

Presentation Material for “Views from the Bench”
October 2, 2009

Current Issues in Plan Confirmation

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I. CRAM DOWN

A. Unfair Discrimination

A Chapter 11 Plan can be confirmed as either a consensual plan or a nonconsensual, or “cram down”, plan. A plan is consensual if each class of creditors either accepts the plan or is not impaired by it. If the plan is nonconsensual, the court may not confirm unless at least one impaired class of claims, not including insider votes, has accepted the plan. The plan must not discriminate unfairly and must be “fair and equitable” with respect to each class of impaired claims that has not accepted the plan. The “fair and equitable” requirement imports the “absolute priority rule”, under which each nonaccepting class must be satisfied in full before any junior class may share in the distribution.

Typically, courts apply one of two approaches to determine whether a plan discriminates unfairly: (1) a case-by-case analysis similar to the “unfair discrimination” rule from the Chapter 13 context exemplified by In re Aztec Co., 107 B.R. 585 (Bankr. M.D. Tenn. 1989) and (2) the presumption test initially adopted in In re Dow Corning, Inc., 244 B.R. 696, 702 (Bankr. E.D. Mich. 1999), which focuses more on the risks presented by the plan’s discrimination. 7 Alan N. Resnick & Henry J. Sommer, Collier on Bankruptcy ¶ 1129.04[3][a] (15th rev. ed. 2008).

In determining whether a proposed plan unfairly discriminates against a nonaccepting class in a Chapter 11 cram down case, the court in Aztec adopted a case-by-case inquiry based on the following four factors:

- (1) whether the discrimination is supported by a reasonable basis,
- (2) whether the debtor can confirm and consummate a plan without the discrimination,
- (3) whether the discrimination is proposed in good faith, and
- (4) the treatment of the classes discriminated against.

107 B.R. 585. In practice, this test generally boils down to “whether the proposed discrimination has a reasonable basis and is necessary for reorganization”. 7 Collier on

Bankruptcy ¶ 1129.04[3][a]. This is a factual inquiry by the court for which the plan proponents must bear the burden of demonstrating that unequal treatment between classes of similarly situated claimants does not constitute unfair discrimination and justifying the degree of the disparity in how such classes would be treated. See In re Barney & Carey Co., 170 B.R. 17, 25 (Bankr. D. Mass. 1994); In re Richard Buick, 126 B.R. 840, 852 (Bankr. E.D. Pa. 1991).

More recently, some courts have adopted a rebuttable presumption test that focuses less on the reasonableness of the discrimination and more on creditors' expectations of risk and their likelihood of recovery outside bankruptcy. This approach was first applied by the court in In re Dow Corning Corp.:

a rebuttable presumption that a plan is unfairly discriminatory will arise when there is: (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a *materially lower* percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of *materially greater risk* to the dissenting class in connection with its proposed distribution.

244 B.R. at 702 (emphasis added) (plan did not unfairly discriminate because classes at issue received similar treatment), aff'd in relevant part, 255 B.R. 445 (E.D. Mich. 2000), aff'd in part and remanded, In re Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002). Under this Dow Corning approach, if there is an allegation of materially lower recovery or a greater risk of non-payment to the dissenting class, a plan proponent may rebut the resultant presumption of unfairness by demonstrating that the unequal distribution is, for example, consistent with the risk assumed by the parties before the bankruptcy. See Dow Corning, 244 B.R. at 696; Greate Bay, 251 B.R. at 223 (paying bondholders 76% of their claims and general unsecured creditors 80% was not unfair in part because "trade creditors have short-term maturities; debenture holders have long-term expectations"). Alternatively, the presumption may be rebutted "by showing that, outside of bankruptcy, the dissenting class would similarly receive less than the class receiving a greater recovery, or that the alleged preferred class had infused new value into the reorganization which offset its gain." Dow Corning, 244 B.R. at 702.

The Dow Corning test has been applied in only a limited number of cases, see, e.g., In re Armstrong World Industries, 348 B.R. 111, 121-24 (D. Del. 2006) (adopting the rebuttable presumption test, but finding the claimants did not satisfy their burden of showing "materially lower" recovery or "materially greater risk"); Sentry Operating, 264 B.R. at 964. Unlike the Aztec test, the few courts applying the rebuttable presumption test do not appear to consider whether there is a legitimate business rationale for favorable treatment of a certain class of creditors. However, in seeking to confirm a plan that treats certain trade creditors much more favorably than other unsecured creditors, the plan proponent would likely need to rely on precisely this type of argument to convince the court that the proposed treatment is not unfairly discriminatory. For example, the rationale that supports a critical vendor motion under the standards set forth

in In re Kmart, 359 F.3d 866 (7th Cir. 2004), would likely provide a fair basis for discrimination. Alternatively, many such trade claims will already have been paid early in the case under a crucial vendors motion of section 503(b)(9), mooted the issue of whether there is unfair discrimination, except in cases involving a prepackaged plan where confirmation occurs promptly after the case is filed and there has been little time to satisfy such claims.

B. “Cram Up”

Cram down has been a feature of the reorganization landscape since Congress amended Section 77, Railroad Reorganizations, of the Bankruptcy Act in 1935. See Bankruptcy Act, § 77(e), 11 U.S.C. § 205 (repealed); *St. Joe Paper Co. v. Atlantic C. L. R. Co.*, 347 U.S. 298, 322-23 (1954) (dissenting opinion of Mr. Justice Douglas). Although the etymology of “cram down” may be lost in the sands of time, it likely derived from the idea of cramming something down the throats of a nonaccepting class. See Polsinelli, *The Devil’s Dictionary of Bankruptcy Terms For Commercial Lenders* 45 (2007). The Bankruptcy Code permits nonconsensual confirmation as to a nonaccepting class anywhere in the debtor’s capital structure, see 11 U.S.C. § 1129(b)(2), but nonconsensual confirmation has probably been used mostly against junior classes, or classes “down” the capital structure. As a result, recent efforts to confirm a plan over the nonacceptance of a senior class of creditors has come to be called “cram up”.

Cram up has taken two forms. The first, more technically correct use of the term, involves confirming a plan over the nonacceptance by an impaired senior class of claims, usually secured. Section 1129(b)(2)(A) expressly contemplates this result. The second involved leaving a class of secured claims unimpaired under 11 U.S.C. § 1124 by cure and reinstatement of the debt, so that the class’s acceptance of the plan is not required at all. Of course, if all other classes accept, then confirmation is technically consensual, despite any confirmation objection of holders of claims of the unimpaired class. Usually, however, a plan that attempts to reinstate a class of secured claims in today’s economic environment will not leave anything for one or more existing junior classes, so the plan will not be consensual.

This strategy has become particularly attractive recently due to the wave of borrower-friendly financings that preceded the current financial downturn. Reinstating credit facilities that were established during the last few years generally means maintaining an interest rate and covenant package far more favorable to the borrower than could typically be obtained through exit financing.

Section 1124 of the Bankruptcy Code,¹ provides that a class is not impaired if its rights of the holders of claims or interests of the class are left unaltered and the debtor cures all defaults other than bankruptcy and financial condition defaults described in section 365(b)(2). If a class of secured claims is unimpaired, it is excluded

¹ 11 U.S.C. § 101 et. seq. (the “Bankruptcy Code”).

from the statutory safeguards with respect to plan confirmation set forth in 11 U.S.C. § 1129. Such a class is not entitled to vote and is not protected by the liquidation value test of 11 U.S.C. § 1129(a)(7). This means that, if at least one class of claims accepts the plan, a debtor could confirm a plan over the secured creditors' objections. In short, if a bankruptcy court were convinced that the class of secured claims is not impaired, the debtor, with the cooperation of other creditors, could push through a plan that reinstated the secured debt and even provided a recovery to the junior classes (typically in the form of equity), in each case over the objection of the secured creditors.

