First Impressions: Shutting Down a Chapter 11 Case Due to Patent Unconfirmability of Plan

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Before soliciting votes on its bankruptcy plan, a chapter 11 debtor that has filed for bankruptcy typically must obtain court approval of its disclosure statement. As part of the disclosure-statement approval process, interested parties are afforded the opportunity to object. For example, a party may object on the grounds that the disclosure statement lacks sufficient information about the debtor. Sometimes, however, a party objects to the disclosure statement because the chapter 11 plan described by the statement cannot be confirmed. Although issues regarding a plan's compliance with the Bankruptcy Code's confirmation requirements are typically deferred until the confirmation hearing, some courts may resolve those issues at the disclosure-statement hearing if the plan is unconfirmable on its face, or "patently unconfirmable."

In *In re American Capital Equipment, LLC*, 688 F.3d 145 (3d Cir. 2012), the Third Circuit Court of Appeals held as a matter of first impression that a bankruptcy court may, in certain circumstances, resolve confirmation issues at the disclosure-statement hearing. The Third Circuit affirmed a bankruptcy court's ruling at the disclosure-statement stage that: (i) the chapter 11 plan did not satisfy the Bankruptcy Code's requirements that the plan be "feasible" and proposed in "good faith"; and (ii) on the basis of the plan's patent unconfirmability (and the debtors' inability to propose a confirmable plan), the debtors' chapter 11 cases would be converted to chapter 7 liquidations.

The Disclosure-Statement and Confirmation Hearings

Confirmation and consummation of a bankruptcy plan are the culmination of a chapter 11 debtor's bankruptcy case. Creditors and interest holders whose rights are "impaired" (e.g., detrimentally affected vis-à-vis treatment outside bankruptcy) by a chapter 11 plan and who are to receive a distribution are entitled to vote on the plan. After a bankruptcy case is commenced and with limited exceptions, a debtor (or other plan proponent) can solicit votes on the plan only if holders of claims or interests are provided with a "disclosure statement" which is approved, after notice and a hearing, by the bankruptcy court and which contains "adequate information." Thus, before soliciting votes, a chapter 11 debtor generally must obtain court approval of its disclosure statement, and interested parties must have the opportunity to challenge approval.

Following approval of the disclosure statement, the debtor may solicit votes on its plan and thereafter seek confirmation of the plan. To be confirmed, the plan must satisfy certain statutory requirements found in section 1129 of the Bankruptcy Code, including the following: (i) the plan complies with the Bankruptcy Code; (ii) the plan has been proposed in good faith; (iii) the plan has been accepted by at least one class of impaired creditors (without taking into account plan acceptances of insiders), if any class of creditors is impaired; (iv) each class of creditors and interest holders has accepted the plan (or is deemed to have accepted by reason of nonimpairment), or the plan is "fair and equitable" with respect to each dissenting class; and (v) the plan is "feasible," in that confirmation is not likely to be followed by the debtor's liquidation or need for further financial reorganization (unless contemplated by the plan). Parties may object to confirmation of the plan if it fails to satisfy one of those requirements, and those objections generally are heard at the confirmation hearing.

In *American Capital Equipment*, the Third Circuit considered whether a bankruptcy court may resolve objections to confirmation of a plan at the hearing to consider approval of the disclosure statement, rather than at the confirmation hearing.

American Capital Equipment

Skinner Engine Company, founded in 1868, manufactured steamship engines and parts from the 1930s to the 1970s that allegedly contained asbestos. In 1998, American Capital Equipment, LLC (collectively with Skinner Engine Company, "Skinner"), acquired all of Skinner Engine Company's common stock. Both companies filed for chapter 11 protection in 2001 in Pennsylvania.

At that time, more than 29,000 asbestos claims were pending against Skinner. The asbestos cases were previously consolidated and, in 1996, were administratively dismissed by a maritime court without prejudice, as the claimants had not provided real medical or exposure history. These "asymptomatic cases" could be activated if the plaintiffs began to suffer impairment and could show evidence of asbestos-related injury as well as evidence of exposure to the defendants' products. After the dismissal, only a few dozen cases met the criteria for reinstatement, and none resulted in a judgment or settlement against Skinner.

