Business Track

Getting to Confirmation: Why Do They Keep Moving the Finish Line on Me?

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SECTION 1111(b) AND HOW IT AFFECTS CONFIRMATION

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INTRODUCTION

Section 1111(b) of the Bankruptcy Code solves two potential problems for secured creditors in Chapter 11. First, section 1111(b) provides that a creditor's claim is treated in bankruptcy as recourse, even when the underlying debt is nonrecourse according to contract provisions or state law. Second, section 1111(b) allows an undersecured creditor to elect to have its claim treated as fully secured in which case it would preserve the potential opportunity to remain a beneficiary of any future appreciation or hidden value of the creditor's collateral held by the debtor.

Many attorneys, including experienced bankruptcy attorneys, do not understand how section 1111(b) functions and incorrectly interpret the section to the detriment of their clients. To get a better understanding of how section 1111(b) fits within the broader scope of Chapter 11 and plan treatment, it is helpful to first look at reorganization proceedings before 1111(b).

I. 1111(b)-WHY IT WAS ENACTED AND HOW IT PROTECTS CREDITORS

A. *Pine Gate* and the Bankruptcy Act Treatment of Secured Creditors Prior to Section 1111(b)

1. Prior to adoption of section 1111(b) in 1979, the Bankruptcy Act allowed debtors to file bankruptcy and to value an asset at a low point in the market, pay a secured creditor in full satisfaction of the creditor's claim based upon a secured claim equal to the low valuation amount, and in so doing eliminate the possibility of additional recovery by the secured creditor upon default or otherwise.

2. *In re Pine Gate Assocs., Ltd.*, 2 Bankr. Ct. Dec. 1478 (Bankr. N.D. Ga. 1976) is the seminal case dealing with just this issue. In *Pine Gate*, a debtor owned a housing complex subject to security interests asserted by two lenders that had made nonrecourse loans to the debtor. The value of the collateral securing the loans dropped significantly. The debtor's confirmed a bankruptcy plan to pay the lenders the appraised value of their collateral. Soon thereafter, the value of the collateral recovered and the debtor became the sole beneficiary of the appreciation.

3. As a result of *Pine Gate*, "a debtor could file bankruptcy proceedings during a period when real property values were depressed, propose to repay secured indebtedness only to the extent of the value of the collateral at that time, and preserve all potential future appreciation of that property solely for the benefit of the debtor." Haydon, Owens, Salerno & Hansen, *The 1111(b)(2) Election: A Primer*, 13 BANKR. DEV. J. 99, 105 (1996). In response to the *Pine Gate* decision, Congress enacted section 1111(b).

B. How Section 1111(b) Solves the *Pine Gate* Problem

1. Typical treatment of claims of a secured creditor in Chapter 11

a. Bankruptcy Code section 506(a)(1) provides that "[a]n allowed claim of a creditor secured by lien on property in which the estate has an interest, … is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, … and is an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of such allowed claim." 11 U.S.C. § 506(a)(1). Under section 506(a), "the total claim of an undersecured creditor is bifurcated into two claims, a secured claim equal to the value of the collateral and an unsecured claim equal to the remainder of the obligation owing to the creditor as of the petition date." *In re Weinstein*, 227 B.R. 284, 291-92 (B.A.P. 9th Cir. 1998). Treatment of the unsecured portion of an undersecured creditor's claim in Chapter 11 (absent section 1111(b)) would depend on whether the creditor has recourse. "Because § 502(b)(1) disallows any claim to the extent that it is unenforceable against the debtor or the debtor's property under any agreement or under applicable nonbankruptcy law, the undersecured creditor with a nonrecourse unsecured claim would not be entitled to a distribution in bankruptcy [based upon the unsecured portion of its claim]" absent section 1111(b). *Id.* at 292 *quoting In re Bloomingdale Partners*, 155 B.R. 961, 969 (Bankr. N.D. Ill. 1993).

2. Cramdown without making an 1111(b) election

a. Section 1129(b)(2) is used to "cram down" a creditor class when the creditor class objects to treatment under a Chapter 11 plan. Section 1129(b)(1) allows a court to confirm a cram down plan over the objections of a secured creditor "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims … that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1). Under a cramdown plan, without a section 1111(b)(2) election, the lien of the undersecured creditor is stripped down by § 506(d) to the amount of the allowed secured claim, which is the value of the collateral. The secured creditor is then entitled to payments over time, the present value of which is at least equal to the value of the collateral. And the unsecured portion of the claim is typically (but not always) classified with the other unsecured creditors.

b. Absent a section 1111(b) election, section 1111(b)(1)(A) provides an important benefit to undersecured creditors holding nonrecourse claims by providing

that a secured claim shall be allowed as if the claim had recourse against the debtor. *See* 11 U.S.C. § 1111(b)(1)(A). Under section 1111(b), "[t]he unsecured portion of [an undersecured creditor's] claim is not disallowed in bankruptcy merely because it is nonrecourse under the security agreement or under applicable nonbankruptcy law." *In re Weinstein*, 227 B.R. at 292.

i. A lien creditor is entitled to an unsecured deficiency claim for the entire amount of its debt even though there is no value in the collateral securing a non-recourse loan lender's mortgage. *See In re Brookfield Commons No. 1 LLC*, 735 F.3d 596, 600 (7th Cir. 2013). *But see In re SM 104 Ltd.*, 160 B.R. 202, 216 (Bankr. S.D. Fla. 1993) (totally unsecured nonrecourse creditor was not entitled to a deficiency claim and therefore had no right to vote on the plan).

ii. The discharge of a secured creditor's recourse debt in a prior Chapter 7 will not prevent the creditor from having an unsecured recourse claim in a subsequent Chapter 11 proceeding. *In re Batista-Sanechez*, 2014 WL 308970, at *5 (Bankr. N.D. Ill. Jan. 27, 2014).

iii. A non-recourse real estate tax claim disallowed under section 502(b)(3) because it exceeds the value of the property is not resurrected as a recourse claim under section 1111(b)(1)(A), and a tax authority is not entitled to an unsecured claim for the amount by which its claim exceeds the value of the property. *In re 300 Washington Street LC*, 528 B.R. 534, 546-46 (Bankr. E.D.N.Y. 2015) (the taxing authority was also precluded from trying to resurrect its disallowed claim by making an 1111(b) election); *In re Shefa, LLC*, 524 B.R. 717, 739-40 (Bankr. E.D. Mich. 2015).

3. Cramdown after making an 1111(b) election

a. If the section 1111(b)(2) election is made, "then notwithstanding section 506(a) … , such claim is a secured claim to the extent that such a claim is allowed." 11 U.S.C. § 1111(b)(2). The creditor's total claim is treated as the allowed secured claim for purposes of Chapter 11 bankruptcy plan confirmation. The election requires the creditor to forego its unsecured deficiency claim, but provides the creditor a single secured claim with a lien on collateral, collateral that is worth less than the amount of the creditor's claim.

b. There are limited exceptions to this general rule. For example, a creditor may not make an 1111(b)(2) election if the value of the property subject to the security interest it holds (after consideration of any priority interests in the collateral) is of inconsequential value. 11 U.S.C. § 1111(b)(1)(B). Also a creditor may not make the election when it has an interest in collateral to be sold under the plan or under section 363. *Id*.

c. Under the election, plan payments made to the secured creditor must equal (1) the present value of the secured creditor's security interest in its collateral (the section 1129(b)(2)(A) requirement), and (2) the payments must aggregate to at least the amount of the allowed claim (the section 1111(b) requirement). 11 U.S.C. § 1129(b)(2)(A)(i)(II). To meet these requirements the debtor must be able to affirmatively answer the following two questions: (1) does the discounted value of all future plan payments equal the present value of the creditor's security interest in the collateral, and (2) do the total plan payments, including principal and interest, total at least the amount of the allowed claim? *In re Scrubs Car Wash, Inc.*, 527 B.R. 453 (D. Colo. 2014) (includes a concise explanation of the distribution calculations). *See In re Settlers' Housing Service, Inc.*, 505 B.R. 483, 491-92 (Bankr. N.D. Ill. 2014) (in concluding that the present value requirement was not met even using the debtor's 5% assumed discount rate, the court implied that a higher rate was required under *Till vs. SCS Credit Corp.*, 541 U.S. 465, 480 (2004)).

4. Post-Confirmation Effect of Section 1111(b) Election

a. Once the section 1111(b)(2) election is made, the undersecured creditor's allowed claim is equal to its total claim rather than the value of the collateral. One instance where the value of a section 1111(b) election is apparent is when the collateral in which a creditor has an interest appreciates and the debtor defaults. In this situation, "instead of having a secured claim based upon the value of the collateral at confirmation, with the remaining debt having received unsecured treatment and/or discharged, the creditor may foreclose on the collateral and recover up to the full amount of its claim." *In re Wandler*, 77 B.R. 728, 732-33 (Bankr. D.N.D. 1987). The creditor will also be entitled to be paid the balance owing on its entire claim upon a sale of the property by the debtor.

b. A secured lender making the election also benefits at the time of refinancing of the underlying debt, whether such financing occurs prior to the maturity of the loan, or at maturity if the total plan payments to the creditor required to be made as a result of the election is greater than the total plan payments that would have been required to be made based upon the secured claim absent the election. The payment at the time of such refinancing or at maturity will equal the total amount of the secured creditor's debt as of the confirmation date less any payments made since confirmation of the plan.

II. THE MECHANICS OF MAKING AN 1111(b) ELECTION-AND CALCULATION

A. Making the Election

1. Bankruptcy Rule 3014 provides that an 1111(b) election may be made at any time prior to the conclusion of the hearing on the disclosure statement or within such later time as fixed by the court. Failure to make a timely election may bar the election from being made at a later time. *See In re Town Centers Develop. Co.,* 516 B.R. 439,

445 (E.D. Mich. 2014) (creditor would have been entitled to make an 1111(b) election with respect to that portion of collateral not being sold but failed to timely do so).

2. The election must be in writing and signed unless made at the hearing on the disclosure statement.

3. A secured creditor cannot withdraw its section 1111(b)(2) election "unless a proposed modification" to a debtor's plan is "objectively and materially adverse to the creditor." Additionally, a secured creditor's knowledge about a proposed modification and its effect on the creditor can preclude the creditor from withdrawing its election. *In re Bloomingdale Partners*, 155 B.R. 961, 971 (Bankr. N.D. Ill. 1993).

4. While the election is made as a class, in most instances a secured creditor is classified in its own class, so it in fact is the one making the election.

B. Example of the Economics of the Election

1. Hypothetical of recovery without a section 1111(b) election.

a. Creditor holds an allowed claim of $10 million.

b. The claim is secured by a lien on property valued at $6 million.

c. The creditor's claim is bifurcated in the plan into a secured claim of $6 million and an unsecured claim of $4 million.

d. The plan proposes to repay the secured claim through a single payment at the end of the first year of the plan, and provides for a 10% payment on the unsecured claim.

e. The single payment of the secured claim will include interest at 5% for a total payment of $6.3 million. This payment satisfies the debtor's obligation under section 1129(b) to repay the present value of the secured claim. If a section 1111(b)(2) election is *not* made, the plan may be approved by the court.

f. An additional payment of $400,000 would be made on the unsecured claim, for total payments of $6.7 million.

