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NONDEBTOR RELEASES IN CHAPTER 11 REORGANIZATIONS: A LIMITED POWER

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INTRODUCTION

On April 20, 2010, an explosion at BP p.l.c.'s ("BP") *Deepwater Horizon* oil rig (the "Rig") caused a massive oil gush 5000 feet below sea level, resulting in the largest environmental disaster in United States history and the largest oil-related disaster in the world.[1] As a result of the explosion, eleven workers were killed, seventeen others were seriously injured,[2] and thousands more in the Gulf area suffered, and continue to suffer, financial losses. The extensive scope of the injuries and economic losses has led to

1. David J. Cook, *Class Actions and the Limits of Recovery: The Glass Jaw of Justice (Part 1 of 2)*, J. LEGAL. TECH. RISK MGMT., Fall 2010, at 1.

2. Verified Amended Shareholder Derivative Complaint at 53, Lampers v. Hayward, No. 2:10-cv-01446 (E.D. La. Aug. 19, 2010), ECF No. 58.

the filing of thousands of claims and hundreds of class actions against BP and other potentially responsible parties for economic damages, environmental cleanup costs, and other losses.[3] BP insiders, including Anthony B. Hayward, the former Chief Executive Officer ("CEO") of BP and former Executive Director of the Board of Directors, face numerous derivative liability suits for breach of fiduciary duties to the company and its shareholders.[4] Transocean Ltd., the company that owned and operated the Rig, which it leased to BP, also faces liability for the disaster.[5] In addition, Cameron International Corporation ("Cameron"), the company that manufactured the blowout preventer that failed to function on the Rig, is confronted with potential liability.[6] Lastly, Halliburton Energy Services, Inc. ("Halliburton"), a subcontractor to the Rig and the company that was servicing the cement casing meant to seal the wellhead to the sea floor, faces extensive liability claims for its part in the disaster.[7]

In response to the onslaught of claims and pressure from President Obama, BP agreed to place $20 billion into an escrow account (the "BP Oil Spill Fund" or "Fund") to pay damage claims.[8] Claimants who choose to recover from the BP Oil Spill Fund must, in exchange for compensation, waive their rights to pursue claims against both BP and others, including Halliburton and Cameron.[9] The question arises: is it fair to release BP from liability in exchange for its contribution of $20 billion?

Some argue that without the BP Oil Spill Fund, BP would be embroiled in litigation with tort claimants for years to come, and the success of the company would be severely in question. The Fund also enables claimants to be compensated far more quickly than they otherwise would be if they were required to obtain a judgment in court. For many Gulf residents, receiving compensation now is imperative, as they cannot afford to wait for their claims to take the inevitably lengthy route through the traditional judicial system. While the Fund offers several benefits, with BP paying the vast majority of these claims, what justification can there be for releasing BP's insiders, Halliburton, and others from liability?

Although BP did not enter bankruptcy, the BP Oil Spill Fund and the proposed releases of BP, BP's insiders, and other potentially liable compa-

3. Cook, *supra* note 1, at 1; Stephen Gidiere et al., *The Coming Wave of Gulf Coast Oil Spill Litigation*, 71 ALA. LAW. 374, 379 (Sept. 2010).

4. *See* Verified Amended Shareholder Derivative Complaint, *supra* note 2, at 9-10.

5. *See id.* at 17.

6. *See id.*

7. *See id.*

8. Jackie Calmes & Helene Cooper, *BP to Set Aside $20 Billion To Help Oil Spill Victims*, N.Y. TIMES, June 17, 2010, at A18.

9. Cook, *supra* note 1, at 2; Gidiere et al., *supra* note 3.

nies parallel many of the issues faced by bankruptcy courts assessing Chapter 11 plans. Bankruptcy courts have long struggled with the question of whether a Chapter 11 plan can contain a provision releasing the liabilities of, or grant injunctions preventing claims from being asserted against, parties other than the debtor, including insiders of the debtor and others entities tangentially related to the debtor, namely insurance companies.[10]

