# Cutting-Edge Chapter 11 Plan Issues

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# Permissibility of Third Party Releases In Non-Asbestos Cases

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## I. Majority Approach: Third Party Releases Are Permissible In Certain Limited Circumstances

A. The Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits have permitted third party releases, but only in limited circumstances.

i. *See S.E.C. v. Drexel Burnham Lambert Grp., Inc. (In re Drexel Burnham Lambert Grp., Inc.)*, 960 F.2d 285, 293 (2d Cir. 1992) ("a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan."); *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 212-14 (3d Cir. 2000) (non-consensual releases by a non-debtor of non-debtor third parties are to be granted only in "extraordinary cases" and there must be evidentiary findings that the release was "necessary" to confirm the plan and "fair" to the releasing parties); *Menard-Sanford v. Mabey (In re A.H. Robins Co., Inc.)*, 880 F.2d 694, 702 (4th Cir. 1989) (holding that section 524(e) must not be "literally applied in every case as a prohibition on the power of the bankruptcy courts" to approve a third party release); *But see Nat'l Heritage Foundation Inc. v. Highbourne Foundation*, No. 13-1608, 2014 WL 2900933 (4th Cir. June 27, 2014) (confirming third party releases are permissible in appropriate circumstances, but affirming <u>denial</u> of third party release because *Dow Corning* factors not met); *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 656-57 (6th Cir. 2002) (holding that section 524(e) merely "explains the effect of a debtor's discharge" and "does not prohibit the release of a non-debtor."); *In re Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993) ("[w]hile a third party release . . . may be unwarranted in some circumstances, a per se rule disfavoring all releases in a reorganization plan would be similarly unwarranted, if not a misreading of [section 524(e)]."); *SE Prop. Holdings LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015) (approving third party release using *Dow Corning* factors and noting that the factors are non-exclusive and that not all of the factors must be satisfied). More recently, the Seventh Circuit clarified that involuntary third-party release may be permissible. *In re Airadigm Communications, Inc.*, 519 F.3d 640, 657 (7th Cir. 2007) (citing Bankruptcy Code sections 105(a) and 1123(b)(6)).

B. Courts have differed regarding the appropriate standard for evaluating whether a third party release is permissible, but generally have approved such releases only in "extraordinary circumstances." *See Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 141 (2d Cir. 2005) ("it is clear that . . . [a third party] release is proper only in rare cases."); *In re Washington Mutual, Inc.*, 442 B.R. 314, 351 (Bankr. D. Del. 2011) (third party releases "are the exception, not the rule").

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i. With Consent: courts have generally held that third party releases are permissible where the third party consents to the release, including consent by voting affirmatively in favor of a plan containing the releases.

a) *See Specialty Equip. Cos.*, 3 F.3d at 1047 ("releases that are consensual and non-coercive . . . [are] in accord with the strictures of the Bankruptcy Code."); *In re Cent. Jersey Airport Servs., LLC*, 282 B.R. 176, 182 (Bankr. D.N.J. 2002); *In re Monroe Well Serv., Inc.*, 80 B.R. 324, 334-35 (Bankr. E.D. Pa. 1987).

b) In *Airadigm*, 519 F. 3d at 657, the Seventh Circuit expanded upon its earlier ruling in *Specialty Equip.* (which permitted consensual third party releases) and held that consent was not necessary because both Bankruptcy Code sections 105(a) and 1123(b) independently provided the requisite jurisdiction for the bankruptcy court to approve third party releases in appropriate cases. Each section provides the bankruptcy court the broad equitable power to confirm a plan. Under the facts of *Airadigm*, without the release, the plan would not have been possible because the plan funding party would not have funded the plan. *Id.*

c) Two bankruptcy courts in the District of Delaware have recently issued conflicting decisions concerning the type of the "consent" needed for third party releases. *Compare Washington Mutual*, 442 B.R. at 354-55 with *In re Indianapolis Downs, LLC*, 486 B.R. 286, 304-06 (Bankr. D. Del. 2013)

i. In *Washington Mutual*, Judge Walrath held that "affirmative consent" is required for a party to be bound by a third party release contained in a plan. 442 B.R. at 354-55. In that case, after amendments by the debtors to satisfy the concerns of the court, the ballot contained an "opt out" provision, where affected parties needed to check the opt-out box in order for the release provisions not to apply. *Id.* Judge Walrath held that consent could not be implied if a party failed to return its ballot, returned a blank ballot, or voted against the plan. *Id.* at 355. Instead, the only way for a party to "consent" to the release was to return the completed ballot voting in favor of the plan and not check the opt-out box. *Id.* ("any third party release is effective only with respect to those who affirmatively consent to it by voting in favor of the Plan and not opting out of the third party releases.").

ii. In contrast, Judge Shannon in *Indianapolis Downs* (another third party release case where there was an "opt-out" box on the ballot) held that affirmative consent is not required for a party to be bound. 486 B.R. at 304-05. Instead, consent could be implied if a creditor merely failed to return its ballot (or does not otherwise check the "opt-out" box). *Id.* "[T]hose who fail to opt out [by checking the opt-out box], or to vote, are 'deemed' to consent to the Third Party Release." *Id.* at 305. Thus, a creditor will be bound by the third party release if it (i) does not return its ballot, (ii) votes to accept the plan but does not check the "opt-out" box, (iii) returns a blank ballot, or (iv) votes to reject the plan but does "not otherwise opt out of the releases[.]" *Id.* at 304-06.

d) Two bankruptcy courts in the Southern District of New York have also skewed towards requiring some degree of consent in connection with the approval of third party releases. *See In re Chassix Holdings, Inc. et al.*, 533 B.R. 64 (Bankr. S.D.N.Y. 2015); and *In re Genco Shipping & Trading Ltd., et al.*, 513 B.R. 233 (Bankr. S.D.N.Y. 2014).

i. In *Chassix*, Judge Wiles (in the absence of objections and on his own initiative) refused to approve the third party releases until certain changes were made to the voting procedures. Specifically, the bankruptcy court was concerned that the voting procedures used by the debtors were designed to spread the release as far as possible, based upon how or whether the creditor voted for or against the plan, or whether the creditor voted at all. The bankruptcy court held that an overly expansive view of what constitutes consent would be inconsistent with the Second Circuit's admonition in *Metromedia* that courts should be wary about imposing involuntary releases upon creditors. Therefore, the court redesigned the voting procedures to curtail what actions or inactions would constitute consent. As reconfigured, for classes entitled to vote, a vote in favor of the plan was deemed to be consent to the third party release; a vote against the plan was deemed to be rejection of the third party release; a vote against the plan but an affirmative opt-in to the third party release, would constitute consent to the release; and, the failure to vote at all would not be consent to the release. As to non-voting classes, those "unimpaired" classes that are presumed to vote "yes" would not be deemed to have consented to the release because the loss of the claim against the third party would result in the members of that class being actually (albeit, technically) impaired; and those impaired classes that are deemed to vote "no" would not be considered to have consented to the third party release. *See generally* 553 B.R. at 75-82.

ii. In *Genco*, the only objecting parties were the United States Trustee and the Equity Committee. The objections focused on the deemed consent of non-voting classes and the question of whether the releases were too broad. Judge Lane, also citing to *Metromedia*, began with the proposition that third party releases may only be approved in "unique circumstances." As would be done in *Chassix* (which was the later of the two cases), the bankruptcy court held that it would not permit non-voting "unimpaired" classes that were presumed to accept the plan, or non-voting impaired classes that were deemed to have rejected the plan, to be deemed to have *automatically* consented to the third party release. The court also agreed that the scope of the release was too broad and potentially extended to too many parties. In assessing the propriety of the third party releases, the court looked at the *Metromedia* factors as applied to the evidence before it to determine whether the releases passed muster. Based upon the record before it, the bankruptcy court found "consent" to the releases from any creditor that consented to the plan by voting for it, or that consented to the release by voting against the plan but failing to check the box on the ballot to opt-out of giving the release. As to creditors holding claims against third parties with a right to indemnity or contribution from the debtors, those claimants would be subject to the third party release even without affirmative consent, provided the indemnity right existed prepetition and was not created in the plan support agreement or under the plan to bootstrap or create an identity of interest between the released parties and the debtors. Lastly, the court approved the third party releases in favor of parties providing significant financial contributions that made the plan possible. *See generally* 513 B.R. at 268-72.

ii. Second Circuit Test: *Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005)

a) In disapproving non-debtor release, holding that "nondebtor release[s] in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release important to the success of the plan. . . ." 416 F.3d at 143 (emphasis added).

b) In determining whether the release is permissible, the Court noted that focus should be paid to the following factors:

i. Whether estate received substantial consideration;

ii. Whether enjoined claims are channeled to a settlement fund rather than extinguished

iii. Whether enjoined claims would indirectly impact debtor's reorganization "by way of indemnity or contribution";

iv. Whether plan otherwise provides for full payment of enjoined claims; and/or

v. Whether there is consent of affected creditors. *Id.* at 142-43.

c) Court noted, however, that whether a non-debtor release is permissible is "not a matter of factors and prongs" and that "[n]o case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique." *Id.* at 142.

iii. Involuntary Third Party Release: Multi-Factor Test

a) **5-Factor Test**

i. Identity of interest between debtor and non-debtor such that a suit against the non-debtor will deplete estate resources;

ii. Substantial contribution to the plan by non-debtor;

iii. Necessity of release to the reorganization;

iv. Overwhelming acceptance of the plan and release by creditors and interest holders; and

v. Payment of all or substantially all of the claims of the creditors and interest holders under the plan.

