

In re Washington Mutual, Inc. : Delaware Bankruptcy
Court Limits Debtors' Release of Third Parties

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In a recent decision, Judge Mary F. Walrath of the United States Bankruptcy Court for the District of Delaware greatly limited debtors' ability to release parties under a chapter 11 plan in the bankruptcy cases of Washington Mutual, Inc. ("WMI"), and its debtor affiliates (together with WMI, the "Debtors"). In *In re Washington Mutual, Inc.*, Judge Walrath approved a global settlement agreement (the "Global Settlement") reached by the Federal Deposit Insurance Corporation ("FDIC") as receiver for Washington Mutual Bank ("WaMu Bank"); JPMorgan Chase Bank, N.A. ("JPMC"), as purchaser of the WaMu Bank assets in the fourth quarter of 2008; WMI; and certain other parties. The Global Settlement resolved litigation stemming from the failure of WaMu Bank in 2008 and the subsequent purchase of WaMu Bank's assets by JPMC and was the basis for the Debtors' Sixth Amended Joint Plan of Reorganization (the "Plan"). Despite finding that the Global Settlement was fair and reasonable, Judge Walrath denied confirmation of the Plan because she found the releases granted by the Debtors to certain parties under the Plan to be excessively broad and impermissible under applicable law.

Background

On September 25, 2008, WaMu Bank's primary regulator, the Office of Thrift Supervision, seized WaMu Bank and appointed the FDIC receiver. The same day, the FDIC sold substantially all of WaMu Bank's assets to JPMC through a Purchase & Assumption Agreement (the "Purchase Agreement") under which JPMC obtained substantially all the assets of WaMu Bank

for \$1.88 billion in cash consideration and assumed more than \$145 billion in deposit and other liabilities. The FDIC retained claims that WaMu Bank held against other third parties. On September 26, 2008 (the “Petition Date”), WaMu Bank’s previous holding company owner WMI and certain of its affiliates filed for relief under chapter 11 of the Bankruptcy Code. Almost immediately thereafter, disputes arose among the Debtors, JPMC, and the FDIC regarding ownership of certain assets.

In the months following the sale of WaMu Bank and the Petition Date, each of the FDIC, JPMC, the Debtors, and various other noteholders and creditors initiated several adversary proceedings and declaratory-judgment actions related to either the failure of WaMu Bank or the Purchase Agreement. The Debtors brought an action in the U.S. District Court for the District of Columbia against the FDIC alleging the taking and conversion of the Debtors’ property and the wrongful denial of proofs of claim filed with the FDIC in the WaMu Bank receivership. JPMC and certain noteholders subsequently intervened in the litigation. JPMC brought an adversary proceeding against the Debtors seeking a declaratory judgment that JPMC owned certain of the WaMu Bank’s assets, including deposit accounts, tax refunds, and certain securities. The Debtors commenced a turnover action against JPMC seeking turnover of certain of WaMu Bank’s deposit accounts and undertook an investigation under Rule 2004 of the Federal Rules of Bankruptcy Procedure into whether any viable business tort claims existed against JPMC. Lastly, two groups of unsecured noteholders of the Debtors initiated adversary proceedings against both the Debtors and JPMC, seeking a declaratory judgment that the noteholders owned certain securities and were entitled to the proceeds of certain litigation. In July 2010, the Delaware bankruptcy court appointed an examiner to review the claims asserted by the parties to help

resolve many of the issues. The examiner submitted his report on November 1, 2010, and the parties thereafter negotiated and finalized the Global Settlement.

Approval of the Global Settlement

The Global Settlement, which the Debtors intended to implement through the Plan, provides approximately \$6.1 to \$6.8 billion in funds to the Debtors' estates for distribution to creditors. Further, the Global Settlement and the Plan contain mutual releases by the Debtors, the FDIC, JPMC, and certain other parties, as well as injunctions against future claims.

Judge Walrath first analyzed the reasonableness of the Global Settlement and found that, on balance, with respect to much of the litigation resolved by the Global Settlement, the Debtors and other parties thereto may not have been able to fare better if they continued to litigate the various claims. Thus, with respect to the various claims and litigated matters, Judge Walrath approved the Global Settlement without alteration or exception, finding it to be reasonable in light of the possible results of the pending litigation; difficulties in collection; complexity; expense and delay associated with continued litigation; and the best interests of creditors.

Denial of Plan Confirmation and Rejection of Mutual Releases

Under the Plan and the Global Settlement, the Debtors released JPMC, the FDIC, and WaMu Bank from claims held by the Debtors against those parties. The Debtors also released and waived claims against other parties to the Global Settlement and "Related Persons," including current and former officers and directors of the Debtors.

In reviewing and evaluating the releases granted by the Debtors under the Plan, Judge Walrath considered a multifactor test set forth in a Missouri bankruptcy court's 1994 ruling in *In re Master Mortgage Invest. Fund, Inc.*, which Judge Walrath had applied in her 1999 ruling in *In re Zenith Electronics Corp.* Under the *Master Mortgage* and *Zenith* test, Judge Walrath approved the Debtors' releases of the FDIC, JPMC, and WaMu Bank but disapproved the releases of claims against other third parties.

