

Insurance Fights Can Complicate The Bankruptcy Labyrinth

By **Shane Dilworth**

Law360 (August 19, 2022, 1:15 PM EDT) -- A company's trek through the bankruptcy process can be arduous enough, and legal experts say the complexities of successfully navigating liquidation or reorganization are amplified when insurance coverage disputes arise.

The bankruptcy process presents obstacles to both policyholders and insurers. While proceedings are intended for the parties to reach a consensual agreement on the resolution of underlying claims and liabilities, each party's competing interests can give rise to disputes that will reach a jurist at either the state or federal court level.

"Bankruptcy is a nuanced body of law and when it intersects with insurance, it can create some complicated scenarios," Travis Knobbe of Freeman Mathis & Gary told Law360.

This is the first part in a series exploring the intersection of bankruptcy and insurance issues.

Pack It Up or Reorganize

Bankruptcy comes in different forms, and each provides a different option for a company in financial peril. Chapter 7 bankruptcy allows a company to liquidate its assets to repay debts and go out of business. Under Chapter 11, a company can reorganize its debts and continue to operate or later shutter its doors.

A bankruptcy under Chapter 7 often does not require the involvement of the company's insurer, experts say, since the purpose of the filing is solely to liquidate assets in order to pay creditors.

Carriers should be informed when a policyholder initially files for Chapter 11 bankruptcy, experts say, as policies include notice and cooperation provisions. However, insurers sometimes do not get involved in a bankruptcy until the last possible minute.

For companies facing mass tort liabilities, a stay of those court cases is entered immediately after filing a petition for Chapter 11.

In some cases, a company submits a preplanned reorganization plan, known as a "prepack," with its petition. The benefit of prepack bankruptcies is that the details of the reorganization plan have already been agreed upon.

Companies following the path of bankruptcy must also submit a list of assets and debts and then go through a process known as estimation and allowance of claims.

That process, Paul Zevnik of Morgan Lewis & Bockius LLP explained, can result in disputes. He said if the policyholder is facing "long-tail" asbestos, talc, silica or environmental claims implicating multiple years, the cumulative value of those claims must be estimated and allowed, and thus the total liability is accelerated since it must be estimated at one moment in time.

"And the obligation of the insurers will be accelerated," said Zevnik, who represents policyholders. "That's where the friction lies."

Once a reorganization plan is agreed upon and funds are set aside to compensate claimants in underlying suits, those actions can be subject to a "channeling injunction." Such an injunction typically funnels claimants to seek compensation from the bankruptcy trust instead of filing a lawsuit.

Bankruptcy's Effect on Coverage

A company's filing for bankruptcy does not automatically impact its insurance coverage, experts say.

Robert Horkovich of Anderson Kill LLP told Law360 that standard commercial general liability policies generally have provisions mandated by statutes in 46 out of 50 states prohibiting insurance companies from reducing or eliminating coverage when a policyholder files for bankruptcy.

Companies going through the bankruptcy process still may press their insurance companies for payment of claims that arose before the bankruptcy.

Freeman Mathis' Knobbe said the payment of premiums can be nuanced and raise complicated questions. He explained that premiums can be paid by the debtor without bankruptcy court approval, provided they are routinely paid in the ordinary course of business when the bankruptcy petition is initially filed.

"If, for some reason, insurance premiums are not being paid post-petition, that's where things can get complicated," said Knobbe, who represents insurers. "An insurance carrier is going to say, 'My duty to insure is conditioned upon timely payments of premiums.' However, if you just yank out insurance coverage, it would often be a violation of the automatic stay."

Scott Seaman, a partner with Hinshaw & Culbertson LLP, said the worlds of bankruptcy and insurance first collided when companies started filing for bankruptcy to resolve asbestos-related liabilities. He explained that carriers "learned the hard way" about navigating the process during the first wave of asbestos-related bankruptcies.

"In general, the bankruptcy of the policyholder can take away an insurer's rights, remedies and defenses," said Seaman, who represents carriers. "It can create additional challenges for insurers, and they often must take steps to protect their interests."

Some of those interests, Seaman said, include reaching a neutral liquidation or reorganization plan, how the assignability of claims is resolved, and the procedures for distributing proceeds from the trust.

Where Coverage Disputes Belong

Although bankruptcy provides a forum for a company to resolve its debts, it is not necessarily the most appropriate venue for the resolution of insurance coverage disputes. Bankruptcy courts are unique in that they do not have jurisdiction over state law claims, which are often at the heart of insurance battles.

Moreover, many problems arising from the reorganization and underlying case claimants, other creditors and insurer settlement plans are discussed in mediation, confidential alternative dispute resolution or otherwise behind closed doors, experts say.

"Most things get resolved in a confirmed plan of reorganization, and the sausage is made somewhere in the negotiating room," Morgan Lewis' Zevnik said. "So, you get very little straight bankruptcy litigation that's decided by a court. That doesn't mean that there's not a lot of litigation; it just means there's a powerful incentive for people to try to get to a resolution in the bankruptcy proceeding that makes sense for everybody."

Additionally, Zevnik said, bankruptcy courts are reluctant to weigh in on insurance coverage fights for three reasons.

"Number one, coverage is a matter of state law," he said. "Number two, the court may not have jurisdiction because you lack diversity. And number three, the insurance coverage controversies can take an awful long period of time to resolve, and a long delay or uncertainty as to timing will typically be a complete impediment to putting together a confirmable plan of reorganization."

As a result, experts say, coverage battles arising during bankruptcy proceedings are more likely litigated in state or federal courts.

--Editing by Aaron Pelc and Roy LeBlanc.