

# Supreme Court to Hear Appeal on Third-party Injunctions in *Manville*

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This term, the U.S. Supreme Court agreed to hear two appeals<sup>1</sup> from the Second Circuit's recent decision<sup>2</sup> reversing the bankruptcy court's interpretation of certain broad third-party injunctions entered more than 20 years ago in the *Johns-Manville Corporation (Manville)* reorganization case. At issue in these consolidated appeals is whether the Second Circuit properly determined that bankruptcy courts do not have jurisdiction to enter third-party injunctions that extend beyond the "res" of a debtor's estate. The appeal is important because it implicates the scope of the bankruptcy courts' jurisdiction to enter third-party injunctions as part of an order confirming a chapter 11 plan of reorganization. Interestingly, the challenged provisions in the confirmation order at issue in this appeal had been previously affirmed by the Second Circuit on direct appeal.<sup>3</sup>

## Equitable Power to Enter Third-party Injunctions



Jeffrey W. Warren

One area where bankruptcy courts have traditionally used their equitable powers is in entering third-party injunctions. Typically, these injunctions have been entered as a means to achieve finality of complex disputes, and in connection with the reorganization of companies facing asbestos and other mass tort liabilities, such injunctions have enabled substantial plan funding from third parties. The ability to achieve finality is essential to the fashioning of effective remedies in these cases. Whether claims against a third party can be subject to a channeling injunction depends on the

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specific claims, relationships, facts and circumstances before the court in the bankruptcy proceeding.

This very important tool in complex reorganization cases gained acceptance and notoriety from its use in the reorganization case of *Manville*, the landmark asbestos-related mass tort bankruptcy case.<sup>4</sup> After its use in *Manville*, Congress even codified the bankruptcy courts' authority to enter broad-reaching third-party injunctions in asbestos-related cases.<sup>5</sup> This column has previously questioned the validity of one of the grounds relied upon by certain courts to restrict the bankruptcy courts' authority to enter third-party injunctions.<sup>6</sup>

## On the Edge

Nevertheless, it is clear that courts have struggled to determine the boundaries of the bankruptcy courts' statutory and equitable jurisdiction. In *Norwest Bank Worthington v. Ahlers*, the Supreme Court held that a bankruptcy court cannot use its general equitable powers to confirm a reorganization plan in contravention of the absolute-priority rule.<sup>7</sup> Expressly limiting the bankruptcy courts' powers, the Supreme Court stated that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."<sup>8</sup> Citing *Ahlers*, the Third Circuit ruled in 2004 that a nondebtor that contributed assets to a postpetition trust could not take advantage of a bankruptcy court's injunction to insulate itself from asbestos liability that was not derivative of claims against the debtor.<sup>9</sup> Yet more recently,

in *Marrama v. Citizens Bank of Massachusetts*, the Supreme Court reasoned that the inherent equitable powers of the bankruptcy court under §105(a) were sufficiently broad to authorize any action that is necessary to prevent an abuse of process.<sup>10</sup> Against this background of uncertainty, the Supreme Court will have an opportunity to add some clarity.

## History of the Manville Bankruptcy

In 1982, Johns-Manville filed a voluntary chapter 11 petition for relief to deal with mounting exposure to lawsuits arising out of the company's decades-long mining of asbestos and manufacturing of asbestos-containing products. In order to fund a plan of reorganization that would

provide a recovery to the existing and potential asbestos claims against the company, *Manville* settled with certain of its insurers, including Travelers Indemnity Company (Travelers), which agreed to pay an aggregate amount of approximately \$850 million into a settlement fund for asbestos claims against *Manville*.<sup>11</sup> A condition of the settlement with these insurers was that the bankruptcy court would enter an injunction protecting the insurers from further lawsuits arising out of or relating to *Manville*'s asbestos liabilities.

As such, in the confirmation order entered in the *Manville* case, the bankruptcy court expressly included language enjoining "all persons from commencing any action against any of the Settling Insurance Companies 'for the purpose of, directly or indirectly, collecting, recovering or receiving payment of, on or with respect to any Claim...or Other Asbestos Obligation.'"<sup>12</sup> The confirmation

<sup>10</sup> 549 U.S. 365 (2007).

<sup>11</sup> 517 F.3d at 56, n.8.

<sup>12</sup> *In re Johns-Manville Corp.*, 2004 WL 1876046, \*16 (Bankr. S.D.N.Y. 2004). See also *In re Johns-Manville Corp.*, 68 B.R. 618 (Bankr. S.D.N.Y. 1986).

<sup>1</sup> *Travelers Indemnity Company v. Bailey* (Docket No. 08-295) and *Common Law Settlement Counsel v. Bailey* (Docket No. 08-307).

