

## OUTLINE OF KEY ISSUES FOR ISSUING CHANNELING INJUNCTIONS IN FAVOR OF NONDEBTOR THIRD PARTIES

**By: Theodore L. Freedman and Deanna D. Boll**

Kirkland & Ellis LLP; New York

tfreedman@kirkland.com

dboll@kirkland.com

### **I. TWO KEY COMPONENTS TO ANALYSIS -- TO ISSUE PERMANENT INJUNCTIONS IN FAVOR OF NONDEBTOR THIRD PARTIES, COURT MUST HAVE (I) JURISDICTION; AND (II) POWER UNDER THE BANKRUPTCY CODE**

#### **A. JURISDICTION (DOES BANKRUPTCY JURISDICTION EXIST)**

1. The bankruptcy court must have jurisdiction to entertain an action between the parties.
2. It is universally accepted that a bankruptcy court may have jurisdiction over claims involving nondebtor third parties pursuant to its “related-to” jurisdiction provided under 28 U.S.C. §1334(b).
3. Most courts apply the *Pacor* test in determining whether related-to jurisdiction exists.
  - a) The seminal case on related-to jurisdiction is *Pacor Inc. v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984), which held that in order for the court to have related-to jurisdiction, the “outcome of [a proceeding involving the third party] could conceivably have any effect on the estate being administered in bankruptcy.” The court in *Pacor* further stated that “[a]n action is related to bankruptcy if the outcome could alter the debtor’s rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate.” *Id.*
  - b) The First, Fourth, Fifth, Sixth, Eighth, Ninth, Tenth, and Eleventh Circuits have adopted the *Pacor* test with little or no variation. *See, e.g., In re G.S.F. Corp.*, 938 F.2d 1467, 1475 (1<sup>st</sup> Cir. 1991); *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1002 n. 11 (4<sup>th</sup> Cir.), *cert. denied*, 479 U.S. 876 (1986); *In re Wood*, 825 F.2d 90, 93 (5<sup>th</sup> Cir. 1987); *Robinson v. Michigan Consol. Gas Co.*, 918 F.2d 579, 583-84 (6<sup>th</sup> Cir. 1990); *In re Dogpatch USA Inc.*, 810 F.2d 782, 786 (8<sup>th</sup> Cir. 1987); *In re Fietz*, 852 F.2d 455, 457 (9<sup>th</sup> Cir. 1988); *In re Gardner*, 913 F.2d 1515, 1518 (10<sup>th</sup> Cir. 1990); *In re Munford Inc.*, 97 F.3d 449 (11<sup>th</sup> Cir. 1996).

- c) The Second and Seventh Circuits appear to apply a different test, according to the Supreme Court's interpretation as articulated in *Celotex Corp. v. Edwards*, 514 U.S. 300 (1995). See *In re Turner*, 724 F.2d 338, 341 (2d Cir. 1983) (applies "conceivability" part of *Pacor* without further discussion); *In re Xonics Inc.*, 813 F.2d 127, 131 (7<sup>th</sup> Cir. 1987) (holding that a dispute is "related to" the bankruptcy if it affects the amount of property available for distribution or the allocation of property among creditors, but citing, among others, *Pacor*).
- d) All courts, however, make clear that bankruptcy courts have no jurisdiction over proceedings that have no effect on the debtor. See also *Celotex Corp. v. Edwards*, 514 U.S. 300 (1995).
4. If the claims or causes of action involve property of the estate, courts applying *Pacor* often conclude that they could have a conceivable effect on the estate such that related-to jurisdiction exists. *In re Wood*, 825 F.2d 90 (5<sup>th</sup> Cir. 1987); see also *In re Zale Corp.*, 62 F.3d 746, 753 (5<sup>th</sup> Cir. 1995) (cases in which courts have upheld related-to jurisdiction over third-party actions do so because the subject of the third-party dispute is property of the estate, or because the dispute over the asset would have an effect on the estate). Shared 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. *Id.* Also, judicial economy alone cannot justify a court's jurisdiction over an otherwise unrelated suit. *Id.* at 753-54.
5. If claims or causes of action are not derivative of the debtor's liability and are claims of nondebtors, some courts have been reluctant to find related-to jurisdiction such that they would grant a third party release or injunction. See *In re Combustion Engineering Inc.*, 391 F.3d 190 (3d Cir. 2005).
- Combustion Engineering sought to obtain a channeling injunction on account of two of its nondebtor affiliates for claims that were not derivative of the debtor's liability.
  - Both the bankruptcy court and the district court held that an injunction pursuant to 11 U.S.C. §105(a) of the Bankruptcy Code barring future claims against these nondebtors on account of non-derivative claims was proper.
  - The Third Circuit Court of Appeals reversed, indicating that (a) the corporate relationship between the three entities was not enough for related-to jurisdiction; (b) tying a sale of one of the nondebtors to contributions under the debtor's plan was not enough, even if all parties consented, because consent does not confer jurisdiction where it is otherwise lacking; (3) cases cited by the debtor were not analogous in so far as they involved derivative claims or claims

