterial that Centrix did not employ the parties who destroyed documents. Boates was the company's court-appointed CRO, and everyone who destroyed documents -- Boates, Hansen, Johnson, Bass and the two law firms -- were Centrix agents. "A party may be held responsible for the spoliation of relevant evidence done by its agents." *Goodman v. Praxair Servs., LLC*, 632 F. Supp. 2d 494, 522 n.16 (D. Md. 2009) ([A]gency law is directly applicable to a spoliation motion, and the level of culpability of the agent can be imputed to the master."). [11]

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[10] *See also Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1150 (11th Cir. 2006) (defenses based on predecessor's misconduct can be asserted against trustee); *cf. Brick v. HSBC Bank USA*, 2004 WL 1811430, at *5 (W.D.N.Y. Aug. 11, 2004) (upholding sanction against trustee's counsel for failure to disclose information previously in the debtor's possession).

[11] *See also N.J. Mfrs. Ins. Co. v. Hearth & Home Techs., Inc.*, 2008 WL 2571227, at *7 (M.D. Pa. June 25, 2008) ("A party to a law suit, and its agents, have an affirmative responsibility to preserve relevant evidence. A [party]. . .is not relieved of this responsibility merely because the [party] did not itself act in bad faith and a third party to whom [the party] entrusted the evidence was the one who discarded or lost it.").

The fact that two of these parties were Centrix's attorneys does not change the result. An attorney is a "freely selected agent" of Centrix and, as such, there is "no merit to the contention that [sanctioning petitioner] because of his counsel's unexcused conduct imposes an unjust penalty on the client." *Link v. Wabash R.R.*, 370 U.S. 626, 633-34 (1962); *c f. Lifetime Prods., Inc. v. Correll, Inc.*, No. 2:02 CV 01366, 2004 WL 6034623, at *2 (D. Utah Mar. 24, 2004) ("Counsel, more than anyone, is aware of the duty [to preserve] and has the responsibility of advising those with whom counsel work."). Plaintiffs and their lawyers each had, and failed to fulfill, an independent duty to ensure that documents were preserved. Because those failures resulted in the destruction of documents, the spoliation is attributable to Plaintiffs.

V. Serious Sanctions Are Warranted Because Plaintiffs "Willfully Failed" to Preserve Critical Documents that Were Then "Intentionally Destroyed"

Plaintiffs maintain that they cannot be sanctioned in the absence of evidence of "bad faith." Under Tenth Circuit precedent, however, bad faith is a *sufficient* condition to impose spoliation sanctions, but it is not a necessary condition. Rather, a party that intentionally destroys documents or willfully fails to comply with a preservation duty possesses the requisite mental state to warrant severe sanctions, including dismissal.

The Tenth Circuit has held that a party is "not required to show that [an adversary] acted in bad faith in destroying the evidence in order to prevail on its request for spoliation sanctions." *103 Investors I, L.P. v. Square D Co.*, 470 F.3d 985, 989 (10th Cir. 2006).[12] Rather, even for severe sanctions, the requisite mental state of the spoliating party is *either* bad faith *or* intentional destruction. *See Smith v. Nichols*, 506 F. App'x 795, 799 (10th Cir. 2013) ("[C]ourts require evidence of intentional destruction or bad faith before a litigant is entitled to a spoliation

[12] *Accord Hatfield v. Wal-Mart Stores, Inc.*, 335 F. App'x 796, 804 (10th Cir. 2009); *Kokins v. Teleflex Inc.*, No. 06CV01018, 2007 WL 4322322, at *4 n.2 (D. Colo. Dec. 6, 2007) ("bad faith is not a requirement for a spoliation sanction").

instruction.").[13] Other circuits have reached the same conclusion, particularly where the aggrieved party shows substantial prejudice. *See Volcan Grp., Inc. v. Omnipoint Commc'ns, Inc.*, 552 F. App'x 644, 646 (9th Cir. 2014) (affirming dismissal of case for spoliation caused by "willfulness, fault, or bad faith").[14]

To be sure, courts in this Circuit have not always been precise when delineating the requirements of spoliation sanctions, and some have suggested (erroneously, in our view) that "bad faith" may be required for dismissal or an adverse-inference instruction, although not for lesser sanctions. *See, e.g., Turner v. Pub. Serv. Co. of Colorado*, 563 F.3d 1136, 1149 (10th Cir. 2009).[15] However, these cases often contrast bad faith with negligence or similar mental states, without considering intermediate culpability like "willful failure" to abide by preservation duties or "intentional destruction" of documents. *See, e.g., Jordan F. Miller Corp. v. Mid-Continent Aircraft Serv., Inc.*, 1998 WL 68879, at *4 (10th Cir. 1998) (unpublished) (contrasting bad faith with negligence and concluding that bad faith is not necessary for dismissal sanction).

This Court attempted to reconcile the relevant case law in *Gates Rubber Co. v. Bando Chem. Indus., Ltd.*, 167 F.R.D. 90 (D. Colo. 1996). In an exhaustive opinion, the Court noted that "[t]he cases generally are unanimous in declaring that a dispositive sanction may be imposed only when the failure to comply with discovery demands is the result of willfulness, bad faith, or some fault of a party other than inability to comply." *Id.* at 103. A "willful failure," the Court

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[13] *Accord Energy W. Mining Co v. Oliver*, 555 F.3d 1211, 1220 n.2 (10th Cir. 2009) (same); *Henning v. Union Pac. R. Co.*, 530 F.3d 1206, 1220 (10th Cir. 2008) (same).

[14] *See also King v. Am. Power Conversion Corp.*, 181 F. App'x 373, 376 (4th Cir. 2006) (bad faith not required "to justify dismissal if the spoliation of evidence effectively renders the defendant unable to defend its case"); *W. v. Goodyear Tire & Rubber Co.*, 167 F.3d 776, 779 (2d Cir. 1999) ("Dismissal is appropriate if there is a showing of willfulness, bad faith, or fault on the part of the sanctioned party."); *Glover v. BIC Corp.*, 6 F.3d 1318, 1329 (9th Cir. 1993) ("[A] finding of 'bad faith' is not a prerequisite to this corrective procedure, [although] [s]urely a finding of bad faith will suffice.").

[15] *Accord McCall v. Skyland Grain, LLC*, No. 08-CV-01128, 2009 WL 1203304, at *3 (D. Colo. Apr. 29, 2009)

explained, "is defined as 'any intentional failure as distinguished from involuntary noncompliance. No wrongful intent need be shown.'" *Id.* (quoting *In re Standard Metals*, 817 F.2d 625, 628–29 (10th Cir. 1987)). In other words, when a party "intentionally fail[s]" to preserve documents, as undeniably happened here, that party cannot avoid severe sanctions—including dismissal— by disclaiming any intent to commit a wrongful act. Moreover, the Court noted that "[t]he concept of misconduct seems mutable: not every instance of nondisclosure merits the same judicial response." *Id.* at 103. A court must account for the fact that "[t]he factors of 'mental state' and 'harm' slide past each other in the wide variety of circumstances which are presented by different cases." *Id.* Thus, in imposing sanctions, "judges need to balance the degree of misconduct evidenced by a party's mental state against the degree of harm which flows from the misconduct." *Id.* at 103–04; *accord Medcorp, Inc. v. Pinpoint Technologies, Inc.*, No. CIVA 08CV00867, 2009 WL 3588518, at *2 (D. Colo. Oct. 26, 2009).

As explained above, prejudice to National Union is at its apex here because Centrix and its agents intentionally destroyed the best evidence of when Centrix discovered the alleged losses—which is central to National Union's defenses based on untimely notice, the two-year contractual period of limitation, and rescission. As a result, dismissal is the appropriate sanction.

VI. Plaintiffs' Cumulative Misconduct Also Justifies Serious Sanctions.

Another factor justifying serious sanctions here is the fact that the Court has previously entered five orders enforcing Plaintiffs' discovery obligations, including one imposing sanctions.[16] Indeed, the Court has previously concluded that it has "never seen a trustee be as obstructive with the discovery process as the Court has witnessed in this case." TX 1006 at 3.

[16] *See* Dkt. 83 (3/21/2012 order granting motion to compel); Dkt. 161 (12/12/2012 order requiring production of law firm records); Dkt. 172 (4/16/2013 order requiring production of law firm records and threatening sanctions); Dkt. 182 (8/15/2013 order sanctioning Plaintiff and his attorneys); and Dkt. 196 (12/4/2013 order denying motion to reconsider Dkt. 182).

Along the way, the Court correctly observed that Plaintiffs' efforts to keep the Squire and HRO documents from National Union showed that the Plaintiffs were "merely attempting to disadvantage [National Union], who would literally have to try to find the needle in the proverbial hay stack, by sorting through a warehouse full of documents in order to find the communications between the Law Firms and Centrix." TX 1006 at 3. Later in the same order, the Court rejected Plaintiffs' protest that he should not be sanctioned for failing to produce certain emails from the law firms, holding:

> Plaintiff[s] misunderstan[d] why the Court imposed sanctions. It was not the failure to produce a few missing emails pointed out by the Defendants for illustrative purposes. Rather, this Court awarded sanctions based on the [Plaintiffs'] protracted failure to provide complete production and a detailed privilege log despite two previous Orders and the passage of more than 8 months since the first Order, coupled with counsel's obvious attempts to obstruct the discovery process as noted above.

Id. That obstruction connects directly to the spoliation, because the massive spoliation detailed above came to light only when the law firm documents finally were produced after years of motions practice and the five aforementioned court orders. Plaintiffs' past misconduct, coupled with their failure to take any steps to ensure that documents were preserved in this case, amply justifies dismissal of this case. *See, e.g., Lee v. Max Int'l, LLC*, 638 F.3d 1318, 1321 (10th Cir. 2011); *see also* Cases cited in National Union's Motion for Sanctions, [Dkt. 226] at 24-25. [17]

VII. The Spoliation Justifies Dismissal or, at a Minimum, Preclusion of Boates' Testimony and other Consequential Sanctions.

As detailed above, Tenth Circuit precedent amply justifies dismissal of a lawsuit where, as here, a party's intentional acts resulted in the destruction of relevant evidence. There is no serious dispute that such spoliation occurred here. That reality, particularly coupled with Plaintiffs' prior discovery misconduct, warrants dismissal.

[17] *See also Archibeque v. Atchison, Topeka and Santa Fe Ry. Co.*, 70 F.3d 1172, 1174–75 (10th Cir. 1995); *Jones v. Thompson,* 996 F.2d 261, 265 (10th Cir.1993); *Philips*, 773 F. Supp. 2d at 1156.

Should the Court decline to dismiss this case, consequential sanctions are nevertheless necessary. In particular, Tim Boates should be barred from testifying. As shown above, Boates' email trail is conspicuously thin because he destroyed his emails after Plaintiffs and their lawyers failed to preserve them. As a result, Boates is now free to conveniently parrot Plaintiffs' theory of discovery and is immune from cross examination based on his contemporaneous email record of what actually happened. Given the central role of Boates in the entire course of events underlying this case, it is fundamentally unfair for National Union to be deprived of such a cross examination opportunity because of the spoliation caused by Plaintiffs' and their predecessors, and only witness preclusion can remedy that wrong. *See 103 Investors*, 470 F.3d at 989 (affirming district court's exclusion of testimony as appropriate spoliation sanction).

Likewise, the record amply justifies entry of a factual finding that the losses underlying this case were discovered before March 13, 2007. Given the destruction of not only Boates' emails but those of Centrix's counsel, and the evidence showing that Centrix and its counsel were well aware of the claimed losses and Sutton's misconduct long before March 2007, such a factual finding is appropriate.

Finally, the Court should award significant monetary sanctions, to fully compensate National Union for Plaintiffs' persistent and unprecedented obstruction of discovery, which continue to the point of Weinman's incredible testimony at the sanctions hearing that Boates' emails were given to Flatiron, despite conclusive evidence to the contrary from Boates himself.

DATED this 25th day of March, 2015.

Respectfully submitted,

/s/ Edwin P. Aro
Timothy R. Macdonald, Attorney No. 29180
Edwin P. Aro, Attorney No. 18698
Holly E. Sterrett, Attorney No. 36684
ARNOLD & PORTER LLP
370 Seventeenth Street, Suite 4400
Denver, Colorado 80202-1370
Telephone: (303) 863-1000
Email: timothy.macdonald@aporter.com
ed.aro@aporter.com
holly.sterrett@aporter.com

Attorneys for Defendants National Union Fire Insurance Company of Pittsburgh, Pa. and AIG Domestic Claims, Inc.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 25th day of March, 2015, the foregoing **CLOSING ARGUMENT OF DEFENDANTS NATIONAL UNION AND AIG DOMESTIC CLAIMS CONCERNING THE EVIDENTIARY HEARING ON DEFENDANTS' MOTION FOR SANCTIONS FOR SPOLIATION OF EVIDENCE** was filed with the Clerk of the Court using the CM/ECF system which will send notification of such filing to all counsel of records as follows:

Ann Marie Uetz
FOLEY & LARDNER LLP
500 Woodward Avenue, Suite 2700
Detroit, Michigan 48226
Telephone: (313) 234-7114
auetz@foley.com

Linda Kornfeld
KASOWITZ, BENSON, TORRES & FRIEDMAN, LLP
2029 Century Park East, 14th Floor
Los Angeles, CA 90067
Telephone: (424) 288-7902
lkornfeld@kasowitz.com

Eileen R. Ridley
FOLEY & LARDNER LLP
555 California St, Ste 1700
San Francisco, CA 94104
eridley@foley.com

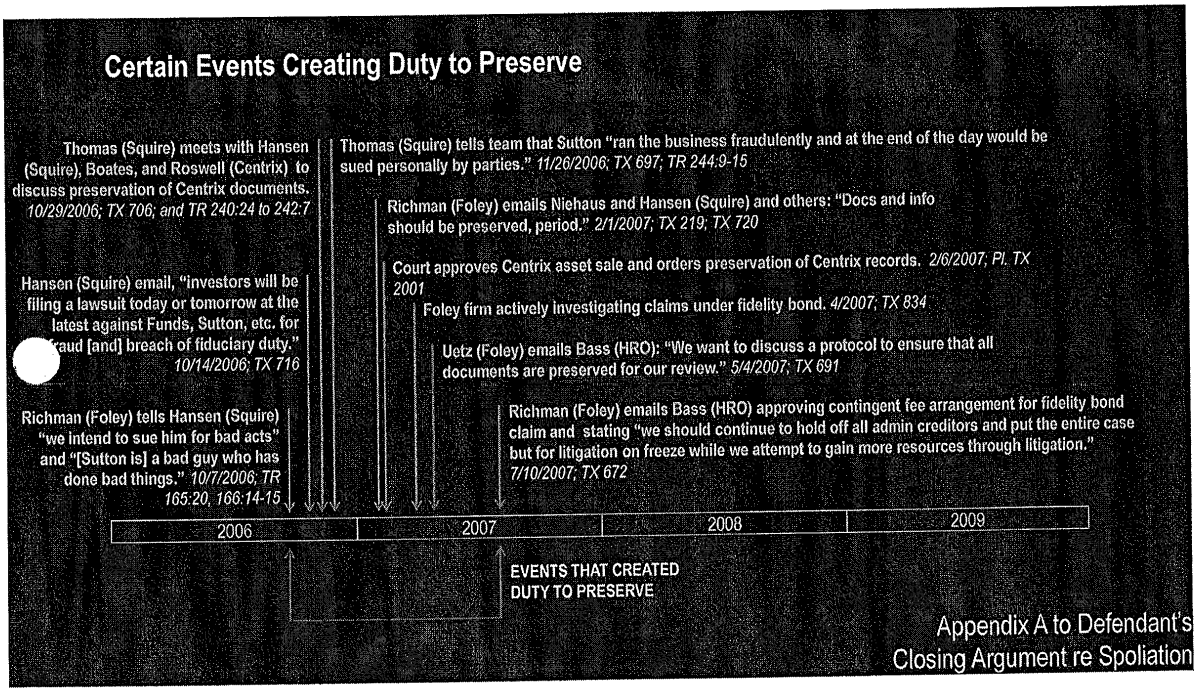
Robert Bressler
Foley & Lardner, LLP
321 North Clark Street, #2800
Chicago, IL 60654
312.832.4500
rbressler@foley.com

Jerold Oshinsky
KASOWITZ, BENSON, TORRES & FRIEDMAN, LLP
2029 Century Park East, 14th Floor
Los Angeles, CA 90067
Telephone: (424) 202-3626
joshinsky@kasowitz.com

John C. Smiley
LINDQUIST & VENNUM, PLLP
600 17th Street
Denver, CO 80202
jsmiley@lindquist.com

/s/ Linda J. Teater
Linda J. Teater

Appendix A


Certain Events Creating Duty to Preserve
Thomas (Squire) meets with Hansen (Squire), Boates, and Roswell (Centrix) to discuss preservation of Centrix documents. 10/29/2006; TX 706; and TR 240:24 to 242:7
Thomas (Squire) tells team that Sutton "ran the business fraudulently and at the end of the day would be sued personally by parties." 11/26/2006; TX 697; TR 244:9-15
Richman (Foley) emails Niehaus and Hansen (Squire) and others: "Docs and info should be preserved, period." 2/1/2007; TX 219; TX 720
Court approves Centrix asset sale and orders preservation of Centrix records. 2/6/2007; Pl. TX 2001
Foley firm actively investigating claims under fidelity bond. 4/2007; TX 834
Hansen (Squire) email, "investors will be filing a lawsuit today or tomorrow at the latest against Funds, Sutton, etc. for raud [and] breach of fiduciary duty." 10/14/2006; TX 716
Uetz (Foley) emails Bass (HRO): "We want to discuss a protocol to ensure that all documents are preserved for our review." 5/4/2007; TX 691
Richman (Foley) tells Hansen (Squire) "we intend to sue him for bad acts" and "[Sutton is] a bad guy who has done bad things." 10/7/2006; TR 165:20, 166:14-15
Richman (Foley) emails Bass (HRO) approving contingent fee arrangement for fidelity bond claim and stating "we should continue to hold off all admin creditors and put the entire case but for litigation on freeze while we attempt to gain more resources through litigation." 7/10/2007; TX 672
2006
2007
2008
2009
EVENTS THAT CREATED DUTY TO PRESERVE
Appendix A to Defendant's Closing Argument re Spoliation

Appendix B

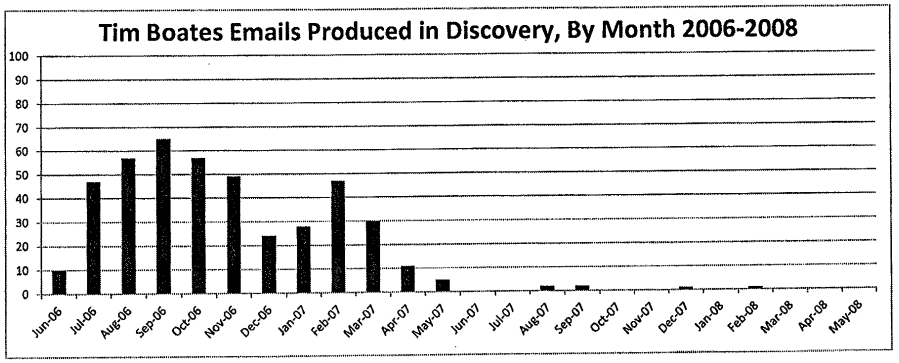
Summary of Emails Authored by Tim Boates Produced in Discovery

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31		Total	Before Alleged Discovery of Loss	After Alleged Discovery of Loss
Jun-06					1	1	1								1							1					1	2		2		Jun-06	**10**		
Jul-06					3					3		8	6				4	7	2	2				1	3	1	2	2	3			Jul-06	**47**	47	
Aug-06	6	8	2	2	1		5	1	6					1	1		6				1	2	2	3				2	3	4	1	Aug-06	**57**	57	
Sep-06	1				2	2	3	2	1		6	2	1	4	3		1	5	1	2	8	5	1		5	3	2	1	3	1		Sep-06	**65**	65	
Oct-06		3	2	2	10	1			3	1	5	2	1	2	1	2	1	4	3				2	2	2	2	6					Oct-06	**57**	57	
Nov-06	1	2				1	2	2	5				1	12	5	1			1	3	2	1						1	5	4		Nov-06	**49**	49	
Dec-06				2			1	1		1			6	4	1			3			1	1				1		1	1			Dec-06	**24**	24	
Jan-07			2		1			2			1				2	1	1			1		2	1	2	4	3		2	1	1	1	Jan-07	**28**	28	
Feb-07	1	3			8		3	3	7			1	1	1	4				3	2	2	2					2	4				Feb-07	**47**	47	
Mar-07	3	2			6	1	1	5	3				1	1						2			1				3	1				Mar-07	**30**	23	7
Apr-07		2		1								3				2		1									1			1		Apr-07	**11**		11
May-07			1				1															2		1								May-07	**5**		5
Jun-07																																Jun-07	**0**		0
Jul-07																																Jul-07	**0**		0
Aug-07						1																							1			Aug-07	**2**		2
Sep-07																1				1												Sep-07	**2**		2
Oct-07																																Oct-07	**0**		0
Nov-07																																Nov-07	**0**		0
Dec-07																											1					Dec-07	**1**		1
Jan-08																																Jan-08	**0**		0
Feb-08					1																											Feb-08	**1**		1
Mar-08																																Mar-08	**0**		0
Apr-08																																Apr-08	**0**		0
May-08																																May-08	**0**		0
TOTAL																																		397	22
																																	426		

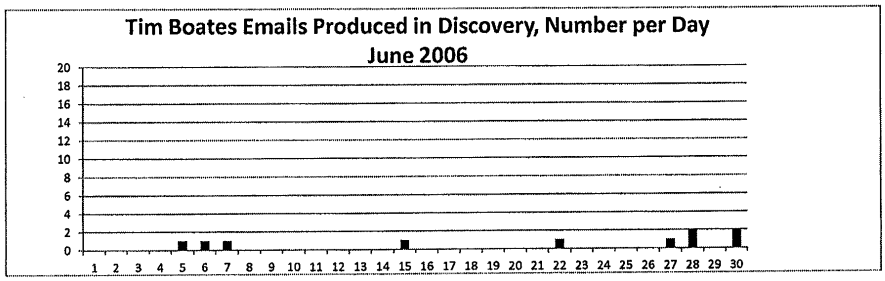
Appendix B to Defendants' Closing Argument re Spoliation

#35080891

Appendix C



Appendix C to Defendants'
Closing Argument re: Spoliation


Tim Boates Emails Produced in Discovery, Number per Day
June 2006
20
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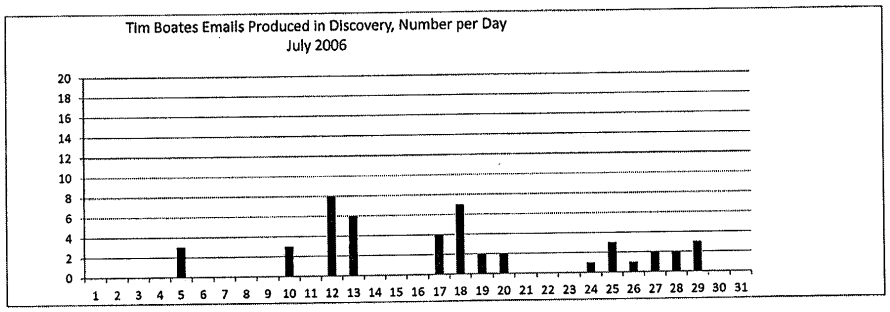
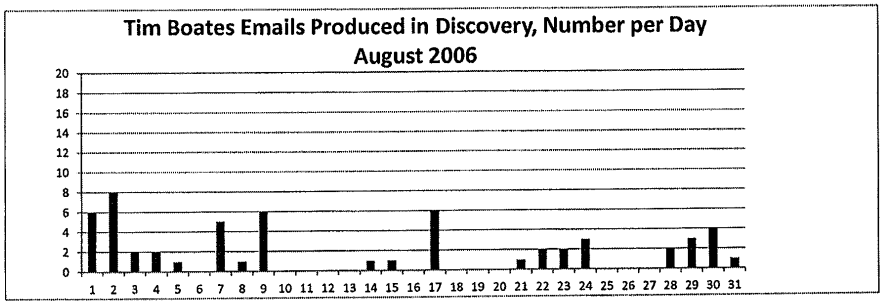