2. Hypothetical of recovery with a section 1111(b) election.

a. If a section 1111(b)(2) election is made the plan as proposed above cannot be confirmed.

b. Once the election is made, the debtor is required to treat the bifurcated claim as a single secured claim, the value of which is $10 million.

c. The debtor now has the to make payments on the secured claim totaling at least $10 million.

d. To meet this obligation, the debtor will have to amend its plan. The debtor cannot afford to increase the payment at the end of year one to $10 million but it may be feasible to seek to extend the repayment term as far out as the court would approve, provided that the total payments during that period of time total at least $10 million. Consider the following

i. $500,000/year for 20 years at a 5% discount rate equals $10 million, and has a present value of $6,231,105.17. This may be confirmable assuming the interest rate is proper and the plan is feasible because the present value equals or exceeds the current value of the property.

ii. $500,000/year for 20 years at a 6% discount rate equals $10 million in total payments but has a present value of $5,734,960.61, which is less than the current $6 million value of the property. This would not be confirmed.

3. Limits to extending loan to meet cumulative payment requirement equaling the total claim.

a. A debtor will usually want to extend payments as long as possible.

b. If the term is extended long enough the total payments required under section 1111(b) intersect with total amount of the stream of payments with a discounted present value that equals the value of the collateral. Such a plan would meet the requirements of section 1111(b)(2) because the debtor could affirmatively answer that the discounted value of all future plan payments equal the present value of the creditor's security interest in the collateral, and the total plan payments, including principal and interest, total at least the amount of the allowed claim.

c. Courts will often limit the term of a loan. For example, repayment may be based on a 20 year amortization but the repayment term may provide for a balloon payment at year 8 year with contemplated refinancing. In this instance, a secured creditor with a substantial collateral deficiency will benefit by making the election which will result in payoff of the secured creditor's total dollar amount owing in full although interest will not have accrued on the value of its claim to the extend it exceeds the value of the collateral at the time of confirmation of the plan.

d. If a plan allows repayment over too long a period of time, or if the contemplated payments to be made under the plan are too large, a court might not approve a plan based on feasibility. "The test for feasibility is whether the plan is likely to be followed by the liquidation, or the need for further financial reorganization of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed under the plan." *In re Sunflower Racing, Inc.*, 226 B.R. 673, 689-90 (D. Kan. 1998). When determining a plan's feasibility, a court must "scrutinize

the plan carefully to determine whether it offers a reasonable prospect of success and is workable." *Id*. (citation omitted). If a deferred payment plan has a term that is nearly ten years, it will be closely scrutinized. *Id*. "The longer a debtor proposes a payout, the more difficult it may become to prove distant future ability to service debts." *Id*. citing *In re White*, 36 B.R. 199, 205 (Bankr. D. Kan. 1983). The feasibility requirement may also fail if there is lack of evidence that a refinancing assumption is realistic. *See In re Sparkle Stor-All Eaton Twp., LLC,* 2011 WL 4542709, *7 (Bankr. N.D. Ohio Sept. 28, 2011).

C. Example of How Adjusting Payment Terms Can Meet 1111(b) Requirements

1. The following hypothetical example from the bankruptcy court in North Dakota, contained in a decision issued during the farm crisis days of the 1980's when 1111(b) elections were routinely made due to the depressed value of land and other collateral, provides another instructive example of how 1111(b) works in practice.

a. "[O]nce an 1111(b) election has been made the creditor must receive the greater of deferred payments equal to the full amount of its allowed claim without including the time value of money, or payments with a present value as of the date of the plan equal to at least the value of the creditors' interest in the estate's interest in the collateral. [citations omitted] A plan which proposes to pay an electing creditor only the value of its collateral is not confirmable when the proposed payments do not total at least the full amount of the creditor's claim. [citation omitted]. The amount that is greater, between the total of the payments necessary to provide a creditor with the present value of the collateral and the total amount of a creditor's claim, switches depending upon the length of the term and the interest rate used to calculate the payments. For example, assume a piece of real estate is worth $50,000 upon which a creditor electing under section 1111(b) holds a $120,000 secured claim. If the debtor proposes to pay the creditor the present value of its collateral $50,000 over twenty years at 10% interest the annual payments would be $5,873. Twenty payments of $5,873 totals $117,460, which is less than the total amount of the creditor's claim. Under this scenario the debtor would be required to pay $6,000.00 annual payments ($120,000.00 total claim ÷ twenty annual payments =$6,000.00 annual payment) to comply with the "greater of the two" requirement. If, however, the terms of the payment are stretched out over twenty-five years the annual payments toward the present value of the collateral would be $5,508. Twenty-five payments of $5,508 total $137,700, which is more than the total amount of the creditor's claim. Thus under this second set of repayment terms the total of the payments necessary to pay the present value of the collateral is greater than the total allowed claim." *In re Kvamme*, 93 B.R. 698, 700 (Bankr. D.N.D. 1988).

III. THE 1111(b)(2) ELECTION AFFECTS VOTING

A. The Unsecured Deficiency Claim Disappears

1. Making the section 1111(b)(2) election affects a creditor's voting rights. When an undersecured creditor makes the election, the creditor retains the right to vote its secured claim; however, because the unsecured claim is merged into the creditor's

secured claim, the creditor does not retain the right to vote an unsecured claim. Therefore, making the election may affect a creditor's ability to "block" or "knockout" a debtor's plan, by preventing the unsecured class from accepting the plan-or by becoming the one necessary accepting class to allow the court to proceed to cramdown. Some considerations to keep in mind when determining whether to make the section 1111(b)(2) election include:

a. whether the collateral is likely to appreciate or depreciate over the duration of the plan;

b. whether the collateral has been correctly valued given the collateral's worth to the debtor as opposed to the market;

c. the likelihood the debtor can or will sell the collateral during the repayment term under the plan;

d. the likelihood of receiving payments on the unsecured claim and the amount of such payments;

e. the likelihood of the debtor defaulting;

f. whether the secured creditor's rejecting votes absent the election will block plan confirmation;

g. whether the election will require a repayment term that is too long and speculative so that feasibility is in doubt;

h. whether election will require a repayment term that is not "fair and equitable."

B. 1111(b) Election Strategy

1. A creditor may use the threat of election to negotiate a better payout under the plan. Using its vote as a negotiating piece, the creditor might agree to vote for plan confirmation only if it receives a favorable payout under the plan. Having negotiated a better payout, the creditor can then make the election and become the consenting impaired class required for confirmation.

2. Conversely, when dealing with an uncooperative debtor, a creditor can make the election and become a rejecting class. The creditor can argue that the payments required under the election are either too large or require too long a term to be feasible for the debtor. Or the creditor may argue that the mathematically required payments are not being made to satisfy both present value and total payment confirmation requirements to satisfy one making the election.

IV. 1111(b), SALE OF PROPERTY AND CREDIT BIDDING

A. Election Not Allowed if a 363 or Plan Sale Because Creditor Receives Benefit of its Bargain Without It.

1. Under section 1111(b)(1)(A)(ii) an undersecured, nonrecourse creditor's claim will not be converted to a recourse claim if the property in which the creditor has an interest is sold under section 363 or will be sold under a plan. Under 1111(b)(1)(B)(ii), an undersecured, recourse creditor may not make the 1111(b)(2) election if the property in which the creditor has an interest is sold under section 363 or will be sold under a plan.

2. The longstanding rational underlying these exceptions has been that, if the property is sold, the undersecured creditor will have the opportunity to credit bid at the sale of the property. Credit bidding protects the creditor up to the full amount of its claim. It also protects the creditor from potential undervaluation of its property by the court. *See In re Town Centers Development Co.,* 516 B.R. 439, 443 (E.D. Mich. 2014) (a creditor holding a recourse claim has the benefit of its bargain because it can credit bid or protect its rights in a sale under the plan through the confirmation process, and 1111(b) protection is unnecessary).

3. The exceptions provided in 1111(b)(1)(A)(ii) and 1111(b)(1)(B)(ii) only make sense when the creditor is allowed to credit bid; however, four cases created a circuit split regarding the interpretation of Code section 1129(b)(2)(A). Two cases, one from the Third and one from the Fifth Circuit, upset the longstanding expectation regarding a secured creditor's right to credit bid under section 1129(b)(2)(A). *See In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010); *In re Pac. Lumber Co.*, 584 F.3d 229 (5th Cir. 2009). Two consolidated cases heard by the Seventh Circuit, in contrast, upheld the creditor's right to credit bid. *See River Rd. Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642 (7th Cir. 2011). The creditors in the Seventh Circuit case appealed. The Supreme Court granted certiorari and affirmed the Seventh Circuit, holding that a dissenting secured creditor has the right to credit bid in a sale proposed under a reorganization plan. *See RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012).

4. Of all the opinions written in these cases, Judge Ambro's dissent in *Philadelphia Newspapers* has been the most widely respected[1] among the bankruptcy community. In his dissent, Judge Ambro warned that disallowing a creditor to credit bid under 1129(b)(2)(A) would allow a stalking horse bidder "to acquire the debtor's assets as cheaply as possible" and would "upset[] three decades of secured creditors'

[1] *See generally* Jason S. Brookner, *Pacific Lumber and Philadelphia Newspapers: The Eradication of A Carefully Constructed Statutory Regime Through Misinterpretation of Section 1129(b)(2)(a) of the Bankruptcy Code*, 85 AM. BANKR. L.J. 127 (2011); Daniel Keating, *Radlax Revisted: A Routine Case of Statutory Interpretation or A Sub Rosa Preservation of Bankruptcy Law's Great Compromise?*, 20 AM. BANKR. INST. L. REV. 465 (2012); Erik W. Chalut & Blair R. Zanzig, *River Road: The Right Road for Selling A Secured Lender's Collateral Under A Chapter 11 Plan of Reorganization*, 129 BANKING L.J. 173 (2012).

expectations, thus increasing the cost of credit." *Philadelphia Newspapers*, 599 F.3d at 337-38. He argued that section 1129(b)(2)(A) was ambiguous. *Id*. at 322. He further argued that a plausible interpretation of the statute was that each subsection of 1129(b)(2)(A) set forth the specific requirements a plan proponent could take. *Id*. at 324. Because he believed section 1129(b)(2)(A) was ambiguous and allowed for more than one plausible interpretation, Judge Ambro argued that the specific statute should prevail over the general statute. *Id*. at 328-29. He further argued that the majority's opinion was not only inconsistent with section 1111(b) and 363(k) of the Code, but also the legislative history of those sections. *Id*. at 332-336. Judge Ambro argued, while section 1111(b) does not directly reference section 1129(b)(2)(A) in its text, "it does make direct reference to the sale of property under a plan, an act specifically contemplated by § 1129(b)(2)(A)." *Id*. at 334. As such, he concludes, "Sections § 1129(b)(2)(A) and 1111(b) are thus best understood as alternative protections for the secured creditor: one to apply when its collateral is sold free and clear of liens, and the other to apply when its collateral is treated other than as a sale." *Id*.

