AMERICAN
BANKRUPTCY
INSTITUTE

2017 Caribbean Insolvency Symposium

Judges' Roundtable

Patricia A. Redmond, Moderator
Stearns, Weaver, Miller, Weissler, Alhadeff & Sitterson, PA; Miami

Hon. Laurel M. Isicoff
U.S. Bankruptcy Court (S.D. Fla.); Miami

Hon. Enrique S. Lamoutte
U.S. Bankruptcy Court (D. P.R.); San Juan

Hon. Robert A. Mark
U.S. Bankruptcy Court (S.D. Fla.); Miami

Hon. Brian K. Tester
U.S. Bankruptcy Court (D. P.R.); San Juan

2017

***Otherwise-valueless exemptions might get value, depending on the outcome of* Jevic.**

Chapter 7 Debtors Might Benefit from *Jevic* by Analogy

Depending on whether the Supreme Court grants *certiorari* and how the justices rule in *Czyzewski v. Jevic Holding Corp.*, the debtor in a Michigan case might be able to preserve some value for herself even though the chapter 7 trustee sold her home for less than the mortgages.

The Solicitor General filed a brief in May recommending that the high court grant *certiorari* and reverse the Third Circuit's decision in *Jevic*. The appeals court held that proceeds from a settlement can be distributed contrary to the rules of priority.

In the Michigan case, a woman filed under chapter 7 while owning a home worth $170,000 that was encumbered by mortgages totaling almost $220,000. On consent of the lenders, the trustee arranged a sale for $160,000. The holder of the first mortgage agreed to take about $148,000 in full satisfaction of the debt. The senior lender also agreed that the trustee could distribute $6,000 to the holder of the second mortgage. After paying the brokerage fee and closing costs, the trustee would have money left over for distribution to unsecured creditors.

The debtor objected, claimed a homestead exemption, and contended that she was entitled to some of the sale proceeds. The bankruptcy judge ruled against her and approved the sale. The district court affirmed in an opinion on May 31.

Chief District Judge Denise Page Hood of Detroit made short shrift of the appeal. Citing Sixth Circuit authority, she said there can be a homestead exemption only if there is equity in the property. Since the sale price was less than the first mortgage, she ruled that there was nothing to which the claimed exemption could attach.

Ordinarily, the exempt value in a home is preserved for the debtor and bypasses creditors. In the Michigan case, unsecured creditors got a sliver of the home's value even though the homeowner claimed an exemption. It could be argued, therefore, that the settlement between the trustee and the mortgage lenders evaded the order of distribution in bankruptcy because unsecured creditors made a recovery from the home while the debtor's exemptions yielded nothing.

The Michigan case shows some similarities to *Jevic* because the holder of the first mortgage made a carve-out for unsecured creditors to curry favor with the trustee and permit a quick sale. The mortgage lenders also benefitted from bankruptcy because the judge's sale approval order evicted the debtor from her home by a date certain.

The second mortgage holder got a $6,000 benefit by allowing a distribution to unsecured creditors because the junior lender would have recovered nothing in foreclosure.

In substance, unsecured creditors whose interests in the home ordinarily would have been subordinate to the debtor's exemptions came out ahead of the homeowner. In that respect, the Michigan settlement seems analogous to *Jevic*.

If the Supreme Court hears *Jevic*, the justices will decide whether settlements must comply with the rules of priority. Although *Jevic* does not involve a claimed exemption, the outcome might provide a basis for deciding whether a chapter 7 trustee can craft a settlement that creates an estate for unsecured creditors while leaving a debtor with no recovery on her exemptions.

The justices will probably decide about granting *certiorari* in *Jevic* before the Supreme Court's term ends on June 27.

To read ABI's discussion of the *Jevic certiorari* petition, click here.

The Michigan opinion is *Brown v. Ellmann (In re Brown)*, 15-11017 (E.D. Mich. May 31, 2016). The *Jevic* case in the Supreme Court is *Czyzewski v. Jevic Holding Corp.*, 15-649. The *Jevic* opinion in the Third Circuit is *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. May 21, 2015).