This strategy was recently employed in the bankruptcy cases for Spectrum Brands and Charter Communications. In Spectrum Brands, the debtor proposed a plan that reinstated its \$1.4 billion senior secured term loan and refinanced its unsecured notes. The refinancing, which was negotiated with three hedge funds holding over 70% of the unsecured notes, called for the cancellation of \$1.05 billion of unsecured notes, which would be replaced by new notes in an aggregate principal amount equal to 20% of the unpaid principal and interest outstanding on the cancelled notes, as well as substantially all the equity in the company (with a small holdback for management). The debtor argued that the noteholders were the only impaired class under this plan and that no other class acceptance was needed to confirm the plan. Over 90% of the noteholders accepted the plan.

Spectrum's secured creditors objected on several grounds. First, they argued that the plan should not be confirmed because it would not comply with 11 U.S.C. § 1129(a)(11), which requires as prerequisite to plan confirmation that "[c]onfirmation of the plan is not 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 in the plan." The secured creditors argued that Spectrum's plan would not enable the company to remain out of bankruptcy because it would lack the cash necessary to operate and that its own projections suggested it was unable to maintain compliance with its financial covenants. Second, the secured creditors argued that the plan did not comply with the requirements for reinstatement under 11 U.S.C. § 1124, because two non-bankruptcy events of default would exist under the confirmed plan: Issuing equity to the noteholders would result in a change of control, which constituted an event of default under the credit agreement, and the distribution of new equity securities to the noteholders would constitute an event of default by violating a negative covenant prohibiting payments or other distributions for "purchase, redemption, retirement, acquisition, cancellation or termination of any subordinated Indebtedness". Senior Secured Lenders' Objection to First Proposed Disclosure Statement with Respect to Joint Plan of Reorganization of Spectrum Jungle Labs Corporation, Et Al., Debtors at 11, *In re Spectrum Jungle Labs Corp.*, No. 09-50455 (RBK) (Bankr. W.D. Tex. Mar. 31, 2009). The "change of control" issue centered on whether the three hedge funds were acting in concert and therefore in control. Finally, the secured creditors argued that the proposed plan would not completely cure the existing defaults, since it did not call for the payment of the default interest rate during the pendency of the chapter 11 cases.

Ultimately, it was not necessary for the court to decide this reinstatement issue. Spectrum reached a settlement agreement with its secured creditors. They agreed that the \$1.4 billion secured loan would remain in place, but added the following amendments: a 2.5% increase in the interest rate spread, a 1.5% LIBOR floor, and a nine month acceleration of the maturity date.

The settlement in Spectrum preserved the uncertainty surrounding this issue for the Charter Communications bankruptcy, where a very similar situation has developed. As in Spectrum, the debtor has aligned with unsecured creditors in an attempt to reinstate \$11.8 billion existing secured debt over the secured creditors' objections. Although the issues are similar to those in Spectrum, with a significant portion of the equity going to unsecured creditors, the change of control issue in the Charter Communications case includes at least one additional twist. The proposed plan contemplates the existing controlling shareholder (Paul Allen) maintaining a significant, controlling equity stake in an attempt to avoid triggering a change of control provision in Charter's credit agreement similar to the one at issue in the Spectrum case.

The secured creditors argued that the class of their claims was impaired under Charter's proposed plan. First, they argued that the proposed plan did, in fact, violate the change of control provision of the credit agreement. Under the proposed plan, Charter's former bondholders would receive 65% of the company's common stock, denominated as Class A shares, while Paul Allen would receive the remaining 35% as Class B shares. The Class A shares were entitled to select seven directors to the company's board, while the Class B shares could select four. Under Charter's credit agreement, a change of control (and therefore an Event of Default) occurs if a person or group (other than Mr. Allen) has more than 35% of the "ordinary voting power for the management of the Borrower". The secured creditors argue that, although no individual shareholder would have more than 35% of the company's equity, a group of bondholders led by Apollo would effectively control the company by controlling the Class A vote, which in turn elects 64% of the directors. The secured creditors argue that, despite an effort at "fig leaf compliance", the plan's substance constitutes change of control and therefore an event of default that would not be cured, rendering the secured creditors' class impaired.

The secured lenders also point to the plan's failure to provide for reimbursement of certain legal expenses as another default that would not be cured by the proposed plan. The credit agreement requires the borrower to reimburse the Secured Lenders for certain legal costs incurred in enforcing and preserving their rights under the credit agreement. The secured lenders argue that the failure to cure this omission constitutes an event of default that precludes reinstatement under 11 U.S.C. § 1124.

In its capacity as administrative agent, JPMorgan Chase Bank N.A. also commenced an adversary proceeding against Charter. In its complaint, JPMorgan sought a declaration that certain other events of default had occurred: (1) certain affiliated entities becoming insolvent, (2) the payment of dividends despite continuing defaults and events of default and (3) impermissible payments of intercompany debt. The Charter Communications case remains undecided at the time of this writing, and these issues

continue to be debated. The current credit environment suggests that debt reinstatement will continue to be a significant issue in the near term.

C. Clear Channel, Chrysler and § 363

The requirements for a cram down suggest that unsecured creditors should not recover in a plan over the nonacceptance of an impaired class of claims secured by liens on substantially all of the debtor's property. Section 1129(a)(7) of the Bankruptcy Code provides that each impaired class must either accept a plan or receive value under the plan at least equivalent to what it would recover in a liquidation. If secured creditors have liens on all the debtor's property and are undersecured, one might conclude that they would be entitled to the proceeds of all liquidated assets, such that unsecured creditors could receive nothing unless the secured creditors accepted the plan. Furthermore, 11 U.S.C. § 1129(b)(1) requires that a cram down plan not discriminate unfairly and be fair and equitable with respect to each impaired class. This provision requires an application of the "absolute priority rule", which provides that a plan must provide full recovery to a class of claims before satisfying any junior claims or interests. While secured creditors enjoy several protections under the Bankruptcy Code, it is possible to avoid some of these requirements when conducting a sale under 11 U.S.C. § 363. In some cases, a secured creditor can experience the functional equivalent of cram down in the context of a § 363 sale.

While the plan confirmation requirements do not extend to 11 U.S.C. § 363, case law has suggested that 363 sales are not to be used as a tool for bypassing the requirements of chapter 11. "Where it is clear that the terms of a section 363(b) sale would preempt or dictate the terms of a Chapter 11 plan, the proposed sale is beyond the scope of section 363(b) and should not be approved under that section." In re Westpoint Stevens Inc., 333 B.R. 30, 52 (S.D.N.Y. 2005); see also In re Iridium Operating LLC, 478 F.3d 452, 466 (2d Cir. 2007) (The "trustee is prohibited from such use, sale or lease if it would amount to a sub rosa plan of reorganization."); In re Abbotts Dairies of Pa., Inc., 788 F.2d 143 (3d Cir. 1986); In re Braniff Airways, Inc., 700 F.2d 935 (5th Cir. 1983). Furthermore, 11 U.S.C. § 363 offer its own protections. Section 363(f) of the Bankruptcy Code provides that to conduct a sale "free and clear" of any third party's interest one of five criteria must be satisfied: (1) nonbankruptcy law permits free and clear a sale, (2) the third party consents, (3) the third party's interest is a lien and the sale price "is greater than the aggregate value of all liens on such property", (4) the interest is subject to a bona fide dispute or (5) the third party "could be compelled, in a legal or equitable proceeding, to accept money in satisfaction of such interest". 11 U.S.C. § 363(f). Section 363(f)(3) in particular provides an element of uncertainty. Courts have disagreed about the scope of its protection for a secured creditor. Some have concluded that the provision requires that the sale be for the value of the collateral, as determined by the court. Others have argued that the sale must be for more than the amount of the secured debt. Two recent cases illustrate the different interpretations of section 363(f).

In Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC), 391 B.R. 25 (9th Cir. B.A.P. 2008), the debtor held several parcels of real estate that were subject to a senior lien held by secured lender DB Burbank. DB Burbank purchased the property free

and clear of all liens through a § 363 sale by a credit bid in a court administered sale process. Another creditor, Clear Channel Outdoor, Inc., held a junior lien on the property and had received no recovery from the sale, because the credit bid had not included any cash. Clear Channel objected to the sale, arguing that the property could not be sold free and clear of its liens because the price paid was not greater than the “aggregate value of all liens” on the property. The court agreed and held that 11 U.S.C. § 363(f)(3) is not satisfied “if the price of the estate property is equal to or less than the aggregate amount of all claims held by creditors who hold a lien or security interest in the property being sold.” Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC), 391 B.R. 25, 41 (9th Cir. B.A.P. 2008).

In In re Chrysler LLC, the debtor was able to consummate a § 363 sale over the objection of some of its secured lenders, despite providing a significant recovery to some unsecured claimants and only a partial repayment of secured claims. Under the transaction proposed by Chrysler, the first lien lenders would receive only \$2 billion on approximately \$6.9 billion in secured claims, while a trust for retired workers’ health claims (the VEBA) received the majority of Chrysler’s equity and a promissory note and many trade claims were paid full, despite objection from the secured lenders. The secured lenders argued that the prearranged sale of Chrysler was an impermissible “sub rosa” plan, designed to sidestep the creditor protections imposed by the Bankruptcy Code. They suggested that the proposal was unfair in ignoring the priority scheme established by the Bankruptcy Code. Finally, they argued that under 11 U.S.C. § 363(f)(3), the court may authorize a sale of collateral over the objection of secured creditors only if the sale price is greater than the face amount of the debt secured by such assets.

The court rejected the argument that the sale was an impermissible attempt to bypass priority requirements.

[I]t is recognized that such creditors may receive more favorable treatment than other creditors either in their class or a higher priority class. Nevertheless, such treatment is not considered a violation of the priority rules nor does it transform a sale of assets into a sub rosa plan.

In re Chrysler LLC, 405 B.R. 84, 99 (Bankr. S.D.N.Y. 2009). The court reasoned that debtors in possession are allowed to provide preferential treatment, for example by choosing which executory contracts to assume. The court felt that the debtor in possession was making a similar decision here: determining what contractual relationships were essential to creating the most value for the estate.

In negotiating with those groups essential to its viability, New Chrysler made certain agreements and provided ownership interests in the new entity, which was neither a diversion of value from the Debtors’ assets nor an allocation of the proceeds from the sale of the Debtors’ assets. The allocation of ownership interests in the new enterprise is irrelevant to the estates’ economic interests.... [T]he UAW, VEBA, and the Treasury are not receiving distributions on account of their prepetition claims. Rather,

consideration to these entities is being provided under separately-negotiated agreements with New Chrysler.

In re Chrysler LLC, 405 B.R. 84, 99 (Bankr. S.D.N.Y. 2009). The court also rejected arguments that the transaction was for inadequate consideration or that such consideration was improperly directed. The court first points out that “there is no attempt to allocate the sale proceeds away from the First-Lien Lenders. Rather, the security interest of the First-Lien Lenders will attach to the sale proceeds” In re Chrysler LLC, 405 B.R. 84, 98 (Bankr. S.D.N.Y. 2009). Next, the court defends the price received for the assets. The court concludes that “the \$2 billion New Chrysler is paying for the Debtors’ assets exceeds the value that the First-Lien Lenders could recover in an immediate liquidation”. Chrysler LLC, 405 B.R. 84, 97 (Bankr. S.D.N.Y. 2009). The court noted that the bidding process provided further evidence that the price was fair. The court noted that no other bidder came forward, including the secured lenders, who had the option to credit bid. Since the only alternative in the absence of a bidder would be liquidation at a lower price, the secured lenders could not dispute the value of the transaction selected.

Ultimately, the Chrysler court sidestepped the question of compliance with 11 U.S.C. § 363(f)(3), however. The court pointed out that, while the liens are for the benefit of all the secured lenders, they were granted to and held by the Collateral Trustee, whose actions with respect to the collateral are directed by the Administrative Agent. The lenders agreed to be bound by any action of the Administrative Agent made at the request of the Majority Lenders. Since the Majority Lenders, the Administrative Agent and the Collateral Trustee had consented to this transaction, the court determined that the entity holding the interest in the property sold had consented under 11 U.S.C. § 363(f)(2), despite the objections of individual secured lenders, thereby eliminating the need to comply with 11 U.S.C. § 363(f)(3).

II. DISCHARGE IN LIQUIDATING CASES

One of the effects of plan confirmation is typically to discharge the claims associated with a debtor’s property. To give the debtor a “fresh start” after confirmation, the debtor is discharged “from any debt that arose before the date of such confirmation” and “the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor”. 11 U.S.C. § 1141(c) & (d)(1). However, debtors (other than individual debtors) that will be liquidated in bankruptcy do not require a fresh start, as the entity survives only to be wound down rather than rehabilitated. As a result, these provisions do not apply to corporations or partnerships that are being liquidated in bankruptcy. Such entities are ineligible for discharge under the Bankruptcy Code, whether they are liquidated under Chapter 7 or Chapter 11.

A. Successor Liability

A liquidating corporate debtor does not require discharge; it simply dissolves once it has exhausted its resources. However, the lack of statutory discharge

does effect those who purchase assets out of the estate under a sale or a plan of liquidation. This lack of statutory protection may expose such a purchaser to increased risk of successor liability.

As a general rule, a purchaser of the assets of another corporation does not assume the selling corporation's debts and liabilities. See 15 Fletcher Cyc. of the Law of Corporations § 7123 (2008). Traditionally, courts have recognized the following four exceptions for when an acquiring party could be liable on a theory of successor liability:

- (1) there is an express or implied agreement of assumption, (2) the transaction amounts to a consolidation or merger of the two corporations, (3) the purchasing corporation is a mere continuation of the seller, or (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts.

Ray v. Alad Corp., 560 P.2d 3, 7 (Sup. Ct. Cal. 1977); see also In re Savage Indus., Inc., 43 F.3d 714, 717 n. 4 (1st Cir. 1994) (citing Conway v. White Trucks, 885 F.2d 90, 93 (3d Cir. 1989) (other citations omitted)). Additionally, a few jurisdictions have recognized the "product line" theory as a fifth ground for successor liability, recognizing that:

a party which acquires a manufacturing business and continues the output of its line of products . . . assumes strict tort liability for defects in units of the same product line previously manufactured and distributed by the entity from which the business was acquired.

Ray v. Alad Corp., *supra*, at 11. A party purchasing assets through a plan of liquidation would receive no protection from the Bankruptcy Code against the application of successor liability under the theories above.

B. The Effect of Reorganization

In contrast, when estate assets are sold under a plan, "the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor". 11 U.S.C. § 1141(c). This does not absolve a purchaser from successor liability altogether. The definition of a "creditor" limits claimants to "entit[ies] that ha[ve] a claim against the debtor that arose at the time of or before the order of relief concerning the debtor". 11 U.S.C. § 101(10)(A). Under 11 U.S.C. § 101(5), a "claim" is defined as a "right to payment" or a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment", in either case "whether or not reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured". 11 U.S.C. § 101(5). Thus, a dischargeable claim under 11 U.S.C. § 1141 must satisfy two requirements: first, it must be a valid "claim" or "interest" and second, such claim or interest must have arisen pre-petition. Courts are divided between the several approaches to determining whether a claim arose pre-petition and have variously

adopted the “conduct theory”, the “accrual theory” or the “pre-petition relationship theory”.