5. In *RadLAX,* 132 S. Ct. 2065, although the Supreme Court affirmed Judge Ambro's dissenting position, they did not adopt his reasoning. Writing the opinion of the court, Justice Scalia stated the issue presented "an easy case." *Id*. at 2073. As he saw it, the issue could be decided on narrow textualist grounds "using well established principals of statutory construction." *Id*. "[F]inding no textual ambiguity" in the section 1129(b)(2)(A), the Court declined to consider the history, policy, purposes of the Code, or other related Code provisions. *Id*. Because the Court did not apply a more comprehensive interpretive lens when deciding *RadLAX*, some argue that, while the outcome of the decision is correct, the reasoning upon which the decision was made is lacking: "Although Justice Scalia correctly analyzed the statutory construction issue, his failure to discuss underlying congressional intent and policy implications missed the larger point—the substantive merits of whether lenders should or should not, as a matter of law, be afforded the opportunity to credit bid when assets are being sold free and clear of liens." Michael J. Hoffman, *Radlax Gateway Hotel, LLC v. Amalgamated Bank: Examining the Importance of Credit Bidding at Chapter 11 Asset Sales*, 50 HOUS. L. REV. 1223, 1232 (2013).

V. ADDITIONAL SELECTED 1111(b) CASES AND ISSUES

A. Inconsequential Value

1. *In re Wandler*, 77 B.R. 728 (Bankr. D.N.D. 1987).

Holding: The court held that inconsequential value did not mean no value. The court found that collateral with a value equal to 4% of the debt was inconsequential, and disagreed with the *Baxley* court: "If the inconsequential value language of section 1111(b) was meant to mean no value, then Congress would have so stated under the language of that section."

2. *In re Baxley*, 72 B.R. 195 (Bankr. D.S.C. 1986).

Holding: When determining inconsequential value pursuant to section 1111(b)(1)(B)(i), the court held that property worth 8% of the total claim was not of inconsequential value and suggested that "the property securing the claim must be of no value for a creditor to be ineligible to make the election under § 1111(b)(2)."

3. *In re McGarey*, 529 B.R. 277, 282-84 (D. Ariz. 2015).

Holding: The court disagreed with *Wandler*, and held that in order to determine inconsequential value 1111(b) requires that the lien value be compared to the asset value.

B. Application of Adequate Protection Payments

1. *First Federal Bank of California v. Weinstein (In re Weinstein)*, 227 B.R. 284 (BAP 9th Cir. 1998)

Holding: By making section 1111(b) election, lender gave up unsecured claim so debtor's adequate protection payments should reduce the secured claim.

C. Importance of Plan Language to Address Section 1111(b) Rights

1. *General Electric Credit Equities, Inc. v. Brice Road Developments, LLC (In re Brice Road Developments, LLC),* 293 B.R. 274 (BAP 6th Cir. 2008).

Holding: Either "Section 1111(b) premium" or payment of balance due on total allowed claim must be specifically provided for in a plan in order for a creditor to be sufficiently protected in a restructured note.

2. *In re Pamplico Highway Development, LLC*, 468 B.R. 783 (Bankr. D.S.C. 2012).

Holding: No new notes were required where the plan specified the allowed amount of the secured claim, provided for specific monthly payments, and further provided that in the event of prepayment, a sale of the property, or a payoff at the balloon date the lender would receive a premium calculated by deducting from the total claim the amount of all payments to ensure full payment of the lender's total claim.

3. *H&M Parmely Farms v. Farmers Home Admin.*, 127 B.R. 644 (D.S.D. 1990).

Holding: While a sale subject to § 363(k) voids the 1111(b)(2) election when a creditor's lien attaches to the proceeds, a plan that does not provide for sale in

compliance with § 363(k) leaves a creditor's 1111(b)(2) election in effect and its lien attaches to the proceeds. "All proceeds derived from the sale must be applied to decrease the amount of [the creditor's] lien on the debtor's properties."

D. Interest and Attorney Fees

1. *In re Saguaro Ran Development Corp., et. al.*, 2011 Bankr. Lexis 2201 (Bankr. D. Ariz. 2011).

Holding: Creditors electing under section 1111(b) do not receive post-petition default interest because Bankruptcy Code section 502 prohibits claims for post-petition unmatured interest in all other cases. Section 1111(b) protects undersecured creditors when collateral appreciates, but the election is not meant to prefer undersecured creditors' unsecured claims over that of other unsecured claims.

2. *In re Idalia Roxana CASTILLO*, 488 B.R. 441, 446-48 (Bankr. C.D. Cal. 2013).

Holding: While a creditor election under section 1111(b) may not accrue post-petition interest on its claim, it is entitled to accrue post-petition attorney fees on its secured claim.

APPENDIX OF RELEVANT STATUTES

11 U.S.C. § 1111(b) - Claims and Interests.

(1)(A) **A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse**, unless –

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(B) **A class of claims may not elect application of paragraph (2) of this subsection if –**

(i) the interest on account of such claims of the holders of such claims in such property is *of inconsequential value*; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and *such property is sold under section 363 of this title or is to be sold under the plan.*

(2) *If such an election is made*, then notwithstanding section 506(a) of this title, *such claim is a secured claim to the extent that such claim is allowed.*

11 U.S.C. § 1129 – Confirmation of Plan

1129(a)(7)(b)

With respect to each impaired class of claims or interests –

(A) each holder of a claim or interest of such class:

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest, property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this on such date or;

(B) **If section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim**

property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.

11 U.S.C. § 1129(b)(2)(cramdown)

For the purpose of this section, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A)With respect to a class of secured claims, the plan provides--

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

> (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

* * *

Third Party Releases and Injunctions

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Third Party Releases and Injunctions

Overview

The courts around the country continue to grapple with whether plan-based third party releases and injunctions are proper, and if so, the parameters and approval standards applicable to such provisions. The majority of courts have permitted plan-based third party releases and injunctions (in addition to exculpatory provisions for estate professionals and others for actions during or relating to the bankruptcy case), but the requirements for approval of such provisions are far from universal. A few jurisdictions, notably the Ninth and Tenth Circuits, and to a lesser extent the Fifth Circuit, have chosen not to permit third party releases or injunctions, often citing Bankruptcy Code Sections 524(e) and 105(a), as well as constitutional deficiencies, whether under due process grounds or otherwise, as a basis for the outcome. In addition to the circuit split which currently exists, there are even differences in approach within districts, which means that practitioners must make themselves aware of the unique requirements and limitations imposed under decisional law in the jurisdiction (or even in the specific court) in which the bankruptcy case is pending before spending too much time devising a case strategy or negotiating a comprehensive restructuring plan with the participants and constituencies in the case. A non-exhaustive chart of the circuit positions to date on non-debtor releases and injunctions is attached hereto as Attachment A.

From a statutory perspective, the bankruptcy courts are armed with a number of tools. 28 U.S.C. § 1334(b) grants the bankruptcy court broad powers over all civil proceedings "related to cases under title 11."[1] The court also has significant injunctive powers. 11 U.S.C. § 105(a) provides that "[t]he court may issue any order, process, or judgment that is necessary or

[1] In fact this "related to" jurisdiction may be the sole source of a bankruptcy court's jurisdiction over "disputes between non-debtors, the type involving claims extinguished by third-party releases..." *See*, Joshua M. Silverstein, Hiding in Plain View: A Neglected Supreme Court Decision Resolves the Debate Over Non-Debtor Release in Chapter 11. Reorganizations, 23 *Emory Bankr. Dev. J. 13*, 13 (2006), n. 38 (hereinafter referred to as "Silverstein").

appropriate to carry out the provisions of this title." This broad power is invoked by the courts under many circumstances, but nearly every decision dealing with plan-based third party releases makes reference to Section 105(a) as a basis and justification for the plan-based injunction.[2] 11 U.S.C. § 524(g) already contains authority for, and significant guidance on the terms and provisions of, so-called "channeling injunctions" pursuant to which claims of a certain type or character are directed or "channeled" exclusively to a trust or fund whose assets are committed to payment of allowed claims. Additionally, of course, under 11 U.S.C. § 1141(d), confirmation of a plan "discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in Section 502(g), 502(h), or 502(i) of this title." With respect to extension of "discharge-like" benefits or injunctive protection for third parties, however, courts have been cautious and thoughtful in their approach.

Although the focus of this paper is upon those jurisdictions in which plan-based third party releases and injunctive relief are permitted, and the circumstances often identified as justification for such relief, it is perhaps helpful to note that in those jurisdictions which have elected to prohibit plan-based releases and injunctions, the courts have tended to point to the language of 11 U.S.C. § 524(e) as one source of support for the decision.[3] Section 524(e) says that "[e]xcept as provided in subsection (a)(3) of this section, a discharge of a debt of the debtor does not affect the liability of any other entity on, or property of any other entity for, such debt." Various courts and commentators, included among them many who believe that plan-based releases and injunctions are entirely appropriate, readily agree with the premise that a discharge of a debt of the debtor—**by itself**—does not affect the liability of any other entity or property

[2] See, e.g., *In re Seaside Engineering & Surveying, Inc.*, 780 F.3d 1070 (11th Cir. 2015).
[3] See, e.g., E. Anderson & J. Basham, "Please Release Me, Let Me Go – Eleventh Circuit Embraces Third-Party Release Standards", ABI Journal, June 2015. See also *Seaside Engineering*, *supra*, at 1078.

liable for such debt, but go on to note that Section 524(e) does not on its face forbid third party releases or otherwise restrict the court's power to implement releases of non-debtor third parties via confirmation orders or otherwise. Courts which have not elected to permit plan-based releases and injunctions also, as noted above, occasionally point to constitutional deficiencies which they discern in circumstances in which a non-debtor, without exposing its assets to the scrutiny of claimants in a Chapter 11 setting, receives absolution from liability which would otherwise remain intact notwithstanding the discharge afforded the debtor equally liable for that same obligation. Having determined that negotiated non-statutory plan-based third party releases and injunctions are not appropriate, these courts have understandably not moved down a path of identifying circumstances in which those releases and injunctions might be permissible under applicable law.