- *See In re Master Mortg. Inv. Fund, Inc.*, 168 B.R. 930, 934-35 (Bankr. W.D. Mo. 1994) (citing cases applying a variety of the five factors); *Indianapolis Downs*, 486 B.R. at 303 (applying *Master Mortgage* test); *In re Zenith Elecs. Corp.*, 241 B.R. 92, 110 (Bankr. D. Del. 1999) (same).

vi. "No court has set out a rigid 'factor test' to be applied in every circumstance. Rather, the courts have engaged in a fact specific review, weighing the equities of each case. The courts seem to have balanced the five listed factors most often. However, these factors do not appear to be an exclusive list of considerations, nor are they a list of conjunctive requirements." *Master Mortg. Inv. Fund*, 168 B.R. at 935; *see also Indianapolis Downs*, 486 B.R. at 303 ("[t]hese factors are neither exclusive nor are they a list of conjunctive requirements.").

b) **6-Factor Test**

i. The Sixth Circuit, in *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002) adopted a variation of the five-factor test, <u>adding one additional factor</u>, namely:

- the plan provides an opportunity for those claimants who choose not to settle to recover in full.

ii. The Fourth Circuit recently adopted this 6-factor test. *See Nat'l Heritage Found., Inc. v. Highbourne Found.*, No. 13-1608, 2014 WL 2900933, at *1-2 (4th Cir. June 27, 2014).

c) **Importance of the Evidentiary Record**

i. Virtually every appellate court emphasizes the additional factor that <u>evidence</u> must be proffered by the plan proponent to demonstrate how each factor has been met.

C. Even if all of the factors enumerated above have been met, a bankruptcy court <u>must have subject matter jurisdiction</u> over the third party dispute in order to grant the non-debtor release. *See Johns-Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.)*, 517 F.3d 52 (2d Cir. 2008) ("*Manville III*"), *rev'd and remanded sub nom Travelers Indem. Co. v. Bailey*, 557 U.S. 137, 129 S. Ct. 2195 (2009) ("*Travelers*"). *See also In re Dreier*, 429 B.R. 112, 132 (Bankr. S.D.N.Y. 2010) ("before the Bankruptcy Court decides whether . . . the 'unusual circumstances' mandated by *Metromedia* [are present], it must first decide whether it has subject matter jurisdiction. . . ."). *See also Metromedia*, 416 F.3d at 142 (stating, in reference to whether Bankruptcy Code section 105(a) by itself supplied the requisite subject matter jurisdiction for approval of a third party release: " . . . but section 105(a) does not allow the bankruptcy court 'to create substantive rights that are otherwise unavailable under applicable law.'" (citations omitted)).

i. In *Manville III*, the Second Circuit held that "a bankruptcy court only has jurisdiction to enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate." 517 F.3d at 66. Unless the third party has "derivative liability for the claims against the debtor[,]" a channeling injunction is inappropriate. *Id.* at 68. Because the claims at issue were "not derivative of [the debtor's] liability, but rather seek to recover directly from [a third party] for its own alleged misconduct[,]" the court found that the district court lacked subject matter jurisdiction to enjoin such claims. *Id.*

ii. The Supreme Court in *Travelers* reversed and remanded *Manville III* on "narrow" grounds, finding that the Second Circuit had improperly permitted a collateral attack on the District Court's subject matter jurisdiction. 557 U.S. at 152-53 (holding that "[e]ven subject-matter jurisdiction . . . may not be attacked collaterally.") (citations omitted). Once the 1986 Order became final without any party having raised the jurisdictional issue, res judicata precluded the Court from addressing it. *Id.* at 152 ("once the 1986 Orders became final on direct review (whether or not proper exercises of bankruptcy court jurisdiction and power), they became res judicata to the "'parties and those in privity with them. . . ."). It is notable, however, that the court expressly stated that it was "not resolv[ing] whether a bankruptcy court . . . could properly enjoin claims against nondebtor insurers that are not derivative of the debtor's wrongdoing." *Id.* at 155. It was merely holding that the issue of whether the court had subject matter jurisdiction was barred by res judicata and not subject to collateral attack.

iii. On remand, the Second Circuit in *Johns-Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.)*, 600 F.3d 135, 148-49 (2d Cir. 2010) ("*Manville IV*"), held that because Chubb was denied due process, its assertion of lack of subject matter jurisdiction was timely (and therefore not an impermissible collateral attack). The court then held that the order enjoining non-derivative claims by Chubb that sought to impose separate liability on a third-party non-debtor "exceed[ed] the bounds of the bankruptcy court's *in rem* jurisdiction." *Id.* at 153. According to the Court, Bankruptcy Code section 524(g), which permits certain channeling injunctions, "does not authorize injunctions of . . . [non-derivative] claims against non-debtor third parties." *Id.*

iv. It should be noted that *Manville III* was not a plan confirmation case, but rather involved a pre-plan settlement. Therefore, the Second Circuit did not address whether the bankruptcy court had core jurisdiction to confirm a plan of reorganization containing a third party release. In *Metromedia*, which was decided three years before *Manville III*, the Second Circuit did not reject the release on the ground that the bankruptcy court lacked subject matter jurisdiction; but, instead, held the evidence presented did not support the existence of the requisite factors. Interestingly, *Manville III* discusses *Metromedia* (517 F.3d at 66), but does not disavow the indication in *Metromedia* that had the requisite factors been met, the third party release might have been permissible. Nor does *Manville III* address whether subject matter jurisdiction was present or absent in *Metromedia*. Instead, the panel in *Manville III* cited *Metromedia* in conjunction with its observation that conditioning a release on payment was subject to abuse because the debtor could not create subject matter jurisdiction by structuring a settlement or plan in such a way as to make the settlement or plan dependent upon the third party's contribution thereby manufacturing subject matter jurisdiction where it might not otherwise exist. This statement can either suggest there is no subject matter jurisdiction in the plan confirmation context to impose a third party release on claims that do not affect the *res* of the bankruptcy estate or that the necessity must be real rather than manufactured. Because the panel in *Manville III* did not reject the multi-factor approach required by *Metromedia*, or revisit the admonition in *Metromedia* that no single factor (such as identity of interest) is mandatory, it appears the latter interpretation is plausible at the very least.

v. In *Continental Airlines*, the Third Circuit made the point in footnote 12 (203 F. 3d. at 214) that "a court cannot simply presume it has jurisdiction in a bankruptcy case to enjoin third-party class actions against non-debtors. We must remain mindful that bankruptcy court jurisdiction is limited, as is the explicit grant of jurisdiction to bankruptcy courts….We do not treat this very significant issue more fully, however, because the record does not permit us to resolve this issue and the parties have not raised and discussed it in their appellate briefs."

vi. Nevertheless, although not every court addresses the question of subject matter jurisdiction at length when ruling on third party releases, most courts rely upon some combination of Bankruptcy Code sections 105, 1123(a)(5) (plan must include adequate means of implementation), or 1123(b)(6) (plan may include any other provision not barred by the Bankruptcy Code) in finding the requisite jurisdiction. *See Airadigm* (519 F.3d at 657), *A.H. Robins* (888 F.2d at 701-02), *Dow Corning* (280 F.3d at 656-57), and *Master Mortgage* (168 B.R. at 934), each cited above. Perhaps the existence of core subject matter jurisdiction is presumed under Bankruptcy Code sections 105(a), 1123(a)(5), and 1123(b)(6) because virtually all of the third party release cases arise in the context of plan confirmation. The necessity requirement found in all of the various tests would supply the nexus between the third party release and the indispensability of the releases to plan confirmation, on the one hand, and the equitable power of the bankruptcy court to implement its order confirming the plan, on the other hand. Consequently the bankruptcy court has <u>core</u> "arising under" and/or "arising in" jurisdiction to approve the releases in connection with confirmation of a plan. 28 U.S.C. § 157(b)(2)(L). *See In re Charles Street African Methodist Episcopal Church of Boston*, 499 B.R. 66, 99 (Bankr. D. Mass.) (citing to Bankruptcy Code sections 105 and 1123(a)(5)). (The bankruptcy court in *Charles Street* disapproved the release because the evidence presented did not meet the *Master Mortgage* factors, held applicable in *In re Quincy Medical Center, Inc.,* 2011 WL 5592907 (Bankr. D. Mass. 2011). *Id*. at 100, 103.)

vii. Other courts reject the notion that Bankruptcy Code section 105(a) by itself can supply the requisite subject matter jurisdiction because section 105 can only implement and assist extant provisions of the Bankruptcy Code but cannot create substantive rights that do not exist. *See Digital Impact, Inc.*, 223 B.R. 1, 14 (Bankr. N.D. Okla. 1998). These courts either side with the Ninth Circuit's view that Bankruptcy Code section 524(e) bars third party releases (in which case section 105 cannot be used to contradict the bar of section 524) or hold that the absence of express authorization for third party releases prevents the bankruptcy court from using section 105 to bootstrap into jurisdiction whenever parties band together and claim necessity for the release.

viii. Still other courts discuss the limitations of section 105, but do not appear to address whether section 105 in conjunction with section 1123 and the proper evidentiary record would furnish subject matter jurisdiction for the bankruptcy court to approve third party releases. *Metromedia*, 416 F.3d at 142; *Cont'l Airlines*, 203 F.3d at 211. Notably, these courts did not rule out third party releases in all cases, but instead rejected the third party releases in the specific case before it.

