

Client Alert

Second Circuit Decision Limits Non-Debtor Party Releases

In an important decision entered last month in the Metromedia Fiber Network, Inc. bankruptcy case, the Second Circuit Court of Appeals significantly tightened the restrictions on a debtor's ability to impose non-debtor third-party releases as part of its plan of reorganization. After examining the releases at issue and giving a fairly restrictive reading of the relevant law, the Court held that the plan of reorganization should not have contained such comprehensive third-party releases. Nevertheless, the Court affirmed the bankruptcy court's confirmation of the plan on the grounds of equitable mootness because the plan was substantially consummated at the time of the decision.

The Metromedia Fiber Network, Inc. Bankruptcy Case and Plan of Reorganization

Metromedia Fiber Network, Inc. ("MFN") and fourteen of its wholly owned subsidiaries (collectively, the "Debtors") filed their petitions for relief under chapter 11 of the United States Bankruptcy Code on May 20, 2002 in the United States Bankruptcy Court for the Southern District of New York. Chadbourne & Parke LLP represented the Unsecured Creditors' Committee and Chadbourne's bankruptcy partners Howard Seife and David LeMay were actively involved in the resolution of the cases and the negotiation and formation of the plan of reorganization (the "Plan").

The Debtors were part of the large conglomerate Metromedia Company owned by John W. Kluge. The creditors in the case included both secured and unsecured noteholders and holders of significant trade claims. A trust established by John Kluge (the "Kluge Trust") held a secured claim against the estate for \$15.7 million and approximately \$150 million in unsecured claims.

The Plan was confirmed on August 21, 2003 and went effective on September 8, 2003. The Plan provided for payments to secured creditors primarily in the form of cash or cash pledges. Holders of general unsecured claims received common stock in the reorganized entity, AboveNet, Inc. ("AboveNet"). In addition to the AboveNet stock, unsecured creditors holding notes issued by MFN also received five-and seven-year stock warrants. The Plan provided for comprehensive releases by creditors of claims against the Kluge Trust as well as against certain other non-debtor third-party insiders, including Mr. Kluge himself (collectively, the "Kluge Insiders"), "arising out of or in connection with any matter related to [MFN] or one or more subsidiaries . . ."

In exchange for these releases, the Kluge Trust (i) forgave approximately \$150 million in unsecured claims against the estate; (ii) converted the \$15.7 million in secured claims into equity in AboveNet; (iii) invested approximately \$12.1 million in AboveNet; and (iv) agreed to purchase up to \$25 million of unsold common stock in AboveNet's planned stock offering.

The Objections to Confirmation

A group of subordinated noteholders objected to the confirmation of the Plan on two separate grounds. First, they challenged the Plan's enforcement of the subordination provision in the indenture through the reallocation of warrants otherwise distributable to them under the Plan to the senior noteholders. Second, they argued that the releases in the Plan, specifically the release of the

Kluge Trust and the Kluge Insiders, improperly enjoined creditors from bringing suit against non-debtor third-parties. The Bankruptcy Court denied the objections and the noteholders' appeal to the District Court was denied as well. A further appeal was made to the Second Circuit. At no time did the objecting noteholders seek a stay of the confirmation order pending their appeals.

With respect to the subordinated noteholders' first argument, their unsecured notes were governed by an indenture agreement that subordinated their claims to those of the senior unsecured noteholders. In recognition of the subordination provision in the indenture, the Plan provided that the senior noteholders would receive, in addition to plan securities distributable to them on account of their senior claims, both common stock and warrants otherwise distributable to subordinated noteholders. The subordinated noteholders conceded that the common stock distribution earmarked for them under the Plan were properly reallocated to the senior noteholders pursuant to the indenture's subordination provision, but they argued that the subordination agreement's "X-Clause" allowed them to retain the warrants. An X-Clause allows a subordinated noteholder to retain plan securities if a senior noteholder receives other plan securities with a higher priority to future distributions and dividends. This ensures the full payment of the senior notes before any payment is made on account of the subordinated notes. In this case, the Court held that the subordinated noteholders' retention of the warrants would impair the priority assured to the senior noteholders under the subordination agreement because the warrants would enable the holder to purchase common stock of equal priority to common stock held by the senior noteholders. Therefore, allowing subordinated noteholders to retain the warrants would have effected an unacceptable impairment of seniority. Accordingly, the objection was denied.

Non-Debtor Third-party Releases

The Court then turned to the objectors' second contention -- that the third-party releases embodied in the Plan were improper. The Court analyzed the law in the Second Circuit and held that the releases of the Kluge Trust and the Kluge Insiders were not justified by the evidence. The Court cited earlier Second Circuit cases for the proposition that "a court may enjoin a creditor from suing a third-party, provided the injunction plays an important part in the debtor's reorganization plan. It is clear, however, that such a release is proper only in rare cases."