Under the “conduct theory”, a “claim arises at the time of the debtor’s conduct giving rise to the alleged liability, rather than when the cause of action accrued.” In re Parker, 313 F.3d 1267, 1269 (10th Cir. 2002). For example, in In re Manville Forest Products, the court concluded that an indemnification obligation was a valid, contingent, pre-petition claim that was properly discharged by the confirmation of the plan, even though the event that would give rise to the indemnification obligation had not yet occurred when the petition had been filed. 209 F.3d 125, 129 (2d Cir. 2000). In contrast, the minority “accrual theory” requires that a right to payment, as determined by state law, exist pre-petition before a claim can exist. In re M. Frenville Co., Inc., 744 F.2d 332 (3d Cir. 1984).

Other courts have expressed concerns about the applicability of the conduct test when a tortious act may have occurred pre-petition, but the causes of action, including environmental clean-up costs, personal injury or product liability, may not arise until many years after the debtor has emerged from bankruptcy. Accordingly, some courts have adopted the “relationship theory”, which recognizes that certain contingent claims are simply too remote to fall within the scope of 11 U.S.C. § 105(a). Under this approach, to have a cognizable claim, an entity must have some kind of pre-petition relationship with the debtor. See In re Jensen, 995 F.2d 925 (9th Cir. 1993); In re Chateaugay Corp., 944 F.2d 997, 1004 (2d Cir. 1991) (in the CERCLA context, limiting contingent claims “to obligations that will become due upon the happening of a future event that was within the actual or presumed contemplation of the parties at the time the original relationship between the parties was created”); see also Lemelle v. Universal Mfg. Corp., 18 F.3d 1268 (5th Cir. 1994) (finding products liability claimant did not have a claim where fire giving rise to cause of action occurred two years after confirmation due to lack of evidence of any pre-petition contract, privity or relationship with the debtor).

Special rules have been developed in the CERCLA context, where the dischargeability of a claim also turns on when the claim arises, and there is a similar divergence of approaches taken by the courts. The majority rule is the “fair contemplation” approach applied in In re National Gypsum Co.², although a number of courts have adopted the relationship test from Chateaugay Corp. discussed above. Additionally, in the event the property of the reorganized company includes contaminated sites that may be subject to a federal cleanup order under CERCLA, an equitable injunction may not be a dischargeable “claim” within the meaning of 11 U.S.C. § 1141, as a discharge by the bankruptcy court could not relieve a reorganized company from

² Under the National Gypsum test, “knowledge by the parties of a site in which a [potential responsible party] may be liable, a National Priorities List listing, notification of EPA of [potential responsible party] liability, commencement of investigation and cleanup, and occurrence and response costs” would be considered “fair contemplation”.

ongoing compliance with environmental laws. Matter of CMC Heartland Partners, 966 F.2d 1143, 1147 (7th Cir. 1992). However, to the extent a governmental cleanup order gives rise to a “right to payment”, such liabilities may be dischargeable. Ohio v. Kovacs, 469 U.S. 274, 284-85 (1985).

Although the methods for defining the temporal limitations of discharge vary, the general rule is that, with the exception of certain regulatory requirements, prepetition claims are discharged by confirmation of a plan of reorganization, and successor liability does not pose a risk for a reorganized debtor.

C. Alternative: 363 Sales

A purchaser of assets sold under a plan of liquidation does not receive the protections described above. Such a party may obtain similar, although arguably less extensive, protections by purchasing the assets before plan confirmation through a sale under 11 U.S.C. § 363(b).

Section 363(f) of the Bankruptcy Code provides for a sale free and clear of “interests in such property”; accordingly, the bankruptcy court’s ability to extinguish successor liability under 11 U.S.C. § 363 is limited by the scope of the phrase “interests in property”. The drafting of 11 U.S.C. § 1141, which provides for the transfer of property free and clear of “claims and interests”, suggests that the scope of 11 U.S.C. § 363 should be narrower than that of § 1141, but the definition of “interests” under § 363 is not a settled issue. A number of courts have adopted an equally broad interpretation of the court’s powers under a § 363 sale as has been applied in connection with a plan of reorganization under § 1141. Others have interpreted the discrepancy in language to imply a more limited scope to § 363.

“Interests” as used in section 363(f) of the Bankruptcy Code has not been limited to liens and includes “obligations that are connected to or arise from the property being sold”.³ In re Trans World Airlines, 322 F.3d 283, 289 (3d Cir. 2003) (travel vouchers issued prepetition to settle general unsecured employment discrimination claims are interests that arise from the property being sold). For example, courts have upheld limiting successor liability for diverse categories of general unsecured claims, including employment discrimination claims, intellectual property rights, leasehold interests, future pension obligations, personal injury actions and product liability claims. See, e.g., id. at 289-90 (3d Cir. 2003) (suggesting employment discrimination claims are interests in property because they arise from the property being sold); FutureSource LLC v. Reuters Ltd., 312 F.3d 281, 285 (7th Cir. 2002) (license agreement: for intellectual property);

³ Notwithstanding a court’s broad understanding of “interests”, for a purchaser of the debtor’s assets to benefit from the protections of Section 363(f), the sale order must specifically provide that the sale is being made free and clear of liens, claims, interests, etc., and not merely “free and clear of all liens”. See, e.g., Mickowski v. Visi-Trak Worldwide, LLC, 321 F. Supp. 2d 878, 880 (N.D. Ohio 2003).

Precision Inds. v. Qualitech Steel SEQ, LLC, 327 F.3d 537 (7th Cir. 2003); (recognizing a real property leasehold as an “interest” under 11 U.S.C. § 363(f)); In re Leckie Smokeless Coal Co., 99 F.3d 573, 581-82 (4th Cir. 1996) (benefit plan’s right to seek premium payments was an “interest in such property”); Myers v. U.S., 774, 782 (S.D. Cal. 2003) (personal injury claim arising from debtor’s negligent handling of toxic materials was “interest in such property” because it arose from property being sold, *i.e.*, government contracts to transport such materials); In re All American of Ashburn, Inc., 56 B.R. 186 (Bankr. N.D. Ga. 1986) (precluding mobile home owners from prosecuting products liability action against purchase of debtor’s assets), aff’d, 805 F.2d 1515 (11th Cir. 1986).

Conversely, other courts have limited the scope of “interests” extinguishable under 11 U.S.C. § 363(f) to a narrower category of claims, excluding from its scope certain in personam claims and equitable rights or defenses of third parties. Focusing on the phrase “in such property”, a small number of courts have even limited the scope of “interests” under 11 U.S.C. § 363(f) to conventional security interests such as liens and mortgages. See In re Oyster Bay Cove, Ltd., 196 B.R. 251, 255 (E.D.N.Y. 1996) (“Free and clear” should be interpreted as speaking of interests *against the property*, such as liens or mortgages, which now attached to the proceeds of the sale” and has no effect on easements that run *with* the land); In re Fairchild Aircraft Corp., 184 B.R. 910, 917 (Bankr. W.D. Tex. 1995) (concluding that interests in such property under 11 U.S.C. § 363(f) refers only to in rem interests in property), vacated on other grounds, 220 B.R. 909 (Bankr. W.D. Tex. 1998); see also Zerand-Bernal, 23 F.3d at 163 (11 U.S.C. § 363(f) refers only to liens) (dictum). Other courts have concluded that certain third party defenses such as a right of recoupment are not interests that may be extinguished under 11 U.S.C. § 363. See Folger Adam Security, Inc. v. DeMatteis/MacGregor, JV, 209 F.3d 252, 261 (3d Cir. 2000). By contrast, property may be sold free and clear of setoff rights, which is an affirmative claim against the debtor and is treated the same as a lien under Section 506(a). However, to the extent a claimant actually takes a setoff before a bankruptcy, the debt being set off would simply not be a part of the bankruptcy estate and would not be subject to a § 363 sale. Id. at 263. But see In re De Laurentiis Entertainment Group Inc., 963 F.2d 1269 (9th Cir. 1992) (citing the language of 11 U.S.C. § 553 that “this title does not effect [any right of set off]”, suggesting set off rights survive the confirmation of a plan).