Appendix C to Defendants'
Closing Argument re: Spoliation


Tim Boates Emails Produced in Discovery, Number per Day
August 2006
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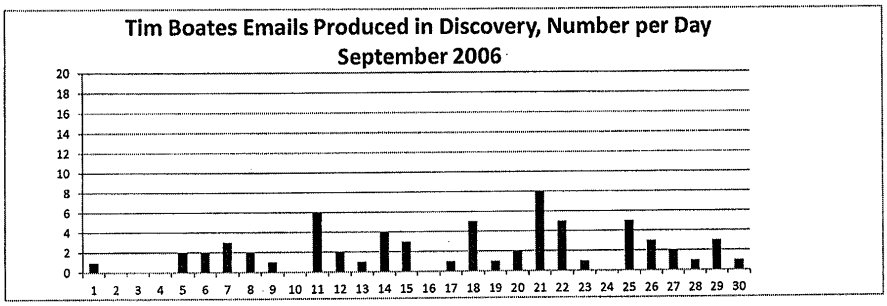
Tim Boates Emails Produced in Discovery, Number per Day
September 2006
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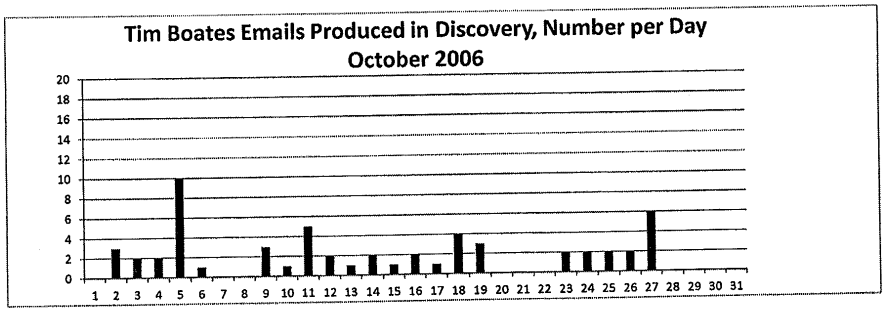
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October 2006
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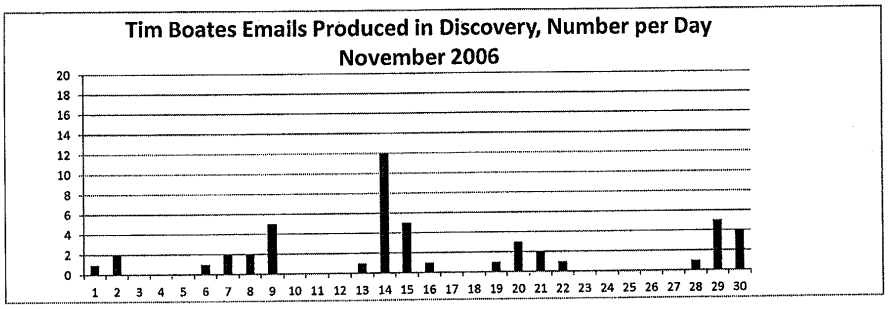
Tim Boates Emails Produced in Discovery, Number per Day
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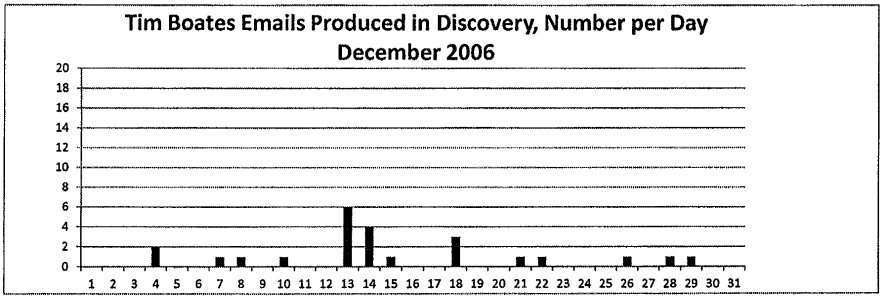
Tim Boates Emails Produced in Discovery, Number per Day
December 2006
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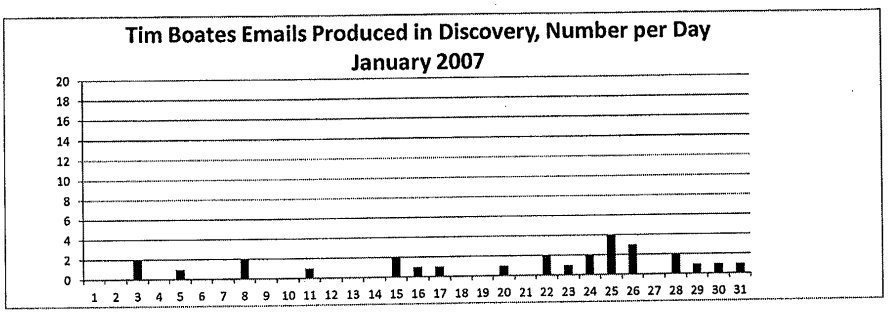
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30 31


Tim Boates Emails Produced in Discovery, Number per Day
January 2007
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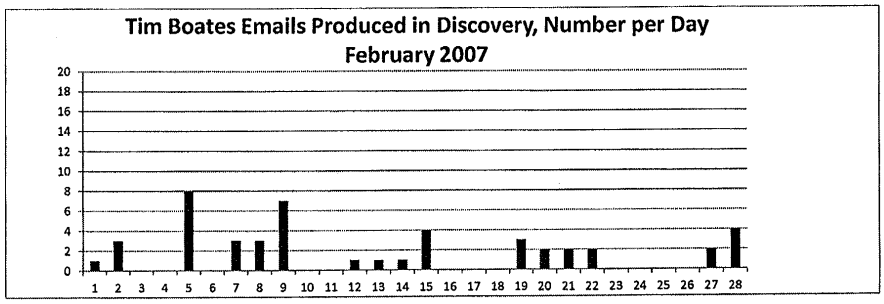
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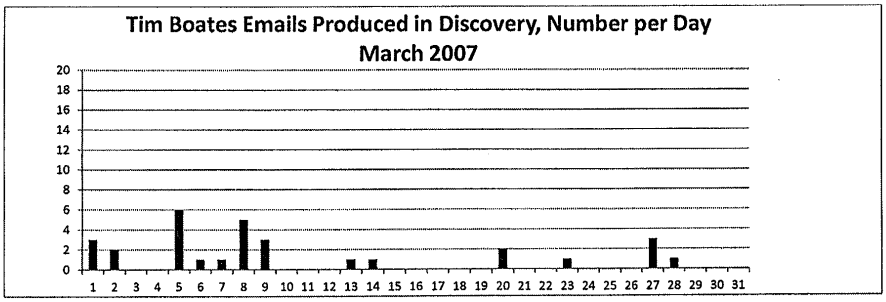
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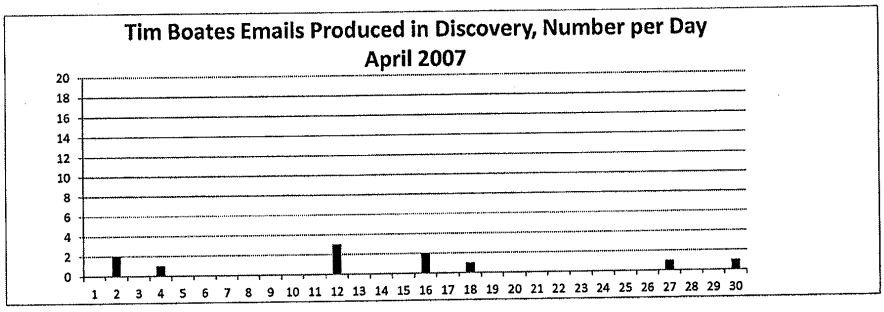
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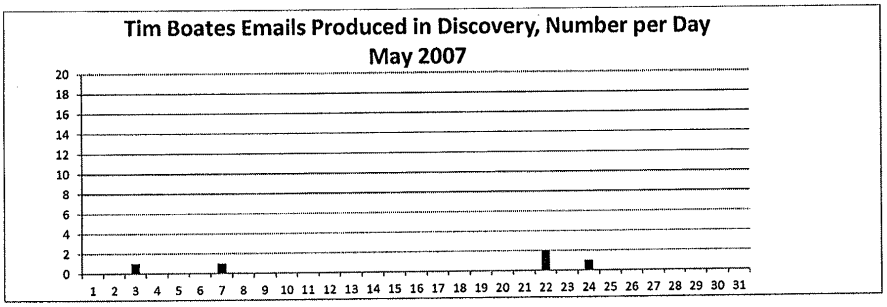
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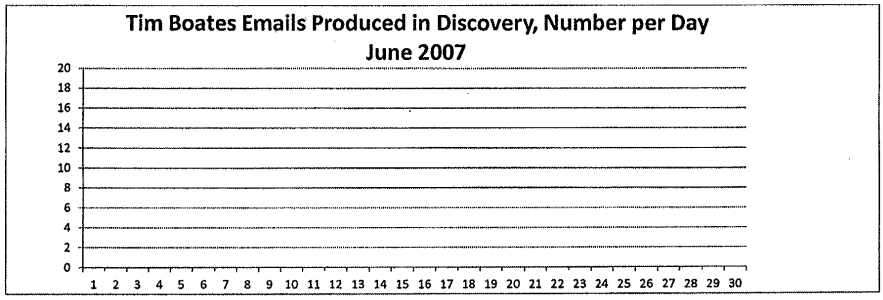
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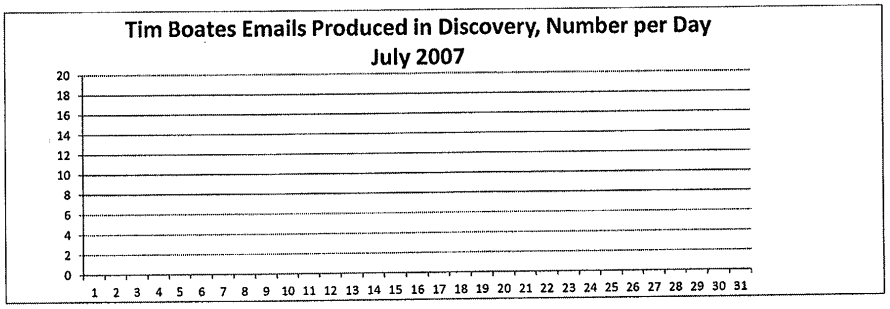
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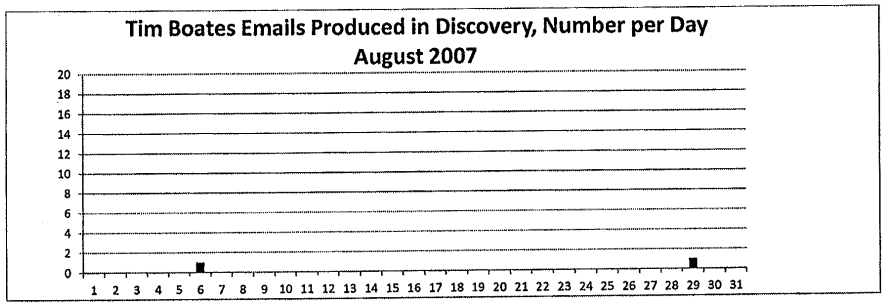
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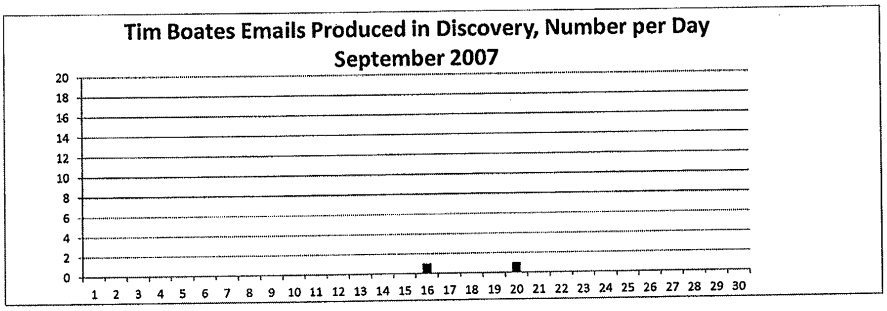
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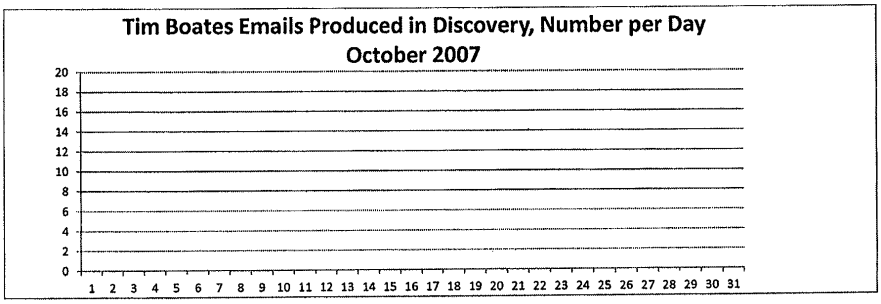
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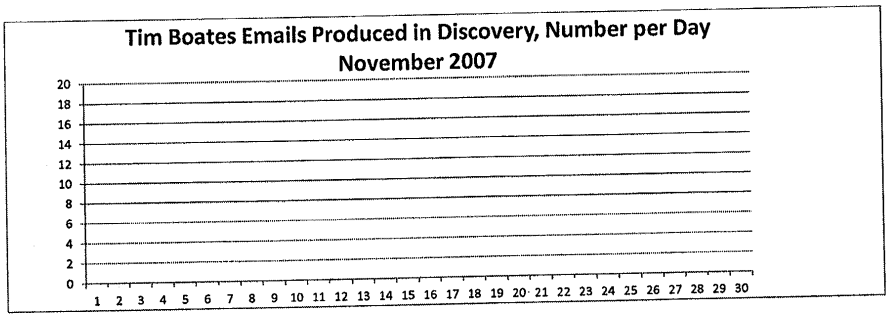
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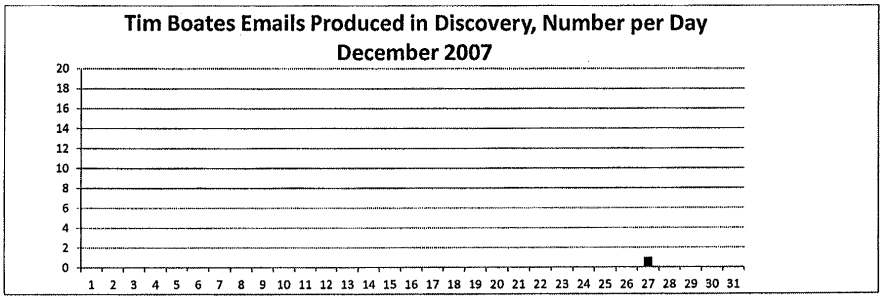
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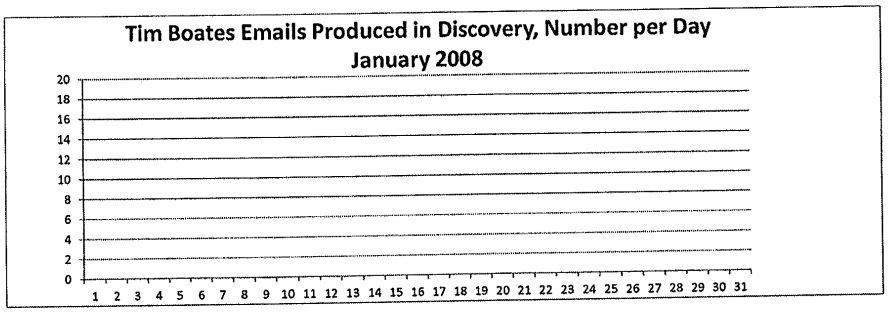
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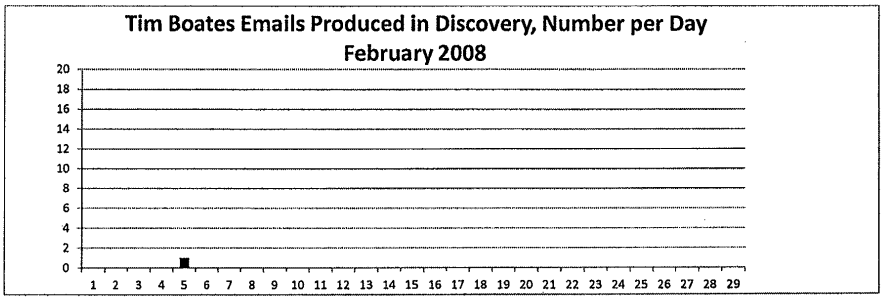
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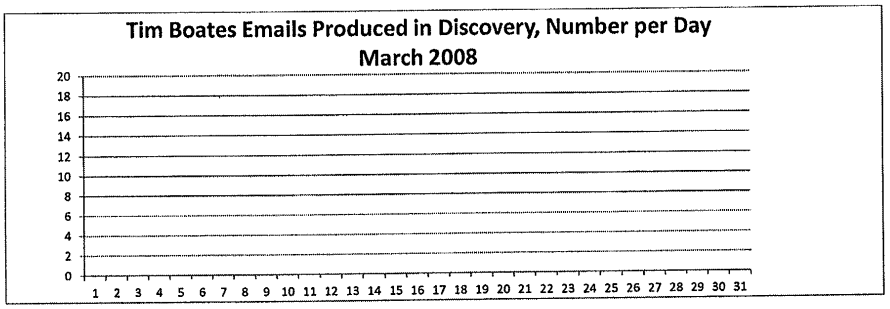
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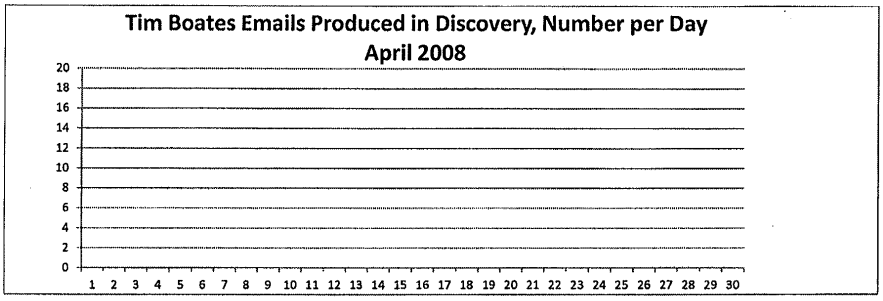
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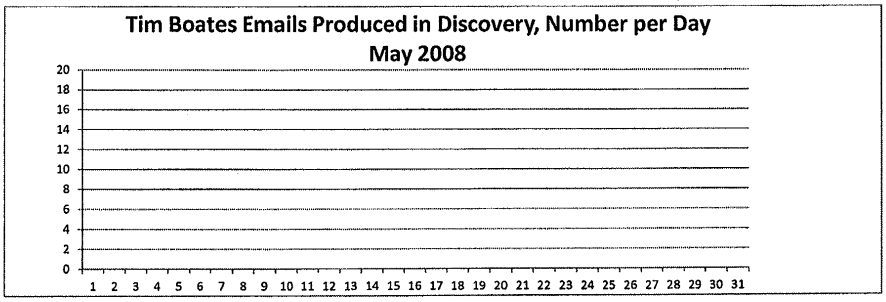
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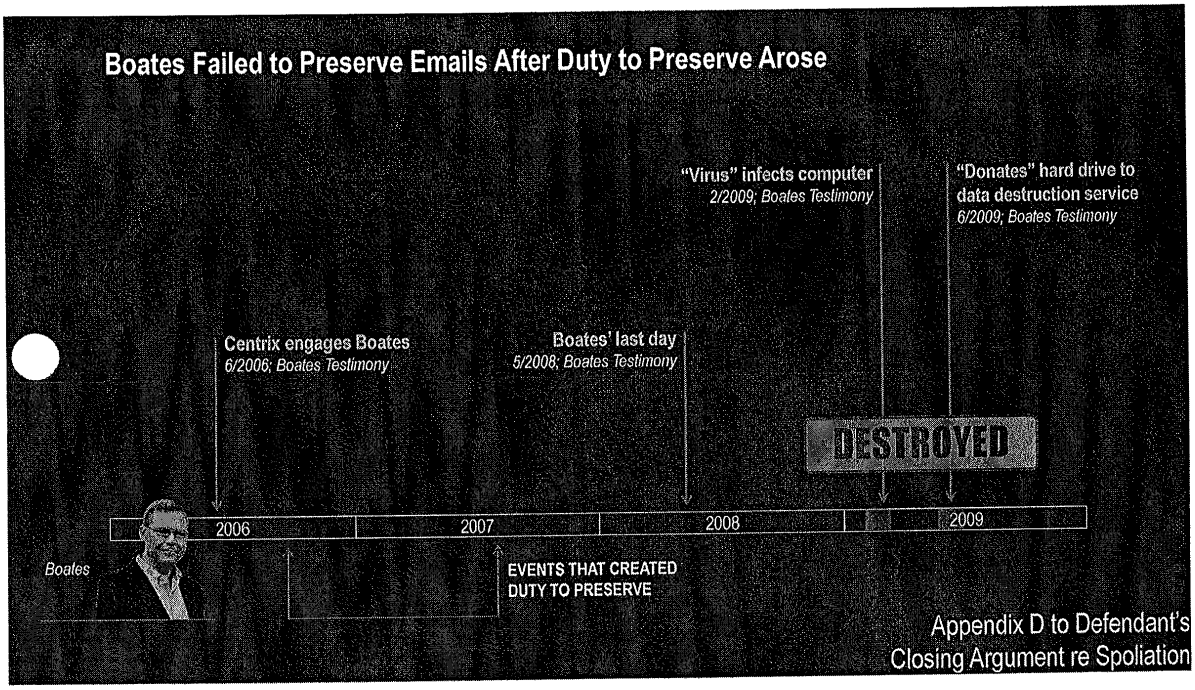
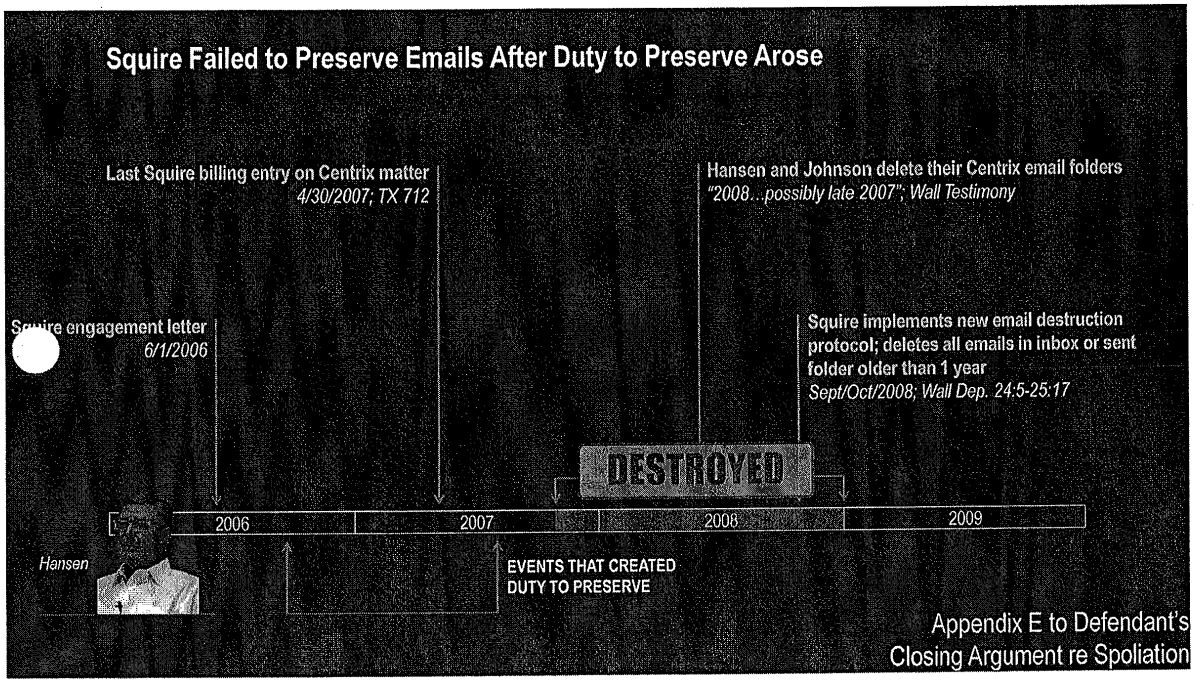
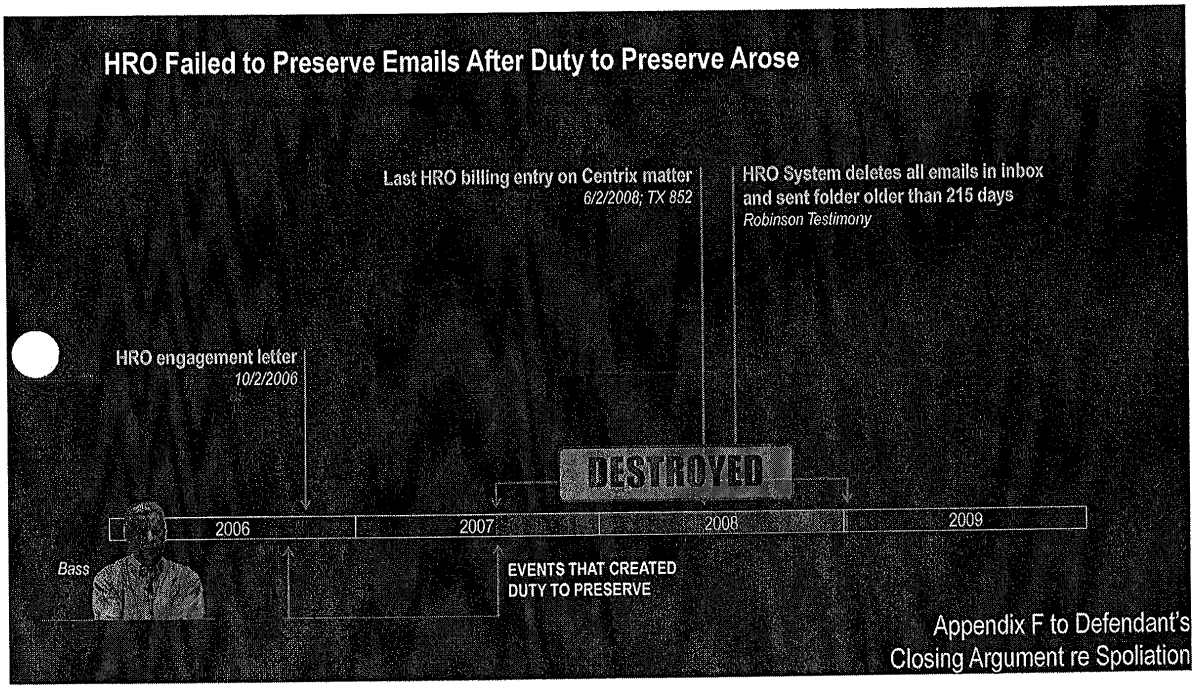
Appendix D


