

JOURNAL

AMERICAN BANKRUPTCY INSTITUTE

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Rest of the Story: Lessons from *Leslie Controls*

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In a recent *ABI Journal* article,² Edwin Harron and Sara Beth Kohut argued that *In re Leslie Controls Inc.*³ “adds to the growing precedent in the Third Circuit that effective insurance-neutrality provisions will deprive a debtor’s insurer of standing to object to a plan of reorganization proposed pursuant to 11 U.S.C. § 524(g).”⁴ The authors apparently submitted their article before all of the case proceedings were completed because later developments show that a much different lesson should be gleaned from it. Specifically, relying on debtor-proposed “insurance neutrality” language as a means of “streamlining” the road to plan confirmation by eliminating insurers’ participation in the bankruptcy court can have precisely the opposite effect. Instead of clearing the path to a quick exit from bankruptcy, “insurance neutrality” provisions that are foisted on insurers over their objection can actually extend a debtor’s tour in bankruptcy. In short, “insurance neutrality” provisions are most effective when they are negotiated and agreed to by all of the parties, including insurers, based on the facts and circumstances of the case at hand.

Asbestos Claims Leading to *Leslie’s Bankruptcy Case*

Leslie began facing increasing numbers of asbestos personal-injury claims

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after the “bankruptcy wave” in 2000-01, when many of the major asbestos defendants sought chapter 11 relief and thus could no longer be sued in the tort system.⁵ Working with its insurers, Leslie successfully defended against a vast majority of those claims.⁶ Discovery in the bankruptcy case established that Leslie’s insurers paid the lion’s share of the company’s defense and settlement costs and that no tort claim was settled without the insurers’ agreement. (Leslie paid a share of the costs to account for

filed the reorganization plan that it had negotiated pre-petition.

The cornerstone of Leslie’s plan was the issuance of a “channeling injunction” pursuant to § 524(g) of the Bankruptcy Code, which would “channel” all current and future asbestos claims into a trust for payment.⁹ Leslie’s trust contribution included its rights to proceeds from insurance policies and settlement agreements.¹⁰ The trust would resolve asbestos claims pursuant to a matrix contained in the trust distribution procedures (TDP), which set forth medical and exposure criteria and scheduled values for various disease levels. The trustees of the trust would be vested with exclusive authority to resolve asbestos claims; the insurers who had been defending Leslie in the tort system pre-petition had no role in the resolution of claims.¹¹ Leslie’s insur-

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the shares of insolvent insurers or insurers with whom it had settled.) Leslie and its insurers mounted a strong defense to the claims and resolved many claims without any payment at all.

However, because of the asserted “substantial” cost of defending against asbestos claims and a “declin[ing]” amount of available insurance coverage (due to the actual or impending exhaustion of some of its coverage),⁷ Leslie decided to enter into pre-petition negotiations with representatives of holders of asbestos claims and a putative representative for future asbestos claimants (FCR) to formulate a reorganization plan that would permanently resolve Leslie’s asbestos liabilities.⁸ On July 12, 2010, Leslie commenced its bankruptcy case and

ers were not asked to participate in any of the plan negotiations, including the negotiations relating to the TDP.

Confirmation Objections and “Insurance Neutrality”

Several of Leslie’s insurers objected to confirmation of the plan.¹² Among other things, they argued that the plan violated their contractual rights under the policies to participate in the defense and to control the settlement of asbestos claims they would be called upon to pay. This was significant, the insurers argued, because confirmation of the plan and approval of the TDP would result in the insurers having to pay more, and sooner, than they would have had to pay in the tort system. In part, this was because the TDP valued claims at nearly double

¹ Crowell & Moring represents one of the insurers involved in the Leslie case.

² Edwin J. Harron and Sara Beth A.R. Kohut, “Effective Insurance Neutrality Language Deprives Insurers of Standing in Delaware,” *XXX ABI Journal* 1, 32-33, 60, February 2011 (hereinafter, “Insurance Neutrality”).

³ *In re Leslie Controls Inc.*, No. 10-12199 (CSS) (Bankr. D. Del.) (July 12, 2010). Unless otherwise indicated, all references in this article to “Dkt. No.” are to the docket in the bankruptcy case, *In re Leslie Controls Inc.*, No. 10-12199 (CSS) (Bankr. D. Del.).

⁴ Insurance Neutrality at 32.

