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Chapter 11 Plan Confirmation Issues: Settlements, Releases, Gifting and Death Traps

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The requirements set forth in § 1129 of the Bankruptcy Code are not all that one needs to know to understand the chapter 11 confirmation process. This article intends to provide the young or new lawyer with a review of certain important concepts on which practicing lawyers spend incredible amounts of time but cannot simply be found in the statutory language or most basic bankruptcy texts. Such concepts include providing for plan payments to “out of the money” creditors, releasing third parties and methods to encourage parties to vote in favor of a plan. With each discussion topic building on the next, the authors have attempted to address these concepts below.

Settlements



Douglas E. Deutsch

Given that parties often recognize that a debtor's finite resources are better spent on a consensual resolution of a litigation issue rather than actual litigation, it is unsurprising that one of the most common issues faced when designing a plan of reorganization is the inclusion of one or more settlements of outstanding claims. Section 1123(b)(3)A) of the Code states that a plan of reorganization may provide for “the settlement or adjustment of any claim or interest belonging to the debtor

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and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors.⁴



Eric Daucher

In evaluating the first factor, likelihood of success on the merits, a bankruptcy court is not to conduct a full trial on the merits. The very purpose of a settlement is to avoid spending the time and money necessary to litigate the underlying issues. The court will review the issues settled and the arguments relating to those issues to ensure that the debtor acted reasonably in reaching a settlement.⁵ The review process is supposed to provide the court with an understanding of the strengths

and weaknesses of the debtor's position, as well as the risks posed by an adverse outcome.⁶ It is not entirely clear what level of evidence courts require before deciding that this factor is satisfied, but an utter lack of evidence proffered on the subject is almost invariably fatal to the approval of a settlement.⁷

With respect to the second factor, the court will likewise look for information sufficient to enable it to make an educated estimate of the possible difficulties of collecting on any judgment which might be obtained. For example, if the defendant has little or no ability pay a

Building Blocks

ment to the sound discretion of the bankruptcy court.² Such settlements are incorporated into plans of reorganization and form the framework that allows a plan proponent to use the other plan tools discussed below.

As long as a settlement that is incorporated into a plan falls above the lowest point in the range of reasonableness, it should be approved.³ In evaluating the reasonableness of a settlement, courts generally consider four factors: (1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved,

¹ See *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry Inc. v. Anderson*, 390 U.S. 414, 434 (1968).

² See *Key3Media Group Inc. v. Pulver.com Inc.* (In re *Key3Media Group Inc.*), 336 B.R. 87, 92 (Bankr. D. Del. 2005).

³ See *In re Spansion Inc.*, No. 09-10690 (KJC), 2009 Bankr. LEXIS 1283, *13 (Bankr. D. Del. June 2, 2009) (citing *In re Exide Techs.*, 303 B.R. 48, 68 (Bankr. D. Del. 2003)).

⁴ See *Meyers v. Martin* (In re *Martin*), 91 F.3d 389, 393 (3d Cir. 1996); see also *In re Texaco Inc.*, 84 B.R. 893, 902 (Bankr. S.D.N.Y. 1988) (listing additional factors for consideration in assessing settlements).

⁵ See *Spansion*, 2009 Bankr. LEXIS 1283 at *13.

⁶ See *In re Adelpia Commc'ns Corp.*, 327 B.R. 143, 166 (Bankr. S.D.N.Y. 2005).

⁷ See *Exide*, 303 B.R. at 69.

judgment, the court should be inclined to approve a settlement. That saves the debtor great expense to reach a result that may not have any value for the estate in terms of final recovery.

According to the third factor, courts should favor settlement of a complex case that would otherwise drain substantial resources from the estate. As it is “axiomatic that settlement will almost always reduce the complexity and inconvenience of litigation,”⁸ courts will balance the relative complexity of the case to be settled against the possible gains to the estate from opting not to settle.

The fourth factor requires the seemingly obvious: Courts are obliged to consider the paramount interests of the creditors of the estate. This means that bankruptcy courts will give considerable deference to the views of non-settling parties in deciding whether a settlement is appropriate.⁹ However, out-of-the-money creditors hoping for a recovery based on speculative litigation with little chance of success will generally not be allowed to determine the fate of the reorganization process. It is imperative for settlements to benefit the estate as a whole, even if it may disadvantage a particularly constituency.¹⁰ Therefore, courts tend to grant significant weight to the opinion of in-the-money unsecured creditors, while viewing the objections of other creditors more cautiously.¹¹

Based on the foregoing, we know that a debtor can create a plan of reorganization that settles various matters and that, in general, the bankruptcy court should review the settlement under the Rule 9019 framework. This framework allows us to turn to our other plan concepts.