<sup>2</sup> *In re Johns-Manville Corp.*, 517 F.3d 52 (2d Cir. 2008).

<sup>3</sup> *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89 (2d Cir. 1988).

<sup>4</sup> *In re Johns-Manville Corp.*, 68 B.R. 618 (Bankr. S.D.N.Y. 1986).

<sup>5</sup> See 11 U.S.C. §524(g).

<sup>6</sup> See Jeffrey W. Warren, "Jurisdiction to Enjoin Claims of Third Parties: Correcting a Flawed Analysis," *ABI Journal* (May 2000); see, also Jeffrey W. Warren and Carrie Beth Lesser, "Requirements for the Approval of Third-party Non-debtor Releases," *ABI Journal* (April 2003).

<sup>7</sup> See 485 U.S. 197, 206 (1988).

<sup>8</sup> *Id.*

<sup>9</sup> See *In re Combustion Eng'g Inc.*, 391 F.3d 190 (3d Cir. 2004).

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order was affirmed on appeal by the district court<sup>13</sup> and subsequently affirmed by the Second Circuit.<sup>14</sup> In addition, when enacting §524(g) of the Code to authorize channeling injunctions in asbestos cases, Congress also enacted §524(h), which codified the validity of the injunctions contained in the *Manville* confirmation order.<sup>15</sup>

## The Manville Bankruptcy Court's "Clarifying Order"

Despite the entry of the *Manville* confirmation order and the channeling injunction barring the filing of claims against the insurers arising out of asbestos claims against Manville, plaintiffs continued to assert "direct actions" against certain of Manville's insurers, including Travelers, under various state statutes and common law permitting claims to be asserted directly against the insurers. Specifically, certain plaintiffs alleged that they had a direct action against Travelers and other insurers because, by advancing a "state of the art" defense that Travelers knew through its longstanding relationship with Manville was meritless, such insurers had fraudulently conspired with Manville to violate state laws prohibiting unfair insurance practices and breached a common-law duty to warn potential victims of Manville's continued asbestos mining and manufacturing activities.<sup>16</sup>

As a result of the continued lawsuits, Manville obtained a preliminary injunction in 2006 from the court against the continuation of such direct action claims against the insurers as violating the channeling injunctions issued in connection with the *Manville* confirmation order. The bankruptcy court ordered the insurance companies and the direct-action plaintiffs to mediate their disputes before former New York Gov. Mario Cuomo. In the mediation, several of the insurers reached a settlement with the plaintiffs whereby the insurers would

pay an additional sum in excess of \$500 million into the *Manville* asbestos claims trust upon the bankruptcy court entering an order clarifying that the direct actions against the insurers were barred by the terms of the *Manville* confirmation order that enjoined "any action against any of the Settling Insurance Companies 'for the purpose of, directly or indirectly, collecting, recovering or receiving payment of, on or with respect to any Claim.'"<sup>17</sup>

In the clarifying order, Judge **Burton R. Lifland**, who had presided over the *Manville* bankruptcy case since its commencement, expressly relied on the bankruptcy courts' equitable power under §105(a) to "issue any order, process or judgment that is necessary to carry out the provisions of this title."<sup>18</sup> In its clarifying order, the bankruptcy court also relied on the inherent power of the bankruptcy courts, stating: "Even more fundamentally, bankruptcy courts—as courts of record created by Congress—'have inherent or ancillary jurisdiction to interpret and enforce their own orders.'"<sup>19</sup> The court justified its jurisdiction to enjoin the direct actions against the insurers based on the "[c]ourt's conclusion that claims 'based upon, arising out of, or related to' the Travelers/Manville relationship would adversely affect the Manville estate."<sup>20</sup> On appeal, the district court affirmed Judge Lifland's decision in all material respects.<sup>21</sup>

## The Second Circuit's Reversal

On appeal to the Second Circuit Court of Appeals, the decision of the district court was reversed and remanded.<sup>22</sup> In overturning the decision below, the Second Circuit concluded that "the bankruptcy court erred insofar as it enjoined suits that, as a matter of state law, are predicated upon an independent duty owed by Travelers to Appellants, that do not claim against the *res* of the Manville estate, and that seek damages in excess of and unrelated to Manville's insurance policy proceeds."<sup>23</sup>

