Clarifying The Scope Of Bankruptcy Code 3rd-Party Injunction

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A recent Third Circuit decision has clarified the scope of the third-party injunction, including injunctions in favor of insurers that resolve insurance coverage in asbestos bankruptcy cases, that may be issued under Section 524(g) of the Bankruptcy Code. Liability covered by such an injunction must be "derivative" of the debtor, meaning that under state law, the third party's liability must depend on the debtor's liability. And it must be limited to liability that is "legally caused" by a statutory relationship (such as insurer, director, etc.) between the third party and the debtor.

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Almost 25 years ago, Section 524(g) was added to the Bankruptcy Code to codify a procedure, pioneered by the U.S. Bankruptcy Court for the Southern District of New York in the Johns Manville bankruptcy case, to permit bankrupt companies faced with continuing liabilities because of their use or distribution of asbestos-containing products to resolve both their current and their future asbestos-related liabilities. A conventional Chapter 11 bankruptcy case addresses only "claims" against the debtor, and it was argued that the rights of individuals who had been exposed to asbestos-containing products but who had not yet manifested any injury as of the date of the debtor's bankruptcy were not claims that were subject to the discharge. If the holders of such "demands" could bring suit, if and when they developed an asbestos-related disease, against the company that emerged from bankruptcy protection, it would be impossible for a company with asbestos liabilities to reorganize in bankruptcy.

This new section of the Bankruptcy Code allowed the bankruptcy plans of such companies to enjoin the holders of such future asbestos demands against the debtors from pursuing the reorganized company. The statute required, however, that the trust that would pay such creditors receive securities issued by the reorganized company. And it imposed procedural protections designed to ensure that the holders of future demands received the same treatment as current creditors did.

Significantly, although the Bankruptcy Code does not otherwise expressly authorize third-party releases, Section 524(g) also permits bankruptcy courts to grant such protection to certain categories of third parties that might be held derivatively liable for the conduct or claims against the debtors. Perhaps the paradigmatic candidates for such third-party releases are those that own (or that previously owned) the debtor, that might be held liable on a veil-piercing theory of liability. Section 524(g)(4) authorizes the bankruptcy court to include such entities within the channeling injunction, so long as the bankruptcy court concludes that the injunction is "fair and equitable" to those who might assert demands subject to the injunction, in light of the third party's contributions to the trust.

Section 524(g)(4) also authorizes third-party releases for the benefit of a debtor's insurer. Where an insurer settles with a debtor prior to confirmation, Section 524(g)(4) permits the insurer to obtain the benefit of the channeling injunction, which operates to protect the insurer from any liability that any person may seek to impose on it that derives from the debtor's liability and results from the insurer's issuance of insurance to the debtor. Since Section 524(g) was enacted, insurers in scores of bankruptcy cases filed by companies with asbestos-related liabilities have settled their coverage disputes with

their debtor-insureds, relying on the injunctive protection of Section 524(g)(4) to bar all claims against them based on the debtor's asbestos-related liabilities.

The application of this provision is straightforward in the ordinary case. An insurer that has received the benefit of a Section 524(g)(4) injunction is protected from a claim brought by a subsequent claimant who seeks to assert a "direct" claim against the insurer alleging that it settled with the debtor for too little. But as the universe of asbestos manufacturers with sufficient assets (in insurance or otherwise) to satisfy claims has dwindled, the asbestos plaintiffs bar has grown increasingly creative in asserting new and adventuresome theories against insurers. The novelty of these theories of liability has given rise to questions about the scope of the protection provided by bankruptcy law.

In Travelers Indemnity Co. v. Bailey,[1] the U.S. Supreme Court addressed this issue in connection with an injunction issued in the Johns Manville bankruptcy, prior to the adoption of Section 524(g), in favor of Travelers. The "cornerstone" of the Johns Manville reorganization was a settlement with the company's insurers, including Travelers, in which the insurers paid $770 million into the bankruptcy estate in exchange for releases and broad injunctive protection, which covered any claims "arising out of or relating to" the issuance of insurance to Johns Manville.

The plaintiffs, however, thereafter asserted state law claims against Travelers. The liability that these claims sought to impose on Travelers was not wholly derivative of the debtor's conduct. Rather, the complaints included allegations that Travelers itself violated obligations that state law allegedly imposed on it, either as a statutory matter or at common law, to warn the public of the dangers of asbestos. The bankruptcy court concluded that these claims were within the scope of the original injunction, reasoning that everything Travelers knew about the hazards of asbestos derived from its issuance of insurance to Johns Manville, and thus that the claims were covered by the injunction. The Supreme Court agreed. While the court expressly declined to address whether an injunction as broad as the one in Johns Manville would be authorized by Section 524(g), it found that the claimants were bound by the terms of the original injunction entered in 1986, the terms of which were broad enough to cover their lawsuits.

The Third Circuit's recent decision in Continental Casualty Co. v. Carr (In re W.R. Grace)[2] addresses the application of a Section 524(g)(4) injunction to a lawsuit brought against an insurer that, like the statutory and common law actions at issue in Travelers v. Bailey, purported to arise (at least in part) out of the insurer's own conduct.

