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Bankruptcy: The New(found) Paradigm for Handling Mass Tort Claims

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Mass Torts

- Large, complex matters involving numerous claims (e.g., asbestos, prescription drugs, talc, hearing loss, sports head injury, sexual abuse and molestation)

- Volume and scale of mass torts may preclude effective resolution via traditional litigation.

- Difficulties/inefficiencies in resolving mass torts with case-by-case litigation include such factors as the sheer number and dispersion of claims and inconsistent verdicts across jurisdictions.

Resolution of Mass Torts

- Alternatives to case-by-case litigation include:
  - Class action – single lawsuit; strict statutory requirements, including that there be questions of law or fact common to all class members
  - Multi-District Litigation (MDL) – individual lawsuits with a common question of fact transferred to a central court, which manages the litigation during the pretrial and discovery process; MDL judge can conduct “bellwether” trials of individual cases to serve as exemplar for potential result of remaining cases, which may facilitate global settlement
  - Bankruptcy reorganization under Chapter 11 - global resolution of claims and discharge of current and future liability (claims channeled into a trust)

Bankruptcy and Mass Torts

- Use of bankruptcy to resolve mass torts is not new, and first arose in the context of the explosion of asbestos liability in the 1980s.
- *Johns-Manville* was the progenitor of using bankruptcy to resolve mass torts.
  - Company faced a potential $2 billion exposure and filed for Chapter 11 reorganization.
  - Using its equitable powers, the bankruptcy court issued a "channeling injunction" that funneled claims into a trust to compensate victims, with actions against the reorganized debtor and settling insurers barred.
  - This trust/injunction structure was subsequently codified, for asbestos claims only, under Section 524(g) of the Bankruptcy Code.
  - Numerous asbestos bankruptcies followed over the next decades.

Major Asbestos Trusts and Funding

- Johns Manville (1988) – Initial Funding of $2,500,000,000
- U.S. Gypsum Company (2006) – Initial Funding of $3,957,000,000
- Owens Corning (2006) – Initial Funding of $3,423,000,000
- Babcock and Wilcox Company (2006) – Initial Funding of $1,845,000,000
- Combustion Engineering (2006) – Initial Funding of $1,243,000,000

Bankruptcy and Mass Torts

- In recent years, bankruptcy is being used to address a variety of claims, especially sexual abuse claims following states' extensions of the statute of limitations for filing suit.

- Some notable examples:
  - Boy Scouts of America (sexual abuse)
  - Purdue-Pharma (opioids)
  - Roman-Catholic Diocese of Rockville Centre (sexual abuse)
  - USA Gymnastics (sexual abuse)
  - Aearo Technologies (3M subsidiary) (hearing loss due to defective ear plugs)
  - J&J (talc)

The Mass Tort Machine

- Growth in claims also due to plaintiff bar “tort campaigns.”
- So-called “lead generation” companies hired to produce media campaigns, including online ads and websites, in order to identify and collect data on the maximum number of potential tort claimants.
  - Media and clearinghouse companies involved in the campaigns often paid on a “per lead” basis.
  - Campaigns have included sexual abuse claims (such as Boy Scouts and dioceses) and products liability (e.g., 3M earplugs)

Bankruptcy – Liquidation v. Reorganization

- Liquidation – Chapter 7: debtor's assets sold off to pay creditors; debtor goes out of business and ceases normal operations
- Reorganization – Chapter 11: restructuring of debt obligations; debtor retains ownership of assets and continues business operations during pendency of bankruptcy proceedings

Selection or Creation of the "Debtor"

- To take advantage of Chapter 11, there must be a "debtor" to place into bankruptcy. Recent approaches include:

- **Texas Two Step (Divisional Merger).**   J&J used this technique to create *LTL Management, Inc.* as the debtor holding its talc losses. This is a corporate restructuring that relies upon a merger under Texas law.
  - Resulted in dismissal of two LTL bankruptcy petitions because debtor was not in financial distress (was supported by funding agreements in the billions).