The Second Circuit recognized that the terms of the channeling injunction entered by Judge Lifland in the confirmation order, which enjoined all claims against Travelers arising out of or related to asbestos claims against Manville, "were meant to provide the broadest protection possible to facilitate global finality for Travelers as a necessary condition for it to make a significant contribution to the Manville estate."<sup>24</sup> In addition, the court acknowledged the findings by the bankruptcy court that "Travelers learned virtually everything it knew about asbestos from its relationship with Manville" from which the district court concluded that the direct action claims against Travelers arose out of and are related to Manville's insurance policies with Travelers.<sup>25</sup>

Nevertheless, the Second Circuit reasoned that both the statutory and common-law direct-action claims against Travelers sought damages that were not related to Manville's insurance policies with Travelers.<sup>26</sup> The court further concluded:

Moreover, the claims at issue here do not seek to collect on the basis of Manville's conduct. Instead, the Plaintiffs seek to recover directly from Travelers, a non-debtor insurer, for its own alleged misconduct. Plaintiffs neither seek to recover insurance proceeds nor rely on the insurance policies for recovery.<sup>27</sup>

Thus, because Travelers might have owed an independent duty to the direct-action plaintiffs under state law and damages for breaching such duty would not diminish the proceeds of the insurance policies, the Second Circuit concluded that the mere fact that the claims "arose out of" or were "related to" Travelers' defense under such policies was insufficient to grant jurisdiction over such claims to the bankruptcy court.<sup>28</sup> The Second Circuit agreed with the Third Circuit's reasoning in *Combustion Engineering* that a third-party nondebtor could not obtain an injunction against such claims solely by making a financial contribution to the debtor's estate, even if the reorganization plan depended

<sup>13</sup> *In re Johns-Manville Corp.*, 78 B.R. 407 (S.D.N.Y. 1987).

<sup>14</sup> *Kane v. Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988).

<sup>15</sup> The legislative history of §524(h) expressly states that this section was included "so that Johns-Manville and UNR, both of which have met and surpassed the standards imposed in this section, will be able to take advantage of the certainty it provides without having to reopen their cases." Bankruptcy Reform Act of 1994, Section-by-section Description, §111.

<sup>16</sup> In concluding that all potential actions against the insurers arose out of claimant's asbestos claims against Manville, the *Manville* bankruptcy court made a finding that, as a result of Traveler's longstanding relationship in defending Manville in asbestos cases, "Travelers learned virtually everything it knew about asbestos from its relationship with Manville." 2004 WL 1876046, \*13.

<sup>17</sup> *Id.* at \*16.

<sup>18</sup> *Id.* at \*26.

<sup>19</sup> *Id.* at \*28 (quoting *In re Chateaugay Corp.*, 201 B.R. 48, 62 (Bankr. S.D.N.Y. 1996)).

<sup>20</sup> 2004 WL 1876046, \*27 (citing *MacArthur v. Johns-Manville Corp.*, 837 F.2d 89, 93-94 (2d Cir. 1988)).

<sup>21</sup> See *In re Johns-Manville Corp.*, 340 B.R. 49 (S.D.N.Y. 2006). The district court vacated that portion of the bankruptcy court's order that required all plaintiffs wishing to bring asbestos-related direct actions against Travelers to seek leave from the bankruptcy court prior to commencing such action. See *id.* at 65-66.

<sup>22</sup> *Johns-Manville Corp. v. Chubb Indemnity Ins. Co. (In re Johns-Manville Corp.)*, 517 F.3d 52 (2d Cir. 2008).

<sup>23</sup> *Id.* at 55.

<sup>24</sup> *Id.* at 57 (quoting 2004 WL 1876046 at \*31).

<sup>25</sup> *Id.* at 62.

<sup>26</sup> See *id.* at 63.

<sup>27</sup> *Id.* (internal citations omitted).

<sup>28</sup> See *id.* at 63-64.

on the contributions of the nondebtor third-party.<sup>29</sup>

The Second Circuit also rejected any argument that the injunctions barring direct actions against the insurers would be compliant with §524(g), which the court recognized was “enacted in response to the bankruptcy court’s earlier rulings in this case.”<sup>30</sup> Section 524(g) expressly states that an injunction under such provision “may bar any action directed against a third party who is... alleged to be directly or indirectly liable for the conduct of, claims against, or demands on the debtor to the extent such alleged liability of such third party arises by reason of—(III) the third party’s provision of insurance to the debtor.”<sup>31</sup> However, despite the plain language of §524(g), relying again on Third Circuit’s analysis in *Combustion Engineering*, the Second Circuit concluded that “a §524(g) channeling injunction...is limited to ‘situations where...a third party has derivative liability for the claims against the debtor.’”<sup>32</sup> Accordingly, the Second Circuit vacated the decision of the district court and remanded the case to the bankruptcy court to determine if it had jurisdiction to enjoin any of the direct action lawsuits against the insurers.<sup>33</sup>

