5 Bus. & Com. Litig. Fed. Cts. § 51:18 (3d ed.)

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Chapter 51. Bankruptcy Code Impact on Civil Litigation in the Federal Courts
by the Honorable Brian M. Cogan, [*] Lewis Kruger, and Kenneth Pasquale [**]
II. The Bankruptcy Code
C. Scope of the Automatic Stay

§ 51:18. Post-Confirmation Injunctions, Releases, and Exculpation Provisions

If you find yourself representing a plaintiff in a federal or state court action and the defendant files for bankruptcy, the terms of the reorganization plan by which the debtor ultimately emerges from Chapter 11 may bar you from proceeding with the claim. In addition to injunction provisions, reorganization plans and sometimes settlement agreements may contain exculpation and release provisions exempting from liability not only the debtor, but also certain nondebtors with some relationship to the debtor. The propriety of such releases and exculpation provisions has divided the Circuit Courts, although there are more circuits which permit third-party releases and exculpation than do not. Thus, practitioners should be wary of the effect nondebtor releases and exculpation provisions in Chapter 11 plans may have on litigation proceeding elsewhere.

For example, in the case of *In re Dreier LLP*, [1] a lawyer was criminally charged with selling fraudulent promissory notes in a Ponzi scheme. The lawyer allegedly deposited the proceeds of the notes into an attorney trust account, where he also deposited client funds, including escrowed settlement funds, all of which he used to maintain the Ponzi scheme. The prosecution sought forfeiture of the debtors' assets in a criminal proceeding pending in district court while, concurrently in the bankruptcy court, the bankruptcy trustee sought to recover the assets for the benefit of creditors. A global settlement, by way of three separate agreements, was ultimately reached of the outstanding bankruptcy and forfeiture issues between the government, the trustee, and others. [2] One creditor, a former client whose settlement funds were held in the attorney trust account, objected to a bar order in one settlement (the GSO Settlement), precluding claims to recover the funds, arguing that "as a Dreier LLP client, rather than a Dreier investor, [he] was 'uniquely situated' from the other Dreier creditors, as he fell outside the general category of Ponzi scheme victims" and he could trace some of the stolen funds. The creditor contended that the settlement bar order would improperly cut off his right to pursue recovery of the funds and that the funds were not property of the estate because they were stolen. [3] In light of the objection, the bankruptcy court refused to approve the GSO Settlement Agreement, without prejudice, but approved a modified settlement agreement that contained less restrictive third-party releases. [4] The district court affirmed. [5]

The crux of the debate within the circuit courts is the extent to which nondebtor third-party releases can be limited in scope or prohibited altogether under Section 524 of the Bankruptcy Code. Section 524(e) of the Bankruptcy Code provides that "[e]xcept as provided in subsection (a)(3) of this section, 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." [6] Courts in the Second Circuit, for example, will apply a two-prong test to scrutinize nondebtor releases and exculpation provisions: (1) whether "unusual circumstances" are present warranting approval of the provisions, and (2) whether the court has subject matter jurisdiction to approve the provisions. [7] The court must first make the subject matter jurisdictional determination. [8] Still, "[t]he inquiries may nevertheless overlap. A third party action that will directly and adversely impact the reorganization is more likely to present the 'unusual circumstances' required under Metromedia." [9] Furthermore, in the Second Circuit, "[t]he same jurisdictional principles apply to injunctions required by non-plan settlements." [10] An injunction may be beyond the bankruptcy court's

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jurisdiction to issue if it goes beyond barring derivative claims related to, for example, a party's status as a creditor or a party in interest in the bankruptcy case. [11]

The Fifth, Ninth and Tenth Circuits permit nondebtor releases only in the asbestos context under section 524(g), and for committee members for their work performed pursuant to section 1103(c) of the Code. [12]

Courts in the Sixth Circuit apply a seven factor test to determine the validity of any nondebtor releases and exculpation provisions in a reorganization plan: whether: "(1) 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 the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) 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; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions." [13]

Moreover, courts in both the Sixth and Seventh Circuits are reluctant to approve nondebtor releases in liquidating, as opposed to reorganizing, Chapter 11 plans. [14] Seventh Circuit courts may approve nondebtor releases and exculpation provisions in a reorganization plan if (1) the limitation was narrow (for example, it excludes "willful misconduct" and applied only to claims "arising out of or in connection with" the reorganization itself, and thus did not offer "blanket immunity"); (2) it "affect[s] matters beyond the jurisdiction of the bankruptcy court or unrelated to the reorganization itself" and (3) the third party/secured creditor has required the limitation prior to providing "requisite financing, which was itself essential to the reorganization," thereby implicating some of the Sixth Circuit factors. [15]