There is little consensus among the courts regarding the outer reaches of the scope of “interests” which may be subject to 11 U.S.C. § 363(f). The case law regarding sales under 11 U.S.C. § 363 is limited and leaves a number of issues unresolved. With a few exceptions, liens and rights in contract, which are closely tied to the debtor’s property appear safely within the scope of § 363. However, the courts have provided little definitive guidance regarding how the interests of future claimants should be treated under § 363.

D. Chrysler and GM

The uncertainty regarding the scope of a bankruptcy court’s authority to protect a purchaser in a §363 sale came to the fore in both the Chrysler and GM

bankruptcy cases. Since these cases are prominent examples of increasingly common Chapter 11 practice, an examination of the treatment of the issue in these cases is warranted.

Recent trends in Chapter 11 practice suggest that this issue will become increasingly important in the coming years. Chapter 11 is increasingly being used as a forum for selling off the assets of a company, rather than reorganizing, and businesses are often preserved through sales under 11 U.S.C. § 363 rather than reorganization plans. See Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 751 (2002). The Chrysler and GM bankruptcies are both good examples of this trend. In each case, the viable portions of the company were sold off in sales under 11 U.S.C. § 363, and the original entity was left behind to liquidate. Moreover, in each case the issue of successor liability was litigated and opined on by the judge in the case.

In both cases, several objections were filed to the proposed sale order, which would limit the successor liability of the purchaser. The Chrysler court made short work of such objections and brushed aside the successor liability arguments on the basis of Third Circuit precedent.

“Some of these objectors argue that their claims are not “interests in property” such that the purchased assets can be sold free and clear of them. However, the leading case on this issue, In re Trans World Airlines, Inc., 322 F.3d 283 (3d Cir. 2003) (“TWA”), makes clear that such tort claims are interests in property such that they are extinguished by a free and clear sale under section 363(f)(5) and are therefore extinguished by the Sale Transaction. The Court follows TWA and overrules the objections premised on this argument. Even so, in personam claims, including any potential state successor or transferee liability claims against New Chrysler, as well as in rem interests, are encompassed by section 363(f) and are therefore extinguished by the Sale Transaction.”

Chrysler LLC, 405 B.R. 84, 111 (Bankr. S.D.N.Y. 2009).

The GM court’s opinion devotes more attention to this issue, acknowledging that “[t]he issues as to the successor liability provisions in the approval order are the most debatable of the issues now before the Court.” In re General Motors Corp., 2009 WL 1959233 at *25 (Bankr. S.D.N.Y. 2009). The sale order in the GM case called for New GM to assume liability for warranty claims and product liability claims arising from injuries that occurred after the § 363 transaction (regardless of when the vehicle was manufactured). However, New GM would not assume any liabilities for injuries or illnesses that arose before the transaction. These provisions in the proposed order drew numerous objections, not surprisingly from (i) accident litigants (including an Ad Hoc Committee of Consumer Victims), (ii) asbestos litigants and (iii) environmental litigants (most notably, the New York’s Attorney General and the St. Regis Mohawk Tribe).

The court first addressed the issue of successor liability generally, assessing the various legal arguments described above. The court first noted that the scope of permissible protections offered by 11 U.S.C. § 363(f) depend, in large degree, on the interpretation of “interest in property” and the meaning of “interest” specifically. After noting that “interest” is not defined in the Bankruptcy Code, the court conducted a textual analysis of the Bankruptcy Code in an effort to elucidate its meaning, but ultimately found its efforts to be inconclusive. “Neither the Code nor interpretive aids tells us how broadly or narrowly—in the particular context of section 363(f)—‘interest in property’ should be deemed to be defined.” In re General Motors Corp., 2009 WL 1959233 at *27 (Bankr. S.D.N.Y. 2009). The court noted that “interest” means different things in different places in the Bankruptcy Code. The court agreed that 11 U.S.C. § 363(f), which provides for particular treatment when an “interest” is a lien, suggests that “interest” “means more than a lien”, but cautions that it is not clear how much more. In re General Motors Corp., 2009 WL 1959233 at *27 (Bankr. S.D.N.Y. 2009). Because the meaning of interest is unclear, the court declined to read much into the discrepancy in language between 1141(c) and 363(f).

The court next turned to, and ultimately rested its decision upon, the applicable case law. The court acknowledged that courts were split on this issue, but went on to note that the caselaw was not split in either the Second Circuit or the Southern District of New York. The court emphasized that this issue had been addressed in Chrysler, and that court had concluded that successor liability does not survive a “free and clear” sale under §363(f). The court stated that stare decisis suggested they follow the Chrysler decision, but noted that it agreed with that court’s analysis as well. Furthermore, the court noted that the Second Circuit had affirmed Chrysler for “substantially for the reasons stated in the opinion below”, suggesting that not only the result but also the analysis of the lower court in Chrysler was likely building precedent. Since “Chrysler is not distinguishable in any legally cognizable respect”, the court viewed the Second Circuit’s affirmance as controlling authority.

The court directed special attention to the issues raised by the asbestos and environmental litigants. While the court felt that the asbestos liabilities generally fell under the analysis already described above, it conceded that there may be additional issues posed by “claims for future injuries that people exposed to asbestos might suffer when they don’t yet know of their ailments or the need to sue or assert a claim.” In re General Motors Corp., 2009 WL 1959233 at *29 (Bankr. S.D.N.Y. 2009). In such cases, the court conceded that “the notice given on this motion was not fully effective, since without knowledge of an ailment that had not yet manifested itself, any recipient would be in no position to file a present claim.” In order to address such constitutional concerns, the court called for an amendment to the injunction paragraph of the sale order, “applicable (only) to asbestos claims and demands, making the injunction enforceable “to the fullest extent constitutionally permissible.” In re General Motors Corp., 2009 WL 1959233 at *30 (Bankr. S.D.N.Y. 2009).

The environmental litigants were concerned that the court’s sale order would release GM from its duties to comply with environmental laws and cleanup obligations. The court noted that the order makes clear that New GM (and Old GM) will

continue to be obligated to comply with environmental laws. With respect to cleanup obligations, these too are subject to the successor liability analysis described above. The property may be sold free and clear of environmental claims, with one important caveat. While New GM can not be required to satisfy any existing obligations of the seller, it does need to comply with environmental regulations starting the day it receives the property. If the property requires remediation when it comes into the buyer's hands, that is the buyer's responsibility. The court noted that the order does not prevent actions by the environmental litigants to try to force New GM into taking remedial action once it is in possession of the property.

III. THE EFFECT OF PICCADILLY

The U.S. Supreme Court's decision in Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326 (2008), examined the proper application of § 1146(a) of the Bankruptcy Code, which provides an exemption from state transfer taxes to asset sales made "under a plan confirmed under section 1129 [of the Bankruptcy Code]". 11 U.S.C. § 1146(a). The case addressed a circuit split that had developed regarding the proper interpretation of the phrase "under a plan confirmed". Before Piccadilly, the Second and Eleventh Circuits had ruled that this language allowed the tax exemption to be applied to a pre-confirmation asset sale under 11 U.S.C. § 363(b), as long as consummation of the plan was dependent on that sale. The Third and Fourth Circuits, on the other hand, adopted a more limited reading of the provision, concluding that the transfer tax exemption applied only to transactions occurring after plan confirmation. The Court held in Picadilly that "§ 1146(a)'s stamp-tax exemption does not apply to transfers made before a plan is confirmed under Chapter 11". Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326, 2330 (2008). While one might initially conclude that such a holding would preclude the application of the § 1146(a) tax exemption to pre-confirmation § 363(b) sales, a recent case suggests that this issue is not completely closed. In In re New 118th, Inc., the Bankruptcy Court in the Southern District of New York ruled that § 1146(a) can still be applied to pre-confirmation sales so long as the sale does not close until after confirmation.

