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Recent Developments Regarding the Interface between Insurance and Bankruptcy

Robert B. Millner
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Introduction

Mass tort bankruptcies — largely asbestos cases, but also other torts (breast implant, church sex abuse, toxic shock syndrome) — have been a focal point for litigation regarding the interface between state insurance coverage law and the federal Bankruptcy Code, 11 U.S.C. §§ 101 et seq. Insurance is often a principal funding source for mass tort cases, and principal creditors in such cases are the tort claimants, who favor chapter 11 reorganization plans that "maximize" insurance recovery for their benefit.

In mass tort cases, particularly chapter 11 reorganization cases, the debtor's goal usually is to "channel" all tort claims to a trust, leaving the debtor entity free of such claims. The trust, in turn, will resolve the tort claims (generally based on a matrix of claim values and medical and exposure criteria), and be funded *inter alia* by insurance settlement money, proceeds of coverage litigation against insurance (which it may prosecute), as well as contributions from the debtor. Such a plan cannot be confirmed without strong support of the tort claimant constituency. For asbestos cases, the trust structure is codified at Section 524(g) of the Bankruptcy Code, 11 U.S.C. § 524(g), enacted in 1994 and known as the "Manville Amendment" in recognition of the fact that such structure was used in the Johns Manville chapter 11 case.

The insurance issues that such plans raise can be manifold and fundamental, including the impact on coverage of (i) claim payment by the trust without insurer consent or input, (ii) payment by policy holder assignment of policy rights to the trust over insurer objection, and (iii) bankruptcy court orders cutting off non-settling insurers' contribution rights.

Insurer standing in such cases has been a major litigation focus, since insurers often are not creditors of the debtor, and the bankruptcy courts sometimes are not familiar with insurance law and potential impact that a plan can have on insurer rights. Likewise, questions as to whether federal bankruptcy law preempts policy-based state-law rights and whether inclusion of certain provisions in a plan can make it "insurance neutral," are frequent issues. What follows is a summary of recent cases regarding the interface between insurance law and the federal Bankruptcy Code.

1. Insurer Standing And Equitable Mootness In Mass Tort Cases

Two recent circuit-level cases examine insurer standing in the context of mass tort chapter 11 cases. *In re Global Indus. Techs., Inc.*, 645 F.3d 201 (3d Cir. 2011) (en banc); *In re Thorpe*, Case No. 10-56543 (9th Cir. Apr. 3, 2012) ("*Thorpe I*"). Both *Global* and *Thorpe* were asbestos bankruptcies, although in *Global* the focus of the Third Circuit's opinion was the standing of certain insurers to object to the plan's treatment of silica-related liability. In both cases, the debtors contended that the plans were "insurance-neutral" — meaning that the plan "neither increased the insurers' pre-petition obligations nor impaired their pre-petition contractual rights under the subject insurance policies." *Global*, 645 F.3d at 212.[2] The underlying premise of the appellee-debtors (supported by the prior reasoning of the Third Circuit in *Combustion Engineering*) was that if the plan had sufficient "neutrality" language, then the only issue insurers could litigate in the bankruptcy court was a challenge to the adequacy of that language. Both

1. Mr. Millner acknowledges the assistance of Christopher D. Soper, a Managing Associate at SNR Denton US LLP.

2. The "insurance neutrality" concept first appeared at the circuit level in *In re Combustion Engineering Inc.*, 391 F.3d 190, 218 (3d Cir. 2004). It refers to plan provisions designed to protect insurers against impairment or alteration of their pre-petition rights and obligations under their insurance contracts.

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Thorpe I and *Global* call into question the efficacy of insurance neutrality language as a unilateral (as opposed to consensual) device for debtors to negate insurer standing.

a. *Global Industrial Technologies* (Standing)

In *Global*, the bankruptcy court confirmed a plan that included both an asbestos trust, pursuant to § 524(g) of the Bankruptcy Code, and a silica trust, which the bankruptcy court held to be "necessary to the debtor's reorganization and thus lawful pursuant to 11 U.S.C. § 105 . . . ." 645 F.3d at 209, n.20. The bankruptcy court determined that the objecting insurers lacked standing to object to the plan because the insurers "would still be able to assert their coverage defenses and contractual rights if ever faced with putative obligations to reimburse the APG Silica Trust on silica-related claims." 645 F.3d at 208 (footnote omitted). The district court affirmed the bankruptcy court.

Global had unique facts pertaining to silica. Global's debtor-subsidiary (APG) which had silica liability had been subject to only 23 silica-related lawsuits from 1977 to the 2002 petition date. In all that time, the relevant insurer had spent only $312,000 on indemnity and defense of silica claims. At the time of the filing, APG had only one pending silica-related lawsuit, a class action consisting of 169 claims in a Texas state court. During the bankruptcy, the debtor solicited confirmation votes of silica claimants based on a list of such claimants from another company's bankruptcy. Approximately 4,600 silica claims voted, with 5 law firms accounting for more than 4,000 of the votes. The bulk of the claims were "diagnosed" by physicians that had been banned as unreliable by the *Manville* trust or had been discredited by the court in *In re Silica Products Liability Litig.*, 398 F.Supp.2d 563, 622 (S.D. Tex. 2005). The contention of the objecting insurers was that the silica trust and the injunction which channeled claims to that trust "were the products of collusion with the asbestos claimants' counsel and, under § 105 of the Bankruptcy Code, were neither necessary nor appropriate for the debtors' successful reorganization." 645 F.3d at 206.

