

Buy-Side Briefs

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Welcome to *Buy-Side Briefs*, Latham's new publication from the firm's global Restructuring, Insolvency & Workouts Practice. *Buy-Side Briefs* is a series of commentaries on legal issues of interest to buyers and sellers of distressed debt.

Third-party Non-debtor Releases in the Second Circuit

Between 2008 and 2010, the Second Circuit Court of Appeals (the Second Circuit) revisited the circumstances under which it would approve third-party non-debtor releases in Chapter 11 plans of reorganization. Traditionally, the Second Circuit found such releases to be appropriate if the bankruptcy case had certain special — “unique” — circumstances.¹ In *In re Johns-Manville Corp.*, 517 F.3d 52 (2d. Cir. 2008) (*Manville*), the Second Circuit (relying heavily on Fifth Circuit case law)² held that a bankruptcy court did not have subject matter jurisdiction to enjoin direct claims belonging to third parties against other third parties. By requiring that a bankruptcy court have subject matter jurisdiction over claims it seeks to enjoin, *Manville* further limited the availability of third-party non-debtor releases.³

Although the additional jurisdictional requirement imposed in *Manville* may at first glance seem onerous, it has not proven to be insurmountable. Indeed, plan proponents in the Second Circuit have been successful in finding ways to confirm a plan of reorganization that includes third-party non-debtor releases. Most notably, so that bankruptcy judges may confirm plans with releases of either unknown claims held by known non-debtor third parties or known claims held by unknown non-debtor third parties, plans' releases are being specifically limited “to the extent permitted by applicable law.” Additionally, voting ballots have been giving creditors the ability to consent to third-party non-debtor releases, thereby allowing confirmation of a plan containing a release that might otherwise be outside the bankruptcy court's jurisdiction (or power) to approve, a practice that was recently endorsed by bankruptcy courts in the Second Circuit.⁴

Third Party Releases in the Second Circuit

Early Second Circuit Law Established a Multi-Factor Test to Approve a Third-Party Non-Debtor Release

Although the Second Circuit has long upheld reorganization plans containing third-party non-debtor releases, the legal requirements for approval of such releases has continually evolved. In *In re Drexel Burnham Lambert Group Inc.*, in a passage often cited to support the enforceability of third-party non-debtor releases and injunctions, the Second Circuit held that such provisions are proper so long as they play “an important part in the debtor's reorganization plan.”⁵

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Later, in *In re Metromedia Fiber Network Inc.*, the Second Circuit attempted to clarify its holding in *Drexel* and limited the availability of third-party non-debtor releases.⁶ *Metromedia* warned that third-party non-debtor releases should be approved only in “rare cases,” as “a non-debtor release is a device that lends itself to abuse.”⁷ The Second Circuit then identified several unique situations in which such releases may be appropriate: “where the estate has received a substantial contribution, when the enjoined claims are channeled to the settlement fund, when the enjoined claims indirectly impact the debtor’s reorganization, such as claims for contribution or indemnity, and where the affected creditors consent.”⁸ The Second Circuit emphasized that third-party non-debtor releases should not be approved unless “truly unusual circumstances render the release terms important to success of the plan, focusing on the considerations discussed above.”⁹

In the seven years since *Metromedia* was decided, lower courts in the Second Circuit have adhered to both the spirit and the letter of *Metromedia*’s holding. For instance, in *In re Karta Corp.*, the bankruptcy court strictly interpreted *Metromedia* by finding that third-party releases must “bear a reasonable relationship to the protection of the estate and go no further than necessary to protect those interests.”¹⁰ And in *In re Adelphia Comm’ns Corp.*, the bankruptcy court stated that parties could not get around *Metromedia*’s requirements by simply agreeing to make a third-party non-debtor release an essential element of their plan of reorganization.¹¹

Recent Second Circuit Law Imposes a Threshold Requirement of Subject Matter Jurisdiction

In *Manville*, the Second Circuit introduced the element of bankruptcy subject matter jurisdiction to the analysis of whether a third-party non-debtor release should be approved in a plan of reorganization.¹² More specifically, in *Manville*, the Second Circuit held that the bankruptcy court did not have the subject matter jurisdiction to enjoin lawsuits asserted by third-party creditors of the debtor against a non-debtor insurance company based on the insurance company’s — not the debtor’s — alleged misconduct.¹³ In other words, the bankruptcy court did not have the subject matter jurisdiction to pass on third-party creditors’ direct claims against the insurance company, a non-debtor. In so ruling, *Manville* required a bankruptcy court to satisfy a subject matter jurisdiction test before even reaching the *Metromedia* analysis. Specifically, a bankruptcy court must find that the third party claims it is asked to enjoin are sufficiently related to the bankruptcy case such that the bankruptcy court has either ‘related to,’ ‘arising in’ or ‘arising under’ jurisdiction over those claims under the Bankruptcy Code.¹⁴

Whether any given claim falls within the bankruptcy jurisdiction of a court is the subject of countless judicial opinions in both lower courts as well as at the Circuit Court level. Generally speaking, however, courts in the Second Circuit find that “[r]elated to’ jurisdiction [over a third party dispute] exists where the subject of the third party dispute is property of the estate, or the dispute would have an effect on the estate.”¹⁵ Unless a non-debtor third-party release is specific as to which parties are releasing what claims, the nature of analyzing whether a claim falls within a court’s bankruptcy jurisdiction is such that it is almost impossible for a bankruptcy court to determine, much less rule upon, whether it has the subject matter jurisdiction to approve of such release. However, bankruptcy courts have been receptive to language limiting the scope of the third-party non-debtor injunction “to the extent permitted by applicable law” and have approved plans of reorganization with such limitations.¹⁶

