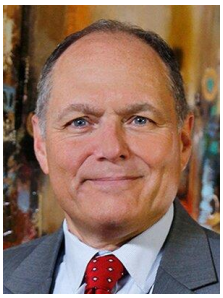
Justices' Ch. 11 Ruling Is A Big Moment For Debtors' Insurers

By **Stuart Gordon and Benjamin Wisher** (July 22, 2024)



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In one of the most publicized terms for the U.S. Supreme Court, one June decision has not received the attention it deserves: Truck Insurance Exchange v. Kaiser Gypsum Company Inc.

Truck upends decades of Chapter 11 bankruptcy jurisprudence that often relegated a debtor's insurer to the sidelines, even if the insurer had financial responsibility under the proposed reorganization plan.

As long as the reorganization plan was insurance-neutral, the debtor's insurer was not considered a party in interest under Chapter 11 and lacked a right to be heard. Truck reverses that rule, broadly holding that a debtor's insurer with financial responsibility for bankruptcy claims is a party in interest with the right to object to the reorganization plan.

This legal about-face will undoubtedly have immediate and lasting impacts. Not only will pending Chapter 11 proceedings have to promptly accommodate Truck, but future proceedings will be influenced from inception by this new legal landscape, one that now effectively gives debtors' insurers a seat at the table.

That shift will be most important in proceedings involving mass tort claims, like Truck, where insurers can use their new footing to try and avoid significant liability for which they would otherwise be left holding the bag without objection.

Of course, creditors and debtors may push back, but it may be wise to treat the debtor's insurer as an equal.

Otherwise, continuing to regard insurers as mere piggybanks with no meaningful voice will likely lead to delay and further litigation, neither of which are generally productive to creditors who seek prompt payment or debtors who desire swift confirmation of their reorganization plan.

The Past: The Insurance Neutrality Doctrine

In Chapter 11 bankruptcy proceedings, generally speaking, the debtor is a business seeking to reorganize while remaining in possession 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.

Until recently, that phrase — "party in interest" — was understood to extend to the debtor, the bankruptcy trustee and creditors, but a debtor's insurer did not automatically enjoy that status.

Instead, pursuant to the insurance neutrality doctrine, a debtor's insurer was only considered a party in interest if the proposed reorganization plan either increased the insured's obligations or impaired its policy rights. If the plan did neither, it was insurance-

neutral and essentially forced the debtor's insurer to accept it without objection.

Insurers argued that, despite the fact that it was their pockets that were being forcibly reached into, the insurance neutrality doctrine gave them no meaningful voice in the process. Without that voice, reorganization plans could potentially:

- Be collusive between the debtor and creditors without insurers' consent;
- Force a debtor's insurer to pay out claims above their value, including claims that were unsubstantiated or fraudulent; and
- Trample on the insurer's policy rights to control the defense or settlement of claims, and have the debtor cooperate and assist in that defense.

Despite these concerns, courts were typically slow to deem a reorganization plan not insurance-neutral. And creditors and debtors used standard insurance neutrality language in their proposed reorganization plans to take advantage and give courts an easy out to prevent the debtor's insurer from having a seat at the table.

In the context of the majority of proceedings, which generally have limited creditor claims, the foregoing was still unfair but did not seem entirely egregious. Indeed, a practical concern supporting the insurance neutrality doctrine was that allowing the debtor's insureds a meaningful voice would stymie proceedings and therefore clog court dockets, derail reorganization plans, and delay payment to creditors.

However, imagine a bankruptcy proceeding involving mass torts. The debtor's insured could be silenced with respect to hundreds or thousands of claims to the tune of tens or hundreds of millions of dollars.

Such proceedings are also typically resolved through the formation of a trust, which extends to future creditors and effectively forces a debtor's insurer to pay claims in perpetuity. Could a debtor's insurer, even in that context, still be handcuffed without objection to the will of the debtor and its creditors?

The Present: Truck

Along comes Truck. Truck began with a Chapter 11 proceeding filed by manufacturers of products containing asbestos that faced overwhelming asbestos liability in the form of thousands of pending lawsuits and incalculable future claims.

The reorganization plan proposed included the formation of a trust through which all claims would be channeled and paid. Claims that were subject to the debtors' insurance would be litigated and, if they obtained judgment, the trust would pay the deductible and the debtors' insurer, Truck Insurance, would pay the rest — up to $500,000 per claim.

Unsurprisingly, the debtors and creditors agreed to this proposed plan, and Truck Insurance was the only party that did not support it.

Truck Insurance argued that the proposed plan was a bad faith, collusive agreement between the debtors and creditors without regard to the insurer's rights and interests.

For example, the plan required certain disclosures and authorizations for uninsured claims

but did not maintain those requirements for insured claims. That difference potentially exposed Truck Insurance to fraudulent claims.

Truck Insurance also argued that the reorganization plan impaired its policy rights by relieving the debtors of their obligations to assist and cooperate, and barred Truck Insurance from raising the debtors' bankruptcy conduct as a defense to coverage.

Last, Truck Insurance argued that the proposed trust was unlawful because it was not set up to address present and future claims equitably.

Truck Insurance's arguments failed. 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 increased Truck's obligations nor impaired its prepetition contractual rights under the Truck policies."

As such, Truck Insurance was not a party in interest and was precluded from objecting to the reorganization plan.

Truck Insurance appealed, but was again unsuccessful. The U.S. Court of Appeals for the Fourth Circuit affirmed.