Third-Party Releases

Plans of reorganization may—and routinely do—provide for releases of liability against various parties involved in the reorganization process, such as the debtor’s professionals, members of the committee of unsecured creditors, and the committee’s professionals. The Bankruptcy Code does not, however, provide any explicit basis for a similar release of claims against non-debtors (except in the case of asbestos claims).¹² Indeed, § 524(e) “makes clear that the bank-

ruptcy discharge of a debtor, by itself, does not operate to relieve non-debtors of their liabilities.” Of course, as a practical matter, third parties will often seek a release as part of a settlement of case issues.

Third-party releases initially became prominent in the context of bankruptcies involving asbestos mass-tort claims. Because asbestos injuries often only become apparent years or decades after exposure, the courts in these cases developed “channeling injunctions,” which released all current and future claims against the debtors and any insurer settling with the debtors owing to pre-petition asbestos exposure in exchange for the right to recover against a fixed fund. Although there was significant debate over the propriety of these releases, they were generally approved under the bankruptcy court’s broad equitable powers. Courts generally saw third-party releases as the only avenue for eliminating the uncertainty created by long-term litigation overhang. Congress agreed, and in 1994 amended the Bankruptcy Code to provide explicit statutory authority for third-party releases in bankruptcies involving asbestos torts.¹³ Subsequently, third-party releases were applied in other mass-tort cases based on a similar rationale (although without specific statutory support).

Third-party releases have become somewhat more commonplace outside of the mass-tort context. Courts have concluded that, although the Code does not specifically authorize third-party releases, neither does it explicitly prohibit them.¹⁴ Bankruptcy courts in many jurisdictions may therefore believe that their broad equitable powers give them authority to grant third-party releases where appropriate. (Importantly, the Fifth, Ninth and Tenth Circuits have adopted *per se* rules barring third-party releases.)¹⁵

When a debtor proposes a plan of reorganization that calls for third-party releases, a court will often weigh five factors in analyzing whether such a release is appropriate: (1) an identity of interests between the debtor and the third party; (2) substantial contribution by the non-debtor of assets to the reorganization; (3) the essential nature of the injunction to the reorganization; (4)

overwhelming agreement by the impacted classes to support the release; and (5) provision in the plan for substantially all of the claims of the impacted classes.¹⁶ While these factors may vary somewhat from circuit to circuit, they provide some guidance as to what a court is seeking: assurance that the release will not adversely and unfairly impact any particular class of creditors.¹⁷

Senior Creditor Gifting: Flexibility in Absolute Priority?

Generally, a plan of reorganization can only be confirmed if it satisfies all 13 requirements set forth in § 1129(a), including the § 1129(a)(8) requirement that all classes must vote in favor of the plan. However, a plan can be confirmed, absent approval by all creditors classes, through “cramdown” under § 1129(b). Under cramdown, a plan may be confirmed only if it is “fair and equitable.”

A plan is only considered “fair and equitable” if, among other things, it satisfies the “absolute-priority rule.” The absolute-priority rule requires that no class of claims or interests receive any compensation under a plan unless all dissenting classes senior to such a class are paid in full. In some instances, however, the absolute-priority rule may interfere with otherwise viable and desirable plans of reorganization. To address this conundrum, plan proponents have created—and courts have in many cases approved—innovative “gift” structures in which a senior creditor carves out a portion of its own recovery for the benefit of a junior creditor, notwithstanding an objecting creditor of intervening priority.¹⁸

The so-called “gifting doctrine” traces back to the First Circuit decision of *In re SPM Manufacturing Corp.*¹⁹ In *SPM*, a secured lender entered into an agreement with the unsecured creditors’ committee to share a portion of its

⁸ *Will v. Northwestern Univ. (In re Nutraquest Inc.)*, 434 F.3d 639, 646 (3d Cir. 2006).

⁹ *See In re Nutritional Sourcing Corp.*, 398 B.R. 816, 824 (Bankr. D. Del. 2008).