- **Subsidiary or Affiliate Named as Debtor**. 3M (which was also a defendant in earplug liability suits) utilized this method by facilitating the filing of Chapter 11 petitions by certain wholly-owned subsidiaries (Aearo entities) that were the original designers and manufacturers of the Combat Arms Earplugs.
  - Petition also dismissed because court found debtors to be financially healthy and secure (were also supported by a funding agreement).

Chapter 11 Process

- Filing of bankruptcy petition
- First day hearing and submissions
- Notice to creditors and establishment of “bar date”
- Plan formulation and negotiation
- Disclosure statement (sets forth terms of proposed plan for review by creditors, including tort claimants)
- Plan submission to claimants and voting
- Confirmation hearing
- Plan adoption (or rejection)
- Appeals

Chapter 11 Process

- Although there is no specific provision in the Bankruptcy Code for a channeling injunction/trust for non-asbestos claims, other provisions may be used.
  - 11 U.S.C. § 105(a) – "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title …"
  - 11 U.S.C § 1123(b)(6) – bankruptcy plan "may include any other appropriate provision not inconsistent with the applicable provisions of this title."

Chapter 11 Process

- After plan confirmation, trust becomes responsible for resolving tort claims using court-approved TDPs (trust distribution procedures), which are negotiated – generally between plaintiffs' attorneys and the debtor – during the plan formation stage.

- TDPs typically include a matrix that: (i) specifies the necessary medical and other criteria (e.g., exposure to a debtor's product); (ii) sets out the categories of injury that will be compensated and (iii) fixes claims values or ranges.

- TDPs may also include dispute resolution procedures (mediation, arbitration, litigation) for claims that are not resolved through the matrix criteria.

Benefits of Chapter 11 for Mass Tort Debtors

- Automatic Stay – immediate cessation of all litigation against debtor
- Settlement Trust – fund established to pay existing and future claims that caps the aggregate value of debtor's exposure
- Channeling Injunction – all existing and future claims funneled to the trust
- Release/Discharge – debtor's liability is discharged; releases may also include debtor affiliates (though this is increasingly controversial)
  - Potential benefit for carriers – release for settling insurers

Third-Party Releases

- *Purdue Pharma* – ability of bankruptcy court to approve a plan of reorganization that includes non-consensual third party releases is the subject of a present appeal to the Supreme Court.
- The plan included releases to non-debtor third parties (including the Sackler family), which did not declare bankruptcy or claim to be insolvent.
- Question before the court is whether the Bankruptcy Code authorizes such a release, which extinguishes claims against such non-debtors, without claimants' consent.
- The Supreme Court's ruling will have great significance on the bankruptcy process, including for existing cases. (E.g., in *Boy Scouts*, claimants are appealing the enforceability of non-consensual third party releases extended to settled insurers, local councils and chartered organizations.)

Injunctive Relief for Debtor Affiliates

- Debtors have also tried to get the automatic stay extended to affiliates, with courts reaching different results.
  - ***In Re Aearo Technologies LLC*** Bankruptcy Court for the Southern District of Indiana denied 3M's motion for a preliminary injunction extending stay to 3M (as parent of the debtor Aearo Technologies LLC).
  - ***In re: LTL Management, LLC***, ("LTL 1") Bankruptcy Court for the District of New Jersey granted J&J's motion to extend injunctive relief to the parent and many affiliated entities.
  - ***In re: LTL Management, LLC***, ("LTL 2") Bankruptcy Court for the District of New Jersey granted a limited preliminary injunction that prohibited only the commencement or continuation of any trial or appellate practice against specifically identified parties.
    - Note: Narrower injunction in LTL2 likely due to fact that bankruptcy court's decision denying a motion to dismiss the LTL1 bankruptcy petition was overturned by the Third Circuit, leading to a more limited injunction in LTL2 (and ultimately to dismissal of that petition as well).