Courts which have allowed, if not embraced, consensual and non-consensual plan-based releases have approached the issue in a variety of ways. Where the release and injunctive provisions are consensual – whether pursuant to a global agreement, a plan consented to as determined by accepting ballots, or opt-in elections available in the ballot process, most courts have no problem approving a release.[4] Where the release is non-consensual – such as where the claimant's claim against the debtor is unimpaired under the plan, so that claimant is deemed to have accepted the plan and is not entitled to cast a ballot under 11 U.S.C. 1126(f), but its claim against a third party liable with the debtor is being released under the plan, or where the release is a release of a non-debtor from claims of entities who were not creditors of the debtor, courts

[4] See, e.g., *In re Specialty Equip. Cos.*, 3 F.3d 1043, 1046-47 (7th Cir. 1993) (holding that consensual non-debtor releases do not violate Section 524(e) and are permissible under the Code), *In re Digital Impact, Inc.*, 233 B.R. 1, 14-15 (N.D. Okla. 1998) (holding that bankruptcy courts do not have the power to grant involuntary non-debtor releases, but may issue voluntary third party releases where said provisions comply with general principles of contract law) and other cases cited in *Silverstein, supra,* n. 58.

have been cautious in their approach to confirmation.[5] Bankruptcy Rule 3016(c), which by its mere existence supports the notion that the bankruptcy courts have the power to provide injunctive relief beyond what is specifically provided for under the Bankruptcy Code, provides that "[i]f a plan provides for an injunction against conduct not otherwise enjoined under the Code, the plan and disclosure statement shall describe in specific and conspicuous language (bold, italic, or underlined text) all acts to be enjoined and identify the entities that would be subject to the injunction." When coupled with the statutory power referenced above and the "equitable powers" perceived to exist in abundance in the bankruptcy courts' arsenal, it is clear that for courts willing to approve plan based releases and injunctions, the tools are available.

The reality is that where courts once seemed willing to approve third party non-consensual releases without much comment or without particular findings as to the appropriateness of those provisions as part of the confirmation process, more recent decisions have tended to reflect much more cautious, and analytical, approach to third party releases than in the past. Why is this the case? Perhaps it is a response to the proliferation of release and exculpation provisions in major bankruptcy cases today, as officers, directors, lenders, affiliates, parent entities or insurance carriers all seek the "cover" of a release or injunction without the necessity of going through chapter 11 themselves in the face of potential claims. The result is that many parties other than the debtor, which receives a discharge upon confirmation under Code Section 1141(d)(l), seek to benefit from confirmation of a plan, ostensibly in many cases as a contributor to the reorganization's success, or to a global "settlement" of claims of which the reorganization is just a part.

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[5] See *In re Ingersoll, Inc.*, 562 F.3d 856 (7th Cir. 2009).

Certainly the corporate regulatory environment has become more stringent, and the pursuit of claims by shareholders and other parties allegedly harmed by "misdeeds" of corporate leadership and those involved in the debtor's business operations pre-bankruptcy more common. Combined with the long string of significant corporate bankruptcies beginning with Enron, and continuing with WorldCom, Adelphia Communications, and others, perhaps, as one excellent analysis has suggested,[6] heightened regulatory scrutiny and challenging economic circumstances have brought the "honest but unfortunate debtor"[7] and the potential securities fraud defendant, together. In any event, the courts have been forced to react and to carefully analyze issues less exhaustively evaluated in the past as more and more "fearful" constituencies have maneuvered to use the Chapter 11 process as a means to an end.

Cases of Note

Against this backdrop, the following are several cases exemplifying the courts' attempts to accommodate both the restructuring goals of debtors, and exculpatory, release and/or injunctive relief for non-debtor participants in the process.

1. *In re Master Mortgage Investment Fund, Inc.*, 168 B.R. 930 (Bank. W.D. Mo. 1994).

   Judge Frank Koger's comprehensive and extensively researched opinion in this case represents to this day one of the most authoritative roadmaps for determining the appropriateness of third party releases and injunctions in plan confirmation settings. [8] Notably, the ABI Commission to Study the Reform of Chapter 11 (the "ABI

[6] *See* M. Etkin & N. Brown, *Third Party Releases? – Not So Fast! Changing Trends and Heightened Scrutiny*, AIRA Journal Vol. 29, No. 3 (2015), for an excellent analysis and compendium of caselaw on these issues.
[7] *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).
[8] Notwithstanding the regard this opinion has typically been afforded, at least one commentator has criticized the opinion as having failed to distinguish different types of non-debtor releases from one another, and from related forms of relief. *Silverstein, supra*, n. 39.

Commission") in 2014 recommended adoption of the 5-part test set out in the *Master Mortgage* case as the standard for analysis of non-consensual third party releases,[9] concluding that these five factors adequately captured the careful review required in such cases.

Master Mortgage was a real estate investment fund which filed its Chapter 11 case in 1992. The opinion deals with objections filed to the debtor's Fourth Amended Plan of Reorganization in 1993, five out of six of which were resolved before or during the confirmation hearing, with the remaining objection of the SEC ultimately being overruled in the court's written opinion. The plan incorporated a settlement with the debtor's largest secured lender under which the lender assigned to the debtor nearly $4 million in participation interests held by the lender, and agreed to additionally assign additional notes, mortgages and investment notes, all in exchange for (a) a release of all claims against the lender, including those asserted in a pending lawsuit; (b) assignment of certain loans to the lender by debtors; and (c) a plan-based injunction preventing any creditor or equity security holder from asserting any claim against the lender arising from its transactions with Master Mortgage. The injunction was to be permanent and survive confirmation.

The plan also contained settlement agreements with certain non-debtor affiliates of Master Mortgage, under which the affiliates released over $3 million in claims against the lender, released liens on Master Mortgage property, and agreed to contribute 80% of their payments on post-petition contracts to Master Mortgage, which would use those funds to settle a pending lawsuit. The non-debtor affiliates

[9] See the excerpt from the ABI Commission's report dealing with non-consensual third party releases attached hereto as Attachment B.

were to receive a permanent injunction in exchange for their contributions to the reorganization.

In the plan voting process four of five impaired classes of claimants approved the plan by a wide margin. Only the SEC rejected the plan, with the focus of its objection being the broad injunctive relief afforded third parties, which the SEC contended was violative of Section 524(e), thereby rendering the plan violative of the Bankruptcy Code.

In its opinion confirming the plan and overruling the SEC's objection, the court reviewed caselaw to date on plan-based releases and injunctions, and enunciated a five-part test by which the appropriateness of permitting non-debtor releases and injunctions in a plan should be evaluated. These include consideration of: (1) the identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) whether the non-debtor has contributed substantial assets to the reorganization; (3) whether the injunction is essential to reorganization; (4) whether a substantial majority of the creditors agree to such injunction – specifically, whether the impacted class or classes have "overwhelmingly" voted to accept the proposed plan treatment; and (5) whether the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction. As noted, this standard for analysis of plan-based releases and injunctions remains a significant source of guidance to courts to this date when considering these issues.

2. *In re Dow Corning Corporation*, 280 F.3d 648 (6th Cir. 2002).

In an effort to deal with the thousands of healthcare related claims asserted by recipients of the debtor's silicone gel breast implants, Dow Corning commenced a chapter 11 case in the Eastern District of Michigan in 1995. Ultimately a plan of reorganization, establishing a $2.35 billion fund for the payment of claims asserted by personal injury claimants and certain government healthcare payers as well as other creditors asserting claims related to the silicone implant products liability claim, was filed. The plan contained a release of debtor's insurers and shareholders from all further liability arising out of the personal injury claims. The plan further permanently enjoined any party holding a claim against Dow Corning from bringing an action related to that claim against Dow Corning's insurers or shareholders.

The mechanism for addressing liquidation of claims under the plan involved channeling all claims to a pool of funds set aside for claims resolution purposes. The bankruptcy court confirmed the plan, although it initially determined that the non-debtor release and injunction provisions could only apply to **consenting** creditors. On appeal, the district court upheld the bankruptcy court's confirmation of the plan, but concluded that the plan and the non-debtor release and injunction provision of it could apply to all creditors, consenting and non-consenting. On appeal, the Sixth Circuit analyzed whether a bankruptcy court could properly enjoin a non-consenting creditor's claims against a non-debtor (here, Dow Corning's insurers and shareholders) in order to facilitate a reorganization plan. The Sixth Circuit discussed the bankruptcy's court broad equitable powers, and the considerable discretion, consistent with Section 105(a) and with the permission granted under Section

1123(b)(6) of the Code, for approval of a reorganization plan including any appropriate provisions not inconsistent with the applicable provisions of Title 11.

Following a discussion of plan-based releases and injunctions in general as addressed by various courts, the Sixth Circuit concluded that enjoining a non-consenting creditor's claim against a non-debtor is "not inconsistent" with the Code, and then went on to evaluate when such an injunction is an "appropriate provision" of a reorganization plan for purposes of Section 1123(b)(6). The Court noted that such an injunction is a dramatic measure to be used cautiously and that enjoining a non-consenting creditor's claim is only appropriate in "unusual circumstances." To assist courts in determining whether there are "unusual circumstances" justifying non-debtor injunctive relief in a case, the Court identified seven factors which it viewed as necessary for entry of such relief, as follows:

> We hold that when the following seven factors are present, the bankruptcy court may enjoin a non-consenting creditors' claims against a non-debtor: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions.[10]

The Sixth Circuit ultimately affirmed the district court's determination that when there are "unusual circumstances," the bankruptcy court may enjoin non-consenting creditor's claims against a non-debtor to facilitate a chapter 11 plan of

[10] 280 F.3d 648, 658.

reorganization. However, the Sixth Circuit remanded the case to the district court for various matters needing additional findings.

As noted previously, the ABI Commission has recommended use of the five-factor test set forth in *Master Mortgage* as opposed to the seven-factor test enunciated in *Dow Corning*. Interestingly, the five *Master Mortgage* factors which the ABI Commission deemed sufficient to facilitate analysis of the issues are fully aligned with five of the *Dow Corning* factors.

3. *In re Airadigm Communications, Inc.*, 519 F.3d 640 (7th Cir. 2008).

Airadigm Communications, Inc. (the "Debtor") filed for bankruptcy on May 8, 2006. This bankruptcy followed its previous bankruptcy filed in 1999, which resulted in a reorganization in 2000. At the time of its 2006 bankruptcy, the Debtor had two primary secured creditors: Telephone and Data Systems ("TDS"), which was owed over $188 million, and the FCC, which was owed $64.2 million. TDS committed to financing the Debtor's plan of reorganization and, in exchange, the Debtor's plan provided a release[11] for TDS: "[e]xcept as expressly provided . . . [TDS shall not] have or incur any liability to . . . any holder of any Claim . . . for any act or omission arising out of or in connection with the Case, the confirmation of this Plan, the consummation of this Plan, or the administration of this Plan or property to be distributed under this Plan, except for willful misconduct." The FCC objected to this release, asserting that TDS, as a non-debtor party, could not receive such a release.

The U.S. Bankruptcy Court for the Western District of Wisconsin overruled the FCC's objection to the release. The bankruptcy court found that without this

[11] Although the protection afforded TDS could perhaps more appropriately be characterized as an *exculpation* because it deals primarily with case-related activities of TDS, the opinion, and therefore this summary, will refer to the provision as a release.

limitation on liability, TDS would not finance the Debtor's plan. And, without TDS's financing of the plan, there was a question whether the Debtor could reorganize. The bankruptcy court also noted that the limitation on liability was not absolute—TDS remained liable for certain "willful misconduct."

The FCC appealed the bankruptcy court's decision to the U.S. District Court for the Western District of Wisconsin. The district court affirmed the bankruptcy court's decision.

The FCC then appealed the decision to the U.S. Court of Appeals for the Seventh Circuit which ultimately held that the Bankruptcy Code allows releases of non-debtor parties.