In *Master Mortgage*, the court outlined the following five factors that bankruptcy courts should consider when evaluating the release of claims against a nondebtor third party without the consent or agreement of the party deemed to be bound by such release:

- (1) An identity of interest between the debtor and the third party, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate;
- (2) Substantial contribution by the nondebtor of assets to the reorganization;
- (3) The essential nature of the injunction to the reorganization to the extent that, without the injunction, there is little likelihood of success;
- (4) An agreement by a substantial majority of creditors to support the injunction, specifically if the impacted class or classes "overwhelmingly" vote to accept the plan; and
- (5) Provision in the plan for payment of all or substantially all of the claims of the class or classes affected by the injunction.

Ultimately, the court in *Master Mortgage* held that a release of, and injunction against, claims a creditor held against the debtors' nondebtor affiliate and plan supporter were appropriate.

In *Zenith*, Judge Walrath applied the multifactor *Master Mortgage* test to releases granted by debtors to third parties, finding that the debtors' releases of third parties in that case satisfied the *Master Mortgage* test. With respect to third-party releases, however, the court found that a

release of claims held by a third party against another third party was not appropriate under the plan without the affirmative agreement or consent of the creditor whose claim would be enjoined.

In *Washington Mutual*, Judge Walrath applied the *Master Mortgage* test to all releases granted by the Debtors. She found reasonable and approved the Debtors' releases of Plan supporters JPMC, the FDIC, and WaMu Bank. However, Judge Walrath concluded that the releases granted by the Debtors to settling noteholders, the official committee of unsecured creditors and its members, certain indenture trustees, and the liquidating trust and trustee under the Plan were not reasonable because, among other things, none of the parties contributed significantly to the reorganization; there was no identity of interest between the Debtors and such parties; and, in the case of the creditors' committee, its members did nothing more than fulfill their fiduciary duties and were otherwise covered by the Plan's exculpation provisions.

Impact of Washington Mutual

While some circuits prohibit or significantly limit releases of claims held by a nondebtor third party against another nondebtor third party, a full release of claims held by a debtor against a nondebtor party is frequently approved in exchange for the nondebtor's support of the chapter 11 plan. Ordinarily, a nondebtor party will contribute to or otherwise support the debtor's plan and emergence from bankruptcy if the debtor grants it a full release from claims held by the debtor.

Similarly, it is customary for a debtor to release the official committee of unsecured creditors and its professionals in exchange for the committee's support for the debtor's plan and as part of the overall settlement set forth in the chapter 11 plan. For all such releases, a debtor must establish its determination in the exercise of its business judgment whether releasing claims under the

chapter 11 plan will provide a greater benefit to the debtor's estate than the debtor would receive if it were to pursue such claims.

In *Washington Mutual*, the court applied the *Master Mortgage* test to releases granted by debtors to creditors who otherwise support a chapter 11 plan. As noted above, the *Master Mortgage* test originally was used to determine whether to approve plan provisions that release claims held by a creditor against a nondebtor without that creditor's consent. Thus, *Washington Mutual* expands the application of the *Master Mortgage* five-factor test to a *debtor's* decision to release certain parties under a plan.

Judge Walrath correctly stated that the Third Circuit has not articulated a test to determine whether releases by debtors are appropriate. As such, she indicated that she "continues to believe that the factors articulated in *Master Mortgage* form the foundation for such an analysis, with due consideration of other factors that may be relevant to [the] case." Other bankruptcy courts, however, both in Delaware and elsewhere, have permitted debtors to release claims belonging to the debtor's estate if the release can be demonstrated to represent a valid exercise of the debtor's business judgment, is fair and reasonable, and is in the best interest of the debtor and its estate. By contrast, application of the *Master Mortgage* test to all releases granted by debtors would suggest substantially stricter scrutiny of such releases in the context of the chapter 11 plan.

Epilogue

On February 8, 2011, the Debtors submitted a modified Sixth Amended Joint Plan of Reorganization substantially modifying the releases and injunctions granted to third parties

contained therein to address the concerns of the bankruptcy court. The Debtors also moved for approval of a revised disclosure statement and for an order setting a new confirmation hearing for May 2, 2011, following a resolicitation of votes. Judge Walrath granted the motions on March 22, 2011, directing, however, that the Debtors explain in their revised disclosure statement what effect suspicions of insider trading could have on the \$7 billion to be distributed under the modified Plan.

In re Washington Mutual, Inc., 2011 WL 57111 (Bankr. D. Del. Jan. 7, 2011).

In re Master Mortgage Invest. Fund, Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994).

In re Zenith Electronics Corp., 241 B.R. 92 (Bankr. D. Del. 1999).

In re Aleris Intern., Inc., 2010 WL 3492664 (Bankr. D. Del. May 13, 2010).

In re Spansion, Inc., 426 B.R. 114 (Bankr. D. Del. 2010).

In re DBSD N. Am., Inc., 419 B.R. 179 (Bankr. S.D.N.Y. 2009).

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