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Nondebtor Releases in Reorganization Plans

Are They Still Viable or a Thing of the Past in the Second Circuit?

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Reorganization plans increasingly include provisions releasing and permanently enjoining claims against not only the debtor—who is generally entitled to a discharge¹ of all pre-confirmation debts—but also third parties. Arguably, nondebtor release provisions may be critical to ensuring the reorganized debtor's fresh start where it would otherwise be faced with post-confirmation indemnification claims by officers and directors, lenders, insurance carriers and others.

In the Second Circuit, courts have regularly approved nondebtor release provisions, based on the appeals court's pronouncement in *In re Drexel Burnham Lambert Group Inc.*² that “[i]n bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan.”



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Recently, however, in *In re Metromedia Fiber Network Inc.*,³ the Second Circuit for the first time sought to define and clearly limit the circumstances under which a nondebtor release may be deemed “important” to the debtor's plan. This article will examine the *Metromedia* decision in light of the statutory framework and prior, divergent circuit decisions on the issue of nondebtor releases.

Statutory Framework

¹ See 11 U.S.C. §1141(d).

² 960 F.2d 285, 293 (2d Cir. 1992).

³ 416 F.3d 136, 141-43 (2d Cir. 2005).

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In relevant part, 11 U.S.C. §524(e) provides that “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.” Section 524(e) appears to carry forward §16 of the prior Bankruptcy Act of 1898, which provided that “[t]he liability of a person who is a co-debtor with, or guarantor or in any manner

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a surety for, a bankruptcy shall not be altered by the discharge of such bankrupt.”⁴ Based on §524(e), some courts have held nondebtor releases to be *per se* invalid. Such courts find further support for their view in the one clear statutory exception: asbestos mass tort cases under 11 U.S.C. §524(g).⁵ This argument appears to ignore the legislative history of §524(g), which expressly declines to take a position on whether nondebtor releases in a plan are otherwise enforceable.⁶

Other courts maintain that §524(e) does not expressly prohibit nondebtor releases and relies instead on the “all-writs” clause, 11 U.S.C. §105(a), which authorizes the bankruptcy court to “issue any order, process or judgment that is necessary or appropriate

to carry out the provisions of [the Bankruptcy Code].”⁷ In response, courts that adopt the *per se* prohibition argue that §105(a) does not authorize relief inconsistent with the more specific provisions of §524⁸ and “does not...create substantive rights that are otherwise unavailable under applicable law.”⁹

Distinctions exist even among courts that are willing to approve nondebtor releases. For example, some will limit the effect of such releases to parties who have consented—*i.e.*, voted in favor of the plan containing the release provisions.¹⁰ Others have approved even nonconsensual third-party releases provided that the plan containing the release provision is confirmed by appropriate vote.¹¹

Thus, the venue of the bankruptcy case will be one factor dictating whether, and

under what conditions, nondebtor releases will be available.

Circuit Split Decisions

The Fifth, Ninth and Tenth Circuits have adopted a *per se* rule prohibiting nondebtor releases.¹² As noted above, these circuit courts rely on §524(e), which, they argue, precludes bankruptcy courts from discharging the liability of nondebtors,¹³ and they reject the contention that the general equitable powers bestowed upon the bankruptcy courts by the “all-writs” clause permits the court to release the liabilities of

⁷ See, e.g., *Metromedia*, 416 F.3d at 142; *In re Continental Airlines*, 203 F.3d 203, 211 (3d Cir. 2000).

⁸ See, e.g., *Lowenschuss*, 67 F.3d at 1402.

⁹ *Metromedia*, 416 F.3d at 142 (quoting *In re Dairy Mart Convenience Stores Inc.*, 351 F.3d 86, 92 (2d Cir. 2003)).

¹⁰ See, e.g., *In re Specialty Equipment Companies*, 3 F.3d 1043, 1047 (7th Cir. 1993).

¹¹ See, e.g., *In re Johns Manville Corp.*, 837 F.2d 89 (2d Cir.), cert. denied, 488 U.S. 868 (1988).

¹² See *Lowenschuss*, supra; *In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995); *In re Western Real Estate Fund Inc.*, 922 F.2d 592 (10th Cir. 1990).

¹³ See, e.g., *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985).

non-debtors.¹⁴

Initially, in a case decided under §16 of the old Act, the Seventh Circuit also appeared to adopt a *per se* rule prohibiting nondebtor releases in a plan.¹⁵ More recently, however, the Seventh Circuit departed from its earlier decision and held that §524(e) “does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party,” provided that such releases were “consensual and non-coercive.”¹⁶

The Third Circuit in *Continental Airlines* sustained objections to plan provisions granting a nonconsensual release to nondebtor parties. The court expressly declined to rule out nonconsensual releases or to establish a “rule regarding the conditions under which nondebtor releases and permanent injunctions are appropriate or permissible.”¹⁷ The court found the release there to fail under even the most flexible test, stating that “[t]he hallmarks of permissible nonconsensual releases—fairness, necessity to the reorganization and specific factual findings to support these conclusions—are all absent here.”¹⁸

Shortly thereafter, that circuit court upheld an exculpation clause (except for willful misconduct and gross negligence) that covered representatives and professionals for the debtor and creditors committee.¹⁹ The Sixth Circuit in *In re Dow Corning Corp.*²⁰ held that nonconsensual nondebtor releases in a plan were permissible in “unusual circumstances” and listed several factors necessary to validate such releases, including (1) an identity of interest between the debtor and third party—*e.g.*, an indemnity relationship, (2) a substantial contribution of assets by the nondebtor to the reorganization, (3) necessity of the release and injunction to the reorganization, (4) overwhelming vote for acceptance of the plan by the impacted classes, (5) provision for payment of the claims of the impacted classes, (6) payment in full to creditors who opt not to settle and (7) specific factual finding to support the release and injunction.²¹