The first question the Seventh Circuit addressed was whether 11 U.S.C. § 524(e) bars bankruptcy courts from releasing non-debtor parties. The court held that this section does not preclude a third party from being released from a creditor's claim. The court considered the comparable section of the Bankruptcy Act, 11 U.S.C. § 34, which stated, "The liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt **shall** not be altered by the discharge of such bankrupt." The court noted that § 524(e) does not include the mandatory "shall," but rather uses the word "does": "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." Under the Bankruptcy Act, the court held that non-debtor party releases were not permitted. However, with the change in language to "does" from "shall," the court held that Congress did not intend to limit non-debtor party releases with § 524(e).

The next question the Seventh Circuit considered was whether Congress affirmatively gave bankruptcy courts the authority to provide for non-debtor party releases. Looking to both Sections 105(a) and 1123(b)(6), the court held that the broad equitable powers afforded to bankruptcy courts allowed such courts to grant non-debtor party releases.

The final question the Seventh Circuit considered was under what circumstances a court should permit non-debtor party releases. The court began by noting that this was a fact intensive investigation that depends on the nature of the reorganization. In the present case, the court found that the non-debtor release of TDS was narrow—it only applied to matters relating to the reorganization and did not provide blanket immunity (i.e., no release for acts of willful misconduct). Further, the court found that the release of TDS was limited by other provisions of the plan (e.g., the FCC's regulatory powers were not impeded by the release). Finally, the court found that the release was essential for TDS to provide financing for the plan. Because the release of TDS was limited and was essential to the reorganization, the release of TDS was appropriate.

The *Airadigm* case remains controlling law in the Seventh Circuit. When crafting releases of non-debtor parties, consider limitations on such releases (e.g., matters arising out of or relating to the bankruptcy, some discrete act, for post-confirmation acts, for pre-confirmation acts, etc.). Additionally, consider the necessity of the release—if the release is not necessary for an effective reorganization, this will be a significant hurdle to overcome under *Airadigm*.

4. *United States v. Energy Resources Co., Inc., et al.*, 495 U.S. 545 (1990)

Has the United States Supreme Court addressed bankruptcy court authority to approve plan-based non-debtor releases and injunctive provisions over the objection of affected parties? Some say yes.[12] In the *Energy Resources* case, the Supreme Court adopted an expansive reading of the equitable powers conferred upon bankruptcy courts and concluded, over the objection of the Internal Revenue Service, that the bankruptcy court had the power to direct the allocation of tax payments by debtor post-confirmation first to trust fund taxes, and thereafter to the regular unpaid taxes due, where that approach is essential to the success of a reorganization.

In *Energy Resources*, the bankruptcy court confirmed a plan of reorganization for Energy Resources Co., Inc., in 1984 under which Energy Resources' federal tax debt of approximately $1 million was to be paid over roughly five years. The trustee for the special trust created pursuant to the plan asked the IRS to apply a tax payment in the amount of approximately $358,000 to the trust fund portion of the tax obligations, but the IRS refused to do so. The trustee then successfully sought and obtained from the bankruptcy court an order directing the IRS to apply the funds first to the trust fund tax liabilities. The IRS appealed this order to the District Court for the District of Massachusetts, which affirmed the bankruptcy court in an oral opinion. The government then appealed to the First Circuit, which accepted the IRS's view that payments made under the Chapter 11 plan should be deemed "involuntary" for purposes of the IRS's rules (which in a non-bankruptcy setting would allow the IRS

[12] See the extensive and persuasive discussion in *Silverstein, supra*, at 104. The author asserts that the *Energy Resources* decision represents the Supreme Court's adoption of an "expansive view" of the equitable powers available to the bankruptcy courts, and its approval of the use of those powers in a factual context similar if not identical in effect to the plan-based releases and injunctions discussed elsewhere in this article.

to determine the allocation of tax payments as between trust fund or regular taxes), but went on to rule that even if the payments were properly characterized as involuntary the bankruptcy court nevertheless had the authority to order the IRS to apply the "involuntary" payment made by a Chapter 11 debtor to trust fund tax liabilities first if the bankruptcy court concluded that this approach was necessary to ensure the success of the reorganization.

The Supreme Court granted certiorari because the First Circuit's conclusion on the allocation issue conflicted with decisions in other circuits. In its opinion, the Supreme Court adopted an expansive interpretation of the bankruptcy court's equitable powers. Acknowledging that the Bankruptcy Code does not explicitly authorize bankruptcy courts to approve reorganization plans designating tax payments as either trust fund or non-trust fund, the court noted that the Code does grant the bankruptcy courts residual authority to approve reorganization plans including "any...appropriate provision not inconsistent with the applicable provisions of this title."[13] The court continued its analysis by noting that the Code additionally states that bankruptcy courts may "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Code in Section 105(a), and that these statutory directives are consistent with the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships, citing *Pepper v. Litton*, 308 U.S. 295, 303-304 (1939); *United States National Bank v. Chase National Bank*, 331 U.S. 2836 (1947); and *Katchen v. Landy*, 382 U.S. 223, 327 (1966) for this proposition.

[13] 11 U.S.C. § 1123(b)(5); see also 11 U.S.C. § 1129.

Addressing the government's arguments that bankruptcy court had overstepped its authority and/or failed to assure itself that a reorganization will succeed so that the IRS in all likelihood would actually collect the tax debt owed, the Supreme Court stated:

> It is evident that these restrictions on a bankruptcy court's authority do not preclude the court from issuing orders of the type at issue here, for those restrictions do not address the bankruptcy court's ability to designate whether tax payments are to be applied to trust fund or non-trust fund tax liabilities. The Government is correct that, if it can apply a debtor corporation's tax payments to non-trust fund liability before trust fund liability, it stands a better chance of debt discharge because the debt that is not guaranteed will be paid off before the guaranteed debt. While this result may be desirable from the Government's standpoint, it is an added protection not specified in the Code itself. Whereas the Code gives it the right to be assured that its taxes will be paid in six years, the Government wants an assurance that its taxes will be paid even if the reorganization fails – i.e., even if the bankruptcy court is incorrect in its judgment that the reorganization plan will succeed.[14]

Following additional analysis, the court concluded as follows:

> In this case, the Bankruptcy Courts have not transgressed any limitation on their broad power. We therefore hold that they may order the IRS to apply tax payments to offset trust fund obligations where it concludes that this action is necessary for a reorganization's success. The judgment of the Court of Appeals is therefore affirmed.[15]

The Silverstein treatise notes that tax allocation orders like the one approved in the *Energy Resources* case decrease the likelihood that the IRS will receive payment in full because they mandate that liabilities guaranteed by a third party – the liabilities for trust fund taxes – be extinguished first. Should the plan fail after the debtor has paid its trust fund taxes, but before all non-trust fund tax debts are satisfied, the IRS would have no alternative source from which to recover its deficiency. Arguably, therefore, the tax allocation order had the effect of shifting the risk of plan failure from the guarantors of the debtor's tax obligations (responsible persons) to the IRS by

[14] 495 U.S. 545, 550.
[15] 595 U.S. 545, 551.

requiring the IRS to retire first those taxes as to which it had the ability to pursue the guarantors in the event of a default.[16]

A compelling case can be made for the proposition that non-debtor releases and permanent injuctions have precisely the same effect in comparison to provisional injunctions or other "less permanent" forms of relief – they decrease the likelihood that a creditor will receive payment in full if the reorganization fails by permanently barring the creditor from pursuing a co-obligor of the debtor rather than merely restraining the creditor from such action temporarily or until the debtor defaults.[17] In the words of Professor Silverstein:

> In sum, the type of risk shifting endorsed by *Energy Resources* is nearly identical to that which takes place if a non-debtor release is contained in a Chapter 11 plan rather than a provisional injunction. And the Supreme Court held that it is appropriate to reallocate risk in this manner when such action is necessary to the success of a reorganization. Therefore, the argument that channeling releases are inequitable must be rejected. A bankruptcy court's power under Sections §§ 105(a) and 1123(b)(6) is not limited to the issuance of provisional injunctions.[18]

The bottom line is that the circuit split which now exists relative to plan-based third party releases and injunctions may have already been effectively resolved by the discussion and holdings present in the *Energy Resources* decision. Whether creative counsel will successfully cause that view to become the prevailing one or whether the Supreme Court will need to accept the invitation to resolve the split which currently exists remains to be seen.

Conclusion

Time will tell whether or not the pendulum which has swung significantly in favor of permitting non-consensual third-party releases and injunctions in carefully evaluated

[16] See *Silverstein, supra*, at 120, citing *Energy Resources*, 495 U.S. 545, at 548-50.
[17] *Id.*
[18] *Id.*, at 121.

circumstances in which the five *Master Mortgage* tests have been met, or where a similarly exhaustive analysis of the facts has occurred, will continue its trajectory, or whether increased regulatory scrutiny or a new wave of bankruptcy filings by significant corporations will cause the courts to further restrict the circumstances in which such non-debtor benefits may be provided for in Chapter 11 plans. In the interim, practitioners must continue to be aware developments on these issues in each jurisdiction to the extent that case strategy or a successful outcome requires the use of releases or injunctive relief.

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Plan-Based Releases and Injunctions
– Representative Decisions by Circuit –

Circuit	Key Decisions	Ruling
First	*Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973 (1st Cir. 1995)	Plan-based injunction in favor of non-debtor plan proponent (former counsel to Debtor affiliate) upheld (but on collateral estoppel grounds).
Second	*In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2nd Cir. 2005)	Releases and injunctions are proper in rare cases where an injunction plays an important part in reorganization plan (affirmed on "equitable mootness" grounds).
Third	*In re Continental Airlines*, 203 F.3d 203 (3rd Cir. 2000)	Suggests willingness to permit third party releases, but reversed confirmation order where bankruptcy court had not made findings as to the fairness and necessity of the releases. Involves a settlement agreement.
	In re American Family Enterprises, 256 B.R. 377 (D. N. J. 2000)	Upheld release of multiple parties where only one released party was contributing to the settlement.
	In re Washington Mutual Ins. Co., 442 B.R. 314 (D. Del. 2011)	Section 524(e) is not a bar to injunctive relief, but court denied relief to non-contributing officers, directors and non-debtors, some of whom were actively defending securities litigation during the Chapter 11 case.
Fourth	*In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir. 1989)	Plan containing non-debtor releases where contribution of funds for mass tort claimants was provided by released parties was upheld. Section 524(e) does not limit equitable power of court to enjoin suits against non-debtor third parties particularly when plan was overwhelmingly supported by creditors.
Fifth	*In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995)	Bankruptcy court did not have jurisdiction to enjoin tort claims against settling non-debtor insurer. "Must overturn a section 105 injunction if it effectively discharges a non-debtor."
	But see, *Republic Supply Co. v. Shaof*, 815 F.2d 1046, 2051 at n. 5	Section 524(e) does not by its specific words preclude the discharge of a guaranty when it has