Skinner maintained insurance to provide coverage for such claims. Litigation concerning the scope of the insurance coverage commenced in 2005. Under its policies, Skinner was obligated to cooperate in the defense of claims and obtain the insurers' consent to claim settlements. As will be seen, these policies were a factor in the Third Circuit's decision.

In June 2001, Skinner filed its first chapter 11 plan. Following various objections, Skinner amended that plan. However, creditors voted to reject Skinner's second chapter 11 plan. Thereafter, Skinner sold its assets and paid the proceeds (other than certain funds to cover processing of asbestos claims) to its secured lender.

Following the sale, Skinner filed yet another chapter 11 plan, its third. Under the plan, common stock of "Reorganized Skinner," insurance recoveries, and $35,000 in cash from Skinner's secured lender would fund a section 524(g) asbestos trust to provide for current and future asbestos claimants. Section 524(g) of the Bankruptcy Code establishes a procedure for dealing with future personal-injury asbestos claims against a chapter 11 debtor that 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.

As part of Skinner's third plan, asbestos claimants would need to show asbestos injuries and exposure to Skinner's products. Further, any cash from insurance actions and policies otherwise payable to asbestos claimants would be subject to a 10 percent "surcharge," which would be used to pay other creditors from a "Plan Payment Fund." Following bankruptcy-court approval of the disclosure statement in February 2005, Skinner's creditors voted to accept the plan.

A few months later, Skinner's insurers moved to dismiss its bankruptcy cases because Skinner allegedly was no longer proceeding in good faith. In denying that motion (a ruling that was affirmed on appeal by a district court and the Third Circuit), the bankruptcy court stated that it could not approve a section 524(g) trust because Skinner was not a going concern. Thereafter, Skinner filed a fourth chapter 11 plan, omitting the section 524(g) trust but providing for a 20 percent surcharge on insurance recoveries to pay nonasbestos creditors under the Plan Payment Fund and retaining a process for allowance of asbestos claims (including future claims). Although asbestos claimants could resort to tort litigation to seek recovery, claimants were enjoined under the plan from doing so until claims allowed in the bankruptcy cases were paid. After the bankruptcy court rejected the injunction and questioned the propriety of the surcharge, Skinner filed a fifth plan.

The fifth chapter 11 plan omitted the injunction but retained the surcharge on insurance proceeds payable to asbestos claimants who opted into the plan's settlement process. The surcharge would be used to pay creditors through the Plan Payment Fund and to fund a claims-resolution process for asbestos claimants called the "Court Approved Distribution Procedures" (the "CADP"). Specifically, the CADP provided that:

> Each Asbestos Claimant shall maintain full and complete ownership of his or her Asbestos Claim, including, without limitation, the right to prosecute or settle any Asbestos Claim, but upon the Asbestos Claimant submitting his or her claim to the CADP, he or she shall thereby have agreed to pay the Surcharge Cash from any amounts paid on account of the Asbestos Claim under and through the CADP.

The CADP provided a basis for the plan trustee to evaluate asbestos claims and would have implemented claims-allowance criteria similar to those in the third and fourth plans. Insurers disagreeing with the plan trustee's determination of a claim could elect to seek a bankruptcy-court "determination" of that issue. However, a court determination was limited; the court was required to accept the amount proposed by either the trustee or the insurance company, and any decision would be binding and nonappealable by the insurers. Further, the plan's success depended on the surcharge to pay creditors and fund the CADP.

The Lower-Court Rulings and Appeal

At the disclosure-statement hearing, the bankruptcy court ruled that the fifth plan was "facially unconfirmable" because it failed to satisfy: (a) section 1129(a)(3) of the Bankruptcy Code, in that it was not proposed in good faith and was forbidden by law; and (b) section 1129(a)(11), because it was not feasible. The bankruptcy court also converted the cases to chapter 7, on the basis of its finding that Skinner would not be able to propose a confirmable plan. On appeal, the district court affirmed, and an appeal to the Third Circuit followed.

The Third Circuit's Decision

A three-judge panel of the Third Circuit addressed three primary issues on appeal.