¹⁰ *See Adelphia*, 327 B.R. at 164-65.

¹¹ *See In re Best Prods. Co. Inc.*, 168 B.R. 35, 60-61 (Bankr. S.D.N.Y. 1994).

¹² *See Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203, 211 (3d Cir. 2000).

¹³ *See* 11 U.S.C. § 524(g).

¹⁴ *See In re Genesis Health Ventures Inc.*, 266 B.R. 591, 603 (Bankr. D. Del. 2001).

¹⁵ *See In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996); *In re Western Real Estate Fund Inc.*, 922 F.2d 592 (10th Cir. 1990).

¹⁶ *See Zenith Elecs. Corp.*, 241 B.R. 92, 110-11 (Bankr. D. Del. 1999) (approving third-party release of party that compromised its claim, provided funding necessary for reorganization and obtained support of overwhelming majority of creditors for release).

¹⁷ *See also In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2001); *In re Transit Group Inc.*, 286 B.R. 811, 817 (Bankr. M.D. Fla. 2002) (weighing similar factors to those discussed in *Zenith* in deciding whether third-party release was appropriate). It is important to note that when the third-party claims are less closely entwined with claims against the debtor, courts are less likely to approve releases. Courts have held that nonconsensual third-party releases of creditors’ direct claims against others may be approved only in extraordinary circumstances. *See In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000); *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89 (2d Cir. 1988); *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694 (4th Cir. 1989), *cert. denied*, 493 U.S. 959 (1989); *SEC v. Drexel Burnham Lambert Group Inc. (In re Drexel Burnham Lambert Group Inc.)*, 960 F.2d 285 (2d Cir. 1992).

¹⁸ For an expanded discussion of recent developments regarding gift plans, see Damian S. Schaible and Eli J. Vonnegut, “SPM Manufacturing to Journal Register: Indicators of a Successful ‘Gift Plan,’” *XXVIII ABI Journal* 8 (2009).

¹⁹ *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993).

bankruptcy recoveries with the unsecured creditors in exchange for the committee's support. The reorganization subsequently failed, and the case was converted to chapter 7. Thereafter, the secured lender and the unsecured creditors sought to compel a distribution in accordance with the sharing agreement, despite objections by out-of-the-money priority tax creditors. The sharing arrangement was ultimately approved by the First Circuit Court of Appeals, which held that because the estate's (fully lien'd) asset value was less than the value of the secured party's claim and the sharing (or siphoning) of value for the unsecured (junior) creditors took place only after distribution from the estate, the sharing agreement had no impact on the objecting (intervening priority) creditors and was therefore permissible. Although *SPM* was a chapter 7 case, and therefore the § 1129(b) absolute-priority rule was not applicable, subsequent chapter 11 cases have adopted some or all of its reasoning in decisions finding plans containing such "gifts" permissible.

In the wake of *SPM*, a number of cases have provided conflicting views on the limits of acceptable gift plans. For example, in *In re MCorp Financial Inc.*,²⁰ the court confirmed a plan of reorganization under which a senior bondholder voluntarily relinquished a portion of its claim in order to fund the settlement of litigation against the debtor, without making any provision for full payment to junior bondholders whose claims were senior to the litigation claim. The court found no fault with the arrangement because the settlement was funded entirely by assets incontestably allocated to the senior claimant. Similarly, the court in *Genesis Health Ventures*²¹ approved gifts by a senior undersecured party to subordinated debt-holders and old equity over the objection of an out-of-the-money objecting class.²² Recently, the court in *In re Journal Register Company*²³ approved a plan that used a gift from a secured creditor to fund a "trade account," the proceeds of which were used to pay a subset of the general unsecured class identified as "trade creditors." The court found that although the "trade creditors" were members of the general unsecured class and would, as a result of the trade

account, recover more than fellow members of the unsecured creditor class, the plan did not unfairly discriminate.

Reading these cases, one might be tempted to assume that senior creditor gifts are a surefire method for circumventing absolute priority. However, the decisions by the district court and Third Circuit (which explicitly adopted much of the district court's reasoning) in *In re Armstrong World Industries Inc.*²⁴ offer an opposing view. In *Armstrong*, the court rejected a plan of reorganization as violating the absolute-priority rule where the plan called for a particular class of unsecured creditors to receive and automatically transfer warrants to the holder of an equity interest in the event that a co-equal class of unsecured creditors voted to reject the plan. The court explicitly rejected "the unconditional proposition that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive."²⁵ The courts distinguished, but did not reject, *SPM* and its progeny, holding that the absolute-priority rule was intended to address give-ups by senior creditors in bankruptcy.