Attachment A

	(5th Cir. 1987)	been accepted and confirmed as an integral part of reorganization.
Sixth	*In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002)	When there are "unusual circumstances" the bankruptcy court may enjoin non-consenting creditors' claims against a non-debtor to facilitate a plan of reorganization. Used 7-part test to reach result.
Seventh	*In re Specialty Equip. Co.*, 3 F.3d 1043 (7th Cir. 1993)	Section 524(e) does not prohibit the release of a non-debtor. Non-voting or non-consenting creditors were not bound by the releases, so entirely consensual releases. Court upheld confirmation and releases, declaring that appeal was equitably moot since plan had been substantially consummated.
	In re Airadigm Communications, Inc., 519 F.3d 640 (7th Cir. 2008)	Non-consensual release of third party challenged. Section 524(e) does not prohibit releases. "Residual authority" under Section 1123(b)(6) plus other code provisions support injunctive and release power. Substantial contribution by released party was also important to the outcome. Note that the "release" provisions were actually exculpation provisions, typically narrower in scope than releases.
Eighth	No appellate level decisions, but bankruptcy courts have confirmed plans containing releases, including the *Master Mortgage* case. *In re Master Mortgage Inv. Fund Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994).	Court may enjoin non-consenting creditor's claims against a non-debtor using a 5-part test which considers: (1) the identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) whether the non-debtor has contributed substantial assets to the reorganization; (3) whether the injunction is essential to reorganization; (4) whether a substantial majority of the creditors agree to such injunction – specifically, whether the impacted class or classes have "overwhelmingly" voted to accept the proposed plan treatment; and (5) whether the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or

		classes affected by the injunction.
Ninth	*In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995)	Non-debtor releases are prohibited by the Code except in asbestos cases.
Tenth	*In re Western Real Estate Fund*, 922 F.2d 592 (10th Cir. 1990)	Releases not allowed pursuant to Section 105(a) – would conflict with Section 524(e).
Eleventh	*In re Munford, Inc.*, 97 F.3d 449 (11th Cir. 1996)	Section 105(a) and other bankruptcy provisions authorize bankruptcy courts to enter bar orders protecting third parties where such protection is integral to settlement in an adversary proceeding.
DC	*In re AOV Industries, Inc.*, 792 F.2d 1140 (U.S. App. D.C. 1986)	Plan-based releases, where over 90% of creditors accepted the plan, upheld, but under equitable mootness standards.

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Excerpt from: ABI Commission to Study The Reform of Chapter 11 (2012 - 2014)

3. Third-Party Releases

Recommended Principles:

- A debtor or plan proponent should be permitted to seek approval of third-party releases in connection with the solicitation and confirmation of the chapter 11 plan. Such third-party releases should be clearly and conspicuously highlighted and explained in the plan and the disclosure statement, identifying the proposed scope of, and parties to be covered by, the releases. The court should approve any such third-party releases based on evidence presented at the hearing and in accordance with the factors set forth below.
- In reviewing a proposed third-party release included in a chapter 11 plan, the court should consider and balance each of the following factors: (i) the identity of interests between the debtor and the third party, including any indemnity relationship, and the impact on the estate of allowing continued claims against the third party; (ii) any value (monetary or otherwise) contributed by the third party to the chapter 11 case or plan; (iii) the need for the proposed release in terms of facilitating the plan or the debtor's reorganization efforts; (iv) the level of creditor support for the plan; and (v) the payments and protections otherwise available to creditors affected by the release. In a case involving the application of third-party releases to creditors and interest-holders not voting in favor of the plan, the court should give significant weight to the last of these factors.
- A proposed release of a debtor's affiliates in the chapter 11 plan should be subject to the same review and approval process proposed above for general third-party releases in these principles.

Attachment B

Third-Party Releases: Background

A confirmed chapter 11 plan "discharges the debtor from any debt that arose before the date of such confirmation."[908] The discharge voids any judgments, and enjoins collection and similar actions, asserting personal liability against the debtor based on debts discharged under the plan.[909] Section 524(e) also provides that "[a] 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."[910] Courts and plan proponents often grapple with the scope and application of this limitation under section 524(e) in the context of third-party releases included in a chapter 11 plan. The Bankruptcy Code recognizes an exception to this limitation for debtors establishing trusts for asbestos claimants; in those cases, the court may enter an order enjoining actions against nondebtor parties.[911]

A release provision in a chapter 11 plan essentially relieves the identified nondebtor parties of any liability for any claims or causes of actions that third parties might hold against them. In a chapter 11 plan, a release may seek to cover the debtor's directors and officers, an unsecured creditors' committee and its members, a nondebtor plan proponent, a plan sponsor, the debtor's lenders and their agents, and other parties who may have been actively engaged in the chapter 11 case and perhaps made contributions to the process.[912] The release may encompass any and all claims or causes of action, or resulting liability, of these nondebtor parties. The release may be binding on only those third parties who consent to the release or who vote in favor of (or abstain from voting on) the plan and the release; it may also be binding on all third parties if the release is approved in connection with confirmation of the plan.[913]

Some commentators assert that section 524(e) prohibits all third-party releases, regardless of their scope or the parties purportedly bound by the provision. Two circuits, the Ninth and the Tenth, have adopted this strict view of third-party releases.[914] Specifically, the Ninth Circuit has stated: "The bankruptcy court lacks the power to confirm plans of reorganization which do not comply with the

908 11 U.S.C. § 1141(d)(1)(A).

909 *Id.* § 524(a). Specifically, section 524(a) provides that a discharge "voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived." *Id.*

910 11 U.S.C. § 524(e).

911 11 U.S.C. § 524(g). *See generally Written Statement of Professor S. Todd Brown, SUNY Buffalo Law School Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 7, 2013) (discussing issues related to resolution of asbestos claims), *available at* Commission website, *supra* note 55.

912 Nondebtor releases for insiders such as officers and directors may be subject to more rigorous scrutiny, in part because "[t]hose who benefit from this type of release are most likely the ones asserting that the debtor will be irreparably harmed without it." Elizabeth Gamble, *Nondebtor Releases in Chapter 11 Reorganizations: A Limited Power*, 38 Fordham Urb. L.J. 821, 840 (2011) (analogizing to *Spach v. Bryant*, 309 F.2d 886 (5th Cir. 1962) and noting that bankruptcy court must apply "careful attention and special scrutiny when the claimants are officers, directors or stockholders of the corporate bankrupt"). *See also* Hopper v. Am. Nat'l Bank of Cheyenne, Wyo. (*In re* Smith-Chadderdon Buick, Inc.), 309 F.2d 244, 247 (10th Cir. 1962) ("A claim presented by an officer or director of the bankrupt is subjected to rigorous scrutiny and the claimant must prove good faith and fairness in the transaction").

913 "[T]he provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan." 11 U.S.C. § 1141(a). *See also* Sharon L. Levin et al., *The* WaMu *Lesson: Craft Your Release Carefully*, Law360, Jan. 28, 2011 (discussing rejection of releases in chapter 11 cases of *Washington Mutual Inc.* and *WMI Investment Corp.*).

914 *See* Resorts Int'l, Inc. v. Lowenschuss (*In re* Lowenschuss), 67 F.3d 1394, 1402 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996) (holding that section 524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors); Am. Hardwoods, Inc. v. Deutsche Credit Corp. (*In re* Am. Hardwoods, Inc.), 885 F.2d 621, 625 (9th Cir. 1989) (same); Underhill v. Royal, 769 F.2d 1426, 1432 (9th Cir. 1985) ("Section 524(e) precludes discharging the liabilities of nondebtors."). *See also* Landsing Diversified Props.-II v. First Nat'l Bank & Trust Co. of Tulsa (*In re* W. Real Estate Fund, Inc.), 922 F.2d 592, 601 (10th Cir. 1990) (holding that nondebtor release "improperly insulate[s] nondebtors in violation of section 524(e)"), *modified*, Abel v. West, 932 F.2d 898 (10th Cir. 1991).

applicable provisions of the Bankruptcy Code.... This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors."[915] The Ninth Circuit has, however, recognized that nondebtor releases may be permitted in asbestos claims cases pursuant to specific statutory authority.[916] The Fifth Circuit also appears to be more restrictive than permissive with respect to third-party releases.[917]

The other circuits that have considered the issue focus instead on section 105(a) of the Bankruptcy Code, which gives the court authority to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]."[918] These courts are willing to consider and approve third-party releases under appropriate circumstances. To make this determination, these courts undertake a fact-intensive inquiry analyzing factors such as any contractual or consensual basis for the releases, the role and contributions of the nondebtor parties in the chapter 11 case, the protections afforded by the plan for third parties bound by the releases, and whether the releases are necessary for the debtor's effective reorganization.[919]

Courts adopting a permissive approach to third-party releases do not find section 524(e) as impermeable barrier.[920] They generally point out that section 524(e) does not contain "language of prohibition" and thus should not be interpreted to limit the court's power under section 105(a).[921] They also may distinguish the releases based on the facts of the given case, such as when the third

915 Resorts Int'l, Inc. v. Lowenschuss (*In re* Lowenschuss), 67 F.3d 1394, 1402 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996).

916 *Id.* at 1402, n. 6 ("The Bankruptcy Reform Act of 1994 added § 524(g) to the [Bankruptcy] Code. That section provides that in asbestos cases, if a series of limited conditions are met, an injunction issued in connection with a reorganization plan may preclude litigation against third parties.").

917 The Fifth Circuit view on nondebtor third-party releases and exculpation clauses is less clear. In several cases, the court has rejected such third-party releases, particularly when such releases are nonconsensual. *See, e.g.*, Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 253 (5th Cir. 2009); Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 760 (5th Cir. 1995). However, some Fifth Circuit cases suggest that the court does not categorically disprove of such releases and may approve them in certain limited circumstances. Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 253 (5th Cir. 2009) (suggesting that nondebtor releases are "most appropriate as a method to channel mass claims toward a specific pool of assets"); Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 760 (5th Cir. 1995) (suggesting that a release may be approved where the third party nondebtor liability is not extinguished but instead channeled to a settlement fund). *But see* Ad Hoc Group of Vitro Noteholders v. Vitro S.A.B. de C.V. (*In re* Vitro S.A.B. de C.V.), 701 F.3d 1031, 1062 (5th Cir. 2012) (stating that "[the Fifth Circuit] has firmly pronounced opposition to [nonconsensual nondebtor] releases"). The Fifth Circuit's decision in *Vitro* contains very strong language suggesting a complete prohibition on nonconsensual third-party releases. Nevertheless, even in *Vitro*, the Fifth Circuit acknowledges that specific, rather than general, third-party releases may be permissible under certain limited circumstances: "We have distinguished other cases for including general, as opposed to specific, releases. As a result, *Republic Supply Co.* provides no guidance where, as here, we are confronted not by a specific release, but by a general release of all the non-debtor subsidiaries." *Id.* at 1068–69 (citations omitted). Accordingly, the Fifth Circuit appears to lean more toward the restrictive approach of the Ninth and Tenth Circuits but may not be as all-inclusive in its prohibition. In addition, the Fifth Circuit has actually approved of releases in some limited circumstances, although the court has utilized different statutory authorization to do so. *See, e.g.*, Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229 (5th Cir. 2009) (using section 1103(c) to approve exculpation provisions for members of the creditors' committee but rejecting other release provisions).