II. **Minority Approach: Third Party Releases Are Impermissible As A Matter Of Law**

A. The Fifth, Ninth and Tenth Circuits have held that non-debtor third party releases are impermissible as a matter of law.

i. *See Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746, 760-61 (5th Cir. 1995) (where permanent injunction "provided no alternative means . . . to recover from [third party] . . . [it] improperly discharged a potential debt of [third party]" and "the bankruptcy court exceeded its powers under § 105."); *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401-02 (9th Cir. 1995) (holding that third party release violates section 524(e), which "precludes bankruptcy courts from discharging the liabilities of non-debtors."); *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) ("the bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan."); *Landsing Diversified Properties-II v. First National Bank and Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600-01 (10th Cir. 1991) ("Congress did not intend to extend such benefits [of discharge] to third-party bystanders.").

B. These courts have narrowly interpreted Bankruptcy Code section 524(e), which provides that "the discharge of a debt of the debtor does not affect the liability of any other third entity on, or the property of any other entity for such debt."

C. According to these courts, third party releases effectively allow the bankruptcy process to discharge non-debtors, a result clearly inconsistent with section 524(e).

D. Courts disagreeing with this approach (*see, e.g.*, *Specialty Equip. Cos.*, 3 F.3d at 1047 *supra*) point out that section 524(e) is not a bar to third party releases under plans, but instead section 524(e) merely defines and confines the effect of the <u>debtor's</u> discharge of <u>its</u> debts and clarifies that the debtor's discharge does not <u>automatically</u> discharge third parties that are co-liable with the debtor of the third party's own, separate, debts. In this manner, the debtor's discharge does not automatically discharge a guarantor of the debtor.

III. **Impact Of Stern v. Marshall**

A. In *Stern v. Marshall*, 131 S. Ct. 2594 (2011), the Supreme Court held that the bankruptcy court lacked constitutional authority to enter a final order in a lawsuit brought by the debtor against a non-debtor even though the matter was designated as core in 28 U.S.C. § 157(b)(2)(C). The Court held that notwithstanding the statutory designation as "core," the debtor's lawsuit (which would exist outside of the debtor's bankruptcy case) was constitutionally non-core. The lawsuit in *Stern* was brought to augment the debtor's estate using private rights that existed outside bankruptcy, and was not a claim stemming from the bankruptcy itself; nor did the lawsuit have to be resolved as part of the claims allowance process. 131 S. Ct. at 2618. The Court relied in large part upon its ruling earlier in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 102 S. Ct. 2858 (1982), and held that the nature of the debtor's claim was such that the judicial power of the United States as exercised by an Article III judge was required to adjudicate the claim. 131 S. Ct. at 2611, 2620. Because the bankruptcy judge was an Article I judge, the court lacked the necessary authority to adjudicate the debtor's lawsuit against the non-debtor. *Id.* at 2620. For a brief time, *Stern v. Marshall* threw into doubt whether the bankruptcy court could enter proposed findings of fact and conclusions of law under 28 U.S.C. § 157(c)(1) for matters that were statutorily core but constitutionally non-core, and whether (and how) parties would be deemed to have manifested consent to the bankruptcy court adjudicating a non-core matter. Both questions were answered (sort of) in the follow-on decisions of the Supreme Court in *Executive Benefits Insurance Agency v. Arkison*, 134 S. Ct. 2165 (2014), and *Wellness International Network Ltd., et al. v. Sharif*, 135 S. Ct. 1932 (2015). In *Executive Benefits*, the Supreme Court confirmed that the so-called statutory gap of how the bankruptcy court could handle "*Stern*-type-matters" that were statutorily core but constitutionally non-core, did not really exist. The Court held that the savings clause in the note following 28 U.S.C. § 151 enabled the bankruptcy court to use 28 U.S.C. § 157(c)(1) (and, hence, Bankruptcy Rule 9033) to issue proposed findings of fact and conclusions of law to the district court for de novo review in statutorily core but constitutionally non-core matters. 134 S. Ct. at 2172-73. In other words, the jurisdiction system established by Congress after *Marathon* would indeed survive *Stern v. Marshall*. Notably, the Court also held that, in the case of the specific litigants before it, any constitutional defect was cured because even though the matter was appealed to the district court rather than submitted to the district court as a report and recommendation under Bankruptcy Rule 9033, the defendant received on appeal the same treatment that he would have received under section 157(c)(1) and Bankruptcy Rule 9033 -- de novo review and a judgment entered by an Article III court. 134 S. Ct. at 2174-75. In *Wellness*, the Court answered in the affirmative the question of whether the bankruptcy court was structurally permitted to enter an order on a "Stern-type-claim" upon the consent of the litigants. The Court described consent as a "permissible waiver" of the right to adjudication by an Article III judge. Given the pervasive oversight of the bankruptcy court by the district court, the Court held that there would be no constitutional bar to the bankruptcy court adjudicating a non-core matter with the consent of the parties. 135 S. Ct. at 1944-48. Lastly, the Court held that consent could be implied from actions or inactions, provided it was knowing and voluntary. 135 S. Ct. at 1948. Assuming the bankruptcy court has core jurisdiction to approve a third party release in connection with confirmation of a plan, then the presence or absence of consent (in whatever form) is irrelevant. But, if the bankruptcy court only has "related-to" jurisdiction, then the presence or absence of consent by the objecting involuntary releasor may be highly relevant.

B. In the context of third party releases, some courts have raised the issue of whether the bankruptcy court has the authority to enter an order approving a third party release and issue a bar order/injunction on the theory that the release and corresponding injunction is a final adjudication of the claim of one non-debtor against another non-debtor, which could only be approved by an Article III judge upon a report and recommendation from the bankruptcy court. This argument is premised upon the contention that if subject matter jurisdiction exists at all, it would be "related-to" (non-core) jurisdiction *See, In re Digital Impact, Inc*., 223 B.R. 1, 14 (footnote 8) (Bankr. N.D. Okla. 1998). Other courts believe that confirmation of a plan is quintessentially core and that the requisite jurisdiction is supplied by Bankruptcy Code sections 105(a), 1123(a)(5), and/or 1123(b)(6) so long as the requisite factors are met. *See, e.g.*, *Airadigm* (519 F.3d at 657), *Dow Corning* (280 F.3d at 656-57), *Charles Street* (499 B.R. at 99), *supra*. As noted above, outside the context of plan confirmation, in connection with a pre-plan settlement that sought to bar third party claims that had no effect on the rest of the bankruptcy estate, the Second Circuit has held there is no subject matter jurisdiction at all, not even related-to jurisdiction, to compel the release of third party claims. *See Manville III*, *supra*.

C. Given the focus on subject matter jurisdiction, there appears to be a potential question as to whether subject matter jurisdiction can only be found in third party release cases in which the party to be released has a contractual or statutory indemnification claim against the debtor such that a lawsuit against the proposed releasee would be a lawsuit against the debtor. As stated above, the issue has not been framed this way in most of the third party release cases. In many cases, the courts focus on the necessity and fairness of the release and do not discuss subject matter jurisdiction in depth. This could be because <u>core</u> subject matter jurisdiction is presumed to exist in the context of plan confirmation. It is also notable that virtually all of the circuit level decisions that hold third party releases are permissible include among the factors to be considered whether there is an identity of interest between the third party being released and the debtor. The identity of interest factor is almost always framed as whether the third party has an indemnity or contribution claim against the debtor such that a lawsuit against the third party will affect the debtor and the estate by triggering a claim by the third party against the debtor. These cases also make it clear that the factors are not exclusive and the presence or absence of any particular factor is not required. *Metromedia*, 416 F.3d at 142; *Master Mortg.*, 168 B.R. at 935. Consequently, if subject matter jurisdiction only existed as "related-to" jurisdiction, then the cases would uniformly hold that the identity of interest factor is <u>mandatory</u> in order for the court to have jurisdiction to approve a third party release. Yet, no case has made the presence of that particular factor an absolute requirement. However, even most liberal cases caution the parties that courts will not look kindly upon parties that try to manufacture necessity by reciting its existence without actually proving it through evidence proferred to the trial court.