Boates Failed to Preserve Emails After Duty to Preserve Arose
"Virus" infects computer
2/2009; Boates Testimony
"Donates" hard drive to data destruction service
6/2009; Boates Testimony
Centrix engages Boates
6/2006; Boates Testimony
Boates' last day
5/2008; Boates Testimony
DESTROYED
2006
2007
2008
2009
Boates
EVENTS THAT CREATED DUTY TO PRESERVE
Appendix D to Defendant's Closing Argument re Spoliation

Appendix E


Squire Failed to Preserve Emails After Duty to Preserve Arose
Last Squire billing entry on Centrix matter
4/30/2007; TX 712
Hansen and Johnson delete their Centrix email folders
"2008...possibly late 2007"; Wall Testimony
Squire engagement letter
6/1/2006
Squire implements new email destruction protocol; deletes all emails in inbox or sent folder older than 1 year
Sept/Oct/2008; Wall Dep. 24:5-25:17
DESTROYED
2006
2007
2008
2009
Hansen
EVENTS THAT CREATED DUTY TO PRESERVE
Appendix E to Defendant's Closing Argument re Spoliation

Appendix F


HRO Failed to Preserve Emails After Duty to Preserve Arose
Last HRO billing entry on Centrix matter
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HRO System deletes all emails in inbox and sent folder older than 215 days
Robinson Testimony
HRO engagement letter
10/2/2006
DESTROYED
2006
2007
2008
2009
Bass
EVENTS THAT CREATED DUTY TO PRESERVE
Appendix F to Defendant's Closing Argument re Spoliation

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO
Bankruptcy Judge Elizabeth E. Brown

In re: CENTRIX FINANCIAL, LLC, et al., Debtors.	Jointly Administered under Bankruptcy Case No. 06-16403 EEB Chapter 11
JEFFREY A. WEINMAN as Trustee of CENTRIX FINANCIAL LIQUIDATING TRUST, Plaintiff, v. NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA., and AIG DOMESTIC CLAIMS, INC., Defendants.	Adversary Proceeding No. 09-1150 EEB

ORDER DENYING DEFENDANTS' MOTION FOR SANCTIONS FOR SPOLIATION OF EVIDENCE

THIS MATTER came before the Court on March 5 and 6, 2015 for an evidentiary hearing on the Defendants' Motion for Sanctions for Spoliation of Evidence. The Court has considered the evidence and the arguments of counsel, and being advised, FINDS and CONCLUDES:

I. BACKGROUND

Pursuant to the confirmed Chapter 11 Plan of Debtor Centrix Financial LLC ("Centrix" or "Debtor"), Plaintiff Centrix Financial Liquidating Trust, through its Trustee, Jeffrey Weinman (the "Trustee"), has the right to pursue causes of action that remained in Centrix' bankruptcy estate at the time of confirmation. The Trustee filed this adversary proceeding against National Union Fire Insurance Company of Pittsburgh PA ("National Union") and AIG Domestic Claims, Inc. ("AIG", and together with National Union, the "Defendants") on one such claim. The Trustee seeks to recover on a fidelity bond under which National Union agreed to indemnify Centrix for "dishonest or fraudulent acts" committed by employees of Centrix.

The Trustee alleges that Robert Sutton ("Mr. Sutton"), the former owner and CEO of Centrix, improperly and fraudulently diverted or transferred $83 million of Centrix' assets to himself or for his personal benefit, and that as a result of these acts by Mr. Sutton, the Defendants are liable on the fidelity bond.

The fidelity bond required a notice of claim to be filed within 60 days after discovery of a covered loss. One of the Defendants' defenses to liability on the bond is that Centrix failed to make a timely claim. Centrix' gave notice of the claim on May 16, 2007. The Trustee asserts that the claim was timely because the losses were discovered on or after March 17, 2007. The Defendants have argued that the losses were discovered weeks or perhaps months earlier.

In their Motion, the Defendants argue that evidence critical to establishing the date of Centrix' discovery of the losses has been lost because Timothy Boates ("Mr. Boates"), the Chief Restructuring Officer ("CRO") of Centrix, and two of Centrix' bankruptcy attorneys failed to preserve all of their Centrix-related emails. The Defendants argue that the failure to preserve the emails of these three individuals constitutes spoliation of evidence so pervasive and prejudicial that the most severe sanction – dismissal of the Trustee's complaint – is warranted.

II. THE FACTUAL BASIS FOR THE SPOLIATION CLAIM

Extensive and protracted discovery has occurred in this case. At some point in the course of this discovery, the Defendants obtained copies of emails that had not been produced by other persons who were either authors or recipients of the emails. In the course of investigating why they did not receive copies of Centrix emails from all of the authors or recipients from whom discovery had been requested, the Defendants learned of the failure to preserve certain Centrix emails in the circumstances described below. The Defendants' instant motion for sanctions is based on this alleged spoliation.

A. Mr. Boates

Sometime prior to its bankruptcy filing in September, 2006, Centrix hired Mr. Boates, through his company, RAS Management Advisors, Inc., as a turnaround consultant. Mr. Boates served as Centrix' CRO throughout the chapter 11 case. He was never a direct employee of Centrix and did not use any Centrix computers for his work there. All of his Centrix work, including all emails he composed or received, was done on a personal laptop. When that laptop was infected by a virus in February 2009, the Centrix-related emails that had been saved on the laptop could not be accessed. Mr. Boates testified that he asked an IT person from the company where he was then working to try to recover the data from his laptop, but that the only thing that was recovered was some personal financial information. He spoke with someone at AOL about recovering his emails but they were also unable to help. Mr. Boates donated the laptop to a destruction service in June, 2009. The Court found Mr. Boates' testimony as to the reason for the loss of his emails and his inability to recover them to be wholly credible.

Mr. Boates also testified credibly that he believed that substantially all of his email correspondence during the Centrix bankruptcy included Centrix employees and, therefore, would have been preserved on Centrix' servers. He also testified that he rarely communicated by

formal letter and that all communications during his Centrix engagement would have been by phone, face-to-face meetings, or by email.

B. Craig Hansen

Craig Hansen ("Mr. Hansen"), a bankruptcy attorney with Squire Sanders and Dempsey ("Squire Sanders"), represented Centrix prior to and in the initial stages of the bankruptcy case. He was the primary bankruptcy lawyer responsible for the negotiation, drafting and court approval of an Asset Purchase Agreement ("APA") that provided for the sale of substantially all of Centrix' assets. Other Squire Sanders attorneys worked on other aspects of the Centrix bankruptcy case. The APA was approved by the Court in February, 2007. Mr. Hansen continued to work on the Centrix case for a short time after the approval of the APA but, by the end of the spring of 2007, Mr. Hansen and the other Squire Sanders attorneys ceased work for Centrix. Full responsibility for the Centrix bankruptcy was then assumed by local Denver counsel at Holme Roberts and Owen ("HRO").

During 2007 and 2008, Mr. Hansen's normal practice regarding emails was to save important emails in an electronic folder for a particular matter. Then, in the absence of a litigation hold, he would delete the entire folder for the matter after a certain period of time after his work on it was concluded. Mr. Hansen ordinarily kept email folders for 90 days or more after a matter was concluded, depending on the nature and size of the matter. In accordance with this normal practice, he deleted his Centrix email folder sometime within the year after his work on Centrix was completed.[1] Mr. Hansen's testimony was entirely credible that he did not seek out specific emails to delete, nor did he take any action that was inconsistent with how he handled all emails on all matters in which he was involved at the time.

C. Larry Bass

Larry Bass ("Mr. Bass"), a bankruptcy attorney at HRO, began working on the Centrix case as local counsel when venue of the case was transferred from Nevada to Colorado shortly after it was filed. He and other attorneys at HRO first worked at the direction of the Squire Sanders attorneys. Mr. Bass and HRO eventually took on full responsibility for representing Centrix after the APA was approved and Squire Sanders transitioned out of the case.

Mr. Bass testified that he received many emails in the course of the Centrix case. He printed hard copies of emails that he thought were important, that he might need to refer to in the future, or that he might want others to see. Emails that were, in his mind "of no import," such as "How was your weekend?" or "How are the kids?" he either deleted immediately or left in his

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[1] The Defendants' Motion also references emails deleted by Chris Johnson, another Squire Sanders attorney. The Defendants presented no testimony from Mr. Johnson at the trial and referred only very briefly to the deletion of Mr. Johnson's emails in their written closing argument. Apparently Mr. Johnson treated his Centrix emails in the same fashion as did Mr. Hansen – he placed them into a "Centrix folder" and then deleted the folder in accordance with his normal practice sometime after his work on the Centrix case was done. The Defendants have tied no specific "missing" emails to the deletion of Mr. Johnson's Centrix folder.

electronic in-box. Mr. Bass testified credibly that he never affirmatively deleted nor directed anyone else to delete any important emails relating to the Centrix matter.

During 2006 and 2007, the email system at HRO automatically moved an email that was not saved in a user-created folder to a "deleted items folder" 150 days after it was sent or received. After 30 days in the "deleted items folder," or a total of 180 days after it was sent or received, an email that was not specifically placed in a user-created folder, or otherwise preserved, would be automatically purged from the email system. Purged emails would be preserved for an additional 5 weeks on backup tapes but, after that time, may not have been accessible in any electronic form.

III. WHAT PRECISELY IS ALLEGED TO HAVE BEEN SPOLIATED?

As a preliminary matter, it is important to keep in mind that during the time period that the Defendants assert is critical to their defense, there were many attorneys, employees of Centrix and other potential recipients of emails involved in the case, and much email traffic occurred. The Trustee has asserted, and the Defendants do not dispute, that the Defendants did not seek discovery from all of the individuals who may have sent or received emails during the case. For this reason, the only evidence made completely unavailable to Defendants by the actions or inactions of Mssrs. Boates, Hansen, and Bass are emails between these individuals *and no one else.* If a particular email was sent or copied to other people in addition to Mr. Boates, Mr. Hansen, and Mr. Bass, then their failure to preserve their Centrix emails does not establish that such evidence was "destroyed" or rendered permanently unavailable to the Defendants, because it was at least theoretically available from other sources.

IV. GENERAL LAW APPLICABLE TO SPOLIATION

Federal courts have "inherent power" to impose sanctions for the destruction or loss of evidence that occurs before or outside of the formal discovery process. *Silvestri v. General Motors Corp.*, 271 F.3d 583, 590 (4th Cir. 2001); *Jordan F. Miller Corp. v. Mid-Continent Aircraft Serv., Inc.*, 139 F.3d 912, *3 (1998) (unpublished opinion)("*Miller*"). "The power is limited to that necessary to redress conduct 'which abuses the judicial process.'" *Silvestri,* 271 F.3d at 590 (citing *Chambers v. NASCO, Inc.*, 501 U.S. 32, 45-46, 111 S.Ct. 2123 (1991)). The policy underlying this inherent power, and the basis for any sanctions to be imposed, is to preserve the integrity of the judicial process by punishing those who have destroyed evidence, deter future abuses, promote accurate fact finding by the court or jury, remedy any evidentiary imbalance caused by spoliation, and compensate the injured party for additional expenses incurred as a result of any improper conduct. *Silvestri,* 271 F.3d at 590; *Austin v. City and County of Denver*, 2006 U.S. Dist. LEXIS 47451, at *8 (D. Colo. July 13, 2006).

Sanctions may be imposed for spoliation of evidence if "(1) a party has a duty to preserve evidence because it knew, or should have known, that litigation was imminent, and (2) the adverse party was prejudiced by the destruction of the evidence." *Turner v. Public Service Co. of Colorado*, 563 F.3d 1136, 1149 (10th Cir. 2009). The critical factors to evaluate when determining appropriate sanctions to impose for spoliation are: (1) the culpability of the responsible party and (2) the degree of actual prejudice to the other party. *Miller*, 139 F.3d 912 at *4. "The party seeking sanctions has the burden of proving the essential elements of a

spoliation claim." *Oto Software, Inc. v. Highwall Technologies, LLC*, 2010 WL 3842434, at *7 (D. Colo. August 6, 2010). Whether to impose sanctions for spoliation and the determination of what sanctions are appropriate are matters committed to the trial court's discretion. *Turner,* 563 F.3d at 1150; *Burlington Northern and Santa Fe Ry. Co. v. Grant*, 505 F.3d 1013, 1032 (10th Cir. 2007). A court should select the least drastic sanction necessary to vindicate the purpose for which it is imposed. *Miller*, 139 F.3d 912 at *6.

A spoliation claim may not be decided on the basis of speculation. *Turner,* 563 F.3d at 1150 (upholding trial court's decision not to impose sanctions where there was no evidence of actual, rather than merely theoretical, prejudice). Where documents no longer exist, a party need not conclusively demonstrate that the evidence would have established liability on the part of spoliator, but it must at least have plausible concrete suggestions of what the evidence would have been. *Gates Rubber Co. v. Bando Chemical Industries, Ltd.* 167 F.R.D. 90, 104-105 (D. Colo. 1996). The Tenth Circuit has not always required proof of bad faith on the part of the spoliator for a dispositive sanction such as dismissal. *Miller,* 139 F.3d 912 at *7.[2] To justify this most extreme sanction in the absence of bad faith, however, the destruction of the evidence must severely prejudice the opposing party. *See Gates v. Bando Chemical Industries, Ltd.*, 167 F.R.D. at 102-03 (D. Colo. 1996); *Computer Associates Int'l, Inc. v. American Fundware, Inc.*, 133 F.R.D. 166 (D. Colo. 1990) (dispositive sanction is a last resort to be invoked only if misconduct is willful or in bad faith, serious prejudice results, and alternative sanctions would not be adequate).

Prejudice deserving of a dispositive sanction may occur in cases where there is no substitute for the destroyed evidence and the opposing party is practically unable to pursue or defend a claim without it. For example, in *Miller,* the plaintiff sued for damages resulting from the crash of an airplane that the plaintiff claimed was caused by the failure of its landing gear. The landing gear was destroyed before the defendant's experts had a chance to examine it. The Tenth Circuit upheld dismissal of the plaintiff's claim where there was no adequate substitute for visual inspection of the landing gear by the defendant's experts. *Miller*, 139 F.3d 912 at *6-7.

As summarized by the Fourth Circuit:

> At bottom, to justify the harsh sanction of dismissal, the district court must consider both the spoliator's conduct and the prejudice caused and be able to conclude either (1) that the spoliator's conduct was so egregious as to amount to a forfeiture of his claim, or (2) that the effect of the spoliator's conduct was so prejudicial that it substantially denied the defendant the ability to defend the claim.

Silvestri v. General Motors Corp., 271 F.3d at 593.

With these general principles in mind, the Court turns to the specific facts of this case.

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[2] Note, however, that in a more recent published decision, the Tenth Circuit suggested that only sanctions *lesser* than an adverse inference instruction would be appropriate in the absence of bad faith. *See, Turner*, 563 F.3d at 1149 (citing *Henning v. Union Pacific R.R. Co.*, 530 F.3d 1206, 1220 (10th Cir. 2008))

V. DISCUSSION

A. Is The Trustee Chargeable With the Actions of Mr. Boates, Mr. Hansen and Mr. Bass?

The Trustee argues that spoliation may be sanctioned only if the destruction of or failure to preserve evidence was committed by a "party." The Trustee urges the Court to deny the Defendant's Motion because the actions upon which it is based were taken by individuals who were employed by or were agents of Centrix, not the Trustee. The Trustee also asserts that the Court should not sanction the Trustee for the actions of these individuals because the Trustee had no ability to control them.

The Defendants strenuously dispute the Trustee's contention that he lacked the ability to direct Mr. Boates to preserve his Centrix emails. The Defendants point out that the Trust was established in June, 2008, when Centrix' confirmed plan became effective, and that Mr. Boates' emails were not lost to the computer virus until early 2009. The Defendants contend the Trustee could have, and should have, directed Mr. Boates to back up his laptop to preserve his Centrix-related emails well prior to the time the virus destroyed them. The Defendants also assert that the Trustee, as the successor-in-interest to Centrix, takes the claims of Centrix subject to any misconduct by Centrix or its agents, including any spoliation of evidence that occurred prior to the creation of the Trust. They argue that, under this theory, the Trustee may be sanctioned for Centrix' failure to direct Mr. Hansen or Mr. Bass to preserve their emails.

The Defendants rely on *Ehrenhaus v. Reynolds*, 965 F.2d 916, 920 (10th Cir. 1991) for the proposition that a bankruptcy trustee takes the claims of a debtor burdened with the debtor's past discovery conduct and subject to sanctions for any discovery abuses. In *Ehrenhaus,* the Tenth Circuit upheld the post-bankruptcy dismissal of a lawsuit as a sanction for the pre-bankruptcy willful failure of the plaintiff/debtor to comply with a discovery order. The court stated that the bankruptcy estate's interest in the lawsuit was encumbered with the debtor's pre-bankruptcy conduct, and that "[a]lthough the sanction now affects parties other than the one who engaged in the wrongful conduct, the nature of the property interest transferred [to the estate] cannot be altered." *Id.* The case does not, however, *mandate* sanctioning a bankruptcy successor in the same manner as though the successor were guilty of the debtor's improper conduct. The Tenth Circuit specifically noted that "it would not exceed a district court's discretion to consider whom the sanction affected in determining what sanction was appropriate." *Id.*

For the purposes of this order, the Court will assume, without deciding, that the holding of *Ehrenhaus* is equally applicable in the case of sanctions for spoliation which derives from the Court's inherent power, not from Rule 37, and that the Trustee is subject to sanctions for any spoliation committed by Centrix or its agents. The Court is also mindful, however, that *Ehrenhaus* allows the Court to consider the degree of fault of the party who will suffer the sanctions in determining what sanctions, if any, are appropriate.

B. Was Relevant Evidence Lost?

Whether the deletion of Mr. Hansen's and Mr. Bass' emails or the virus that destroyed emails on Mr. Boates' laptop resulted in the loss of relevant evidence is critical to a number of the factors the Court must consider when evaluating the Defendants' spoliation claim. The Court must first determine whether any emails were in fact completely lost, or whether they existed in other records available to the Defendants. If there were truly emails that are no longer available to the Defendants because of what Mr. Boates, Mr. Hansen and Mr. Bass did, the relevance of such lost emails must next be considered. The relevance of lost evidence bears not only on whether there was a duty to preserve it,[3] but also on whether the Defendants were prejudiced by the loss of the emails, and on the determination of an appropriate sanction. The Court is well aware that "the dilemma of lost evidence is that the aggrieved party can never know what it was, and can therefore never know the value that it may have had to the aggrieved party's case." *Gates v. Bando Chemical Industries, Ltd.*, 167 F.R.D. at 104-05. But spoliation may not be determined on the basis of pure speculation, so the Defendants must at least present some extrinsic evidence of the content of the lost evidence for the court to determine "in what respect and to what extent it would have been detrimental." *Id.* at 105 (quoting *Hudson Transit Lines, Inc. v. Zozichowski*, 142 F.R.D. 68, 76 (S.D.N.Y. 1991)).

In their written closing argument, the Defendants identified the following eight "missing" documents or emails that they contend would be relevant to the issue of the timing of discovery of Centrix' bond claim. Whether the Defendants sufficiently demonstrated these documents were in fact completely unavailable to them, and whether they presented at least some extrinsic evidence to demonstrate the content and potential relevance of these eight documents, is discussed below.

1. The "No Timely Claims" Email and March 16, 2007 Email Exchange

The Defendants claim the best example that relevant evidence was destroyed is an email from Mr. Bass to Michael Richman ("Mr. Richman"), who was the lead counsel for Centrix' creditors' committee, sometime subsequent to March 15, 2007. The Defendants know of the existence of this email because it (or a part of it) was copied into an April 4, 2007 email from Teresa McMahon of FTI Consulting, a financial advisor to the creditors' committee, to Mr. Boates. The April 4, 2007 email appears in an email string that was copied to Mr. Bass and printed out by Mr. Bass and stored in his paper files. The entirety of Ms. McMahon's email is set forth below, with the cut and pasted quote from Mr. Bass in italics.

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[3] Though the Tenth Circuit does not always focus on the nature of destroyed evidence when defining spoliation, it seems obvious that sanctions are not appropriate unless *relevant* evidence is lost or destroyed. *See Hatfield v. Wal-Mart Stores, Inc.*, 335 Fed. Appx. 796, 804 (10th Cir. 2009) (unreported opinion) (no abuse of discretion in failing to sanction defendant where destroyed security tapes did not show plaintiff's fall). *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 217 (S.D.N.Y. 2003) (duty to preserve extends to unique relevant evidence that might be useful to adversary).

> Tim, Larry Bass sent to Michael Richman the email below. Can you expand on where the $100K is coming from, as it is not clear if it is from the E&O policy or other policies? My understanding was that the D&O policy was not renewed.
>
> *Michael – it appears that there are no timely claims that can be made against the debtors' E&O or other insurance policies. If Centrix advises its broker that the policies will not be renewed, the estate stands to receive close to $100K in premium refunds. Tim Boates is planning to make that call so that we can get some much needed cash into the estate. If you or the Committee feel strongly to the contrary based on your review of the policies I provided you when we met in Phoenix, we'd be pleased to discuss the issue on tomorrow morning's call, but otherwise I just wanted to let you know of the planned non-renewal.*
>
> Thanks, Teresa

Trial Exhibit ("TX") 666.[4]

The Defendants argue that this email suggests that Mr. Bass analyzed the fidelity bond to determine if timely claims could be made, and that the email, in conjunction with Mr. Bass' billing records showing a March 15, 2007 meeting at Squire Sanders between Mr. Bass, Mr. Hansen, Mr. Richman, and Mr. O'Hearn (another creditors' committee attorney) suggests that the timeliness of a fidelity bond claim was a topic that "may" have been addressed at the meeting. The Defendants also note that Mr. Bass' billing records from March 16, 2007 indicate that he had an "email exchange" with Mr. Boates "re outcome of meeting with Lyndon and Committee," but the March 16, 2007 email or emails were not produced by Mr. Boates or Mr. Bass.

