Plan Issues

Concurrent Session

Hon. Joel B. Rosenthal (Ret.)
U.S. Bankruptcy Court (D. Mass.); Worcester

Eric A. Henzy
Reid and Riege PC; Hartford, Conn.

Harold B. Murphy
Murphy & King, PC; Boston

Deryck A. Palmer
Cadwalader, Wickersham & Taft LLP
New York

George W. Shuster, Jr.
WilmerHale; Boston

American Bankruptcy Institute

DISCOVER VOLO
volo.abi.org

Access circuit court opinion summaries

From the courts to you within 24 hours!

With Volo:

- **Receive case summaries and view full decisions**
- **Automatically have opinions in your circuit delivered**
- **Search by circuit, case name or topic**
- **Access it FREE as an ABI member**

Be the first to know with Volo
volo.abi.org

44 Canal Center Plaza • Suite 400 • Alexandria, VA 22314-1546 • phone: 703.739.0800 • abi.org

Join our networks to expand yours:

© 2011 American Bankruptcy Institute. All Rights Reserved.

Chapter 11 Plan Issues

Plan Sales versus Section 363 Sales: Pros and Cons

George W. Shuster, Jr. & Katelyn H. Rood

WILMERHALE

Much has been written about a recent trend in favor of fast-track bankruptcy liquidations through Section 363 sales, and about a possible counter-trend in favor of Chapter 11 plans of reorganization, which may also call for asset sales under Section 363 or under Section 1123(a)(5). The following pages attempt to capture, at a very high level, some of the considerations that may affect whether a debtor or a buyer might prefer to sell or purchase assets in bankruptcy through a non-plan Section 363 sale (a "363 Sale"), on the one hand, or through a plan sale (a "Plan Sale"), on the other hand.

1. Timing & Cost. Beginning with the somewhat obvious, by opting to pursue a 363 Sale instead of a Plan Sale, both the debtor and the potential purchaser may benefit from a shorter timeline, and possibly an earlier and greater sense of finality. A 363 Sale can occur as early as 21 days after the order approving the notice of sale is entered,[1] although usually the period is roughly double that, because of a preceding period in which sale bidding procedures are proposed and approved. A Plan Sale, by contrast, generally occurs after a disclosure statement hearing, solicitation process, confirmation hearing, and plan effective date, a process that can take substantially longer than a 363 Sale process.[2] But the comparison of these periods—21 to 42 days versus 56 days—is misleading, because a Plan Sale must also be preceded by the proposal of a Chapter 11 plan of reorganization, which can take time to develop. It may be the

[1] Fed. R. Bankr. Pro. 2002(a)(2). This presumes a waiver of the 14-day stay under Fed. R. Bankr. Pro. 6004(h), which waiver is customary.
[2] Fed. R. Bankr. Pro. 2002(b) provides for 28 days' notice of the disclosure statement hearing, and a further 28 days' notice of the confirmation hearing.

case that a buyer willing to endure the timing of a 363 Sale will not remain on the hook for the duration of a Chapter 11 plan confirmation process. Of course, in part because of the potentially more truncated schedule, a 363 Sale can involve transactional costs that are far less than the costs of a Plan Sale and related elements of the plan confirmation process.

2. Finality. Customarily, substantial comfort was also taken in the finality of a 363 Sale, based on the language of Section 363(m). However, some recent case law questions whether a sale order may be interpreted in a manner adverse to a purchaser by a non-bankruptcy court, diminishing the purchaser's sense of certainty,[3] or whether a court may find that specific provisions of an order approving the 363 Sale are not subject to the general mootness rule found in Section 363(m).[4] For these reasons, the perceived greater and quicker finality of a 363 Sale, as contrasted with a Plan Sale, may not, in fact, be a substantial advantage of a 363 Sale.

3. Consent. Depending on the circumstances, it may be possible to consummate a 363 Sale without the consent of any creditor or creditor class, or, for that matter, any other constituency. While the consent of a holder of an interest in the assets to be sold is one possible method of meeting the requirements for a sale "free and clear" of that interest, under Section 363(f)(2), there may be alternative methods available within Section 363(f) that require no consent. Conversely, the confirmation of a Chapter 11 plan of reorganization requires both the

[3] In a recent Eighth Circuit decision, the circuit court allowed a state court to interpret a bankruptcy court's Section 363 sale order and hold that the sale order had not sold the property free and clear of an implied covenant. *Mid-City Bank v. Skyline Woods Homeowners Association (In re Skyline Woods Country Club)*, 2011 WL 589912 (8th Cir. 2011).

[4] In a 2008 Ninth Circuit Bankruptcy Appellate Panel decision, the court held that an aggrieved junior lienholder could challenge the effect of the "free and clear" provisions of a sale order, notwithstanding Section 363(m), because a challenge to the "free and clear" provisions was not an attack on the sale order itself. *Clear Channel Outdoor, Inc. v. Knupfer*, 391 B.R. 25 (B.A.P. 9th Cir. 2008).

consent of at least one class of creditors and the satisfaction of the absolute priority rule for any impaired non-consenting class.[5]

Yet this distinction alone does not create the full picture; in some instances, it may be easier to satisfy the absolute priority rule as to an objecting secured creditor than to satisfy an element of Section 363(f) with respect to that secured creditor's interest. The *Clear Channel* decision cited above exemplifies the potential difficulty in satisfying the other Section 363(f) elements when an interest-holder's consent is not forthcoming. In addition, where there are multiple secured creditors or multiple tranches of secured creditors, the Chapter 11 class voting mechanics, as well as potential "cram-down" solutions, may increase the possibility of forcing a sale over the consent of a dissenting secured party.

4. Gifting. 363 Sales may be more flexible than Plan Sales with respect to "gifting" by senior creditors to junior classes. Under a Plan Sale, the absolute priority rule will certainly apply, and may prevent a junior class from receiving any property under the Chapter 11 plan on account of its junior claims or interests, if a senior dissenting class has not received the full value of its claim.[6] Under 363 Sales consummated outside of a Chapter 11 plan—and most clearly for 363 Sales consummated in Chapter 7 cases—the absolute priority rule does not as certainly apply, making gifting more possible.[7]

However, the apparent bright line on "gifting" between 363 Sales and Plan Sales may not be so bright after all. Courts have questioned whether the absolute priority rule should be applied, directly or by analogy, in settlements and other transactions that are not, technically, part

[5] 11 U.S.C. § 1129(a)(7) (2011); 11 U.S.C. § 1129(b)(2) (2011).
[6] 11 U.S.C. § 1129(b)(2) (2011). *See, e.g., In re DBSD North America, Inc.*, 2011 WL 350480 (2d Cir. 2011).
[7] *See, e.g., In re SPM Manufacturing Corporation*, 984 F.2d 1305 (1st Cir. 1993).

of a Chapter 11 plan.[8] It seems possible that, in a Chapter 11 case, a pre-plan 363 Sale may not avoid the hurdle of the absolute priority rule, and could impose the burdens both of that rule and of the Section 363(f) requirements.

5. "Free and Clear" Section 363 Order versus Discharge. While some asset transfers in bankruptcy are made to third-party purchasers, others are made to newly-created entities as part of the overall reorganization strategy. For example, in the recent Chapter 11 case of Workflow Management,[9] substantially all of the debtors' assets were "sold" in a 363 Sale, consummated through a Chapter 11 plan, to a newly-created entity, the equity in which was distributed to former creditors and equity holders under the Chapter 11 plan's terms. Why weren't the debtors' assets simply "vested" in the "reorganized debtors" as might be more customary? Because there was a concern that only through a 363 Sale could legacy pension obligations be separated from the operating assets.

