AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Insurance Issues

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Federal-Mogul Prompts Preemption Precedent

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The Third Circuit Court of Appeals recently affirmed a debtor's ability to transfer its rights to insurance coverage for asbestos-related personal-injury claims to a trust established under 11 U.S.C. § 524(g) to resolve and pay such claims. In *In re Federal-Mogul Global Inc.*,[2] the court rejected insurer objections to such a transfer, determining that insurance-policy provisions prohibiting assignment were preempted by the Bankruptcy Code and that preemption was consistent with the public-policy objectives of § 524(g). Buttressed by *Motor Vehicle Cas. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*,[3] which reached the same result on different grounds, *Federal-Mogul* settles a long-standing issue of contention in asbestos-reorganization cases.

Since 1994, many companies facing overwhelming asbestos (and other mass-tort) liabilities have constructed their reorganization plans on the foundation of § 524(g), which channels all existing and future asbestos liabilities to a trust designed to benefit tort claimants. To obtain a § 524(g) channeling injunction that will permit the company to emerge from bankruptcy free of legacy-asbestos liabilities, the company must, among other requirements, fund the trust with sufficient assets and garner the support of at least 75 percent of asbestos claimants voting on the plan while allocating its remaining assets for the benefit of its commercial and other creditors. In general, § 524(g) trusts are funded by three primary sources: (1) cash, (2) stock and (3) insurance.[4] With respect to the third category, debtors often have insurance (acquired long before bankruptcy) to cover personal-injury liabilities arising from asbestos-containing materials.

In many asbestos cases, the debtor's plan seeks to assign the debtor's insurance rights to the § 524(g) trust, sometimes with the consent of settling insurers in exchange for protection under the channeling injunction. In several cases, however, insurers have opposed this strategy, insisting that any assignment of insurance rights to the trust would violate standard consent-to-assignment provisions in the underlying policies. In response, debtors (and their plan supporters) have argued that such assignments are proper because the Code preempts any state law-based contractual limitations to the contrary. This issue, which has been litigated in numerous chapter 11 cases and potentially implicates billions of dollars of insurance assets, was decided in favor of the debtors and their stakeholders in *Federal-Mogul* and *Thorpe*.

Federal-Mogul Finds Grounds for Express and Implied Preemption

Federal-Mogul involved facts similar to those discussed above. The debtor, along with the ACC and FCR (collectively, the "plan proponents"), argued that its plan's proposed transfer of insurance rights to a trust under § 524(g) was proper because anti-assignment provisions in the debtors' insurance policies were preempted by the Bankruptcy Code.[5] Certain insurers objected to the plan's proposed transfer of insurance rights and challenged preemption as contrary to the structure and context of the Code.[6] The bankruptcy and district courts agreed with the plan proponents, holding that §§ 541 and

1 This article has been prepared for informational purposes only and does not constitute legal advice. This information is not intended to create, and the receipt of it does not constitute, a lawyer/client relationship. Readers should not act without seeking advice from professional advisers. The opinions expressed herein are those of the authors and do not necessarily reflect the views of their respective firms, clients or any affiliates of any of the foregoing. Mr. Lockwood's firm represented the Official Committee of Asbestos Claimants (ACC), Mr. Steen's firm represented the debtors and Mr. Harron's firm represented the legal representative for the future asbestos claimants (FCR) in *Federal-Mogul*. Young Conaway associate **Sara Beth A.R. Kohut** also contributed to this article.

2 684 F.3d 355 (3d Cir. 2012).

3 677 F.3d 869 (9th Cir. 2012).

4 *Federal-Mogul*, 684 F.3d at 360.

5 *Id.* at 363.

6 *Id.* at 369-75.