The Defendants complain of the absence of any March 16, 2007 emails and also argue that the cut and pasted email from Mr. Bass to Mr. Richman may not be complete. They say that the evidence demonstrates that timeliness of bond claims was being discussed at this time and that the missing emails and/or portions of emails could show a discussion of why claims were not timely. The Court concludes from the weight of the evidence that the latter is not likely.

The cut and pasted email from Mr. Bass to Mr. Richman appears to be a complete communication. There is no indication from the wording of the cut and pasted portion, or from Ms. McMahon's email, that she selected only a portion of the email to copy. There was certainly no analysis of why claims would not be timely before the first sentence of the email, because that sentence appears immediately after the salutation "Michael—." The last sentence, which includes the phrase "I just wanted you to know," appears to be a concluding sentence. It certainly does not appear, nor do the Defendants even suggest, that Ms. McMahon altered the portion of the email that she cut and pasted.

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[4] For convenience, the Court has adopted the abbreviations used by Defendants in their closing argument, and will refer to trial exhibits as "TX" and cites to the trial transcript as "TR."

There is also nothing in the reference to an email exchange "re outcome of meeting with Lyndon and Committee" that implies that timeliness of claims under the fidelity bond were discussed at that meeting. Defendants have provided the Court with no other evidence that the timeliness of fidelity bond claims was a subject of the meeting. Lyndon was an insurance company that had sued Mr. Sutton and/or Centrix directly. Lyndon would not have had a claim under the fidelity bond issued to Centrix. Nor does the Court find it very likely that attorneys for Centrix and the creditors committee would discuss the timeliness of Centrix' bond claims with Lyndon.

Certainly this evidence falls far short of demonstrating what the Defendants claim it does. The Defendants assert that the "no timely claims email" and the missing March 16, 2007 email exchange regarding the meeting with Lyndon and the committee show that "what appears to have happened is that the lawyers held a meeting in Phoenix on March 15, 2007 and then or thereafter concocted a scheme to bring a claim under the fidelity bond, even though they believed there were 'no timely claims.'" Defendants' Closing Argument at 16. The Court disagrees. Neither the failure to preserve these specific emails, nor any of the other evidence the Defendants presented to the Court, gives any indication that there was such a scheme.

2. Squire Sanders Report on Potential Claims Against Mr. Sutton

The Defendants next cite Mr. Bass' testimony that he believed there was a report provided by Squire Sanders to Mr. Boates "sometime prior to May 2007," that contained an analysis of potential claims against Mr. Sutton, including claims for fraud, fraudulent transfers, and preferential transfers. Trial Transcript ("TR") 298:22-299:3; 328:6-23. The Court notes that the existence of this report is debatable. Mr. Hansen credibly testified that he recalled no such report created by Squire Sanders. TR 194:9-24.

Even if such report existed, the Defendants do not claim, nor have they cited any evidence whatsoever, suggesting that the report was *emailed* to Mr. Bass, Mr. Boates or Mr. Hansen, or that it had any relation to any alleged spoliation of emails by Mr. Bass, Mr. Boates or Mr. Hansen. Thus, there is no evidence on which the Court could determine that the failure to preserve these three individuals' emails deprived the Defendants of the Squire Sanders report referred to by Mr. Bass.

3. Squire Sanders Memo Regarding Insurance Policies

The Defendants point to billing records of Squire Sanders that indicate K. Singer billed 25 hours in August, 2006 for research on "case law regarding insurance policies and assumption and assignment under the bankruptcy code" and for drafting a memo regarding this research. TX 1016 at 45-47. The Defendants claim the memo was never produced. They assert that it would likely show that Squire Sanders knew of the fidelity bond in August, 2006 and that it "may" have shown what Squire Sanders knew at that time about the relationship between the bond and Mr. Sutton's alleged misconduct.

There is no dispute that Centrix knew of the existence of the fidelity bond in the fall of 2006. The fidelity bond was specifically mentioned by Centrix in one of its first day motions, filed on September 19, 2006. *See* Exhibit "A" to Docket #27, in Case No. 06-16403 EEB.

Based on the language of Mr. Singer's billing entry, and its timing in relation to the Centrix first-day motions, the Court concludes that the research was more likely than not related to the filing of this first day motion, the ability or necessity of a chapter 11 debtor to assume and assign insurance policies, and the methods for doing so. The Court is not persuaded that, at this early juncture in the case, it was likely to have included any specific reference to the timing of claims to be made under any of the policies. Furthermore, as with the alleged Squire Sanders report of claims against Mr. Sutton, the Defendants have provided no evidence whatsoever suggesting that the report was *emailed* to Mr. Bass, Mr. Boates or Mr. Hansen, or that it had any relationship to any alleged spoliation of emails by Mr. Bass, Mr. Boates or Mr. Hansen.

4. "Roswell Summary" on Deponents

The Defendants obtained a copy of a November 22, 2006 email from Jim Thomas ("Mr. Thomas") to Stephanie Niehaus ("Ms. Niehaus") and others. TX 1000. Both Mr. Thomas and Ms. Niehaus were Squire Sanders attorneys who worked on the Centrix case. Mr. Thomas was the lead litigation counsel involved in the Centrix case.[5] Ms. Niehaus printed out this particular email which says, "Resending the Roswell summary on deponents." The email indicates that it has an attachment described as "[s]ummary of ex-employees," but no attachment was produced with the email. Within the same email string in TX 1000 is an email from Scott Roswell ("Mr. Roswell"), then Centrix' general counsel, to Mr. Thomas and others which says, in part, "Tom/Jim, here is contact info for the list of ex-employees. Please call me for a more substantive discussion."

The Defendants assert that the missing attachment would "likely confirm" that Squire Sanders and Centrix' general counsel knew that Mr. Sutton would ultimately be sued for fraud. The Court finds this argument completely unsupported by the evidence. The Defendants presented no evidence which would suggest that the missing attachment described the ex-employees in any fashion, that Mr. Sutton was among the ex-employees included in the summary, or that any claims against any ex-employees were included in the summary. In fact, the evidence from Mr. Roswell's email initially forwarding the attachment indicates that the summary likely contained only "contact information," and that "more substantive" information would be discussed by phone.

5. Draft Everest Complaint Sent March 9, 2007

On March 9, 2007, Mr. Thomas sent an email to Mr. Roswell, Mr. Boates, Mr. Hansen, Mr. Bass, and two other Squire Sanders attorneys, with a copy to Ms. Niehaus. The email said,

> All, Attached you should find the Everest NJ action against Mr. Sutton and a fax notice of an injunction in the Founders Everest reinsurance arbitration. Fred Alvarez was supposed to send the underlying "complaint" but I have not received it yet. Thanks, Jim

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[5] The Defendants do not dispute that Mr. Thomas saved all his Centrix emails in a Centrix folder that was never deleted. The Defendants cited no evidence to the Court regarding whether or for how long Ms. Niehaus preserved her Centrix emails.

TX 688.

Below Mr. Thomas' typed signature in the email, there is a designation that a "pdf Complaint" was attached to the email. The attachment to Mr. Thomas' March 9, 2007 email was not produced. The Defendants argue that the attachment was a draft of the Everest complaint that was filed five days later. The actual complaint that was filed on March 14, 2007 was made available to the Defendants. TX 46. The Everest complaint contains allegations of fraud by Mr. Sutton that mirror some of the facts on which the Trustee's bond claim is based. The Defendants claim that the missing draft complaint would show that Centrix and its agents discovered this claim prior to March 17, 2007. The Court agrees that this evidence is relevant to the Defendants' defense, though whether it is more probative than the cover email, which confirms that Centrix and its attorneys received the draft complaint prior to March 17, 2007, is doubtful. The failure by Mr. Boates, Mr. Hansen, and Mr. Bass to preserve their emails certainly could have caused it to be more difficult, though probably not impossible, for the Defendants to obtain a copy of this draft complaint. The Defendants could have attempted to obtain a copy of it from Mr. Roswell or from Mr. Alvarez, Everest's attorney.

6. March 2007 and May 2007 Emails Among Mr. Boates, Mr. Bass and Foley

Mr. Bass' billing records from March 2007 refer to an email exchange with Mr. Boates regarding a March 15, 2007 meeting in Phoenix about "transition issues, plan, claims, Lyndon litigation, etc.," and email exchanges with Mr. Boates, Mr. Richman and others regarding "wind-down" issues and "status." TX 835 at 25.[6] Mr. Bass' billing records from May 2007 refer to emails to Mr. Boates and Maxim Chester ("Mr. Chester"), another attorney that represented the creditors' committee, regarding the notice of claim on the financial institution bond and "claims v. bonding company." The Defendants note that the March emails occurred around the time the Trustee alleges the losses were discovered, and the May emails occurred around the time that notice of the claim was made. The Defendants argue that the emails "likely would show the perceptions of Mr. Boates, Mr. Bass, and Foley [Mr. Richman and Mr. Chester's firm] as to the timeliness of the notice and the creation of Mr. Boates' fictional discovery of the alleged loss in March 2007." It is possible that the March email from Mr. Bass to Mr. Boates about the Phoenix meeting where the "Lyndon litigation" was discussed could demonstrate Centrix' knowledge of some of the underlying facts which form the basis for the claim on the fidelity bond. The Court believes it is very unlikely that the March, 2007 emails about "wind-down" issues would contain relevant information. The Court finds there is a small possibility that the May, 2007 emails could have contained relevant evidence in the form of discussions of timeliness of the claims. More likely the May emails discussed the manner in which the claims would be described in the notice to the Defendants. There is no evidence whatsoever that suggests that the March or May emails would have contained discussions of a "fictional discovery" of the loss.

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[6] The Defendants also mention the March 16, 2007 email exchange between Mr. Bass and Mr. Boates about the "outcome of meeting with Lyndon and Committee." This email and the Court's conclusion regarding its potential relevance is discussed in Section V.B.1. above.

Except for the March 15, 2007 email between Mr. Boates and Mr. Bass regarding the Phoenix meeting, the Defendants have not demonstrated that the failure of Mr. Boates, Mr. Hansen, or Mr. Bass to preserve all their Centrix emails caused a complete loss of this potentially relevant evidence. The Defendants did not dispute the Trustee's contention that the Defendants did not seek to obtain copies of any Centrix emails from the Foley lawyers who were also recipients of the emails.

7. January 2008 Emails Regarding Proof of Loss

The Defendants next cite Mr. Bass' billing records from January 2008. TX 852 at 9. These records show emails between Mr. Bass and two Foley attorneys and, in one instance, Mr. Boates, regarding a revised proof of loss on the fidelity bond. The Defendants also note that Foley billing records show that on January 11, 2008, Mr. Chester responded to an email from A.M. Uetz (a Foley attorney) and Mr. Bass "on Fidelity Bond policy provisions." TX 847 at 26.

As with the May 2007 emails, the Court finds it most likely that these emails concerned what claims to include in the proof of loss and how they should be described. It is possible that the January 11, 2008 emails concerned the bond provisions on timeliness and could be relevant to the Defendants' claims. Once again, however, the Defendants did not show that Mr. Bass' alleged spoliation caused a complete destruction of this evidence because they did not show that they attempted to obtain copies of these emails from the Foley attorneys who were deeply involved in the discussions concerning the revised proof of loss.

8. Emails Regarding Analysis of Insurance Issues and Bonds

Finally, the Defendants cite a Foley billing entry for February 28, 2007 showing that a Foley attorney, J. Simon, analyzed "insurance policy issues," and "correspond[ed] with Mr. Hansen re: Centrix insurance policies and bonds." TX 715. The Defendants state that these records "would likely show cognizance of bond and potential claims against Mr. Sutton more than 60 days before Centrix filed its initial notice."

The Court first notes that the "correspondence" with Mr. Hansen is not specifically identified as an email, so there is no proof that the deletion of Mr. Hansen's Centrix email folder deleted this communication with J. Simon. Second, as the Court has already explained, Centrix' cognizance of the bond in February, 2007 is not disputed. Further, there is nothing in the Foley billing entry that persuades the Court that it is likely that the correspondence contained any discussion of claims against Mr. Sutton. Finally, once again, the Defendants did not assert that they attempted to obtain a copy of the correspondence from J. Simon or the Foley firm.

C. Alleged Gaps in Email Traffic During Critical Times

In addition to specific emails or documents discussed above, the Defendants also assert that there are significant time periods during which few emails from Mr. Boates, Mr. Hansen or Mr. Bass were produced. These time periods are: (1) November and December 2006, during which Mr. Sutton, Centrix, and the creditors' committee were engaged in discussions concerning whether Mr. Sutton would receive a release of claims against him in connection with the APA; (2) March 2007, and specifically March 17, 2007, the date that the Trustee claims the loss under

the fidelity bond was discovered; (3) May 2007, during which time the initial notice of the claim was given; and (4) January 2008, when the proof of loss was submitted. The Defendants also note that there is no email describing why the fidelity bond was included in Centrix' first day motions filed in September 2007.

The Court finds that the existence of more extensive and relevant email traffic during these time periods purely speculative and that the lack thereof gives rise to no inference that relevant emails were deleted by Mr. Boates, Mr. Hansen, or Mr. Bass. The record reflects several emails between the individuals involved during all these time periods. The Defendants' summary exhibits, TX 1046-1048, show 32 emails authored by Mr. Hansen and 72 emails authored by Mr. Boates in November and December 2006, 28 emails by Mr. Boates in March 2007, five emails from Mr. Boates and four emails from Mr. Bass in May, 2007, and three emails from Mr. Bass regarding the proof of loss in January, 2008. In addition, the Trustee demonstrated that TX 2015, which the Defendants stipulated is a list of documents produced to them, has some emails not contained in the Defendants' summaries, so the evidentiary value of the Defendants' summaries and their support of the argument that there are suspicious "gaps" in email traffic has even less force. The Court declines to consider any sanction for these alleged gaps.

D. Appropriateness of Sanctions

Based on the discussion above, which summarizes the Court's review of the extensive evidence presented by the Defendants in this case, the only potentially relevant evidence that the Defendants have identified by more than mere speculation as missing is: (1) the copy of the draft Everest complaint attached to the March 9, 2007 email from Mr. Thomas to Mr. Roswell, Mr. Boates, Mr. Hansen (and other Squire Sanders attorneys), and Mr. Bass; (2) the March 15, 2007 email between Mr. Boates and Mr. Bass regarding the Phoenix meeting; (3) Mr. Bass' May 2007 email to Mr. Boates and Mr. Chester regarding the notice of claim on the financial institution bond and "claims v. bonding company;" (4) the January 11, 2008 email to Mr. Bass from Mr. Chester "on Fidelity Bond policy provisions;" and, perhaps, (5) the March 16, 2007 email exchange between Mr. Boates and Mr. Bass regarding the meeting with Lyndon and the committee. Of these five items, only the March 15 and 16, 2007 emails between Mr. Boates and Mr. Bass could have been rendered completely unavailable to the Defendants by the failure of Mr. Boates, Mr. Hansen, and Mr. Bass to preserve their Centrix emails.

Even if the Court were to determine that any of the other missing documents or emails could have been relevant and were rendered unavailable to the Defendants by the actions of the three individuals involved, the Court must still consider the culpability of Mr. Boates, Mr. Hansen and Mr. Bass, and the prejudice caused to the Defendants by the lack of these documents in determining the appropriate sanctions, if any, to enter.

1. Culpability

The Defendants would have the Court believe that the vast quantity of information they provided to the Court creates a picture of bad faith conduct by Mr. Boates, Mr. Hansen and Mr. Bass. The Defendants assert that these individuals planned a scheme in March, 2007 to make a claim on the fidelity bond even though they personally believed that the claim was untimely.

The Court finds no evidence even tending to show such a scheme. The testimony of Mr. Boates, Mr. Hansen and Mr. Bass was completely credible and showed that the only emails deleted intentionally were deleted by Mr. Hansen in the course of his normal procedures for dealing with emails. Neither Mr. Boates nor Mr. Bass made any conscious decision to delete emails. On the contrary, Mr. Bass saved all the Centrix emails he thought were important, and the rest were deleted automatically from the HRO computer system, in accordance with HRO's normal practice, with no direction whatsoever from Mr. Bass. Mr. Boates did not intend to delete any of his Centrix emails – the computer virus was beyond his control.

Despite the thousands of pages of evidence and hours of testimony they presented, the Defendants did not connect the admitted deletion and loss of emails to any intent to destroy damaging evidence. If there was such a scheme in March, 2007, as the Defendants have alleged, one would expect the evidence to show selective deletion of emails at the time the claim on the fidelity bond was made. The evidence showed nothing of the sort. Mr. Boates' emails were not even lost from his laptop until two years later. The Court finds not a shred of evidence that any emails were deleted by Mr. Boates, Mr. Hansen, or Mr. Bass, for the purpose of preventing the Defendants from obtaining access to damaging information. The Defendants' evidence fell far short of demonstrating bad faith.

Moreover, the degree of culpability to be assigned to Mr. Hansen's failure to preserve his Centrix email folder and Mr. Boates' failure to back up the emails on his laptop depends on whether either Mr. Boates or Mr. Hansen knew or should have known that preservation of their Centrix emails was relevant to ongoing or threatened litigation. Mr. Boates credibly testified that he believed that substantially all of his Centrix emails also were copied to Centrix employees and that they were therefore preserved on Centrix' server. The Court ascribes a very low degree of negligence to Mr. Boates for the failure to back up his laptop because he believed the emails stored there were already preserved elsewhere. Mr. Hansen was aware of potential bond litigation at the time he deleted his Centrix email folder, but the Court finds that he was not aware that any information in his Centrix emails would be relevant to that litigation. Mr. Hansen had no reason, in 2007 or 2008 to believe he would be a fact witness on any issue in the bond litigation. As of the spring of 2007, when the asset sale transaction was completed and Squire Sanders ceased their work on the Centrix bankruptcy, Mr. Hansen and the other Squire Sanders attorneys took care to return all Centrix' information and documents to Centrix. It would have been reasonable for Mr. Hansen to believe that any factual evidence relevant to the bond litigation would thereafter be in the possession of Centrix or its successors. For this reason, the court finds Mr. Hansen's actions negligent at best. It is difficult to assign any culpability to Mr. Bass. The Defendants did not persuade the Court that any emails Mr. Bass knew or should have known were relevant were deleted. The Court believes Mr. Bass' testimony that he preserved all the Centrix emails that he believed were substantive in paper files. Finally, the Trustee has very little direct culpability for his failure to direct Mr. Boates to back up his laptop. It is unlikely that the Trustee knew or should have known that relevant Centrix emails were only available there. At the very most, the actions of the Mr. Bass and the Trustee were negligent.

2. Prejudice

The Court finds that the failure of Messrs. Boates, Hansen and Bass to preserve all their Centrix emails caused little, if any, prejudice to the Defendants' ability to present their theory

that Centrix' bond claim was not timely. There are several reasons for this. First, the allegedly "missing" documents, save for the March 15 and 16, 2007 email between Mr. Boates and Mr. Bass, were all potentially available to the Defendants from other sources. All of the other identified emails had other addressees who are not alleged to have deleted their emails. The Defendants did not explain their failure to attempt to obtain the emails from such other addressees.

The evidence was uncontroverted that Mr. Thomas kept all his substantive Centrix emails in a separate Centrix folder that was never deleted. Mr. Thomas was the person who conducted or supervised the interviews of Centrix employees in an attempt to discover wrongdoing by Mr. Sutton and others. He also conducted a meeting at which the misconduct of Mr. Sutton and others was discussed. Notes taken at that meeting, including a reference to "shenanigans" by Mr. Sutton, were made available to the Defendants. Mr. Thomas was deposed by the Defendants, and presumably the other Squire Sanders attorneys present at that meeting and who participated in the interviews of the Centrix employees were available for interviews or depositions. This evidence is highly probative of the date of the discovery of the facts upon which the bond claim is based.

Other evidence available to the Defendants that tends to show Centrix' discovery of the losses included the email forwarding the draft Everest complaint, the actual Everest complaint that was filed five days after the email was sent, the Lyndon complaint, the testimony of Mr. Bass that a list of specific claims against Mr. Sutton was prepared by Squire Sanders, and the testimony and documents related to the dispute with Mr. Sutton over the release of claims against him. All of this evidence is also extremely probative on the discovery of the bond claims by Centrix.

The Trustee points out that the Defendants never subpoenaed any documents from the Foley firm relating to their work on behalf of the creditors' committee. The Defendants do not dispute this. The Court was surprised that the Defendants did not seek documents from Mr. Richman or any of the associates of the Foley firm. These attorneys, especially Mr. Richman, were major players in the negotiation over preservation of claims against Mr. Sutton that took place very early on in the bankruptcy case and they were very closely involved with Centrix and Centrix' attorneys in pursuing the fidelity bond claim. At the beginning of the case, all parties, except Mr. Sutton and his attorneys, believed that any claims against Mr. Sutton should be preserved as a means of recovery for the unsecured creditors. Clearly Mr. Richman, and perhaps other attorneys at the Foley firm, would have been intimately involved in any discussions of the nature of the claims against Mr. Sutton. Records from the Foley firm could have provided valuable information about who knew about which claims and when they were discovered. Other individuals who were likely to have knowledge of claims against Mr. Sutton, how and when they were developed, and who was aware of them, include Mr. Roswell, other Centrix employees, and Fred Alvarez, the attorney who drafted the Everest complaint. None of these individuals was identified as "unavailable" to the Defendants.

When considered in light of the quantity of information the Defendants possess related to the factual basis for their defense, and the additional information available to the Defendants which they did not seek to obtain, the Court finds that the loss of evidence identified by the Defendants in support of this Motion, caused little, if any discernable prejudice. This lack of

significant prejudice coupled with a low degree of culpability on the part of Mr. Boates, Mr. Hansen, and Mr. Bass cannot justify the extreme sanction of dismissal which the Defendants seek. The Court also deems it inappropriate to prohibit the testimony of these witnesses at trial. Had the Defendants produced any evidence of the additional cost in terms of attorney fees they incurred as a result of the failure to preserve these individuals' emails, the Court may have considered an award of some fees to be an appropriate sanction. The Defendants provided the Court with no basis, however, with which to make such an award. Accordingly, the Court declines to award any sanctions to the Defendants.

VI. CONCLUSION

The Defendants have access to plenty of information concerning the timing of the discovery by Centrix of the facts that formed the basis for Centrix' claim on the fidelity bond. What the Defendants lack is a "smoking gun" – an email of outright admission by Centrix that its bond claim was untimely. Despite thousands of pages of evidence and hours of testimony, the Court is unpersuaded that such an email ever existed. The Court is also unable to find that anything that was contained in emails deleted or lost by Mr. Boates, Mr. Hansen, or Mr. Bass so hindered the Defendants in the presentation of the timeliness defense that the severe sanction of dismissal is warranted. Finding no other, lesser sanction was proven or is appropriate, it is hereby

ORDERED that the Defendants' Motion for Sanctions for Spoliation of Evidence is DENIED.

Dated this 11th day of May, 2015.

BY THE COURT:

Elizabeth E. Brown, Bankruptcy Judge

Tab 3: Materials from *In re UWT, Inc.*

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO

In re:	)	
	)	
UWT, Inc.,	)	
	)	Case No.: 13-18184-EEB
Debtor.	)	Chapter 7
	)	
	)	
	)	
ST. PAUL MERCURY INSURANCE COMPANY	)	
	)	
	)	
Movant,	)	
v.	)	
	)	
UWT, Inc.,	)	
	)	
Debtor.	)	

ST. PAUL MERCURY INSURANCE COMPANY'S MOTION FOR RELIEF FROM AUTOMATIC STAY

St. Paul Mercury Insurance Company ("Travelers"), by and through its undersigned attorneys, hereby moves for relief from the automatic stay, to the extent it applies, *nunc pro tunc*, for the limited purpose of authorizing it to advance defense costs to its insureds from the proceeds of a liability insurance policy (the "Policy") it issued to United Western Bancorp, Inc. ("UWB"), the corporate parent of Debtor, UWT, Inc. ("UWT").