In situations where assets are vested the reorganized debtor, reliance is sometimes placed on the Chapter 11 plan's "discharge" of prepetition claims.[10] But in some recent decisions, courts have interpreted the term "claim" more narrowly than bankruptcy practitioners might expect, resulting in the non-dischargeability of certain obligations of the debtor.[11] "Interests," in a 363 Sale, as contrasted with "claims" in a plan discharge, have been interpreted broadly by courts in other recent decisions.[12] This difference in recent approaches—narrow discharge of claims and sales free and clear of broad interests—may suggest that a "free and clear" order may

[8] *See, e.g., In re Iridium Operating, LLC*, 478 F.3d 452 (2d Cir. 2007).
[9] Lead Case No. 10-74617(SCS) (Bankr. E.D, Va.).
[10] 11 U.S.C. § 1141(d)(1)(A) (2011).
[11] *See In re Mark IV Industries*, 438 B.R. 460 (Bankr. S.D.N.Y. 2010).
[12] *See, e.g. In re Trans World Airlines, Inc.*, 322 F.3d 283, 288-91 (3d Cir. 2003) and *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009).

indeed give debtors, and potential purchasers in *Workflow*-like sales, more relief than a "discharge" of claims.

6. Credit Bidding. A more recent development in the Third Circuit has made Plan Sales that are decidedly not 363 Sales—that are consummated instead under the authority of Section 1123(a)(5)—potentially less favorable to secured creditors.[13] The Third Circuit recently held that there is no statutory right of a secured party to "credit bid" its secured claim for the purchase of collateral in a Section 1123(a)(5) Plan Sale, because the statutory right to credit bid appears only in Section 363(k). Because credit bidding can sometimes deter cash buyers from making competing bids as 363 Sales, and can sometimes allow secured creditors great leverage in the sale process, this development provides alternate buyers and some debtors with a potential reason to pursue a Plan Sale—at least in the Third Circuit.

7. Transfer Taxes. A now well-known distinction between 363 Sales outside the Chapter 11 plan context and Plan Sales is the qualification of the latter for the exemption from transfer taxes pursuant to Section 1146(a). While older case law was more flexible on the point, a 2008 Supreme Court decision ensured that only sales consummated in connection with a confirmed Chapter 11 plan would qualify for the exemption.[14] Because transfer taxes might be viewed as a "transaction cost," one might weigh the additional time and expense of a Plan Sale if the driving factor in pursuing a Plan Sale is the avoidance of transfer taxes—on a net basis, a 363 Sale outside of a plan could be less expensive.

8. "All-In" Resolution of the Estate. Of course, a Chapter 11 plan is a method for resolution of all claims against and interests in the estate, where a 363 Sale only provides sale

[13] *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 302 n.4, 320–21 (3d Cir. 2010).
[14] *Fla. Dept. of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33 (2008).

proceeds for later disposition (and, potentially, dispute). When a sale is tied to a Chapter 11 plan, asset sale proceeds can be realized and distributed as part of the same process. This could be a positive or a negative aspect of a Plan Sale. On the one hand, it may be better to realize asset value first, when it is perhaps worth most, and allow parties in interest to take their time in negotiating or litigating their respective interests in the resulting cash. On the other hand, time may not be of the essence for the sale, and it may be easier to reach an agreed Chapter 11 plan if the sale process is occurring simultaneously. The latter situation has been the case in the Innkeepers USA Trust Chapter 11 case, where 363 Sale bids were required to be accompanied by proposed Chapter 11 plans, with the bidders also becoming plan proponents.[15]

9. Releases and Exculpations. Finally, there may be ancillary benefits of a Chapter 11 plan that make it a worthwhile process for consummating a sale, as compared to a 363 Sale that may be followed by a conversion of the case to Chapter 7. For example, the releases and exculpations that may be available under a Chapter 11 plan, for principals, advisors, and others, may be an incentive to pursue the plan process. It should not be assumed, of course, that broad releases and exculpations will be available—courts in some recent decisions have been hesitant to grant releases, and it would be a disappointment to pursue a Plan Sale, rather than a 363 Sale, for the purpose of obtaining releases and exculpations that ultimately prove unavailable.

[15] Lead Case No. 10-13800 (SCC) (Bankr. S.D.N.Y.).

Chapter 11 Plan Issues

Cramdown Interest Rates

Harold B. Murphy and John C. Elstad

MURPHY & KING, Professional Corporation

Cramdown.

A plan of reorganization can be confirmed notwithstanding non-acceptance of a plan by a secured creditor (a "cramdown") if the plan treatment for the secured creditor's claim is "fair and equitable." Pursuant to the Bankruptcy Code provision most commonly utilized in cramdown plans, plan treatment is fair and equitable if it provides that the secured creditor retains its liens on its collateral and receives deferred cash payments which total at least the allowed amount of the claim and which have a present value equal to the value of the creditor's interest in the collateral.[1] 11 U.S.C. §1129(b)(2)(A)(i).[2] The interest rate necessary to ensure that a stream of deferred cash payments has a value equal to the allowed secured claim is the "cramdown interest rate."

[1] Plan treatment of a secured creditor's claim can also be fair and equitable if (i) it provides for the sale of the secured creditor's collateral and for the creditor's liens to attach to the proceeds of such sale or (ii) it provides for the secured creditor to realize the "indubitable equivalent" of its secured claim.

[2] Section 1129(b)(2)(A) provides that a plan is fair and equitable:

> With respect to a class of secured claims, [if] the plan provides –
> (i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that the holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
> (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
> (iii) for the realization by such holders of the indubitable equivalent of such claims.

Prior Approaches to Selecting the Cramdown Interest Rate.

Prior to *Till v. SCS Credit Corp*., 541 U.S. 465 (2004), courts adopted four general approaches to determining cramdown interest rates: (i) the coerced loan approach – the rate the creditor could obtain if it were permitted to foreclose and reinvest the proceeds in an equivalent loan; (ii) the presumptive contract rate approach – utilizing the prepetition contract rate of interest but adjusting it up or down depending on the circumstances of the case; (iii) the cost of funds rate – the rate necessary to compensate the lender for its costs of capital; or (iv) the formula approach – beginning with the national prime rate and adjusting it upwards to account for the risk of non-payment. *Id*. at 477-79.

Supreme Court Adopts the Formula Approach.

In *Till*, the Supreme Court ruled on the approach to be taken in Chapter 13 cases for determining the cramdown interest rate. The Chapter 13 Debtors had proposed a 9.5% cramdown interest rate in their plan as treatment for a $4,000 secured claim on a used truck the debtors had purchased a year prior to the bankruptcy. The debtors relied on the formula approach, adding a risk factor of 1.5% to the then prevailing national prime rate of 8%. The secured creditor argued that 21% was the appropriate interest rate because it would receive that return if it were permitted to foreclose and reinvest the proceeds in a new loan of similar duration and risk – the coerced loan approach. *Id*. at 470-71.

The bankruptcy court approved the debtors' plan, but on appeal, the district court reversed, holding that applicable Seventh Circuit precedent required cramdown interest rates to be set according to the coerced loan method which interest rate, pursuant to the unrebutted testimony presented by the secured creditor, was 21%. On further appeal, the Seventh Circuit endorsed the result in the district court but on a modified basis, holding that cramdown interest

rates should be set at the pre-bankruptcy contract rate as adjusted for any changed circumstances – the presumptive contract rate approach – which contract rate happened to be 21%. Interestingly, 21% was the maximum interest rate that could be charged on consumer loans under applicable Illinois usury laws. *Id.* at 472-73.