1123(a)(5) preempted the contractual anti-assignment provisions.[7] The Third Circuit affirmed, holding that "the anti-assignment provisions in the relevant insurance policies are preempted by § 1123(a)(5)(B) to the extent they prohibit transfer to a § 524(g) trust."[8]

As a preliminary matter, the court concluded that the preemption question was not, as the insurers argued, an issue of first impression.[9] Although it had not been "one of the paramount issues" in *In re Combustion Engineering Inc.*[10] or *In re Global Indus. Techs. Inc.*,[11] the court had preliminarily reached the same conclusion in favor of preemption in those cases.[12] Nonetheless, because preemption was the principal question presented in *Federal-Mogul*, the court addressed "the proper scope of § 1123(a)" and conducted "a thorough preemption analysis."[13]

Section 1123(a) sets forth the required elements of a plan in eight numbered subsections.[14] One of those elements—in § 1123(a)(5)—prescribes that a plan shall "provide adequate means for the plan's implementation"[15] and lists 10 illustrative transactions (in lettered clauses) that may fulfill that requirement.[16] Based on the plain language of § 1123(a), including the "critical [preamble] words...'[n]otwithstanding any otherwise applicable nonbankruptcy law,'" the court of appeals concluded that Congress used "explicit language" to demonstrate its intent to preempt state law.[17]

The court rejected a series of arguments raised by the insurers against preemption. For example, the court found that the insurers' structural contention that the 10 lettered clauses of § 1123(a)(5) were not subject to the "notwithstanding" language was contrary to "any normal method of statutory interpretation" and would produce "absurd results" because many of the listed transactions required preemption of nonbankruptcy law.[18] Similarly, "on the strength of the statutory language and precedent," the court determined that "the phrase 'otherwise applicable nonbankruptcy law' encompasses private contracts, including the insurance policies at issue here."[19]

Additionally, relying on the Ninth Circuit's ruling in *PG&E Co. v. Cal. Dep't of Toxic Substances Control*,[20] the insurers maintained that preemption under the preconfirmation "plan contents" provision in § 1123(a) would conflict with the post-confirmation "plan implementation" provision in § 1142(a), which provides that the debtor (and others) "shall carry out the plan" and comply with the court's orders "[n]otwithstanding any otherwise applicable nonbankruptcy law, rule, or regulation *related to financial condition*."[21] Because the terms of § 1123(a) are "self-executing" and govern a different (pre-confirmation) period from the (post-confirmation) phase covered by § 1142(a), the Third Circuit found that the two provisions are not similar enough to require that they be read together.[22] Moreover, based on the plain statutory language, as well as the fact that § 1123 had been amended in 1984 after the 1978 enactment of § 1142, the court declined to rewrite the preemptive language in § 1123 by importing "limiting words" from § 1142.[23]

The insurers also claimed that the assignment of policy rights increased their bargained-for coverage risk.[24] The court, however, expressed "doubt [as to] whether transfer in this instance materially alters Insurers' risk," because the liabilities for which the insurers were potentially responsible were based on events that had already occurred and were simply being transferred from the debtors to the trust.[25] The only potential change in risk was that claimants would recover through the trust's distribution procedures instead of the tort system,[26] but trust-distribution procedures "are mandated by Congress for asbestos trusts and must be approved by the bankruptcy court."[27] Thus, the insurers' "true objection seem[ed] to be against the public policy [that] Congress chose to enact."[28] The court noted that while there may be instances when creating a trust alters an insurer's exposure, § 524(g) contains requirements that, along with other provisions of the Bankruptcy Code and "traditional requirements of procedural due process," adequately protect the interests of all affected parties.[29]

Lastly, the court declined to address the "parade of horribles" that the insurers warned would occur if preemption were found.[30] While "the Bankruptcy Code clearly provides preemption in this instance," the court observed that there are legal and practical limits on the scope of preemption under § 1123(a).[31] For example, the court indicated that under § 1129(a)(3), in order to be confirmed, a plan must be "proposed in good faith and not by any means forbidden by law."[32] The court also acknowledged