Deathtraps

A "death-trap" provision is a coercive provision that seeks to encourage claimants to vote in favor of a plan with promises—in return for a favorable vote—of treasure and/or favorable treatment. Should the claimants vote against the plan, the claimants will receive less or no treasure and/or is otherwise penalized. Simply, a death-trap provision provides a choice for a claimant when voting between a carrot and a stick.

In practice, deathtrap issues arise in preparing for a possible plan cramdown scenario. As noted, for a plan of reorganization to be confirmed in the absence of favorable votes by creditors in all classes (thus the plan fails § 1129(a)(8)), the plan must not "discriminate unfairly" or be found to be "fair and equitable" under § 1129(b)(1). The question is whether death traps are inconsistent with these requirements. The *Zenith* case is again instructive for our analysis.

In *Zenith*, out-of-the-money bondholders were offered a distribution in return for their favorable vote while out-of-the-money shareholders were not offered any distribution. The shareholders objected on the ground that the treatment of the bondholders violated § 1129(b) because the bondholders were

entitled to nothing and received some treasure/benefit while the shareholders were not offered a similar deal.

The *Zenith* bankruptcy court reviewed the different treatment proposed for the classes and, recognizing that the bondholders were senior to the equity-holders and thus otherwise satisfied the absolute-priority rule, concluded that there was no prohibition against a plan proponent offering different treatment to a class depending on whether it accepts or rejects a plan.²⁶ The court explained that such disparate treatment was justified because if the class accepts, "the [p]lan proponent is saved the expense and uncertainty of a cramdown fight. This is in keeping with the Bankruptcy Code's overall policy of fostering consensual plans of reorganization and does not violate the fair and equitable requirement of [§] 1129(b)."²⁷

The teaching of the death-trap cases is that such provisions are probably valid, but are not universally accepted. Again, consult the case law carefully if you are considering this option.²⁸

Conclusion

Third-party releases, senior creditor gifts and deathtraps are innovative plan devices that are designed to quell potential objections, gain creditor support and push a plan to confirmation. In doing so, they debatably push the Code to its limits in terms of acceptable plan content. While savvy practitioners should be aware of how these tools can be used to obtain votes for confirmation, they should also be aware that they are not universally accepted. When considering any of these options, always carefully examine case law from the relevant jurisdiction before deciding on a course of action. ■

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²⁶ *Zenith*, 241 B.R. at 105.

²⁷ *Id.*; see also *In re Drexel Burnham Lambert Group*, 138 B.R. 714, 717 (Bankr. S.D.N.Y. 1992); *In re Adelphia Comms. Corp.*, 368 B.R. 140, 275 (Bankr. S.D.N.Y. 2007) ("I see no valid Absolute-Priority Rule objection to the so called 'deathtrap provision,' requiring equity holders to vote in favor of the Plan or forfeit their distributions under it. Because the...[i]nterests at issue will have only speculative value on the Effective Date, and because a 'carrot and stick' provision such as the one set forth in the Plan is wholly permissible, the...[contrary] argument fails.")

²⁸ See, e.g., *In re MCorp Fin. Inc.*, 137 B.R. 219 (Bankr. S.D. Tex. 1992) (finding without substantial analysis that tying treatment of two classes to vote by third was not fair and equitable and was unfair discrimination).

²⁰ *In re MCorp Financial Inc.*, 160 B.R. 941 (S.D. Tex. 1993).

²¹ *Genesis Health Ventures*, 266 B.R. at 601-2.

²² However, because *Genesis Health Ventures* was subsequently distinguished by the district court and Third Circuit opinions in *Armstrong*, *infra*, it is unclear to what extent such a gift remains possible.

²³ *In re Journal Register Company*, 407 B.R. 520 (Bankr. S.D.N.Y. 2009).

²⁴ *In re Armstrong World Industries Inc.*, 320 B.R. 523 (D. Del. 2005), *aff'd*, 432 F.3d 507 (3d Cir. 2005).

²⁵ *Armstrong*, 320 B.R. at 539-540.