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U.S. District Court Finds Coverage Survives Procedural Changes of Bankruptcy

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A bankrupt insured, particularly one with significant mass tort liability and assets primarily restricted to its insurance policies, should pay close attention to coverage issues during the bankruptcy proceedings to minimize subsequent difficulties in securing insurance recovery. Bankruptcy proceedings may complicate a bankrupt insured's access to its third-party liability insurance coverage, but, properly executed, the proceedings can be structured to safeguard access to coverage

For example, a 2009 decision, the United States District Court for the District of Maryland brought some clarity to the coverage-neutral aspects of bankruptcy by addressing efforts by a liability carrier to justify its denial of coverage upon the procedural changes wrought by bankruptcy. *See Nat'l Union Fire Ins. Co. v. Porter Hayden Co.*, 408 B.R. 66, 2009 U.S. Dist. LEXIS 61992 (D. Md. July 7, 2009). The insured, the Porter Hayden Company, had sold and installed asbestos-containing insulation products for decades and, more recently, had emerged from bankruptcy proceedings with an injunction that channeled all asbestos claims to a trust for possible resolution with Porter Hayden's pre-discharge assets. The District Court rejected the argument by National Union Fire Insurance Company of Pittsburgh, Pennsylvania and American Home Assurance Company (collectively "National Union") that somewhere between the injunction and the creation of the trust, National Union's obligation to provide coverage for the third-party claims against Porter Hayden had evaporated.

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History

Early efforts by insurers to escape contractual obligations in the event of an insured's bankruptcy led to mandated policy language precluding such efforts.

In the early 1900s, insurers sometimes contended that an insured's bankruptcy meant the insured could not and need not satisfy a third party's judgment and, thus, there was nothing for the insurers to indemnify, leaving victims uncompensated and the (solvent) insurers retaining the insured's premium with no corresponding obligation to perform. Insurance companies would argue that insurance indemnifies the policyholder for its liability to pay damages and that bankruptcy discharges the policyholder's liability such that the insurance company has nothing to indemnify. S*ee, e.g., Merchs.' Mut. Auto. Liab. Ins. Co. v. Smart*, 267 U.S. 126 (1925); *Jackson v. Citizens Cas. Co.*, 14 N.E.2d 446 (N.Y. 1938); *Roth v. Nat'l Auto. Mut. Cas. Co.*, 202 A.D. 667 (N.Y.A.D. 1st Dep. 1922). Where an insurance company succeeded, it garnered a windfall of collected premiums on policies that did not pay claims while injured third parties went uncompensated, all because the insured happened to go bankrupt or become insolvent after purchasing the insurance policies.

New York Leads the Way

As it has with regard to other insurance issues, New York led the way in formulating insurance regulation in response to these maneuvers. *See* Robert Eric Wright & George D. Smith, Mutually Beneficial 285 (2004) ("New York State … has often served as a bellwether of standards."). New York enacted a statute providing that all liability policies were required to include a provision stating that the insolvency or bankruptcy of the person insured shall not release the insurance carrier from the payment. *See Roth*, 202 A.D. at 668 (citing § 109 of the New York Insurance law, now codified at N.Y. C.L.S. Ins. § 3420(a)(1) (2010)). New York enacted its insurance reform to prevent the "evil" of an insurer pointing to an insured's bankruptcy and refusing to honor its promises under an insurance policy by standing on "a technical construction of the policy [to] claim, that, since it was an indemnity policy for loss occasioned to the assured, the assured having sustained no loss, there was nothing which the company could legally be called upon to pay." *Roth*, 202 A.D. at 669.

Similar Statutory Requirements

Numerous jurisdictions followed New York's lead and enacted similar statutory requirements applicable to some or all liability policies. *See, e.g.*, Cal. Ins. Code § 11580(b)(1) (2009); § 215 Ill. Comp. Stat. 5/388 (2010); Md. Code Ann., Ins.