Is there flexibility to depart from bankruptcy priorities? Professors disagree.

Law Professors Disagree on How the Supreme Court Should Decide *Jevic* on Structured Dismissals

Outnumbered almost six to one by legal scholars from other universities, three law professors filed an *amicus* brief urging the Supreme Court to affirm *Czyzewski v. Jevic Holding Corp.* and permit a so-called structured dismissal where the bankruptcy court approves a settlement, dismisses the chapter 11 case, and authorizes distribution of settlement proceeds that contravene the priorities set forth in Section 507.

The three professors – David Gray Carlson, Jack F. Williams and David R. Kuney – were keen to ensure that the Supreme Court does not hand down an opinion broadly applying the absolute priority rule to all aspects of bankruptcy. They are concerned that "an expansive view of the absolute priority rule will have harmful consequences in other areas of bankruptcy practice," such as single-asset real estate cases and individual chapter 11s.

The amicus brief explains, historically, why the absolute priority rule is a "limited doctrine" that does not control "all dispositions" of property in bankruptcy.

The three professors' brief, filed on Oct. 17, effectively explains why *Jevic* should turn on the applicability – or not – of Section 507's priorities, rather than the congressionally modified notion of the judge-made absolute priority rule invoked today when cramdown is employed under Section 1129(b).

The *amicus* brief traces the history and evolution of the absolute priority rule, relying in large part on a 2016 *Fordham Law Review* article by Prof. Stephen J. Lubben from Seton Hall Univ. School of Law. From Supreme Court authority, they explain why "absolute priority is not always mandated, and must, at times, give way to practical necessity."

With regard to Section 507, the three professors said it is "not accurate" to say that "all distribution schemes require adherence to the 'statutory priority' scheme."

Urging the Supreme Court to reverse *Jevic*, the *amicus* brief filed by 17 professors on Sept. 2 says that the Third Circuit's 2-1 decision "threatens the foundations of the bankruptcy system – its priority scheme." They said that nothing in the Bankruptcy Code "permits this kind of priority-skipping settlement in the absence of creditor consent."

Affirming *Jevic* and permitting an "end run" on the priority system, the 17 professors said, would foster "perverse incentives: powerful parties will increasingly seek to resolve corporate bankruptcy cases through structured dismissals which lack creditor safeguards that Congress built into the bankruptcy process."

The 17 law professors advocating for reversal of *Jevic* include Ralph Brubaker, Bruce A. Markell, David A. Skeel and Jay L. Westbrook. Their brief was submitted by Professors Melissa B. Jacoby and Jonathan C. Lipson. The three professors' *amicus* brief was submitted by David R. Kuney from Whiteford Taylor & Preston in Washington, D.C.

To read the three professors' brief, click here. For the 17 professors' submission, click here. To read ABI's discussions of *Jevic*, click here and here.

The docket in the Supreme Court is *Czyzewski v. Jevic Holding Corp.*, 15-649 (Sup. Ct.).

Justices search for rationale for departing from Section 507 priorities in settlements.

Supreme Court Seems Primed to Reverse *Jevic*, Precluding Structured Settlements

At oral argument in the Supreme Court today, five justices seemed inclined to reverse the Third Circuit in *Czyzewski v. Jevic Holding Corp.* and hold that settlements cannot distribute proceeds departing from the priority scheme in the Bankruptcy Code when the claim being settled belongs to the estate.

The Supreme Court will resolve a split of circuits in which the Third and Second Circuits held in 2015 and 2007, respectively, that bankruptcy courts may approve so-called structured dismissals where the distribution of proceeds from settlements does not comply with the priorities contained in Section 507. The Fifth Circuit barred structured dismissals in 1984 when it decided *AWECO* and held that the “fair and equitable” test must apply to settlements.

The outcome of the *Jevic* case will likely also determine whether bankruptcy courts can confirm so-called gift plans, where a secured creditor or buyer makes a payment, supposedly from its own property, that enables a distribution in a chapter 11 plan that is not in accord with priorities.