D. In any event, assuming there is at least related-to jurisdiction, even in the absence of consent, the ruling in *Executive Benefits* would permit either a report and recommendation by the bankruptcy court to the district court or support the release if upheld on appeal to the district court based upon de novo review by the district court and its approval of the release.

IV. **Recent Cases Of Interest**

A. *Millennium Lab Holdings, II, LLC*, et al., Case No. 15-12284 (LSS) (Bankr. D. Del.)

In this case, the bankruptcy court approved third party releases over the objection of a dissenting secured lender that was part of a syndicate of almost 100 lenders that made a loan of $1.8 Billion to the debtors. The loan transaction (known colloquially as a dividend recap) closed approximately one year before the debtor (a urine drug testing lab and related businesses) was forced into chapter 11 under threat of loss of its Medicare reimbursement privileges due to whistle blower actions and a DOJ lawsuit. The equity holders were paid $1.3 Billion from the loan proceeds as a special dividend. The DOJ's claims resulted from an investigation into alleged improprieties by the company that included allegations of billing Medicare for medically unnecessary testing and allegations that the company provided kickbacks and other incentives to doctors to use the lab for testing. After the DOJ and the company announced an agreement in principle that required the company to enter into a corporate integrity agreement and pay a civil penalty of $256 Million in order to preserve its Medicare reimbursement privileges, the company turned to its secured lenders and equity holders for assistance in paying or financing the $256 Million penalty. The equity holders, the secured lenders, and the DOJ engaged in months of heated negotiations in order to avoid the devastating consequences of the loss of Medicare reimbursement privileges which undeniably would destroy the business and reduce creditor recoveries to almost zero. Eventually, under threat of a deadline to reach an agreement imposed by government regulators, the parties entered into a series of inter-related agreements as part of a global settlement of all claims. Under the global settlement, a prepackaged plan of reorganization was prepared and voted upon. The linchpin of the plan was the payment of $325 Million by the equity holders that would be used to pay the government penalty, reimburse the debtors for certain prepayments made to the government, and for working capital. The secured lenders retained $600 Million of debt restructured as a new term loan and were given 100% of the equity of the reorganized debtor, which was valued at least $900 Million. Unsecured creditors were to be paid in full and thus were unimpaired. The equity holders insisted on full releases from the debtors and third party releases from all creditors (including any dissenting lenders) as a condition to paying the $325 Million. The bankruptcy court approved the third party releases in an oral ruling from the bench. The transcript is available under Docket No. 203. The bankruptcy court held that in the Third Circuit there is no per se bar against third party releases and looked to *Continental Airlines*, discussed *supra*, as the source for the over-arching requirements for approval of third party releases. Those requirements are fairness to creditors and necessity for the success of the plan. The court then looked at what lower courts in Delaware had done with third party releases and observed that most courts that approved those releases applied the factors developed in such cases as *Master Mortgage*, also discussed *supra*. Going through the factors, the bankruptcy court found that, based on the evidence presented by the debtors (and the lack of any evidence or cross-examination by the objectors), the factors were met. Chief among the factors were the substantial payments being made by the equity holders, the threatened (and, the court found, real) Armageddon if the government was not paid its $256 Million by the end of the month, the lack of other options for the debtors, the overwhelming support of the impaired class, the payment in full of unsecured creditors, and the identity of interest between the equity holders (all of whom had contractual indemnity claims), the debtors (who would be subject to the indemnity claims), and the secured lenders (whose claims (if any) arose from the loan transaction). Notably, the court did not require an opt-out provision that would have enabled creditors to refuse to provide the release. Under the circumstances of the case, the court held that the opt-out was not necessary because the unsecured creditors were being paid in full, the secured lenders overwhelmingly supported the global deal, the plan consideration being given to the secured lenders (including the dissenters) was fair and reasonable, and there would be no plan (and a disastrous liquidation) without the involuntary releases that were required by the parties contributing $325 Million. The objecting secured lender did not oppose the overall settlement and did not disclaim its plan distributions. Rather, it made the technical argument that the court lacked subject matter jurisdiction to approve a third party release. The crux of the argument was that the objecting secured lender had fraud and RICO claims against the equity holders that were independent of any claims of the debtors and therefore the estate would not be affected by the outcome of the secured lender's lawsuit. Apart from plan confirmation being a core matter and the court having the authority to use section 105 in aid of confirmation, the bankruptcy court held that, at the very least, it had related-to jurisdiction because the released parties (and those related to the released parties) had indemnification claims (which included the costs of defense) that made a lawsuit against the released parties equivalent to a claim against the debtor. The objecting secured lender also argued that the bankruptcy court could not approve the third party releases under the rationale of *Stern v. Marshall*, because the release was tantamount to an adjudication of the merits of its claims against the equity holders. The bankruptcy court rejected the notion that it could not enter an order confirming a plan that contained third party releases. The objecting secured creditor has appealed. The reorganized debtor has moved to dismiss the appeal as moot.

B. *New England Compounding Pharmacy, Inc., Case No. 12-19882-HJB* (Bankr. D. Mass.)

This was a non-asbestos mass tort case that resulted from the tragic distribution of prescription medication compounded by the debtor that was tainted with fungal meningitis. The distribution of the tainted medication resulted in several deaths, serious injuries, and thousands of lawsuits against the debtor. Through Herculean efforts, the chapter 11 trustee, the committee, several tort lawyers, multiple parties with potential exposure, and insurance carriers for several parties were able to put together a fund of more than $200 Million to pay tort claimants through a trust and resolve the chapter 11 case. As would be expected, the "contributing parties" who were settling potential claims against them by making cash payments that would be used to fund the trust each required comprehensive third party releases as a condition to making the settlement payments. There was no clear guidance in the First Circuit as to whether third party releases were permissible and if so, under what circumstances. By any measure, the creation of the $200 Million fund from scratch to compensate victims was an extraordinary circumstance, and the linkage of the settlement payments to the delivery of full releases made the third party releases essential to the plan. The bankruptcy court approved the third party releases. No written or oral opinion was issued. In the bankruptcy court's *Findings of Fact, Conclusions of Law and Order Confirming The Third Amended Joint Chapter 11 Plan of New England Compounding Pharmacy, Inc.* (Docket No. 1355) the court appeared to tick off the *Master Mortgage* factors and, as the bankruptcy court did in *Millennium*, focused upon the critical necessity of the funds for the success of the plan, the significant contributions made by the settling parties, the indemnity and contribution claims that would likely be asserted against the debtor by non-debtor parties sued for damages caused by the tainted drugs prepared by the debtor, the overwhelming support for the plan, the absence of any objections from tort claimants, and the significant *near-immediate* recoveries for creditors who (in the absence of the plan) might get little or nothing on their claims or only be paid after years of litigation. The court relied on sections 105, 1123(a)(5)(means of implementation), and 1129 as the basis for jurisdiction. The court also laid the ground work for related-to jurisdiction by focusing on the contribution and indemnification rights of co-liable parties and the identity of interest shared by all in resolving litigation that was connected to a common nucleus of facts concerning the contamination and distribution of the tainted drugs. Lastly, the court used Bankruptcy Rule 9019 to make the requisite findings as to fairness to approve the multiple settlement agreements approved at the confirmation hearing. Little or no case law was cited in the Findings and Conclusions, but two submissions by the plan proponents (Docket Nos. 1178 and 1310) addressed the applicable case law from the lower courts in Massachusetts (such as *Charles Street*, *supra*, and *In re Quincy Med. Ctr. Inc.,* No. 11-16394, Bankr. LEXIS 4405 (Bankr. D. Mass. Nov.16, 2011), and focused on the factors used in the majority rule cases (such as *Master Mortgage*, *supra*, and *Dow Corning*, *supra*). The other notable point to be made is that, again as in *Millennium*, there was no opt-out alternative provided to the releasing parties.

# Overview of Section 1111(b) Elections

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## Introduction

In an economic climate where secured creditors may find themselves in the unenviable position of being undersecured, Section 1111(b) provides a mechanism for such creditors to gain strategic leverage in the plan negotiation process. Where depressed collateral values, particularly in the real estate context, have resulted in large deltas between the amount of the "secured" debt and the actual value of the property securing the debt, the often overlooked Section 1111(b) election is worthy of consideration. These materials will provide a short overview of the Section 1111(b) election, the timing and mechanics of making the election and the practical and tactical considerations which should inform the undersecured creditor's decision.