Travelers seeks an order from the Court either (1) confirming that the automatic stay imposed under Section 362 of the Bankruptcy Code does not prevent the payment of insurance proceeds payable under the Policy for reasonable and necessary fees and costs ("Defense Costs") on behalf of directors and officers of UWT; or (2) granting relief from the automatic stay to allow for payment of the Defense Costs as provided by the Policy.

I. BACKGROUND

A. The Policy

Travelers issued SelectOne for Community Banks Policy No. EC08300506 ("the Policy") to UWB for the claims-made Policy Period from April 1, 2009 to April 1, 2010, which Policy Period was extended to April 15, 2010.[1] (Ex. 1, Policy, Declarations and Endorsement Form PV040 Ed. 4-02, Policy Period Extension Endorsement). UWB subsequently purchased an Additional Extended Discovery Period from April 15, 2010 to April 15, 2011. (Ex. 1, Policy, Endorsement Form PV028 Ed. 4-02, Election of Additional Extended Discovery Period Endorsement – For Entire Policy). The Policy is a composite policy comprised of the following Insuring Agreements: Management Liability (the "MLIA"); Employment Practices Liability; Fiduciary Liability; Trust Liability (the "TLIA"); and Bankers Professional Liability. As explained below, individuals covered under the Policy have tendered three civil actions for coverage under the MLIA and one civil action for coverage under the TLIA.

The Named Insured is UWB. (Policy, Declarations). UWB is presently the subject of a Chapter 7 bankruptcy proceeding. (*In re United Western Bancorp, Inc.*, Case No. 12-13815 (Bankr. D. Colo.) ("UWB Bankruptcy"). The Policy defines the term "Company" to include UWB's subsidiaries. (*Id.*, General Terms, Conditions and Limitations ("GTC&L"), Definitions). UWB's subsidiaries include United Western Bank, UWT, and United Western Administrative Services, Inc. ("UWAS"). The Policy defines "Insured Persons" to include all current and former officers and directors of UWB and all of the current and former officers and directors of UWB's subsidiaries, one of which is UWT. (Policy, GTC&L, Definitions).

[1] The Policy defines the capitalized terms in this Motion and Memorandum. A true and complete copy of the Policy is appended as Exhibit 1.

The Policy only provides coverage for Claims first made against Insureds during the Policy Period or the Additional Extended Discovery Period (i.e., April 1, 2009 to April 15, 2011). In relevant part, a Claim is defined to include: "(a) a written demand against any Insured for monetary damages or non-monetary relief; [or] (b) a civil proceeding against any Insured . . . . on account of a Wrongful Act." (Policy, GTC&L, Definitions). Under the Policy, "all Claims arising out of the same Wrongful Act and all Interrelated Wrongful Acts . . . shall be deemed one Claim, and such Claim shall be deemed first made . . . on the date the earliest of such Claims is first made . . ., regardless of whether such date is before or during the Policy Period." (*Id.*, GTC&L, Limits of Liability, Retentions and Coinsurance). The Policy defines Interrelated Wrongful Acts as "all Wrongful Acts that have as a common nexus any fact, circumstance, situation, event, transaction, cause or series of related facts." (*Id.*, GTC&L, Definitions). In addition, the Policy's Notice clause provides that, if during the Policy Period or any Additional Extended Discovery Period, the Insureds submit a notice of circumstances which could give rise to a Claim, "then any Claims subsequently arising from such circumstances shall be considered to have been made during the Policy Year . . . or, if exercised, the Additional Extended Discovery Period in which such notice of circumstances . . . was first given to the Insurer." (*Id.*, GTC&L, Notice).

1. The Management Liability Insuring Agreement

The MLIA provides Directors and Officers Individual Coverage, Company Indemnification Coverage, Company Liability Coverage, and Investigative Costs Coverage. (Policy, Declarations). Coverage under the MLIA is subject to a $10 million Limit of Liability

for each Policy Year. (*Id.*).[2] The MLIA's $10 million Limit of Liability is entirely separate from the Policy's $4 million Policy Year Total Limit of Liability. (*Id.*). The MLIA's Insuring Agreement for Directors and Officers Individual Coverage provides, in part:

> The Insurer shall pay on behalf of the Insured Persons Loss for which the Insured Persons are not indemnified by the Company and which the Insured Persons become legally obligated to pay . . . for a Management Practices Act taking place before or during the Policy Period.

(*Id.*, MLIA). The "Company" (i.e., UWB and its subsidiaries, including UWT) expressly is *not* an Insured with respect to the Directors and Officers Individual Coverage. (*Id.*, GTC&L, Definitions (definition of "Insured")).

The MLIA also provides indemnification and liability coverage to insured entities. (*Id.*, MLIA). The MLIA's Company Indemnification Coverage extends to "Loss for which the Company grants indemnification to the Insured Persons . . . ." (*Id.*). The MLIA's Company Liability Coverage applies only to covered loss that an insured Company "becomes legally obligated to pay on account of any Securities Claim . . . ." (*Id.*).

It is the duty of the Insureds, not Travelers, to defend claims under the MLIA. (*Id.*, Policy, Declarations). Travelers is required, however, to advance the Insureds' Defense Costs under the MLIA. (*Id.*, GTC&L, Defense and Settlement, Duty of the Insureds to Defend). Defense Costs are part of and shall reduce the MLIA's $10 million limit of liability. (*Id.*, GTC&L, Limits of Liability, Retentions and Coinsurance).

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[2] The MLIA provides a $1 million Excess Directors and Officers Individual Coverage that is in excess of the MLIA's $10 million Limit of Liability. (Policy, MLIA, Extensions, Excess Directors and Officers Individual Coverage). UWT's Trustee has asserted in his adversary proceeding against Travelers that UWB also bought $5 million in excess coverage for its directors and officers and those of its subsidiaries (but not for any insured entity). (*Weinman v. St. Paul Mercury Ins. Co.*, Case No. 15-AP-1171 (Bankr. D. Colo.) (the "Adversary Proceeding"), Dkt. No. 7, ¶ 6).

The MLIA sets forth the priority order in which Travelers shall make payments under the MLIA. The Policy provides, in relevant part:

> In the event of Loss arising from a covered Claim for which payment is due under the provisions of the Management Liability Insuring Agreement made part of this Policy, then the Insurer shall in all events:
>
> (a) first, pay Loss for which coverage is provided under the Directors and Officers Individual Coverage; and then
>
> (b) only after payment of Loss has been made pursuant to subsection (a) above, with respect to whatever remaining amount of the Limit of Liability is available after such payment, at the written request of the chief executive officer of the Company, either pay or withhold payment of such other Loss for which coverage is provided under the Company Indemnification Coverage;

(*Id.*, MLIA, Endorsement Form No. PV131 Ed. 6-03, Order of Payments Endorsement).

2. The Trust Liability Insuring Agreement

The TLIA provides coverage, subject to its terms and conditions, for Trust Acts. (*Id.*, TLIA). The Policy defines a "Trust Act" to include certain acts "committed or attempted by any Insured Person on behalf of the Company . . ." in capacities, including, among others those as a trustee or a co-trustee; a fiduciary or co-fiduciary under a pension profit sharing plan; a custodian, depository or managing agent for securities or real property. (*Id.*, GTC&L, Definitions). The TLIA has a $4 million per Policy Year Limit of Liability and shares the Policy's $4 million Policy Year Total Limit of Liability with the Bankers Professional Liability Insuring Agreement. (*Id.*, Policy Declarations). These are the only insuring agreements that share the Policy's Policy Year Total Limit of Liability. (*Id.*).

Under the TLIA, the Insureds, not Travelers, have the duty to defend Claims. (*Id.*) Travelers, however, is obligated to advance Defense Costs under the TLIA and such advanced Defense Costs are part of and reduce the TLIA's $4 million Limit of Liability. (*Id.*, GTC&L,

Defense and Settlement, Duty of the Insureds to Defend; GTC&L, Limits of Liability, Retentions and Coinsurance).

B. Claims Made Under The Policy

As indicated above, the Policy provides coverage for Claims made during a finite period ending on April 15, 2011. At present, the claims universe consists of four lawsuits, described below.

1. The Securities Class Action

On March 11, 2011, during the Additional Extended Discovery Period, UWB (the Named Insured) and its directors and officers were named as defendants in a securities class action styled *MHC Mutual Conversion Fund, L.P. v. United Western Bancorp, Inc., et al.,* Case No. 1:11-cv-624 (D. Colo.) (the "Securities Class Action"). The operative amended complaint in the Securities Class Action accused UWB and its directors and officers of making false or misleading statements in connection with UWB's September 17, 2009 public offering of shares of its stock. (Securities Class Action, Dkt. No. 46, ¶¶ 34-42). Following UWB's filing of a Chapter 11 petition on March 2, 2012, the defendant directors and officers filed a motion in the UWB Bankruptcy seeking confirmation that the automatic stay did not prevent Travelers from advancing their Defense Costs. (UWB Bankruptcy, Dkt. No. 144 at 2). The Court, the Hon. A. Bruce Campbell, granted the defendants' motion, holding that "[t]he proceeds of the Travelers Policy (as defined in the Motion) are not property of the estates herein . . . ." (UWB Bankruptcy, Dkt. No. 164).

The defendant directors and officers prevailed on their motion to dismiss the Securities Class Action and the United States Court of Appeals for the Tenth Circuit affirmed the dismissal. *See MHC Mut. Conversion Fund, L.P. v. Sandler O'Neill & Partners, L.P.*, 761 F.3d 1109

(10th Cir. 2014). The defendant directors and officers in the Securities Class Action sought coverage from Travelers under the MLIA. Travelers advanced over $1,000,000 in Defense Costs in the Securities Class Action subject to a reservation of rights, which advancement reduced the MLIA's $10 million Limit of Liability.

2. The FDIC Action

On April 12, 2011, during the Additional Extended Discovery Period, the Federal Deposit Insurance Corporation as Receiver for United Western Bank ("FDIC") issued a letter (the "FDIC Demand") to Travelers and certain former directors and officers of United Western Bank "demand[ing] payment of $40 million," and accusing the former directors and officers of "breach of fiduciary duty, negligence, gross negligence, and/or recklessness." Thereafter, the FDIC filed a civil action, styled *FDIC v. Berling*, Case No. 1:14-cv-00137 (D. Colo.) (the "FDIC Action"), on January 17, 2014. The FDIC seeks to recover over $35 million in damages from the former directors and officers of United Western Bank.

The defendants in the FDIC Action seek coverage under the MLIA. Subject to a reservation of rights,[3] Travelers has advanced $628,300 of its insureds' Defense Costs in the FDIC Action and there are approximately $908,000 in invoices yet to be paid. To the extent coverage is available, the advancement of these Defense Costs, like the advancement of the Securities Class Action Defense Costs, reduces the MLIA's $10 million Limit of Liability. (Policy, GTC&L, Limits of Liability, Retentions and Coinsurance). Since receiving the complaint in the Trustee's Adversary Proceeding, Travelers has not advanced any additional

[3] Travelers continues to reserve all of its rights to deny coverage and seek recoupment of amounts advanced under the Policy. By setting forth arguments available to Insured Persons, Travelers does not in any way waive any of its coverage defenses under the Policy or applicable law.

sums for the FDIC Action and will not do so until it is clear that this Court would not view such advancement as a violation of the UWT bankruptcy stay.

3. The Labaty Action

In 2013, Deborah Labaty filed a civil action now styled *Labaty v. UWT, Inc.*, Case No. 5:13-cv-00389 (W.D. Tex.) (the "Labaty Action"). The original defendants in the Labaty Action included UWT, UWAS, former UWT directors Jeff Kelley and Paul Maxwell, former UWB directors and officers Scot Wetzel and Michael McCloskey, and several non-insured entities and individuals. In her operative fourth amended complaint, Labaty accuses the remaining insured defendants of participating in a scheme to defraud investors in Superior Gold Group, which is also a defendant in the case. The Labaty Action includes causes of action against the insured defendants for violations of the Racketeer Influenced Corrupt Organizations Act, negligence, common law fraud and conversion.

UWT and UWAS filed notices of their bankruptcy stays in the Labaty Action shortly after it was filed in 2013. Those stays have remained in place through the course of the Labaty Action. On April 10, 2015, Labaty filed a motion in this proceeding seeking relief from the automatic stay to permit her to prosecute her claims against UWT. (Dkt. No. 41). The Court denied Labaty's Motion on May 7, 2014. (Dkt. No. 52).

To the extent there is any coverage under the Policy for the Labaty Action, it would be under the Policy's TLIA. Although the Labaty Action was filed after the expiration of the Policy Period and the Additional Extended Discovery Period, Travelers' Insureds provided on April 13, 2011, during the Additional Extended Discovery Period, a notice of circumstance with respect to potential claims by UWT customers who had purchased from Superior Gold Group but never received precious metals to be held in their IRA accounts maintained by UWT. That notice of

circumstances specifically identified Labaty (then known as Deborah Fiore) as one such customer and as a potential claimant against UWT and its directors and officers. (*Id.*).

Subject to a reservation of rights, Travelers has advanced approximately $542,000.00 in Defense Costs in the Labaty Action under the TLIA. Thus, those advancements have reduced only the TLIA's $4 million Limit of Liability. (*See* Policy, Declarations). The Labaty Action Defense Costs do not affect the MLIA's $10 million Limit of Liability. (*Id.*). Consequently, the Labaty Action Defense Costs do not compete with the Trustee Action for MLIA proceeds. Since receiving the complaint in the Trustee's Adversary Proceeding, Travelers has not advanced any additional sums for the Labaty Action and will not do so until it is clear that this Court would not view such advancement as a violation of the UWT bankruptcy stay.

4. The Trustee Action

On January 31, 2014, UWT's Trustee filed a civil action styled *Weinman v. McCloskey*, Case No. 1:14-cv-296 (D. Colo.) (the "Trustee Action"), against certain former directors and officers of UWT. In his fourth amended complaint, the Trustee asserts causes of action against UWT's former directors and officers for negligence, breach of fiduciary duty and fraudulent transfer and accuses them of, among other things, breaching duties owed to UWT in connection with the sale of UWT's trust and viatical businesses and the subsequent transfer of the proceeds of those sales.

Although the Trustee Action was filed in 2014, long after the Policy's Additional Extended Discovery Period expired, the insured defendants can argue that the FDIC Demand from April 2011 included some allegations similar to those in the Trustee Action with respect to UWT's sale of its trust business in 2009 such that the two Claims should be deemed a single Claim first made at the time of the FDIC Demand. UWT's Trustee, who views the Policy's

proceeds as a potential source for satisfying a settlement of or potential judgment in the Trustee Action, presumably would agree with such an argument.[4]

On May 30, 2014, the defendants in the Trustee Action filed an unopposed motion in this proceeding confirming Travelers' right to advance their Defense Costs under the MLIA. (Dkt. No. 20). The defendants argued that the Policy's proceeds were not property of UWT's Estate. (*Id.*). The Court granted the defendants' motion on July 1, 2014, and issued an Order permitting Travelers to "follow the express terms of the Policies by advancing and reimbursing legal fees, costs, and expenses and any other payments due, or that may become due in the future . . . in connection with the defense of the Trustee Action . . . ." (Dkt. No. 24). In doing so, this Court did *not* hold that the Policy proceeds were property of the UWT Estate. (*Id.*). Travelers has advanced under the MLIA the defendants' Defense Costs in the Trustee Action subject to a reservation of rights.

II. RELIEF REQUESTED

Travelers seeks the entry of an order confirming that the Policy's proceeds are not property of UWT's Estate and, therefore, are not subject to the automatic stay. Alternatively, Travelers seeks relief from the automatic stay, *nunc pro tunc*, to permit it to advance the Defense Costs of the insured defendants in the FDIC and Labaty Actions and authorizing the Defense Costs that have been paid on behalf of the insured defendants in the Securities Class Action.

[4] Again, Travelers reserves all of its rights under the Policy and applicable law and, by setting forth the Insureds' arguments for coverage, is not in any way expressing agreement with those arguments.

III. ARGUMENT

A. The Policy's Proceeds Are Not Property of the UWT Estate

Putting aside the fact that UWB (the Named Insured), not UWT, purchased and paid for the Policy – which raises the question of whether the Policy itself is even property of the UWT Estate (rather than the UWB Estate) – there should be no question that the Policy's *proceeds* are not property of the UWT Estate.[5] The Policy's proceeds are not property of UWT's Estate and, therefore, are not subject to the automatic stay. Courts considering policies similar to the Travelers Policy have long recognized a distinction between a policy and its proceeds. *See In re World Health Alternatives, Inc.*, 369 B.R. 805, 809 (Bankr. D. Del. 2007) ("It is clear that insurance policies *purchased and paid for by a debtor* are property of the estate. . . . The more important question here is whether the proceeds of the policy are property of the estate." (emphasis added)).

Where a portion of a policy's proceeds inure to the benefit of non-debtor insureds, that portion of the proceeds is not considered part of the bankruptcy estate. This was established in *Louisiana World Exposition, Inc. v. Federal Insurance Co.* (*In re Louisiana World Exposition, Inc.*), 832 F.2d. 1391, 1399-1401 (5th Cir. 1987), in which the court found that officers and directors are the designated beneficiaries of liability policies, thus carving policy proceeds out of the debtor's bankruptcy estate. *See also, In re Adelphia Commc'ns Corp.*, 298 B.R. 49, 52-53 (S.D.N.Y. 2003); *In re Spaulding Composites Co., Inc.*, 207 B.R. 899, 906-07 (9th Cir. BAP 1997) (ruling that automatic stay did not apply to non-debtor insureds under debtor's policy

[5] As indicated, Judge Campbell held in the UWB Bankruptcy that the Policy's proceeds were not the property of the estate of UWB, which is the Named Insured that actually purchased the Policy. (UWB Bankruptcy, Dkt. No. 164).

because debtor's interest in a portion of the policy did not render the entire policy part of the bankruptcy estate).

The fact that the Policy includes entity coverage does not suffice to give the Estate a present property interest in the Policy's proceeds. Hypothetical or speculative claims against a debtor do not render policy proceeds property of the estate. *See In re Downey Fin. Corp.*, 428 B.R. at 604; *In re First Central Fin. Corp.*, 238 B.R. 9, 18 (Bankr. E.D.N.Y. 1999) (observing that the existence of entity coverage did not render policy proceeds property of the estate where there were no pending covered claims against the debtor); *In re Allied Digital Techs.*, 306 B.R. 505, 512 (Bankr. D. Del. 2004) ("[W]hen the 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.").

Nor does the Trustee's desire to preserve the MLIA's proceeds to satisfy his own claim against non-debtor insureds in the Trustee Action give the Estate a property interest in the Policy's proceeds. Several courts have considered and rejected the idea that an estate's status as a potential judgment creditor of non-debtor insureds somehow gives it a property interest in policy proceeds. In *Allied Digital*, a trustee, like UWT's Trustee, attempted to premise the estate's property interest in the policy on the trustee's own claim against insured persons. 306 B.R. at 513. The court disagreed, stating:

> The Trustee's real concern is that payment of defense costs may affect his rights as a plaintiff seeking to *recover from* the D&O Policy rather than as a potential defendant seeking to be *protected by* the D&O Policy. In this way, [the] Trustee is no different than any third party plaintiff suing defendants covered by a wasting policy. No one has suggested that such a plaintiff would be entitled to an order limiting the covered defendants' rights to reimbursement of their defense costs.

Id. (emphasis in original). *See also World Health Alternatives*, 369 B.R. at 811 ("If the Trustee is seeking to recover for the wrongs of the defendants in the Trustee's Action pending in this Court, [he] is not entitled to preference over the settlement of [another covered action against the insureds]."). Put simply, the Bankruptcy Code "provides the Trustee no different status than a non-bankruptcy plaintiff with an unliquidated claim which may be covered by insurance proceeds." *In re Laminate Kingdom LLC*, No. 07-10279, 2008 WL 1766637, at *3 (Bankr. S.D. Fla. Mar. 13, 2008).

Moreover, even if the Trustee could somehow assert that UWT's status as a would-be judgment creditor of the defendants in the Trustee Action gave it a claim to coverage under the MLIA, the Estate's right to such coverage would be subordinate to the rights of the non-debtor Insured Persons and the proceeds *still* would not be property of the Estate. The Policy permits Travelers to advance coverage to UWT (or any other insured entity) under the MLIA *only after* it first has paid the Insured Persons' losses. (Policy, Order of Payments Endorsement).

Courts interpreting similar priority of payment provisions have reached the same conclusion, holding that such provisions preclude insured debtors from claiming policy proceeds as estate property. In *In re Downey Financial Corp.*, the policy at issue included such a provision, requiring the insurer to "first, pay Loss for which coverage is provided under Coverage A" (referring to individual coverage for the directors and officers). 428 B.R. at 599-600. The court held that the provision provided a "clear chain of priority" among the types of coverages and, to the extent the trustee had any interest in the policy, the interest was subordinate to that of the insured directors and officers. *Id.* at 607-08. The policy proceeds could not be considered property of the estate because that would improperly give the trustee "greater rights in the [Policy proceeds] than the debtor had before filing for bankruptcy." *Id.* at 608 (quoting

Integrated Solutions, Inc. v. Serv. Support Specialties, Inc., 124 F.3d 487, 492 (3d Cir. 1997)); *see also In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1401 (5th Cir. 1987) (noting that the concept of "proceeds," as referenced in section 541 of the Bankruptcy Code, "does not give the bankrupt's estate property the debtor would not own if it were solvent"); *In re TierOne Corp.*, No. 10-bk-41974, 2012 WL 4513554, at *3 (Bankr. D. Neb. Oct. 2, 2012) (finding that debtor had no property interest sufficient to prevent payment of insurance proceeds to directors and officers where an order of payments provision rendered estate's interest subordinate to insured directors' and officers' claims).

Lest there be any doubt about the Order of Payment Endorsement's application to the facts of this case, the endorsement provides explicitly that the financial impairment or bankruptcy of an Insured does *not* "relieve the insurer of its obligations to prioritize payment of covered Loss." (Policy, Order of Payments Endorsement). To subject the Policy's proceeds to the automatic stay in the face of the Order of Payments Endorsement would require Travelers (and the Court) to ignore the unambiguous terms of its Policy and would grant UWT greater rights to the proceeds than it had before filing for bankruptcy. *See Louisiana World Exposition, Inc., supra; In re CyberMedica, Inc.*, 280 B.R. 12, 16 (Bankr. D. Mass. 2002) ("A bankruptcy estate can have no greater claim to the proceeds of property of the estate than the debtor would have had outside of bankruptcy.").

In sum, there are multiple bases on which the Court may conclude that the Policy's proceeds are not property of the Estate and, therefore, are not subject to the automatic stay. The fact that UWB, not UWT, purchased the Policy raises the question of whether the Policy itself is Estate property. Even if the Policy were deemed Estate property, its proceeds are not because UWT has no claim for coverage under the Policy, because the non-debtor insureds in the FDIC,

Labaty and Securities Class Actions do, and because UWT's status as a would-be judgment creditor against non-debtor insureds in the Trustee Action cannot transform the proceeds into Estate property. Any of these reasons permit the Court to grant the instant Motion.

B. Travelers Is Entitled To Relief From Stay To Advance The Non-Debtor Insureds' Defense Costs

Were the Court to conclude that the Estate might have a property interest in the Policy's proceeds, cause exists to grant relief from the automatic stay to permit Travelers to advance the non-debtor insureds' Defense Costs in the FDIC and Labaty Actions. 11 U.S.C. § 362(d)(1) provides that "the [C]ourt shall grant relief from the stay provided under subsection (a) of this section, such as by . . . modifying . . . such stay . . . for cause, including the lack of adequate protection of an interest in property of such party in interest[.]" When cause is shown, the Court must grant relief from the stay. *See In re Tucson Estates, Inc.*, 912 F.2d 1162, 1166 (9th Cir. 1990) ("A bankruptcy court 'shall' lift the automatic stay 'for cause.'"); *see also In re Wilson*, 116 F.3d 87, 90 (3d Cir. 1997) ("The Bankruptcy Code provides that the bankruptcy court *shall* grant relief from the automatic stay 'for cause.'") (emphasis added).