The Facts in *Jevic*

In the unsuccessful reorganization of Jevic Holding Corp., the official unsecured creditors’ committee had sued the secured lender and negotiated a settlement calling for the lender to set aside some money for distribution to general unsecured creditors following dismissal. The distribution scheme did not follow the priorities set forth in Section 507 because wage priority claimants were to receive nothing from the lender through a trust set aside exclusively for lower-ranked general unsecured creditors.

Despite the wage claimants’ objection, the bankruptcy court approved the settlement and was upheld in district court. On a second appeal, the Third Circuit, in a 2-1 opinion, upheld the structured settlement, cutting out any recovery by priority wage claimants. Although the dissenter in the Third Circuit agreed that structured dismissals sometimes can be approved, he did not believe *Jevic* was a proper case. Until the Supreme Court granted *certiorari* in June, the appeals court’s opinion was important because the Third Circuit makes law for Delaware, where many of the country’s largest chapter 11s are filed.

Before granting *certiorari*, the Supreme Court sought comment from the Solicitor General, who subsequently urged granting the petition to reverse the court of appeals, stating that "bankruptcy is not a free-for-all in which parties or bankruptcy courts may dispose of claims and distribute assets as they see fit." The government said that "nothing in the Code authorizes a court to approve a disposition that is essentially a substitute for a plan but does not comply with the priority scheme set forth in Section 507."

Five Justices Seem Primed to Reverse

Justices Sonia Sotomayor, Elena Kagan and Stephen G. Breyer seemed firmly in the reversal camp. Justice Ruth Bader Ginsburg also seemed to favor the workers' arguments, as did Chief Justice John G. Roberts, Jr., although his questions were fewer and more difficult to interpret.

Justice Breyer often appears to be the justice best versed in bankruptcy law and practice. Initially, he seemed undecided when he observed that nothing in the Bankruptcy Code either permits or prohibits dismissal with distributions departing from Section 507 priorities. Later, he asked how any group of parties can reverse the order of priorities by agreement among themselves and cut out creditors who do not consent to the settlement.

Later still, Justice Breyer said it was a "dangerous principle" to allow departure from the statutory priorities of distribution.

Justice Breyer focused on the primary weakness in the respondents' argument when he got the lawyer to admit that the settlement was in compromise of a claim belonging to the estate. Therefore, he said, the allocation of settlement proceeds was "quite contrary" to Congress' scheme of distribution.

Although Justice Kagan said that permitting a structured dismissal might be "sensible," she said it does not appear in the Bankruptcy Code.

Justice Sotomayor, like Justice Anthony M. Kennedy, did not think the *Jevic* case and the company's inability to confirm a chapter 11 plan was particularly rare. Since the situation was not extraordinary, Justice Sotomayor asked how a court should protect disfavored creditors from being "preyed upon."

Similarly, Justice Kagan asked where the Bankruptcy Code permits distributions departing from Section 507 even if the situation is extraordinary. She also said the settlement was seemingly done "in collusion."

Early in the morning's one-hour argument, Justices Kagan and Sotomayor were concerned with narrowing their ruling so as to not upset bedrock bankruptcy principles like the so-called doctrine of necessity, which is utilized to approve critical vendor motions and pay workers pre-petition wages before plan confirmation.

The government, although arguing for the justices to reverse the Third Circuit, urged the Court to narrow the ruling to ensure that first-day motions like critical vendor and wage motions are not proscribed.

On the issue of narrowness, the Chief Justice possibly kept the door open to approval of structured settlements in some cases. If priorities inform the exercise of discretion in approving a settlement, then, he said, there must be extraordinary reasons to depart from the statutory distribution scheme.

The Chief Justice's comments were similar in some regards to the view of the Third Circuit's dissenter, who agreed that structured settlements were theoretically permissible. The dissenter, however, did not believe that *Jevic* presented a proper case.