A four justice plurality of the Supreme Court upheld the result in the bankruptcy court, adopting the formula approach for determining the cramdown interest rate, because each of the other three approaches were "complicated, impose[d] significant evidentiary costs, and aim[ed] to make each individual creditor whole rather than to ensure the debtor's payments have the required present value." *Id*. at 477. Justice Thomas concurred in the result, but wrote separately. Justice Thomas took the position that the plain meaning of the statute required that the creditor be compensated only for the delay in payment and not for the risk of default, implying that cramdown interest rates should be set at a risk free rate, such as the prime rate, and no more. Four other justices dissented, taking the position that the presumptive contract rate approach was the appropriate method for determining cramdown interest rates. Significantly, the plurality plus Justice Thomas, a five justice majority, agreed that the coerced loan and presumptive contract rate approaches place improper emphasis on ensuring that the creditor is made whole rather than on ensuring that the creditor realizes the present value of its allowed secured claim.

***Till's* Application to Chapter 11.**

The Chapter 11 cramdown provision is effectively the same as the statutory provision interpreted by the Supreme Court in *Till* under Chapter 13. *Compare* §1129(b)(2)(A)(i)(II) ("that the holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, *of a value, as of the effective date of the plan*, of at least the value of such holder's interest in the estate's interest in such property") (emphasis

added) *with* §1325(a)(5)(B)(ii) ("*the value, as of the effective date of the plan*, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim") (emphasis added). The Supreme Court itself strongly implied that a common approach should be used to determine cramdown interest rates in Chapter 11, 12 and 13 cases. *Id*. at 474. ("We think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these [cramdown] provisions.").[3] Indeed, given the similarity of the statutory provisions, the Supreme Court's comment as to Congressional intent seems well-founded.

Footnote 14 Introduces Ambiguity.

In the now famous Footnote 14, the Supreme Court added, in *dicta*, a comment that has since caused uncertainty as to the method to be employed in the determination of Chapter 11 cramdown interest rates.

> This fact [the fact that a creditor forced to accept a loan with a cramdown interest rate would prefer instead to foreclose] helps to explain why there is no readily apparent Chapter 13 "cram down market rate of interest": Because every cramdown loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cramdown lenders. Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. . . . Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.

Id. at 477 n.14.

Of course, there is no more of a free market of willing cramdown lenders in Chapter 11 cases than there is in Chapter 13 cases. Every cramdown loan is imposed by the court over the objection of the secured creditor in Chapter 11 just as it is in Chapter 13. The very concept of a

[3] The same "value as of the effective date of the plan" language appears in 14 places in the Bankruptcy Code. *See* §§1129(a)(7)(A)(ii), 1129(a)(7)(B), 1129(a)(9)(B)(i), 1129(a)(9)(C), 1129(b)(2)(A)(i)(II), 1129(b)(2)(B)(i), 1129(b)(2)(C)(i), 1173(a)(2), 1225(a)(4), 1225(a)(5)(B)(ii), 1228(b)(2), 1325(a)(4), 1325(a)(5)(B)(ii), 1328(b)(2).

free market of willing cramdown lenders is difficult to grasp – a free market implies a willing buyer and a willing seller in the absence of coercion. In contrast, cramdown is predicated on coercion. The lenders referenced in Footnote 14 may be voluntary providers of debtor-in-possession financing at the outset of bankruptcy cases who willingly provide such financing on a priming basis and negotiate the applicable interest rate with the Chapter 11 debtor, constrained only by competition from other lenders. *See In re North Valley Mall, LLC*, 2010 WL 2632017 at *3 (Bankr C.D. Cal. June 21, 2010) ("Markets by definition imply a willing buyer and a willing seller. But by definition cramdown implies an unwilling seller who is compelled by the court to make a loan to the debtor under the plan."); *see also* COLLIER ON BANKRUPTCY ¶1129.05[2][c] ("[T]he relevant market for involuntary loans in chapter 11 may be just as illusory as in chapter 13."); AM. BANKR. INST. J., July-Aug. 2004 at 10 ("There is no more of a 'free market of willing cramdown lenders' in a chapter 11 (or a chapter 12, for that matter) than in a chapter 13."). Since *Till*, courts in Chapter 11 cases have struggled with whether and how to extend to Chapter 11 cases *Till's* adoption of the formula approach to cramdown interest rates in Chapter 13 cases.

Efficient Market.

Post-*Till*, some courts have adopted a two step approach first expressed by the Sixth Circuit. When picking a cramdown rate, "the market rate should be applied in Chapter 11 cases where there exists an efficient market. But where no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the *Till* plurality." *In re American Home Patient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2006); *see also In re 20 Bayard Views, LLC*, 445 B.R. 83, 108-09 (Bankr. E.D.N.Y. 2011) (utilizing the Sixth Circuit's two step analysis and observing that many courts outside the Second Circuit have also adopted this two step analysis.)

Neither *Till* nor *American Home Patient* provide any guidance on how to ascertain whether there is an efficient market. *In re Brice Road Developments, L.L.C.*, 392 B.R. 274, 280 (6th Cir. B.A.P. 2008). The Bankruptcy Appellate Panel in *Brice Road* has succinctly laid out objective factors that should be considered. First and foremost, the court should determine whether there exists an open, well-developed market for a loan of the kind between the debtor and the secured creditor. The characteristics of the cramdown loan to be taken into account are (i) the priority of the lien securing the loan, (ii) the type of collateral involved, (iii) the quality, age, and life expectancy of the collateral, (iv) the short or long term nature of the proposed term of the loan, and (v) the amount financed. *Brice Road*, 392 B.R. at 279.

To determine if there is an efficient market for a cramdown loan, courts rely on expert evidence. *Bayard Views*, 445 B.R. at 109. Evidence of actual loan offers, of course, is also probative. *In re Deep River Warehouse, Inc.*, 2005 WL 2319201 at *12 (Bankr. M.D.N.C. September 22, 2005) ("[A]n actual loan commitment is 'proof of the pudding' as to the applicable market rate of interest."). However, a debtor is not required to seek such financing and may instead rely on expert testimony. *SPCP Group*, 434 B.R. at 658 ("[T]his Court finds no absolute mandate that a Chapter 11 debtor must attempt to find exit financing before the bankruptcy court can determine whether an efficient market exists.").

Several courts have been able to settle on an efficient market cramdown rate based on actual exit financing proposals made to the debtor. In *In re Winn-Dixie Stores, Inc.*, the debtors sought exit financing in the amount of $720 million secured by all their assets and received 14 proposals. 356 B.R. 239, 255-56 (Bankr. M.D. Fla. 2006). The result was an interest rate of LIBOR plus 1.5%. The court determined that there was an efficient market and the resulting effective rate (7%) should be applied as the cramdown interest rate for a secured tax claim. *Id.* at

256; *see also Deep River Warehouse*, 2005 WL 2319201 at *12 (settling on cramdown interest rate of 5.75% based on quote from bank).

Other courts have relied on expert testimony to determine whether an efficient market exists for the sort of cramdown loan proposed in the plan. In *Brice Road*, the plan proponents and the secured creditor agreed that there was an efficient market, but disagreed as to what the efficient market rate should be. The plan proponents' experts testified that first mortgage financing on multi-family housing including through HUD programs for a partially completed 264 unit apartment complex with 40 year amortization and a balloon payment after 35 years would be between 5.5% and 6.25% or, alternatively, at the 10-year Treasury bond rate of 5.0% plus a 1.0% spread. *Id.* at 281. The secured creditor's expert testified that the market rate would be based on tiered financing which would produce a composite rate of 8.0%. The BAP rejected the secured creditor's proposed cramdown interest rate based on tiered financing as not reflective of the actual loan proposed in the plan and affirmed the bankruptcy court's selection of a 6% cramdown rate. *Id*.