The *en banc* Third Circuit addressed standing under both Article III of the Constitution and § 1109(b) of the Bankruptcy Code, which provides that "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter." 11 U.S.C. § 1109(b).[3] Article III standing requires "injury in fact" that "fairly can be traced to the challenged action and is likely to be redressed by a favorable decision." 645 F.3d at 210. Standing under § 1109(b) of the Bankruptcy Code, according to the Third Circuit, grants standing to "anyone who has a legally protected interest that could be affected by a bankruptcy proceeding." *Id* (adopting the view of the Seventh Circuit in *In re James Wilson Assoc.*, 965 F.2d 160, 169 (7th Cir. 1992).

In the view of the Third Circuit, Article III standing and standing under the Bankruptcy Code "are effectively coextensive." 645 F.3d at 211. Moreover, standing under § 1109(b) "must be construed broadly to permit parties affected by a Chapter 11 proceeding to appear and be heard." 645 F.3d at 211.

The focus of the Third Circuit decision was whether the insurers could show an "injury in fact." The debtor contended that pecuniary injury arising out of the plan was speculative because the plan preserved the insurers' coverage defenses and was adequately "insurance neutral." The insurers, in contrast focused on their role as "funding sources" who would have to address liabilities of the silica trust. (The insurers' policies had been assigned to the silica trust, which would seek coverage based on claims it allowed.)

The principal Third Circuit authority, *Combustion Engineering*, had in fact ruled that certain insurers did not have appellate standing to challenge a plan because the plan contained adequate "neutrality" provisions. The *en banc* Third Circuit endorsed "insurance neutrality" as a "meaningful concept" but limited it to cases where the "plan does not materially alter the quantum of liability that the insurers would

3. The bankruptcy court also ruled on the merits that the assignment of the insurers' policies to the silica trust in contravention of the policies anti-assignment provisions "was not injurious because the Bankruptcy Code and state law rendered those provisions a nullity." 645 F.3d at 208. The Third Circuit did not address that issue or any other issues as to the merits of the insurers' objections, which it remanded back to the bankruptcy court.

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be called to absorb." 645 F.3d at 212. The *en banc* Third Circuit viewed *Combustion Engineering* as such a case; it had experienced a high volume of asbestos claims for several decades.

In contrast, in *Global* "the Plan's promise of an APG Silica Trust appears to have staggeringly increased — by more than 27 times — the pre-petition liability exposure." 645 F.3d at 212. In the court's view, the manifold increase in silica-related claims created "tangible disadvantage" to the objecting insurers, regardless of coverage defenses, since the new claims would create a new set of administrative costs and investigative burden. Moreover, to the extent that the injury was contingent on disposition of the silica claims, the Third Circuit viewed *Clinton v. City of New York*, 524 U.S. 417 (1998), as establishing "that an injury's having a contingent aspect does not necessarily make that injury incognizible under Article III." 645 F.3d at 213 (dealing with challenges to the Line Item Veto Act). According to the Third Circuit, "*Clinton* recognizes that a tangible disadvantage to the affected party can lead to standing." *Id.*

In a further significant discussion, the court also stated that the "suspect circumstances surrounding the creation" of the silica trust also supported insurer standing. 645 F.3d at 214. The court viewed the allegations of collusion between the debtor and asbestos claimants' counsel in establishment of the trust as "non frivolous" and "not without record support." *Id.* The court also placed reliance on its prior decision in *In re Congoleum*, 426 F.3d 675 (3d Cir. 2005), where it had granted insurers appellate standing to raise a disqualification issue because that issue implicated "the integrity of the bankruptcy court proceeding as a whole." 645 F.3d at 214 (quoting *Congoleum*, 426 F.3d at 685).

The upshot of the court's reasoning is that mere inclusion of comprehensive insurance neutrality language in a plan will not necessarily insulate the plan from attack by insurers. Indeed the court's focus on the collusion allegations suggests that insurers should be granted standing in the Third Circuit whenever they advance non-frivolous plan objections based on § 1129(a)(3) of the Bankruptcy Code, which requires that "the plan has been proposed in good faith and not by any means forbidden by law." Certainly the court's advice (at the outset of the opinion) as to the scope of its holding suggests such standing principle: "The decision we announce is not more far-reaching than this: when a federal court gives its approval to a plan that allows a party to put its hands into other people's pockets, the ones with the pockets are entitled to be fully heard and to have their legitimate objections addressed. In short, they at least have bankruptcy standing." 645 F.3d at 205.

b. Thorpe Insulation I (Standing, Equitable Mootness, Assignment Of Policy Rights)

Thorpe I was an asbestos chapter 11 case in which the bankruptcy court confirmed a plan pursuant to § 524(g) of the Bankruptcy Code. Under the plan, the debtors' insurance rights, including rights as to non-settling insurers, were assigned to a trust. The bulk of Thorpe's insurers reached settlements during the chapter 11 case, and the settlements provided for more than $600 million in cash and securities to fund the trust. Insurance proceeds were the principal estate asset.

