Insurance neutrality in Chapter 11 reorganizations

By Damon Thayer and Zain Shirazi

Earlier this year, the 9th U.S. Circuit Court of Appeals handed down an eagerly anticipated decision examining whether a debtor’s bankruptcy reorganization plan was “insurance neutral.” The court’s decision in *Motor Vehicle Casualty Co. v. Thorpe Insulation Co.* (In re Thorpe Insulation Co.), 671 F.3d 980 (9th Cir. 2012), came on the heels of a controversial en banc decision issued by the 3rd Circuit in 2011, which some insurers have argued changed the framework for analyzing insurance neutrality. See *In re Global Indus. Techs.*, 645 F.3d 201 (3d Cir. 2011) (en banc). Although many hoped that the 9th Circuit would resolve the multitude of lingering questions Global Industrial left open, Thorpe instead decided very few. Nevertheless, the 9th Circuit’s decision is significant because it reaffirmed the traditional “textual” approach to determining insurance neutrality, while perhaps implicitly rejecting the overly broad reading of insurance neutrality. See *Global Indus. Techs.*, 645 F.3d 201 (3d Cir. 2011) (en banc). The 9th Circuit ultimately held that the non-settling insurers’ “quantum of liability” analysis was incorrect. That is simply not the case.

Some attorneys have expansively interpreted this “quantum of liability” analysis as requiring courts to always consider whether a reorganization plan’s formation correlates with an increase in the number of claims. In short, Thorpe followed the textual approach that has again and again been utilized by courts addressing insurance-neutrality questions. Although the court discussed Global Industrial, it did not mention the “quantum of liability” approach, much less adopt it. Further, Thorpe may have implicitly rejected an expansive reading of Global Industrial by not engaging in any extracontractual insurance-neutrality analysis. Speculation aside, Thorpe did not foreclose the possibility that a “quantum of liability” analysis may be appropriate in certain unique circumstances, especially where there is extensive evidence of collusion. Debtors should therefore remain wary of the expansive view of Global Industrial that some insurers have taken when crafting their reorganization plans.

Global Industrial advanced by insurers.

Putting the import of Thorpe into proper context requires a bit of background on Chapter 11 bankruptcy proceedings and the concept of insurance neutrality. A reorganization plan is the vehicle that allows a debtor to reorganize its assets and debts in order to get back on its feet. A corporate debtor seeking confirmation of its reorganization plan from the bankruptcy court may frequently find many obstacles in its path, the most notable being creditors. While creditors are guaranteed a say in the reorganization process, noncreditors — such as the debtor’s insurance companies — are not. Rather, insurers can only have their voices heard if they have standing under Article III and the Bankruptcy Code. The standing inquiry primarily turns on whether the debtor’s reorganization plan is insurance neutral. If it is, no standing exists because the insurer by definition has not suffered an injury in fact. Courts around the country have traditionally followed a textual approach to insurance neutrality: as long as the language of the plan does not take away an insurer’s rights, the plan is deemed insurance neutral. And then came the 3rd Circuit’s 2011 decision in *Global Industrial*.

Global Industrial was not a run-of-the-mill bankruptcy case. The debtor faced hundreds of millions of dollars of tort liability for asbestos-related claims. The debtor’s reorganization plan created a trust to deal with these claims. The plan also created a trust to manage the small number of silica-related claims facing the debtor. Certain insurers signed off on the plan, thereby contributing funds to the trust in exchange for a release from liability. Other insurers refused to settle and argued that the plan was not insurance neutral. Specifically, the non-settling insurers asserted that the silica trust and corresponding channeling injunction were unnecessary to the reorganization process, and further, that the plan essentially manufactured the debtor’s silica liability. Although the reorganization plan plainly stated that it preserved all of the non-settling insurers’ legal claims and defenses, the 3rd Circuit concluded that the reorganization plan was not insurance neutral for two reasons.

First, and perhaps most importantly, the court concluded that there were “nonfrivolous allegations of collusion” between the debtor and the asbestos claimants’ counsel in establishing the silica trust. Indeed, the court stated that this was “a profoundly serious charge and not without record support.” In granting standing to the non-settling insurers, the court noted that they were the only parties in interest that had the incentive to pursue the collusion claim. Notably, even under the traditional textual approach, the non-settling insurers would likely have had standing due to the rampant evidence of collusion. The controversial aspect of the 3rd Circuit’s decision was its alternative ground for granting standing based on its conclusion that the reorganization plan increased the non-settling insurers’ “quantum of liability.” Before the reorganization plan, the debtor faced 169 silica-related claims, but after the plan, the number jumped 27-fold. This massive increase was likely due to the plan’s creation of a trust for silica claims: If you build it, the lawyers will come. Although the reorganization plan itself did not affect the number of silica-related claims — they will continue to exist and subject the non-settling insurers to the same amount of liability regardless of whether the insurers successfully object to the plan — the 3rd Circuit reasoned that the “manifold increase” in the number of claims would increase greatly the insurers’ administrative costs.

Some attorneys have expansively interpreted this “quantum of liability” analysis as requiring courts to always consider whether a reorganization plan’s formation correlates with an increase in the number of claims. Others have interpreted the decision as merely carving out a narrow exception to the standard textual analysis for reorganization plans that result in a dramatically increased number of claims, particularly when the whole plan reeks of collusion. And still other attorneys have criticized Global Industrial entirely as out of touch with the textual approach. All of these groups share one thing in common: They have been waiting for another circuit to chime in on whether to apply Global Industrial beyond the 3rd Circuit and, if so, how.

In Thorpe, the 9th Circuit confronted what seemed at first blush to be a similar challenge on insurance-neutrality grounds from a group of non-settling insurers to a debtor’s reorganization plan. Like the plan in Global Industrial, the Thorpe plan purported to be insurance neutral. The 9th Circuit ultimately held that the non-settling insurers had standing because the plan was not, in fact, insurance neutral. The outcome in Thorpe has led some insurers to the conclusion that the 9th Circuit has adopted an insurance-neutrality approach similar to Global Industrial. That is simply not the case.

The 9th Circuit held that the insurers had standing based on the tried-and-true textual method. Specifically, the court concluded that although the plan purported to be insurance neutral, a close reading of the plan revealed that it actually increased the non-settling insurers’ potential liability in at least four respects. First, the plan explicitly stated that the insurers’ defenses were not preserved to the extent affected by principles of claim preclusion or issue preclusion. Second, the plan took away the non-settling insurers’ right to challenge the trust’s valuation of damage amounts, subjecting the non-settling insurers to potentially greater damages than they would face in the absence of the plan. Third, the plan allowed claimants to sue the non-settling insurers directly — a newfound right contrary to the insurers’ economic interests. And finally, the reorganization plan stripped the non-settling insurers of their rights to assert claims against their reinsurers, instead forcing the non-settling insurers to assert such claims against the trust. In the event that the trust ran out of money, however, the non-settling insurers would not be able to collect any reinsurance proceeds.

In short, Thorpe followed the textual approach that has again and again been utilized by courts addressing insurance-neutrality questions. Although the court discussed Global Industrial, it did not mention the “quantum of liability” approach, much less adopt it. Further, Thorpe may have implicitly rejected an expansive reading of Global Industrial by not engaging in any extracontractual insurance-neutrality analysis. Speculation aside, Thorpe did not foreclose the possibility that a “quantum of liability” analysis may be appropriate in certain unique circumstances, especially where there is extensive evidence of collusion. Debtors should therefore remain wary of the expansive view of Global Industrial that some insurers have taken when crafting their reorganization plans.

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