In *In re SJT Ventures, LLC*, the debtor asserted that there was an efficient market for oversecured commercial real estate lending and the efficient market rate should be applied as the cramdown rate. 2010 WL 3342206 at *2 (Bankr. N.D. Tex. August 25, 2010). The secured creditor asserted that the prepetition contract rate of 8.69% should be the cramdown rate. *Id*. The court rejected the secured creditor's presumptive contract rate argument. The court approved a cramdown interest rate of 6.35% based on testimony that the standard spread for an approximately $1.9 million loan with 30–year amortization, a 5-year balloon payment and a 65-70% loan to value ratio would 3.0% over the 1.85% interest rate on the 5-year T-Bill plus an

additional 1.5% because of the higher loan to value ratio (82%) in the debtor's case. *Id*. at 2010 WL 3342206 *2, *6-7.

In *In re TCI 2 Holdings, LLC*, the experts agreed that there was an efficient market for a proposed cramdown loan to the Trump casinos represented by the debt issuances of other comparable gaming companies. 428 B.R. 117, 163-66 (Bankr. D.N.J. 2010). The court analyzed the degree to which the other gaming companies selected by the various experts were truly comparable to the debtor and ultimately selected a cramdown interest rate of 12%, the high end of the range testified to by one of the experts. *Id*. at 166.

Efficient Market Often Not Found.

More often than not, courts have determined that an efficient market does not exist and have therefore relied on *Till's* formula approach. *See, e.g., In re SPCP Group*, *LLC*, 434 B.R. 650, 659-60 (M.D. Fla. 2010) (finding no efficient market exists and selecting a 5.25% cramdown rate based on the 3.25% prime rate plus a 2% risk factor for a $5.5 million claim amortized over 20 years with a 6 year balloon secured against an assisted living facility); *In re G-I Holdings Inc.*, 420 B.R. 216, 267 (D.N.J. 2009) (finding no efficient market exists and approving a cramdown interest rate of LIBOR plus 1% for a priority tax claim pursuant to §1129(a)(9)(C)); *Red Mountain Machinery Co.*, 2011 WL 1428266 at *14 n.19 (Bankr. D. Ariz. April 14, 2011) (parties stipulate as to absence of an efficient market; court approved a cramdown interest rate of 6.5% based on prime rate of 3.25% and a risk adjustment of 3.25% for a $10 million secured claim amortized over 20 years with a 15 year balloon secured by heavy earth moving equipment); *Bayard Views*, 445 B.R. at 110-11 (finding no efficient market exists for 62 unit residential condominium complex in Brooklyn, New York); *In re Denham Homes, LLC*, 2010 WL 6634883 at *16 (Bankr. N.D. Ill. Dec. 27, 2010) (finding no efficient market

exists and approving a cramdown interest rate of prime less 0.25% for a $5.4 million claim secured by an unfinished subdivision); *In re Industry West Commerce Center, LLC*, 2010 WL 3276918 at *1 (Bankr. N.D. Cal. August 13, 2010) (finding no efficient market exists and approving a cramdown interest rate of 4.95% based on the 3.25% prime rate plus 1.2% for the risk of an economic downturn plus 0.5% for the risk of declining lease revenue for a $16.5 million claim secured by an industrial warehouse facility); *In re South Canaan Cellular Investments, Inc.*, 427 B.R. 44, 77-78 (Bankr. E.D. Pa. 2010) (creditor failed to carry its burden that a higher market rate of interest should obtain; court approved a 6% cramdown rate based on a 2.75% risk premium over the 3.25% prime rate); *In re Griswold Building, LLC*, 420 B.R. 666, 693, 695 (Bankr. E.D. Mich. 2009) (parties agreed there was no efficient market for downtown Detroit office building; court applied a 5.0% risk adjustment to the prime rate to arrive at a 8.25% cramdown rate); *In re Am. Trailer & Storage, Inc.*, 419 B.R. 412, 438-40 (Bankr. W.D. Mo. 2009) (no efficient market where only loan available would be from a "loan-to-own" or "hard money" lender; court applied a 2.25% risk premium to the prime rate to arrive at a cramdown rate of 5.5%).

Several courts have determined that a blended cramdown rate based on tiered financing is not reflective of a rate produced by an efficient market. In *American Home Patient*, the Sixth Circuit rejected the creditor's argument that the debtor could not obtain 100% financing in the market and therefore a composite rate of 12% based on first lien, mezzanine and equity financing was the efficient market rate. The Sixth Circuit reasoned that the loan contemplated in the debtor's plan was all senior financing and the court's role was not to provide the creditor with a new loan from the bankrupt but only to provide the creditor with the present value of its claim. *American Home Patient*, 420 F.3d at 568-69; *see also Brice Road*, 392 B.R. at 281 (rejecting

composite rate based on tiered financing as efficient market rate); *Bayard Views*, 445 B.R. at 110 (finding testimony that debtor could obtain financing for 100% of the debt on an unsold condominiums only through tiered financing helped establish that there was no efficient market for the loan proposed in the plan). *But see In re North Valley Mall, LLC*, 2010 WL 2632017 at *3-4 (Bankr C.D. Cal. June 21, 2010) (discussed below).

Even where a court is convinced that an efficient market exists, it can be difficult to identify an efficient market rate. In *In re East Prussia Associates*, there was a seller's market for hotels with financing readily available. 322 B.R. 572, 589 (Bankr. E.D. Pa. 2005). The secured creditor argued for a blended cramdown rate of 9.72% based on first lien and mezzanine financing while the debtor argued its proposed cramdown rate of 6.5% was at the high end of the interest rate market. The court was unable to reconcile the differing views of the experts and applied the *Till* formula approach. *Id*. at 590-91 (adding a risk factor of 1.5% to the then prevailing prime rate of 5.75% to arrive at a 7.25% cramdown rate for $19 million claim amortized over 25 years with a 7 year balloon secured against a 348 room hotel).

Applying *Till*'s Risk Adjustment Factor.

Under the *Till* formula approach, the cramdown interest rate may be determined by adding to the national prime rate an additional percentage factor to reflect the amount of risk associated with the loan at issue. In determining this risk factor, courts consider "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." *Till*, 541 U.S. at 479. For example, in *In re Mace*, the court found that risk was suitably accounted for because, regarding the circumstances of the estate and the nature of the security, the rental real estate collateral was almost fully occupied, well maintained and the debtor had never missed a payment. Also, there had been no challenge to the feasibility of the

plan and the secured creditor was adequately compensated for the longer than desired duration of the plan payments. *In re Mace*, 2011 WL 284435 at *2-3 (Bankr. M.D. Tenn. January 26, 2011).

In addition to the factors cited in *Till*, in determining the risk adjustment, a court may take into consideration the debt coverage ratio, the loan-to-value ratio and the quality of any guarantors. *Bayard Views*, 445 B.R. at 111 (citing *In re Griswold Bldg. LLC*, 420 B.R. 666, 693 (Bankr. E.D. Mich. 2009)). In *Bayard Views*, the 100% loan to value ratio, the lack of a reliable income stream to service the debt and the absence of any guarantors willing to back up the debtor's obligations were significant to the court's determination that the proposed risk adjustment in the plan was inadequate. *Bayard Views*, 445 B.R. at 112-13.

Also, the court may consider the spread of the prepetition contract rate of interest over a "risk-free" rate of interest such as the national prime rate in assessing the degree of risk associated with the subject collateral. In *Red Mountain Machinery Co.*, the court, although noting the Supreme Court in *Till* had rejected the presumptive contract rate approach, found the fact that the secured creditor's pre-bankruptcy interest rates ranged from a high of prime plus 1% to a low of prime plus 0.65% probative of the risk factors inherent in lending against the subject collateral. Because the secured creditor had been willing to lend against the subject collateral at 1% above prime prepetition, a cramdown interest rate of 3.25% above prime was sufficient to account for the risk associated with a 15-year balloon payment for a loan with 20-year amortization considering as well the substantial amortization that would occur before the balloon payment became due and the existence of guarantees. *Red Mountain Machinery*, 2011 WL 1428266 at *8 (Bankr. D. Ariz. April 14, 2011).