The plan included "insurance neutrality" provisions which purported to preserve insurers' coverage defenses. On the basis of that language, the bankruptcy court denied standing to appellants (objecting insurers) to challenge the plan. The bankruptcy court also ruled that § 524(g) preempted the anti-assignment clauses of the objecting insurers' policies, so that policy rights could lawfully be assigned to the trust. The district court affirmed.

i. Standing

In the Ninth Circuit, all parties agreed that the objecting insurers had appellate standing to appeal the finding of insurance neutrality and to appeal the preemption holding. The issue before the Ninth Circuit was whether the objecting insurers had been improperly deprived of standing in the bankruptcy court to challenge the plan as being not proposed in good faith and otherwise defective.

The Ninth Circuit analyzed both statutory standing under § 1109(b) of the Bankruptcy Code and Article III standing, focusing — as did the Third Circuit in *Global* — on the issue of whether the plan was "insurance neutral." The court examined not only the plan's neutrality language but also, more fundamentally, the economic impact of the plan on insurers. As for the neutrality language, the court found that it had exceptions not present in the neutrality language that

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the Third Circuit had approved in *Combustion Engineering*. "Here, the express exceptions to Appellants' defenses signal that the plan is not insurance neutral." 2012 WL 178998 at *10.

One of the neutrality exceptions arguably would have permitted the objecting insurers to be bound by the trust's determination as to amount of liability on an asbestos claim. The court found: "Here Appellants reasonably complain that they were not permitted to participate in establishing the valuation matrix. That would be no problem if they could challenge amounts set by it, but it is a problem for them if they may be bound by it without prior participation." *Id.* at *10. Similarly, the plan, in the court's view, could have prevented the objecting insurers from challenging reasonableness of claim settlements by the trust — without any ability of the insurers to challenge the valuation matrix.

The Ninth Circuit also found bases for standing which appear *not* to be tied to the neutrality language. Specifically, it viewed the objecting insurers as being "a party in interest to the proceedings establishing the trust" because, under the plan, the trust could allow asbestos claimants to file suits directly against the insurers. *Id.* at *11. The court observed that if the trust ran out of money because insufficiently funded or because the trust distribution procedures were insufficiently stringent, then the likelihood of claims against the non-settling insurers would increase. More broadly, the Ninth Circuit stated, "[a]s a general matter, . . . parties with potential responsibility to pay claims against debtors regularly have standing to participate in bankruptcy cases." *Id*. (quoting *Baron & Budd, P.C. v. Unsecured Asbestos Claimants Comm.*, 321 B.R. 147, 158 (D.N.J. 2005)).

Finally the court found that the objecting insurers were parties in interest because the plan provided that they could bring contribution actions against the trust to the extent that such rights against settling insurers were not satisfied through judgment reduction. (The § 524(g) injunction cut off the non-settling insurers' ability to sue the settling insurers directly for contribution.) The court viewed the right of a non-settling insurer to recover the amount of its contribution claim (which would ordinarily be against a settling insurer) as "a legally protected right", giving the objectors an interest in the trust funding; since any "inadequacy in the trust threatens to diminish the value of Appellants' claims" against the trust. *Id.* at *11.

Having found that the objecting insurers were "parties in interest" under § 1109(b), the Ninth Circuit easily found that they had Article III standing, i.e. an injury in fact. The Ninth Circuit also addressed the concept of "prudential" limitations on Article III standing, i.e. the concept that the plaintiff's grievance must fall within the zone of interest protected by the subject statutory provision, and found that party in interest status under § 1109(b) satisfied any such prudential requirement. "Congress intended § 1109(b) to confer broad standing so that those whose rights would be affected by reorganization proceedings could participate and protect their rights." *Id.* at *13.

In sum, the Thorpe plan was not "insurance neutral" in the view of the Ninth Circuit. However, at least in mass tort cases, economic impact of the plan may be sufficient to generate insurer standing — regardless of the phrasing of insurance neutrality language. "The plan potentially increases the liabilities of the insurance companies with real world economic impact, and, as such, Appellants have sufficiently alleged an injury in fact." *Id.* at *12.

ii. Equitable Mootness

A far-reaching holding of the Ninth Circuit in *Thorpe I* was its holding was that the appeal was not equitably moot.[4] Citing *In re Roberts Farms*, 652 F.2d 793, 798 (9th Cir. 1981), the Ninth Circuit explained that "[e]quitable mootness occurs when a 'comprehensive change of circumstances' has occurred so 'as to render it inequitable for this court to consider the merits of an appeal.'" *Id.* at *5. Previously, the Ninth Circuit had not articulated a "comprehensive test" to determine whether an appeal is equitable moot. In *Thorpe I* the Ninth Circuit, based on its review of standards in other circuits (as well as its own precedent), set forth its standard as follows:

> We will look first at whether a stay was sought,

4. The Ninth Circuit found that the appeal was not constitutionally moot because the court could reverse plan confirmation or require modification of the plan, thereby giving relief to Appellants.

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> for absent that a party has not fully pursued its rights. If a stay was sought and not gained, we then will look to whether substantial consummation of the plan has occurred. Next, we will look to the effect a remedy may have on third parties not before the court. Finally, we will look at whether the bankruptcy court can fashion effective and equitable relief without completely knocking the props out from under the plan and thereby creating an uncontrollable situation for the bankruptcy court.

Id. at *6.

As for the first factor, the court found that Appellants had sought a stay from both the court of appeals and the Circuit Justice. They had failed to gain a stay but, in the courts view, "it would be inequitable to dismiss their appeal on equitable mootness grounds merely because the reorganization has proceeded." *Id.* at *6.