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§ 19-102(b) (2006); N.J. Stat. § 17:28-2 (2009); Or. Rev.Stat. § 742.031 (2007); Va. Code Ann. § 38.2-2200 (2009). These statutes expressly prohibit an insured's bankruptcy from serving as justification for an insurer's effort to be released from its contractual obligations through a technical reading of the indemnity clause in a policy or an argument that the insured had no loss. *See, e.g.*, Md. Code Ann., Ins. § 19-102(b) (2008) ("bankruptcy … of the insured does not release the insurer from liability"). *See also, e.g., U.S. v. TUG Marine Venture*, 101 F. Supp.2d 378, 384 (D. Md. 2000) (applying Virginia law to reject carrier's effort to avoid coverage on ground that insured was unable to "pay first"); *Home Ins. Co. v. Hooper*, 691 N.E.2d 65, 70 (Ill. Ct. App. 1998) (voiding policy provision purporting to require insolvent insured to satisfy self-insured retention in order to secure coverage). These statutes and the mandated contract provisions have a "remedial purpose" to "primarily protect the public." *Magalski v. Maryland Cas. Co.*, 318 A.2d 843, 848 (Md. App. 1974) (analyzing and discussing predecessor to Maryland bankruptcy-insurance statute). The statutes ensure that injured third parties still obtain compensation for their injuries from insured tortfeasors, regardless of the tortfeasor's bankruptcy status. *See Id*.

Legal Obligations Continue

Despite dressing old arguments in new clothes, legal obligations continue in post-bankruptcy resolution contexts.

In *Nat'l Union Fire Ins. Co. v. Porter Hayden Co.*, National Union argued on summary judgment that it had no obligation to provide coverage for Porter Hayden's asbestos liabilities following its bankruptcy. National Union presented several bankruptcy-related arguments, including that: 1) because of the Bankruptcy Court's discharge and supplemental bankruptcy injunctions enjoining legal proceedings against Porter Hayden in favor of a newly created trust, Porter Hayden could not meet the insuring agreement's requirement of a legal obligation to pay damages; 2) the "No Action" clauses precluded Porter Hayden's enforcement of the policy terms in the absence of a final judgment against it; and 3) the bankruptcy plan impermissibly assigned the policies to Porter Hayden's trust without National Union's consent such that coverage was forfeited. The court disagreed with each of National Union's arguments and, instead, affirmed the continued existence of coverage. *National Union*, 408 B.R. 66 at **71-75.

A Bankruptcy Discharge Does Not Eliminate the Bankrupt's Legal Obligations

The standard occurrence-based commercial (or comprehensive) general liability policies at issue in *Porter Hayden* promised coverage for "all sums which the Insured shall become legally obligated to pay as damages" because of a covered event.

National Union contended that it was not arguing that it was excused from its contractual obligations merely because the insured was bankrupt. Instead, in a variant on the decades-old approach that spawned the statutory provisions precluding the insurer's release in the event of the insured's insolvency, National Union argued that Porter Hayden could not be legally obligated to pay damages following discharge from bankruptcy because the underlying asbestos claimants were enjoined from bringing suit against Porter Hayden to establish its legal obligation. National Union argued that, because the third parties alleging that Porter Hayden was liable to them had no legal process by which to vindicate their rights against Porter Hayden, Porter Hayden could have no legal obligation and thus would not trigger the insuring agreement.

The court dismissed National Union's argument, noting that a legal obligation exists independently of and prior to any subsequent judicial determination, *i.e.*, judgment. *Id*. at *72. The court cited Maryland's high court, the Court of Appeals, which had declared: "[I]f a 'legal obligation' does not exist until there is a judgment, there would never be a judgment because a judgment of necessity arises out of legal obligations, liabilities, and legal duties." *Id*., quoting *Megonnel v. U.S. Auto. Ass'n.*, 796 A.2d 758, 765-66 (Md. 2001). While a legal obligation might be contingent prior to a judgment, that legal obligation exists prior to judgment because it arises out of a party's contractual agreement or tortious action. As the court further noted, a bankruptcy discharge serves only to preclude creditors from seeking to collect personally upon a legal obligation; the "discharge, however, 'does not affect the liability of any other entity on, or the property of any other entity for, such debt.'" *Id*. at *73 quoting 11 U.S.C. § 524(e).

The No Action Clause Does Not Require the Impossible

In support of National Union's argument that Porter Hayden could not trigger the insuring agreement because Porter Hayden could have no legal obligation to third parties that were unable to secure judgments against it, National Union pointed to the standardized No-Action clause in the policies. The clause states that "[n]o action shall lie against the [insurer] … until the amount of the insured's obligation to pay shall have been finally determined either by judgment against the insured after actual trial or by written agreement of the insured, the claimant, and the company." *Id*. at *77. National Union posited that because no third party could secure a judgment against Porter Hayden following the bankruptcy discharge and because National Union had not agreed to join with Porter Hayden and the third parties in any settlements, it had no contractual obligation to indemnify Porter Hayden.