## Section 1111(b) and Section 506(a)

In the most basic of terms, Section 1111(b) of the Bankruptcy Code provides the undersecured creditor with an option which differs from the customary claim treatment under Section 506(a). Under Section 506(a), in the absence of an election under Section 1111(b), an undersecured creditor's allowed claim is severed into two parts: a ***secured*** claim for the value of the creditor's collateral, and an ***unsecured***, deficiency claim for the balance of the allowed claim amount. 11 U.S.C. §506. In the vast majority of circumstances, the undersecured creditor will

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not elect different treatment, and as a result, the undersecured creditor will be holding claims in multiple classes under a plan.

Section 1111(b) provides an alternative to the ordinary Section 506(a) bifurcation treatment. Under Section 1111(b), subject to certain exceptions, an undersecured creditor may elect to treat its entire allowed claim as a secured claim. In doing so, the creditor waives its right to an unsecured, deficiency claim for the amount of the delta between the value of its collateral and the amount of the allowed claim. The creditor also agrees to forego the corresponding right to vote that claim in the plan confirmation process.

However, by making the Section 1111(b) election, the creditor can make it more difficult for a debtor to "cram down" under Section 1129(b)(1). Section 1129 requires a debtor's plan of reorganization to satisfy two specific requirements:

**<u>First</u>, the payments to the creditor under the plan must at least equal the present value of the secured creditor's security interest under Section 1129; and**

**<u>Second</u>, the payments must total at least the full amount of the allowed claim.**

Put differently, the effect of Section 1111(b) is that "the same payments under the plan must satisfy two requirements: (1) the simple, arithmetic total of the stream of payments must at least equal the total claim and (2) those payments must have a present value equal to the value of the collateral." *In re Bloomingdale Partners*, 155 B.R. 961, 974 (Bankr. N.D. Ill. 1993).

The significance of the Section 1111(b) election in this context is that the "full amount of the allowed claim" is larger, and potentially much larger, as it encompasses both the secured and unsecured portions of the claim. If the election is not made, the allowed claim is bifurcated into two claims - secured and unsecured - under Section 506. As a result, once the Section 1111(b) election is made, a successful cram down may be more difficult for a debtor to accomplish.

Why does the election exist?

The Section 1111(b) election is designed to protect secured creditors from an artificially low valuation of their collateral. For example, where a debtor uses an appraisal to value an asset in formulating treatment under a plan, the secured creditor may disagree with the valuation. In the absence of the Section 1111(b) election, the secured portion of the claim is capped at the valuation amount. Thus, a reliance on hypothetical values, without any exposure to an actual market, has the potential to prejudice the rights of the secured creditor.

A debtor may also attempt to "game" the system, by filing chapter 11 at the moment in time when the collateral has the lowest possible value. As a result, the debtor reorganizes the secured portion of the creditor's claim at the lowest amount and pays a much smaller recovery - potentially pennies on the dollar - to the creditor on account of the unsecured portion while reaping the benefits of any increase in collateral value for itself.

The Section 1111(b) election provides a creditor with protection which can be used in either of these scenarios, as the electing creditor can capture the upside value of its collateral by making the election.

Timing and Mechanics of Making Election

Federal Rule of Bankruptcy Procedure 3014 requires that, "[a]n election of application of § 1111(b)(2) of the Code by a class of secured creditors in a chapter 9 or 11 case may be made at any time prior to the conclusion of the hearing on the disclosure statement or within such later time as the court may fix." F.R.B.P. 3014. The Advisory Committee Note to Rule 3014 further provides that, "[g]enerally it is important that the proponent of the plan ascertain the position of the secured creditor class before the plan is proposed…[o]nly if the plan is not confirmed may the class of secured creditors thereafter change its prior election." F.R.B.P. (Advisory Committee Note). *See also In re IPC Atlanta Ltd. P'ship*, 142 B.R. 547, 554 (Bankr. N.D. Ga. 1992) ("the rule and comment clearly indicate that once the election is made, [the debtor] and any other creditors should be entitled to rely upon the election, absent a material alteration in the plan").

A withdrawal of a Section 1111(b) election may be allowed, "if timely within the context of the case, if no prejudice occurs to other parties, and only if there are material alterations in the disclosure statement or plan upon which the creditor relied." *In re Win Trucking, Inc.*, 236 B.R. 774, 781 (Bankr. D. Utah 1999); *See also In re Heritage Consol.*, No. 10-36484-hdh, 2013 Bankr. LEXIS 3465 at *30 (U.S. Bankr. N.D. Tex. Aug. 26, 2013) (withdrawal of election permitted prior to confirmation hearing); *In re Consol. Properties Ltd. P'ship*, 170 B.R. 93, 95 (Bankr. D. Md. 1994) (withdrawal permitted where material changes to plan occurred); *In re Batista-Sanechez*, 505 B.R. 222 (Bankr. N.D. Ill. 2014) (withdrawal of election permitted with consent of debtor). In contrast, the withdrawal of a Section 1111(b) election may be denied if the plan or disclosure statement has not been materially altered or if the withdrawal does not occur in a timely manner. *See In re Keller*, 47 B.R. 725 (Bankr. N.D. Iowa 1985) (denying withdrawal of election where a plan alteration was such that an electing creditor would have had the controlling vote of an unsecured creditor class but for the election on the basis that the electing creditor should not be permitted to "correct its mistake"); *Mut. Life Ins. Co. v. Paradise Springs Assocs. (In re Paradise Springs Assocs.)*, 165 B.R. 913, 919-20 (Bankr. D. Ariz. 1993) (denying withdrawal of election where plan alterations increased the valuation of the secured creditor's collateral). In order for a plan modification to be considered material, the changes must be tantamount to the filing of an entirely new plan. *Keller*, 47 B.R. at 730; *IPC Atlanta Ltd. P'ship*, 142 B.R. at 554-5.

This strict standard requires that creditors consider the decision early in the plan process. Once a creditor makes the election, it is very unlikely that the court will permit rescission, especially where the debtor or the plan proponent will be prejudiced by the creditor's change of heart. This can present challenges in many different scenarios – in particular where the asset value is fluctuating or the subject of significant dispute.

In addition, the Section 1111(b) election is typically required in advance of any judicial determination of value. Further, because some economic terms - such as cram down interest rate - can be left undetermined until as late as the confirmation hearing, the secured creditor may find itself in the precarious position of being forced to commit to an election (or forego the election) based on incomplete information.

<u>Limitations</u>

The Section 1111(b) election is not without limitations. Notably, an undersecured creditor may not make the election if the property is to be sold in a Section 363 sale or under a plan. 11 U.S.C. §1111(b)(1)(A)(ii) (applicable to non-recourse creditors) and 11 U.S.C. §1111(b)(1)(B)(ii) (applicable to recourse creditors). Conceptually, this limitation is in line with the purpose behind the election. If there is an open market test of the sale price and the secured creditor has the right to credit-bid its debt under Section 363(k), the creditor gains the protection against the artificially low collateral value that the Section 1111(b) election was designed to provide, and thus the election (at least arguably) isn't necessary.

Case Illustration: <u>When the collateral is sold in a nonjudicial sale after the petition is filed, can a Section 1111(b) election still be made?</u>

> In *Mastan v. Salamon (In re Salamon)*, 528 B.R. 171 (B.A.P. 9th Cir. 2015), the plaintiff held a lien on property of the debtor's estate on the date the petition was filed, but a subsequent nonjudicial foreclosure sale of the property satisfied part of the lien. The court found that the plaintiff no longer had a claim "secured by a lien on property of the estate" for purposes of Section 1111(b) after the foreclosure sale, and thus the election could not be made. *Mastan v. Salamon (In re Salamon)*, 528 B.R. 171 (B.A.P. 9th Cir. 2015).

Another limitation is that an undersecured creditor may not make an election where the interest in such property is of "inconsequential value". 11 U.S.C. §1111(b)(1)(B)(i). This limitation is designed to prevent disproportionate leverage in the Section 1129 plan confirmation process.[2]

Courts are divided on the issue of whether "inconsequential value" should be determined by comparing the value of the collateral to the value of the total claim or whether a results oriented test should be employed. *Compare In re Wandler*, 77 B.R. 728, 734 (Bankr. D.N.D. 1987) (adopting a practical approach in concluding that where a claim cannot be paid in full at the end of a specified period of time without exceeding the present value of the collateral, the claim is of inconsequential value and the Section 1111(b) election should not be allowed) *with In re McGarey,* 529 B.R. 277 (D. Ariz. 2015) (inconsequential value is determined by comparing the value of the collateral to the value of the lien, not the creditor's total claim) *and In re AT-NET Services-Charlotte, Inc.*, No. 14-32047, 2015 Bankr. LEXIS 2730 ( Bankr. W.D.N.C. Aug. 17, 2015) (noting that "[h]ad Congress intended inconsequential value to be determined by

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[2] See also Ito, Peter. "How Inconsequential Is 'Inconsequential Value'?" 31 Am. Bankr. Inst. J. 22 (Oct. 2012).

analyzing whether the debtor can satisfy the requirements of section 1129(b) in light of the secured creditor's section 1111(b) election, it would have said so in section 1111(b) or elsewhere in the Bankruptcy Code.").