As for the next factor (substantial consummation), the Bankruptcy Code defines substantial consummation as: a) transfer of all or substantially all of the property proposed by the plan to be transferred; b) assumption by the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and c) commencement of distribution under the plan. 11 U.S.C. § 1101(2). The Ninth Circuit held that substantial consummation had not occurred because only $135 million of $600 million in insurance settlement proceeds had been transferred to the trust. Furthermore, the court noted in a footnote that even if the plan had been substantially consummated, it would still assess whether effective relief might be given. *Id.* at *6, n.7.

As to the third factor, whether plan modification would bear unduly on third parties not before the court, the Ninth Circuit noted that third party rights are always affected "in some way" by a plan that has gone effective. But the fact that third party rights had been affected could not, in and of itself, bar an appeal; otherwise, "no party that failed to obtain a stay in §524(g) cases would ever be able to appeal . . . ." *Id.* at *7. Thus "the question is not whether it is possible to alter a plan such that no third party interests are affected, but whether it is possible to do so in a way that does not affect third party interests to such an extent that the change is inequitable." *Id.* at *7. In this regard, the plan provided that it could be modified after confirmation with the consent of the futures representative and trust advisory committee, without a vote by asbestos claimants; and the futures representative was a party to the appeal. In the Ninth Circuit's view, the bankruptcy court could fashion remedies that would not impact asbestos claimants in a negative way, especially in light of the fact that the asbestos claimants "did not agree to a plan that promised no future changes." *Id.* at *7.

Finally, and most importantly, the court focused on whether the bankruptcy court on remand would be able to devise an equitable remedy. The Ninth Circuit recognized that "it may not be viable totally to upset the plan . . . ." *Id.* at *7. But it viewed it possible to grant "some relief," such as requiring additional contribution by Appellees to the trust; clarification that the trust distribution procedures are not binding on direct suits filed against Appellants; opportunity for Appellants to present evidence to support modification of the trust distribution procedures; changing governance procedure of the trust.

In sum, *Thorpe I* places the Ninth Circuit squarely in line with other circuit-level precedent limiting the equitable mootness doctrine.

iii. Preemption

The plan assigned Thorpe's insurance rights to the trust and excluded from Appellant's defenses any defense from violation of the anti-assignment clauses in their policies. Under California law, such assignment of policy rights, without consent of the insurer, could violate the policies. *Henkel Corp. v. Hartford Accident and Indemnity Co.*, 29 Cal. 4th 934, 944 (2003). The bankruptcy and district courts determined that bankruptcy law preempted anti-assignment clauses in the insurance policies; the Ninth Circuit affirmed.

The court found express preemption in § 541(c) of the Bankruptcy Code, which provides that an interest of the debtor in property becomes property of the estate notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law that restrict or conditions transfer of such interest by the debtor. 11 U.S.C. § 541(c). Following the view of the Third Circuit in *Combustion Engineering*, 391 F.3d at 219 n.27, the court viewed

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the Bankruptcy Code's express preemption of restrictions on transfer of debtor property into the estate as also effectively preempting contractual provisions that would restrict transfer out of the estate to a post-confirmation trust. For reasons unknown, the Ninth Circuit adopted the novel view that the post-confirmation § 524(g) trust was part of the bankruptcy estate. "The trust is part of the debtor's estate. Instead of attempting to sell or assign anything to third parties, the debtor was attempting to transfer its rights and property to the trust, part of the estate." *Id*. at *14.

More cogently, the Ninth Circuit also found implied preemption on the theory that insurance policy anti-assignment clauses conflict with the purpose and objective of § 524(g). In the courts view, without such preemption, "[a]fter a debtor had filed for bankruptcy, no insurer would settle, with the aim of funding a § 524(g) plan, because by refusing to settle, the insurer could position itself to claim forfeiture of the insurance if a plan proceeded and there was a consequent breach of the anti-assignment provisions." The court viewed the contribution by the insurers to the trust as part of the "cornerstone" of a § 524(g) plan. *Id.* at *15. [E]nforcing the anti-assignment provisions would subject virtually all § 524(g) reorganizations to an insurer veto." *Id.* at *15.

The court made clear that "[s]imply making a reorganization more difficult for a particular debtor," would not give rise to an implied preemption. *Id.* at *15. Therefore the case does not suggest that other insurer policy rights, such as the right to cooperation from its insured in the defense of claims and the right to control the defense of claims, are in any way abrogated by the Bankruptcy Code.

2. *Thorpe II* (Arbitration And Breach Of Insurance Contract)

On January 30, 2012, the 9th Circuit issued a second opinion in *Thorpe Insulation* which affirmed rulings by the bankruptcy court and district court disallowing a claim by Continental Insurance Company and denying a motion by Continental to compel arbitration of the claim. *In re Thorpe Insulation Co.*, 2012 WL 255231 (9th Cir. Jan. 30, 2012) (*"Thorpe II")*.

The proof of claim (for which Continental sought damages against the debtor) asserted breach of a pre-petition settlement agreement in which Thorpe had agreed not to assign or transfer any chose-in-action connected with the matters released (the "Assignment Warranty") and not to voluntarily assist any person in establishing a claim against Continental relating to the matters released (the "Establishment Warranty"). The settlement agreement also had an arbitration clause.