Accordingly, "[e]ven in cases where the D&O policy proceeds were considered property of the estate, courts have nonetheless granted relief from stay to allow the insurer to advance defense costs payments when the harms weigh more heavily against the [non-debtor] directors or officers than the debtor." *In re MILA, Inc.*, 423 B.R. 537, 544 (B.A.P. 9th Cir. 2010) (finding that modifying the automatic stay for the payment of defense costs was proper even if policy was considered property of the estate). *See also Allied Digital*, 306 B.R. at 513-14 ("It is not uncommon for courts to grant stay relief to allow payment of defense costs or settlement costs to directors and officers . . . ."); *CyberMedica*, 280 B.R. at 18 (holding that "there [was] cause to lift the automatic stay because [the insureds] may suffer substantial and irreparable harm if

prevented from exercising their rights to defense [coverage]"). The *CyberMedica* court observed that the non-debtor insureds "are in need *now* of their contractual right to payment of defense costs and may be harmed if disbursements are not presently made to fund their defense." *Id.* (Emphasis in original).

Absent the relief Travelers seeks, the non-debtor insured defendants in the FDIC and Labaty Actions will suffer immediate harm. Were Travelers unable to advance the insured defendants' Defense Costs, the defendants will be left to forego a defense or fund it with likely finite personal resources. The non-debtor insureds will likewise face the possibility of having to settle the FDIC and Labaty Actions or satisfy judgments against themselves with their personal resources (to the extent they exist). This Court concluded that it was proper to modify the automatic stay, to the extent it applied, to permit Travelers to advance the Defense Costs of the non-debtor insureds in the Trustee Action. (Dkt. No. 24). It is equally proper to modify the automatic stay, to the extent it applies, to permit Travelers to afford the non-debtor insured defendants in the FDIC and Labaty Action the same coverage the defendants in the Trustee Action are receiving.

To the extent the Court determines that the stay applies to the Policy's proceeds, Travelers respectfully asks the Court to permit continued advancement of defense costs for the FDIC and Labaty Action and to approve prior advancement of defense costs for the Securities Class Action *nunc pro tunc*. The bankruptcy court overseeing the estate of UWB, which is the named insured and the entity that actually paid the premiums for the Policy, previously held that the Policy proceeds are not an asset of the UWB estate. With that ruling and no coverage sought under the Policy by UWT *for any claims against it*, Travelers did not seek leave in the UWT bankruptcy proceedings, or any other bankruptcy proceedings involving insureds under the

Policy, before advancing defense costs in the Securities Class Action, the FDIC Action, or the Labaty Action. Once the UWT Trustee raised the question of whether the proceeds are an asset of the estate, Travelers immediately ceased advancements and sought this Court's guidance, filing a motion to dismiss the Trustee's adversary proceeding, an opposition to his motion for a preliminary injunction, and the instant Motion.

IV. CONCLUSION

For the foregoing reasons, Travelers requests the entry of an order confirming that the Policy's proceeds are not property of the UWT Estate and, therefore, are not subject to the automatic stay. Alternatively, Travelers requests that the Court grant relief from the automatic stay, *nunc pro tunc*, to permit Travelers' advancement of the Defense Costs of the insured defendants in the FDIC, Labaty and Securities Class Actions.

Dated: June 23, 2015

Respectfully submitted,

/s/ Brent R. Cohen

Brent R. Cohen
LEWIS ROCA ROTHBERGER LLP
1200 17th Street, Suite 3000
Denver, CO 80202-5855
Telephone: (303) 628-9521
Facsimile: (303) 623-9222
bcohen@lrrlaw.com

and

Thomas J. Judge
LOSS, JUDGE & WARD, LLP
1133 21st Street NW, Suite 450
Washington, DC 20036
Telephone: (202) 778-4060
Facsimile: (202) 778-4099
tjudge@ljwllp.com

Counsel for Defendant
St. Paul Mercury Insurance Company

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO

In re:	)	
	)	
UWT, Inc.,	)	
	)	Case No.: 13-18184-EEB
Debtor.	)	Chapter 7
	)	
	)	
	)	
ST. PAUL MERCURY INSURANCE COMPANY	)	
	)	
	)	
Movant,	)	
v.	)	
	)	
UWT, Inc.,	)	
	)	
Debtor.	)	

4001-1 NOTICE OF MOTION FOR RELIEF FROM AUTOMATIC STAY AND OPPORTUNITY FOR HEARING PURSUANT TO 11 U.S.C. § 362(d)

OBJECTION DEADLINE: Thursday, July 16, 2015

YOU ARE HEREBY NOTIFIED that a Motion for Relief from Stay (the "Motion") has been filed, a copy of which is attached hereto.

A hearing on the motion has been set for **July 23, 2015 at 11:00 a.m.** at the U.S. Bankruptcy Court, Byron G. Rogers U.S. Courthouse, 1929 Stout, **Courtroom F**, Denver, Colorado 80202. The hearing will be conducted in accordance with the provisions of L.B.R. 4001-1.

IF YOU DESIRE TO OPPOSE THIS MOTION, you must file with this court a WRITTEN OBJECTION to the motion on or before the objection deadline stated above and serve a copy upon movant's attorney, whose address is listed below.

If you file an objection, you are REQUIRED to comply with L.B.R. 4001-1 regarding hearing procedures, including (1) the timely submission and exchange of witness lists and exhibits and (2) attendance at the above-scheduled hearing in person or through counsel, if represented.

IF YOU FAIL TO FILE AN OBJECTION, and the scheduled hearing will be vacated, an order granting the relief requested may be granted without further notice to you.

Dated: June 23, 2015

Respectfully submitted,

/s/ Brent R. Cohen

Brent R. Cohen
LEWIS ROCA ROTHBERGER LLP
1200 17th Street, Suite 3000
Denver, CO 80202-5855
Telephone: (303) 628-9521
Facsimile: (303) 623-9222
bcohen@lrrlaw.com

and

Thomas J. Judge
LOSS, JUDGE & WARD, LLP
1133 21st Street NW, Suite 450
Washington, DC 20036
Telephone: (202) 778-4060
Facsimile: (202) 778-4099
tjudge@ljwllp.com

Counsel for Defendant
St. Paul Mercury Insurance Company

CERTIFICATE OF SERVICE

I hereby certify that on June 23, 2015, true and correct copies of the **MOTION FOR RELIEF FROM AUTOMATIC STAY and the 4001-1 NOTICE OF MOTION FOR RELIEF FROM AUTOMATIC STAY AND OPPORTUNITY FOR HEARING PURSUANT TO 11 U.S.C. § 362 (d)** were mailed by depositing same in the United States mail, first-class postage prepaid, addressed to the following:

UWT, Inc.
P.O. Box 18374
Golden, CO 80402

Jeffrey A. Weinman
730 17th Street, Ste. 240
Denver, CO 80202

Isaac Jay Eddington
1660 W. 2nd Street, Ste. 1100
Cleveland, OH 44114

Frances Floriano Goins
1660 W. 2nd Street, Ste. 1100
Cleveland, OH 44113

Joshua M. Hantman
410 17th Street, Ste. 2200
Denver, CO 80202

Mark A. Larson
1600 Stout Street , Ste. 1100
Denver, CO 80202

Jerold Oshinsky
2029 Century Park East, Ste. 750
Los Angeles, CA 90067

Carl Pipoly
14100 San Pedro Ave., Ste. 308
San Antonion, TX 78232

Jonathan E. Rawlins
508 Twilight Trl., Ste. 99
Richardson, TX 75080

Charles W. Shipman
115 E. Travis, Ste. 1530
San Antonio, TX 78203

Katherine M. Swan
1660 Lincoln St., Ste. 2200
Denver, CO 80264

Matthew Vandenberg
112 E. Pecan St., Ste. 2400
San Antonio, TX 78205

Patrick D. Vellone
1600 Stout Street, Ste. 1100
Denver, CO 80202

U.S. Trustee
999 18th Street, Suite 1551
Denver, CO 80202

/s/ Carol Ealey
OF: LEWIS ROCA ROTHGERBER LLP

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO

In re:	)	
	)	
UWT, Inc.,	)	Case No.: 13-18184-EEB
Debtor.	)	Chapter: 7
	)	
	)	
	)	

TRUSTEE'S OBJECTION TO ST. PAUL MERCURY INSURANCE COMPANY'S MOTION FOR RELIEF FROM AUTOMATIC STAY

Jeffrey A. Weinman, the duly appointed Chapter 7 Trustee ("Trustee"), through his attorneys Allen & Vellone, P.C. and Kasowitz, Benson, Torres & Friedman LLP, hereby objects to St. Paul Mercury Insurance Company's ("Travelers") Motion for Relief from Automatic Stay (the "Motion") [Dkt. No. 59]. In support thereof, the Trustee states as follows:

Introduction

UWT is obligated to indemnify its officers and directors. At the moment, the officers and directors face exposure of approximately $2.2 million. The only source of funds to which UWT's bankruptcy estate (the "Estate") can turn to meet its indemnification obligation are the insurance proceeds of the Travelers Policy (the "Policy's Proceeds"). UWT obtained entity coverage and a waiver of the typical "Insured v. Insured" exclusion, which waiver is applicable only in actions instituted by a bankruptcy trustee, for precisely this circumstance.

Because UWT is entitled to coverage under the Travelers Policy for indemnification claims, at least $2.2 million of the Policy constitutes Estate assets subject to the automatic stay. The Trustee made a first-party request on Travelers to reserve $2.2 million of the Policy to pay indemnification claims, and Travelers refused.

At the very least, this Court should reserve $2.2 million of the proceeds to satisfy the Estate's indemnification obligation. Doing so will not prejudice the defendants in the other actions defended by the Policy and it will save the Estate from significant prejudice.

Background

1. Travelers issued a claims-made insurance policy to United Western Bank ("UWB"), parent corporation of UWT, Inc. ("UWT"), with a policy period from April 1, 2009 to April 1, 2010 (the "Policy"). UWB purchased an additional extended policy period, which extended coverage from April 15, 2010 to April 15, 2011.

2. UWB is also a debtor in bankruptcy, Case No. 12-13815-TBM. UWB, UWT, and their directors and officers are all Insureds under the Policy.

3. The Policy is comprised of the following insuring agreements: Management Liability (the "MLIA"), Employment Practices Liability, Fiduciary Liability, Trust Liability (the "TLIA"), and the Bankers Professional Liability. According to Travelers' Motion, claims have only been made under the MLIA and TLIA.

4. A Claim is defined under the Policy as "a written demand against any Insured for monetary damages or non-monetary relief" or "a civil proceeding against any Insured . . . on account of a Wrongful Act." (Exhibit A, Policy, GTCL, Definitions, Page 27). "All Claims arising out of the same Wrongful Act and all Interrelated Wrongful Acts . . . shall be deemed one Claim and such Claim shall be deemed first made . . . on the date of the earliest of such Claims is first made . . . regardless of whether such date is before or during the Policy Period." (Exhibit A, GTCL, Limits of Liability, Retentions and Coinsurance, Page 35).

5. An Interrelated Wrongful Act is "all Wrongful Acts that have as a common nexus any fact, circumstances, situation, event, transaction, cause or series of related facts." (Exhibit A, GTCL, Definitions, Pages 29-30).

6. The Policy provides that the Insureds must, as a condition precedent to their rights under the Policy, provide written notice as soon as they learn of a claim against them:

> but in no event later than: (a) sixty (60) days after expiration of the Policy Year in which the Claim was first made; or (b) the expiration of the Automatic Discovery Period or, if exercised, the Additional Extended Discovery Period.

(Exhibit A, Amend Notice Section Endorsement, Page 13).

7. If the Insureds become aware of circumstances taking place during the policy period that could give rise to a claim and give written notice of such circumstances ("Notice of Circumstances") to Travelers during the policy period, then a claim arising after the fact under those circumstances is considered to have been made at the time that a Notice of Circumstances was given to Travelers. (Exhibit A, Notice, Page 36).

8. The Policy is a "wasting" policy of insurance in which defense costs reduce the coverage available for indemnity.

Management Liability Insuring Agreement

9. The MLIA provides Directors and Officers Individual Coverage, Company Indemnification Coverage, Company Liability Coverage, and Investigative Costs Coverage. The MLIA has a $10 million limit of liability and $1 million in excess coverage for the Directors and Officers Individual Coverage. (Exhibit A, Policy Declarations).

10. Travelers is obligated to advance defense costs which the Insureds have incurred in connection with claims made during the Discovery Period, Extended Discovery Period, or relating to a Notice of Circumstances as defined above.

11. The Company Indemnification Coverage provides that Travelers will reimburse the Company, i.e. UWT, for indemnification costs paid to the Insured directors and officers.

12. The Policy further provides that UWT "agrees, to the fullest extent permitted by law, to indemnify the Insured Persons for all Loss" and will "take all steps necessary or allowable to provide such indemnification." (Exhibit A, Indemnification, Page 36).

13. Travelers has acknowledged that it has advanced over $1,628,300.00 in defense costs for the Securities Class Action, Trustee and FDIC Actions under the MLIA as outlined in the Motion for Relief from Stay (Travelers Motion, Page 7).

Trust Liability Insuring Agreement

14. The TLIA provides coverage for Trust Acts, defined in relevant part as "any error, misstatement, misleading statement, act, omission, neglect, or breach of duty actually or allegedly committed or attempted by any Insured Person on behalf of the Company, or the Company," in certain capacities, including trustee or co-trustee, a fiduciary or co-fiduciary under a pension profit sharing plan, a custodian, depository or managing agent for securities or real property. (Exhibit A, GTCL, Page 33).

15. Expressly included within the definition of "Trust Act" is "any . . . act . . . actually or allegedly committed or attempted by any Insured Person on behalf of the Company, or the Company, in their capacity as . . . trustee exercising any other trust or fiduciary powers permitted by law." (Exhibit A, GTCL, Page 33).

16. The TLIA has a $4 million limit of liability per Policy year and is reduced by Defense Costs that Travelers is required to advance under the TLIA.

17. Travelers has acknowledged that it has advanced a total of $542,000.00 for defense costs under the TLIA.

UWT's Bankruptcy Case

18. UWT filed for relief under Chapter 7 of the Bankruptcy Code on May 14, 2013. The commencement of Debtor's chapter 7 case triggered the automatic stay pursuant to 11 U.S.C. § 362.

19. On May 14, 2013, Jeffrey A. Weinman was appointed as the Chapter 7 Trustee.

20. During UWT's 341 meeting held on June 19, 2013, Theodore Abariotes ("Abariotes"), a former Director of UWT, testified that UWT had tail coverage for approximately a six year period after the Policy end date which covered acts that occurred during

the Discovery Period and the Extended Discovery Period. A transcript of the 341 meeting is attached as Exhibit B hereto. *See* Exhibit B, 17:19-25; 18:1-21.

Claims Made Under the Policy

21. Travelers has admitted that four claims have been made under the Policy. (Travelers Motion, Page 6). Three claims are set forth below. The fourth claim is the action styled *MHC Mutual Conversion Fund, L.P. v. United Western Bancorp, Inc. et al.*, Case No. 1:11-cv-624 (D. Colo.), identified as the "Securities Class Action" in Travelers' Motion. The Securities Class Action is no longer relevant because the case has been dismissed.

FDIC Action

22. On January 17, 2014, the Federal Deposit Insurance Corporation ("FDIC") as Receiver for UWB filed a civil action against UWB's former directors and officers for breach of fiduciary duty, negligence, gross negligence and/or recklessness, seeking to recover $35 million in damages. The action is styled *FDIC v. Berling et al.*, Case No1:14-cv-00137 (the "FDIC Action").

23. According to Travelers, the FDIC issued a letter to Travelers and certain former directors and officers on April 12, 2011, during the Extended Discovery Period, demanding payment of $40 million in damages allegedly resulting from the directors and officers' breach of fiduciary duty, negligence, gross negligence and/or recklessness. (Travelers Motion, Page 7).

24. Neither Travelers nor the single director/officer of UWT who was named as a defendant in the FDIC Action have sought stay relief for the advancement of insurance proceeds.

25. Despite this fact, the defendants in the FDIC Action sought coverage under the MLIA. Travelers has admitted that it has advanced $628,300.00 in defense costs for the FDIC Action, with a remaining $908,000 in invoices yet to be paid. (Travelers Motion, Page 7). This advancement was in violation of the automatic stay.

Labaty Action

26. On February 22, 2013, three months prior to Debtor's petition date, Deborah (Fiore) Labaty ("Labaty") filed a complaint in Texas state court against the Debtor, former UWT directors Jeff Kelley and Paul Maxwell, former UWB directors and officers Scot Wetzel and Michael McCloskey (who is also a UWT officer and director), and several non-insured defendants.

27. On May 6, 2013, the pre-petition Debtor and two co-defendants removed Labaty's lawsuit to the U.S. District Court for the Western District of Texas, San Antonio, Texas. The action is styled *Labaty v. UWT, Inc.*, Case No. 5:13-cv-00389-XR ("the Labaty Action"). The Third Amended Complaint is attached as Exhibit C hereto.

28. In her complaint, Labaty asserts claims for violations of the Racketeer Influenced and Corrupt Organization Act ("RICO"), negligence, common law fraud, and conversion.

29. The Labaty Action has been stayed as to UWT during the pendency of this bankruptcy case. However, on April 10, 2015, Labaty filed a motion for relief from stay, seeking Court approval to prosecute her claims against UWT [Dkt. No. 41].

30. Former UWT directors Jeff Kelley and Paul Maxwell filed an objection, stating that "Debtor's insurance carrier has assumed financial responsibility for defending the litigation, the policy is a wasting policy and is the only means of recovery available to individuals with whom the Chapter 7 Trustee is in litigation and pursuing the possibility of settlement." [Dkt. No. 43, p. 4]. The Trustee agrees.

31. The Trustee also filed an objection, asserting that Labaty's claims belong to the Estate and are therefore under the control of the Trustee. The Court denied Labaty's motion for relief from stay on May 7, 2014 [Dkt. No. 52].

32. The Labaty Action relates back to both a Notice of Claim and Notice of Circumstances within the Extended Discovery Period of the Policy.

33. On January 28, 2011, Abariotes on behalf of UWB, sent a Notice of Claim to Travelers identifying recent claims by former customers of UWT regarding their self-directed investments in coins from Superior Gold Group, LLC. A copy of the Notice of Claim is attached hereto as Exhibit D.

34. On April 13, 2011, Abariotes sent a Notice of Circumstances during the Extended Discovery Period to Travelers, identifying potential claims by UWT customers who had purchased precious metals from Superior Gold Group to be held in their self-directed IRA accounts maintained by UWT but had never received them. The spreadsheet referenced in the Notice of Circumstances specifically identifies Labaty (f/k/a Deborah Fiore) as a customer and potential claimant, along with 191 other potential claimants whose total claims would exceed $7.6 million. A copy of the Notice of Circumstances is attached hereto as Exhibit E and a copy of the spreadsheet is attached hereto as Exhibit F.

35. Travelers has indicated that "to the extent there is any coverage under the Policy for the Labaty Action, it would be under the Policy's TLIA." (Travelers Motion, Page 8).

36. However, despite having failed to seek relief from stay until April of 2015 and without regard to the Court's ultimate denial of Labaty's motion for relief from stay, Travelers has admitted that it has advanced $542,000.00 in defense costs in the Labaty Action under the TLIA. (Travelers Motion, Page 9).

Trustee Action

37. On January 31, 2014, the Trustee filed a complaint in the United States District Court for the District of Colorado, *Weinman v. McCloskey et al.*, 14-cv-296-CMA-CBS (the "Trustee Action") seeking claims for negligence, breach of fiduciary duty, and fraudulent transfer. The Fourth Amended Complaint is attached as Exhibit G hereto.

38. UWT's directors and officers in the Trustee Action filed a motion for relief from stay, requesting advancement of their defense costs under the Policy [Dkt. No. 20].

39. On July 1, 2014, this Court entered an Order Authorizing Advancements of Defense Costs Under Debtor's Insurance Policies and Granting Relief from the Automatic Stay to the Extent Applicable [Dkt. No. 24]. The Order specifically provides that, "the Insurers are permitted to follow the express terms of the Polices by advancing and reimbursing the legal fees, costs, and expenses and any other payments due, or that may become due in the future, under the Policies (subject to the terms and conditions of, and subject to the coverage limits set forth in, the Policies) **in connection with the defense of the Trustee Action**. *Id.* (emphasis added). This Court specifically limited stay relief for the defense costs of the Trustee Action only.

40. Moreover, this Court did not make a determination as to whether the Policy's Proceeds are property of the Estate [Dkt. No. 24].

41. Travelers has indicated that "the insured defendants can argue that the FDIC Demand from April 2011 included some allegations similar to those in the Trustee Action with respect to UWT's sale of its trust business in 2009 such that the two Claims should be deemed a single Claim first made at the time of the FDIC Demand." (Travelers Motion, Page 9). The Trustee disputes that the Trustee Action relates to the FDIC Action in that the Wrongful Acts alleged in each of the respective actions are entirely distinct.

42. Despite requests for what would clearly be discoverable, if not a mandatory disclosure item, to date Travelers has refused to provide the Trustee a copy of the reservation of rights letter for the Trustee Action.

43. Based on Theodore Abariotes' testimony at UWT's 341 meeting, the Trustee Action plainly falls within the tail coverage of the Policy.

44. Contrary to Travelers' assertion, the Trustee Action relates to *only* the Labaty Action, and does not assert claims "that have as a common nexus any fact, circumstances, situation, event, transaction, cause or series of related facts" in connection with the FDIC Action.

45. In particular, both Labaty's Complaint and the Trustee's Complaint arise out of the same precious metals scheme and, therefore, assert many of the same allegations relating to UWT directors' negligence and breach of their duties. Therefore, the Labaty Action and the Trustee Action assert Interrelated Wrongful Acts under the Policy. *Compare* Exhibit C *with* Exhibit G.

46. The Trustee maintains, as set forth in his objection to Labaty's motion for relief from stay, that the claims in the Labaty Action appear to be claims on behalf of the Estate for damages resulting from the actions of the directors. [Dkt. No. 45].

47. As such, the Notice of Circumstances on April 13, 2011 that Travelers admits relates to the Labaty Action also relates to the Trustee Action.

48. Because the Trustee Action relates to the Labaty Action and also implicates director and officer mismanagement, coverage for the Trustee Action should be provided under both the MLIA and the TLIA.

The Adversary Proceeding Against Travelers

49. On April 29, 2015, the Trustee filed an adversary proceeding against Travelers seeking declaratory and injunctive relief as to the Policy's Proceeds. The adversary is styled as *Jeffrey A. Weinman v. St. Paul Mercury Insurance Company*, Adv. Case No. 15-01171-EEB.

50. In particular, the Trustee seeks a determination from this Court that the Policy's Proceeds are property of the Estate.

51. On May 22, 2015, the Trustee filed a Motion for Temporary Restraining Order and/or Preliminary Injunction, requesting that this Court enjoin Travelers from advancing defense costs for the FDIC Action and Labaty Action in violation of the automatic stay. On May 26, 2015, this Court denied the temporary restraining order, acknowledging that the automatic stay already provided the Debtor with the relief it sought, and set a hearing as to the Trustee's request for a preliminary injunction.

52. On June 1, 2015, Travelers filed a motion to dismiss or for summary judgment and on June 3, 2015, filed a motion to consolidate the hearing on preliminary injunction and motion to dismiss or for summary judgment.

53. The Court granted Travelers' motion to consolidate and set a status and scheduling conference for June 9, 2015.

54. Based on this Court's recommendation, Travelers advised that it would soon file the present motion for relief from stay. The Trustee also advised the Court that he would file an amended complaint and did so on June 19, 2015.

55. Travelers' response to the First Amended Complaint is due by August 24, 2015 as the result of an unopposed Motion to Extend Time to Answer or Respond [Adv. Case No. 15-01171-EEB, Dkt. No. 21].

56. On June 11, 2015, the undersigned sent a first-party demand letter to counsel for Travelers to reserve approximately $2.2 million for UWT's expected indemnification obligation. A copy of the first-party demand letter is attached as Exhibit H.

57. On July 2, 2015, Travelers' counsel sent a letter rejecting the Trustee's demand. A copy of the letter is attached as Exhibit I.

58. After advancing defense costs for both the FDIC Action and Labaty Action in violation of the automatic stay, Travelers now seeks a Court determination *nunc pro tunc* that the insurance proceeds are not property of UWT's Estate and that its unapproved advancements were not subject to the automatic stay or alternatively, an order from this Court granting stay relief to allow for the previously unauthorized and future advancement of defense costs for the FDIC Action and the Labaty Action.

