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Case Law Stresses Chapter 11 Curbs on Legacy Litigation Exposure

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Courts are tightening the boundaries of the Bankruptcy Code's so-called insurer exception, reinforcing the broad protection that Chapter 11's discharge provisions afford to reorganized debtors. This line of authority continues to impose significant hurdles in pursuing post-bankruptcy litigation intended to recover money from a third-party insurer. These developments extend beyond the courtroom and shapes how companies, investors, and claimants navigate the restructuring landscape. With limited appellate guidance, this remains a case law driven area that restructuring practitioners should continue to watch closely.

Discharge of Indebtedness

The discharge of indebtedness is fundamental to the bankruptcy process. Once a Chapter 11 plan of reorganization is confirmed and becomes effective, the reorganized debtor is generally shielded from continuing litigation related to claims that have been discharged, pursuant to Section 524(a) of the Bankruptcy Code. Creditors asserting litigation and other unsecured claims against the debtor typically receive less than full payment under a plan—yet those claims are discharged.

The discharge works as an injunction that protects the reorganized debtor from continued collection attempts by creditors. Under Section 524(e), however, the discharge "does not affect the liability of any other entity," meaning creditors may still pursue the claims against non-debtors such as guarantors, sureties, and insurers. As noted in *Owaski v. Jet Fla. Sys. Inc.*, the statute is "not intended to provide a method by which an insurer can escape its obligations based simply on the financial misfortunes of the insured."

To implement this principle, courts have recognized the insurer exception to discharge, which allows claimants to pursue litigation against reorganized debtors "in name only"—solely to establish liability for purposes of recovering on their claims to the extent of available insurance.

Exception Under Scrutiny

The insurer exception has limits. Most insurance programs require the insured—typically the reorganized debtor—to satisfy a self-insured retention or deductible before coverage is available.

Even if litigation is pursued in name only, SIR obligations and deductibles create real costs for reorganized debtors that can impair the fresh start Chapter 11 was designed to provide. In such circumstances, courts are confronted with the tension between protecting the debtor's fresh start and enabling claimants to pursue insurance recoveries.

Courts across several jurisdictions have generally sided with the debtors, construing the insurer exception narrowly. For example, in May 2024, the US Bankruptcy Court for the District of Delaware noted in *In re Recovery Brands, LLC* that "where granting relief from the discharge injunction to permit a creditor to pursue a third party will impose costs on a reorganized debtor, courts typically will not grant such relief."

The US Bankruptcy Court for the Southern District of Texas—one of the nation's busiest bankruptcy venues—reaffirmed that cautious approach in *In re Valaris plc* in February. This remains the only published decision on the issue this year. Valaris, the world's largest offshore drilling company, emerged from Chapter 11 in 2021. A former employee whose personal injury claim was discharged subsequently sought to continue litigation against the company for the limited purpose of accessing insurance coverage under the insurer exception.

The court denied the request, reasoning that although Valaris had assumed its pre-bankruptcy insurance policy in the reorganization, the policy required the company to satisfy approximately $20 million in SIR payments—including defense costs—before coverage would apply. The court concluded that the insurer exception "must be predicated on the debtor's complete insulation from any interference with its fresh start in economic life," a condition not satisfied on the facts presented.

Key Takeaways

The fresh start. One of Chapter 11's core purposes is to allow companies to shed litigation-related and legacy liabilities. Continued exposure to those liabilities through the backdoor of insurance programs with substantial deductibles or SIR costs would undermine a basic pillar of the Bankruptcy Code. Courts have appropriately mitigated this risk by applying the insurer exception restrictively.

Strategic considerations. For investors evaluating distressed asset acquisitions, optimizing structure—whether through a Chapter 11 plan, a Section 363 sale, or an out-of-court transaction—is a key decision point. While this is a complex determination, the case law discussed above illustrates how a Chapter 11 plan offers unique advantages with respect to minimizing legacy liabilities, as discharge protection is available only through that mechanism.

Insurance analysis. Regardless of the structure selected, insurance programs should be reviewed closely in any restructuring. Even with the discharge protection available under a Chapter 11 plan, issues involving insured claims, SIR obligations, and related costs are best identified and addressed preemptively—before the restructuring is completed.

Options for claimants. The insurer exception to discharge isn't entirely foreclosed. Some insurance policies lack material SIR obligations, and insurers sometimes have waived such requirements in similar post-bankruptcy litigation matters. In other instances, plaintiffs have agreed to cover SIR expenses to avoid burdening the reorganized debtor. Finally, depending on the nature of the claims and applicable law, claimants may sometimes pursue insurance proceeds directly without naming the reorganized debtor.

These issues are important to restructuring strategy. Although a majority view appears to have developed at the bankruptcy court level, limited appellate guidance underscores that this area merits continued close attention.

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