In connection with the bankruptcy, several settling insurers (not Continental) agreed to assign to Thorpe and a § 524(g) trust their contribution, indemnity, and subrogation rights against other insurers, including Continental. Continental asserted that Thorpe's acquisition of these rights and assignment thereof to the trust violated the Assignment Warranty. Thorpe collaborated with asbestos claimants to begin structuring a § 524(g) plan.

Continental alleged that Thorpe's "collaboration" conduct included pre-petition conduct (in September 2007) whereby Thorpe encouraged and assisted filing of three direct action lawsuits against Continental under section 11580 of the California Insurance Code; Continental asserted this pre-petition conduct, as well as Thorpe's post-petition conduct in drafting, proposing, and seeking confirmation of a plan, violated the Establishment Warranty.

Continental requested arbitration of its claim prior to the bankruptcy filing, but Thorpe filed for chapter 11 relief on October 15, 2007 — one day before the scheduled arbitration hearing was to begin.

a. Bankruptcy And District Court Rulings

The bankruptcy court disallowed Continental's motion to compel arbitration and disallowed its claim. The district court affirmed denial of the motion to compel arbitration and affirmed disallowance of Continental's claim except as to Continental's allegations concerning Thorpe's pre-petition encouragement of direct actions against Continental, which the district court reversed and remanded for further hearing.

On remand, Continental refused to argue the remanded issue — Thorpe's alleged prepetition encouragement of three direct actions — as a "standalone claim." *Thorpe II*, 2012 WL 255231 at *5. That is, Continental was unwilling to separate the direct actions from Thorpe's efforts to negotiate a

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plan and prepare for bankruptcy. On that basis, the bankruptcy court granted Thorpe's post-remand motion for summary judgment and sustained the claim objection. The court's reasoning was that the contract was not enforceable to the extent that it constituted a pre-petition waiver of the right to formulate, structure, and negotiate a § 524(g) bankruptcy plan.

The bankruptcy court on remand also denied a renewed motion by Continental to compel arbitration. The bankruptcy court based its reasoning on the need to coordinate resolution of Continental's claim with the plan confirmation process and its view that the remaining claim involved Thorpe's exercise of rights in bankruptcy. The district court affirmed the bankruptcy court's orders, concluding that "Continental repeatedly refused to limit the scope of its claim to matters that were within the scope of the remand and would not require the arbitrator to decide important matters of bankruptcy policy involving § 524(g)." *Thorpe II*, 2012 WL 255231 at *6.

b. Ninth Circuit Rulings

i. Arbitration

The Ninth Circuit dealt first with Continental's motion to compel arbitration. The Ninth Circuit recognized that the Federal Arbitration Act generally requires that agreements to arbitrate be enforced. But it also recognized that the statutory directive could be overridden to the extent that there was a conflict between arbitration and the underlying purposes of the Bankruptcy Code, another federal statute. The appeals court further recognized that in core bankruptcy matters, a bankruptcy court does have discretion to deny enforcement of an arbitration agreement, at least when it sees a conflict with bankruptcy law. Following decisions in other circuits, the court reasoned that the core/non-core distinction is relevant because core matters are more likely to implicate provisions of the Bankruptcy Code, but the core/non-core distinction could not be dispositive since some "core" matters do not involve Bankruptcy Code provisions. The court ruled that "a bankruptcy court has discretion to decline to enforce an otherwise applicable arbitration provision only if arbitration would conflict with the underlying purposes of the Bankruptcy Code." *Thorpe II,* 2012 WL 255231 at * 8.

Focusing on the Continental claim, the appellate court stated that the resolution of the claim was unquestionably a core matter, since resolution of claim objections are always core matters. The Ninth Circuit also found that Thorpe's alleged breaches of the pre-petition Continental settlement agreement raised issues of fundamental bankruptcy policy since they challenged Thorpe's actions in conducting and administering the Chapter 11 case and negotiating with various constituencies. Accordingly, the court ruled that the bankruptcy court did not abuse its discretion denying Continental's motion to compel arbitration.[5]

The court stated that the need to prevent a delay of plan confirmation and the need to coordinate the bankruptcy with resolution of the claim further supported the bankruptcy court's denial of the motion to arbitrate. Interestingly, the Ninth Circuit noted in a footnote that if Continental had presented a "standalone claim relating solely to Thorpe's prepetition encouragement of direct actions, that claim likely should have been arbitrated . . . ." *Thorpe II,* 2012 WL 255231 at n.10. But the same footnote indicates that the Ninth Circuit's notion of such standalone claim would be a claim "isolated to prepetition matters independent of the bankruptcy" -- likely meaning that Continental could not argue that the prepetition conduct was connected to the bankruptcy preparation and strategy. *Id.* Conversely, the Ninth Circuit's footnote suggests that prepetition conduct designed to negotiate or advance a plan may be viewed as being such conduct in the bankruptcy itself.

ii. Breach Of Contract (Prepetition Settlement Agreement)

The Ninth Circuit's ruling on arbitration and discovery are not exceptional rulings. Almost all courts give the bankruptcy court discretion to deny

5. The court stated: "A claim based on a debtor's efforts to seek for itself and third parties the protections of § 524(g) implicates and tests the efficacy of the provision's underlying policies. Because Congress intended that the bankruptcy court oversee all aspects of a § 524(g) reorganization, only the bankruptcy court should decide whether the debtor's conduct in the bankruptcy gives rise to a claim for breach of contract. Arbitration in this case would conflict with congressional intent. *Id.* at *9.