If the Chief Justice is not prepared to outlaw settlements with distributions contrary to Section 507, there is the possibility of a 4/4 split on the Supreme Court, meaning that the Third Circuit would be upheld. In that case, there would be no Supreme Court precedent, leaving the issue open until the Court is at full strength.

If the court is evenly divided, the justices might not rule on whether structured dismissals are always prohibited. In that event, they could say, like the Third Circuit dissenter, that *Jevic* was not a proper case for departing from statutory priorities.

One other outcome is possible. Justice Samuel A. Alito, Jr. queried the workers' lawyer as to whether she had briefed the same issue the court agreed to decide in granting *certiorari*. Earlier this term, the Court dismissed a petition as improvidently granted because the appellant's brief was based on arguments not encompassed by the *certiorari* petition.

In the Supreme Court, the workers' lawyer was Danielle Spinelli, supported by Sarah E. Harrington, Assistant Solicitor General. Urging affirmance was Christopher Landau.

The case in the Supreme Court is *Czyzewski v. Jevic Holding Corp.*, 15-649 (Sup. Ct.). The opinion in the Third Circuit is *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. May 21, 2015).

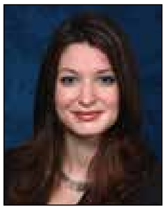
Dicta

By Hon. Harlin D. Hale, Aubrey E. Edkins and Nicole Hay

Set Me Free: Shared Policy Concerns on Nonconsensual Third-Party Releases

Hon. Harlin D. Hale
U.S. Bankruptcy Court (N.D. Tex.); Dallas

Aubrey E. Edkins
SMU Dedman School of Law; Dallas



Nicole Hay
U.S. Bankruptcy Court (N.D. Tex.); Dallas

Hon. Harlin Hale is a bankruptcy judge for the Northern District of Texas in Dallas. Aubrey Edkins, a 2018 J.D. candidate at SMU Dedman School of Law, is an extern and Nicole Hay is a term clerk to Judge Hale.

Nonconsensual third-party releases have recently been thrust to the forefront of bankruptcy law, holding considerable sway with respect to forum choice for large chapter 11 cases. With circuits split and no set rule, the area is in need of clarification. From the bench, major policy concerns drive decisions, causing some disparity, but overall unity. A comparison of Second and Third Circuit cases to the Fifth Circuit cases reveals that the spectrum of opinion is really quite narrow and the difference between circuits, at least at the bankruptcy court level, is smaller than it first appears.

Nonconsensual third-party releases (*i.e.*, a release of nondebtors from direct claims held by creditors or other third-party stakeholders) are common in corporate reorganizations. There is, however, no explicit authority for them in the Bankruptcy Code.[1] Section 524(e)[2] is interpreted differently, depending on the circuit, to either restrict the discharge of any and all nondebtor debts, or to merely ensure that the discharge of a debtor's debts is not an automatic release from liability for nondebtors. The latter employ § 105(a)[3] to allow third-party releases when necessary to fulfill a purpose under the Bankruptcy Code. However, even in these "permissive circuits," the lack of clear authority, as well as the potential for abuse, creates a general reluctance to grant nonconsensual third-party releases. To adopt the language of the Third Circuit in *In re Cont'l Airlines*,[4] the authors will refer to these circuits as "flexible circuits" and correspondingly, more-restrictive circuits as "non-flexible circuits."

The main tension underlying the release debate is between the practicality of releases and due-process concerns. While a true fresh start for a debtor can require a release of claims against nondebtors, third-party releases can apply to known and unknown creditors who have no chance of being heard. In the extreme case, it is a discharge without notice. In the non-extreme case, it is still a discharge without consent. Yet, even in the Bankruptcy Code, it is recognized that sometimes these releases can be so crucial to the plan as to be necessary.[5] Even precedent from courts in the Fifth Circuit, often viewed as a non-flexible circuit,[6] still allows for releases of claims against certain classes of third parties in light of this practical reality.[7] As bankruptcy courts in the Fifth Circuit routinely confront this issue of nonconsensual releases, the classes of third parties that are released are expanding. At the same time, even the flexible circuits only allow nonconsensual third-party releases in the rarest of circumstances.[8] In reality, the decisions of bankruptcy courts in the Second, Third and Fifth Circuits do not fit so seamlessly into the flexible and non-flexible classifications.[9]