<u>Strategic Considerations</u>

With an understanding of how the Section 1111(b) election works in practice, the undersecured creditor should consider the following in determining whether to make an election:

1. Collateral Value;
2. Unsecured Claim Value;
3. Potential to Control Unsecured Claim Class;
4. Likely Cram Down Interest Rates and Other Terms; and
5. The Debtor's Prospects for Defaulting Under Plan and/or Selling Asset.

While a number of these considerations are simply not knowable at the time the election is made, the creditor should be able assess the extent to which its collateral is undervalued, the prospect for the collateral to increase in value, and the timetable for appreciation to occur. Further, the creditor should attempt to determine what the value of its deficiency claim might be and whether the claim is large enough relative to other unsecured claims such that it may control the class. Finally, a thorough examination of the plan's economic terms will enable the creditor to compare potential recoveries with and without the election.

# Exploring the Boundaries of Bankruptcy Code § 1141(d)(6)(A)'s Exception to Discharge

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A central advantage of chapter 11 for a reorganizing corporate debtor is the ability to receive a discharge of its debts under Bankruptcy Code § 1141 upon confirmation of a plan of reorganization. However, there are exceptions to a corporate debtor's ability to obtain a discharge under § 1141. One such exception, added to the Bankruptcy Code in 2005, is contained in § 1141(d)(6)(A). Section 1141(d)(6)(A) excludes from discharge certain debts relating to fraud and false statements. Because the precise contours of § 1141(d)(6)(A) remain undefined, it continues to present uncertainty for many corporate debtors.

**I. Availability of a Discharge Under Bankruptcy Code § 1141**

Upon confirmation of a chapter 11 plan, a corporate debtor generally receives a discharge of all debts arising prior to confirmation.[1] The discharge serves as a demarcation line between obligations of the prepetition debtor and obligations of the reorganized debtor and provides finality that allows the reorganized debtor to focus on its future operations.[2] With limited exceptions (the discharge does not apply to a liquidating debtor), the discharge was generally understood as broad, applying to all pre-confirmation debts.[3] Indeed, until 2005, the discharge was generally understood to cover debts for fraud.[4] The introduction of § 1141(d)(6) in 2005 has changed the landscape of the discharge available to a corporate debtor.

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[1] 11 U.S.C. § 1141(d)(1)(A) ("the confirmation of a plan . . . discharges the debtor from any debt that arose before the date of such confirmation").

[2] "The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders." H.R. Rep. No. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

[3] 11 U.S.C. § 1141(d)(3) (stating that confirmation of a plan does not discharge the debts of a liquidating debtor); Ralph Brubaker, *Taking Exception to the New Corporate Discharge Exceptions*, 13 Am. Bankr. Inst. L. Rev. 757, 757 n.4 (2005) ("Before the 2005 amendments, particular kinds of debts were excepted from this discharge only in the case of an *individual* debtor.") (emphasis in original).

[4] William Hildbold, *Will Section 1141(d)(6) of the Bankruptcy Code Destroy Corporate Chapter 11 Reorganizations by Rendering SEC Claims Non-Dischargeable?*, 17 Am. Bankr. Inst. L. Rev. 551, 551 (2009) ("Historically, corporate debtors received a total discharge of their debts for fraud.").

## II. Introduction of § 1141(d)(6)

Section 1141(d)(6) was added to the Bankruptcy Code in 2005 as part of the Bankruptcy Abuse and Consumer Protection Act of 2005 ("BAPCPA").[5] Section 1141(d)(6) was one of only a handful of BAPCPA provisions pertaining to corporate bankruptcies in a statute that otherwise, as its name suggests, focused primarily on issues affecting consumer bankruptcies. Section 1141(d)(6) provides:

> 6) Notwithstanding paragraph (1), the confirmation of a plan does not discharge a debtor that is a corporation from any debt—
>
> (A) of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to a domestic governmental unit, or owed to a person as the result of an action filed under subchapter III of chapter 37 of title 31 or any similar State statute; or
>
> (B) for a tax or customs duty with respect to which the debtor—
>
> (i) made a fraudulent return; or
>
> (ii) willfully attempted in any manner to evade or to defeat such tax or such customs duty.[6]

## III. Scope of Debts Covered by § 1141(d)(6)(A)

On its face, § 1141(d)(6)(A) excludes from discharge debts owed to two types of creditors—debts owed to a governmental unit and debts owed to a person as a result of an action filed under the False Claims Act (FCA).[7] While it is not abundantly clear whether the prefatory language—"of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a)"—applies to both types of debts, the only court that has addressed the issue has held that the two clauses of § 1141(d)(6)(A) are separate; therefore, the § 523 limitation applies only to debts owed to a

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5 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

6 11 U.S.C. § 1141(d)(6).

7 The False Claims Act is codified at 31 U.S.C. §§ 3729-33.

governmental unit.[8] Debts owed to a person as a result of an FCA action are not subject to the same limitation.

### A. Debts Owed to a Governmental Unit

By incorporating certain of § 523's exceptions to discharge for individual debtors into § 1146(d)(6)(A), those exceptions become applicable to corporate debtors with respect to debts owed to a governmental unit.[9] The question then becomes: what types of debts fall within the scope of § 523(a)(2)(A) and (B) such that they are excepted from a corporate debtor's discharge?

#### 1. Scope of § 523(a)(2)'s Discharge Exclusion

Section 523(a)(2)(A) and (B) provides that the following types of debts may not be discharged:

> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;
> (B) use of a statement in writing—
> (i) that is materially false;
> (ii) respecting the debtor's or an insider's financial condition;
> (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
> (iv) that the debtor caused to be made or published with intent to deceive;[10]

In *Field v. Mans*, the Supreme Court interpreted the standard that must be met for a debt to be non-dischargeable under § 523(a)(2) and held that the elements of the tort of actual fraud

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8 *United States ex rel. Minge v. Hawker Beechcraft Corp. (In re Hawker Beechcraft, Inc.)*, 515 B.R. 416, 424 (S.D.N.Y. 2014).

9 *Southwest Ga. Farm Credit, ACA v. Breezy Ridge Farms, Inc. (In re Breezy Ridge Farms, Inc.)*, Adv. Pro. No. 09-1011-JDW, 2009 WL 1514671, at *2 (Bankr. M.D. Ga. May 29, 2009) ("Thus, in Chapter 11, Congress has applied parts of § 523(a) to corporate debtors, even though such debtors are excluded from § 523(a) by its terms.").

10 11 U.S.C. § 523(a)(2)(A)-(B).

apply.[11] The Supreme Court's decision in *Field* has led many courts to limit the application of § 523(a)(2) to prevent the discharge of debts for money or property obtained based on a misrepresentation by the debtor.[12] Those courts generally hold that, to establish fraud, "[a] creditor must prove that: (1) the debtor made a false representation to deceive the creditor, (2) the creditor relied on the misrepresentation, (3) the reliance was justified, and (4) the creditor suffered a loss as a result of the misrepresentation."[13]

The U.S. Court of Appeals for the First Circuit, joining several other courts, has held that "actual fraud" can be broader than just fraud relating to a misrepresentation by the debtor.[14] For example, it could include the receipt by the debtor of fraudulently transferred property or other fraudulent conduct.[15] In one recent case, the U.S. Bankruptcy Court for the District of Massachusetts noted that allegations that the debtor obtained money and property through failures to disclose conflicts of interest, commingling of cash, creation of separate books and records, and the submission of false and misleading accounting reports and false financial records, could constitute fraud within the meaning of § 523(a)(2). The court concluded that "[t]hose allegations do not rely exclusively on false statements, rather they allege fraudulent conduct and as such they are sufficient to survive a motion to dismiss."[16]

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11 *Field v. Mans*, 516 U.S. 59, 69 (1995).

12 *McClellan v. Cantrell*, 217 F.3d 890, 892 (7th Cir. 2000) ("Plenty of cases, it is true, assume that fraud equals misrepresentation").

13 *SEC v. Bilzerian (In re Bilzerian)*, 153 F.3d 1278, 1281 & n.12 (11th Cir. 1998) (citing *Field*, 516 U.S. at 73-75); *see Palmacci v. Umpierrez*, 121 F.3d 781, 786 (1st Cir. 1997) ("Under the traditional common law rule, a defendant will be liable if (1) he makes a false representation, (2) he does so with fraudulent intent, i.e., with 'scienter,' (3) he intends to induce the plaintiff to rely on the misrepresentation, and (4) the misrepresentation does induce reliance, (5) which is justifiable, and (6) which causes damage (pecuniary loss).").