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7 *Id.* at 363-64.
8 *Id.* at 382.
9 *Id.* at 365-67.
10 391 F.3d 190 (3d Cir. 2004).
11 645 F.3d 201 (3d Cir. 2011) (*en banc*).
12 *Federal-Mogul*, 684 F.3d at 365-67.
13 *Id.* at 367.
14 *See* 11 U.S.C. § 1123(a) (quoted in *Federal-Mogul*, 684 F.3d at 368 n. 20).
15 The statute provides in relevant part that "[n]otwithstanding any otherwise applicable nonbankruptcy law, a plan shall...(5) provide adequate means for the plan's implementation, such as...(B) transfer of all or any part of the property of the estate to one or more entities." 11 U.S.C. § 1123(a)(5)(B).
16 *See Federal-Mogul*, 684 F.3d at 368.
17 *Id.* at 369 (quoting *Integrated Solutions Inc. v. Serv. Support Specialists Inc.*, 124 F.3d 487, 493 (3d Cir. 1997)).
18 *Id.* at 369-70.
19 *Id.* at 371.
20 350 F.3d 932 (9th Cir. 2003).
21 *Federal-Mogul*, 684 F.3d at 372 (emphasis supplied).
22 *Id.* at 372-73 (quoting 7 *Collier on Bankruptcy* ¶ 1123.01[5] (Alan N. Resnick and Henry J. Sommer eds., 16th ed. 2009)).
23 *Id.* at 373-74. The insurers also urged a narrow reading of § 1123(a) based on legislative history and prior practice. *Id.* at 374. The court concluded that pre-Bankruptcy Code practice and legislative history were "too equivocal to overcome the plain meaning of the text, which provides compelling evidence of Congress's intent to preempt contrary nonbankruptcy law." *Id.*
24 *Id.* at 379.
25 *Id.*
26 *Id.* at 379-80.
27 *Id.* at 380.
28 *Id.*
29 *Id.* at 380-81.
30 *Id.* at 381.
31 *Id.* at 381-82.
32 *Id.* at 381 (quoting 11 U.S.C. § 1129(a)(3)).

"the long-standing presumption against preemption of state police power laws and regulations" as recognized by the U.S. Supreme Court.[33]

In ruling against the insurers, the court ultimately emphasized that preemption would advance the purposes of the Bankruptcy Code, especially § 524(g): "The debtor here seeks to use its existing assets to address current and future claims arising out of past occurrences and resolve its asbestos liability, a goal consonant with the 'fresh start' purpose of bankruptcy."[34] Thus, contractual limitations preventing a debtor from assigning its property to a § 524(g) trust would contravene both § 541(c)(1)(B), which preempts contractual provisions that alter a debtor's rights in the event of insolvency, and § 524(g), which aims to maximize value for asbestos claimants while shielding reorganized debtors and their stakeholders from legacy asbestos liabilities.[35] Without preemption, debtors and claimants would be deprived of "assets specifically intended to compensate" asbestos victims.[36]

The Influence of Ninth Circuit Precedent

Federal-Mogul favorably cited to *Thorpe*,[37] in which the Ninth Circuit Court of Appeals had found that similar anti-assignment provisions were preempted expressly and impliedly by the Bankruptcy Code.[38] The Ninth Circuit approached the preemption issue differently, relying primarily on § 541(c) to find express preemption of the insurers' contractual rights.[39]

The fact that the Ninth Circuit did not rely on § 1123(a)(5) may be attributable to its prior precedent in *PG&E*, which held that the preemption of nonbankruptcy law pursuant to § 1123 was limited "to the extent that such law relates to financial condition" based on language imported by the court from § 1142(a).[40] Relying on *PG&E*, the objecting insurers in *Thorpe* argued that preemption did not apply because their contract rights did not relate to the debtor's financial condition.[41] *Thorpe* distinguished *PG&E* on the basis that it "dealt only with §§ 1123(a) and 1142(a)" and therefore did not shed light on "whether the anti-assignment clauses in the contracts between insurers and the debtors are preempted by § 541(c)."[42]