In the Third Circuit, the controlling precedent, *In re Continental*, did not establish a rule for when nondebtor releases were allowed.[10] Instead, the court outlined the "hallmarks" of permissible nonconsensual third-party releases: fairness, necessity to reorganization and specific factual findings to support conclusions.[11]

Finding all the hallmarks missing on the facts in *Continental*, the Third Circuit rejected nonconsensual releases for nondebtor D&Os.[12] This ruling left the Third Circuit's bankruptcy courts with only minimal guidance as to the interpretation of these releases. The Second Circuit similarly set a controlling precedent with the potential for conflicting outcomes. In *In re Metromedia*, the Second Circuit allowed nondebtor releases, but only where truly unusual circumstances rendered the releases important to the plan's success (*i.e.*, only in rare cases).[13]

The unresolved tension between due process and practicality in third-party releases post-*Continental* and *Metromedia* is displayed in recent decisions from bankruptcy courts in the Second and Third Circuits. For example, in interpreting and applying

1 With the exception of asbestos cases, for which releases are specifically allowed. 11 U.S.C.A. § 524(g) (West 2016).
2 "Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C.A. § 524(e) (West 2016).
3 "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C.A. § 105 (West 2015).
4 *In re Cont'l Airlines*, 203 F.3d 203, 213 (3d Cir. 2000).
5 This concept was recognized even in the Bankruptcy Code through the creation of asbestos trusts. The latency period was so long that the release was necessary in order for the companies to ever think of reorganizing. 11 U.S.C.A. § 524(g) (West 2016).
6 *See, e.g.*, Menachem O. Zelmanovitz, "Nondebtor Releases in Reorganization Plans: Are They Still Viable or a Thing of the Past in the Second Circuit," 25 May *Am. Bankr. Inst. J.* 16 (May 2006), *available at* abi.org/abi-journal.
7 *See, e.g.*, *In re Texas Rangers Baseball Partners*, 2010 WL 4106713, *11 (Bankr. N.D. Tex. 2010).
8 *In re Cont'l Airlines*, 203 F.3d at 213 (3d Cir. 2000); *see also In re Vitro SAB de CV*, 701 F.3d 1031, 1061-62 (5th Cir. 2012).
9 The Ninth and Tenth Circuits, however, while outside the scope of this article, do tend to remain more truly prohibitory. *See* Zelmanovitz, *supra* n.6.
10 *In re Cont'l Airlines*, 203 F.3d at 203, 214 (3d Cir. 2000).
11 *Id.*
12 *Id.*
13 *In re Metromedia Fiber Network Inc.*, 416 F.3d 136, 143 (2d Cir. 2005).

the Third Circuit decision of *Continental*, bankruptcy courts have produced conflicting rules and often harsh results — an uncomfortable fit for a flexible circuit. In *In re Washington Mutual*, noting that while the Third Circuit had not barred third-party releases, they were the exception and not the rule, the bankruptcy court proceeded to establish its own rule based on its precedent.[14] The bankruptcy court held that any third-party release of a nondebtor needed to be based on the consent of the releasing party, either by contract or by voting in favor of the plan.[15] By adopting this affirmative consent requirement, the court acknowledged the strength of the due process protection policy, winning out over the more practical concerns. Contrast this holding with *In re Millennium*. In that case, the court adopted the *Continental* hallmarks as the standard and upheld nonconsensual third-party releases for post-petition lenders, former equityholders and two corporate executives as fair and necessary to the reorganization.[16]

The contrast between the ruling in *In re Millenium* and *In re Washington Mutual* led to a direct certification of appeal to the Third Circuit. This certification was denied by the court of appeals, however, and the case is now pending before the U.S. District Court for the District of Delaware. The Third Circuit's refusal to state a rule in *In re Continental* and its denial of appeal in *In re Millennium* may show a hesitation to disturb the flexibility of a bankruptcy court's ability to balance the equities.