918 *See, e.g.*, MacArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89 (2d Cir. 1988), *cert. denied*, 488 U.S. 868 (1988) (noting that section 105(a) "has been construed liberally to enjoin suits that might impede the reorganization process").

919 Deutsche Bank AG v. Metromedia Fiber Network, Inc. (*In re* Metromedia Fiber Network, Inc.), 416 F.3d 136, 142 (2d Cir. 2005) ("Courts have approved nondebtor releases when: the estate received substantial consideration; the enjoined claims were 'channeled' to a settlement fund rather than extinguished; the enjoined claims would indirectly impact the debtor's reorganization 'by way of indemnity or contribution'; and the plan otherwise provided for the full payment of the enjoined claims. Nondebtor releases may also be tolerated if the affected creditors consent.") (citations omitted). "But this is not a matter of factors and prongs. No case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique." *Id.* *See also* Gillman v. Cont'l Airlines (*In re* Cont'l Airlines), 203 F.3d 203, 212 (3d Cir. 2000) (indicating that nondebtor releases may be appropriate in extraordinary cases); Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 761–62 (5th Cir. 1995) (holding that nondebtor releases could be issued because case satisfied "unusual circumstances" requirement; released parties provided substantial consideration to the estate and the release was a key provision of the plan).

920 *See generally* Ryan M. Murphy, *Shelter from the Storm: Examining Chapter 11 Plan Releases for Directors, Officers, Committee Members, and Estate Professionals*, 20 J. Bankr. L. & Prac. 4 Art. 7, Sept. 2011 (general review of case law addressing third-party releases).

921 Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973, 979 (1st Cir. 1995) (citations omitted).

party claims subject to the release are not extinguished, but channeled to allow recovery from separate assets, which commonly means the nondebtor did not receive a complete discharge.[922] Notably, some courts have held that the court's power under section 105(a) in the nondebtor release context should be exercised only when there are unique circumstances. The U.S. Supreme Court also has, in *dicta*, provided an additional factor to consider: whether the claims against the nondebtor third party are derivative of the debtor's wrongdoing.[923]

Third-Party Releases: Recommendations and Findings

The Commission considered this basic question: Should the Bankruptcy Code prohibit third-party releases in chapter 11 plans? The Commission agreed that a blanket prohibition on third-party releases was inadvisable. The Commissioners discussed case examples and particular fact patterns in which third-party releases facilitated a confirmable plan and ultimately benefited all stakeholders. They recognized, however, that third-party releases might not be appropriate in every chapter 11 case. For example, a release provision could be overly broad or not really necessary, particularly in cases where the benefits of the release to the estate are nominal, but the harm to creditors is significant. Accordingly, the Commission rejected carte blanche approval of third-party releases, as well as a presumption in favor of such releases.

The Commissioners discussed the competing considerations underlying the third-party release debate. A debtor may need the assistance of nondebtor parties to effect its reorganization. This assistance may be in the form of service, collaboration, funding, business commitments, or other means that allow the debtor to achieve its objectives in the chapter 11 case or in its postconfirmation operations. Nondebtor parties may be reluctant to contribute to the plan or the debtor's reorganization efforts if the nondebtor party might be exposed to liability or will have ongoing liability despite confirmation of the chapter 11 plan. On the other hand, limiting creditors' recoveries to those provided under the plan may substantially change the nature of their rights against nondebtor parties, and in turn further reduce their overall recoveries. In these instances, from the creditors' perspective, nondebtor parties may be receiving a windfall at the creditors' expense.

In light of these considerations, the Commission methodically worked through the various issues that arise in the context of third-party releases. The Commissioners started from the premise that consensual third-party releases — those releases binding only on creditors who expressly consent to the release through a vote on the plan that includes consent to the third-party release, a separate indication on the ballot that the creditor consents to the third-party release, or a separate agreement from the creditor in which it consents to the release — should be enforceable. The Commission disagreed with the Ninth and Tenth Circuits' position that contractual agreements between the affected parties regarding a third-party release should not be enforced. The Commissioners found these kinds of contractual agreements outside the scope of section 524(e) and consistent with the underlying policies of the Bankruptcy Code.

922 Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 760–61 (5th Cir. 1995).
923 Travelers Indemnity Co. v. Bailey, 557 U.S. 137, 155 (2009) ("Our holding is narrow. We do not resolve whether a bankruptcy court . . . could properly enjoin claims against nondebtor insurers that are not derivative of the debtor's wrongdoing.").

The Commissioners then reviewed the different kinds of nonconsensual third-party releases commonly included in chapter 11 plans. The Commissioners observed the challenges in crafting a bright-line test or general approval standard for such nonconsensual releases. They then considered the different tests used by courts to evaluate nonconsensual third-party releases. Specifically, the Commissioners analyzed the multi-factor tests used by the courts in the *Dow Corning* and the *Master Mortgage* cases, respectively. For example, the court in *Dow Corning* stated:

> We hold that when the following seven factors are present, the bankruptcy court may enjoin a nonconsenting creditor's claims against a nondebtor: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The nondebtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions.[924]

The court in *Master Mortgage* articulated a five-factor test that considers: (1) the identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) whether the nondebtor has contributed substantial assets to the reorganization; (3) whether the injunction is essential to reorganization; (4) whether a substantial majority of the creditors agree to such injunction — specifically, whether the impacted class or classes have "overwhelmingly" voted to accept the proposed plan treatment; and (5) whether the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.[925]

The Commission considered the application of each factor to different scenarios, including the relationship of the factors to nonconsensual releases. It agreed that in the context of nonconsenting creditors or classes of claims, the factors focusing on the contributions of nondebtor parties, percentage recoveries by the affected creditors, and mechanisms established to facilitate recoveries to those creditors were of particular importance, with specific emphasis on the last of these factors. On balance, the Commission recommended a standard based on the *Master Mortgage* factors and rejected application of the *Dow Corning* factors. It further determined that the *Master Mortgage* factors adequately captured the careful review required in these cases and declined to incorporate separate identification of unique or unusual circumstances.

924 *In re* Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002), *cert. denied*, 537 U.S. 816 (2002).
925 *In re* Master Mortg. Inv. Fund Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994).

Voting Designation in Chapter11

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Voting Designation in Chapter 11

A creditor's right to vote on the plan is a fundamental right in a chapter 11 bankruptcy. *In re Adelphia Communications Corp.,* 359 B.R. 54, 61 (Bankr.S.D.N.Y.2006). To successfully confirm a plan, the debtor must obtain approval by a super majority of each class of claims, which under 11 U.S.C. § 1126 (c) requires that in classes entitled to vote, at least two-thirds of the dollar amount of the class and more than one-half of the number of allowed claims held in the class vote to accept the plan.

Chapter 11 allows an entity to preserve value for its shareholders and creditors through the formation of a plan. Courts have recognized that chapter 11 assumes creditors, like shareholders, will act or vote in a way that maximizes value not only for the estate but specifically for their interests as creditors. Theoretically, a more valuable debtor is able to pay a larger dividend than a less valuable debtor. When entities cast a vote disregarding their interests as creditors (or shareholders) and pursue some other agenda adverse to the estate and its constituencies, courts may scrutinize the motives behind the vote and in appropriate circumstances may designate or disqualify the vote under the authority of 11 U.S.C. § 1126(e), which provides:

> On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such a plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.

In this paper we examine the background to voting designation and some of the case law interpreting and applying section 1126(e) and its predecessor under the Bankruptcy Act.

Voting Designation under the Bankruptcy Act

The predecessor to section 1126(e) was adopted by Congress in 1938 in response to the decision in *Texas Hotel Securities Corp. v. Waco Development Co.*, 87 F.2d 395 (5th Cir. 1936).

In *Waco*, Conrad Hilton purchased claims to block a plan of reorganization that would have given a lease on the debtor's property to a third party. *Id*. at 397-99. Prior to confirmation, an entity owned by Hilton held the lease and Hilton and his partners sought to force a plan that would once again put them in control of the operation of the hotel or otherwise reestablish an interest that they felt they had in the property. *Id*. at 399. The District Court refused to count Hilton's vote but the Court of Appeals reversed, holding that the District Court lacked authority under the Bankruptcy Act to look into the motives of creditors voting against the plan. *Id*. at 400.

In response to the *Waco* decision, Congress enacted the good faith clause as part of the Chandler Act of 1938, in Section 203 of Chapter X, as follows:

> If acceptance or failure to accept a plan by the holder of any claim or stock is not in good faith, in the light of or irrespective of the time of acquisition thereof, the judge may, after hearing upon notice, direct that such claim or stock be disqualified for the purpose of determining the requisite majority for the acceptance of a plan.

In re Pine Hill Collieries Co., 46 F. Supp. 669, 670 (E.D. Pa 1942).

The new statute left to the courts the determination of what actions were "not in good faith" under the circumstances of each case. *Id*. at 671. In explaining the purpose and its application of the new statute, the *Pine Hill* court said:

> The new provision was intended to empower the court to disregard the dissenters, as well as assenters, not voting in good faith. It prescribes a standard of conduct defined by the elusive term 'good faith' which must be met under pain of disqualification. The test is plainly to be sought in the motives of the holder of the claims.

Id. In *Pine Hill*, the trustee moved for, and the Securities and Exchange Commission ("SEC") supported, the disqualification of a creditor's vote after the creditor acquired the entire amount of the second mortgage bond issue to be able to vote against the plan. *Id*. In its filing, the SEC

suggested that there was no good faith if assent is withheld to serve some "ulterior selfish" purpose. The court accepted this test– to a certain extent – stating:

> If the emphasis be placed on 'ulterior' rather than 'selfish' this seems to be as practical a test as could be found. What is selfishness from the standpoint of those who derive no benefit from conduct under scrutiny often becomes enlightened selfinterest if viewed from the standpoint of those who gain by it. If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster. On the other hand*, pure malice, 'strikes' and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior.*
>
> Without attempting anything more than the suggestion already made as to what good faith means, it will be sufficient to say that a party, largely interested in the Debtor before his acquisition of controlling votes, who withholds consent to a plan primarily because he believes its consummation will be more injurious to his investment in the Debtor than liquidation, meets the standard of good faith. Further, that in the case of a party so positioned, there must be more evidence of an ulterior purpose than the mere fact that the controlling votes were acquired during the progress of the proceedings, without regard to their intrinsic value and for the purpose of defeating the plan.
> *Id*. [Emphasis supplied].