⁵ Dkt. No. 173 (“Disclosure Statement”) at 6.

⁶ Disclosure Statement at 5, 6.

⁷ Disclosure Statement at 9.

⁸ Disclosure Statement at 9-10.

⁹ Dkt. No. 172, at § 4.4, 9.3(a)(31).

¹⁰ Dkt. No. 382.

¹¹ Dkt. No. 172, at Exh. C. (TDP) at 1; TDP § 5.2.

¹² See Dkt. Nos. 268, 270, 271, 272, 278 and 294.

Leslie's historical settlement values for similar claims. In addition, it contained lax exposure and medical criteria that would have resulted in the payment by the trust of some claims that would not have been paid in the tort system. The upshot, according to the insurers, was that Leslie's coverage would have been consumed more rapidly, causing Leslie's excess insurers to begin paying claims much sooner than they would have expected to pay had the claims remained in the tort system. The insurers designated several experts to provide supporting testimony, and through document discovery and depositions developed evidence to support their objections.

Shortly before the confirmation hearing was scheduled, Leslie (joined by the committee and FCR) moved to strike the insurers' objections, arguing that the insurers lacked standing because the plan contained "insurance neutrality" language that had been agreed to among Leslie, the committee and the FCR, but without any input from the insurers.¹³ Leslie claimed that the "insurance-neutrality" provision was "modeled after" language supposedly "required by" the Third Circuit in *Combustion Engineering*,¹⁴ except that Leslie had revised the language supposedly to "broade[n]" the protections such language afforded to the insurers.¹⁵ In *Combustion Engineering*, an asbestos bankruptcy case, the Third Circuit had held under the facts of that case that certain "insurance neutrality" language added to the plan meant [that] the insurers there lacked "appellate standing."¹⁶

Specifically, the *Combustion Engineering* court had examined whether that plan "diminished" insurers' rights or "increase[d] their burdens," and found that "[s]o long as claims are paid in a manner consistent with the rights and conditions set forth in the [insurers'] policies, the [insurers] are not 'aggrieved' for purposes of bankruptcy appellate standing."¹⁷ The Third Circuit further found that insurers were not "aggrieved" by plan provisions excluding them from participating in the resolution of asbestos claims by the trust, based on the bankruptcy court's finding that insurers did not have that right pre-petition.¹⁸

The insurers objected to Leslie's motion to strike, explaining that the plan would harm their pecuniary interests if it were confirmed and that the plan's "insurance neutrality" did not adequately protect insurers.¹⁹ The insurers explained that whether the plan is "insurance neutral" presented factual issues that the bankruptcy courts could consider only after hearing the fact and expert evidence that the insurers planned to adduce at the confirmation hearing.²⁰

At the outset of the confirmation hearing, Hon. **Christopher S. Sontchi** heard argument on the motion to strike and acknowledged that whether a plan is "insurance neutral" "has to be judged on the facts of th[e] case," a determination that requires the court to consider not only "the plan provisions themselves," but also "the particular facts that the Court had in front of it."²¹ Thus, the court said, "I don't think the *Combustion Engineering* language in front of the Third Circuit was magic words."²² Notwithstanding the acknowledged importance of "facts" and "context," and without hearing any evidence or considering any facts or the context in which Leslie's plan had been negotiated, the court concluded that Leslie's proposed insurance-neutrality provision was sufficient to protect the insurers' interests, and therefore the insurers lacked standing to object to the plan.²³ The court thus entered a confirmation order (the "first confirmation order") without considering the insurers' objections or explaining why the insurance-neutrality language proposed by Leslie was, in fact, sufficient to protect the insurers.²⁴

The following is where the previous article left off. Based on the entry of the first confirmation order, the authors concluded that the *Leslie* case provided valuable lessons about the ability to use insurance-neutrality language over insurer objections to cut off insurers' standing, but the entry of the first confirmation order is not the end of the *Leslie* story.