In considering the spread of the prepetition contract interest rate over the then-current risk-free rate, it can also be significant if the degree of risk associated with a loan to the debtor

has declined. *See Denham Homes*, 2010 WL 6634883 at *16-17 (Bankr. N.D. Ill. December 27, 2010) (where risk of non-payment for loan originally made to develop subdivision was significantly less at time of confirmation than when loan was made, court determined that reducing the cramdown interest rate to 0.25% below the prime rate would provide secured creditor with present value).

Other Approaches Adopted by Courts Post-*Till*.

There are some other cases that apply *Till* in unique ways or not at all. The following discussion of these cases, is intended to be representative and not exhaustive. For example, in *In re North Valley Mall, LLC*, the court purported to apply *Till*, but adopted a composite interest rate 8.5% for the cramdown interest rate for a shopping center loan based on tiered financing. 2010 WL 2632017 at *3-7 (Bankr. C.D. Cal. June 21, 2010). In doing so, however, the court in effect reverted to the coerced loan approach. *Id*. at *3 ("[T]he non-consenting creditor must receive a value under the plan not less than the value of its right to immediately foreclose upon its collateral.").

In *In re Good*, the court applied the contract default rate of 15% as the cramdown interest rate because the debtor was a solvent debtor. 413 B.R. 552, 560 (Bankr. E.D. Tex. 2009). The court appears to have misunderstood the distinction between award of postpetition interest to an oversecured creditor pursuant to Bankruptcy Code Section 506(b) and determination of the cramdown interest rate for application to deferred payments made after the effective date of a plan. *See Drive Financial Services, L.P. v. Jordan*, 521 F.3d 343, 350 (5th Cir. 2008) (prepetition contract rate of interest does not automatically apply post-confirmation); *SJT Ventures*, 2010 WL 3342206 at *3 (Bankr. N.D. Tex. August 25, 2010) (criticizing the reasoning in *Good*). On appeal, the district court upheld the bankruptcy court's decision in *Good* reasoning that *Till* was

not binding precedent in Chapter 11 cases. *Good v. RMR Investments, Inc.*, 428 B.R. 249, 255 (E.D. Tex. 2010).

In *In re DBSD North America, Inc.*, the court approved the 12.5% cramdown interest rate proposed in the plan. 419 B.R. 179, 209 (Bankr. S.D.N.Y. 2009). The court relied on evidence of market rates on similar loans and the prepetition contract rate of interest and found Till to be only "arguably relevant law, under Chapter 13 of the Bankruptcy Code." *Id.* The court reasoned that because the spread over the national prime rate for the interest rate proposed in the plan was greater than the spread for the prepetition contract, but the debtors were significantly less leveraged pursuant to the plan, the cramdown interest rate proposed in the plan was acceptable. *Id.* The court also noted that it was deciding the cramdown issue under the indubitable equivalent standard of Bankruptcy Code Section 1129(b)(2)(A)(iii) and not under Section 1129(b)(2)(A)(i). *Id.* Thus, *DBSD* may be distinguished because it was not decided with reference to the "value as of the effective date of the plan" language of Section 1129(b)(2)(A)(i)(II).

#597771

CADWALADER

Cadwalader, Wickersham & Taft LLP
www.cadwalader.com

Gifting Plans: Development and Limitations

American Bankruptcy Institute
North East Conference
Summer 2011

Deryck A. Palmer
Cadwalader, Wickersham & Taft, LLP

Unfair Discrimination and the Absolute Priority Rule

The subhead would go here, Arial 18 pt. black

- **Under 11 U.S.C. § 1129(b), if an impaired class rejects a plan, the court will confirm the plan if, with respect to each dissenting impaired class:**
  - **(i) the plan does not discriminate unfairly, and**
  - **(ii) it is fair and equitable (complies with the absolute priority rule).**
- **Unfair Discrimination (horizontal):**
  - **A class may not receive less than similarly situated (equal priority) creditors.**
  - **The Bankruptcy Code does not articulate when discrimination is fair, but under the majority view, discrimination is fair if: (i) it has a reasonable basis; (ii) it is necessary to consummate the plan; (iii) it is proposed in good faith; and (iv) its degree of discrimination is in direct proportion to its rationale.**
- **The Absolute Priority Rule (vertical):**
  - **If a dissenting creditor class does not receive 100% on its allowed claims, any junior class shall: (i) "not receive or retain . . . any property"; (ii) "under the plan"; (iii) "on account of such . . . junior interest".**

SPM: Birth of the Gifting Doctrine

- Citizens Savings Bank held a $9 million senior secured claim and liens on substantially all of the debtor's assets.
- Citizens and the Unsecured Creditors Committee entered into agreement whereby Citizens and the Committee would share in whatever proceeds they received from the debtor's reorganization or liquidation.
- After reorganization failed, the bankruptcy court granted Citizens' motion to appoint a receiver and sell the debtor's assets; the assets were sold for $5 million; the bankruptcy court granted Citizens stay relief; and the case was converted to chapter 7.
- Citizens and the Committee then filed a motion requesting the sale proceeds be distributed to Citizens, which was entitled to the entire amount. The motion also noted that after Citizens received the proceeds, it would share them with the Committee pursuant to their agreement.
- The Bankruptcy Court rejected the motion to the extent it recognized the sharing of the proceeds with the Committee, finding that the agreement effectuated a distribution of proceeds that violated the Bankruptcy Code's priority rules.
- The District Court affirmed.

SPM: First Circuit's Holding

- The First Circuit reversed the lower courts. See Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.), 984 F.2d 1305, 1312-19 (1st Cir. 1993)
  - The distribution scheme of 11 U.S.C. § 726 does not apply until all valid liens are satisfied. Here, the $5 million in proceeds belonged to Citizens, which held an undersecured, first priority interest, leaving nothing for the estate to distribute.
  - Creditors junior to Citizens but senior to general unsecured creditors lost nothing under the agreement, because they had no entitlement to a distribution.
  - Once the stay was lifted and the proceeds distributed to Citizens, those proceeds became Citizens' property, and not the estate's. The bankruptcy court would then have no control over how Citizens chose to disburse those proceeds, and nothing in the Bankruptcy Code prevented Citizens from turning over part of the proceeds to the unsecured creditors.
- Note: SPM was not a chapter 11 case involving a reorganization plan—the distribution mechanism occurred in chapter 7, outside of the plan process and without a chapter 7 trustee seeking to cover the costs of case administration.

The Development of Gifting after SPM

- Debtors and lenders began using SPM to effectuate "gifts" to junior creditor classes under the terms of chapter 11 plans.
- Bankruptcy courts approved these plans, greatly expanding the scope of SPM:
  - MCorp. Financial (S.D. Tex. 1993) (gifting from senior unsecured bondholders to junior bondholders)
  - Parke Imperial (Bankr. N.D. Ohio 1994) (gifting from senior secured creditor class to particular unsecured class)
  - Genesis Health Ventures (Bankr. D. Del. 2001) (gifting from senior secured creditors to old equity holders)
- Other courts rejected gifting attempts in the chapter 11 context:
  - Sentry (Bankr. S.D. Tex 2001) (gifting created impermissible unfair discrimination)
  - Snyders (Bankr. N.D. Ohio 2004) (same)

Armstrong: Rejection of Gifting From Unsecured Creditor Classes

- Proposed plan issued equity warrants in the reorganized debtor to an unsecured creditor class for automatic transfer to junior class of equity holders if a class of unsecured tort claimants rejected the plan.
  - An even greater expansion of SPM.
- The bankruptcy court recommended to the district court that the plan be confirmed, but the district court denied confirmation. The district court found that the issuance of new equity to the debtor's shareholder was a direct violation of the absolute priority rule and no exception to the rule applied.
- The Third Circuit affirmed the denial of confirmation. See In re Armstrong World Indus., Inc., 432 F. 3d 507, 509, 518 (3d Cir. 2005).