The court dismissed National Union's argument, primarily because it found the failure of contractual performance attributable not to Porter Hayden, the insured, but to National Union. The court noted long-standing Supreme Court precedent that where an insurer has refused to defend or otherwise has denied coverage, an insured's reasonable settlement of an underlying matter would not oust coverage regardless of whether the insurer agreed to the settlement. Id.

at *77-78 quoting *St. Louis Dressed Beef & Provision Co. v. Md. Cas. Co.*, 201 U.S. 173 (1906). (Porter Hayden was assisted by its record of having sought National Union's participation and having provided notice to National Union of its activities.) To the contrary, where an insurer "has determined that it refuses to enter into [settlement agreements between the insurer, insured, and third party, the insurer] cannot now invoke the 'No Actions' clause … ." *Id.* at 78. To hold otherwise would require troubled companies to have "to choose between seeking Chapter 11 bankruptcy protections or (b) keeping insurance coverage. Forcing insolvent companies to make this choice is, indisputably, against public policy." *Id.* at 79.

Surviving a Delegation

While Policies may preclude assignments without the insurer's consent, an insured's coverage survives a delegation. National Union argued that Porter Hayden's bankruptcy, which placed Porter Hayden's assets in a trust so that they could be distributed to third party claimants in an orderly and equitable manner, effected an impermissible assignment of the insurance policies to the trust and thus excused National Union from its contractual obligations. *Id.* at * 74. The court corrected National Union, stating that there was no express or implicit assignment. Instead, Porter Hayden's bankruptcy plan had "effectuated a delegation" by which the trust was to manage liabilities that remained Porter Hayden's following the bankruptcy proceedings and pay appropriate liabilities with the Porter Hayden assets that had been placed in the trust during the bankruptcy for that purpose. *Id.*

'Suit' Extends Beyond Actions in a Court of Law to Encompass Alternative Procedures

National Union also sought to escape its obligation to provide Porter Hayden a defense because Porter Hayden's bankruptcy discharge enjoined lawsuits in court against Porter Hayden and, instead, established an alternative process by which claims would be presented to the trust for evaluation and potential resolution. National Union argued that the term "suit" was limited to actions in court and thus, as a result of the channeling injunction, there could be no suits against Porter Hayden for which National Union had an obligation to provide a defense, only administrative claims upon the assets held by the trust. *Id.* at *75.

In the absence of a policy definition restricting suits to court actions, the court applied Maryland law governing the construction of policy language and surveyed various popular definitions of "suit." In the light of the definitions' varying references to suits in a court of law and to other to tribunals and proceedings, and viewed against the existence of "proceedings such as settlements, alternative dispute resolution, administrative determinations, etc., that may be construed as court proceedings, but nevertheless fall outside the contemplation of the dictionary definitions," the court determined that the term "suit" was ambiguous and that it could be understood by a layperson to apply "to legal proceedings other than one initiated by the filing of a complaint against a defendant." *Id.* The court also gave consideration to relevant decisions from other jurisdictions in which those courts rejected a narrow definition of "suit" in favor of an approach that considered whether the insured was being subjected to some form of legally authorized process by which an injured party could seek redress. *Id.* at 75-76. The court also took note of the decision in *In re Eagle-Pitcher Indus., Inc.*, 134 B.R. 248, 254 (Bankr. S.D. Oh. 1991), in which the Bankruptcy Court found that an insured's costs of paying a private claims-handling service to resolve asbestos bodily injury claims on behalf of the insured are not mere "costs of doing business" as the insurers had alleged in that case, but, rather, are not different in kind from the defense costs incurred in more traditional venues. *See Id.* at 253-54.

Conclusion

The recent *Porter Hayden* decision confirms the long line of decisions stretching for more than a century that an insured's bankruptcy does not operate to reduce an insurance company's obligations. Insurance companies are debtors to the bankrupt insured, and even if the insured obtains a discharge against its creditors it makes no sense for those creditors' right to be reduced against the insurers. While the interaction of liability, insurance and bankruptcy is complex, the governing principles remain certain and clear and do not inure to the advantage of opportunistic insurers whose failures to perform lead the insured into bankruptcy in the first place.