In the Third Circuit, courts have recognized that "[o]utside the context of § 524(g), § 524(e) provides statutory authority for limiting the extension of bankruptcy relief to nondebtors" and the Code does not specifically authorize nondebtor releases and permanent injunctions. [16] That said, a debtor defendant may succeed in obtaining third-party releases if the releases meet certain "very demanding" criteria, "correlate[ing] very closely with the criteria for allowing the bankruptcy stay to be extended to non-debtor parties ….." [17] An "identity of interest" alone between the debtor and those released is not sufficient to warrant nondebtor releases and exculpation provisions. [18] A debtor will face a similar test in the Eighth Circuit, though the courts may weigh the various factors differently. [19]

A more stringent test is applied in the Fourth Circuit, where courts permit nondebtor releases and exculpation only when (1) the Plan was "overwhelmingly approve[d]," (2) "in conjunction with insurance policies provided as a part of a plan of reorganization … a second chance for even late claimants to recover where, nevertheless, some have chosen not to take part in the settlement in order to retain rights to sue other parties" and (3) "where the entire reorganization hinge[d] on the debtor being free from indirect claims such as suits against parties who would have indemnity or contribution claims against the debtor." [20] The Fourth Circuit also highlights the importance of creditors receiving full recovery on their claims under any Plan containing third-party releases. [21]

The split in the courts concerning the scope of third-party releases in a plan of reorganization may be more bankruptcy law than commercial litigators wish to encounter.

But, if a plan proposes to impact your pending litigation through a proposed release, the time to object to that provision is prior to and as part of the proceedings in the Bankruptcy Court to confirm the plan of reorganization. Diligent monitoring of, and often active participation in, the debtor's bankruptcy case will be required to ensure that your litigation is not impacted by a third party release.

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Footnotes

* United States District Judge, Eastern District of New York.

** Mr. Kruger and Mr. Pasquale are partners of Stroock & Stroock & Lavan LLP. The assistance in the preparation of this update by Sophia Dai, Yee Hong and Darien Smith is greatly appreciated.

1 See, e.g., In re Dreier LLP, 2010 WL 3835179, at *1 (S.D. N.Y. 2010).

2 In re Dreier LLP, 2010 WL 3835179, at *2 (S.D. N.Y. 2010).

3 In re Dreier LLP, 2010 WL 3835179, at *3 (S.D. N.Y. 2010).

4 In re Dreier LLP, 2010 WL 3835179, at *3 (S.D. N.Y. 2010).

5 In re Dreier LLP, 2010 WL 3835179, at*5 (S.D. N.Y. 2010) ("Here, the Trustee agreed to settle with GSO, in part, because [the Chapter 11 Trustee]'s investigation found no evidence of bad faith by GSO …. [Objecting creditor] has not challenged the Trustee's conclusion … the stolen settlement funds were part of the Dreier LLP Bankruptcy estate.")

6 11 U.S.C.A § 524(e). Section 524(g), adopted in 1994, explicitly authorizes nondebtor release and exculpation provisions in asbestos-related bankruptcy cases in favor of affiliates, past owners, predecessors-in-interest, managers, officers, directors, employees of the debtor or "a related party," as well as (a) those involved in transition "changing the corporate structure" or transactions (including loans) affecting the financial condition of the debtor or "a related party" (for example, providing financing or advice related thereto), or (b) "acquiring or selling a financial interest in the entity as part of such a transaction." Such injunctive relief is permissible "notwithstanding the provisions of section 524(e)." 11 U.S.C.A § 524(g).