A. Section 1146(a)

Section 1146(a) of the Bankruptcy Code provides that "[t]he issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of [the Bankruptcy Code], may not be taxed under any law imposing a stamp tax or similar tax". While the Bankruptcy Code does not define "stamp tax or similar tax", the Court of Appeals for the Second Circuit has determined that a tax meeting the following five elements falls within this category:

- (1) the tax is imposed only at the time of transfer or sale of the item at issue;
- (2) the amount due is determined by the consideration for, par value of, or value of the item being transferred;

- (3) the tax rate is a relatively small percentage of the consideration, par value or value of the property;
- (4) the tax is imposed irrespective of whether the transferor enjoyed a gain or suffered a loss on the underlying sale or transfer; and
- (5) in the case of state documentary transfer taxes, the tax must be paid as a prerequisite to recording.

In re 995 Fifth Ave. Assoc., L.P., 963 F.2d 503 (2d Cir. 1992), cert. denied, 506 U.S. 947 (1992); see also 8 Collier on Bankruptcy ¶ 1146.02, at 1146-3 (15th ed. rev. 2008) (presenting the Second Circuit test). As this definition suggests, transfer taxes are not limited to any particular category of property. However, transfer taxes pertaining to the sale of real estate are probably the most significant application of this provision, due to both the number of states that have such taxes and the relative size thereof as a percentage of an asset sale.

B. The Circuit Split

Reading the language of 11 U.S.C. § 1146(a) that limits the exemption to transfers made “under a plan confirmed”, one might conclude that a transfer completed before plan confirmation would be excluded from the exemption. However, such an interpretation would exclude a substantial portion of asset sales in bankruptcy from the benefits of this provision. As several recent notable cases have illustrated, it is now common practice to sell a substantial portion of a debtor’s assets long before a plan is confirmed. The increasing reliance of bankruptcy litigants on § 363(b) sales put pressure on the interpretation of this provision, as parties to pre-confirmation transactions were eager to maintain the benefits of the 11 U.S.C. § 1146(a) tax exemption.

In 1985, the Second Circuit suggested that the 11 U.S.C. § 1146(a) exemption could be applied to pre-confirmation transactions under certain circumstances. In New York v. Jacoby-Bender, 758 F.2d 840 (2d Cir. 1985), the court held that a sale does not need to be explicitly authorized by the confirmed plan so long as such sale is necessary for the consummation of the plan. Jacoby-Bender was interpreted to mean that pre-confirmation sales could qualify for the § 1146(c) exemption. However, the Fourth Circuit subsequently rejected this notion. In In re NVR, LP, 189 F.3d 442 (4th Cir. 1999), the Fourth Circuit concluded that a transaction made before plan confirmation could not be deemed a transfer “under a plan confirmed”, and, thus, could not qualify for the 11 U.S.C. § 1146(a) exemption. The court interpreted “under” to mean “subordinate to” or “authorized by”, and concluded that a transfer could not be authorized by a confirmed plan if such a plan did not yet exist at the time of transfer. The Third Circuit followed the Fourth Circuit in In re Hechinger Inv. Co. of Delaware, Inc., 335 F.3d 243 (3d Cir. 2003), although it restricted application of § 1146(c) even further, concluding that any sale eligible for the tax exemption could not be authorized by any means other than a confirmed plan. This reading effectively excluded all § 363 sales from the exemption. In 2007, the Eleventh Circuit evened the score, siding with the Second

Circuit in Florida Department of Revenue v. Piccadilly Cafeterias, 484 F.3d 1299 (11th Cir. 2007), before the case moved on to the Supreme Court.

C. Picadilly

Piccadilly Cafeterias, Inc. filed for bankruptcy and moved to sell substantially all its assets under 11 U.S.C. § 363(b)(1) of the Bankruptcy Code. In conjunction with its sale motion, Piccadilly sought an exemption under 11 U.S.C. § 1146(a) from any stamp taxes on the asset sale. In 2004, the bankruptcy court approved the proposed sale and granted the stamp tax exemption. Picadilly's assets were sold for \$80 million. After the sale was consummated, Piccadilly filed a Chapter 11 plan of liquidation, which provided for, among other things, the distribution of the sale proceeds. The plan of distribution did not include the payment of any stamp taxes. The State of Florida filed an objection to the plan and initiated an adversary proceeding seeking a declaration that \$39,200 in stamp taxes on certain transferred assets were not covered by 11 U.S.C. § 1146(a), arguing that the exemption was not applicable to an asset sale conducted before plan confirmation. The bankruptcy court granted summary judgment to Piccadilly, concluding that the sale was a transfer "under" a confirmed plan, under 11 U.S.C. § 1146(a), because the sale was necessary to consummate the plan. The district court upheld the decision, In re Piccadilly Cafeterias, Inc., 379 B.R. 215, 226 (S.D. Fla. 2006), and the Eleventh Circuit affirmed, holding that "§1146[(a)]'s tax exemption may apply to those pre-confirmation transfers that are necessary to the consummation of a confirmed plan of reorganization, which, at the very least, requires that there be some nexus between the pre-confirmation transfer and the confirmed plan." In re Piccadilly Cafeterias, Inc., 484 F.3d 1299, 1304 (11th Cir. 2007) (per curiam).

The Supreme Court reversed the Eleventh Circuit's decision, holding that Piccadilly's asset sale did not qualify for the 11 U.S.C. § 1146(a) exemption "because Piccadilly transferred its assets before its Chapter 11 plan was confirmed". Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326, 2339 (2008). The Court's analysis addresses three issues of statutory construction presented by the parties.

First, the court considered whether the statute was facially ambiguous. Ultimately, the Court concluded that it was unnecessary to decide this issue, but it offered a lengthy suggestion that Florida had the better reading. The Court recapped and endorsed Florida's interpretation, which rested on a basic grammatical analysis. The Court noted that "confirmed" is a past participle modifying "plan" and that this combination suggests a plan that has been confirmed in the past. Furthermore, the Court recounted Florida's claim that the use of "under" elsewhere in § 1146 clearly means "subject to" and should be ascribed the same meaning in interpreting "under a plan confirmed", citing the textual canon that "identical words used in different parts of the same act are intended to have the same meaning". Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326, 2332 (2008) (quoting Commissioner v. Keystone Consol. Indus., Inc., 508 U.S. 152, 159 (1993)). Florida concluded, and the Court was persuaded, that "a transfer made prior to the date of plan confirmation cannot be subject to ... something that did not exist at the time of the transfer—a confirmed plan". Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326, 2332 (2008).

However, the Court noted that it was not necessary to decide whether the statute was ambiguous, since “[e]ven assuming, arguendo, that the language of §1146(a) is facially ambiguous, the ambiguity must be resolved in Florida’s favor. First, the court rejected numerous contextual arguments raised by Piccadilly, concluding that, “if the statutory context suggests anything, it is that §1146(a) is inapplicable to preconfirmation transfers”. In particular, the Court noted that the provision falls within a subchapter entitled “POSTCONFIRMATION MATTERS”, and “statutory titles and section headings ‘are tools available for the resolution of a doubt about the meaning of a statute’”. Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326, 2336 (2008) (quoting Porter v. Nussle, 524 U.S. 516, 528 (2002)). Second, the Court applied the holding in Sierra Summit, “courts should ‘proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed’”. Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326, 2337 (2008) (quoting California State Bd. of Equalization v. Sierra Summit, Inc., 490 U.S. 844, 851-852 (1989)). The Court concluded that this federalism canon dictated a narrow construction of the 11 U.S.C. § 1146(a) exemption. For these reasons, the court held that “Section 1146(a) affords a stamp-tax exemption only to transfers made pursuant to a Chapter 11 plan that has been confirmed.” Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326, 2339 (2008).