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arbitration of core matters that implicate central Bankruptcy Code provisions, and it is rare to obtain a reversal on a discovery issue. The remaining portion of the Ninth Circuit decision is different; it deals with whether Thorpe's actions in pursuing a § 524(g) reorganization created a claim for damages as a consequence of breach of a contract (the prepetition settlement agreement).

Specifically Continental claimed (i) that Thorpe breached the "Assignment Warranty" of the settlement agreement by acquiring the settling insurers' contribution claims and assigning them to the § 524(g) trust (ii) and that it breached the "Establishment Warranty" by collaborating with asbestos claimants to structure and confirm a § 524(g) plan. The Ninth Circuit's broad holding in effect rules that the Bankruptcy Code preempts such claims, i.e. that the Bankruptcy Code made certain provisions of the settlement agreement unenforceable in the present context. The court, however, analyzed the matter as an issue of prepetition waiver of statutory bankruptcy protections. "[E]ven if the covenants in the Settlement Agreement by their terms would have proscribed these actions, we conclude that, to the extent that they did, they were not enforceable, because they then would be purported prepetition waiver of the protections of the Bankruptcy Code, which need not here be permitted." *Thorpe II,* 2012 WL 255231 at *11.

As to the Assignment Warranty, the court noted that § 541(c)(1)(A) of the Bankruptcy Code expressly transfers property of the debtor to the estate regardless of any provision in any agreement to the contrary. The court also placed reliance on § 1123(a)(5)(B) of the Code which provides that a plan shall provide "adequate means for the plan's implementation, such as . . . transfer of . . . property of the estate to one or more entities . . . ." The court viewed Thorpe's assignment of the contribution rights to the trust as necessary for the plan's implementation. The court's reasoning on this point was not clear. It does state as a general matter that "inability to transfer valuable assets to the trust could have thwarted confirmation of the plan." *Thorpe II,* 2012 WL 255231 at *12. But the court does not explain why the trust needed the contribution rights. On the other hand, given that in *Thorpe I*, the Ninth Circuit did not view the trust as an entity separate from the debtor' estate, the court may simply be of the view that all assets of the debtor that are not necessary for the debtor's continuing operation necessarily have to go to the trust (which in its view is just part of the debtor's estate).

Potentially more far-reaching is the Ninth Circuit's view that the Establishment Warranty was unenforceable to the extent that Thorpe, as part of a plan negotiation "had to accommodate the asbestos claimants' interest in preserving direct action rights in maximizing the trust's insurance assets . . . ." *Thorpe II,* 2012 WL 255231 at *12. The court based this view on the fact that Thorpe needed a 75% vote of the asbestos claimants in order to confirm a § 524(g) plan and therefore had to obtain support of the claimants. Taken to its logical limit, such reasoning could be used to say that any clause of an insurance policy could be viewed as unenforceable to the extent that it stood in the way of a debtor making a deal with the asbestos claimants.

However, it is not at all clear that the Ninth Circuit in *Thorpe II* meant to grant bankruptcy courts broad power to invalidate or rewrite portions of insurance contracts. First of all, the decision dealt only with a proof of claim whereby Continental was seeking to obtain a monetary recovery against Thorpe. It did not deal with preservation of coverage defenses.

Second, the Ninth Circuit made clear in *Thorpe I* that "[s]imply making a reorganization more difficult for a particular debtor," would not give rise to an implied preemption. *Thorpe I*, 2012 WL 178998 at *15. *Thorpe II* was decided just six days later by the same panel and was written by the same judge (Gould) as *Thorpe I*. It gives no indication of any intent by the court to contradict or limit *Thorpe I*.

Third, as to asbestos claimants' negotiation with Thorpe, there is no question that the Bankruptcy Code requires a vote by the claimants and there is no question that one of the items that has to be disclosed, structured, and discussed is the method by which claimants will prosecute claims, which necessarily includes the method or methods by which non-settling insurers' coverage will be accessed. In fact, the Thorpe plan did allow asbestos claims to proceed in the tort system against the insurers (with Thorpe named only nominally as a defendant).

Fourth, the decision is unclear as to Continental's loss of its claim that Thorpe helped claimants assert prepetition direct claims against Continental, in violation of a prepetition settlement agreement.

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Because that claim was never separated from the post-petition conduct, there is no clean statement by the court as to whether prepetition conduct of that type — which goes far beyond typical plan negotiation — could somehow be viewed as preempted by the Bankruptcy Code.

3. W.R. Grace (Claimants Have No Vested Right In Policy Proceeds)

Among the many issues dealt with in the recent district court decision confirming confirmation in *In re W.R. Grace & Co.*, 2012 WL 310815 (D. Del. Jan. 30, 2012), is the assertion by asbestos claimants that they have a "vested" right in a debtor's insurance coverage, such that the debtor cannot enter into a settlement of that coverage over their objection. The issue arose when a group of asbestos personal injury claimants, the "Libby Claimants," objected to a settlement between Grace and one of its insurers, CNA, and claimed a unique right (over and above that of other asbestos claimants) to receive a portion of the insurance proceeds. One assertion by the Libby Claimants was that the policy proceeds were not property of the estate at all and therefore could not be dealt with by the bankruptcy court. The court rejected that proposition, noting "the common decision in mass tort bankruptcies [sic] cases to include insurance proceeds as property of the estate to avoid a 'free-for-all against the insurer[.]'" *W.R. Grace*, 2012 WL 310815, at * 15 (quoting *Houston v. Edgeworth*, 993 F.2d 51, 56, n.21 (5th Cir. 1993)). Alternatively, the Libby Claimants maintained that they had a "vested right" to the insurance proceeds under Montana law. The court observed that since the Libby Claimants were not named insureds or intended beneficiaries of any of the policies, they would have to establish one of the following to support their position: 1) a state statute crafted by the legislature conferring a right upon the parties to pursue a direct action for the proceeds, 2) a judicial opinion of the state's judicial system, or 3) a public policy of particular importance to the state.