Consent of Third Parties to the Third-Party Non-Debtor Releases

Notwithstanding the foregoing, it is important to note that bankruptcy courts within the Second Circuit have held that if affected creditors consent to third-party non-debtor releases, they are enforceable against those parties.¹⁷ In *DBSD*, the question of what constituted consent arose when the debtors requested approval of a plan that contained an exculpation clause releasing third-parties from claims by the debtors’ stakeholders.¹⁸ First, the court noted that the *DBSD* plan, disclosure statement and voting ballot all gave appropriate notice of the existence of a release clause as the language was set out in bold, and, in the ballot, it was also capitalized.¹⁹ Second, the *DBSD* ballot allowed a party to abstain from voting on the plan and to opt out of the release provisions.²⁰ Thus, if a stakeholder either (i) voted in favor of the plan, or (ii) abstained from voting on the plan but did not opt out of the third-party release, such party consented to the third-party exculpation clause and was bound by it.²¹ However, if non-voting constituencies are unable to opt-out of the third-party non-debtor release, such constituencies are not deemed to have consented, regardless of whether such constituencies raised any objections to the plan of reorganization.²²

Conclusion

In the shadow of *Manville*, it is clear that third-party non-debtor releases in Chapter 11 plans of reorganization are still viable in the Second Circuit. However, the ruling court must have subject matter jurisdiction over the claims being enjoined and the bankruptcy case must have sufficiently unique

circumstances warranting approval of third-party non-debtor releases under *Metromedia*. Notably, courts within the Second Circuit also appear willing to approve third-party non-debtor releases as part of plans of reorganization when the third parties being enjoined consent to such treatment.

Endnotes

- ¹ See *Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d. Cir. 2005). The Second Circuit's approach on these releases had differed from other circuits' approach. Compare e.g., *In re Lowenschuss*, 67 F.3d 1394, 1402 n6 (9th Cir. 1995) (holding that § 524(e) of the Bankruptcy Code precludes bankruptcy courts from discharging the liabilities of non-debtors), *In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995) (holding that, once subject matter jurisdiction is established, the bankruptcy court has the power to impose a temporary injunction if the case evidences unique circumstances), and *In re Western Real Estate Fund Inc.*, 922 F.2d 592 (10th Cir. 1990) (stating that post-confirmation permanent injunctions of non-debtors violate § 524(e) of the Bankruptcy Code).
- ² *In re Zale Corp.*, 62 F.3d 746.
- ³ See generally, *In re Johns-Manville Corp.*, 517 F. 3d 52.
- ⁴ See e.g., *In re Calpine Corp.*, 2007 Bankr. LEXIS 4390 (Bankr. S.D.N.Y. Dec. 19, 2007); *In re DBSD North America, Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y., Mar. 24, 2010), *rev'd on other grounds*, 634 F.3d 79 (2d. Cir. 2010).
- ⁵ *In re Drexel Burnham Lambert Group Inc.*, 960 F.2d 285, 293(2d Cir. 1992).
- ⁶ *In re Metromedia Fiber Network Inc.*, 416 F.3d 136 (2d Cir. 2005).
- ⁷ *In re Metromedia*, 416 F.3d at 142.
- ⁸ *Id.* at 142-143.
- ⁹ *Id.*
- ¹⁰ 342 B.R. 45, 56-57 (Bankr. S.D.N.Y. 2006).
- ¹¹ 368 B.R. 140, 269 (Bankr. S.D.N.Y. 2007).
- ¹² See generally 517 F.3d 52, *vacated & remanded on other grounds*, 129 S.Ct. 2195, 174 L.Ed.2d 99 (2009), *aff'g in part & rev'g in part*, 600 F.3d 135, 2010 U.S. App. LEXIS 5877, 2010 WL 1007832 (2d. Cir. Mar. 22, 2010).
- ¹³ 517 F.3d at 63.
- ¹⁴ 28 U.S.C. § 1334.
- ¹⁵ *In re Dreier*, 429 B.R. 112, 131 (Bankr. S.D.N.Y. 2010) (citing *Manville*, 517 F.3d at 65).
- ¹⁶ See e.g., *In re Chemtura Corp.*, 2010 WL 4272727 (Bankr. S.D.N.Y., Oct. 21, 2010) and *Metro-Goldwyn-Mayer Studios, Inc.*, 10-15774 Confirmation Order, 26, at 28 (Docket No. 173); *In re RHI Entm't, Inc., et al.*, 10-16536 Confirmation Order, FF, at 23-24 (Docket Nos. 323), Final Cumulative Joint Prepackaged Plan of Reorganization of RHI Entertainment, Inc. and Affiliated Debtors, Section 11.8, at 36 (Docket No. 329).
- ¹⁷ *In re DBSD*, 419 B.R. 179; *In re Calpine*, 2007 Bankr. LEXIS 4390.
- ¹⁸ *Id.* at 217.
- ¹⁹ *Id.* at 218.
- ²⁰ *Id.*
- ²¹ *Id.* at 218-219 (citing *In re Calpine Corp.*, 2007 WL 4565223 (December 17, 2007)).
- ²² See e.g. *In re Conseco, Inc.*, 301 B.R. 525 (Bankr. N.D. Ill. 2003).

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