59. The Trustee objects to this *nunc pro tunc* relief as improper, and requests that this Court deny such relief. Alternatively, if this Court is inclined to grant stay relief, the Trustee requests that it order Travelers to reserve $2.2 million of the Policy's Proceeds for UWT's expected indemnification obligation under the terms of the Policy.

Standard of Review

60. The automatic stay under section 362 of the Bankruptcy Code is one of the most significant provisions of the Code and the primary vehicle for enforcement of the bankruptcy court's jurisdiction. Section 362(a)(1) provides in relevant part:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302 or 303 of this title ... operates as a stay, applicable to all entities, of—
>
> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title.

61. The legislative history of section 362 evidences Congress' intent that the automatic stay be broadly applied to effectuate its protective purposes:

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 340 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 49 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5840-41, 5963; see also In re A.H. Robins Co., 788 F.2d 994, 998 (4th Cir.), cert. denied, 479 U.S. 876 (1986) (stating that the automatic stay "is to protect the debtor from an uncontrollable scramble for its assets in a number of uncoordinated proceedings in different courts, to preclude one creditor from pursuing a remedy to the disadvantage of other creditors, and to provide the debtor and its executives with a

reasonable respite from protracted litigation, during which they may have an opportunity to formulate a plan of reorganization for the debtor") (emphasis added).

62. The automatic stay broadly extends to all matters which may have an effect on a debtor's estate, enabling bankruptcy courts to ensure that debtors have the opportunity to rehabilitate and reorganize their operations. *See, e.g., In re Johns-Manville Corp.*, 801 F.2d 60, 62, 63-64 (2d Cir. 1986). "Such jurisdiction is necessary to exclude any interference by the acts of others or by proceedings in other courts where such activities or proceedings tend to hinder the process of reorganization." *Fidelity Mortgage Inv. v. Camelia Builders, Inc.*, 550 F.2d 47, 53 (2d Cir. 1976); *see also In re S.I. Acquisition, Inc.*, 817 F.2d 1142, 1146 (5th Cir. 1987) (stating that the automatic stay "imposes a moratorium on all actions against the debtor or its property and assets" and thereby "ensures a respite for the debtor so that it may attempt to reorganize or decide to liquidate and promotes the overriding policy of equal distribution of a debtor's assets among creditors").

63. In light of this strong policy favoring the automatic stay whereby "even slight interference with the administration [of the Debtor's estate] may be enough to preclude relief," *In re Curtis*, 40 B.R. 795, 806 (Bankr.D.Utah 1984), the party seeking to lift or modify the automatic stay bears the initial burden to show cause why the stay should be lifted. "If the movant fails to make an initial showing of cause ... the court should deny relief without requiring any showing from the debtor that it is entitled to continued protection." *See In re Sonnax Industries*, 907 F.2d 1280, 1285 (2d Cir. 1990); *In re Curtis*, 40 B.R. at 802 ("This Court holds that one who seeks relief from the automatic stay must, in the first instance, establish a legally sufficient basis, i.e., 'cause,' for such relief"); *In re Unioil*, 54 B.R. 192, 194 (Bankr.D.Colo. 1985) (requiring creditor to establish "legally sufficient basis" for relief). This Court has therefore explained: "Upon filing a relief from stay motion, the initial burden going forward to show the grounds that compel lifting of the stay rests with the creditor. Once grounds have been established, the moving party need only prove the issue of lack of equity in the property. The burden of proof rests with the debtor as to all other issues." *In re Gunnison Center Apartments, LP*, 320 B.R. at 395 (internal citations omitted); *accord In re DB Capital Holdings, LLC (DB Capital)*, 454 B.R. 804 (Bankr.D.Colo. 2011).

64. "[A] request for retroactive annulment of the automatic stay benefits only the creditor who failed at the outset to request relief from the stay before taking action in violation of the stay." *In re Veltmann*, 2008 WL 5157892, at *2 (Bankr. D.N.M. June 7, 2008). As such, retroactive annulment is only appropriate in "certain very limited circumstances." *Id.*

65. The Tenth Circuit has aptly stated that while bankruptcy courts have the authority to retroactively annul the stay pursuant to 11 U.S.C. § 362(d), "such a result is rare and probably available only to claimants who were honestly ignorant of the bankruptcy stay." *Franklin Sav. Ass'n v. Office of Thrift Supervision*, 31 F.3d 1020, 1022, 1023 (10th Cir. 1994) (citations omitted). *See also In re Soares*, 107 F.3d 969, 977 (1st Cir. 1997) ("Retroactive relief should be the long-odds exception, not the general rule . . . [A]lthough courts possess a limited discretion to grant retroactive relief from the automatic stay, instances in which the exercise of that discretion is justified are likely to be few and far between").

66. Courts may consider the following factors in determining whether to retroactively annul the stay: (1) the creditor's knowledge of debtor's pending bankruptcy at the time of the stay violation; (2) whether the debtor filed the petition in bad faith or otherwise acted in bad faith; (3) prejudice to creditors if retroactive relief is not granted; (4) whether the debtor has complied with the Bankruptcy Code and Rules; (5) expediency with which the creditor sought annulment or debtor sought to set aside the act taken in violation of the automatic stay; (6) whether the creditor continued to violate the stay after learning of the bankruptcy. *Veltmann*, 2008 WL 5157892, at *2 (citations omitted).

67. The Ninth Circuit BAP has concluded that the proper standard for determining annulment of the stay is a balancing of the equities test, which focuses on two primary factors: "(1) whether the creditor was aware of the bankruptcy petition; and (2) whether the debtor engaged in unreasonable or inequitable conduct, or prejudice would result to the creditor." *In re Fjeldsted*, 293 B.R. 12, 24 (9th Cir. BAP 2003).

Argument

A. The Policy's Proceeds Are Property of UWT's Bankruptcy Estate.

68. Whether insurance proceeds are property of the estate is analyzed on a case by case basis. *In re CyberMedica, Inc.*, 280 B.R. 12, 16 (Bankr.D.Mass.2002). "[T]he cases are controlled by the language and scope of the policy at issue[,] not by broad general statements." *In re Petters Co., Inc.*, 419 B.R. 369 (Bankr.D.Minn.2009) (citation omitted).

69. When a policy provides for both D&O and entity coverage, as here, the Bankruptcy Code provides little guidance. In these instances, some courts have held that the proceeds are considered estate property "if depletion of the proceeds would have an adverse effect on the estate to the extent that the policy actually protects the estate's other assets from diminution." *In re MF Global Holdings Ltd.*, 515 B.R. 193, 203 (Bankr.S.D.N.Y.2014) (citations omitted).

70. "To the extent that such proceeds are property of the estate, any action through which a party would 'obtain possession of' them is *restrained by the automatic stay in bankruptcy*." *Petters*, 419 B.R. at 375 (emphasis added) (citing 11 U.S.C. § 362(a)(3); *In re Metropolitan Mortg. & Sec. Co., Inc.*, 325 B.R. 851, 855 (Bankr.E.D.Wash.2005)).

71. There are a number of cases where courts have analyzed insurance policies similar to those at issue in this case and have held that those proceeds are property of the estate. *In re CyberMedica* is one such example. In finding that the D&O proceeds were property of the estate, the court held that the D&O insurance proceeds were property of the estate. In doing so, the court considered whether "the debtor's estate is worth more with them then without them." *CyberMedica*, 280 B.R. at 17.

72. The *CyberMedica* court found that the proceeds were property of the estate, and that the estate was worth more with it than without it, because it insured the debtor against indemnity and entity claims. *Id.*

73. Here, the Estate is worth more with the proceeds than without; indeed, the Insurance Proceeds are the primary asset of the Estate. As the Insureds have argued to this Court, "exposing Debtor to extensive litigation costs in the Labaty case would certainly prejudice the interests of other creditors whose only hope of recovery depends upon the availability of insurance proceeds and the success of related litigation brought by the bankruptcy trustee." *See* Dkt No.43, p. 4.

74. Although the *CyberMedica* court ultimately lifted the automatic stay, it did so because it found that two of the directors and officers would suffer irreparable harm if they were prevented from exercising their rights to defense payments. *Id.* at 18. There is no danger of irreparable harm to the directors and officers in this case because the defendants in the Trustee Action have already sought and received relief from stay, limited to defense (not indemnity) of the Trustee Action and Travelers has, by its own admission, already advanced a total of over $1.6 million in Defense Costs for *all* of the ongoing lawsuits (albeit without authority to do so as to the FDIC and Labaty Actions, in which only 3 of the 7 officers and directors named in the Trustee Action are also named in the FDIC Action and only 1 of 7 is named in the Labaty Action).

B. A Portion of the Policy's Proceeds Should Be Reserved for UWT's Indemnification Obligations.

75. Even if this Court is not inclined to determine that *all* of the Policy's Proceeds are property of the Estate, then it may allocate a portion of the Policy's Proceeds as Estate property and reserve those for UWT's indemnification obligations.

76. Other courts have used their equitable powers to fashion a remedy with respect to insurance proceeds. In the recent case of *In re MF Global Holdings Ltd.* in the Southern District of New York, the court established a $13.06 million reserve of the insurance proceeds. *In re MF Global Holdings Ltd.*, 515 B.R. 193, 203 (Bankr. S.D.N.Y. 2014). MF Global's D&O policies, similar to the Travelers Policy here, covered both the directors and officers and the debtor company. *Id.* at 198. The court noted that whether the proceeds were considered property of the estate turned on whether MF Global could assert a claim against the policy for indemnification or a securities claim. *Id.* at 199.

77. No party had instituted a securities claim against MF Global and the statute of limitations had run to assert such a claim, making it unlikely that MF Global would seek coverage under the policy. *Id.* at 199, 203. As to indemnification, several directors and officers had sought indemnification from MF Global, to which MF Global was entitled to assert a $13.06 million claim against the policy if it had to indemnify the directors and officers. *Id.* at 203. MF Global, however, did not intend to do so and objected to the indemnification claims in its bankruptcy case. *Id.* Despite the fact that MF Global did not intend to indemnify the directors and officers, the court nonetheless established a $13.06 million reserve of the proceeds. *Id.*

78. Importantly, MF Global's D&O policies contained a priority-of-payment provision which provided that the D&O coverage must be paid prior to payments made to debtor for indemnification or for losses resulting from securities claims against debtors. *Id.*

79. Moreover, as the insureds' defense costs exhaust the policy limits, the estate's asset is decreased which leaves the Debtor susceptible to third-party claims and subsequently decreases the realization of the Debtor's claim against the proceeds. *In re Petters*, 419 B.R. at 377. The *Petters* court explores this dilemma:

> until any insured has presented a claim to the insurer, the value of its rights to payment as an insured are not yet fixed or liquidated, let alone realized; but nonetheless, upon the occurrence of any covered loss, any insured has a contingent and unliquidated right to a payment from the insurer . . . [w]hen the availability of reimbursement or indemnification is subject to a first-come, first-served order of distribution, as apparently is the case here, the potential jeopardy to the bankruptcy estate's rights is obvious: it may have accrued but unpresented claims, or may accrue them shortly, in large amounts, against the unknown ripening of competitors rights.

Id. at 378.

80. In an attempt to provide for accrued but unpresented claims of the debtor, the *Petters* court determined that some portion of the proceeds were property of the estate until the policy limits were exhausted. "The value of that property of the estate cannot be identified, at present or at least on the present record; *but it is protected by the automatic stay, and properly so*." *Id.* at 379 (emphasis added). On this basis, the court preserved $2.5 million and instructed the insurance companies to renew their motion for relief once those funds were exhausted. *Id.* at 380.

81. UWT is obligated under its Bylaws and the Policy to indemnify its directors and officers for their acts or omissions that occur in their capacity as directors and officers.

82. Damages in the Trustee Action may be limited to the proofs of claims filed in the case, which stand at approximately $2.2 million. This arguably may be the extent of UWT's, and the Estate's, indemnification obligation.

83. Because Travelers has not produced the reservation of rights letter for the Trustee Action, it is unclear whether Travelers intends to cover the Trustee Action or whether the UWT directors and officers will have to reimburse Travelers for their defense costs under the Policy. If the latter, it is highly likely that the UWT directors and officers will then seek indemnification costs from UWT, and the Estate.

84. In the likely event that UWT directors and officers seek indemnification costs from the Estate for the Trustee Action, this Court should order Travelers to retain $2.2 million of the Policy's Proceeds for such a claim.

85. As set forth above, because the Trustee Action relates to the Labaty Action, while at the same time implicating mismanagement of the Debtor/Insured, this Court should require Travelers to reserve the $2.2 million from the MLIA policy limits, the TLIA policy limits, or a combination of both.

C. Travelers Has Not Demonstrated that Cause Exists to Annul the Stay.

86. In its Motion, Travelers sets forth the wrong standard with respect to stay relief.

87. As set forth above, Travelers must demonstrate that it is entitled to a retroactive annulment of the automatic stay, only available in very limited circumstances and many times only available if a claimant was ignorant of the bankruptcy stay. *Franklin Sav. Ass'n v. Office of Thrift Supervision*, 31 F.3d 1020, 1022, 1023 (10th Cir. 1994).

88. In this case, the balancing of the factors weighs heavily in favor of denying retroactive stay relief. Travelers had knowledge of UWT's bankruptcy filing yet continued to advance defense costs for multiple lawsuits. It certainly had knowledge of the bankruptcy filing when the former UWT directors and officers filed a motion for relief from stay requesting advancement of its defense costs from Travelers, on May 30, 2014. At that point, Travelers was put on notice that stay relief was required *prior* to its advancement of defense costs.

89. Despite this fact, Travelers continued to advance defense costs in violation of the automatic stay for both the FDIC Action and the Labaty Action for over a year.

90. Travelers even admits that it only ceased advancement of defense costs when the Trustee filed its adversary proceeding against Travelers in April 2015. (Travelers Motion, Page 9).

91. Moreover, Travelers is a sophisticated insurance company that cannot claim ignorance of the automatic stay.

92. Nevertheless, Travelers willfully violated the automatic stay and did so for over a year. Travelers only now seeks retroactive relief from the stay because of the Trustee's complaint in the adversary proceeding and this Court's recommendation that it seek stay relief during the status and scheduling conference held on June 9, 2015.

93. Based on the foregoing, Travelers has not demonstrated any extraordinary circumstances that would entitle it to retroactive stay relief. Thus, this Court should deny the requested relief.

Conclusion

For the foregoing reasons, and for any additional reasons articulated during the hearing on Travelers' Motion for Relief from Stay, Jeffrey A. Weinman, the Chapter 7 Trustee, respectfully requests that this Court deny retroactive relief from the automatic stay to, after-the-fact authorize Travelers to advance defense costs (nearly $2 million of which have already been

advanced) for the FDIC Action and the Labaty Action, or alternatively, reserve $2.2 million of the Policy's Proceeds from the MLIA and/or TLIA for any indemnification claim that will be paid out of the Estate, and grant such additional relief that this Court deems just and proper.

DATED this 16th day of July, 2015.

Respectfully submitted,

ALLEN & VELLONE, P.C.

s/ Patrick D. Vellone
Patrick D. Vellone, #15284
Jordan Factor, #38126
Mark Larson, #30659
Nicole Detweiler, IL Bar #6308875
1600 Stout Street, Ste. 1100
Denver, Colorado 80202
303-534-4499
pvellone@allen-vellone.com
jfactor@allen-vellone.com
mlarson@allen-vellone.com
ndetweiler@allen-vellone.com

-and-

Jerold Oshinsky
Kasowitz, Benson, Torres & Friedman LLP
2029 Century Park East, Suite 750
Los Angeles, CA 90067
joshinsky@kasowitz.com

ATTORNEYS FOR CHAPTER 7 TRUSTEE

CERTIFICATE OF SERVICE

I hereby certify that on this the 16th day of July, 2015, I caused the foregoing **TRUSTEE'S OBJECTION TO ST. PAUL MERCURY INSURANCE COMPANY'S MOTION FOR RELIEF FROM AUTOMATIC STAY**, to be served via United States Mail, postage prepaid, to the following:

Jeffrey A. Weinman
Weinman & Associates, P.C.
730 17th Street, Suite 240
Denver, CO 80202

Joshua M. Hantman
410 17th Street, Suite 2200
Denver, CO 80202

Jonathan E. Rawlins
508 Twilight Trail, Suite 99
Richardson, TX 75080

Matthew Vandenberg
112 E. Pecan Street, Suite 2400
San Antonio, TX 78205

Carl Pipoly
14100 San Pedro Avenue, Suite 308
San Antonio, TX 78232

Harvey Sender
Sender Wasserman Wadsworth, P.C.
1660 Lincoln Street, Suite 2200
Denver, CO 80264

Chad S. Caby, Esq.
Lewis Roca Rothgerber LLP
1200 17th Street, Suite 3000
Denver, CO 80202-5855

U.S. Trustee
999 18th Street, Suite 1551
Denver, CO 80202-2415

s/ Courtney Christensen
FOR ALLEN & VELLONE, P.C.

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO

In re:	)	
	)	
UWT, Inc.,	)	
	)	Case No. 13-18184-EEB
Debtor.	)	Chapter 7
	)	
	)	
	)	

FDIC DEFENDANTS' JOINDER IN ST. PAUL MERCURY INSURANCE COMPANY'S MOTION FOR RELIEF FROM AUTOMATIC STAY

Charles J. Berling, James H. Bullock, Anthony C. Codori, Bernard C. Darre, Gary G. Petak, William Snider, Cindy J. Sterett, John S. Umbaugh, and Scot T. Wetzel (the "FDIC Defendants"), by and through their undersigned attorneys, hereby submit their Joinder in St. Paul Mercury Insurance Company's Motion for Relief from Automatic Stay, and in further support thereof state as follows:

I. INTRODUCTION

St. Paul Mercury Insurance Company ("Travelers") is correct. The proceeds of the liability policy issued by Travelers to United Western Bancorp, Inc. ("UWB") are not property of the UWT Estate and, therefore, are not subject to the automatic stay pursuant to Section 362 of the Bankruptcy Code. Accordingly, Travelers is permitted to continue to fund the Defense Costs incurred in the civil action brought by the FDIC pending in the U.S. District Court for the District of Colorado, *FDIC v. Berling*, Civil Action No. 14-cv-00137-CMA (the "FDIC Action"), as required under the Policy terms. Alternatively, the Court should grant relief from the automatic stay to allow Travelers to pay the Defense Costs as provided by the Policy.

Well-settled case law, in conjunction with the Policy terms, establishes that the Estate has no interest, either legal or equitable, in the proceeds of the Policy. Instead, the Management

Liability Insuring Agreement ("MLIA") and, in particular, the Directors and Officers Individual Coverage, inures solely to the benefit of the former officers and directors of UWB and UWT, which includes each of the FDIC Defendants. To the extent the Estate may have some future right to Policy proceeds under the MLIA's Company Indemnification Coverage, as Travelers points out, such a hypothetical or speculative possibility is insufficient to transform the proceeds into the property of the Estate. In any event, the Policy's Order of Payments Endorsement confirms that payments on behalf of the FDIC Defendants and other former directors and officers of the respective companies have priority over any payments due pursuant to the Company Indemnification Coverage.

Furthermore, even if the Court were to conclude that the Estate has a property interest in some or all of the Policy proceeds, relief from the automatic stay to permit Travelers to advance the Defense Costs in the FDIC Action is necessary. The amount of the Defense Costs that have been incurred but unpaid by Travelers due to the Trustee's remonstrations in the Adversary Proceeding are huge. Meanwhile, the proceedings in the FDIC Action continue, and the unpaid Defense Costs mount. Absent forthwith relief, the FDIC Defendants will suffer immediate, and serious, harm. Without Travelers' financial assistance, the FDIC Defendants will be asked to fund the high costs of the FDIC Action. As the FDIC Defendants are ill-equipped to do this, they will face the prospect of having to forego a defense, to their great financial detriment. In all, good cause exists for the Court to grant relief from the stay in order that the FDIC Defendants can receive the financial protection provided for them under the Policy.

II. THE POLICY

The Policy's MLIA contains three separate coverages. Doc. No. 59-1 at 45. Each is subservient to its predecessor.

First, the MLIA contains individual coverage for the Directors and Officers of UWB and its subsidiaries, including UWT:

> **Directors and Officers Individual Coverage**
>
> The Insurer shall pay on behalf of the Insured Persons Loss for which the Insured Persons are not indemnified by the Company and which the Insured Persons become legally obligated to pay on account of any Claim first made against them, individually or otherwise, during the Policy Period, the Automatic Discovery Period, or, if exercised, the Additional Extended Discovery Period, for a Management Practices Act taking place before or during the Policy Period.

Id. This coverage provides for, among other things, the payment of Defense Costs to Insured Persons to the extent those costs have not been previously indemnified by the company. *See id.* at 45-46. The coverage inures solely to the benefit of Insured Persons, which is defined to include directors and officers like the FDIC Defendants, to the exclusion of the company itself. *Id.*; *see also id.* at 29 (defining Insured Persons).

Second, the MLIA contains indemnification coverage for the company to the extent it has paid losses on behalf of Insured Persons:

> **Company Indemnification Coverage**
>
> If **Company Indemnification Coverage** is granted as set forth in the Declarations, the Insurer shall pay on behalf of the Company Loss for with the Company grants indemnification to the Insured Persons, as permitted or required by law, and which the Insured Persons have become legally obligated to pay on account of any Claim first made against them, individually or otherwise, during the Policy Period, the Automatic Discovery Period, or, if exercised, the Additional Extended Discovery Period, for a Management Practices Act taking place before or during the Policy Period.

Id. at 45. The indemnification coverage provides benefits to the company only if: (1) Insured Persons like directors and officers have incurred covered losses; and (2) the company has agreed

to provide indemnification to the Insured Persons for those losses. *Id.* If the company has not provided indemnity, it is not entitled to coverage. *See id.*

Third, the MLIA provides entity liability coverage to the company in still narrower circumstances:

> **Company Liability Coverage**
>
> If **Company Liability Coverage** is granted as set forth in the Declarations, the Insurer shall pay on behalf of the Company Loss for which the Company becomes legally obligated to pay on account of any Securities Claim first made against the Company during the Policy Period, the Automatic Discovery Period, or, if exercised, the Additional Extended Discovery Period, for a Management Practices Act taking place before or during the Policy Period.

Id. In essence, the entity coverage provides liability protection to the company if a qualifying securities claim is made against the company by a third party during the applicable policy period. *See id.*

Crucially, each of the above coverages is subject to the MLIA's Order of Payments Endorsement, which sets forth how claim payments will be allocated among the various coverages in potential exhaustion of the MLIA's $10,000,000 liability limit:

> **Order of Payments**
>
> In the event of Loss arising from a covered Claim for which payment is due under the provisions of the Management Liability Insuring Agreement made part of this Policy, then the Insurer shall in all events:
>
> (a) first, pay Loss for which coverage is provided under the Directors and Officers Individual Coverage; and then
>
> (b) only after payment of Loss has been made pursuant to subsection (a) above, with respect to whatever remaining amount of the Limit of Liability is available after such payment, at the written request of the chief executive officer of the Company, either pay or withhold payment of such other Loss for which coverage is provided under the Company Indemnification Coverage; and then;

> (c) only after payment of Loss has been made pursuant to subsections (a) and (b) above, with respect to whatever remaining amount of the Limit of Liability is available after such payment, at the written request of the chief executive officer of the Company, either pay or withhold payment of such other Loss for which coverage is provided under the Company Liability Coverage.
>
> * * *
>
> The Financial Impairment[1] of the Company or the bankruptcy or insolvency of any Insured Person shall not relieve the Insurer of any of its obligations to prioritize payment of covered Loss under the Management Liability Insuring Agreement pursuant to this Order of Payments section.

Id. at 15 (emphasis added). The Order of Payments Endorsement dictates that directors and officers like the FDIC Defendants have a priority entitlement to any payments under the MLIA—potentially up to the $10,000,000 liability limit—before the company can have any claim to benefits under either the indemnity or company liability coverages. *See id.* In other words, the coverages available to the company are residual. *See id.* If the limits of insurance are exhausted by the directors and officers, the company is not entitled to coverage. *See id.*

III. ARGUMENT

Traveler's Motion for Relief from Automatic Stay should be granted for two reasons: First, no stay applies because any proceeds available under the Directors and Officers Individual Coverage are not property of the bankruptcy estate. Second, and in the alternative, relief from stay is appropriate to avoid irreparable harm to the FDIC Defendants and other Directors and Officers.

