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Insurers Have A Ch. 11 Voice Following High Court Ruling

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On June 6, the U.S. Supreme Court in Truck Insurance Exchange v. Kaiser Gypsum Co. Inc. **reaffirmed** the fundamental construct of Chapter 11 as envisioned by Congress: a collective proceeding intended to maximize value for the benefit of all stakeholders that contemplates participation by all those that may be affected.[1]

The court explained that the plain meaning of "party in interest" in Section 1109 of the Bankruptcy Code refers to any "entities that are potentially concerned with or affected by a proceeding."

No longer will insurance companies that have issued policies prior to the bankruptcy case be relegated to the sidelines in Chapter 11 cases with no real voice. The Supreme Court's decision now makes insurers, particularly in mass tort bankruptcies, a potentially consequential participant in the proceedings and formulation of a plan or reorganization.

The debtors in Kaiser Gypsum faced significant asbestos-related liability and sought refuge in Chapter 11 to rid themselves of mounting claims. The debtors purchased insurance policies that provided coverage prior to the bankruptcy case which became pivotal for a successful reorganization.[2] The debtors proposed a reorganization plan that created a trust and channeled all present and future claims to the trust, and enjoined claimants from taking legal action against the debtors.

Notably, the trust and resolution of the claims would be funded in significant part by prepetition insurance policies. The debtors' primary insurer objected to the plan, arguing, among other things, that the mechanisms in the plan relating to disclosure obligations of claimants exposed it to millions of dollars in fraudulent tort claims.

The debtors, receiving the benefit of a discharge and plan conferred injunction, would have little incentive cooperate or facilitate the resolution of claims.

The bankruptcy court concluded that the insurer was not a party in interest — and so it had no right to be heard on its objections. The debtors essentially viewed the insurer as an interloper in the proceedings and convinced the bankruptcy court that the plan was "insurance neutral,"

meaning that it did not alter the insurer's prebankruptcy rights or obligations under the insurance policies.

The U.S. District Court for the Western District of North Carolina agreed and confirmed the plan in 2021. The U.S. Court of Appeals for the Fourth Circuit **affirmed** in February 2023.

Section 1109 of the Bankruptcy Code permits "a party in interest" to "appear and be heard on any issue" in a Chapter 11 proceeding.

The Supreme Court, in an 8-0 ruling — Justice Samuel Alito recused — had no difficulty concluding that an insurer with financial responsibility for bankruptcy claims is a party in interest.

In fact, as correctly argued by the petitioning insurer at the outset of oral argument before the high court: such an insurer is likely the party in interest.

On June 6, the court issued its ruling and rejected the debtors' argument that the insurer lacked standing because of the insurance neutrality doctrine adopted by some courts.

In furtherance of the argument, the debtors contended that the plan neither increased the insurer's obligations nor impaired its prepetition contractual rights under existing insurance policies.

The court expressly rejected the argument and the insurance neutrality doctrine as "too limited," "conceptually wrong" and making "little practical sense."

The court readily observed that bankruptcy reorganization proceedings can affect an insurer's interest in many ways.[3] Further, the court opined that the debtors, whose liability is extinguished by the plan, had no "incentive to limit the post-confirmation cost of defending or paying claims," making the insurer potentially "the only entity with an incentive to identify problems with the Plan."

This "'realignment of the insured's economic incentives ... [makes] participation in the bankruptcy by insurers — who will ultimately be asked to foot the bill for most or all of those claims — critical.'"

In decisively rejecting the insurance neutrality doctrine, the court explained that the doctrine is conceptually wrong because it conflates the merits of an objection with the threshold party in interest inquiry. That inquiry examines whether an insurer might be directly or adversely affected by a Chapter 11 plan.

The court was unpersuaded by what it called the "parade of horribles" advanced by the debtors that permitting the insurer to be heard would allow "peripheral parties" to derail a reorganization. An opportunity to be heard is not the same thing as a veto or vote with respect to a Chapter 11 plan. It is just that.

The court's ruling in Kaiser Gypsum confirms that insurers that have financial responsibility for claims in a bankruptcy case do have a fair opportunity to participate to protect interests that may be affected by a plan.

The Supreme Court's ruling furthers the collective proceeding construct of Chapter 11 and the breadth of the standing statute in bankruptcy reorganizations.[4] Congress envisioned broad participation in Chapter 11 such that anyone whose rights are conceivably affected by a matter, may be heard.[5]

Now, mass tort bankruptcy cases can no longer rely on the insurance neutrality doctrine to exclude insurers whose insurance contracts are property of the bankruptcy estate. Insurers will not, going forward, have to establish that plans change their prepetition obligations in order to be heard in Chapter 11 proceedings.

The Supreme Court's decision will provide insurers responsible under policies for paying out on bankruptcy claims more opportunity to protect their interests and identify problems with reorganization plans — a result the debtor-manufacturers in this case attempted to avoid.

When debtors and other parties formulate plans that contemplate the resolution of tort claims and the contribution of funds from insurers under prepetition insurance policies, plan proponents cannot ignore process or provisions for resolving claims that affect insurers.

And insurers should carefully examine the potential financial exposure that might be faced as a result of its insured's Chapter 11 reorganization plan.

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[1] Truck Insurance Exchange v. Kaiser Gypsum Co. Inc. , No. 22-1079, __ S. Ct. __ (June 6, 2024).

[2] 2 Insurance policies and other contracts that are in force as of the bankruptcy filing are "property of the bankruptcy estate." 11 U.S.C. § 541(a).

[3] The Court recognized that a Chapter 11 plan can, for example, impair an insurer's contractual right to control the settlement of claims and impair an insurer's financial interest by inviting fraudulent claims and effectively abrogate the discharged debtor's duty to cooperate and assist.

[4] See 11 U.S.C. § 1109(b).

[5] Promoting broad participation in reorganization cases promotes fairness in the plan formulation and confirmation process. The Supreme Court's decision makes clear that statutory standing under Chapter 11 should now be understood to be available to any party with an actual or potential financial interest in the proceeding.