The Ninth Circuit's analysis also was based on the finding that enforcing the anti-assignment clauses would frustrate the purposes behind § 524(g) and "subject virtually all § 524(g) reorganizations to an insurer veto."[43] According to the court, debtors are "entitled" to reorganize under § 524(g) instead of "merely allowed" to do so as the insurers argued, and "[p]art of the 'cornerstone' of the reorganization is contribution by the insurers to the trust."[44] Indeed, § 524(g) was "specifically designed to allow companies with large asbestos-related liabilities to use Chapter 11 to transfer those liabilities, along with substantial assets, to a trust responsible for paying future asbestos claims."[45]

Practical Consequences

The recent rulings in *Federal-Mogul* and *Thorpe* substantially clarify and reaffirm the rights of reorganizing debtors faced with uncertain asbestos liabilities to earmark insurance assets for the benefit of asbestos claimants pursuant to a § 524(g) plan. These decisions should also enhance the utility of § 524(g) as a practical tool for asbestos-driven debtors seeking to restructure their liabilities for the benefit of all stakeholders, consistent with that provision's remedial objectives.

For debtors, this preemption precedent should curtail insurer opposition to the transfer of insurance assets to a § 524(g) trust, thereby reducing the length and expense of reorganization cases.[46] Specifically, for debtors with relatively few noninsurance assets, these decisions should provide some assurance that their insurance assets are available to satisfy § 524(g) trust-funding requirements, thereby alleviating the risk of liquidation in the event that their insurance assets are deemed ineligible for the trust. For debtors with a substantial mix of insurance and other assets, the decisions should afford greater flexibility to fully utilize insurance assets as plan currency available to satisfy asbestos claimants, thereby freeing up cash and other non-insurance assets for purposes of negotiating a consensual plan with commercial and other claimants.

For insurers, *Federal-Mogul* and *Thorpe*, along with insurance-neutrality precedent,[47] should eliminate the basis for assignment objections that historically have prolonged asbestos-reorganization cases. As a practical matter, under these decisions, particularly if followed in other circuits, the insurers' conventional consent-to-assignment objection will no longer be available in either the plan confirmation context or in postbankruptcy coverage litigation. Instead, these decisions clarify that legitimate disputes over the manner in which a § 524(g) trust may access insurance assets, and other nonassignment contractual defenses preserved by insurance-neutrality provisions, are appropriately the subject of post-confirmation coverage actions rather than bankruptcy-confirmation objections. abi

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33 *Id.* (citing *Medtronic Inc. v. Lohr*, 518 U.S. 470 (1996), and *Midlantic Nat'l Bank v N.J. Dep't of Envtl. Prot.*, 474 U.S. 494 (1986)).
34 *Id.* at 378.
35 *Id.* at 378-79.
36 *Id.* at 379.
37 *Id.* at 367, 373 n. 26.
38 *Thorpe*, 677 F.3d at 888-91.
39 *Id.* at 889.
40 *Thorpe*, 677 F.3d at 890 (quoting *PG&E*, 350 F.3d at 937) (internal quotations omitted); *see also Federal-Mogul*, 684 F.3d at 372.
41 *Thorpe*, 677 F.3d at 890.
42 *Id.*
43 *Id.* at 890-91. The court noted that enforcing the anti-assignment provisions "would be to the detriment of the potential efficacy of a § 524(g) plan" in as much as "no insurer would settle...because by refusing to settle, the insurer could position itself to claim forfeiture of the insurance if a plan proceeded and there was a consequent breach of the anti-assignment provisions." *Id.* at 890.
44 *Id.* at 891.
45 *Id.* at 891.
46 Asbestos bankruptcy cases tend to be lengthy and litigious. Indeed, the *Federal-Mogul* case was filed in 2001, and the plan was not confirmed until 2007.
47 *See, e.g., Combustion Eng'g*, 391 F.3d at 218; *In re Pittsburgh Corning Corp.*, 417 B.R. 289, 315-17 (Bankr. W.D. Pa. 2006). Like many insurance-neutrality provisions, those in the *Federal-Mogul* plan gave "insurers the right to assert against the trust any defense to coverage already available under the policies, excepting only the defense that the transfer to the trust violated the policies' anti-assignment provisions." *Federal-Mogul*, 684 F.3d at 363.