---

[1] "Financial Impairment" is defined to include the appointment of a trustee by a federal court. Doc. No. 59-1 at 29.

A. Any Proceeds Available Under The Directors and Officers Individual Coverage Are Not Property Of The Bankruptcy Estate

1. Legal Standard

The automatic stay provision of the Bankruptcy Code stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3). Property of the estate is defined as "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). While it is generally accepted that debtor-owned insurance policies are property of the estate, "the question is not who owns the policies, but who owns the liability proceeds." *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987). If the debtor is not entitled to the proceeds of a liability policy, then those proceeds cannot be considered property of the debtor's bankruptcy estate. *See id.*; *see also In re Allied Digital Techs., Corp.*, 306 B.R. 505, 509 (D. Del. 2004); *In re Laminate Kingdom, LLC*, No. 07-10279-BKC-AJC, 2008 WL 1766637 at *2 (S.D. Fla. March 13, 2008).

Whether the proceeds of a liability insurance policy are property of the bankruptcy estate is a fact-specific inquiry controlled by the language and scope of the specific policies at issue. *In re Downey Financial Corp.*, 428 B.R. 595, 603 (D. Del. 2010). Several considerations inform this analysis, including: (1) who the liability policy was intended to protect, and (2) whether the debtor's estate is worth more with the policy proceeds than without them. *In re Laminate Kingdom*, 2008 WL 1766637 at *2.

> The overriding question when determining whether insurance proceeds are property of the estate is whether the debtor would have a right to receive and keep those proceeds when the insurer paid on a claim. When a payment by the insurer cannot inure to the debtor's pecuniary benefit, then that payment should neither enhance nor decrease the bankruptcy estate. In other words, when the debtor has

> no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate.

Matter of Edgeworth, 993 F.2d 51, 55-56 (5th Cir. 1993).

Applying these precepts in analogous circumstances, courts have identified four guiding principles:

> [W]hen a debtor's liability policy provides direct coverage to the debtor the proceeds are property of the estate, because the proceeds are payable to the debtor. Further, when the liability insurance policy only provides coverage to the directors and officers, the proceeds are not property of the bankruptcy estate. However, when there is coverage for the directors and officers and the debtor, the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution. Lastly, when the 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.

In re Allied Digital, 306 B.R. at 512 (emphasis added); *see also In re Downey*, 428 B.R. at 603.

2. The Payment Of Defense Costs On Behalf Of UWT's Directors And Officers Cannot Diminish Any Estate Assets Under The Policy

Here, any Policy proceeds payable under the MLIA to UWT's directors and officers are not property of the estate because they cannot inure to UWT's benefit. At this juncture, UWT has no present or future entitlement to any proceeds. Further, any claim for benefits under the indemnity or entity liability coverages would be hypothetical and speculative as no claims under these coverages have been made.

a. Priority

While the MLIA facially contains indemnity and entity coverage for the company, the Order of Payments Endorsement clarifies that such coverage is junior to that provided to the directors and officers individually. Indeed, the directors and officers have a contractual right to

use the limits of the MLIA coverage for the payment of any defense or settlement costs in the actions brought against them. Any contingent rights UWT has to payment under the indemnity or entity coverages are residual and subordinate to any potential limits remaining after all amounts are paid for the defense, settlement, or satisfaction of any judgment incurred in the actions brought against UWT's and UMB's former directors and officers, including the FDIC Defendants. Until all such amounts have been paid, UWT has no rights to any proceeds under the MLIA insuring agreement. Further, should the defense or settlement of the actions against the directors and officers exhaust the policy limits, UWT has no right to payment at all. Thus, Travelers' payment of Policy proceeds under the Directors and Officers Individual Coverage cannot impair UWT's rights when the Policy specifically contemplates that the Policy limits may be exhausted by payments to the directors and officers.

"Section 541(a) is not intended to expand the debtor's rights against others beyond what rights existed at the commencement of the case." *In re Downey*, 428 B.R. at 607 (internal quotations omitted). It is clear that if UWT had not filed for bankruptcy, it would have no ability to enjoin Travelers from paying under the Directors and Officers Individual Coverage in the hope of preserving Policy limits for the satisfaction of its claims falling within the indemnity or entity liability coverage parts. Accordingly, the Trustee cannot be heard to make this argument now without impermissibly expanding the debtor's rights.

In re TierOne Corp, No. BK10-41974-TLS, 2012 WL 4513554 * 2-3 (D. Neb. Oct. 2, 2012), guides the analysis. There, Travelers issued a policy to TierOne Corporation, which eventually filed for Chapter 7 bankruptcy relief. *Id.* at *1. The directors and officers of TierOne were subsequently sued and sought relief from the automatic stay, if applicable, for the payment of their defense costs under the directors and officers individual coverage portion of the policy.

Id. The Chapter 7 Trustee, and the FDIC as receiver for TierOne, both resisted the motion on grounds that the policy proceeds were property of the bankruptcy estate since the policy provided indemnity and entity liability coverage to TierOne. *Id.* In rejecting this entreaty, the court concluded that the policy proceeds were not part of the bankruptcy estate due to the order of payments endorsement:

> The estate is not entitled to any of the funds under the Policy until the claims against the directors and officers are satisfied; therefore, the issue of whether the policies are property of the bankruptcy estate is irrelevant to the stay relief motion. . . . The directors and officers are entitled to the Policy proceeds *before* any interest of the estate comes into play. 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. . . . The directors and officers have a right to make claims under the policies and to receive payment of the policy proceeds to the exclusion of the bankruptcy estate since they are the insureds who are first in line. . . . [T]here is no property of the estate involved (that is, the estate's interest is subordinate), so whatever resolution the non-debtor parties reach will not affect the bankruptcy estate.

Id. at *2-3 (emphasis in original).

In re Downey, 428 B.R. at 607, involved similar facts and likewise held that the policy proceeds were not estate property:

> [W]ere the Court to hold that the Policy proceeds are property of the estate and, thus, subject to the automatic stay, the trustee would have greater rights in the Policy proceeds than the debtor had before filing for bankruptcy. Prior to bankruptcy, there was no means by which the Debtor's interest in [indemnity or entity] coverages could become superior to, or even equal to, the Insured's interest in [directors and officers individual coverage].

Id. (internal quotations omitted).

The bankruptcy court in *In re Laminate*, 2008 WL 1766637 * 3, made similar observations in rejecting the trustee's argument that policy proceeds were estate property:

> [T]he Court believes the depletion of proceeds to pay the Costs of Defense does not diminish the protection afforded the estate's assets under the terms of the Policy. The Policy's "Priority of Payments Endorsement" specifically requires that the proceeds be used *first* to pay non-indemnifiable loss for which coverage is provided under Coverage A of this Policy, which coverage includes Cost of Defense. Then, only after such payments are made, and only if proceeds remain after payment of such Costs of Defense, will the Trustee or the estate be paid any proceeds. Thus, under the language of the Policy itself, the estate has only a contingent, residual interest in the Policy's proceeds; and, payment of the proceeds in accordance with the "Priority of Payments Endorsement" does not diminish the protection the Policy affords the estate, as such protection is only available after the Costs of Defense are paid.

Id. (emphasis in original).

Here, as in the above cases, the proceeds of the Traveler's Policy are not property of the estate because the Order of Payments Endorsement grants senior and potentially exclusive rights to the MLIA Policy limits to the directors and officers for the payment of their defense and settlement costs. Foreclosing access to these rights in favor of preserving Policy limits for UWT cannot be accomplished without impermissibly expanding the rights of the debtor and restricting the contractual rights of the directors and officers.

b. Indemnification And Entity Coverage Are Not At Issue

"Where a liability insurance policy includes entity coverage, but there are no covered Securities Claims outstanding, courts have generally held that the insurance proceeds are not property of the estate." *In re Downey*, 428 B.R. at 604. Further, "when the 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." *In re Allied Digital*, 306 B.R. at 512.

Here, in addition to the fact that UWT's rights are junior to those of the individual directors and officers, it has no concrete claim to either indemnity or entity liability coverage under the

MLIA. The Policy period expired long ago, and no qualifying Securities Claims have been presented against UMT which implicate the MLIA's entity coverage. Further, UMT has paid no indemnity for the losses incurred by its directors and officers to which it may be entitled to reimbursement. Thus, any assertion that payment of Defense Costs would impermissibly erode coverage necessary for the protection of UMT by way of the indemnity and entity liability coverage is hypothetical. *See In re Allied Digital*, 306 B.R. at 513; *In re Adelphia Commc'ns Corp.*, 298 B.R. 49, 53-54 (S.D.N.Y. 2003); *In re CHS Electronics, Inc.*, 261 B.R. 538, 542-43 (S.D. Fla. 2001).

In *Adelphia Communications*, the trustee argued that the proceeds of the debtor's insurance policy were property of the bankruptcy estate because the policy included indemnity and entity liability coverage. 298 B.R. at 53-54. In rejecting this assertion, the court noted that the coverages were only hypothetically implicated because no claims for indemnification or entity coverage had been made:

> Claiming the debtors have a property interest in those proceeds makes no sense at this juncture. Such an argument would be akin to a car owner with collision coverage claiming he has the right to proceeds from his policy simply because there is a prospective possibility that his car will collide with another tomorrow, or a living person having a death benefit policy, and claiming his beneficiaries have a property interest in the proceeds even though he remains alive.

Id. at 53.

The circumstances are no different here. Neither the indemnity nor the entity liability coverage faces a real risk of erosion because no claims have been made which implicate those coverages. Instead, the Trustee is evidently attempting to restrict payments to the directors and officers so that more liability limits will be available to satisfy any judgment he may obtain in the action he has brought against them. In other words, every dollar denied to the directors and officers

is a dollar potentially recoverable by the Trustee in his separate action. But the Trustee's endeavor to protect his ability to *recover from* the Policy is distinct from UWT's rights to be *protected by* the policy's coverage. *In re Allied Digital*, 306 B.R. at 513. Only the former is at issue, and it is not sufficient to categorize the Policy proceeds as estate property. *See id.* As observed by the court in *Allied Digital*:

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

Id.

The court in *CHS Electronics* held similarly:

> [T]his contested matter does not involve insurance proceeds which are property of the estate. Rather, what is at issue are the rights of a bankruptcy trustee in his role as a competing claimant. Simply because Cooper is a trustee in bankruptcy does not arm him with super-plaintiff powers in causes of actions between third parties. . . Rather, as succinctly stated by movant's counsel, "the estate is merely another litigant wishing to pursue claims against the Ds and Os."

261 B.R. at 544; *see also Edgeworth*, 993 F.2d at 56 (explaining difference between policy proceeds directly protecting the debtor and policy proceeds available to satisfy judgment of third-party claimants).

Because neither the indemnity nor entity liability coverage is actually in danger of erosion, there is no cognizable interest in the Policy proceeds sufficient to classify them as Estate property.

B. In The Alternative, Relief From Stay Is Necessary

Under 11 U.S.C. § 362(d)(1), relief from the automatic stay is appropriate when an interested party demonstrates that his or her property interest will lack adequate protection if the stay is not lifted. Here, the directors and officers insured under the Policy, including the FDIC Defendants, will be irreparably harmed absent relief from stay. At this juncture, over $1,000,000 in Defense Costs incurred in the FDIC Action remains unpaid, pending the Court's ruling on Travelers' Motion. Moreover, denial of further benefits under the Policy may hamper settlement negotiations, or force the directors and officers to fund any settlement or judgments entered against them, which they are ill-equipped to do. Denial of relief from stay will thus result in crushing financial liability to the insured directors and officers, including the FDIC Defendants, and will cripple their defense of the actions against them. Prevention of these calamities is the very reason they obtained liability insurance and should not be diminished or eliminated because UWT filed for bankruptcy. Moreover, relief from stay will not harm the Estate because a defense will help reduce any monetary judgments potentially payable under the Policy which could significantly erode, if not erase, any further liability coverage available to either UWT or the Trustee. As observed by one bankruptcy court:

> [I]f the Individual Insureds are not provided access to the MFGA Policies, the Individual Insureds would be deprived of the benefits of payment of defense costs that the insurance was intended to provide. Some Individual Insureds may also be deprived of fair and efficient settlement opportunities and suffer increased out-of-pocket costs. Furthermore, without adequate defense counsel, the cost of settling any of the cases against the Individual Insureds will needlessly increase. Moreover, in connection with MFGA Policies, the estates will actually benefit from a vigorous defense by the Individual Insureds and may suffer if those Individual Insureds cannot defend themselves because the outcome of the Underlying Cases may affect the estates' ability to defend any related claims against them should the ever be made.

In re MF Global Holdings Ltd, 469 B.R. 177, 193-94 (S.D.N.Y. 2012). The hardship is no less severe here.

IV. CONCLUSION

Based on the foregoing, the FDIC Defendants join in Travelers' request that the Court enter an order confirming that the Policy proceeds are not property of the UWT Estate or, alternatively, grant relief from the automatic stay to permit Travelers' advancement of Defense Costs in the FDIC Action.

DATED this 16th day of July 2015.

LEVIN ROSENBERG PC

s/ Bradley A. Levin
Bradley A. Levin
Nelson A. Waneka
1512 Larimer Street, Suite 650
Denver, CO 80202
Telephone: (303) 575-9390
Fax: (303) 575-9385
bal@levinrosenberg.com
naw@levinrosenberg.com
Attorneys for FDIC Defendants

CERTIFICATE OF SERVICE

I hereby certify that on this 16th day of July, 2015, a true and correct copy of the foregoing **FDIC DEFENDANTS' JOINDER IN ST. PAUL MERCURY INSURANCE COMPANY'S MOTION FOR RELIEF FROM AUTOMATIC STAY** was filed with the Clerk of the Court via Hand Delivery and served on the following by sending to the following email addresses and by US MAIL:

UWT, Inc.
P.O. Box 18374
Golden, CO 80402
Via US MAIL only

Equity Trust Company
1 Equity Way
Westlake, OH 44145
Via US MAIL only

Jeffrey A. Weinman
730 17th Street, Ste. 240
Denver, CO 80202
jweinman@epitrustee.com

Isaac Jay Eddington
1660 W. 2nd Street, Ste. 1100
Cleveland, OH 44114
ieddington@ulmer.com

Frances Floriano Goins
1660 W. 2nd Street, Ste. 1100
Cleveland, OH 44113
fgoins@ulmer.com

Joshua M. Hantman
410 17th Street, Ste. 2200
Denver, CO 80202
jhantman@bhfs.com

Patrick D. Vellone
Mark A. Larson
Jordan D. Factor
1600 Stout Street , Ste. 1100
Denver, CO 80202
pvellone@allen-vellone.com
mlarson@allen-vellone.com
jfactor@allen-vellone.com

Jerold Oshinsky
2029 Century Park East, Ste. 750
Los Angeles, CA 90067
joshinsky@kasowitz.com

Brent R. Cohen
Chad S. Caby
1200 17th Street, Ste. 3000
Denver, CO 80202
bcohen@lrrlaw.com

Carl Pipoly
14100 San Pedro Ave., Ste. 308
San Antonio, TX 78232
c_pipoly@pipolylaw.com

Jonathan E. Rawlins
508 Twilight Trl., Ste. 99
Richardson, TX 75080
jrawlins@hodgesrawlins.com

Charles W. Shipman
115 E. Travis, Ste. 1530
San Antonio, TX 78203
cshipman@themoralesfirm.com

Katherine M. Swan
1660 Lincoln St., Ste. 2200
Denver, CO 80264
kswan@sendwass.com

Matthew Vandenberg
112 E. Pecan St., Ste. 2400
San Antonio, TX 78205
mvandenberg@jw.com

U.S. Trustee
999 18th Street, Suite 1551
Denver, CO 80202
USTPRegion10.DV.ECF@usdoj.gov

Thomas J. Judge
Loss, Judge & Ward, LLP
1133 21st Street, Ste. 450
Washington, DC 20036
tjudge@ljwllp.com

s/ Nicole R. Peterson

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLORADO IN BANKRUPTCY

Minute Order

Date: July 23, 2015

Honorable Elizabeth E. Brown, Presiding
Kerstin Cass, Law Clerk

In re: **UWT, Inc.,** **Debtor.** **St. Paul Mercury Insurance Co.,** **Movant,** **v.** **UWT, Inc.,** **Respondent.**	**Bankruptcy Case No. 13-18184 EEB** **Chapter 7**

Appearances

Trustee		Counsel	**Jordan Factor, Nicole Detweiler**
Debtor		Counsel	
Creditor	**St. Paul Mercury Insurance ("Travelers")**	Counsel	**Thomas Judge, Chad Caby**
Creditor	**FDIC Defendants**	Counsel	**Bradley Levin**
Creditor	**Labaty Defendants**	Counsel	**Matt Vandenburg**

Proceedings: **Motion for Relief from Stay On Insurance Policy Proceeds filed by St. Paul Mercury Insurance Co., Joinder to Motion for Relief from Stay by FDIC Defendants and the Objection thereto by Chapter 7 Trustee Jeffrey Weinman**

[X] Exhibits entered: Trustee's Exhibits C-L; Movant's Exhibit 1 [X] Evidentiary[1]

[X] The parties made oral offers of proof and presented oral arguments.

Orders:

[X] For the reasons stated on the record, the Court granted partial relief from stay. A separate order and judgment will enter.

[X] On or before **July 29, 2015,** the Trustee shall submit to Travelers his claim for direct coverage under the TILA portion of the policy. Travelers shall respond to that claim on or before **September 1, 2015**. If Travelers denies coverage, the Trustee shall have until **September 15, 2015** to amend his complaint in Adversary Proceeding No. 15-01171-EEB. Travelers will not oppose any such motion.

Date: July 23, 2015

BY THE COURT:

Elizabeth E. Brown

Elizabeth E. Brown, United States Bankruptcy Court

[1]This hearing is considered evidentiary for statistical reporting purposes.

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO

In re:	
UWT, Inc.,	Case No.: 13-18184-EEB
Debtor.	Chapter 7
ST. PAUL MERCURY INSURANCE COMPANY,	
Movant,	
v.	
UWT, Inc.,	
Debtor.	

ORDER GRANTING PARTIAL RELIEF FROM STAY

THIS MATTER comes before the Court on the Motion for Relief from Stay (Docket No. 59) (the "Motion") filed by St. Paul Mercury Insurance Company ("Travelers"), the FDIC Defendants' Joinder in St. Paul Mercury Insurance Company's Motion for Relief from Automatic Stay (Docket No. 67) (the "Joinder"), and the Trustee's Objection to Motion for Relief from Stay (Docket No. 65) (the "Objection").

The Motion requests relief from stay *nunc pro tunc*, to the extent the automatic stay applies, for the purpose of permitting Travelers to advance defense costs under SelectOne for Community Banks Executive Liability Policy No. EC8300506 (the "Policy") to the defendant insureds in the lawsuits captioned: (1) *FDIC v. Berling, et al.*, No. 1:14-cv-00137 (D. Colo.) (the "FDIC Action"); and (2) *Labaty v. UWT, Inc., et al.*, No. 5:13-cv-00389 (W.D. Tex.) (the "Labaty Action").

On July 23, 2015, the Court heard offers of proof and arguments on the Motion, Joinder and Objection, after which the Court made oral findings of fact and conclusions of law, granting the Motion in part and denying it in part. Accordingly,

IT IS HEREBY ORDERED that, for purposes of this proceeding only, the Policy is property of the UWT Estate pursuant to 11 U.S.C. § 541 and therefore subject to the automatic stay contained in 11 U.S.C. § 362(a)(2); it is further

ORDERED that, pursuant to 11 U.S.C. § 362(d)(1), cause exists to grant relief from stay to allow Travelers to advance defense costs under the Policy's Management Liability Insuring Agreement (the "MLIA") to the defendants in the FDIC Action. The granting of relief from stay with regard to the MLIA proceeds and the FDIC Action is granted prospectively only, permitting

advancement on all pending but as of yet unpaid defense invoices and future defense invoices; it is further

ORDERED that Travelers is hereby required, pending further review and approval by this Court, to set a reserve of $2.2 million relating to the Policy's Trust Liability Insuring Agreement (the "TLIA"). Otherwise, cause exists pursuant to 11 U.S.C. § 362(d)(1) to allow Travelers to advance defense costs under the Policy's TLIA to the defendant insureds in the Labaty Action. The granting of relief from stay with regard to the TLIA and the Labaty Action is also granted prospectively only, permitting advancement on all pending but as of yet unpaid defense invoices and future defense invoices; it is further

ORDERED that the Trustee will submit to Travelers any notice of claim(s) for TLIA coverage under the Policy for the UWT Estate by no later than July 29, 2015, and Travelers shall respond to that notice no later than September 1, 2015; it is further

ORDERED that Travelers' request for *nunc pro tunc* relief from the automatic stay will, if necessary, be determined in the Trustee's Adversary Proceeding No. 15-1171 EEB; it is further

ORDERED that the findings of fact and/or conclusions of law made in the context of this summary proceeding are not binding or preclusive in any other proceedings before the Court, including in the previously referenced Adversary Proceeding No. 15-1171 EEB.

Dated this 28th day of July, 2015.

BY THE COURT:

Elizabeth E. Brown, Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO

In re:	
UWT, Inc.,	Case No.: 13-18184-EEB
Debtor.	Chapter 7
ST. PAUL MERCURY INSURANCE COMPANY,	
Movant,	
v.	
UWT, Inc.,	
Debtor.	

JUDGMENT

Pursuant to and in accordance with the Order entered by the Honorable Elizabeth E. Brown, Bankruptcy Judge, and entered on the record in the above-entitled matter on July 28, 2015 herewith, it is hereby

ORDERED that, for purposes of this proceeding only, the Policy is property of the UWT Estate pursuant to 11 U.S.C. § 541 and therefore subject to the automatic stay contained in 11 U.S.C. § 362(a)(2); it is

FURTHER ORDERED judgment is entered in favor of the Movants and against the Respondent, granting partial relief from stay to allow Travelers to advance defense costs under the Policy's Management Liability Insuring Agreement (the "MLIA") to the defendants in the FDIC Action. The granting of relief from stay with regard to the MLIA proceeds and the FDIC Action is granted prospectively only, permitting advancement on all pending but as of yet unpaid defense invoices and future defense invoices. It is

FURTHER ORDERED judgment is entered in favor of the Movants and against the Respondent, granting partial relief from stay to allow Travelers to advance defense costs under the Policy's Trust Liability Insuring Agreement (the "TLIA") to the defendant insureds in the Labaty Action. The granting of relief from stay with regard to the TLIA and the Labaty Action is also granted prospectively only, permitting advancement on all pending but as of yet unpaid defense invoices and future defense invoices, and is further conditioned on Travelers setting a reserve of $2.2 million relating to the Policy's TILA.

DATED: July 28, 2015.

APPROVED BY THE COURT:

Elizabeth E. Brown
UNITED STATES BANKRUPTCY JUDGE

FOR THE COURT:

Deputy Clerk

Transcript of Hearing Held on Motion for Relief From Stay on Insurance Policy Proceeds Filed by St. Paul Mercury Insurance Co., Joinder to Motion for Relief From Stay by FDIC Defendants and the Objection Thereto by Chapter 7 Trustee Jeffrey Weinman. Date Of Hearing: 7/23/2015 before Judge Elizabeth E. Brown. THIS TRANSCRIPT WILL BE MADE ELECTRONICALLY AVAILABLE TO THE GENERAL PUBLIC 90 DAYS AFTER THE DATE OF FILING, TRANSCRIPT RELEASE DATE IS 11/19/2015. Until that time the transcript may be viewed at the Bankruptcy Court or a copy may be obtained from the official court transcriber. Requested by Lewis Roca Rothgerber on 7/23/2015. Transcribed and filed by Julie Lord / Verbatim Digital Reporting, LLC. Total cost of Transcript $259.25 (RE: related document(s) 71 Minutes of Proceedings/Minute Order). Notice of Intent to Request Redaction Deadline Due By 8/28/2015. Redaction Request Due By 9/11/2015. Redacted Transcript Submission Due By 9/21/2015. Transcript Access Will Be Restricted Through 11/19/2015. (mjp) (Entered: 08/21/2015)