7 See In re Dreier LLP, 429 B.R. 112, 131-32 (Bankr. S.D. N.Y. 2010) (citation omitted); In re Metromedia Fiber Network, Inc., 416 F.3d 136, 143, 44 Bankr. Ct. Dec. (CRR) 276, 54 Collier Bankr. Cas. 2d (MB) 1033, Bankr. L. Rep. (CCH) P 80397 (2d Cir. 2005); In re Johns-Manville Corp., 517 F.3d 52, 65, 49 Bankr. Ct. Dec. (CRR) 144, Bankr. L. Rep. (CCH) P 81107 (2d Cir. 2008), rev'd and remanded, 129 S. Ct. 2195, 174 L. Ed. 2d 99, 51 Bankr. Ct. Dec. (CRR) 210, 61 Collier Bankr. Cas. 2d (MB) 1441, Bankr. L. Rep. (CCH) P 81505 (2009). In Manville, the injunctions at issue traced back to Manville's 1986 reorganization plan that, inter alia, attempted to resolve Manville's asbestos liabilities. In considering the effect of the injunction upon certain insurers, the court held that "a bankruptcy court only has jurisdiction to enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate" and, thus, "the district court lacked subject matter jurisdiction to enjoin claims against [one of the debtor's insurance company] that were predicated, as a matter of state law, on [the insurance company's] own alleged misconduct and were unrelated to [the debtor's] insurance policy proceeds and the *res* of the [debtor's] estate." In re Dreier LLP, 429 B.R. at 66. Notably, the 2008 Manville decision ultimately was heard by the U.S. Supreme Court, which remanded, finding that the 1986 orders were final and not subject to review. Travelers Indem. Co. v. Bailey, 129 S. Ct. 2195, 2205, 174 L. Ed. 2d 99, 51 Bankr. Ct. Dec. (CRR) 210, 61 Collier Bankr. Cas. 2d (MB) 1441, Bankr. L. Rep. (CCH) P 81505 (2009). On remand, the Second Circuit addressed another insurer's claims (which was not party to the 1986 orders) and held, inter alia, that "the bankruptcy court exceeded its jurisdiction in 1986" and therefore that the other insurer "[wa]s not bound by the terms of the 1986 Orders." In re Johns-Manville Corp., 600 F.3d 135, 149, Bankr. L. Rep. (CCH) P 81727 (2d Cir. 2010), cert. denied, 131 S. Ct. 644, 178 L. Ed. 2d 512 (2010).

8 In re Dreier LLP, 429 B.R. at 131-32 (citation omitted).

9 In re Dreier LLP, 429 B.R. at 132. In In re Metromedia Fiber Network, Inc., 416 F.3d 136, 143, 44 Bankr. Ct. Dec. (CRR) 276, 54 Collier Bankr. Cas. 2d (MB) 1033, Bankr. L. Rep. (CCH) P 80397 (2d Cir. 2005), the court determined that nondebtor releases were only appropriate in "rare cases," cautioning that "[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 discussed above …."

10 In re Dreier LLP, 429 B.R. at 132 (citing In re Mrs. Weinberg's Kosher Foods, Inc., 278 B.R. 358, 364-66, 39 Bankr. Ct. Dec. (CRR) 164 (Bankr. S.D. N.Y. 2002)).

11 In re Dreier LLP, 429 B.R. at 133.

12 See In re TCI 2 Holdings, LLC, 428 B.R. 117, 137-38 (Bankr. D. N.J. 2010) (collecting cases) (The Fifth, Ninth and Tenth Circuits hold that, "with the exception of sections 524(g) and 1103(c) [dealing with the powers of Committees, thereby 'impl[ying] committee members have qualified immunity for actions within the scope of their duties'], section 524(c) prohibits all non-debtor third party releases and permanent injunctions.") citing In re Pacific Lumber Co., 584 F.3d 229, 252, 52 Bankr. Ct. Dec. (CRR) 46, Bankr. L. Rep. (CCH) P 81642 (5th Cir. 2009) [see also id. at 253]; In re Lowenschuss, 67 F.3d 1394, 1401, 34 Collier Bankr. Cas. 2d (MB) 544, Bankr. L. Rep. (CCH) P 76673, 33 Fed. R. Serv. 3d 249 (9th Cir. 1995); In re Drier LLP, 429 B.R. at 130-131.

13 E.g., In re Dow Corning Corp., 280 F.3d 648, 39 Bankr. Ct. Dec. (CRR) 9, 47 Collier Bankr. Cas. 2d (MB) 1158, Bankr. L. Rep. (CCH) P 78582, 2002 FED App. 0043P (6th Cir. 2002) (rejected by, In re PTI Holding Corp., 346 B.R. 820 (Bankr. D. Nev. 2006)).

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14 In re SL Liquidating, Inc., 428 B.R. 799, 803 (Bankr. S.D. Ohio 2010) ("A close reading of the In re Dow Corning factors shows that the Sixth Circuit makes reference to the debtor's 'reorganization' not once but twice … a reorganized debtor, as opposed to a liquidating debtor, needs to be protected from suits that may deplete its assets so that it can, in fact, reorganize … To hold otherwise may be to encourage the filing of liquidating chapter 11 cases where the driving purpose is to obtain non-consensual third-party releases.") (citing In re Berwick Black Cattle Co., 394 B.R. 448, 461, 50 Bankr. Ct. Dec. (CRR) 241 (Bankr. C.D. Ill. 2008)); In re Berwick Black Cattle Co., 394 B.R. at 461 ("The rationale for granting third-party releases is far less compelling, if it exists at all, in a liquidation than a reorganization.").