Armstrong: Rejection of Gifting From Unsecured Creditor Classes con't.

- Third Circuit held that the plain meaning of section 1129(b) "makes it clear that a plan cannot give property to junior claimants over the objection of a more senior class that is impaired . . . ."
- In addition, the Third Circuit rejected the application of SPM and its progeny because those cases involved carve outs from priority lien proceeds, while the plan at issue in Armstrong involved an automatic distribution of equity from an unsecured creditor class.
  - It was essentially a mechanism effectuating a distribution ahead of more senior creditor classes to equity holders that contributed no new value to the reorganized debtor—a result in complete contrast to the absolute priority rule.
- Armstrong shows how court have begun to push back on the use of SPM's logic in the chapter 11 plan context.
- Although the Third Circuit rejected the gifting mechanism in Armstrong, the decision is not viewed as a complete repudiation of SPM or gifting plans in general. See In re World Health Alternatives, Inc., 344 B.R. 291,297 (Bankr. D. Del. 2006) ("Armstrong distinguished, but did not disapprove of, a line of authority that approved [carve-outs from priority liens in favor of junior creditor classes]").

Iridium: The Effect of the Absolute Priority Rule on Pre-Plan Settlements

- Secured lenders and Unsecured Creditors Committee entered into a settlement prior to plan confirmation that would recognize the seniority of the lenders' liens and direct $37.5 million of the estate's cash into a litigation funding vehicle. Any of the $37.5 million remaining after the litigation would be distributed to the unsecured creditors (in deviation from the absolute priority rule).
- Both the bankruptcy and district courts approved the settlement.
- Second Circuit rejected SPM's application. See Motorola, Inc. v. Official Committee of Unsecured Creditors (In re Iridium Operating LLC), 478 F.3d 452, 460-61 (2d Cir. 2007).
  - Lenders' liens were contested and would only be allowed upon settlement approval, meaning that the cash was still estate property.
  - Second Circuit thus did not decide on whether SPM could apply to chapter 11 settlements.

Iridium: The Effect of the Absolute Priority Rule on Pre-Plan Settlements con't.

- Second Circuit held that deviations from the absolute priority rule are allowed in pre-plan settlements:
  - Section 1129(b) is inapplicable to the consideration of a settlement presented apart from a plan.
  - Courts must apply traditional Rule 9019 factors when considering whether to approve a pre-plan settlement.
  - "[W]hether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable' under Rule 9019."
  - Deviations from the Bankruptcy Code's priority scheme are allowed if: (i) the remaining factors weigh heavily in favor of approval; (ii) the proponents justify the deviation; and (iii) the court clearly articulates its reasons for approving the settlement.

DISH: Second Circuit Rejects Gifting as an Exception to the Absolute Priority Rule

- Under the proposed plan in DBSD (aka "DISH"), the pre-bankruptcy equity holder received a "gift" of equity in the reorganized entity from the second lien lenders, even though a dissenting unsecured creditor class did not receive full satisfaction of its claims. The holder of an unsecured claim objected to the plan, arguing that the plan violated the absolute priority rule.
- Bankruptcy court confirmed the plan and held that the plan did not violate the absolute priority rule because of the gifting doctrine (second lien lenders were undersecured and junior classes were otherwise out of the money and thus not harmed by the gift), and the district court affirmed.
- Second Circuit reversed on absolute priority grounds. See DISH Network Corp. v. DBSD N.A., Inc. (In re DBSD N.A., Inc.), 634 F.3d 79, 85, 93-101 (2d Cir. 2011).

DISH: Second Circuit's Absolute Priority Rule Holding

- Second Circuit found that the shareholder received equity (property) pursuant to the terms of the plan and on account of its junior interest.
  - Shareholder received equity in exchange for its old shares and to secure its continued assistance and support.
  - Shareholder made no capital contribution.
  - Second Circuit held that even if a grantee receives only partly on account of its junior interest (i.e., contributes new value as well), then it still receives on account of its junior interest and in violation of the absolute priority rule. Even if the shareholder here had also contributed capital, it still would have received the gift "on account of" its junior interest.

DISH: Second Circuit's Absolute Priority Rule Holding con't

- Second Circuit holds that the gifting doctrine is not an exception to the absolute priority rule.
  - The rule as codified provides no such exception.
  - SPM is distinguishable because in that case:
    - the secured creditor was granted stay relief;
    - the case was converted to a chapter 7 (no absolute priority rule); and
    - the property no longer belonged to the estate -- it belonged to the creditor.
  - The facts of DISH are similar to those cases that prompted the absolute priority rule's creation in the first place.
    - In old railroad cases, over-leveraged debtor with under-secured lenders agreed to give new equity to the old shareholders while intermediate creditors received nothing (or very little).
  - Congress was aware of policy arguments for and against the absolute priority rule when it codified the rule without a gifting exception.

The Effect of DISH on Gifting Plans

- DISH severely restrains, and perhaps precludes, gifting under a chapter 11 plan.
  - Although the decision only concerned a gift to old equity (and not to an unsecured creditor class), the Second Circuit's strict interpretation of the absolute priority rule as codified leaves little room for gifting.
  - The only exception the Second Circuit noted is the new value corollary, where the grantee receives its consideration solely on account of new and necessary value contributed to the reorganized debtor.
- Is SPM still viable?
  - The Second Circuit expressly distinguished DISH from the agreement at issue in SPM.
  - The DISH decision should have little, if any, impact on the validity of gifting in a chapter 7 context, where there is no absolute priority rule and the property has passed to an undersecured creditor with perfected and allowed liens.

Does DISH Overrule Iridium?

- Whether a pre-plan settlement that distributes value in violation of the absolute priority rule can stand may depend on whether the settlement's distribution scheme will or will not be implemented through the plan itself.
  - If the proposed distribution scheme will be part of a plan, it will likely not survive the standards of confirmation (assuming there is a dissenting impaired class) pursuant to the DISH decision.
  - If the proposed distribution scheme will be effectuated outside of the plan (and the plan will follow the priority rules), it likely is viable.
  - Courts in the Second Circuit, and perhaps elsewhere, may be hesitant to approve such schemes outside of confirmation in light of DISH, even though section 1129(b) would not apply to the approval of a settlement under Rule 9019.

What's Left?: Structured Dismissals

- For a secured creditor who wants to use bankruptcy to liquidate collateral, and is prepared to make a "gift" of the collateral proceeds to gain the cooperation of other classes, one option is a "structured dismissal" such as was done in Butler Services Int'l, No. 09-11914-KJC, (Bankr. D. Del.).
  - secured lender had all-asset lien, and substantially all assets had been sold
  - no proceeds available for unsecured creditors
  - remaining asset was cause of action under D&O policy that needed to be pursued by "a trustee"
  - secured lender had lien on that cause of action
- Debtor, secured lender, and creditor's committee agreed:
  - bankruptcy case would be dismissed
  - remaining assets would be contributed to a trust
  - secured lender and all unsecured creditors were beneficiaries of the trust, with agreed-upon sharing of proceeds (Note: beneficiaries included not just general unsecured creditors, but priority unsecured creditors as well —a broader inclusion than usually the case under settlements or plans in gifting cases)
- Bankruptcy court approved the structured dismissal over the US Trustee's objection.

AMERICAN BANKRUPTCY INSTITUTE
NORTHEAST CONFERENCE
SUMMER 2011

PLAN ISSUES

THIRD PARTY RELEASES AND EXCULPATIONS

Eric Henzy
Reid and Reige, P.C.
One Financial Plaza
Hartford, CT 06103

Third Party Releases

- A debtor and/or other parties in interest may seek to include in a plan broad releases of claims against non-debtors, on the grounds that the non-debtors are necessary to the debtor's reorganization because, for example, the non-debtors will serve as officers or directors of the reorganized debtor, they have made a substantial contribution to the debtor's reorganization, they will be providing new capital to the reorganized debtor, or they have indemnification claims that they are releasing.

