Second Circuit Invalidates Chapter 11 Plan Releases of Non-Debtors

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A provision in a chapter 11 plan releasing or enjoining litigation against non-debtors who play a significant role in a reorganization case is an increasingly common feature of many large chapter 11 cases, especially if the case involves a company seeking to deal with mass tort liabilities. Nevertheless, whether and under what circumstances a bankruptcy court has the power to approve such releases or injunctions has been a magnet for controversy. So much so, that two courts of appeal have ruled that such provisions in a chapter 11 plan are categorically invalid, while other circuit and lower courts are divided on the issue. A ruling recently handed down by the Second Circuit Court of Appeals represents the latest word on the controversy at the appellate level. In *In re Metromedia Fiber Network, Inc.*, the court held that a chapter 11 plan impermissibly released certain non-debtors where there was no indication that the release was important or even necessary to implementation of the plan.

Effect of Plan Confirmation on Third Party Obligations

With certain exceptions, the provisions of a confirmed chapter 11 plan of reorganization are binding upon all creditors, whether or not they vote to accept the plan. In addition, confirmation of a plan acts to discharge the debtor from any debt that arose prior to the confirmation date, even if a creditor failed to file a proof of claim evidencing its debt or voted to reject the plan. Although the Bankruptcy Code precludes actions against the reorganized debtor or its property to collect on pre-bankruptcy debts, the same cannot be said with respect to litigation against non-debtor third parties who share liability for the same debts. Thus, section 524(e) of the Bankruptcy Code provides that "the discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."

The Bankruptcy Code explicitly authorizes non-debtor releases only in cases involving companies with asbestos-related liabilities. Section 524(g) was added to the Bankruptcy Code in 1994. It establishes a procedure for dealing with future personal injury asbestos claims against a chapter 11 debtor. The 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. Section 524(g) was enacted in response to lawmakers' concerns that future claimants — *i.e.*, persons who have been exposed to asbestos but have not yet manifested any signs of illness — are protected and recognizes that these claimants would be ill-served if asbestos companies are forced into liquidation. 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.

Nevertheless, under certain circumstances, bankruptcy courts have approved chapter 11 plans that release or enjoin litigation against non-debtors in non-asbestos cases. Examples include situations where the estate receives substantial consideration in exchange for the release or injunction, where the enjoined claims are "channeled" to a settlement fund rather than extinguished or where the enjoined or released claims would indirectly impact the debtor's reorganization by way of indemnity or contribution and the plan otherwise provides for full payment of the claims. Non-debtor releases also have been approved if the affected creditors consent.

The Courts of Appeals for the Ninth and Tenth Circuits have held that non-debtor releases and injunctions are impermissible (outside the scope of section 524(g)). The Fourth and Second Circuits (prior to the decision discussed below) have approved releases and injunctions benefiting non-debtors in the context of global settlements of massive liabilities of debtors and co-liable non-debtors that provided for compensation to claimants in exchange for releases that made the reorganizations feasible. The D.C. Circuit ruled that a plan provision releasing non-debtors was unfair because the plan did not provide additional compensation to a creditor whose claim against a non-debtor was being released. The Fifth Circuit reversed approval of a settlement that permanently enjoined a variety of claims because the injunction impermissibly discharged non-debtor liabilities, distinguishing other cases where the injunction channeled those claims to allow recovery from separate assets.

After it concluded that enjoining claims against a non-debtor consulting firm for contribution and indemnification was integral to a debtor's settlement with the firm, the Eleventh Circuit affirmed a district court ruling that a bankruptcy court has the power to enjoin non-settling defendants from asserting such claims. The Third Circuit, declining to decide whether or not non-debtor releases legitimately can be part of a chapter 11 plan, ruled that a plan releasing and permanently enjoining litigation against the non-debtor D&O defendants did not pass muster under even the most flexible tests for the validity of non-debtor releases. Other courts of appeal either have issued non-binding rulings on the subject or avoided addressing the issue on its merits.

The Sixth Circuit Court of Appeals picked up the gauntlet in 2002 when it ruled in *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)* that the issuance of an injunction preventing a non-consenting creditor from suing a non-debtor was within the powers conferred to bankruptcy courts under the Bankruptcy Code, but that this power can be wielded only under "unusual circumstances." The Court of Appeals adopted the following seven-part test to be applied in determining whether "unusual circumstances" justify enjoining non-consenting creditors under a plan of reorganization:

- there is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the debtor's estate;
- the non-debtor has contributed substantial assets to the reorganization;
- the injunction is essential to reorganization — namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;
- the affected class or classes have voted overwhelmingly to accept the plan;
- the plan provides a mechanism to pay for all, or substantially all, of the claims in the class or classes affected by the injunction;
- the plan provides an opportunity for those claimants who choose not to settle to recover in full; and
- the bankruptcy court made a record of specific factual findings that support its conclusions.

Applying this test to the facts before it, the Sixth Circuit found that the record produced by the bankruptcy court was inadequate to support a conclusion that "unusual circumstances" existed. It faulted both the bankruptcy court's ambiguous factual determination that the release and injunction provisions were essential to the reorganization and the absence of detailed factual findings that contributions to be made by Dow's insurers and affiliates were substantial. Finally, the court took exception to the absence of any finding by the bankruptcy court that each claimant who chose not to settle had an opportunity to recover in full by pursuing litigation against the non-debtor insurers and shareholders.