that would alter the priority status of the debtor's creditors, which would have effects on the estate; (4) potential indemnification is not enough where no express agreements or statutory requirements for indemnification exist and there is not near certainty of indemnity claims nor liability arising out the same products as the debtor's; and (5) the record was lacking findings regarding the scope, terms, and operation of alleged shared insurance such that the court could not form a basis of related-to jurisdiction on this ground.

- The Third Circuit appeared to indicate that if certain findings were made in terms of shared insurance, depending on the particular facts of a given case, the existence of shared insurance may provide a nexus to the debtor's estate to warrant related-to jurisdiction. However, while the issue was not completely foreclosed, the court was very skeptical as to whether related-to jurisdiction could be found to exist in most contexts involving nondebtors on account of nonderivative claims.

## **B. POWER (SCOPE AND THE FORMS OF RELIEF THAT THE COURT MAY ORDER IN AN ACTION IN WHICH IT HAS JURISDICTION)**

1. Even if the court in a bankruptcy case has jurisdiction over a dispute between third parties, for the court to enter an injunction it must also have the power pursuant to the Bankruptcy Code or any other applicable law, to grant the requested relief and issue an injunction or release in favor of third-party nondebtors.
2. Whether courts have the power to issue injunctions or grant third-party releases effectively discharging the liability of nondebtors centers primarily around conflicting interpretations of §§105(a) and 524(e) of the Bankruptcy Code.
  - a) Section 105(a) provides that “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. §105(a).
  - b) Section 524(e) provides that “discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.” 11 U.S.C. §524(e).
3. Section 524(e) arguably restricts the broad equitable authority that §105(a) confers on the courts. However, a number of courts that allow non-debtor releases find no conflict between §§105(a) and 524(e).
4. **The Second, Third, Fourth, Sixth, and Seventh Circuits, and lower courts of the First, Eighth, and Eleventh Circuits are pro-release courts that hold**

that bankruptcy courts have power under §105(a) to issue permanent injunctions or third-party releases under certain factual circumstances. The circumstances vary depending on the jurisdiction:

- First Circuit: Applying *Master Mortgage* factors of the Eighth Circuit. *In re Mahoney Hawkes LLP*, 289 B.R. 285, 302-03 (Bankr. D. Mass. 2002) (noting that the First Circuit Court of Appeals had not directly addressed this issue, but applies *Master Mortgage* factors to conclude injunction inappropriate on the facts); see also *Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973, 980 (1<sup>st</sup> Cir. 1995) (lower courts agreeing with pro-release courts that in ‘extraordinary circumstances,’ a bankruptcy court can grant permanent injunctive relief essential to enable the formulation and confirmation of a reorganization plan, and court of appeals not overturning this result where objector was collaterally estopped by plan confirmation order from belated challenge to the relief and the bankruptcy court’s jurisdiction to issue such relief).
- Second Circuit: Courts may issue permanent injunctions for the benefit of third party if the injunction play an “important role in the debtor’s reorganization.” *In re Drexel Burnham Lambert Group Inc.*, 960 F.2d 285 (2d Cir. 1992); *In re Chateaugay Corp.*, 167 B.R. 776 (S.D.N.Y. 1994) (§524(e) does not address whether a bankruptcy court can expressly discharge or otherwise affect the liability of a nondebtor; thus courts may use §105 to grant third-party releases where they are “essential to the reorganization”); *In re Metromedia Fiber Network Inc.*, 416 F.3d 136 (2d Cir. 2005) (holding that an injunction must play an important part in the debtor’s plan, and while no cases from the circuit explain when a release is “important,” it is clear that such a release is proper only in rare cases -- 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 the success of the plan). The *Metromedia* court clarified that two considerations justify the reluctance to approve nondebtor releases: (1) the only explicit authorization in the Bankruptcy Code for this relief is §524(g), applicable only in the asbestos context; and (2) the high possibility of abuse. The *Metromedia* court also makes clear that regardless of the jurisdiction, no court has tolerated third party releases without the presence of unique circumstances.
- Third Circuit: No precise universally adopted test, but courts examine a variety of factors, and require extraordinary circumstances, although some courts note that they are “customary” in large mass tort cases. See *In re American Family Enterprises*, 256 B.R. 377 (D.N.J. 2000) (citing *Drexel* and *Celotex* for such proposition). The *American Family* court also applies a five-factor