Similar variance in the treatment of nonconsensual third-party releases exists in the Second Circuit's bankruptcy courts' decisions. In *In re Chassix*, the U.S. Bankruptcy Court for the Southern District of New York construed the rationale behind the *Metromedia* holding, noting that there is no public policy in support of making third-party releases applicable to as many creditors as possible; rather, there is a clear policy that such releases are only appropriate in narrow and unusual circumstances.[17] The bankruptcy court in *Chassix* thus required affirmative consent for third-party releases.[18] Here, too, showing a policy determination in favor of due-process concerns over practical considerations is a rather restrictive approach in a flexible circuit. Moreover, in a recent U.S. Trustee objection filed in the U.S. Bankruptcy Court for the Southern District of New York in *In re Fairway Group*,[19] an additional argument was raised in support of further limiting the circumstances under which nonconsensual third-party releases should be granted. Using *Chassix*, the U.S. Trustee argued that because a party is impaired if its legal, equitable and contractual rights are altered by the plan, parties affected by the release cannot be considered unimpaired by the plan for voting purposes, especially if the release was a condition of its confirmation.[20] Thus, even the Second Circuit places severe limitations on third-party releases, blurring further the distinctions between the circuit approaches.

In the meantime, bankruptcy courts across the Fifth Circuit have approved third-party nonconsensual releases for certain classes of claims, despite Fifth Circuit precedent considered to be non-flexible. The seminal Fifth Circuit case dealing with nonconsensual third-party releases and exculpation clauses in a chapter 11 plan is *In re Pacific Lumber*, determined in 2009 in the context of an equitable-mootness argument.[21] In *Pacific Lumber*, the Fifth Circuit considered a plan that, other than for willful misconduct or gross negligence, (1) released the plan proponents, reorganized entities, unsecured creditors' committee and their respective current members, officers, directors, employees, affiliates, agents and advisors from liability in connection with the bankruptcy case and administration of the plan; and (2) exculpated the plan proponents, their officers, directors and professionals, the unsecured creditors' committee, its members and professionals, and the reorganized entities, their officers, directors and professionals from liability related to the bankruptcy case and administration of the plan. As to the unsecured creditors' committee, the court determined that § 1103(c) impliedly granted the committee and its members qualified immunity for acts and omissions within the scope of their duties.[22] Striking down the remaining releases and exculpations, the Fifth Circuit stated that its own precedent "seem[ed] to broadly foreclose nonconsensual, nondebtor releases and permanent injunctions."[23] It is noteworthy that the Fifth Circuit refused to address the releases and exculpations with regard to the reorganized entities because the objecting parties failed to brief the issue.[24] Despite the fact that the Fifth Circuit appears to be less flexible than the Second and Third Circuits, bankruptcy courts have been much more lenient in applying this precedent in the Fifth Circuit than in its flexible sister circuits.

In *Pilgrim's Pride*, the bankruptcy court upheld an injunction, release of pre-effective date claims and exculpations related to the bankruptcy case as to the debtor and reorganized entities, to the extent consistent with §§ 524 and 1141 of the Bankruptcy Code.[25] As to other third parties, which the court identified as the debtors' management and professionals and a guarantor, the bankruptcy court refused to uphold the proposed exculpatory provisions, but held that the management and professionals presumably received immunity for good-faith acts performed during the bankruptcy and retained jurisdiction over any such determination.[26] In addition, bankruptcy courts in the Fifth Circuit have approved nonconsensual third-party releases for plan proponents, secured lenders and their directors and officers, professionals and affiliates, chapter 11 trustees, receivers, receiverships, and their employees, officers, agents and attorneys as being in the form of a settlement under § 1123(b)(3)(A).[27] Likewise, in the paramount case of *In re Texas Rangers Baseball Partners*, the bankruptcy court upheld exculpation provisions for the debtor, reorganized debtor, purchaser, creditors' committee and its members related to acts and omissions taken post-petition in conjunc-