Bankruptcy Pros and Cons

- Positive aspects cited by courts and commentators:
  - global resolution of present and future claims, capping exposure and saving judicial resources and individual case expenses, including discovery
  - described by courts as a means of achieving a “fair collective result” in cases with numerous creditors and potentially insufficient assets
  - bankruptcy court can use its powers to ensure similarly situated tort claimants are treated equitably

Bankruptcy Pros and Cons

- Criticism raised includes the following:
  - imposing a collective, mass solution ignores the needs and circumstances of individual plaintiffs (some of whom may want “their day in court”)
  - bad actors, especially in SAM claims, may escape in-depth discovery and scrutiny
  - plaintiffs may lose rights under state law (for example, even if an extended statute of limitations for SAM claims has not run, the bankruptcy “bar date” by which claims must be filed will govern)
  - potential for fraudulent or meritless claims as a result of large-scale tort campaigns, which may also greatly increase exposure
  - disproportionate power given to plaintiff’s lawyers since approval of a plan is driven by the aggregate amount of creditor claims, and a specified number of tort claimants must vote in favor

Example – Boy Scouts of America

- Prior to bankruptcy filing, the number of lawsuits was about 400, and 1,400 future claims were expected. Plaintiffs' lawyers then brought more than 80,000 new claims into the case.
- Insurers objected to the bankruptcy plan, arguing among other things that it was not proposed in good faith because the debtor had turned the pen over to plaintiff groups to draft and negotiate a restructuring plan and that these lawyers had hijacked and manipulated the process, including improper solicitation and submission of claims.
- Plan was drafted to bind non-settling insurers to plan distributions, ultimately overriding coverage defenses. Bankruptcy court rejected all but one of the "binding findings" but ultimately approved the plan, which remains subject to an insurer appeal.
  - Plaintiffs' lawyer groups have openly conceded that they will be entitled to up to 30-40% of proceeds associated with claimant recovery through the settlement trust.

Bankruptcy & Insurers

- Insurance policies are often a significant (if not the most significant) asset contributed to a trust to pay out existing and future claims.
- Policies typically provide that the insured's bankruptcy or insolvency will not operate to relieve the insurer of its policy obligations, particularly the payment of (covered) claims.
- The other side of the coin, at least in theory, is that bankruptcy cannot be used to rewrite state law contracts, such as insurance policies. See, e.g., *In re SPM Mfg. Corp.*, 984 F.2d 1305, 1311 (1st Cir. 1993) (bankruptcy courts do not have authority to enter orders that "expand the contractual obligations of parties").

Bankruptcy & Insurers

- In practice, bankruptcy plans sought by debtors, and the related TDPs, may seek to modify or even nullify a number of the rights a carrier typically has under its policies.
- As a general matter, the rights and obligations contained in an insurance policy are directed to the common goal of limiting exposure on claims against the insured – which is not the goal of plaintiffs' attorneys (whose interest is to maximize payouts) when negotiating TDPs and bankruptcy plans.
- Policy provisions that may be affected by bankruptcy:
  - anti-assignment clauses
  - insured's duty of cooperation
  - insurer's right to defend
  - consent to settlement

Anti-Assignment Provisions

- Anti-assignment, or consent to assignment, provisions generally prohibit a policyholder from assigning its interest under a policy without the insurer's consent.
- While asbestos bankruptcies were still prevalent, many insurers tried to invoke their anti-assignment clauses.
- But the Bankruptcy Code (federal law) was ultimately found to preempt anti-assignment provisions to the extent they prevent the transfer of the debtor's rights under its policies to a trust. *See In re Federal-Mogul*, 684 F. 355 (3d Cir. 2012).

Consent to Settlement Provisions

- Insurance policies typically call for an insured to obtain the insurer's consent to any settlement.