The Supreme Court, in *Young v. Higbee Co*., 324 U.S. 204, 65 S.Ct. 594, 89 L.Ed. 890 (1945), recognized a court's ability to designate votes in cases involving stockholders whose purpose was to obstruct a fair and feasible reorganization in an effort to entice someone to pay them more for their interest than the share provided to the class of stockholders under the plan. In *Young,* two preferred stockholders, Potts and Boag, appealed the confirmation order on the basis of objections to allowance of the claims of junior indebtedness which left less available for the preferred stockholders. 324 U.S. at 206. If they had been successful on the appeal, the value of the junior claims would have been reduced, increasing the value of the claims held by all the preferred stockholders as a class. *Id*. at 207. During the appeal, Potts and Boag sold their claims and their rights under the appeal to the junior claim holders, Bradley and Murphy, for more than six times the market value of the stock at the time. *Id*. Furthermore, as part of the agreement,

Potts and Boag agreed to dismiss the appeal, which they did. *Id*. After an unsuccessful attempt to intervene in and pursue the appeal, Young, on behalf of the class of preferred stockholders, petitioned the court to require Potts and Boag to account to the debtor for the difference between what they received for their claims and the market value of the stock, or in the alternative, to require them to pay that amount over to the class of preferred stockholders. *Id*. at 208. While procedurally it was too late for voting designation in that case, the Court recognized the remedy under those circumstances and further recognized that the relief Young had requested under the circumstances may be appropriate.

Voting designation under the Bankruptcy Act involved an examination of the underlying motives of the holder of a claim and was invoked when the vote was made with an improper ulterior motive or other action that enabled the holder to obtain some benefit beyond its interest as a creditor or shareholder at the expense of the estate and other parties in interest. That examination continues in cases under section 1126(e) of the Bankruptcy Code, and many of the principles developed in interpreting voting designation under the Act serve as the cornerstone to the analysis under the Code today.

Voting Designation under the Bankruptcy Code

Under the Bankruptcy Code, courts are still tasked with differentiating between "ulterior" motives warranting designation and the self-interestedness with which all creditors assess and evaluate a plan. When a creditor's motive shifts from mere self-interest to "ulterior" motives courts scrutinize the motive behind the vote and if appropriate, designate votes. However, because voting is a fundamental right in chapter 11, designation is viewed as a drastic remedy that is the exception, rather than the rule. *In re Dune Deck Owners Corp.,* 175 B.R. 839, 844 (Bankr. S.D. NY 1995).

The mere pursuit of economic gain does not in itself indicate bad faith so long as the interest being served is that of the creditor as creditor, as opposed to the creditor in some other capacity. *In re Landing Associates, Ltd.,* 157 B.R. 791, 807 (W.D.Tex. 1993). Furthermore, the determination of whether a creditor's vote should be designated is inherently fact intensive and difficult to apply "for what appears to be an enlightened self-interest to a creditor may well appear to be an ulterior motive to the debtor." *Id.* at 803 . The party seeking to designate a vote or votes bears a heavy burden of proof. *In re Adelphia Communications,* 359 B.R. 54, 61 (Bankr. S.D. NY 2006). At least one court has determined that the ulterior or improper motive must be established as of the time of voting and the sole or primary goal in rejecting the plan must be to benefit the holder of the claim at the expense of other creditors. *In re GSC*, *Inc.,* 453 B.R. 132, 161 (S.D. NY 2011). If a creditor can articulate a valid reason for rejecting a plan, even if the rejection may also be consistent with the creditor's non-creditor interests, courts are reluctant to invoke designation. *In re Lightsquared Inc.,* 513 B.R. 56, 92 (Bankr. S.D. NY 2014), citing *In re Figter Ltd.,* 118 F.3d 635 (9th Cir. 1997). What sort of ulterior motives trigger designation is a question of law that is reviewed *de novo*, while whether a particular creditor has acted with an impermissible motive is a question of fact that is reviewed for clear error on appeal. In re DBSD North America, Inc., 634 F.3d 79, 102 (2d Cir. 2011).

In *Dune Deck Owners*, the court examined the case law applying section 1126(e) and found two types of bad faith developed by the case law: 1) when a claimant tries to extract or extort an advantage not available to other claimants in its class, or 2) when a claimant has an ulterior motive unrelated to its claim, such as to obtain some collateral or a competitive advantage. 175 B.R. at 844. The court recognized that the most common bad faith case is the "ulterior motive" case. *Id*. The court further described the badges of bad faith developed in the

case law, which may justify the designation of votes, including creditor votes designed to 1) put the creditor in control of the debtor; 2) put the debtor out of business or otherwise gain a competitive advantage for the creditor; 3) destroy the debtor out of pure malice, or 4) advance the creditor's interests apart from recovery under the proposed plan, such as obtaining benefits from a third party under a private agreement conditioned on the debtor's failure to reorganize . *Id.* at 844-45.

Badges of Bad Faith—Exacting Payment

A claimant who threatens to oppose a plan or hold off confirmation in an attempt to exact more than it would under the plan, may be found to have acted in bad faith. In *In re Featherworks Corp.* 25 B.R. 634, (Bankr. E.D. NY 1982), aff'd sub nom, *Matter of Featherworks Corp.*, 36 B.R. 460 (E.D. NY 1984), a creditor initially voted against the plan but attempted to change its vote after receiving a $25,000.00 payment from the debtor's affiliate. Until the creditor received the payment it had voted against the plan, and the plan could not be confirmed without the change in the creditor's vote. *Id*. The court refused to allow the creditor to change its vote under the circumstances. Id. at 640. In its decision the court described the importance of maintaining the Code's built-in controls as follows:

> The bankruptcy laws extend extraordinary relief to insolvent debtors by permitting them to slough off their debts and continue in operation, provided their creditors agree to that course of action. The Code depends upon the self-interest of the creditors to act as a barrier against abuse of the bankruptcy laws. If a majority in number and amount of all creditors vote for a plan, there is good reason to believe that that plan is in the best interest of all creditors, since it would not receive such a vote otherwise. However, if any creditor receives some special consideration peculiar to him, his vote is no longer disinterested and unbiased and the Code's built-in controls are neutralized.

Id. at 641.

Badges of Bad Faith— Control of the Debtor

In *In re Allegheny International, Inc.,* 118 B.R. 282 (Bankr. W.D. Pa 1990), the creditor Japonica, purchased claims for the purpose of influencing the vote on the debtor's plan and its own competing plan. Japonica was not otherwise a pre-Petition creditor, but only became a creditor by virtue of the purchases, which occurred shortly before the debtor filed its plan and disclosure statement. *Id*. Furthermore, Japonica filed a competing plan in the case. The court recognized that although the mere purchase of claims for securing the approval or rejection of a plan does not *per se* amount to bad faith, when the purpose is to further an interest other than an interest as a creditor, the purchase does amount to bad faith. *Id.* at 289, citing *In re P-R Holding Corp.*, 147 F.2d 895 (2d Cir. 1945). In *Allegheny*, the court found that the creditor purchased a blocking position so the creditor could take control of the debtor, and it needed to be able to block the debtor's plan to do so. Therefore, the court found that Japonica acted in bad faith and designated its votes. *Id*. at 290. The *Allegheny* court recognized that Japonica did not have to become a creditor in the case but chose to do so and for an ulterior motive.

In *In re DBSD North Americ*a*, Inc*., 634 F3d 79 (2nd Cir. 2011), the Court designated the votes of a competitor who overpaid to purchase claims in order to propose its own plan. The court found that like the creditor in *Waco*, DISH Network Corporation ("DISH") was less interested in maximizing the return on its claim than obstructing the reorganization process for its own outside gain. *Id*. at 104. Most damaging to DISH was an internal memo that showed a desire to obtain a blocking position and "control of the bankruptcy process for this potentially strategic asset". *Id*. at 105.

Badges of Bad Faith—Running the Debtor out of Business

In *In re MacLeod*, 63 B.R. 654 (Bankr. S.D. Ohio 1986), the dissenting creditors were former employees of the debtor who had formed a competitor of the debtor while still employed by the debtor. The amount of the claims for any one of these dissenters was nominal compared to the total claims of other unsecured creditors. However, the dissenters sent multiple letters to the court in an attempt to persuade the court that the debtor should no longer exist to do business. The court determined that the employees cast their votes for the purpose of destroying or injuring the debtor and its business so the competing business interests could be furthered. *Id*. at 655. As a result, the court designated the dissenters' votes. *Id*.

Badges of Bad Faith--Benefiting Outside of the Plan

In *In re Dune Deck Owners Corp*., 175 B.R. 839 (Bankr. S.D. NY 1995), the debtor was the lessee of a ground lease and owned an apartment building. The apartment building was largely a vacation resort and shareholders either used their units or rented them to vacationers through the summer months. The property is subject to a recorded Declaration by which the debtor's tenants were granted certain rights of way for ingress and egress and use and enjoyment of common areas. *Id*. at 841. At the time of the filing, the debtor's property, together with its rents, issues and profits secured a loan of approximately $3 million held by Marine Midland Bank, N.A. ("Marine"). The debtor valued its property at $1.6 million so Marine had a large, undersecured claim. Prior to the case, the debtor defaulted on the underlying note and Marine commenced a foreclosure action. Dune Deck Acquisition Corp. ("DDAC") agreed to purchase Marine's interest prior to the bankruptcy filing but the agreement was not consummated at the time of the filing.

Immediately after the filing of the case, DDAC assigned its rights under the purchase agreement with Marine to KHD Acquisition Corp. ("KHD") for $1.8 million, the amount it was required to pay Marine. *Id*. at 841. The assignment from DDAC to KHD contained provisions relating to the Declaration that clearly benefitted KHD and not the debtor or its creditors. For example, if the plan failed so that KHD could foreclose on its interests, and KHD was the successful bidder at the sheriff's sale, it agreed to terminate the Declaration. Under those circumstances, DDAC would pay KHD a bonus of $100,000. *Id*. at 846. If KHD was not the winning bidder but the purchaser at sale bid enough to satisfy KHD's secured claim of nearly $3 million, then KHD would pay to DDAC $100,000 but would still have profited by the sale. *Id*. The court recognized that under the Assignment, KHD had nothing to lose and much to gain by opposing the plan and foreclosing on its mortgage against the debtor's property. *Id*.

After KHD obtained the assignment, litigation increased, particularly over the use of cash-collateral. Eventually, KHD filed a motion to dismiss the bankruptcy case, which was denied after the court determined that the issues raised in KHD's motion were better suited for a confirmation hearing. In an attempt to control the plan confirmation process, KHD purchased seventeen unsecured claims – more than half of the number of claims in the class--after the bar date had passed. In response, the debtor sought to designate KHD's vote. The court found that there was enough to suggest KHD had ulterior motives to warrant an evidentiary hearing on the matter as part of the plan confirmation hearing and stated:

> In the final analysis, the Court must decide whether KHD's opposition to the Second Plan stems from its business judgment that its secured claim faces better prospects through foreclosure than under the Debtor's plan, or on the other hand, derives from a desire to reap the obvious and potential benefits for itself or DDAC that come with foreclosing the mortgage and terminating the Declaration. Consequently, the fact that KHD has purchased a blocking position does not necessarily grant it veto power over the Second Plan, or render the Second Plan unconfirmable as a matter of law.
>
> *Id*. at 846-847.

Conclusion

The circumstances around whether a court will invoke voting designation will be evaluated on a case by case basis. Given the fundamental right to vote on a plan, courts are hesitant to designate votes under 11 U.S.C. § 1126(e) except in response to egregious conduct that threatens the core chapter 11 principles found in the Bankruptcy Code. As long as a claimant can identify a valid reason for its vote, courts will be reluctant to invoke voting designation, even if another non-creditor related reason appears to be present.

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