Release of Chapter 11 Plan Proponent Overbroad and Impermissible

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Chapter 11 plans in complex restructurings routinely contain provisions either releasing, or enjoining litigation against, various stakeholders involved in the case, particularly where the plan contemplates an infusion of cash from an existing creditor or insurance company to fund distributions, or is predicated in part on the settlement of a major dispute between the debtor and a significant creditor or shareholder. The validity of such releases or injunctions, however, has often been disputed in the courts. Two areas that continue to be a magnet for controversy concern: (i) a provision in a chapter 11 plan purporting to enjoin actions against or release entities other than the debtor; and (ii) the scope of the release or injunction. Both of these were the subject of a ruling recently handed down by the First Circuit bankruptcy appellate panel. In *Whispering Pines Estates, Inc. v. Flash Island, Inc. (In re Whispering Pines Estates, Inc.)*, the court reversed an order confirming a creditor-proposed chapter 11 plan, ruling that a release provision in the plan that insulated the plan proponent from a breach of its obligations to implement the plan was overbroad.

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, 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 have also been approved if the affected creditors consent. In addition, releases have been approved as part of a settlement between the debtor and various stakeholders, without which the debtor could not achieve confirmation of a chapter 11 plan.

Inconsistency Among the Circuit Courts of Appeal

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 Second and Fourth Circuits 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 defendants (officers and directors) did not pass muster under even the most flexible tests for the validity of non-debtor releases.

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 is within the powers conferred to bankruptcy courts under the Bankruptcy Code, but that this power can be wielded only under "unusual circumstances." The court adopted a seven-part, conjunctive test to be applied in determining whether such circumstances exist:

- 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.

Finally, in one of the latest pronouncements on the issue at the circuit level, the Second Circuit ruled in *Deutsche Bank AG v. Metromedia Fiber Network, Inc.* (*In re Metromedia Fiber Network,*

Inc.) that release provisions in a plan were invalid, in the absence of any showing that they were necessary or even important to the plan's confirmation, because the releases purported to exonerate the debtor's personnel as well as a trust settled by various insiders to infuse capital into the reorganized debtor from a wide range of liabilities. Remarking that "a non debtor release is a device that lends itself to abuse," the court 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. Other courts of appeal have either issued non-binding rulings on the subject or avoided addressing the issue on its merits.

The chapter 11 plan in *Whispering Pines* also contained a provision releasing a non-debtor. The reason that the appellate panel found it objectionable, however, had more to do with the scope of conduct covered by the release than the identity of the parties released.

Whispering Pines

Whispering Pines Estates, Inc. operates an assisted-living facility in New Hampshire. Its most valuable asset — the real property housing the facility — is encumbered by first and second mortgages held by Flash Island, Inc. securing loans in the amounts of, respectively, $489,000 and $920,000. Facing imminent foreclosure on Flash Island's first mortgage, Whispering Pines filed for chapter 11 protection in 2005 in New Hampshire. Flash Island acquired the second mortgage debt shortly afterward.

Whispering Pines' estate included potential causes of action against Flash Island, whose second mortgage was allegedly avoidable as a fraudulent transfer because the proceeds of the loan were paid to an affiliate of the debtor. In an order authorizing the debtor's consensual use of Flash

Island's cash collateral, the bankruptcy court established a deadline to object to Flash Island's secured claims or liens. No objections were ever filed.

After exclusivity expired without any plan proffered by Whispering Pines, Flash Island filed a liquidating chapter 11 plan. Under the proposed plan, a plan trustee would be appointed to manage the debtor's business for 60 days, during which time the trustee would market and attempt to sell the property for no less than $1.7 million, relying on funds provided by Flash Island for a marketing budget. In the event that the trustee could not close on any sale during that period, the plan provided that Flash Island would be free to sell the property at foreclosure, without further order of the court. Other plan provisions included a carve-out from Flash Island's collateral to pay administrative claims, professional fees and non-priority unsecured claims (each capped at a specified amount). The plan also contained the following release of the plan proponent:

> In consideration of (1) the Carve-out, without which no Dividends could be paid to the Unsecured Creditors holding Allowed Claims, (2) the Marketing Budget and (3) the implementation of the Plan (the "Proponent Release Consideration"), the Trustee for himself and on behalf of the Debtor and the Estate (the "Releasing Trustee Parties") shall execute and deliver to the Proponent on the Effective Date a General Release discharging, releasing and relinquishing all Claims and Causes of Action which any Releasing Trustee Party has or might have against the Proponent or its participants and any of their equity holders, directors, managers, officers, employees, accountants, attorneys, consultants, and other agents (the "Released Proponent Parties").

Whispering Pines objected to the plan, contending, among other things, that the plan's release provisions violate section 1129(a)(1) of the Bankruptcy Code, which requires, as a condition to confirmation, that a plan comply with all applicable provisions of the statute, and the requirement in section 1129(a)(3) that a chapter 11 plan be proposed in good faith and not by any

means forbidden by law. After conducting a confirmation hearing during which no evidence on this or any other contested issue was offered or received, the bankruptcy court confirmed Flash Island's plan.

The Appellate Panel's Ruling

The bankruptcy appellate reversed the confirmation order on appeal. In articulating the reasons for its ruling, the court explained that the release provision in Flash Island's plan was really "two distinct releases rolled into one": a settlement or adjustment of claims belonging to the estate; and a release or limitation of liability of the party responsible for implementing the plan. Both releases were objectionable, the court concluded, but for different reasons.

Observing that "the standard governing approval of [a release of estate claims] in a plan of reorganization has not been established in this circuit," the court concluded that it need not decide what standard should apply, given the absence of any evidentiary findings below on any issue regarding the propriety of the release. It accordingly ruled that, if the order were not reversible on other grounds, the court would vacate the confirmation order and remand the case below to remedy this error.

Ultimately, however, the court reversed the confirmation order because the release purported to absolve the plan proponent of all liability. "As a grant of immunity to a party responsible for implementing the plan," the court explained, "the release is overbroad and impermissible." According to the court, the release would insulate Flash Island from suit by Whispering Pines or the plan trustee for breach of the terms of the plan and for negligence or malfeasance in its implementation. Moreover, the court emphasized, "the release being categorical, even gross

negligence and willful misconduct would be inactionable." A provision of this kind, the court ruled, "renders a plan unenforceable."

Analysis

Whispering Pines differs from many cases involving the propriety of releases in a chapter 11 plan in two respects: (i) most rulings on the issue involve releases or injunctions that operate to prevent creditors and other third parties from suing the non-debtor recipient of the release; and (ii) relatively few cases involve releases of a plan proponent. Even so, the decision is consistent with the approach taken by the handful of other courts that have considered whether a plan can permissibly release the party implementing it from liability.

For example, a bankruptcy court ruled in *In re Hoffinger Indus., Inc.*, that a plan provision purporting to insulate the reorganized debtor from liability for simple breach of the plan was unconscionable because "a confirmed plan should be enforceable and amenable to damages between contractually bound parties." Likewise, the bankruptcy court in *In re WCI Cable, Inc.*, held that a provision in a plan exculpating the debtor's officers, directors, employees and agents (including professionals) from liability for post-petition acts, except for willful misconduct or gross negligence, precluded confirmation of the plan unless it were amended to include acts of negligence and fiduciary infractions.

Whispering Pines, Inc. v. Flash Island, Inc. (In re Whispering Pines, Inc.), 370 B.R. 452 (Bankr. 1st Cir. 2007).

Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394 (9th Cir. 1995).

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).

Menard-Sanford v. Mabey (In re A.H. Robins Co.), 880 F.2d 694 (4th Cir. 1989)

SEC v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 960 F.2d 285 (2d Cir. 1992).

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

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

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

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

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

In re Hoffinger Indus., Inc., 321 B.R. 498 (Bankr. E.D. Ark. 2005).

In re WCI Cable, Inc., 282 B.R. 457 (Bankr. D. Or. 2002