D. New 118th

Piccadilly may have been intended to resolve uncertainty regarding the applicability of the 11 U.S.C. § 1146 exemption to pre-confirmation sales, but a recent case in the Southern District of New York Bankruptcy Court, decided in January of this year, added a new level of subtlety to this question that may trigger a new debate. In In re New 118th, Inc., the court addressed the question of whether “the exemption applies to a pre-confirmation sale that closes after confirmation and is necessary to the consummation of the plan”. 398 B.R. 791 (Bankr. S.D.N.Y. 2009). In New 118th, the court authorized a § 363 sale before confirmation, but the sale did not close until after confirmation. The court distinguished between the terms “sale” and “transfer”, noting that property is not transferred until the closing. On the basis of this distinction, the court concluded that a pre-confirmation sale could be eligible for the 11 U.S.C. § 1146(a) exemption, provided that the closing did not occur until after plan confirmation.

“Piccadilly did not address whether the exemption could apply to a pre-confirmation sale that closed post-confirmation.... [T]he Supreme Court’s adoption of the NVR standard, and by extension, the reasoning of Jacoby-Bender, suggests that the § 1146(a) exemption applies to a post-confirmation transfer that follows a pre-confirmation sale if the transfer facilitates the implementation of the plan, or in the words of Jacoby-Bender, is necessary to the consummation of the plan.”

In re New 118th, Inc., 398 B.R. 791, 797 (Bankr. S.D.N.Y. 2009). The New 118th interpretation of Piccadilly’s timing requirements alone might be enough to trigger a new debate, although its reasoning on this point is fairly straightforward. However, New

118th acknowledges another issue with respect to pre-confirmation sales that suggests grounds for future challenge.

The court noted that disagreement had existed before Piccadilly on the issue of whether “under a plan confirmed” required that a sale be authorized by a plan, as opposed to authorized by 11 U.S.C. § 363, to qualify for the 11 U.S.C. § 1146 exemption. The court pointed to the split between the Fourth Circuit’s decision in NVR Homes, Inc. v. Clerks of the Circuit Courts of Anne Arundel County (In re NVR, LP), 189 F.3d 442 (4th Cir. 1999), cert. denied, 528 U.S. 1117 (2000), and the Third Circuit’s decision in In re Hechinger Inv. Co. of Del., 335 F.3d 243 (3d Cir. 2003). In the New 118th court’s view, NVR had adopted the reasoning in Jacoby-Bender, but clarified that any transfers must be made post-confirmation. It concluded that NVR picked up Jacoby-Bender’s conclusions regarding the underlying authority for the transaction:

That the plan did not empower the debtor to make a specific sale or deliver a specific deed is irrelevant to our determination that the delivery of the deed took place “under” the plan within the meaning of section 1146(c) [W]here, as here, a transfer, and hence an instrument of transfer, is necessary to the consummation of a plan, the plan seems implicitly to have ‘dealt with’ the transfer instrument.

In re Jacoby-Bender, Inc., 758 F.2d 840, 841-42 (2d Cir. 1984) (internal quotation marks omitted). In contrast, “[u]nder Hechinger, the plan also had to provide the ‘legal authority’ for the transfer, and the ‘legality’ of the transfer had to depend on the confirmation of the plan”. In re New 118th, Inc., 398 B.R. 791, 797 (Bankr. S.D.N.Y. 2009). In the New 118th court’s view, Piccadilly had adopted “the NVR standard, and by extension, the reasoning of Jacoby-Bender”. In re New 118th, Inc., 398 B.R. 791, 797. Therefore, a sale authorized by 11 U.S.C. § 363, rather than a plan, satisfies the prerequisites for the 11 U.S.C. § 1146 exemption as long as it is necessary to consummation of the plan.

However, whether Piccadilly stands for this proposition is open to debate. While the Supreme Court did “agree with the Fourth Circuit’s summation of § 1146(a) [in NVR]”, the NVR case really stands for an interpretation of the temporal requirements of 11 U.S.C. § 1146, not any authorization requirement, and its reasoning suggests little more than tacit approval of Jacob-Bender. Furthermore, the language from NVR quoted by the Supreme Court as the summation in question does not really address the issue of authorization. In contrast to the reading suggested by New 118th, the Piccadilly opinion also offers evidence of the opposite conclusion. The Court endorsed Florida’s textual analysis of the statute, which suggests “that the word ‘under’ in ‘under a plan confirmed’ should be read to mean ‘with the authorization of’ or ‘inferior or subordinate’ to its referent, here the confirmed plan”. Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc., 128 S.Ct. 2326, 2332 (2008). While this does not discredit the New 118th conclusion, it reveals that an alternate interpretation of Piccadilly is available to litigants seeking a different result.

IV. THIRD PARTY RELEASES

A. Third-Party Releases Generally

The confirmation of a chapter 11 plan discharges the debtor from debts that arose before the date of plan confirmation, 11 U.S.C. § 1141(d)(1), and prevents the enforcement or pursuit of legal actions imposing liability on the debtor for such debts, 11 U.S.C. § 524(a). However, this statutory release does not extend to third parties—such as insurance providers—who may be deemed (contractually or otherwise) to assume or share the liabilities of the debtor. 11 U.S.C. § 524(e). To induce participation in a chapter 11 plan, debtors will frequently provide for so-called “third-party releases” in their plan, which release non-debtors from liability to the debtor’s creditors. Although this practice has become quite common, particularly in New York and Delaware,⁴ the proper scope of such releases is not clear nor is the legal propriety of issuing such releases universally accepted. Indeed, some jurisdictions have prohibited the inclusion of third-party releases in chapter 11 plans altogether. The Supreme Court recently had an opportunity to address the issue of third-party releases in Travelers Indem. Co. v. Bailey, 129 S.Ct. 2195 (2009). However, the Court issued a narrow ruling that avoided authorizing or prohibiting third party releases, so the controversy remains.

B. The Circuit Split

Although third-party releases have become quite customary in certain jurisdictions, there are widely divergent views among the courts of appeal on whether and to what extent, such releases are permissible under the Bankruptcy Code. The Fifth, Ninth and Tenth Circuits all prohibit third-party releases altogether, concluding that 11 U.S.C. § 524(e) of the Bankruptcy Code prohibits releasing claims against non-debtor entities. See Feld v. Zale Corp. (In re Zale Corp.), 62 F.3d 746 (5th Cir. 1995); Resorts Int’l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394, 1402 n.6 (9th Cir. 1995); Landsing Diversified Props.- II v. First Nat’ Bank & Trust Co. of Tulsa (In re W. Real Estate Fund, Inc.), 922 F.2d 592 (10th Cir. 1990), modified sub nom. Abel v. West, 932 F.2d 898 (10th Cir. 1991).

The Second, Third, Fourth, Sixth and Seventh Circuits have all taken the view that § 524(e) merely limits the effect of the statutory release of § 524 and that bankruptcy courts have the power to impose nonconsensual third-party releases on creditors. See SEC v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 960 F.2d 285 (2d Cir. 1992); United Artists Theatre Co. v. Walton (In re United Artists Theatre Co.), 315 F.3d 217 (3rd Cir. 2003); Menard-Sanford v. Mabey (In re A.H. Robins Co.), 880 F.2d 694,702 (4th Cir. 1989); Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2001); In re Ingersoll, Inc., 562 F.3d 856 (7th Cir. 2009). However, these cases do not suggest that third-party

⁴ “Inclusion in a plan of reorganization of a narrow release of claims relating to the bankruptcy case, running in favor of the debtor, the creditors committee and all professionals and advisors, now appears to be de rigueur in cases filed in New York and Delaware.” In re Berwick Black Cattle Co., 394 B.R. 448, 459 (Bankr. C.D. Ill. 2008)

releases should be granted without limitation. Instead, these courts have suggested that non-consensual third-party releases should be granted only under “unusual” circumstances that warrant such relief. Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648, 658 (6th Cir. 2001); see also Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.), 416 F.3d 136, 143 (2d Cir. 2005) (“A nondebtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to success of the plan”). The Sixth Circuit has articulated a seven factor test for identifying such “unusual” circumstances:

We hold that when the following seven factors are present, the bankruptcy court may enjoin a non-consenting creditor’s 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.

Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648, 658 (6th Cir. 2001). The Eleventh Circuit has limited the application of third-party releases even further, concluding that such relief is appropriate only where the affected creditors have consented to the release of the non-debtors. See Munford v. Munford, Inc. (In re Munford, Inc.), 97 F.3d 449 (11th Cir. 1996).

C. Jurisdiction and Third-Party Releases

In addition to the question of whether bankruptcy courts can issue third-party releases at all under the Bankruptcy Code, there is also a question as to the scope of their jurisdiction and power to do so.

The subject matter jurisdiction of the bankruptcy courts is derived from that of the district courts. The district courts “have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11”, 28 U.S.C. § 1334(b), and may refer “any or all proceedings arising under title 11 or arising in or related to a case under title 11 ... to the bankruptcy judges for the district”, 28 U.S.C. § 157(a). Under this language, a bankruptcy court has jurisdiction to enjoin an action that does not involve a party to the bankruptcy case only if such action is “related to” the bankruptcy case. In re Zale Corp., 62 F.3d 746, 751 (5th Cir. 1995) (citing Quattrone Accountants, Inc. v. I.R.S., 895 F.2d 921, 926 (3d Cir.1990)). The Supreme

Court has confirmed that there is a limit to such authority. “[A] bankruptcy court’s ‘related to’ jurisdiction cannot be limitless.” Celotex Corp. v. Edwards, 514 U.S. 300, 308 (1995).

Courts have held that a matter is “related to” the bankruptcy case if “the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy.” Feld v. Zale Corp. (In re Zale Corp.), 62 F.3d 746, 752 (5th Cir. 1995) (quoting Wood v. Wood (In re Wood), 825 F.2d 90, 93 (5th Cir. 1987)) see also Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir. 1984). If the outcome of an action “could alter the debtor’s rights, liabilities, options, or freedom of action (either positively or negatively)”, it will be deemed to be at least “related to” the bankruptcy case. Walker v. Cadle Co. (In re Walker), 51 F.3d 562, 569 (5th Cir. 1995); see also Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir. 1984). When an action lacks such a nexus to the bankruptcy case, courts have held that a bankruptcy court lacks subject matter jurisdiction to enjoin or otherwise dispose of such an action. In re Zale Corp., 62 F.3d 746, 752 (5th Cir. 1995); In re Berwick Black Cattle Co., 394 B.R. 448 (Bankr. C.D. Ill. 2008). “[C]ourts have held that a third-party action does not create ‘related to’ jurisdiction when the asset in question is not property of the estate and the dispute has no effect on the estate.” In re Zale Corp., 62 F.3d 746, 753 (5th Cir. 1995) (providing extensive case support for this proposition). In addition, “[s]hared facts between the third-party action and a debtor-creditor conflict do not in and of themselves suffice to make the third-party action “related to” the bankruptcy.” In re Zale Corp., 62 F.3d 746, 753 (5th Cir. 1995).

D. Travelers Indemnity v. Baily

In Travelers Indemnity Co. v. Baily, the Supreme Court granted certiorari in a case addressing third-party releases. However, the Court decided the case on very narrow grounds and did little to resolve the controversy in this area.

The case arose from the 1986 reorganization of Johns-Manville Corporation, formerly the foremost suppliers of asbestos and asbestos related products in the United States. The Travelers Indemnity Company, as an insurer to Johns-Manville, participated in a chapter 11 settlement whereby it contributed to a settlement trust created to pay asbestos related personal injury claims in exchange for a permanent injunction against any suit or other proceeding relating to Travelers’ coverage of Johns-Manville. The order providing this injunction was incorporated by reference in the order confirming Johns-Manville’s plan of reorganization. Over a decade after the plan was confirmed, plaintiffs began filing asbestos actions against Travelers for its relationship with Johns-Manville. Some of these actions derive from alleged wrongdoing by Johns-Manville, while others point to alleged wrongdoing by Travelers. In 2002, Travelers moved the bankruptcy court to enjoin numerous actions pending in state court, invoking the injunction issued in conjunction with the plan of reorganization.

The bankruptcy court held that actions against Travelers continued to be barred by the original order issued in 1986. The bankruptcy court did not distinguish between derivative actions arising from conduct by Johns-Manville versus direct actions

arising from conduct by Travelers, since the alleged conduct by Travelers still arose from its relationship with Johns-Manville. The District Court affirmed. However, the Second Circuit reversed. See Travelers Indem. Co. v. Bailey, 129 S.Ct. 2195, 2199-2202 (2009) (reviewing the lower court decisions)

The Second Circuit held that the Bankruptcy Court lacked subject matter jurisdiction to enjoin the direct actions. “[T]he district court lacked subject matter jurisdiction to enjoin claims against Travelers that were predicated, as a matter of state law, on Travelers’ own alleged misconduct and were unrelated to Manville’s insurance policy proceeds and the res of the Manville estate.” Johns-Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.), 517 F.3d 52, 68 (2d Cir. 2008). The Second Circuit did not view Travelers’ settlement payments to the estate as establishing a sufficient relationship for purposes of subject matter jurisdiction. In addition, although 11 U.S.C. § 524(g) grants explicit authority to channel claims against a debtor’s insurer to the bankruptcy estate, that authority is “limited to situations where a third party has derivative liability for the claims against the debtor” and “was not intended to reach non-derivative claims.” 517 F. 3d, at 68.

The Supreme Court reversed the Second Circuit. It did not address the jurisdictional question, nor did it consider whether third-party releases were permissible generally. Instead, the Court concluded that the Second Circuit had committed error by reevaluating the bankruptcy court’s subject matter jurisdiction in 1986. The court held that the 1986 orders issuing the injunction “became final on direct review (whether or not proper exercises of bankruptcy court jurisdiction and power) [and] became res judicata to the parties and those in privity with them”. Travelers Indem. Co. v. Bailey, 129 S.Ct. 2195, 2205 (2009). While the question of subject matter jurisdiction could have been challenged on direct review, it may not be collaterally attacked. Thus, whether or not the bankruptcy court had jurisdiction in 1986, the validity of the orders enjoining actions against Travelers could not be challenged now.

Since the jurisdiction question was not a proper subject of review, the Court offered little guidance on the scope a bankruptcy court’s jurisdiction to issue third party releases. In addition, the Court explicitly declined to consider the propriety of third-party releases under such circumstances. “We do not resolve whether a bankruptcy court, in 1986 or today, could properly enjoin claims against nondebtor insurers that are not derivative of the debtor’s wrongdoing.” Travelers Indem. Co. v. Bailey, 129 S.Ct. 2195, 2207 (2009). Hence, it is unlikely that Travelers will have a significant impact on the debate among the courts of appeals on this issue. Perhaps the most significant development in this case is the restrictive view of jurisdiction taken below by the Second Circuit. Whether allegedly wrongful conduct by an insurer in conjunction with its coverage of a debtor is “related to” the bankruptcy estate is at least a close question, as evidenced by the reasoning of the bankruptcy court. That the Second Circuit found an insufficient link between such conduct and the estate may indicate a predisposition to enforce third-party releases narrowly in the future.