The court did not find the Montana state precedent cited by the Libby Claimants to be apposite. Among other things, the plaintiff in the case they cited, *McLane v. Farmers*, 150 Mont. 116 (Mont. 1967), had obtained a judgment entitling him to insurance proceeds. The Libby Claimants had not obtained judgments. In addition the policy involved in that case was a motor vehicle liability (not general liability) policy, subject to a unique state statute.

The district court in *Grace* found no statute, judicial opinion, or public policy that supported the Libby Claimants. Instead, it found guidance in the bankruptcy court decision of *In re Dow Corning Corp.*, 198 B.R. 214 (Bankr. E.D. Mich. 1996). In *Dow Corning*, the bankruptcy court found that while an injured party's claim against an insured is a vested property interest entitled to constitutional protection, the injured party has no more than an expectation that he/she will be able to collect from the insured prior to obtaining a judgment.

The district court in *Grace* found "highly persuasive" the following observations in *Dow Corning*:

> Even more troubling is the situation . . . where at the time of the proposed settlement there are injured party claimants who are not yet known. If each unknown claimant could later sue the insurer and not be estopped by a fully litigated judgment against its insured or by a fair and equitable settlement, there would be no finality to litigation and no realistic likelihood of settlement.
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> ***
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> To grant an injured party more than an expectation before receipt of judgment would inhibit legitimate settlements. An insurer would never be able to settle a coverage suit with its insured without impleading the known injured party. It is axiomatic that the more parties involved, the more difficult it is to settle. . . . Therefore, it is not surprising that there appears to be no case where a fair and reasonable settlement entered into in good faith between an insurer and insured was subsequently undone by a court.

Dow Corning, 198 B.R. at 242.[6]

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4. *Artra 524(g) Asbestos Trust v. Fairmont Premier Ins. Co*., 2011 WL 4684356 (N.D. Ill. September 30, 2011) (Measure Of Insurer Indemnity Obligation)

Transport Insurance Co. was an excess-level insurer for the Artra 524(g) Asbestos Trust. Transport contended that its contractual indemnity obligation was only for the amounts actually paid to the trust's claimants (7.5% of the allowed claim amount), rather than the full amount of allowed claims against the trust.

The policy contained the following provision: "In the event of the bankruptcy or insolvency of the [policyholder], the [insurer] shall not be relieved thereby of the payment of any claims hereunder because of such bankruptcy or insolvency." 2011 WL 4684356 at *1. The court cited to the Seventh Circuit *UNR* decision that interpreted a virtually identical policy provision to require the insurer to indemnify the insured for the full amount of loss claims rather than the fractional amount of the bankruptcy estate's payments. *UNR Industries, Inc. v. Continental Casualty Co.*, 942 F.2d 1101, 1105 (7th Cir. 1991).

In support of its position, Transport cited a California case, unnamed in the *Artra* opinion, but undoubtedly *Fuller-Austin Insulation Co. v. Highlands Insurance Co.*, 38 Cal. Rptr. 3d 716 (Ct. App. 2006), *cert. denied*, 127 S.Ct. 248. In *Fuller-Austin*, the trust paid claimants on the basis of a Claims Resolution Procedures (CRP) matrix that provided that a claimant would receive only a fraction of the allowed value (the Payment Sum Percentage), which percentage could be periodically adjusted by the Trustees based on the trust's assets. The California appellate court in *Fuller-Austin* ruled that the insurer would be required to pay indemnity only at a fractional amount of the allowed claim, not the amount of the allowed claim. *Fuller-Austin*, 38 Cal. Rptr. 3d at 998-999.

Transport pointed to provisions in the plan specifically disclaiming reliance on *UNR*, but the court held that those provisions were intended to ensure that Transport retained the right to assert that claims were not covered by the policy even if they were allowed by the bankruptcy trustee. Indeed, "the parties [Transport and the debtor] agree that the policy's coverage of any given claim and the reasonable nature of any payment agreement by the trust are still to be determined." *Artra*, 2011 WL 4684356 at *2. The court here found no support for Transport's assertion that the plan language prevented trust from asserting that the policy language and Illinois law require Transport to pay covered claims at the full amount.

The court granted the trust's motion for partial summary judgment in part, holding that subject to applicable defenses, the measure of Transport's indemnity obligation was the full amount of any claim allowed by the trust. The court also held that the full amount of the allowed claim must be used in determining whether Transport's excess layer was triggered.

