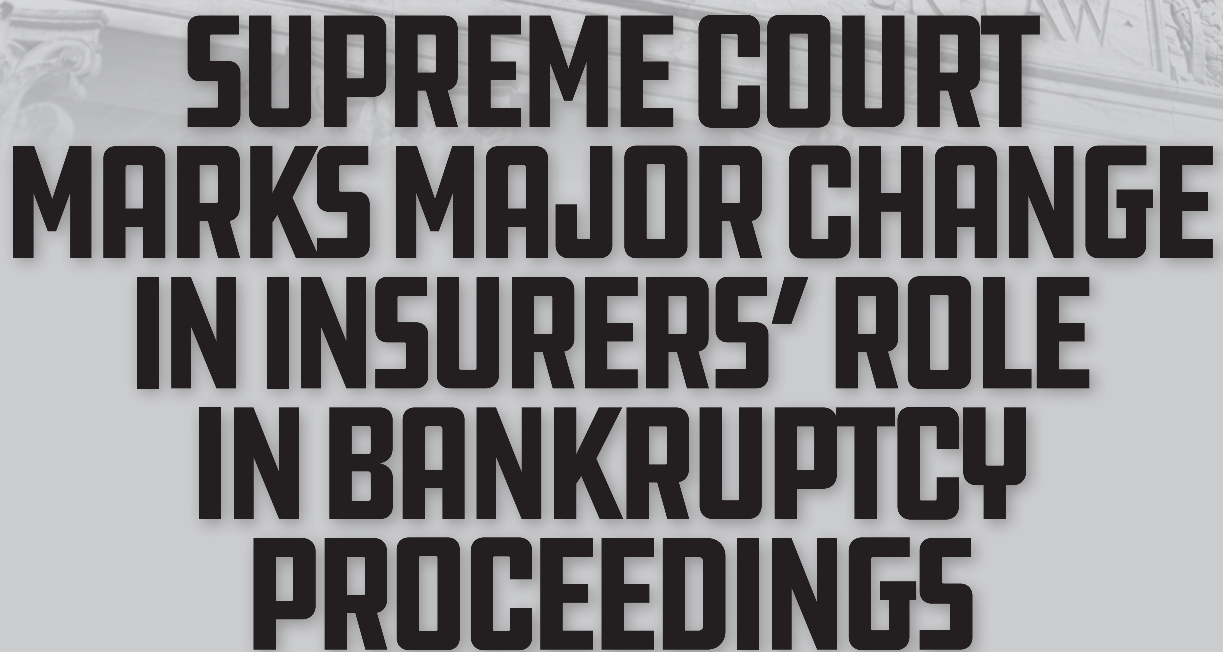

SUPREME COURT MARKS MAJOR CHANGE IN INSURERS' ROLE IN BANKRUPTCY PROCEEDINGS

Insurers May Now Object to Insureds' Chapter 11 Reorganizations

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It's not often that the U.S. Supreme Court weighs in on insurance issues. That's because the McCarran-Ferguson Act gives states the primary authority to regulate the business of insurance. So, when the Supreme Court speaks on insurance, even in the context of a bankruptcy plan, it's noteworthy for insurers.

This past term, the U.S. Supreme Court issued a decision in *Truck Ins. Exch. v. Kaiser Gypsum Co.*, No. 22-1079 (U.S. June 6, 2024) exploring the intersection of bankruptcy and insurance issues. In *Truck*, the Supreme Court held that debtors' insurers have a right to be heard in a Chapter 11 bankruptcy proceeding. *Truck* is a reversal from decades of bankruptcy jurisprudence.

In Chapter 11 bankruptcy proceedings, a debtor is generally a business seeking to reorganize while remaining in operation and paying its creditors over time. The debtor

usually proposes a plan for its reorganization, which is then subject to judicial scrutiny and potential objection by any "party in interest" under 11 U.S.C. § 1109(b).

Until recently, that phrase — "party in interest" — was understood to extend to the debtor, the bankruptcy trustee and creditors, but not necessarily a debtor's insurer. An insurer was only considered a "party in interest" if the proposed reorganization plan either increased the insured's obligations or impaired its policy rights.

Insurers often complained about this situation. During normal third-party litigation, insurers and insureds usually cooperate to resolve the insured's liability. But, in bankruptcy proceedings, the insured and third-party claimant would work together, with the insurer watching from the outside. From the insurer's perspective, this creates several potential problems. Even if a reorganization plan did not on its face purport to prejudice insurers, it could do so indirectly. For example, the reorganization plan could be collusive between debtors and creditors, it could create conditions making it more likely that insurers face inflated or fraudulent claims, and it could affect an insurer's right to control the defense or settlement of claims.

These insurer concerns were usually downplayed. Courts were more concerned with not disrupting reorganization proceedings and delaying payments to creditors than protecting the rights of the parties who might actually pay on the claims, the debtor's insurer. Insurers were left with the short end of the stick.