- Practice grew in, at the very least, the Second Circuit that broad release and exculpation provisions included in plans with little or no comment from parties or courts. Recent decisions have changed that. In re Adelphia Communications Corp., 368 B.R. 140, 267 (Bankr. S.D.N.Y. 2007) ("The tenor of the Metromedia decision, as much as its plain language, cannot be ignored. It requires the bankruptcy community in this Circuit to be much more circumspect in providing for third-party releases than it used to be.")

- A "typical" release provision (from a plan filed in the Southern District of New York within the last year):

> As of the Effective Date, each holder of a Claim or an Interest shall be deemed to have conclusively, absolutely, unconditionally, irrevocably and forever, released and discharged . . . the Released Parties [defined to include the debtors' current and former officers and directors, agents, financial advisors, accountants, investment bankers, consultants, attorneys, employees and partners] from any and all claims, interests, obligations, rights, suits, damages, causes of action, remedies and liabilities whatsoever, whether known or unknown, foreseen or unforeseen, existing or hereafter arising, in law, equity or otherwise, that such holder would have been legally entitled to assert, based on or relating to, or in any manner arising from, in whole or in part, the Debtors, the Debtors' restructuring, the purchase, sale or rescission of the purchase or sale of any security of the Debtors, the subject matter of, or the transactions or events giving rise to, any Claim or Interest that is treated in the Plan, the business or contractual arrangements between any Debtor and any Released Party, upon any other act or omission, transaction, agreement, event or other

occurrence taking place on or prior to the Effective Date, other than Claims or liabilities arising out of or relating to any act or omission of a Released Party that constitutes willful misconduct (including fraud) or gross negligence.

Bankruptcy Code Provisions

- Bankruptcy Code section 105(a) provides in part: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

    - Even Circuit Courts that have held that permanent injunctions and/or releases of claims against non-debtors are not permissible have recognized that "[s]ection 105 empowers the court to enjoin preliminarily a creditor from continuing an action or enforcing a state court judgment against a nondebtor prior to confirmation of a plan." American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.), 885 F.2d 621, 624 (9th Cir. 1989).

- Bankruptcy Code section 524(e) provides in part: "[D]ischarge 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."

- Bankruptcy Code section 1123(b)(6) provides that a plan may "include any other appropriate provision not inconsistent with the applicable provisions of this title."

Split In Authority On Whether Third Party Releases Permissible

Not Permissible in Ninth, Fifth and Tenth Circuits

- Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394, 1401 (9th Cir. 1995) ("This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors."); American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.), 885 F.2d 621, 625-27 (9th Cir. 1989) ("Section 524(e) . . . limits the court's equitable power under section 105 to order the discharge of the liabilities of nondebtors . . . .")

- In re Western Real Estate Fund, Inc., 922 F.2d 592, 601-02 (10th Cir. 1990) ("[W]hile a temporary stay prohibiting a creditor's suit against a nondebtor . . . during the bankruptcy proceeding may be permissible to facilitate the reorganization process in accord with the broad approach to nondebtor stays under section 105(a) outlined above, the stay may not be extended post-confirmation in the form of a permanent injunction that effectively relieves the nondebtor from its own liability to the creditor. Not only does such a permanent injunction improperly insulate nondebtors in violation of section 524(e), it does so without any countervailing justification of debtor protection—as discussed earlier, the discharge injunction provided for in section 524(a) from potential derivative claims, such as indemnification or subrogation, that might arise from the creditor's post-confirmation attempts to recover the discharged debt from others.")

- Feld v. Zale Corp. (In re Zale Corp.), 62 F.3d 746, 759-61 (5th Cir. 1995) ("[B]ecause the permanent injunction as entered improperly discharged a potential debt of CIGNA, a nondebtor, the bankruptcy court exceeded its powers under § 105."). Suggesting that channeling injunction which gives creditors alternative means to recover on claim against third party permissible.

Third Circuit Unclear

- Gilman v. Continental Airlines (In re Continental Airlines), 203 F.3d 203, 214 n.12 (3rd Cir. 2000) ("Because the release and permanent injunction of Plaintiffs' claims are so clearly invalid under any standard, we need not speculate on whether there are circumstances under which we might validate a non-consensual release that is both necessary and given in exchange for fair consideration.")

Fourth, Sixth, Seventh and Eleventh Permit Releases With Different Standards

- Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648, 658 (6th Cir. 2002) ("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 state; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to the 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.")

- Airadigm Communications, Inc. v. FCC (In re Airadigm Communications, Inc.), 519 F.3d 640, (7th Cir. 2008) ("In light of these

provisions, we hold that this 'residual authority' permits the bankruptcy court to release third parties from liability to participating creditors if the release is 'appropriate' and not inconsistent with any provision of the bankruptcy code."). Release appropriate where it was narrowly tailored, applying only to claims "arising out of or in connection with" the reorganization itself; did not affect matters beyond the jurisdiction of the bankruptcy court or unrelated to the reorganization; and necessary before released party would provide financing essential to the reorganization.

- Menard-Sanford v. Mabey (In re A.H. Robins Co.), 880 F.2d 694, 702 (4th Cir. 1989) (upholding non-debtor releases that were necessary to reorganization and accompanied by consideration provided by non-debtors)

- Shearson Lehman Brothers v. Munford, Inc. (In re Munford, Inc.), 97 F.3d 449, 454-56 (11th Cir. 1996) (section 105 gives bankruptcy authority to permanently enjoin non-settling defendants from asserting contribution and indemnification claims against a defendant when the permanent injunction was integral to the debtor's settlement and the bar order was fair and equitable)

First Circuit—Releases Permissible Under Mahoney Hawkes Standard

- Unscientific survey of recent District of Massachusetts plans—no third party releases included. Why?

- Monarch Life Insurance Company v. Ropes & Gray, 65 F.3d 973, 978-984 (1st Cir. 1995) ("Though there is conflicting authority on the 'jurisdictional' reach of section 105(a), the confirmation order cited precedent for a broad-based 'incidental' injunctive provision. Accordingly, Monarch Life cannot now argue that the confirmation order is not subject to this broad construction. We express no view on the soundness of the precedent cited in the confirmation order, nor on their applicability to the particular plan proposed by Monarch Life."). Holding that former chapter 11 debtor's subsidiary was collaterally estopped by plan confirmation order from belatedly challenging jurisdiction of bankruptcy court to permanently enjoin lawsuits against debtor's attorneys and other third parties.

- In re Mahoney Hawkes, LLP, 289 B.R. 285 (Bankr. D. Mass. 2002) (Issuance of injunction not prohibited by Code section 524(e); court's

utilization of authority under Code section 105 involves extraordinary exercise of discretion; among the factors that court should consider in deciding whether to release or permanently enjoin actions against non-debtor parties are : (1) whether there is identity of interest between debtor and nondebtor party, (2) whether nondebtor has contributed substantial assets to debtor's reorganization, (3) whether injunction is essential to debtor's reorganization, (4) whether substantial majority of creditors agree on issuance of injunction, and (5) whether debtor's plan provides mechanism for payment of all, or substantially all, of claims or classes affected by injunction)

Second Circuit—Tighter Standard in the Last Few Years, But Releases Permissible Under Certain Conditions

- SEC v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.), 960 F.2d 285, 293 (2nd Cir. 1992) ("In bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan.")

- Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.), 416 F.3d 136, 142 (2nd Cir. 2007) (citations omitted):

> While none of our cases explains when a nondebtor release is "important" to a debtor's plan, it is clear that such a release is proper only in rare cases. . . .
>
> At least two considerations justify the reluctance to approve nondebtor releases. First, the only explicit authorization in the Code for nondebtor releases is 11 U.S.C. § 524(g), which authorizes releases in asbestos cases when specified conditions are satisfied, including the creation of a trust to satisfy future claims. True, 11 U.S.C. § 105(a) authorizes the bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code"; but section 105(a) does not allow the bankruptcy court "to create substantive rights that are otherwise unavailable under applicable law. Any "power that a judge enjoys under § 105 must derive ultimately from some other provisions of the Bankruptcy Code."

> Second, a nondebtor release is a device that lends itself to abuse. By it a nondebtor can shield itself from liability to third parties. In form, it is a release; in effect, it may operate as a bankruptcy discharge arranged without a filing and the safeguards of the Code. The potential for abuse is heightened when releases afford blanket immunity. . . .
>
> Courts have approved nondebtor releases when: the estate received substantial consideration, the enjoined claims were "channeled" to a settlement fund rather than extinguished, the enjoined claims would indirectly impact the debtor's reorganization "by way of indemnity or contribution," and the plan otherwise provided for the full payment of the enjoined claims. Nondebtor releases may also be tolerated if the affected creditors consent.
>
> But this is not a matter of factors and prongs. No case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique.

- Travelers Casualty and Surety Co. v. Chubb Indemnity Insurance Co. (In re Johns-Manville Corp.), 517 F.3d 52, 66-68 (2nd Cir. 2008), rev'd, 129 S.Ct. 2195 (2009) ("A court's ability to provide finality to a third-party is defined by its jurisdiction, not its good intentions. . . . It was inappropriate for the bankruptcy court to enjoin claims brought against a third-party non-debtor solely on the basis of that third-party's financial contribution to a debtor's estate. . . . Instead, a bankruptcy court only has jurisdiction to enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate. . . . In our view, the 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."). While this case was reversed by the Supreme Court on other grounds, at least one bankruptcy judge has expressed the view that it still stands for the proposition that the Second Circuit takes a very dim view of third party releases.

- Judge Gerber decisions: In re Adelphia Communications Corp., 368 B.R. 140, 267 (Bankr. S.D.N.Y. 2007); In re Motors Liquidation Co., 447 B.R. 198 (Bankr. S.D.N.Y. 2011); In re Chemtura Corp., 439 B.R. 561 (Bankr. S.D.N.Y. 2010).

- A release that recently was found to pass 2nd Circuit muster:

Release of Released Parties By Holders of Claims and Equity Interests. As of the Effective Date, each holder of a Claim or Equity Interest shall be deemed to have conclusively, absolutely, unconditionally, irrevocably and forever, released and discharged the Released Parties from any and all losses, claims, demands, costs, damages and liabilities in connection with or based upon any act performed or omitted to be performed by them in connection with the operation or business of the Debtor, provided that such liability or loss was not the result of gross negligence, fraud, willful misconduct or criminal conduct on the part of the Released Party and provided that such release shall be effective only to the extent of any indemnification obligation of the Debtor to such Released Parties pursuant to the Trust Declaration.

Supreme Court Does Not Decide Whether Releases Permissible

- Travelers Indemnity Co. v. Bailey, 129 S.Ct. 2195, 2207 (2009) ("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." Holding that issue of whether bankruptcy court had jurisdiction and authority to enter injunction at time its orders, which had become final on direct review over two decades earlier, was not properly before Court of Appeals on appeal from district court decision affirming bankruptcy court ruling that terms of injunction barred direct actions against insurer for bankrupt manufacturer of asbestos-containing products, or before Supreme Court on writ of certiorari.)

"Self-Correction" Provisions

- "to the extent permitted by applicable law"

- In re Chemtura Corp., 439 B.R. 561, 610 (Bankr. S.D.N.Y. 2010) ("[T]he releases are plainly impermissible under the applicable caselaw . . . . But as the Plan has 'self-correction' features, the deficiencies don't make the plan unconfirmable."); In re Adelphia Communications Corp., 368 B.R. 140, 266 (Bankr. S.D.N.Y. 2007) ("Since the third-party releases and exculpation . . . apply only 'to the extent permitted by applicable law,' the Plan is confirmable without change, and without resolicitation of votes.")

- Concern that impermissible release provisions will be included in plans, with "self-correcting" feature, leaving non-bankruptcy courts and parties unsophisticated in bankruptcy to sort out whether a release properly bars a claim.

Exculpation

- Typical exculpation provision (from recent First Circuit plans):

> Except as otherwise set forth in the Plan, neither the Debtors, the Reorganized Debtors, the Committee nor any of their respective present or former members, managers, officers, directors, employees, general or limited partners, advisors, attorneys, agents, successors or assign, shall have or incur any liability to any holder of a Claim or an Interest, or any other party in interest, or any of their respective agents, employees, representatives, financial advisors, attorneys, or affiliates, or any successors or assigns, for any act or omission in connection with, relating to, or arising out of, the administration of these Chapter 11 bankruptcy proceedings, the pursuit of confirmation of this Plan, the Disclosure Statement, the consummation of this Plan, or the administration of this Plan or the property to be distributed under this Plan occurring prior to the Effective Date, provided that the terms of this section shall not apply to any liability for willful misconduct or ultra vires acts.

- Exculpations have been treated differently than third party releases for pre-petition claims—generally allowed with little or no comment.

- But see In re Motors Liquidation Co., 447 B.R. 198, 221 (Bankr. S.D.N.Y. 2011) ("I well recognize how hard the Debtors, the Chapter 11 Fiduciaries, and their professionals worked on this case, and how, with thousands of disappointed creditors and stockholders out there to second guess their actions, they would like to be protected for their good faith actions in maximizing value and bringing this case to a successful conclusion. But I'm constrained by existing law to place some limits on their protection."); In re Adelphia Communications Corp., 368 B.R. 140, 267-68 (Bankr. S.D.N.Y. 2007) ("First, though without question it has long been the custom in the bankruptcy community to make distinctions between

releases involving pre- and postpetition conduct, I think that after Metromedia, limitation to postpetition events, by itself, is insufficient to justify a third-party release. Plainly there is less potential for abuse if only postpetition events are covered. But every chapter 11 case, large or small, has a postpetition period. That is hardly unique. And many large chapter 11 cases, though thankfully not all of them, have intercreditor bickering and threats, aimed at each other and at debtor board members and management, that give the targets of those threats a legitimate fear that they will be sued. But unfortunately, that can't be said to be unique, either. Likewise, many players in the bankruptcy process provide benefits to the case. DIP lenders are certainly in the category, and so are professionals to the estate or its fiduciaries. But they get interest and fees for their services. Their delivery of services is not unique." Holding that indemnified person, unique transactions or consent justify exculpation.)

- But In re Chemtura Corp., 439 B.R. 561, 612 (Bankr. S.D.N.Y. 2010) ("I recognize here, as I did in Adelphia, the legitimate needs and concerns of parties to seek protection from frivolous claims of other stakeholders. . . . [C]onsistent with my ruling in Adelphia, I'll include a provision in the Confirmation Oder, if such is desired, providing (subject to any subject matter jurisdiction limitations) for exclusive jurisdiction in this Court to consider any claims concerning matters for which the released parties might wish protection to the extent that they involve the administration of the estates during the course of these chapter 11 cases, or my earlier rulings and orders in these cases. I'll be able to tell the difference between legitimate claims, on the one hand, and harassment, retaliation, or frivolous litigation, on the other. Any claims hereafter brought will not be released in advance, but they will be subject to Rule 9011.")

- Query whether such a confirmation order provision would be within the subject matter jurisdiction of the bankruptcy court.