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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Insurer-Funded Ch. 11s Not Always Win-Win

By **Christie Smythe**

Law360, New York (June 16, 2009) -- Insurance benefits are sometimes used in bankruptcy to help fund reorganization plans for companies beset by asbestos and other mass tort claims. But while some attorneys view the option as an all-around win, others say insurers are starting to raise concerns about the practice.

The method of using insurance benefits to fund reorganizations, applied in concert with the creation of liability trusts, has emerged in a number of pending Chapter 11 bankruptcy cases, including those of mining company Asarco LLC, flooring company Congoleum Corp. and diversified materials company W.R. Grace & Co.

Such bankruptcies became common several years ago as a consequence of tort reform, which sparked a rush by plaintiffs to file mass tort claims, particularly asbestos injury claims, before the new laws took effect, insurance and bankruptcy lawyers said.

While there are fewer of those cases entering the courts now, some attorneys said the pace could pick up as a result of the slowing economy, especially as many bankrupt companies find themselves overleveraged and short on assets to pay back creditors.

In some cases, "the only real recourse and payment to the creditors are the insurance proceeds," said Paul Nussbaum, chair of the debtor/creditor rights and bankruptcy department of Whiteford Taylor Preston LLP, who represented installation company Porter-Hayden Co. in its successful attempt to emerge from bankruptcy in 2006 using an insurer-funded asbestos liability trust.

Insurers have reason to like bankruptcies where insurance benefits are used to fund liability trusts because those mechanisms can cut down on legal costs for insurers by consolidating outstanding and future claims and directing them to the trusts, Nussbaum said.

“The whole structure is for the purpose of making it more efficacious and more efficient,” for debtors, claimants and insurers, he said.

But some attorneys who represent insurers said that while the trusts could provide some benefits for insurance companies, there are also reasons for insurers to be wary of those arrangements — as they may lead to insurers finding themselves without much say over how benefits are used.

Harry Lee, a partner in the insurance practice of Steptoe & Johnson LLP, who has represented a number of insurers in such bankruptcies, said that in some cases, insurers might believe there is a substantial likelihood claims won’t need to be paid at all and may prefer to defend them.

In recent years, insurers “have fought to have the courts recognize their standing in these bankruptcies,” he said.

The Road to Section 524(g)

While most circuits do recognize insurance benefits as an asset of bankruptcy estates, the benefits are not allowed to be used in funding Chapter 11 plans as a general rule, insurance and bankruptcy attorneys said.

Asbestos claims and potentially other mass tort claims are the exception, however, thanks in large part to Section 524(g), they said.

Added to the Bankruptcy Code in 1994, the statute codified the combination of insurance benefits and a liability trust that was devised as part of the Chapter 11 plan for insulation company and major asbestos litigation target Johns-Manville Corp., which filed for bankruptcy in the 1980s, attorneys said.

Under that section, or by way of a copycat method through the Chapter 11 process, insurance benefits are used to fund special trusts set up to handle mass tort claims, and insurers and debtors can seek a channeling injunction, which requires that all current and future injury claims be channeled to the trust, rather than be lodged against the debtor or contributing insurers, attorneys said.

The Bankruptcy Code change allowed debtors to use insurance benefits and set up an asbestos liability trust provided they could obtain the approval of 50 percent of the total voting tort claimants and 75 percent of the tort claim dollars, as well as put at least 51 percent of their stock into the trusts, “so in essence, the trust can control the reorganized debtor,” Lee said.

Debtors facing other types of tort claims, such as environmental claims, can attempt to follow the framework prescribed in Section 524(g), but it can be more difficult for them to pull it off, Nussbaum said.

Insurers Not Always on Board

Nick Williams, a partner in the insurance transactional and regulatory group of Clifford Chance US LLP, said the use of special purpose trusts for mass tort claims such as asbestos claims could provide some benefits to insurers, but generally provided the greatest advantages to debtors by allowing them to set up a so-called good bank, bad bank arrangement.

“It’s generally good for the debtor because it allows a reorganized company to do business in the future without the overhanging effect that those liabilities would otherwise cause,” he said.

Section 524(g) was “designed to allow companies to leave their mass tort liabilities behind,” Lee said.

“There are significant benefits to a policyholder who goes into these bankruptcies to actually to wash itself of all tort liability, and to dangle the insurance policies and benefits in front of the claimants’ lawyers and to basically have it all wrapped up in a big package,” he said.

But while debtors may be eager to leave their tort claims with a trust and get on with business, insurers are not always pleased which that use of policy benefits, some attorneys who represent insurers said.

Laura A. Foggan, a partner with Wiley Rein LLP who regularly represents insurers in complex claims disputes, said in an e-mail that the use of insurance benefits in bankruptcies could present problems, including the acceleration of potential insurer obligations that otherwise would be based on litigation and the assignment of insurance rights to trusts that may violate anti-assignment clauses in insurance policies.

Additionally, insurers have voiced concerns in bankruptcy courts about potential presumptions of the availability of coverage, the use of the bankruptcy proof of claims process to allocate benefits based on abbreviated information, and the actions of policyholders in court to make commitments or enter settlements without consulting insurers, Foggan said.

Insurers might also have reason to suspect that policyholders are colluding with claimants to win Chapter 11 plan approval at the insurers’ expense, said Lee, who is representing insurers in the Congoleum bankruptcy, where insurers have objected to proposed Chapter 11 plans.

Also, some insurers have contended that the creation of a trust, itself, can attract spurious claims, as purported victims would not have to prevail through litigation, he said.

“Policyholders and claimants can’t just get together and shake hands,” Lee said. “Insurers are actually part of the process.”

In March, a judge in the U.S. Bankruptcy Court for the District of New Jersey shot down the flooring manufacturer’s 12th attempt at a Chapter 11 reorganization plan, which included a trust for asbestos claims, after insurers objected to the plan.

A Cutting-Edge Area

Although insurance benefits can be called on in bankruptcy reorganizations in certain circumstances,

the treatment of insurance through bankruptcy courts is a tricky area of the law that is still developing, insurance and bankruptcy attorneys said.

For instance, issues can arise when courts need to determine how the automatic stay imposed by bankruptcy affects insurance, they said.

One such issue is whether an insurer can cancel a policy if it is not being paid premiums, Williams said, adding that it may depend on the provisions of the insurance contract.

In bankruptcy, for instance, debtors can also reject executory contracts, such as leases, but there are debates about the ramifications if a debtor breaches its insurance contract, Lee said.

Also, while insurance coverage is viewed as an asset, “it’s not an asset with any certainty, and it’s only an asset that goes to certain creditors,” Lee said.

“As a result, it’s sort of a square peg with a round hole,” he said, regarding the use of insurance in bankruptcy. “It’s very much a cutting-edge area of the law.”