Echoing the findings below, 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. Truck Insurance then appealed to its last resort: the Supreme Court.

The Supreme Court agreed to hear the appeal and decide "whether an insurer with financial responsibility for a bankruptcy claim is a 'party in interest'" under Chapter 11.

In a unanimous decision — 8-0, with Justice Samuel Alito abstaining — the Supreme Court pronounced that a debtor's insurer with financial responsibility for bankruptcy claims is a party in interest under Chapter 11, and has a right to raise, be heard and object to a proposed plan of reorganization.

The court began its analysis by stating that the determination of whether one is a party in interest must be made on a case-by-case basis to determine if the prospective party in interest has a "sufficient stake in [the] reorganization proceedings," but the "text, context, and history" of Chapter 11 "confirm[ed] that an insurer such as Truck with financial responsibility for a bankruptcy claim is a 'party in interest' because it may be directly and adversely affected by the reorganization plan."

As to the relevant text, the Supreme Court analyzed Section 1109(b) of the U.S. Bankruptcy Code. That section "permits any 'party in interest' to 'appear and be heard on any issue' in a Chapter 11 proceeding."

The court characterized this provision as "capacious," meaning it is to be interpreted and extended broadly. Therefore, although Section 1109(b) lists certain parties in interest — the debtor, creditors, trustee, etc. — that list is not exhaustive, and the court analyzed the enumerated parties in Section 1109(b) to identify a common thread among them: "[T]hat each may be directly affected by a reorganization plan."

The court then specifically analyzed the words "party" and "interest," finding that together

they substantiated the court's identified thread that those enumerated as parties in interest are those that are "potentially concerned with or affected by a proceeding."

The court then turned to the historical underpinnings of Section 1109(b). The court explained that Congress passed that statute to encourage greater participation in bankruptcy proceedings. This further supported the court's "capacious" characterization of Section 1109(b) and the expansive meaning of "party in interest."

The court ended its analysis of Section 1109(b) by noting the practicality of the court's interpretation. Reading "party in interest" expansively would "broad[en] participation" and "promote a fair and equitable reorganization process."

By giving more interested parties a seat at the table, it would help prevent the danger inherent in any reorganization plan proposed by a debtor that the plan will simply turn out to be too good a deal for the debtor's owners, and instead allow a "broad range of individual[s]" and "interests to intervene" to facilitate just reorganization outcomes.

"Applying these principles, the Court h[eld] that insurers such as Truck with financial responsibility for bankruptcy claims are parties in interest," according to the decision. That is because "reorganization proceedings can affect an insurer's interests in myriad ways," including either or both financially and contractually under the applicable policies.

The court continued: "A reorganization plan can impair an insurer's contractual right to control settlement or defend claims," "abrogate an insurer's right to contribution from other insurance carriers," or "violat[e] ... the debtor's duty to cooperate and assist," or "impair the insurer's financial interests by inviting fraudulent claims ... The list goes on."

The court found all of these considerations potentially relevant to Truck Insurance under the proposed reorganization plan. "Truck will have to pay the vast majority of the Trust's liability — up to $500,000 per claim for thousands of ... claims" effectively alone and into the future and potentially be left exposed to "millions of dollars in fraudulent tort claims," the justices held.

The court also found that the "potential financial harm — attributable to Truck's status as an insurer with financial responsibility for bankruptcy claims — gives Truck an interest in bankruptcy proceedings and whatever reorganization plan is proposed and eventually adopted."

The Supreme Court further addressed the jurisprudence that required the opposite result below: the insurance neutrality doctrine. The court outright rejected that jurisprudence, finding that it was ill-premised and made "little practical sense."

The court explained that the inquiry of whether one is a party in interest rests upon whether the proposed reorganization might affect the prospective party, and not whether the prospective party is actually affected.

The insurance neutrality doctrine improperly "zoom[ed] in on the insurer's prepetition obligations and policy rights. That wrongly ignores all the other ways in which bankruptcy proceedings and reorganization plans can alter and impose obligations on insurers," according to the decision.

The Supreme Court ended by stating that its decision "does not opine on the outer bounds of [Section] 1109" and there "may be difficult cases that require courts to evaluate whether

truly peripheral parties have a sufficiently direct interest," but "[t]his case is not one of them ... Insurers such as Truck with financial responsibility for claims are not peripheral parties."

The Future: Significant and Lasting Implications

Truck will likely have an immediate and lasting impact.

Most pressing, pending bankruptcy proceedings previously adhering to the insurance neutrality doctrine will have to rewind, adopt Truck and permit debtors' insurers to object to the reorganization plan as parties in interest.

Insurers, this is no time to sit back. It would be prudent to get involved and raise objections as a party in interest where in pending proceedings where appropriate.

Aggressive participation may effectuate change to the proposed plan of reorganization, potentially save debtors' insureds significant amounts, and possibly preserve and protect the insured's policy rights; all of this is emphatically most important in proceedings involving mass torts like Truck.

This is also true in future proceedings, which will also have to abide by Truck. And because Truck creates a new legal landscape for Chapter 11 proceedings — one that puts debtors' insurers on more equal footing with debtors and creditors — a new dynamic will be required.

Continuing to treat insurers as mere piggybanks without rights is unlikely to be productive, and will cause delay and further litigation.

The more productive approach to achieving swift reorganization for the debtor and prompt payments to creditors would be giving the debtor's insurer a seat at the table from the proceeding's inception.

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