14 *In re Washington Mut. Inc.*, 442 B.R. 314, 351-52 (Bankr. D. Del. 2011).
15 *Id.* at 352.
16 *See In re Millennium Lab Holdings II LLC*, 543 B.R. 703, 706, 711 (Bankr. D. Del. 2016).
17 *In re Chassix Holdings Inc.*, 533 B.R. 64, 78 (Bankr. S.D.N.Y. 2015).
18 *Id.* at 81.
19 *In re Fairway Grp. Holdings Corp.*, No. 16-11241 (MEW), U.S. Trustee Objection, Docket No. 136 (June 2, 2016).
20 *Id.* at 7-8; *In re Chassix*, 533 B.R. at 81.

21 *In re Pacific Lumber*, 584 F.3d 229 (5th Cir. 2009).
22 *Id.* at 253.
23 *Id.* at 252.
24 *Id.* at n.26.
25 *In re Pilgrim's Pride*, 2010 Bankr. LEXIS 72, **12-13 (Bankr. N.D. Tex. Jan. 14, 2010).
26 *Id.* at *17.
27 *See, e.g., In re Ondova Ltd.*, 2012 WL 5879147 (Bankr. N.D. Tex. Nov. 21, 2012); *In re Hallwood Energy LP*, 2009 Bankr. LEXIS 5099 (Bankr. N.D. Tex. Oct. 16, 2009).

continued on page 59

Dicta: Shared Policy Concerns on Nonconsensual Third-Party Releases

from page 27

tion with the bankruptcy case.[28] In doing so, the bankruptcy court stated that these limited exculpations did not violate the precedent established by *Pacific Lumber* or §§ 524 or 1123 of the Bankruptcy Code.[29]

Altogether, the growing number of bankruptcy court decisions dealing with nonconsensual third-party releases has reflected a breakdown in the general characterization of the Fifth, Second and Third Circuits within a flexible and non-flexible dichotomy. While all courts seem to disfavor nonconsensual third-party releases, courts are considering the factual circumstances on a case-by-case basis. It is apparent from the recent case law coming out of the bankruptcy courts that judges struggle with, on the one hand, the practical consideration of the need for a release to confirm the plan (to obtain the post-petition financing, and ultimately to "get the deal done"), and on the other hand, the requirement of notice and fairness to the third-party claimant. Practitioners in all circuits are encouraged to tailor releases narrowly, arrange for some consent mechanism, provide as much notice as possible and keep up with developments regarding this issue, which is ripe for review by the U.S. Supreme Court. abi

28 *In re Texas Rangers Baseball Partners*, 2010 WL 4106713, *11 (Bankr. N.D. Tex. 2010).
29 *Id.*

Another circuit joins the trend toward limiting the doctrine of equitable mootness.

Second Circuit May Be Trimming Back Doctrine of Equitable Mootness

The Second Circuit trimmed back the doctrine of equitable mootness used to dismiss appeals from chapter 11 plans that have been consummated.

The appeal was brought by an 8% shareholder from confirmation of the LightSquared Inc. reorganization plan. The unsigned, summary opinion on March 22 held that the appeal was "presumed equitably moot" because the plan had been substantially consummated.

The appeals court held that the shareholder satisfied all five tests required for overcoming the presumption of mootness. On the critical test, the circuit court said it could grant "at least some effective relief in the form of monetary damages in this case – even as little as one dollar – without knocking the props out from under the completed transaction."

Avoiding dismissal ultimately failed to help the shareholder because the circuit court proceeded to rule on the merits by finding that LightSquared's plan did not violate the "fair and equitable" rule. The bankruptcy judge made an adequately based finding that the reorganized company had no equity for "old" shareholders.