First, the Third Circuit rejected Skinner's argument that the bankruptcy court erred by finding the plan unconfirmable absent a confirmation hearing. Agreeing with other courts that have addressed this issue, the Third Circuit ruled that a bankruptcy court can (subject to addressing due-process concerns) resolve confirmation issues at the disclosure-statement stage if the plan is patently unconfirmable. According to the court, a plan is patently unconfirmable if it has defects that cannot be overcome by the voting results and that concern matters for which all material facts are undisputed or have been developed at the disclosure-statement hearing.

Second, the Third Circuit agreed that the plan was not feasible and had not been proposed in good faith. As to feasibility, the court explained, a plan—including a liquidation plan—can be confirmed only if it is not likely to be followed by liquidation or further financial reorganization of the debtor or a successor under the plan, unless the liquidation or reorganization is proposed in the plan. Success need not be guaranteed; however, the plan must be reasonably likely to succeed. Thus, if the plan's success turns on uncertain and speculative litigation, it is not feasible, because success is only possible, not reasonably likely.

According to the Third Circuit, Skinner's plan was not feasible (i.e., it was not likely to succeed) because its sole source of funding was a surcharge on what the court characterized as "wholly speculative litigation proceeds." Not only did the plan depend on a sufficient number of claimants opting into the CADP rather than the court system, but even in that case, it could succeed only if enough claimants prevailed and contributed sufficient surcharge funds. Most of the claims, however, had been administratively dismissed and had so far been overwhelmingly unsuccessful. Because Skinner admitted that no plan would work absent a surcharge, the feasibility issue could not be cured. As there were no remaining disputed material facts, the Third Circuit concluded that the plan was patently unconfirmable on the grounds of unfeasibility.

In addressing the good-faith issue, the Third Circuit noted that what constitutes good faith depends on the context (and as a result, the Third Circuit's previous good-faith ruling in connection with the motion to dismiss did not dictate the results of the good-faith determination in the confirmation context). For purposes of plan confirmation, the court explained, the focus of the inquiry is the plan itself and whether the plan will achieve a result consistent with the objectives of the Bankruptcy Code. A debtor can pursue a valid bankruptcy goal (such as maximizing assets, thereby proceeding in good faith for purposes of determining whether the debtor's case should be dismissed), yet still propose a plan that is inconsistent with the Bankruptcy Code (and thus have a plan that has not been proposed in good faith).

The Third Circuit concluded that the plan was not proposed in good faith. The plan, the court explained, contained an inherent conflict of interest. On the one hand, Skinner could pay its creditors under the plan only if asbestos claimants obtained settlements and paid the surcharge. On the other hand, Skinner was obligated to cooperate in defending against the asbestos claims (thereby minimizing the amount of allowed claims as well as the surcharge). The Third Circuit agreed with the bankruptcy court's conclusion that the plan established a system under which Skinner would be "financially incentivized to sabotage its own defense."

At the same time, the Third Circuit emphasized, the claims process limited or eliminated the insurers' rights, including the right to take discovery and to appeal, without the protections of section 524(g). Finally, the plan trust was inconsistent with the asbestos-trust provisions of section 524(g). Under section 524(g), the court explained, a debtor is to fund the trust (at least partially) with its securities, and the trust, in turn, pays the asbestos claimants. Under Skinner's plan, however, the opposite would occur: contributions from participating asbestos claimants would be made to a fund that would be used to pay attorneys and other creditors.

While the Third Circuit did not rule that such provisions were per se impermissible, it found good faith lacking where: (i) Skinner's bankruptcy, which was due to cash-flow problems, was unrelated to the asbestos litigation, which involved mostly "asymptomatic" cases; (ii) the CADP, rather than being funded by the debtor (or its profits) to pay asbestos claimants, was funded by the asbestos claimants to pay creditors and attorneys; and (iii) the surcharge created an inherent conflict of interest, while the claims process deprived the insurers of their rights.

Finally, the Third Circuit affirmed the order converting Skinner's chapter 11 cases to chapter 7 liquidations.

Case Implications

By agreeing with those courts that have enabled parties to prevail on confirmation objections at the disclosure-statement stage, the Third Circuit has confirmed in *American Capital Equipment* that bankruptcy courts can avoid the expense and delay of pursuing confirmation of a plan that is destined to fail.