15 In re Airadigm Communications, Inc., 519 F.3d 640, 655-657, 49 Bankr. Ct. Dec. (CRR) 179, Bankr. L. Rep. (CCH) P 81123 (7th Cir. 2008) ("Section 105(a) codifies this understanding of the bankruptcy court's powers by giving it the authority to effect any 'necessary or appropriate' order to carry out the provisions of the bankruptcy code. And a bankruptcy court is also able to exercise these broad equitable powers within the plans of reorganization themselves. Section 1123(b)(6) permits a court to 'include any other appropriate provision not inconsistent with the applicable provisions of this title.'") (citations omitted); Matter of Specialty Equipment Companies, Inc., 3 F.3d 1043, 29 Collier Bankr. Cas. 2d (MB) 1215, Bankr. L. Rep. (CCH) P 75398 (7th Cir. 1993).

16 In re Combustion Engineering, Inc., 391 F.3d 190, 233-34, n. 48, 43 Bankr. Ct. Dec. (CRR) 271, Bankr. L. Rep. (CCH) P 80206 (3d Cir. 2004), as amended, (Feb. 23, 2005) (citing 11 U.S.C.A. § 524(e)); In re Continental Airlines, 203 F.3d 203, 211, 35 Bankr. Ct. Dec. (CRR) 176 (3d Cir. 2000). Furthermore, the In re Combustion Engineering, Inc., court determined that in the Third Circuit, asbestos-related injunctions (and their attendant exculpation and release provisions) must satisfy 524(g): "we do not believe that § 105(a) can be employed to extend a channeling injunction to non-debtors in an asbestos case where the requirements of § 524(g) are not otherwise met." 391 F.3d at 233-34.

17 In re West Coast Video Enterprises, Inc., 174 B.R. 906, 911, 26 Bankr. Ct. Dec. (CRR) 417 (Bankr. E.D. Pa. 1994) (citations omitted); compare In re Market Square Inn, Inc., 163 B.R. 64, 66-67, 25 Bankr. Ct. Dec. (CRR) 255 (Bankr. W.D. Pa. 1994) (not permitting third-party injunction but implying that it might be possible in certain limited circumstances); In re Saxby's Coffee Worldwide, LLC, 436 B.R. 331, 336, 64 Collier Bankr. Cas. 2d (MB) 907 (Bankr. E.D. Pa. 2010), as amended, (Sept. 24, 2010) (third-party release not granted because it did not satisfy even "most flexible" test) citing In re South Canaan Cellular Investments, Inc., 427 B.R. 44, 72 (Bankr. E.D. Pa. 2010) ("[M]ost flexible" test assesses: "(1) whether the third party who will be protected by the injunction or release has made an important contribution to the reorganization; (2) whether the requested injunctive relief or release is "essential" to the confirmation of the plan; (3) whether a large majority of the creditors in the case have approved the plan; (4) whether there is a close connection between the case against the third party and the case against the debtor; and (5) whether the plan provides for payment of substantially all of the claims affected by the injunction or release."); In re Exide Technologies, 303 B.R. 48, 71-74, 42 Bankr. Ct. Dec. (CRR) 108 (Bankr. D. Del. 2003); In re Zenith Electronics Corp., 241 B.R. 92, 110, 35 Bankr. Ct. Dec. (CRR) 329, 43 Collier Bankr. Cas. 2d (MB) 206, 53 Fed. R. Evid. Serv. 523 (Bankr. D. Del. 1999).

18 In re Continental Airlines, 203 F.3d 203, 217, 35 Bankr. Ct. Dec. (CRR) 176 (3d Cir. 2000) ("We conclude that granting permanent injunctions to protect non-debtor parties on their head. Nothing in the Bankruptcy Code can be construed to establish such extraordinary protection for non-debtor parties.")