The Second Circuit opinion could be read as bringing that court more in line with other appeals courts that have been narrowing the doctrine of equitable mootness. The Second Circuit approvingly cited the Fifth Circuit's 2013 decision in *Texas Grand Prairie Hotel Realty LLC*, where the New Orleans-based court took a "narrow view" of equitable mootness, "particularly where pleaded against a secured creditor." *Texas Grand Prairie* said that equitable mootness only protects creditors who are not parties to the appeal.

The Second Circuit also approvingly cited the Ninth Circuit's *Transwest Resort Properties* decision from 2015. In that case, the Ninth Circuit held, over a vigorous dissent, that a buyer who actively participates in reorganization is not protected by equitable mootness. The Ninth Circuit denied motions for rehearing *en banc*.

By citing the other two circuits, it is far from clear, however, that the Second Circuit is going equally far in trimming back equitable mootness. The significance of the opinion is also limited because it was a summary order intended to have limited precedential effect.

The Second Circuit opinion is *Ahuja v. LightSquared Inc.*, 15-2480 (2d Cir. March 22, 2016).

ROCHELLE'S DAILY WIRE

Small case is making big Third Circuit law on confirmation of chapter 11 plans.

Each Third Party Release Must Be Economically Justified, District Judge Holds

A small New Jersey company is again making big law in the Third Circuit on confirmation of chapter 11 plans.

In an appeal last year involving the debtor One2One Communications LLC, the Third Circuit ostensibly held that equitable mootness can be invoked to dismiss a confirmation appeal only in the largest and most complex chapter 11 reorganizations. See *In re One2One Communications LLC*, 805 F.3d 428 (3d Cir. July 21, 2015).

The new decision, by District Judge Jose L. Linares of Newark, N.J., deals with so-called third party releases where the plan for the debtor One2One waived avoidance actions and other claims against insiders, creditors and nondebtor third parties generally. The waiver of claims was negotiated with the official creditors' committee.

In his opinion on June 14, Judge Linares reversed the bankruptcy court for failing to determine whether nondebtor recipients of releases "have made a substantial contribution to the debtor's reorganization."

A small company, debtor One2One was in bankruptcy to deal with a $9 million judgment against the company and its chief executive. Otherwise, One2One had one secured claim for $100,000 and $1.3 million owing to 17 unsecured creditors, not including a judgment creditor. The sponsor of the plan agreed to invest $200,000 in return for the equity.

Opposing the releases and confirmation of the plan, the judgment creditor offered to buy the claims for $20,000. The company declined the offer, having taken the position that potential claims against the chief executive had no net value, given the uncertainty of success, the cost of litigation and the difficulty of collection.

The bankruptcy court confirmed the plan and approved the third party releases, saying that suits against management "would significantly impair their ability to devote full-time to the management responsibilities of the debtor." The bankruptcy judge found that the releases were "necessary for reorganization." The confirmed plan did not affect the creditor's judgment against the chief executive.

Invoking equitable mootness, the district court had dismissed the judgment creditor's appeal from the confirmation order without reaching the merits. Holding that equitable mootness was improperly applied, the Third Circuit remanded the case to the district court to consider the merits of the appeal.

While remand was pending in district court, the judgment creditor agreed not to unwind the consummated plan. Instead, the judgment creditor only attacked the third party releases.

Although there is clearer law governing the ability of a plan to bar a third party's claims against a nondebtor, Judge Linares said there is no Third Circuit authority with a definitive list of factors to consider in judging the propriety of a *debtor's* release of claims against nondebtor third parties. Citing the $20,000 offer for the claims, he held that the bankruptcy court "erred as a matter of law in approving the plan by failing to analyze the contribution made by the non-debtors to the plan in exchange for releases."

Judge Linares did not say how the bankruptcy judge should rule on remand. Even though the chief executive and his wife waived their own claims, he noted that they were rehired at a combined salary of $300,000.

In the penultimate paragraph in his opinion, Judge Linares remanded the case to the bankruptcy court, "reemphasizing that it is appropriate to analyze each of the released non-debtors."

The opinion is *Quad/Graphics Inc. v. One2One Communications LLC (In re One2One Communications LLC)*, 13-1675 (D. N.J. June 14, 2016).