These concerns are pronounced in the asbestos mass tort claims at issue in *Truck*. In 1994, Congress enacted Section 524(g) of the U.S. bankruptcy code. Section 524(g) allows Chapter 11 debtors with substantial asbestos liabilities to fund a trust and channel present and future asbestos claims into that trust. Section 524(g) provides a special procedure for debtors previously engaged in the sale or production of asbestos-containing products to restructure while ensuring those injured through exposure to those products are compensated. In particular, Section 524(g) provides for the formation of a trust that can settle asbestos-related tort claims after the plan has been confirmed by a bankruptcy court. These trusts are funded in whole or in part by the securities of the debtor, which is required to make future payments to the trusts. In return, the debtor receives an injunction barring direct claims against it for asbestos-related injuries.

Before Section 524(g), asbestos bankruptcies were heavily litigated. Since then, many bankruptcy proceedings have ended with negotiated bankruptcy plans, with little or no say from insurers. And because claims were more likely to be settled than litigated, there was little case law about the permissible scope of Section 524(g).

Insurance assets can be a significant factor in a trust's proceeds. This creates issues for insurers who, again, issue policies to the debtor, not the trust. This is exactly the problem that arose in *Truck*.

There, two insureds, Kaiser Gypsum Co. and its parent company, Hanson Permanente Cement, filed for Chapter 11 bankruptcy after facing thousands of asbestos-related lawsuits. As part of the bankruptcy process, Kaiser filed a proposed reorganization plan.

Truck argued that (1) the plan was collusive between the debtors and claimants' representatives because it had fewer fraud-preventing disclosure requirements for insured claims than for uninsured claims, and (2) the plan altered Truck's policy rights by relieving the debtors of their assistance-and-cooperation obligations and barring Truck from raising their conduct in the bankruptcy proceedings as a defense in coverage disputes.

The U.S. Bankruptcy Court for the Western District of North Carolina recommended the plan's confirmation, and the plan was adopted by the U.S. District Court for the Western District of North Carolina. Both found the proposed plan insurance-neutral because it "neither increase[d] Truck's obligations nor impair[ed] its prepetition contractual rights under the Truck policies." Because the plan didn't alter Truck's "quantum of liability," the Bankruptcy Court concluded that the plan was "insurance neutral." As such, Truck Insurance was not a "party in interest" and was precluded from objecting to the reorganization plan.

Truck appealed but was again unsuccessful. The Fourth Circuit affirmed. The Fourth Circuit held that Truck Insurance was not a "party in interest" and lacked a right to object because the reorganization plan was insurance-neutral and did not increase the insured's liability under the policy or impair the insured's policy rights.

The Supreme Court granted certiorari to decide the extent to which an insurer has standing to assert objections in an insured's Chapter 11 bankruptcy proceedings.

The Supreme Court, in an 8-0 opinion by Justice Sotomayor,[1] ruled for the insurer. The Court emphasized that "party in interest" was a broad phrase that includes any entity potentially concerned with or affected by the bankruptcy proceeding. In this case, Truck faced exposure of up to $50,000 per claim for thousands of asbestos-injury claims, and thus, it could certainly be affected by the bankruptcy proceedings.

As the court observed, neither the debtor nor the claimant had an incentive to limit the post-confirmation costs of defending or paying claims. Because the reorganization plan eliminated all of the debtors' ongoing liability and the claimant had no reason to limit their own recovery, the insurer was the only entity with any incentive to identify problems with the plan before it was confirmed.

The Court added that it was immaterial, for a standing analysis, whether the plan was "insurance neutral" or whether Truck would have been entitled to fraud prevention disclosure requirements under its policies absent the bankruptcy trust. Those arguments, Justice Sotomayor reasoned, conflated the merits of the insurer's objections with its standing to raise objections in the first instance. The Court emphasized that when an insurer like Truck has a financial interest in the proceedings, 11 U.S.C. § 1109(b) grants the insurer neither a vote nor veto but a voice in the proceedings.

The opinion could have wide-ranging effects. Both pending and future bankruptcy proceedings will need to account for *Truck*. At first blush, fewer insurers will have to litigate the issue of bankruptcy standing. On the other hand, as Uncle Ben in Spiderman said, with this new insurer power comes new responsibility. If insurers fail to voice concerns early about draft reorganization plans, insureds may use that failure against them in later coverage disputes. Insureds may argue that an insurer's silence was acquiescence to a reorganization plan. Thus, depending on the facts of each situation, insurers should strongly consider acting early to voice their concerns and protect their rights before a reorganization plan is confirmed.

The case is *Truck Ins. Exch. v. Kaiser Gypsum Co.*, No. 22-1079 (U.S. June 6, 2024).

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[1] Justice Samuel Alito did not participate in consideration of the case.