- Bankruptcy courts have also rejected insurer objections to bankruptcy plans based on such provisions:

> "… given the plan's wide notice, the lack of any objection to the plan's allocation of value either to personal injury claimants or to abate the opioid crisis, and the fact that insurers' consent rights, like any other contract party's consent rights, are circumscribed by the Bankruptcy Code's separate notice and hearing process, the Debtors' request for a finding that the plan does not violate the policies' applicable consent provisions is justified and appropriate. In addition, ample case law establishes the authority under sections 1123(a)(5)(B) and (b)(2) and (6) of the Bankruptcy Code to transfer insurance rights and insurance policies as part and in furtherance of a plan to pay mass claims, such as in these cases." *In re Purdue-Pharma,* Modified Bench Ruling on Confirmation.

Control of Investigation, Defense and Settlement of Claims

- These rights typically accrue to the insurer under its policy language.
- Bankruptcy TDPs, in contrast, generally give the debtor or a third party, such as a trustee, the exclusive right to resolve claims which the insurance will be called upon to cover.
- Insurers will therefore seek to be involved in a bankruptcy, and impose objections, in order to ensure that the TDPs are consistent with policy terms and preserve coverage defenses.

Insurance Neutrality

- “Insurance neutrality” provisions may be included in proposed bankruptcy plans.
- Such provisions typically state that the bankruptcy plan will not increase insurers’ obligations or impair their contractual rights, for example:

> *“Nothing in the Plan or in the Confirmation Order shall preclude any Entity from asserting in any proceeding any and all claims, defenses, rights or causes of action that it has or may have under or in connection with any Subject Insurance Policy or any Subject Insurance Settlement Agreement. Nothing in the Plan or the Confirmation Order shall be deemed to waive any claims, defenses, rights or causes of action that any Entity has or may have under the provisions, terms, conditions, defenses and/or exclusions contained in the Subject Insurance Policies and the Subject Insurance Settlement Agreements, including, but not limited to, any and all such claims, defenses, rights or causes of action based upon or arising out of Asbestos PI Trust Claims that are liquidated, resolved, discharged, channeled, or paid in connection with the Plan.”*

Insurance Neutrality

- Originally developed in the Third Circuit (in the Combustion Engineering bankruptcy) as a standing doctrine.

  In re Combustion Engineering, 391 F.3d 190 (3d Cir. 2004), as amended, (Feb. 23, 2005) (if claims are paid in a manner that is consistent with the terms of the relevant insurance policies, insurers are not "aggrieved" for purposes of appellate standing)

- Insurers, however, argue that such "neutrality" requires that their contractual rights be preserved in a bankruptcy plan and is not simply a matter of standing.

Insurance Neutrality

- *But see In Re Boy Scouts of America and Delaware BSA, LLC*, Case No. 20-10343 (LSS)(July 29, 2023 opinion, p. 250), in which the court disagreed with insurers' argument that because the Plan was not "insurance neutral" it could not be confirmed:

> Debtors are correct that "insurance neutrality" is a standing concept that appears to have arisen in the context of mass-tort cases in order to prevent insurance companies from objecting to confirmation. . . . Neither of these decisions [*Global Industrial* or *Combustion Engineering*] guarantee an insurance company an "insurance neutral plan,“ rather these decisions recognize that if a plan is not "insurance neutral," insurance companies have standing (at either the bankruptcy or the appellate level, as applicable) to be heard.

Insurance Neutrality

- "Insurance neutrality" is also set to be addressed by the Supreme Court, which granted cert last fall with regard to an appeal involving the Fourth Circuit's decision in the Kaiser Aluminum asbestos bankruptcy.
  - The Fourth Circuit found insurers lacked standing to object to the bankruptcy plan under the insurance neutrality doctrine.
    - Appeal noted a split between the circuits: the Fourth and Seventh Circuits deny insurer standing, the Third Circuit may generally grant it and inconsistent decisions in the Ninth Circuit.
  - The insurer at issue had objected to the bankruptcy plan on the ground that it breached the duty to cooperate under the policies because protections against fraudulent or duplicative claims had not been obtained. The court found that the duty to cooperate was applicable only to traditional litigation activities, and not the negotiation of bankruptcy plans.
  - Issue on appeal is "whether an insurer with financial responsibility for a bankruptcy claim is a 'party in interest' that may object to a Chapter 11 plan of reorganization."

