Federal-Mogul Global: A Victory for Bankruptcy Asbestos Trusts

September/October 2012

Benjamin Rosenblum

Affirming the bankruptcy and district courts below, the Third Circuit Court of Appeals, in *In re Federal-Mogul Global Inc.*, 684 F.3d 355 (3d Cir. 2012), held that a debtor could assign insurance policies to an asbestos trust established under section 524(g) of the Bankruptcy Code, notwithstanding anti-assignment provisions in the policies and applicable state law.

Asbestos Trusts in Bankruptcy

One of the mechanisms available to a company seeking to address its asbestos liabilities is the creation of an "asbestos trust" by means of confirmation of a chapter 11 plan of reorganization. Asbestos trusts are an innovation of the 1982 bankruptcy case of Johns-Manville Corporation, which was once the largest producer of asbestos-containing products. In 1994, Congress seized on this innovation and enacted section 524(g) of the Bankruptcy Code, which established a statutory procedure for dealing with future personal-injury asbestos claims against a bankrupt company.

This procedure entails the creation of a trust to pay future claims and the issuance of an injunction to prevent future claimants from suing the debtor. All claims based upon asbestos-related injuries are channeled to the trust. The statute contains detailed requirements governing the nature and scope of any injunction issued under section 524(g) in connection with the confirmation of a chapter 11 plan under which a trust is established to deal with asbestos claims.

Almost every section 524(g) trust is funded at least in part by the proceeds of insurance policies that the debtor has in effect to cover asbestos or other personal-injury claims. The debtor's plan of reorganization typically provides for an assignment of both the policies and their proceeds to the trust. Such an assignment, however, may violate the express terms of the policies or applicable nonbankruptcy law.

The Estate, the Plan, and Pre-Emption

Section 541 of the Bankruptcy Code provides that the filing of a bankruptcy case creates an estate. With some exceptions, the estate comprises all legal or equitable interests of the debtor in property as of the commencement of the case. Specifically included within this estate are all "[p]roceeds . . . from property of the estate" and "[a]ny interest in property that the estate acquires after commencement of the case." The majority of courts have concluded that a debtor's insurance policies (as well as policy proceeds) are property of the bankruptcy estate.

Section 1123 of the Bankruptcy Code provides that "[n]otwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . . provide adequate means for the plan's implementation, such as . . . [a] transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan." Reading sections 541 and 1123 together, it would appear that despite any otherwise applicable nonbankruptcy law, a plan may provide for the transfer of property of the estate, such as an insurance policy, to an entity such as an asbestos trust established under section 524(g).

The Third Circuit Court of Appeals, in the earlier decision of *In re Combustion Engineering, Inc.*, 391 F.3d 190 (3d Cir. 2004), appeared to so hold. However, whether an assignment of an

insurance policy to an asbestos trust could be made, notwithstanding state law, was not the focus of the appeal, which addressed, among other things, whether the bankruptcy court's equitable powers could be deployed to extend the scope of a channeling injunction to include claims against nondebtor affiliates.

Further, section 1142 of the Bankruptcy Code, which generally addresses "implementation" of a chapter 11 plan, provides that "[n]otwithstanding any otherwise applicable nonbankruptcy law, rule, or regulation *relating to financial condition*, the debtor and any entity organized or to be organized for the purpose of carrying out the plan shall carry out the plan and shall comply with any orders of the court" (emphasis added). Section 1142, which was implemented in 1978 together with the rest of the Bankruptcy Code, has been construed to pre-empt only nonbankruptcy laws relating to financial condition.

In *Pac. Gas & Elec. Co. v. California ex rel. California Dept. of Toxic Substances Control*, 350 F.3d 932 (9th Cir. 2003), the Ninth Circuit Court of Appeals interpreted section 1123's pre-emption to be coextensive with section 1142's pre-emption. To reach this result, the Ninth Circuit relied on two presumptions: first, Congress would not lightly pre-empt state law, particularly in areas of traditional state regulation, and second, absent a clear indication to the contrary, Congress would not intend to drastically change bankruptcy law and practice from the law and practice under the Bankruptcy Act—the predecessor statute to the modern Bankruptcy Code. The precursor to section 1123 under the former Bankruptcy Act did not contain any pre-emptive language, and the pre-emptive language in section 1123 was added in 1984 pursuant to what were termed "technical" rather than substantive amendments. Because of this statutory

history and context, and due to a general presumption that Congress does not undertake lightly to pre-empt state law, the Ninth Circuit interpreted the pre-emptive text of section 1123 to be no more broad than the already existing "notwithstanding" clause of section 1142 of the Bankruptcy Code, which, as noted, pre-empts only nonbankruptcy laws, rules, or regulations "relating to financial condition." Under this approach, a state-law or contract provision prohibiting assignment of an insurance policy would not be pre-empted by contrary provisions in a chapter 11 plan.

Federal-Mogul

On October 1, 2001, Federal-Mogul Global Inc. and affiliated entities (collectively, "Federal-Mogul") filed for chapter 11 relief in Delaware. Prior to the bankruptcy filing, Federal-Mogul was one of the world's largest manufacturers of automobile parts. Like many other manufacturers before it, the company faced enormous asbestos-related liabilities.