### What Is at Stake on Appeal?

In the current consolidated appeals, the Supreme Court granted *certiorari* in December 2008 and oral arguments are scheduled for March 30, 2009. In the briefs, the petitioners have primarily argued that the Second Circuit’s decision improperly ignored the 2006 Supreme Court ruling in *Central Virginia Community College v. Katz* that “[t]he Framers would have understood that laws ‘on the subject of Bankruptcies’ included laws providing, in certain respects, for more than simple adjudications of the *res*.”<sup>34</sup> Interestingly, the Court in *Katz* also recognized that bankruptcy courts generally have jurisdiction to issue ancillary orders enforcing their *in rem* jurisdiction.<sup>35</sup>

As examples of the bankruptcy courts’ historical equitable powers to issue broad injunctions protecting

third-party nondebtors, the petitioners point to *In re Drexel Burnham Lambert Group Inc.*, a case in which the Second Circuit affirmed the bankruptcy court’s approval of a settlement agreement enjoining future claims against the debtor’s directors and officers.<sup>36</sup> Likewise, the petitioners cite to the Fourth Circuit’s *In re A.H. Robins Co.* decision affirming a bankruptcy court’s confirmation enjoining claims against a debtor’s directors, professionals and insurers,<sup>37</sup> and the Sixth Circuit’s *In re Dow Corning Corp.* decision affirming a bankruptcy confirmation order enjoining claims against the debtor’s insurers after establishing a multi-billion dollar trust to satisfy personal injury claims,<sup>38</sup> as examples of the bankruptcy courts’ jurisdiction. Indeed, if the Supreme Court affirms the Second Circuit’s decision in *Manville*, there would be great concern that the floodgates would open to challenges of the numerous confirmation orders granting similar injunctions that have been entered in cases notwithstanding that the time for appeals of such orders has long passed and notwithstanding the Court’s own precedent prohibiting collateral attacks upon such injunctions.<sup>39</sup>

In addition, the petitioners have argued that the Second Circuit’s reversal was in error because, as discussed, it is at odds with the plain language of §524(g) and (h). The text of §524(g) does not limit the injunctions that a bankruptcy court can enter to the “*res*” of the bankruptcy estate or only those claims that are derivative of the claims against the debtor. As such, the Supreme Court will be required to reconcile the extent to which Congress may enact provisions consistent with the Constitution’s Bankruptcy Clause. The petitioners also argue that the Second Circuit’s decision allows the state law direct-action lawsuits to run afoul of the Supremacy Clause in that such state-created rights trump a valid discharge.

### Conclusion

The recent Second Circuit ruling has injected additional uncertainty about the scope of bankruptcy courts’ jurisdiction and power to enter third-party injunctions. Many practitioners will be watching to see if the Supreme Court will uphold the bankruptcy

courts’ broad jurisdiction and power to channel claims and preserve the settled expectations of stakeholders, or whether the Court will let stand the more restrictive ruling. ■

<sup>29</sup> See *Johns-Manville Corp.*, 517 F.3d at 66 (“It was inappropriate for the bankruptcy court to enjoin claims brought against a third-party nondebtor solely on the basis of that third-party’s financial contribution to a debtor’s estate. If that were possible ‘a debtor could create subject matter jurisdiction over any nondebtor third-party by structuring a plan in such a way that it depended upon third-party contributions’”) (quoting *In re Combustion Eng’g Inc.*, 391 F.3d 190, 228 (3d Cir. 2004)).

<sup>30</sup> *Johns-Manville Corp.*, 517 F.3d at 67.

<sup>31</sup> 11 U.S.C. §524(g)(4)(A)(ii)(III).

<sup>32</sup> *Johns-Manville Corp.*, 517 F.3d at 68 (quoting *Combustion Eng’g*, 391 F.3d at 234).

<sup>33</sup> *Johns-Manville Corp.*, 517 F.3d at 68.

<sup>34</sup> In *Katz*, the Supreme Court held that a bankruptcy trustee’s proceeding to set aside a debtor’s preferential transfers to state agencies is not barred by sovereign immunity. See 546 U.S. 356, 359 (2006).

<sup>35</sup> *Id.* at 370.

<sup>36</sup> *In re Drexel Burnham Lambert Group Inc.*, 130 B.R. 910 (Bankr. S.D.N.Y. 1991), *aff’d*, 960 F.2d 285 (2d Cir. 1992).

<sup>37</sup> *In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir. 1989).

<sup>38</sup> *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002).

<sup>39</sup> *Celotex Corp. v. Edwards*, 514 U.S. 300 (1995).