19 See, e.g., In re Master Mortg. Inv. Fund, Inc., 168 B.R. 930, 934-35, 31 Collier Bankr. Cas. 2d (MB) 240 (Bankr. W.D. Mo. 1994) (not considering whether (1) "the plan provides an opportunity for those claimants who choose not to settle to recover in full" and (2) "the bankruptcy court made a record of specific factual findings that support its conclusions" as the Sixth Circuit did in Dow Corning, and also weighing the various factors differently than the Sixth Circuit). See also In re Hoffinger Industries, Inc., 321 B.R. 498, 513-14, 44 Bankr. Ct. Dec. (CRR) 120 (Bankr. E.D. Ark. 2005) ("The courts appear to employ a balancing test in instances where they have concluded that § 524(e) is not restrictive and that it does permit, under certain circumstances, injunctions that extend to non-debtor third parties. There are five nonexclusive factors pertinent to this analysis: (1) There is an identity of interest 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 estate. (2) The non-debtor has contributed substantial assets to the reorganization. (3) The injunction is essential to reorganization. Without it, there is little likelihood of success. (4) A substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has 'overwhelmingly' voted to accept the proposed plan treatment. (5) The plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction"); compare In re SL Liquidating, Inc., 428 B.R. 799, 802 (Bankr. S.D. Ohio 2010) ("We note that In re Master Mortgage predates In re Dow Corning and is not binding on this Court [and thus the overwhelming acceptance of the plan is not the most important factor to consider]."); In re TCI 2 Holdings, LLC, 428 B.R. 117, 137-38 (Bankr. D. N.J. 2010) (collecting cases) ("The Second, Fourth and Sixth Circuits permit non-debtor releases in unique or 'truly unusual' cases, considering, among other things, whether creditors

received consideration in exchange for the non-debtor releases.") citing In re Metromedia Fiber Network, Inc., 416 F.3d 136, 143, 44 Bankr. Ct. Dec. (CRR) 276, 54 Collier Bankr. Cas. 2d (MB) 1033, Bankr. L. Rep. (CCH) P 80397 (2d Cir. 2005); In re A.H. Robins Co., Inc., 880 F.2d 694, 702, 19 Bankr. Ct. Dec. (CRR) 997, Bankr. L. Rep. (CCH) P 72955 (4th Cir. 1989) (noting that affected creditors would receive 100 cents on the dollar under the Plan).

20 In re A.H. Robins Co., 880 F.2d at 702. Still, the Fourth Circuit in A.H. Robbins cited to the Fifth Circuit's decision in Republic Supply Co. v. Shoaf, 815 F.2d 1046, 1050, 16 Collier Bankr. Cas. 2d (MB) 1305, Bankr. L. Rep. (CCH) P 71802 (5th Cir. 1987), in which the Fifth Circuit determined: "[a]lthough section 524 has generally been interpreted to preclude release of guarantors by a bankruptcy court, the statute does not by its specific words preclude the discharge of a guaranty when it has been accepted and confirmed as an integral part of reorganization" which is not necessarily in line with its later decision in In re Pacific Lumber Co., 584 F.3d 229, 252, 52 Bankr. Ct. Dec. (CRR) 46, Bankr. L. Rep. (CCH) P 81642 (5th Cir. 2009), citing n. 3, supra, in which it prohibited nondebtor releases except with respect to committees and under 524(g). Shoaf was distinguished by the Pacific Lumber Co. court on the ground that it "concern[ed] the res judicata effect of non-debtor releases, not their legality." In re Pacific Lumber Co., 584 F.3d at n. 27.

21 In re A.H. Robins Co., 880 F.2d at 702 ("The First, Eleventh, and D.C. Circuits do not address directly the issue of whether a bankruptcy court has the authority to permit third-party nondebtor releases or permanent injunctions in a reorganization plan under Chapter 11. However, these courts specifically align themselves with the pro-release courts.") citing Matter of Munford, Inc., 97 F.3d 449, 29 Bankr. Ct. Dec. (CRR) 1087, 36 Collier Bankr. Cas. 2d (MB) 1604, 35 Fed. R. Serv. 3d 1538 (11th Cir. 1996) (approving third party nondebtor releases in a settlement agreement in a related adversary proceeding); Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973, 980, 27 Bankr. Ct. Dec. (CRR) 1039, 34 Collier Bankr. Cas. 2d (MB) 313, Bankr. L. Rep. (CCH) P 76634 (1st Cir. 1995) (agreeing with pro-release courts that in "extraordinary circumstances, a bankruptcy court can grant permanent injunctive relief essential to enable the formulation and confirmation of a reorganization plan"); In re AOV Industries, Inc., 792 F.2d 1140, 14 Bankr. Ct. Dec. (CRR) 816, Bankr. L. Rep. (CCH) P 71190 (D.C. Cir. 1986) (affirming confirmation of a plan of reorganization, noting that the district court held that the plan's releases did not constitute an impermissible discharge of nonpetitioning third parties contrary to Bankruptcy Code § 524(e), rendering appellants' challenge to confirmation of the plan moot).

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