The most flexible approach appeared to be the one adopted by the Second and Fourth Circuit Appeals Courts. In *In re A.H. Robins Co.*,²² *Drexel*²³ and *Johns-Manville*,²⁴ the courts upheld reorganization

plans containing broad releases and permanent injunctions of claims against nondebtor parties. Each of these plans included the global settlement of massive tort liability of the debtors and co-liable parties and channeled creditor claims to trusts funded by substantial contributions from the nondebtor parties benefiting from the releases, and was thus rendered feasible and confirmable.²⁵

Drexel, which approved a class action settlement agreement that was subject to later confirmation of a plan, is particularly noteworthy. The court’s statement that a nondebtor release and injunction was proper provided that they played “an important part in the debtor’s reorganization plan”²⁶ has been frequently cited in support of the inclusion of nondebtor releases in many reorganization plans, not limited to the mass tort context.²⁷ The diverse range of views among the circuits on the viability of nondebtor releases in reorganization plans and the lack of any clear rules or boundaries circumscribing the permissible scope and applicability of such releases, particularly in the Second Circuit, was the setting for the court’s decision in *Metromedia*.

Metromedia: Findings Required Before Approval

In *Metromedia*, the court affirmed the order confirming the plan on the ground of equitable mootness and need not have reached the merits of the nondebtor release at issue.²⁸ Instead, the court seized the opportunity to clarify its holding in *Drexel*.²⁹

At the outset, the court stated that “this is not a matter of factors and prongs,”³⁰ emphasizing that nondebtor releases were “proper only in rare cases”³¹ upon a “finding of circumstances that may be characterized as unique.”³² The court identified two considerations underlying the reluctance to approve nondebtor releases: the lack of any express authorization in the Bankruptcy Code, and the fact that such a release is “a

device that lends itself to abuse” since “it may operate as a bankruptcy discharge without a filing and without the safeguards of the Code.”³³

The court rejected “material contribution” by the nondebtor party to the estate as sufficient to justify a nondebtor release,³⁴ but also refused to require that consideration be paid to the enjoined creditors.³⁵ Rather, the court identified the following findings that are necessary for approval of a nondebtor release:

- (i) that the release is important to the plan of reorganization (“which is what *Drexel Burnham* at a minimum requires”); and
- (ii) that the breadth or scope of the release—*i.e.*, the parties and claims covered—is necessary to the plan.³⁶

The court concluded:

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.³⁷

Conclusion

In *Metromedia*, the Second Circuit clearly enunciated a requirement for specific factual findings, based on evidence presented, to demonstrate not only that the proposed nondebtor release is essential to confirmation of a reorganization plan, but that “truly unusual circumstances”³⁸ exist to render the full scope of such release—both as to parties and claims covered—essential. This requirement merits closer examination by the lower courts on the justifications for nondebtor releases and greater limitations on the scope of such releases proposed by plan proponents. It remains to be seen whether this requirement will be followed in practice, or whether it will be accorded only lip service in reliance on the doctrines of equitable mootness and *res judicata*³⁹ to eliminate appeals and collateral attacks. ■

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¹⁴ See, e.g., *Lowenschuss*, 67 F.3d at 1402.

¹⁵ *Union Carbide Corp. v. Newboles*, 686 F.2d 593 (7th Cir. 1982).

¹⁶ *Specialty Equipment Companies*, 3 F.3d at 1047.

¹⁷ 203 F.3d at 214 and n. 11.

¹⁸ *Id.*

¹⁹ *In re PWS Holding Corp.*, 228 F.3d 224 (3d Cir. 2000).

²⁰ 280 F.3d 648 (6th Cir. 2002).

²¹ *Id.* at 658.

²² 880 F.2d 694 (4th Cir. 1989).

²³ *supra*, fn. __.

²⁴ *supra*, fn. __.

²⁵ See *Continental Airlines*, 203 F.3d at 212-13.

²⁶ 960 F.2d at 293.

²⁷ See, e.g., *In re Transit Group Inc.*, 286 B.R. 811, 818 (Bankr. M.D. Fla. 2002) (approving permanent release of lender who agreed to accept equity for prepetition debt and who provided significant DIP and exit financing, without which “there would be no plan and no reorganization”); *In re Master Mortgage Investment Fund Inc.*, 168 B.R. 930, 938 (Bankr. W.D. Mo. 1994) (injunction was essential in that there could be no reorganization without principal creditor settlement); *In re Heron, Burchette, Ruckert & Rothwell*, 148 B.R. 660, 689 (Bankr. D.C. 1992) (enjoining actions against partners of debtor law firm “is the *sine qua non* of the debtor’s reorganization”).

²⁸ 416 F.3d at 143-45. In contrast, the Third Circuit in *Continental Airlines* addressed the merits of the release at issue there only after first determining that the appeal was not equitably moot. 203 F.3d at 209-11.

²⁹ 416 F.3d at 141; see, also, *In re XO Communications Inc.*, 330 B.R. 394, 436 (Bankr. S.D.N.Y. 2005).

³⁰ *Id.* at 142.

³¹ *Id.* at 141.

³² *Id.* at 142.

³³ *Id.*

³⁴ *Id.* at 143.

³⁵ *Id.* (“such consideration has weight in equity, but it is not required”).

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ See, e.g., *Continental Airlines*, 203 F.3d at 213 n. 10.