By filing for bankruptcy protection, Federal-Mogul sought a mechanism to address its asbestos exposure through a section 524(g) trust. In its plan of reorganization, the company proposed to channel present and future asbestos claims to an asbestos trust. The trust would be funded with various assets, including Federal-Mogul's rights to recovery under its liability insurance policies. The plan contained an "insurance neutrality" provision, which preserved the insurers' rights to assert against the trust any defense to coverage that might exist. The one defense that was not preserved for the insurers was the defense that the transfer to the trust violated the policies' anti-assignment provisions.

The insurers objected to the plan. As is standard in the industry, the policies prohibited the insured company from assigning them (or the rights thereunder) without the insurance companies' consents. According to the insurance companies, the chapter 11 plan could not transfer the policies to the asbestos trust in contravention of these rights and state law. The bankruptcy and district courts ruled against the insurers.

The Third Circuit's Ruling

Like the courts below, a three-judge panel of the Third Circuit Court of Appeals rejected the insurance companies' argument that Federal-Mogul could not assign its insurance policies to the asbestos trust. In doing so, the court first set the table by discussing the purpose and history of asbestos trusts. It noted their importance and that they are "the only national statutory scheme extant to resolve asbestos litigation through a quasi-administrative process." According to the court, "[T]he trusts are similar to workers' compensation or other administrative remedies that employ valuation grids to compensate injuries, subject to individualized and judicial review." However, the court wrote, "unlike those schemes, the trusts place the authority to adjudicate claims in private rather than public hands."

The Third Circuit then examined the Bankruptcy Code provisions at issue and noted the well-established principle that the Supremacy Clause of the U.S. Constitution (Art. VI, Cl. 2) invalidates state laws that interfere with federal law. While acknowledging that there is a presumption against pre-emption, the court explained that this presumption is overcome where Congress's desire to pre-empt state law is clear.

Next, the court turned to the insurers' argument that this was a case of first impression. Not so, according to the Third Circuit. Like the courts below, the Third Circuit determined that it had already held in *Combustion Engineering* that section 1123 of the Bankruptcy Code pre-empts anti-assignment provisions that would otherwise bar the transfer of insurance rights to an asbestos trust. Although the Third Circuit determined that its prior decision controlled the result in this case, it went on to address the insurers' various arguments.

The Third Circuit rejected the argument that section 1123's pre-emption scope should be based on section 1142 of the Bankruptcy Code and the Ninth Circuit's *Pacific Gas* decision. The court saw no reason to read sections 1123 and 1142 coextensively. And, while it found *Pacific Gas* distinguishable, it was "unconvinced" that sections 1123 and 1142 are so similar that they must be read together.

The court also rejected the argument for narrow pre-emption based on prior practice under the Bankruptcy Act and the applicable legislative history. While the law under the Bankruptcy Act may have been different, the Third Circuit explained, those practices were not governed by a statute that said "[n]otwithstanding any otherwise applicable nonbankruptcy law" and thus were not informative. Further, the legislative history was too "thin" and "inconclusive" to override the statutory language of section 1123.

Lastly, the Third Circuit addressed various hypotheticals raised by the insurers to demonstrate that section 1123 should not have broad pre-emptive scope because numerous scenarios exist where a debtor might employ section 1123 to avoid the strictures of federal or state law, resulting

in absurdity. For example, under a broad reading of section 1123, a debtor could unilaterally override environmental laws barring transfer of a contaminated property, or a debtor could transfer a nuclear power plant to a third party in contravention of applicable regulations. According to the insurers, the statute could not possibly be read that way, and thus section 1123's pre-emptive scope has to be narrow. The Third Circuit answered these hypotheticals by explaining that its decision does not mean that the scope of pre-emption under section 1123(a) is boundless. Rather, the court emphasized, there is a long-standing presumption against pre-emption of state police powers, as well as the laws and regulations rooted in health and public safety. As such, while the anti-assignment provisions at issue did not implicate public health, safety, and welfare, the court acknowledged that limiting section 1123(a)'s pre-emptive scope on these grounds is "sensible." Consequently, the Third Circuit concluded that reading section 1123 to pre-empt the anti-assignment provisions does not result in absurdity.

Analysis

The Third Circuit's ruling in *Federal-Mogul* is a favorable development for companies wishing to address their asbestos liabilities through a chapter 11 plan of reorganization by means of the trust mechanism contained in section 524(g). *Federal-Mogul* holds unequivocally that insurance policies associated with these liabilities may be transferred to these specialized trusts notwithstanding state-law anti-assignment clauses to the contrary. By promoting the transferability of such insurance policies, the holding may contribute to increased recoveries for asbestos claimants. The obvious losers in this case, by contrast, are the debtors' pre-petition insurers.

Although the Third Circuit's reasoning focused primarily on the plain language of the statute, the court's interpretation of such language is not free from controversy. Under *Federal-Mogul*'s interpretation of section 1123, any applicable nonbankruptcy law—at least any applicable nonbankruptcy law that does not address public health, safety, and welfare—would arguably be pre-empted, while under the Ninth Circuit's view, only nonbankruptcy law relating to financial condition is pre-empted. Given these conflicting authorities, the debate concerning the scope of section 1123 will undoubtedly continue. It also remains to be seen how courts will interpret the Third Circuit's suggestion that section 1123 may not pre-empt laws relating to public health, safety, and welfare.