test set forth by the Eighth Circuit in *In re Master Mortgage Investment Fund Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994): (1) identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) the nondebtor has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization; (4) a substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has “overwhelmingly” voted to accept the proposed plan treatment; and (5) the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.); *In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000) (indicating that the Third Circuit had not ruled on the validity of provisions in chapter 11 plans releasing and permanently enjoining third party actions against nondebtors, and that the court would not permit it in this particular case because no findings of fairness or why such relief was necessary were made below or that the nondebtors made any critical financial contributions to the plan).

- Fourth Circuit. Section 524(e) does not by its specific words preclude the discharge of a guaranty when it has been accepted and confirmed “as an integral part of reorganization.” *In re A.H. Robins Co. Inc.*, 880 F.2d 694 (4<sup>th</sup> Cir. 1989) (relying on Fifth Circuit authority). The *Robins* court concludes that §105(a) would be appropriate “where the entire reorganization hinges on the debtor being free from indirect claims such as suits against parties who would have indemnity or contribution claims against the debtor.”
- Sixth Circuit. Standard developed in *In re Dow Corning Corp.*, 280 F.3d 648 (6<sup>th</sup> Cir. 2002). Court notes that the Bankruptcy Code doesn’t explicitly prohibit or authorize a bankruptcy court to enjoin a nonconsenting creditor’s claims against a nondebtor to facilitate a reorganization plan. Section 105(a) grants a court broad authority to issue “any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” Section 1123(b)(6) permits a reorganization plan to “include any . . . appropriate provision not inconsistent with the applicable provisions of this title.” Court notes that because a permanent injunction is a dramatic measure to be used cautiously, it follows those circuits that have held that enjoining a nonconsenting creditor’s claim is only appropriate in ‘unusual circumstances’ (agreeing with *Drexel Burnham, A.H. Robins Co.*, and *Johns-Manville* courts). It further developed a seven-factor test to determine whether unusual circumstances exist by examining whether: (1) there is an identity of interests between the debtor and

the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) the nondebtor 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.

- Seventh Circuit. Applies no test but indicates that a *per se* rule against permanent injunctions is inappropriate, particularly if such releases are consensual. *In re Specialty Equipment Companies Inc.*, 3 F.3d 1043 (7<sup>th</sup> Cir. 1993). In *Specialty Equipment*, appellants raised jurisdictional challenge arguing that §524(e) precludes approval of plan releasing nondebtor third parties from liability. The court held that the plan was substantially consummated so the appeal was moot. However, on the merits, the court noted that “a bankruptcy court does have the power to determine the legality of provisions, including releases, incorporated into a reorganization plan. In fact, appellants are not so much challenging the bankruptcy court’s subject matter jurisdiction, which is quite broad under §105(a), as they are the legitimacy of the releases included in the plan. Appellants seem to be arguing for a much broader reading of §524(e), one that would effectively preclude a reorganization plan from granting releases to any party other than the debtor. But §524(e) provides only that a discharge does not affect the liability of third parties. This language does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party. While a third-party release may be unwarranted in some circumstances, a *per se* rule disfavoring all releases in a plan would be similarly unwarranted, if not a misreading of the statute. Accordingly, courts have found releases that are consensual and noncoercive to be in accord with the strictures of the Bankruptcy Code.” (citing *AOV Industries*, 792 F.2d at 1145; *In re Monroe Well Serv. Inc.*, 80 B.R. 324 (Bankr. E.D. Pa. 1987)). Unlike the injunction created by the discharge of a debt, a consensual release does not inevitably bind individual creditors. It binds only those creditors voting in favor of the plan of reorganization.
- Eighth Circuit. Applies five-factor test. *In re Master Mortgage Investment Fund, Inc.* 168 B.R. 930 (Bankr. W.D. Mo. 1994).