14 *Sauer Inc. v. Lawson (In re Lawson)*, 791 F.3d 214, 220 (1st Cir. 2015), *petition for cert. filed*, 84 U.S.L.W. 3054 (U.S. July 24, 2015) (No. 15-113) ("We adopt this common law understanding and hold that 'actual fraud' under § 523(a)(2)(A) is not limited to fraud effected by misrepresentation.").

15 *Id.*

16 *Babin v. Stepanian (In re Stepanian)*, 545 B.R. 424, 431 (Bankr. D. Mass. 2015).

Whatever form "actual fraud" takes, the claimant must establish that it suffered damages in the form of a pecuniary loss for its claim to be excluded from discharge under § 523(a)(2).[17] While a pecuniary loss is required to exclude a debt from discharge, the amount of the debt excluded is not limited to the amount of money or property obtained by the debtor's fraud. Rather the exclusion extends to all damages arising out of the fraud claim.[18]

**2. Claims by the Securities and Exchange Commission**

Section 1141(d)(6)(A) is particularly relevant with respect to claims by the SEC against a corporate debtor that seek disgorgement (designed to make investors whole) and civil penalties (designed to punish wrongdoers) for securities law violations. The SEC has taken the position that § 1141(d)(6)(A) makes such monetary claims non-dischargeable in a chapter 11 corporate debtor case. If it is true that such claims could survive confirmation of a plan and be asserted against a reorganized debtor, the quantum of and uncertainty surrounding these types of claims could threaten to derail a successful reorganization.[19] Indeed, the SEC has recognized that "an SEC monetary claim is potentially an overhang on the company's ability to reorganize."[20]

To be sure, some courts have suggested that monetary claims by the SEC are non-dischargeable under § 523.[21] But this conclusion is not free from debate. Critics of the SEC's position argue that the SEC cannot meet the *Field v. Mans* standards for non-dischargeability under § 523(a)(2), because the SEC itself neither relied on any misrepresentation by the debtor

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17 *Id.*

18 *Cohen v. de la Cruz*, 523 U.S. 213, 219 (1998).

19 *See* Hildbold at 590 (Stating that accepting the SEC's interpretation of § 1141(d)(6)(A) would "allow the SEC to maintain its contingent securities law claims past the reorganization of the debtor, creating uncertainty and instability in the wherewithal of the reorganized debtor").

20 Alistaire Bambach, *The SEC in Bankruptcy: Past, Present and Future*, 18 Am. Bankr. Inst. L. Rev. 607, 610-11 (2010).

21 *See SEC v. Hodge (In re Hodge)*, 216 B.R. 932, 937 (Bankr. S.D. Ohio 1998).

nor suffered a pecuniary loss from the debtor's fraud.[22] In addition to relying on authority interpreting the scope of § 523(a)(2), critics focus on the other portions of § 1141(d)(6)(A), each of which deals with fraud on the government itself: "The tie that binds the subsections of 1141(d)(6) together is debts owed for perpetrating a fraud against the Government, which results in a pecuniary harm to the Government. . . . Therefore a logical reading of the first clause of subsection (A) is it must have been intended to cover only those debts owed to the Government for fraud perpetrated by debtors against the Government."[23]

Critics also argue that an interpretation of § 1141(d)(6)(A) that would render monetary claims by the SEC non-dischargeable would subvert the Bankruptcy Code's priority scheme. For example, § 510(b) subordinates shareholders' claims for fraud to claims of all unsecured claimants.[24] If the SEC's interpretation were accepted, shareholders could receive funds that they would not otherwise be entitled to under the Bankruptcy Code. The SEC would be able to collect funds from the reorganized debtor and distribute them to the shareholders while other unsecured creditors would not have any such recourse. This would effectively reorder the priority of shareholder claims above the claims of unsecured creditors in a manner inconsistent with § 510(b).[25]

The boundaries of § 1141(d)(6)(A) and its potential application to monetary claims by the SEC remain largely untested and undetermined. Until courts provide additional clarity on this issue, regardless of which interpretation ultimately prevails, in the words of one commentator:

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22 Hildbold at 570, 594.

23 Hildbold at 582.

24 11 U.S.C. § 510(b).

25 *See* Hildbold at 583, 591

"Section 1141(d)(6) is sure to foster endless misunderstandings (and even outright manipulation) regarding the function of the corporate discharge in chapter 11."[26]

### 3. Procedural Requirements of § 1141(d)(6)(A)

In addition to the substantive uncertainty surrounding the scope and application of § 1141(d)(6)(A), there are procedural ambiguities as well. Specifically, what steps (if any) the government needs to take to prevent discharge of a debt pursuant to that section. "There are two types of exceptions to discharge: (1) those that are self-executing and (2) those that require the creditor to seek a determination of dischargeability in the bankruptcy court by a fixed deadline, failing which the exception does not apply and the debt is discharged."[27]

The exception to discharge against an individual pursuant to § 523(a)(2) is not self-executing—a creditor must satisfy the procedural requirements set forth in § 523(c)(1) and Federal Rule of Bankruptcy Procedure 4007(c). Rule 4007(c) requires that the creditor file a complaint within 60 days of the first date set for the meeting of creditors.[28] The U.S. Bankruptcy Court for the Southern District of New York, in *Hawker Beechcraft*, held that those same procedural requirements applied to the government's attempt to exclude a debt from discharge under § 1146(d)(1)(A).[29] The court reasoned that, although the exception to discharge contained in § 523(a)(2) expressly applied to only individual debtors, § 523(c), which contained the procedural requirements for seeking to prevent discharge of a debt, contained no such limitation.

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26 Brubaker at 775.

27 *United States ex rel. Minge v. Hawker Beechcraft Corp. (In re Hawker Beechcraft, Inc.)*, 493 B.R. 696, 701 (Bankr. S.D.N.Y. 2013), *rev'd in part,* 515 B.R. 416 (S.D.N.Y. 2014).

28 Fed. R. Bankr. P. 4007(c).

29 *Hawker Beechcraft*, 493 B.R. at 705.

Ultimately, the U.S. District Court for the Southern District of New York reversed the Bankruptcy Court's decision, holding that § 1141(d)(6)(A)'s exception to discharge *is self-executing*.[30]

**B. FCA-Related Debts**

Section 1141(d)(6)(A)'s second clause excepts from discharge debts owed to a person as the result of an action brought under the FCA. "The FCA imposes civil liability upon 'any person who,' *inter alia*, 'knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval.'"[31] FCA claims can be brought directly by the government. In addition, FCA claims are often brought by a private person "for the person and for the United States Government . . . in the name of the Government" through a *qui tam* action.[32] Even when a private person pursues an FCA claim through a *qui tam* action, the violator remains liable to the government.[33] In the event of a recovery, the *qui tam* plaintiff receives a portion of the award. The mechanics of *qui tam* actions led the court in *Hawker Beechcraft* to conclude that a debt owed in respect of a *qui tam* action did not fall within the scope of the second clause of § 1141(d)(6)(A) because it was not "owed to a person" within the meaning of that section.[34] The court noted that its conclusion did not render the second clause of § 1141(d)(6)(A) toothless—a *qui tam* plaintiff could still be entitled to an award for attorneys' fees, costs, and expenses in a

30 *Hawker Beechcraft*, 515 B.R. at 425 ("Nothing in the language of 11 U.S.C. § 1141(d)(6) indicates that Congress sought to import the procedural requirements of 11 U.S.C. § 523(c)(1) to apply to a debtor that is a corporation. On its face, therefore, section 1141(d)(6) is self-executing.").

31 *Hawker Beechcraft*, 493 B.R. at 710 (quoting 31 U.S.C. § 3729(a)(1)).

32 31 U.S.C. § 3730(b)(1).

33 *Hawker Beechcraft*, 493 B.R. at 711 (quoting 31 U.S.C. § 3729(a)(1)).

34 *Id.* at 712 ("'Persons' and 'governmental units' are mutually exclusive under the Bankruptcy Code").

successful *qui tam* suit, and those amounts could be non-dischargeable under § 1141(d)(6)(A)'s FCA provision.[35]

Notwithstanding the potential limitations on seeking to render FCA debts non-dischargeable under the second clause of § 1141(d)(6)(A), such debts may be non-dischargeable under the first clause of that section—either through an action brought by the government itself, or potentially through an action brought by a *qui tam* plaintiff on the government's behalf.[36]

## V. Practice Considerations

### A. Chapter 11 Plan Language

Given the continuing uncertainty surrounding the scope of § 1146(d)(6)(A), particularly with respect to securities claims, practitioners should take care to address its application specifically in any chapter 11 plan where government claims could be a concern. The following examples demonstrate a few ways that the application of § 1141(d)(6) has been addressed in plans depending on the desired result.