The Court noted that the Ninth and Tenth Circuits have held that non-debtor releases are actually *prohibited* by the Code, except in the asbestos context. While the Court did not explicitly bring the Second Circuit in line with these other circuits and actually prohibit non-debtor releases, it did hold that "a non-debtor release in a plan of reorganization should not be approved absent the finding that *truly unusual circumstances render the release terms important to the success of the plan.*" (*Emphasis Added.*) In this case, the sole finding made to justify the third-party release was that the Kluge Trust made a "material contribution" to the estate. But there was no finding (or evidence presented) that the release was itself important to the Plan. Nor was any inquiry made into whether the breadth of the release was necessary to the Plan. Without such findings, the Court held that the releases should not have been allowed.

Regardless, the confirmation of the Plan was upheld despite the impermissible use of third-party releases because the Plan had been effective for over a year and "substantially consummated." Virtually all of Debtors' stock had been issued, the Kluge Trust had provided the agreed upon funding for the Plan, the cash had been distributed, and contracts, leases, and other arrangements had occurred. The Court held that it would be inequitable and impractical to revoke confirmation of the Plan at such a late date, therefore the holding was equitably moot. As noted, the subordinated

noteholders failed to seek a stay of the Bankruptcy Court's order confirming the Plan nor did they seek an expedited appeal.

Analysis

Even though the Plan confirmation was ultimately affirmed on appeal, the Court's restrictive holding is important for future plan proponents looking to include non-debtor releases in a plan of reorganization. The Court explained that there are at least two considerations that justify the reluctance to approve non-debtor releases. First, the only explicit authorization in the Code for non-debtor releases is Bankruptcy Code section 524(g), which authorizes release in asbestos cases when certain specified conditions are satisfied. Second, "a non-debtor release is a device that lends itself to abuse." The Court reasoned that a non-debtor that is shielded from liability to third-parties essentially receives a bankruptcy discharge without an official filing and the accompanying procedural safeguards and creditor protections provided by the Bankruptcy Code. The potential for abuse is heightened when releases afford blanket immunity, like the release in the MFN Plan.

Courts in previous cases in the Second Circuit have approved non-debtor releases in situations where 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. Non-debtor releases have also been permitted if the affected creditors consent. However, based upon the Court's restrictive reading of these prior cases and the specific focus on strict evidentiary standards, the Court in this case clearly emphasized that non-debtor releases are exceptional remedies that should rarely be authorized.

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For additional information, please contact:

New York

Howard Seife	+1 (212) 408-5361	hseife@chadbourne.com
Joseph H. Smolinsky	+1 (212) 408-5489	jsmolinsky@chadbourne.com
N. Theodore Zink	+1 (212) 408-5356	tzink@chadbourne.com
David M. LeMay	+1 (212) 408-5112	dlemay@chadbourne.com
Andrew P. Brozman	+1 (212) 408-5227	abrozman@chadbourne.com
Jennifer C. DeMarco	+1 (212) 408-5366	jdemarco@chadbourne.com

Chadbourne & Parke LLP

New York

30 Rockefeller Plaza
New York, New York 10112
Telephone: +1 (212) 408-5100
Facsimile: +1 (212) 541-5369

Los Angeles

350 South Grand Avenue, Suite 3300
Los Angeles, CA 90071
Telephone: +1 (213) 892-1000
Facsimile: +1 (213) 622-9865

London

Chadbourne & Parke
(a multinational partnership)
Regis House
45 King William Street
London EC4R 9AN
Telephone: +44 (0)20 7337-8000
Facsimile: +44 (0)20 7337-8001

Warsaw

(through a Polish partnership)
ul. Emilii Plater 53
00-113 Warsaw, Poland
Telephone: +48 (22) 520-5000
Facsimile: +48 (22) 520-5001

Almaty

90 Shevchenko Street, 3rd Floor
Almaty 050022, Kazakhstan
Telephone: +7 (3272) 585-088
Facsimile: +7 (3272) 588-084

Washington, D.C.

1200 New Hampshire Avenue, N.W.
Washington, D.C. 20036
Telephone: +1 (202) 974-5600
Facsimile: +1 (202) 974-5602

Houston

1100 Louisiana, Suite 3500
Houston, TX 77002
Telephone: +1 (713) 571-5900
Facsimile: +1 (713) 571-5970

Moscow

52/5 Kosmodamianskaya Naberezhnaya
Moscow 115054, Russian Federation
Telephone: +7 (095) 974-2424
Facsimile: +7 (095) 974-2425

Kyiv

11 Mykhailivska Street, 4th Floor
Kyiv 01001, Ukraine
Telephone: +380 (44) 230-2534
Facsimile: +380 (44) 230-2535

Beijing

Room 902, Tower A, Beijing Fortune Centre
7 Dongsanhuan Zhonglu
Chaoyang District, Beijing 100020
China
Telephone: +86 (10) 6530-8846
Facsimile: +86 (10) 6530-8849

If you would like additional copies of this client alert, please contact Phillipa Yule, Director of Marketing and Creative Services, at +1 (212) 408-5240 or e-mail: pyule@chadbourne.com.