CNA issued a number of insurance policies to W.R. Grace, including policies for workers' compensation and employers' liability that permitted CNA to "inspect ... the workplaces, operations, machinery and equipment" covered by the policies. CNA resolved its coverage with W.R. Grace during the W.R. Grace bankruptcy case. In exchange for $84 million in payments to the trust, CNA received the benefit of an injunction issued under Section 524(g)(4).

Despite that injunction, the plaintiffs thereafter asserted against CNA claims alleging that the plaintiffs had suffered from asbestos-related bodily injury as a result of CNA's negligence in providing industrial hygiene services to W.R. Grace. CNA filed a complaint in the bankruptcy court seeking to enjoin the claims and channel them to the W.R. Grace Asbestos PI Trust. The bankruptcy court granted CNA summary judgment, agreeing that the claims fell within the terms of the

injunction (and did not fall within exclusions from coverage for benefits for state-mandated workers' compensation) and that the claims were derivative claims that could be enjoined under Section 524(g)(4) because the injuries underlying the claims were based on exposure to W.R. Grace's asbestos products or operations.

On appeal, the Third Circuit, in an opinion by Judge Thomas Ambro, explained that a Section 524(g)(4) injunction applies only where the liability is "derivative" and is predicated on a "statutory relationship" between the third party and the debtor. Because the bankruptcy court had not made findings that sufficiently answered either question, the court remanded the case to the bankruptcy court to address those issues.

Derivative Liability

Observing that Section 524(g) applies only to derivative liability, the Third Circuit rejected the plaintiff's understanding of derivative liability as being too narrow and CNA's as being too broad. The plaintiffs argued that only claims that sought to recover insurance proceeds due to the debtor under the insurance policy were derivative claims. CNA, by contrast, argued that any injury involving the debtor's product was derivative liability. The Third Circuit, however, charted a middle course. To determine whether liability is derivative, a court must examine the underlying state law that gives rise to the claim and determine "whether the third party's liability is wholly separate from the debtor's liability or instead depends upon it."[3] The court explained that its decision comports with the analysis that the Second Circuit had adopted (in the context of successor liability) in In re Quigley Co. Inc.,[4] wherein one must look to the relevant state law to determine "whether the plaintiff's rights derived from the debtor's rights and the alleged duty the third party owed to the plaintiff derived from the duty it owed to the debtor."[5]

Statutory Relationship

In addition to satisfying the derivative liability requirement, an injunction under Section 524(g)(4) can only extend to liability that "arises by reason of" the third party's statutory relationship with the debtor. The parties debated whether it was sufficient for the third party's relationship with the debtor to be a "but for" cause of the third party's liability, or whether the relationship must be the "proximate" or "legal" cause of the third party's liability. The bankruptcy court had concluded that the causation must be proximate, but did not examine state law to determine whether, under the applicable state law, the third party's relationship to the debtor was relevant to the alleged liability. The Third Circuit agreed that the relationship needs to be the "legal cause" of the liability and directed the bankruptcy court to engage this analysis on remand.

The Third Circuit's decision in W.R. Grace contains valuable lessons for insurers (and other third parties) regarding the benefits that can be obtained by an injunction issued under Section 524(g)(4). Within its proper scope, it seems clear that a Section 524(g)(4) third-party injunction is valid and enforceable, and will operate to bar the assertion of claims against the third party. So an insurer that settles with its insured and then faces a direct claim from a claimant arguing that it settled for too little will be protected. (Note, however, that an insurer may likely be able to obtain similar protection by "buying back" the debtor's rights under the insurance policy as an asset that can be acquired in a Section 363 "free and clear" sale

— without being dependent on the debtor's confirming a plan that comports with the various requirements of Section 524(g).)

At the same time, that scope is not limitless. While Travelers may have succeeded (prior to the enactment of Section 524(g)) in the Johns Manville case in arguing that everything it knew about the hazards of asbestos derived from its issuance of insurance to the debtor, and thus any liability stemming from that alleged knowledge was covered by the injunction, such an effort is unlikely to pass muster under Section 524(g)(4). Rather, a third party seeking to enforce a Section 524(g)(4) injunction against a claimant seeking to impose liability on that third party will be required to engage in a careful analysis of the underlying state law giving rise to the alleged liability. Under the W.R. Grace decision, the injunction will bar the claim only where the alleged liability (a) "depends on" the debtor's liability to the third party, and (b) is proximately caused by the third party's relationship to the debtor.

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[1] Travelers Indemnity Co. v. Bailey, 557 U.S. 137 (2009).

[2] Continental Casualty Co. v. Carr (In re W.R. Grace), No. 17-1208, slip op. dated Aug. 14, 2018.

[3] Slip op. at 21.

[4] In re Quigley Co. Inc., 676 F.3d 45, 54-58 (2012).

[5] Slip op. at 21 n.7.