5. *Rosciti v. Insurance Company of Pennsylvania*, 659 F.3d 92 (1st Cir. 2011) (Effect Of Self-Insured Retention)

Appellants sued manufacturer over alleged defects in a motor home. Manufacturer filed for bankruptcy and appellants added excess insurer as a defendant, invoking the Rhode Island direct action statute allowing tort victims to recovery damages directly from liability insurers of a bankrupt tortfeasor, but only within the limits of the insurance policy. The insurer moved for summary judgment, arguing that its coverage obligations had not been triggered because of a limiting provision in the policy stating that the insurer's duty to pay arose only after manufacturer paid an initial $500,000 before excess coverage was triggered (the manufacturer was self-insured for liability up to a retained limit of $500,000). Appellants pointed to other language in the policy providing that manufacturer's bankruptcy would not relieve the insurer of its obligations, and that any conflict in the policy was to be resolved against the insurer. The district court granted summary judgment to the insurer, but the First Circuit reversed and remanded, finding that the limiting provision in the policy was against public policy.

The retained limit provision of the policy provided: "[insurer's] duty to pay any sums that [manufacturer] become[s] legally obligated to pay

6. *See also In re The Salem Baptist Church Of Jenkintown*, 455 B.R. 857 (Bankr. E.D. Pa. 2011) (under Pennsylvania law, a stranger to a policy may claim a prejudgment interest in policy proceeds *only if* it secures from the insured an assignment of the policy proceeds).

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arises only after there has been a complete expenditure of [manufacturer's] retained limit(s) by means of payments for judgments, settlements, or defense costs." The policy also had a bankruptcy provision, which provided:

> [Manufacturer's] bankruptcy, insolvency or inability to pay, or the bankruptcy, insolvency or inability to pay of any of [manufacturer's] underlying insurers shall not relieve [insurer] from the payment of any claim covered by this Policy. But under no circumstances shall such bankruptcy, insolvency, or inability to pay require [insurer] to drop down or in any way replace [manufacturer's] retained limit or assume any obligation associated with [manufacturer's] retained limit.

659 F.3d at 94.

The First Circuit agreed with the insurer that the policy is not ambiguous; the bankruptcy provision is plainly subject to the limitations in the retained limit provision. "The Bankruptcy Provision, by referring to claims 'covered by this Policy,' clearly alerts the reader to examine the rest of the contract for possible limits on [insurer's] liability. The Retained Limit provision, in contrast, contains no such cautionary language; [insurer] is liable '*only after* there has been a complete expenditure of [manufacturer's] retained limit." 659 F.3d at 97 (emphasis in original). Thus under the literal policy language, the insurer would be liable above the retained limit if the manufacturer is bankrupt, but only after the manufacturer exhausts the retained limit.

The First Circuit, however, focused on public policy. Appellants argued that the insurer's interpretation of the policy frustrated Rhode Island's direct action statute, which was to "give an aggrieved and injured party the right to proceed directly against an insurer in those circumstances in which the tortfeasor has sought protection under the applicable provisions of the United States Bankruptcy Code." *Id.* at 98 (quoting *D'Amico v. Johnston Partners,* 866 A.2d 1222, 1229 (R.I. 2005). The insurer argued that the statute limited recovery to "insurance coverage *available* for the tort complained of" (emphasis added) and that nullifying the retained limit provision would improperly expand the scope of coverage by eliminating the threshold requirement for the insurer's obligations. Moreover, argued the insurer, appellants position would require the insurer to "drop down" below the $500,000 limit.

The First Circuit held that "it is clear that Rhode Island's public policy is to prevent insurance companies from avoiding their obligations when an insolvent insured cannot make an expenditure towards discharging liability." 659 F.3d at 98. The direct action statute "reflects the Legislature's intent to preserve a tort victim's right of recovery when the insured becomes insolvent" and "the Rhode Island Supreme Court has recognized the 'generally agreed' rule that 'the debtor's discharge does not affect the liability of the debtors insurer for damages caused by the debtor." *Id.* (citations omitted). In light of public policy, the court refused to enforce the retained limit provision.

The court noted "mixed results" in these cases, but that in cases governed by state law similar to Rhode Island's, courts generally hold that a limiting provision must yield to public policy. Conversely, and citing to *Pak-Mor Mfg. Co. v. Royal Surplus Lines Ins. Co.*, 2005 WL 3487723 (W.D. Tex. Nov. 3, 2005), the court noted that in states without such a strong policy in favor of a claimant's right to recover from an insurer in the event of insolvency, courts reach the opposite result. The court stated that "[i]f , as in *Pak-Mor*, the language of the policy was the only factor controlling the outcome of this case, we would affirm the district court." 639 F.3d at 99.

The court also disagreed with appellants' contention that its ruling would expand the scope of coverage. The insurer will pay only if the appellants eventually win a judgment over $500,000 and any award would be capped by the limits of the policy. In other words, any recovery from the insurer will be reduced by $500,000. The insurer also argued that it would be forced to defend claims within the self-insured (under $500,000) layer, which was not factored into the premiums charged to the manufacturer. But the court noted that appellants maintained throughout that their claim was above $500,000, so the insurer would be defending a claim above the self-insured limit, with exposure capped at the policy limits. Moreover, the policy language expressly gave the insurer the right to defend or participate in the defense of any claim or suit and provides that the insurer will bear its own costs. The court could not conclude that the insurer did not

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contemplate having to pay defense costs. The court did concede that the appellants would have no incentive to settle at any amount less than $500,000, but this did not outweigh the strong policy considerations involved.

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