The Second Circuit Revisits the Issue in *Metromedia*

The Second Circuit is the latest court of appeals to rule on the propriety of non-debtor releases. The chapter 11 plan proposed by Metromedia Fiber Network, Inc. and its subsidiaries contained three separate release provisions. The first released all claims against a trust settled by certain Metromedia insiders in exchange for, among other things, forgiveness of approximately $150 million in unsecured claims, conversion of $15.7 million in senior secured claims to equity, and investment in the reorganized company of up to $37 million. The release covered "any and all claims, obligations, rights, causes of action and liabilities arising out of or in connection with any matter related to [Metromedia] or one or more subsidiaries based in whole or in part upon any act or omission or transaction taking place on or before the [effective date of the plan]." The plan also barred claims against former or current Metromedia personnel related to the bankruptcy case and based upon acts or omissions that occurred on or before the plans effective date, unless based upon "gross negligence or willful misconduct." Finally, the plan released former or current Metromedia personnel from any claim relating to Metromedia, the reorganized companies or the plan.

Several creditors objected to the plan, claiming, among other things, that non-debtor releases are not authorized by the Bankruptcy Code. The bankruptcy court overruled these objections and confirmed Metromedia's chapter 11 plan on August 21, 2003. The district court affirmed that determination on March 18, 2004, but not before Metromedia's plan became effective on September 8, 2003. At no time did the creditors seek a stay of the order confirming the chapter 11 plan.

The creditors appealed the lower courts' decisions to the Second Circuit. Emphasizing that a non-debtor release "is proper only in rare cases," the court noted that "[a]t least two considerations justify the reluctance to approve" such a release. First, the Second Circuit explained that the only explicit authority in the Bankruptcy Code for such releases is section 524(g). Acknowledging that section 105(a) contains broad equitable authority for a bankruptcy court to issue orders necessary to carry out the provisions of the Bankruptcy Code, the court rejected the provision as a source of authority for non-debtor releases because section 105(a) does not allow the bankruptcy court "to create substantive rights that are otherwise unavailable under" other provisions of the statute. Second, the Court of Appeals observed that "a non debtor release is a device that lends itself to abuse." According to the Second Circuit, "[i]n form, it is a release; in effect, it may operate as a bankruptcy discharge arranged without a filing and without the safeguards of the Code." It characterized the potential for abuse as "heightened" in cases, such as the one before it, where the release affords blanket immunity from a wide universe of claims.

The Second Circuit distinguished Metromedia's case from other cases in which courts have approved non-debtor releases. "No case," the Court of Appeals remarked, "has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique." The record in *Metromedia*, the Second Circuit emphasized, was devoid of any evidence that the releases were necessary or even important to implementation of Metromedia's chapter 11 plan. According to the Second Circuit, "[a] nondebtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to success of the plan," focusing on the considerations that typically inform a court's reluctance to authorize such releases except in a narrow range of circumstances

Moreover, the Court of Appeals rejected Metromedia's contention that because the creditors received a distribution under the plan, they were compensated for releasing the trust and Metromedia personnel from liability. "[A] nondebtor release is not adequately supported by consideration," the Second Circuit concluded, "simply because the nondebtor contributed something to the reorganization and the enjoined creditor took something out."

The creditors' victory on the release issue was short-lived. Because they failed to obtain a stay pending their appeal of the order confirming Metromedia's chapter 11 plan, the plan had been substantially consummated by the time the Second Circuit issued its ruling. As such, the Court of Appeals ruled that the appeal was moot and affirmed the decision below on this basis.

Outlook

The rulings in *Dow Corning* and *Metromedia* can be regarded as a primer on the usage of releases or injunctions for the benefit of non-debtors in a bankruptcy case. In situations where section 524(g) does not apply (*i.e.,* non-asbestos cases), most courts — if they do not categorically consider the practice illegitimate — will carefully scrutinize the circumstances under which a non-debtor is receiving the benefit of a release or injunction to ascertain whether the circumstances are unusual enough to warrant extraordinary relief. To a considerable degree, the ruling in *Metromedia* appears to be driven by the debtors' failure to develop an adequate evidentiary record more than any substantive failure on the merits. The outcome might have been otherwise if the debtors had introduced evidence demonstrating that the non-debtor releases were a necessary or even indispensable prerequisite to implementation of their chapter 11 plan.

Both decisions reinforce the important principles underlying chapter 11 of the Bankruptcy Code, particularly in large cases involving mass tort liabilities. A great many chapter 11 plans are the product of extensive negotiations resulting in a carefully crafted settlement of complex debtor-creditor, intercreditor and shareholder issues. This is especially so in mass tort cases involving tens of thousands of existing creditors, as well as an untold number of future creditors whose injuries have not even manifested themselves at the time of the chapter 11 case.

Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.), 416 F.3d 136 (2d Cir. 2005).

Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996).

Landsing Diversified Props. II v. First Nat'l Bank & Trust Co. (In re Western Real Estate Fund, Inc.), 922 F.2d 592 (10th Cir. 1990), *modified sub nom. Abel v. West*, 932 F.2d 898 (10th Cir. 1991).

Securities & Exchange Commission v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 960 F.2d 285 (2d Cir. 1992).

Menard-Sanford v. Mabey (In re A.H. Robins Co.), 880 F.2d 694 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989).

In re AOV Indus., Inc., 792 F.2d 1140 (D.C. Cir. 1986).

Feld v. Zale Corp. (In re Zale Corp.), 62 F.3d 746 (5th Cir. 1995).

In re Munford, 97 F.3d 449 (11th Cir. 1996).

In re Specialty Equipment Cos., 3 F.3d 1043 (7th Cir. 1993).

Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973 (1st Cir. 1995).

In re Continental Airlines, 203 F.3d 203 (3d Cir. 2000).

Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2002).