Court noted that §524(e), on its face, does not restrict a bankruptcy court's power to issue a permanent injunction. Then the court notes that five factors are typically considered: (1) identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) the nondebtor has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization; (4) a substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has "overwhelmingly" voted to accept the proposed plan treatment; and (5) the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction. Court also notes that "these factors do not appear to be an exclusive list of considerations, nor are they a list of conjunctive requirements." *See also In re Chiles Power Supply Co.*, 264 B.R. 533 (Bankr. W.D. Mo. 2001) (issues permanent channeling injunction on third-party products claims pursuant to §105).

- Eleventh Circuit. For a debtor to confirm a plan containing a nondebtor release, the debtor must demonstrate that *unusual circumstances* exist, and that the nondebtor release is *fair and necessary*, utilizing those *Dow Corning* factors that are applicable. A case-by-case analysis is required. Allowing the nondebtor release is the exception, not the norm. *In re Transit Group Inc.*, 286 B.R. 811 (Bankr. M.D. Fla. 2002). *See also In re Munford Inc.*, 97 F.3d 449 (11<sup>th</sup> Cir. 1996) (approving third-party nondebtor releases in a settlement agreement in a related adversary proceeding).
5. **The D.C. Circuit does not address directly this issue of whether a bankruptcy court has the authority to permit third-party nondebtor releases or permanent injunctions in a reorganization plan under chapter 11. However, this court specifically aligns itself with the pro-release courts.** *In re AOV Indus. Inc.*, 792 F.2d 1140 (C.A.D.C. 1986) (affirming confirmation of a plan of reorganization, noting that the district court held that the plan's releases did not constitute an impermissible discharge of nonpetitioning third parties, contrary to §524(e), rendering appellants' challenge to confirmation of the plan moot).
6. **The Fifth Circuit has approved of the issuance of third-party injunctions, but only in the case of temporary injunctions.**
- Rationale: jurisdiction should extend only to temporary injunctions, not permanent injunctions because permanent injunctions are outside the jurisdiction -- claims will have no effect on the estate after confirmation of the plan. Confirmation of a plan and close of a case will mean that the nexus between the related claim and bankruptcy

estate no longer exists. See *SAS Overseas Consultants v. Benoit*, 2000 WL 140611 (E.D. La Feb. 7, 2000) (“A bankruptcy court has broader authority under §105 to grant a stay than it does under the automatic stay provisions of section 362, and may use its equitable powers to ensure the orderly resolution of reorganization proceedings.”). The *Benoit* court also noted that “[t]he Fifth Circuit has held that a court may temporarily enjoin actions against a nondebtor under ‘unusual circumstances.’” (citing *In re Zale Corp.*, 62 F.3d 746, 761 (5<sup>th</sup> Cir. 1995)). Stays under §105(a) are also subject to the usual rules for the issuance of an injunction under Fed. Rule of Civ.P. 65. Accordingly, the court must examine whether both “unusual circumstances” and the prerequisites to issuance of an injunction exist so as to stay litigation temporarily.

- Under *Zale*, “unusual circumstances” exist if (1) the debtor and nondebtor enjoy an identity of interests that the suit against the nondebtor is essentially a suit against the debtor, and (2) when the third-party action will have an adverse impact on the debtor’s ability to accomplish reorganization. Test is disjunctive and an injunction may be warranted under either set of circumstances. *Zale* court also distinguished cases in which permanent injunctions were issued. The *Zale* court reasoned that the courts upheld permanent injunctions of third-party claims because while the injunction permanently enjoined lawsuits, it also channeled those claims to allow recovery from separate assets and thereby avoiding discharging the nondebtor (citing *SEC v. Drexel Burnham Lambert Group Inc. (In re Drexel Burnham Lambert Group Inc.)*, 960 F.2d 285, 293 (2d Cir. 1992); *In re MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 94 (2d Cir. 1988) (holding injunction didn’t discharge creditor because third-party interest could be asserted against settlement fund)).
- *Zale* appears to leave open the possibility of the issuance of a permanent injunction under §105 if a settlement trust is created from which claims could be paid in full.