Preserving only non-pecuniary SEC actions:

> Pursuant to section 1141(d) of the Bankruptcy Code, and except as otherwise specifically provided in the Plan, the distributions, rights, and treatment that are provided in the Plan shall be in complete satisfaction, discharge, and release, effective as of the Effective Date (regardless of when a distribution is made), of Claims, Equity Interests, and Causes of Action of any nature whatsoever …. ***The actions of the Securities and Exchange Commission that (1) are non-pecuniary, (2) do not relate to collection of a Claim, or (3) do not pursue injunctions that could***

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35 As noted above, the Bankruptcy Court's decision in *Hawker Beechcraft* was overturned on appeal. The District Court did not reach the issue of whether a *qui tam* plaintiff's claims are "debts owed to a person" under § 1141(d)(6)(A).

36 *See United States v. Spicer (In re Spicer)*, 155 B.R. 795, 802 (Bankr. D.D.C. 1993) (recognizing that debts relating to FCA claims may be non-dischargeable if they satisfy the standards of § 523(a)(2)), *aff'd,* 57 F.3d 1152 (D.C. Cir. 1995); *Hawker Beechcraft*, 515 B.R. at 432-33 ("In short, *qui tam* relators have Article III standing to assert FCA claims in a federal court even though those claims assert the government's injury in fact.").

> ***be reduced to a monetary Claim, are not discharged under Article VIII.A of the Plan.***[37]

Preserving a broader set of SEC actions:

> Notwithstanding anything to the contrary in this Confirmation Order or the Plan, the Securities and Exchange Commission ("***SEC*** ") expressly reserves its right to continue to investigate, and, in its sole discretion, prosecute and enforce any and all Claims against any or all of the Debtors or the Reorganized Debtors arising from any prepetition violations by any Debtor of any of the U.S. securities laws other than Plan–Related Claims (collectively, the "***Reserved SEC Claims*** "), including, without limitation, any claims for disgorgement of any benefits received by any Debtor as a result of any such violations and any Claims for penalties imposed by the SEC in respect of any such violations. For the avoidance of doubt, pursuant to Section 10.2(b) of the Plan, all Plan–Related Claims of the United States Government or any of its agencies or any state and local authority whatsoever are released, waived and discharged. ***Nothing in this Confirmation Order or the Plan shall result in the discharge of any Reserved SEC Claims, and the SEC expressly reserves its rights to assert that any and all Reserved SEC Claims are non-dischargeable as against the Reorganized Debtors pursuant to Sections 1141(d)(6)(a) and 523(a)(2)(A) of the Bankruptcy Code.*** The SEC has advised this Court and the Debtors that, as of the entry of this Confirmation Order, it has not yet determined whether to assert any Reserved SEC Claims against any or all of the Debtors or Reorganized Debtors.[38]

### B. Application of § 1141(d)(6) to § 363 Sales

In an effort to avoid the application of § 1141(d)(6), rather than seeking to confirm a chapter 11 plan, a corporate debtor may pursue a sale of its assets and business pursuant to § 363. Section 1141(d)(6) expressly applies only in the chapter 11 plan confirmation context. Because a § 363 sale can result in the transfer of a debtor's property "free and clear of any interest" of a

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[37] Order (I) Approving the Debtors' Disclosure Statement Pursuant to Sections 1125 and 1126(b) of the Bankruptcy Code and (II) Confirming the Debtors' Amended Prepackaged Joint Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code, *In re AR Broad. Holdings, Inc.*, No. 11-13674, 2011 WL 6841150 (Bankr. D. Del. Nov. 18, 2011) ¶ 85 (emphasis added).

[38] Findings of Fact, Conclusions of Law and Order (I) Approving Disclosure Statement and (II) Confirming the Debtors' First Amended Joint Prepackaged Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, *In re Bally Total Fitness of Greater New York, Inc.*, No. 07-12395 (Bankr. S.D.N.Y. Sept. 17, 2007), ECF No. 466 ¶ 16 (emphasis added).

creditor, this approach could limit the SEC's recourse so that it could not pursue the successor entity for any potential claims. Of course, the § 363 sale would not itself extinguish any SEC claim, and to the extent that such a claim were determined to be non-dischargeable, it would remain non-dischargeable against the estate following the sale. In that event, the SEC would have recourse to any assets of the debtor's estate, including the proceeds of the sale, in accordance with its priority under the Bankruptcy Code.

# *ASARCO* and *Boomerang Tube*: Recent Decisions Limit Attorneys' Reimbursement for Fees Incurred Defending Fees

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The recent decisions by the Supreme Court in *ASARCO*[1] and by the U.S. Bankruptcy Court for the District of Delaware in *In re Boomerang Tube*[2] held that attorneys must bear the cost of defending their fees against challenges.

Bankruptcy Code § 330 authorizes bankruptcy courts to award "reasonable compensation for actual, necessary services rendered by . . . [an] attorney."[3] Attorneys file fee applications for compensation under this provision, which are then subject to court review and possible objections from various parties in the bankruptcy case. Until last year, many courts would allow attorneys to recover the cost of defending their fees if they prevailed in protecting their fees from an objection or other challenge, typically on the theory that "[t]o deny [counsel] reasonable compensation for successfully defending its fee awards would dilute its compensation for 'actual and necessary services,'"[4] which are compensable under §330. In *ASARCO*, Justice Thomas, writing for the majority, explained that courts should recognize departures from the American Rule—which that each litigant pays its own attorneys' fees—"only in 'specific and explicit provisions for the allowance of attorneys' fees under selected statutes.'"[5] Finding no such "specific and explicit" provisions in § 330 or elsewhere in the Bankruptcy Code, the Court held that § 330 did not authorize courts to award attorneys' fees for time spend defending their fees.[6] The Court reasoned that the time spent on fee-defense litigation was not a "service" rendered to

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1 *Baker Botts L.L.P v. ASARCO LLC*, 135 S. Ct. 2158 (2015).

2 *In re Boomerang Tube, Inc.*, 548 B.R. 69 (Bankr. D. Del. 2016)

3 11 U.S.C. § 330.

4 *Smith v. Edwards & Hale, Ltd. (In re Smith)*, 317 F.3d 918, 929 (9th Cir. 2002) (abrogated in part on other grounds by *Lamie v. United States Tr.*, 540 U.S. 526, 531-539 (2004)); see also e.g., *Hennigan Bennett & Dorman LLP v. Goldin Associates L.L.C. (In re Worldwide Direct),* 334 B.R. 108, 111 (D. Del. 2005) (following *Smith*); *In re Computer Learning Ctrs., Inc.,* 285 B.R. 191, 224 (Bankr. E.D. Va. 2002) ("the Congressional objective of compensating professionals the same whether they are engaged in a bankruptcy case or in a non-bankruptcy matter are furthered by allowing additional fees to successfully present, prosecute or defend a fee application in appropriate circumstances").

5 *ASARCO*, 135 S.Ct. at 2164.

6 *Id.*

the estate within the scope of § 330.[7] The Court—by acknowledging that the American Rule could be eschewed by contract—seemed to leave open the possibility that attorneys could recoup amounts incurred for defending their fees under certain circumstances.[8]

In *Boomerang Tube*, the Delaware Bankruptcy Court appears to have limited the contractual approach to preserving the ability to seek payment for defending fee disputes. There, Judge Walrath held that fees for defending fees were "outside the scope" of an attorney's employment and therefore "unreasonable."[9] She rejected the United States Trustee's argument that *ASARCO* prohibited fee-defense provisions, but found that the fee-dispute provisions in the attorneys' contract with their client, an official committee, could not be exceptions to the American Rule because the party ultimately responsible for paying the attorneys' fees was the estate, which was not party to the contract. Moreover, following *ASARCO*, the court found that any time spent defending fees benefitted the attorney and not the committee, and was therefore not a service to the committee and not compensable under § 328(a).[10] The court noted that its holding would be the same if the fee defense provisions were included in a retention agreement filed by any professional under § 328(a)—including one retained by the debtor.[11]

While it is too early to know the full impact of these decisions, they could reduce the amount of fees that bankruptcy professionals can expect to recover in any given engagement.

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7 *Id.* at 2166.

8 *Id.* at 2161 ("'Each litigant pays his own attorney's fees, win or lose, unless a statute or contract provides otherwise.'" (quoting *Hardt v. Reliance Standard Life Ins. Co*., 560 U.S. 242, 253 (2010))).

9 *Boomerang Tube, Inc.*, 548 B.R. at 75.

10 Section 328(a) provides that "The trustee, or a committee appointed under section 1102 of this title, with the court's approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment. . . "

11 *Boomerang Tube, Inc.*, 548 B.R. at 79 n.6.