Negotiated Insurance-Neutrality Provision

The insurers appealed the first confirmation order to the district court, arguing that the bankruptcy court committed reversible error by (1) refusing to permit the insurers to participate in the

confirmation hearing or present evidence to support their standing, (2) failing to explain why the insurance-neutrality language that it approved was, in fact, sufficient to protect the insurers' interests from harm, and (3) finding that the plan was "insurance neutral" notwithstanding the myriad flaws and omissions in the insurance-neutrality provision approved by the court.²⁵

After the appeal was fully briefed, but before the scheduled oral argument in the district court, Leslie and the other plan proponents agreed to significant modifications in the plan's insurance-neutrality provision in exchange for the insurers withdrawing their appeal and their objections to confirmation of the plan. Among the changes was the addition of provisions that negated the accelerated effect on the insurers of the TDP's inflated underlying claim payments.²⁶ Other provisions clarified that the TDP, plan and confirmation order could not be used in post-bankruptcy coverage litigation to support arguments that the TDP and plan, or claims resolved pursuant to those documents, should be deemed to be reasonable settlements that the insurers could be required to indemnify.²⁷

After the insurers, Leslie and other plan proponents agreed to the new insurance-neutrality provision, the district court remanded the insurers' appeal of the first confirmation order so that the bankruptcy court could, in the first instance, review and approve the revised plan and the negotiated insurance-neutrality amendments, and then incorporate the parties' agreements into a new confirmation order.²⁸ The court approved the modified plan and entered a new, superseding confirmation order on Jan. 18, 2011 (the "second confirmation order"),²⁹ which specified that, unlike the case with the first confirmation order, the bankruptcy court *was not determining* "any issue relating to the insurers' standing or whether the [revised plan] is 'insurance neutral.'"³⁰ On Feb. 9, the district court affirmed the second confirmation order and issued the § 524(g) channeling injunction.³¹

Conclusion

In light of the event's subsequent entry of the first confirmation order, it

¹³ See Dkt. No. 284. Leslie also moved to exclude certain insurers' experts, Dr. Charles Mullin and Prof. George Priest. See Dkt. Nos. 337, 338.

¹⁴ See *In re Combustion Eng'g Inc.*, 391 F.3d 190, 217-18 (3d Cir. 2004).

¹⁵ See Dkt. No. 284 at 5.

¹⁶ *Combustion Eng'g*, 391 F.3d at 217. The Third Circuit emphasized that appellate standing is not as broad as bankruptcy court standing. See *id.* at 214 n. 5.

¹⁷ *Id.* at 217.

¹⁸ *Id.* (citing *In re Combustion Eng'g Inc.*, 295 B.R. 459, 473 (Bankr. D. Del. 2003)).

¹⁹ See Dkt. No. 343; Insurance Neutrality at 33.

²⁰ *Id.* at 23.

²¹ Dkt. No. 381 (transcript of Oct. 26, 2010, hearing) at 47.

²² *Id.* at 47:20-22.

²³ *Id.* at 47:13-48:13.

²⁴ Dkt. No. 382.

²⁵ See Dkt. Nos. 1, 2, *In re Leslie Controls Inc.*, No. 1:10-cv-01002-JBS (D. Del. Nov. 22, 2010).

²⁶ Dkt. No. 505 at § 10.4.

²⁷ *Id.* See also Dkt. No. 503 at 37-38, ¶ 23.

²⁸ Dkt. No. 503 at 56, ¶ 68.

²⁹ Dkt. No. 503.

³⁰ Dkt. No. 503, at 55, ¶ 66.

³¹ Dkt. No. 21, *In re Leslie Controls Inc.*, No. 11-mc-00013-JBS (D. Del. Feb. 7, 2011).

cannot accurately be said that the bankruptcy court's findings regarding insurer standing in the context of that order are somehow precedential or even suggestive of what may be required to render a plan "insurance neutral." Indeed, before the district court could rule on insurers' appeal of that very issue, the parties reached agreement on completely different "insurance-neutrality" language, and the district court remanded the appeal to the bankruptcy court. As a matter of law, there can be only one operative order confirming a chapter 11 plan, and in Leslie's case, that order was the second confirmation order, which specifically provided that the bankruptcy court was not determining any issue regarding insurers' standing or "insurance neutrality."

In light of these subsequent developments, it is simply not accurate to assert that *Leslie* provides "further guidance on Third Circuit precedent with respect to insurance neutrality."³² Nor can it plausibly be argued that the superseded first confirmation order provided support for arguments that insurers lack standing in other asbestos bankruptcy cases. Indeed, the most important lesson to be learned from the *Leslie* case is that the best course for asbestos debtors who wish to rely on "insurance-neutrality" provisions to speed their exit from bankruptcy is to negotiate agreed language with their insurers based on the facts and issues raised in each particular case. ■

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³² Insurance Neutrality at 60.