**7. The Ninth and Tenth Circuits have also not allowed permanent third-party releases under a plan pursuant to §105(a) (with the exception of a lower court in the Ninth Circuit in an asbestos-related case).**

- Ninth Circuit. Relies on §524(e) as the reason to disallow injunctive relief under §105(a). *In re Lowenschuss*, 67 F.3d 1394 (9<sup>th</sup> Cir. 1995). The *Lowenschuss* court held that §524 does not provide for the release of third parties from liability; §524(e) specifically states that “discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.” Thus, §524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors. *But see In re*

*Western Asbestos Co.*, Case Nos. 02-46284, Mem. Of Decision After Conf. Hrg., filed Feb. 3, 2004 (Bankr. N.D. Calif.). Court found it has jurisdiction over third-party claims under §1334(b) and concluded the injunctions should issue as to third-party nondebtors (including insurers) pursuant to §524(g). However, one of the debtors didn't qualify for §524(g) relief (no assets), so the court analyzed whether it and the others who were eligible for §524(g) relief, including nondebtors, would also be eligible under §105. The court said that it had the power to grant the relief if it determined it was "necessary or appropriate to do so." The court determined that even to the extent duplicative, it was "appropriate" since §524(g) is relatively new and untested. The court held that based on substantial contributions, risks regarding settling insurers terminating their settlements, the fact that holders of claims who would be affected have voted in favor of plan by substantial majority, §105(a) permitted the court to issue such orders as are either necessary or appropriate to render its more explicitly prescribed powers effective and the issuance of an injunction under 11 U.S.C. §105(a) protecting the debtors, the settling insurers, and related parties from the future prosecution of asbestos related claims is either 'necessary' or 'appropriate.'" It further held that the scope of the §105(a) injunctions would be no broader than the scope of the §524(g) injunctions. The district court affirmed the bankruptcy court on April 16, 2004, finding specifically that "each of the criteria under the Bankruptcy Code for confirmation of the plan and for issuance and entry of the injunctions set forth in the confirmation order have been satisfied." *In re Western Asbestos Co.*, No. 3:03-CV-00989, 2004 WL 1944792 (N.D. Calif. Apr. 16, 2004).

- Tenth Circuit. Allows temporary injunctive relief, but not permanent. *In re Western Real Estate Fund Inc.*, 922 F.3d 592 (10<sup>th</sup> Cir. 1990). The *Western* court held that a temporary restraining order against debtor's former attorney's pursuit of settlement funds subject to indemnification by debtor might be warranted during pendency of case, but injunctive relief should not extend to litigation over sums for which settling party might look for reimbursement to nondebtor mortgagee of debtor's damaged property that had shared in settlement. Permanent injunction precluding debtor's former attorney's attempt to recover unpaid portion of his fee from settling party would be improper. While temporary stay prohibiting creditor's suit against nondebtor during bankruptcy proceeding may be permissible to facilitate reorganization process in accord with broad approach to nondebtor stays, stay may not be extended postconfirmation in form of permanent injunction effectively relieving nondebtor from its own liability to creditor.

8. Of the courts that are pro-release, all agree that §105(a) can only be exercised within the confines of the Bankruptcy Code. It does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute “a roving commission to do equity.” *In re Dairy Mart Convenience Stores Inc.*, 351 F.3d 86, 92 (2d Cir. 2003) (quoting *United States v. Sutton*, 786 F.2d 1305, 1308 (5<sup>th</sup> Cir. 1986)).
9. Furthermore, in the asbestos context, no courts dispute the relief available for third parties under §524(g) of the Bankruptcy Code, however, the courts have held that §105(a) cannot be invoked to afford relief that goes beyond the scope of §524(g).
  - See *In re Western Asbestos Co.*, Case Nos. 02-46284, Mem. Of Decision After Conf. Hrg., filed Feb. 3, 2004 (Bankr. N.D. Calif.) (discussed above).
  - See also *In re Combustion Engineering Inc.*, 391 F.3d 190 (3d Cir. 2005). In *Combustion*, as discussed above, the court held that the lower courts did not make the requisite findings respecting shared insurance in order for the Third Circuit to determine whether related-to jurisdiction existed in order to grant §105(a) injunctive relief over nondebtor, nonderivative claims. However, the Third Circuit did not remand on this issue because it determined that §105(a) does not permit the extension of a channeling injunction to nonderivative claims of nondebtors in any event. The court observed that §524(g) would not cover these nonderivative nondebtors by nature of the express Bankruptcy Code language -- *i.e.*, such claims would violate the requirements of §524(g)(4)(A). The court held that §105 can only go as far as §524(g) and no further: “[a]lthough the bankruptcy court has broad equitable authority to craft remedies necessary to facilitate the reorganization of a debtor, this power is cabined by the Code.” The court also noted: “[w]hatever may be the limits of §105(a) in other contexts, we hold only that §105(a) cannot be used to achieve a result not contemplated by the more specific provisions of §524(g), which is the means Congress prescribed for channeling the asbestos liability of a nondebtor.”