Binding Findings and Insurance-Hostile Plans

- Plans have been proposed that are not “insurance neutral” and that include language that attempt to bind insurers to the TDPs and the plan.
- In *BSA*, the reorganization plan as originally proposed was seen by some carriers as overtly and intentionally insurance hostile.
- Insurers argued that plaintiff lawyers (exercising the power associated with the "vote") derailed the Plan negotiation process and that BSA literally "handed over the pen." The failure to preserve insurer's rights was no accident and reflected a concerted effort by BSA and plaintiff lawyers to achieve what they termed the "holy grail" - making claim valuations binding on non-settling insurers notwithstanding their ability to assert contractual rights in subsequent coverage litigation.

Binding Findings and Insurance-Hostile Plans

- As a condition precedent to confirmation, the BSA plan required the court to make a series of "findings and determinations" (referred to as the "binding findings").
  - The Plan and Confirmation Order shall be binding on all parties in interest
  - The TDP are appropriate and provide for a fair and equitable settlement of Abuse Claims
  - The right to payment that the holder of an Abuse Claim has is the amount determined by the TDP;
  - The Plan TDP's were proposed in good faith
  - The Base Matrix Values in the TDP's are based on, and consistent with, the Debtors historical abuse settlements and litigation outcomes.
- With one exception, the court declined to enter the findings but confirmed the plan.

Binding Findings and Insurance-Hostile Plans

- BSA insurers' appeal to the Third Circuit is nevertheless pending because of additional objections and issues.
- These include:
  - a failure to preserve certain rights and obligations in the policies (lack of insurance neutrality language and improper assignment of rights without concomitant obligations to the bind insured)
  - "good faith" arguments based on improper control by and involvement of plaintiffs' lawyers in the bankruptcy process

Coverage Litigation

- Post-confirmation – DJ may be brought, typically by or against the trustee(s) of the settlement trust to determine coverage of specific claims or issues

- Pre-confirmation – insurers may attempt to have the automatic stay lifted to pursue coverage litigation, for example, an existing DJ

Bankruptcy Process – What Insurers Should Watch for

- A bankruptcy plan will set forth how claims must be submitted and documented, the procedure for processing the claim, and usually a matrix or other formula for valuing and paying claims (TDPs).
  - In fixing claim values or ranges, TDPs will often set a base figure that is adjusted by scaling factors to either increase or decrease the award.
  - May also set up a system to address claims with a value that exceeds the matrix cap (such as the "Independent Review Option" in the BSA Plan which addresses claims that plaintiffs believe exceed the maximum matrix cap)
  - Insurers are typically not involved in (excluded from) the negotiation of TDPs.

Bankruptcy Process – What Insurers Should Watch for

- Monitor attempts by debtors/policyholders and other plan proponents, viz. plaintiff’s lawyers, to:
  - include language in the plan that abrogates insurer's rights and defenses to the claims
  - binds insurers to the claim process and result (including TDP assessment and valuation to remove an insurer's ability to object to the "reasonableness" of a trust payment)
  - employ procedures or terms that are inconsistent with the terms of an insurance policy.

Bankruptcy Process – What Insurers Should Watch for

- Insurers may often be precluded from (left out of) negotiations regarding plan formation and implementation, and may face a plan that is hostile and/or is not "insurance neutral" and that fails to protect the rights of insurers post reorganization.
- Depending on their exposure, some insurers may seek to conclude a settlement during the bankruptcy proceedings, and obtain the benefit of a bankruptcy release for the claims.

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Thank you!

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