This Note will argue that the power of bankruptcy courts to grant nondebtor third party releases and injunctions should be carefully limited. As the BP case illustrates, there are significant benefits to the creation of a claimants trust, both for the company and claimants. Claimants trusts most often arise in the bankruptcy context in cases where the debtor faces mass tort claims or securities class actions.[11] In these cases, the debtor's insurer often agrees to make a contribution to the fund or to channel proceeds of the insurance policy into a fund in exchange for a release from future liability and an injunction barring future action by claimants against the insurer. This Note will argue that bankruptcy courts should continue to grant releases and injunctions in exchange for the insurer's substantial contribution to the plan of reorganization when the debtor is faced with class action or mass tort litigation that threatens to upend any efforts to reorganize the debtor. The insurer's contribution to a claimants trust can aid the debtor's reorganization because the debtor can avoid time-consuming litigation with the insurer over the scope of the insurance policy, the cost of which would deplete assets of the estate. These assets will instead be available to creditors. Insurer releases and injunctions in exchange for channeling insurance proceeds into a fund may further promote the fair and equitable distribution of assets to creditors because the proceeds will be distributed under the supervision of the bankruptcy court, as opposed to the state law rule of first-come, first-served that leaves some creditors paid in full and others with little or no compensation.

Recent developments in the Chapter 11 process have important implications for whether courts should grant releases to another type of nondebtor third party—insiders of the debtor.[12] In the past, many courts were willing to grant insider releases or injunctions based on various theories, including the need to obtain the insider's assistance and cooperation with the reorganization, the debtor's need to obtain the release of the insider's indemnity or contribution claims against the debtor, and the need to secure monetary contributions from the insider to the plan of reorganization.[13] This Note

10. *See infra* Part II.A.
11. *See* cases cited *infra* note 198 and accompanying text.
12. *See* discussion *infra* Part III.B.
13. *See* discussion *infra* Part II.B.1.

will argue that recent shifts towards pre-arranged bankruptcies and the increased use of turnaround specialists render at least two of these justifications moot.[14] These changes to the traditional Chapter 11 proceeding indicate that large corporate debtors do not view existing management as integral to the reorganization of the debtor, and that it is, therefore, unnecessary to provide the insiders with releases or permanent injunctions. Securing existing management's cooperation and assistance is no longer, and may never have been, a valid reason for granting a release or an injunction.[15] In addition, since corporations more and more frequently replace existing management, the need to grant a release in exchange for the insider's contribution of new value to induce the insider to retain an equity interest in the reorganized entity is also no longer a valid justification.[16] Lastly, as some commentators have argued, the debtor's need to obtain releases from insiders' indemnification and contribution claims is an illusory argument that courts have too often accepted without question.[17]

This Note proceeds in three parts. Part I addresses the history of nondebtor releases and injunctions, the origins of bankruptcy courts' jurisdictional powers, the traditional and more unique ways in which bankruptcy courts interpret and exercise this power, and the policy goals behind Chapter 11. Part II explores seminal decisions on whether bankruptcy courts have the power to grant nondebtor third party releases and injunctions. It also lays out the main arguments asserted by both courts and scholars on both sides of the argument. Lastly, Part III sets forth my argument that courts should never grant permanent releases to insiders and only under rare circumstances, to the debtor's insurers.

I. THE HISTORY OF NONDEBTOR RELEASES AND INJUNCTIONS

In a Chapter 11 bankruptcy, one of the main policy goals includes successful reorganization of a debtor with going concern value and fair and equitable distribution to creditors.[18] Deciding when a debtor has going concern value is a matter left to the court's discretion. Some argue that the

14. *See* discussion *infra* Part III.B.

15. *See* discussion *infra* Part III.B.1.

16. *See* discussion *infra* Part III.B.2.

17. *See* discussion *infra* Part III.B.3.

18. *See, e.g.*, Barry L. Zaretsky, *Insurance Proceeds in Bankruptcy*, 55 BROOK. L. REV. 373, 377 (1989) [hereinafter Zaretsky, *Insurance Proceeds*] (explaining that Chapter 11 aims to maximize the amount that creditors recover and to distribute assets among creditors equally). Additional policy goals also exist. *See* H.R. REP. NO. 595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 (legislative history shows that Congress intended the Code to enable reorganization of the debtor so that it could continue to employ its workers, satisfy its debts to creditors, and yield a return to shareholders).

assets of firms with revenues falling below nonfinancing costs should be sold off because the assets are better put to use elsewhere.[19] Insolvent firms with revenues in excess of production costs, but that are unable to pay the firm's debt, should continue as going concerns.[20] The capital structure of the firm should be restructured to allow the firm to function under less leverage.[21]

Issues arise because individual creditors have the incentive to attempt to grab assets of the firm—to liquidate the firm piecemeal—in order to satisfy their own claims.[22] This incentive is present whether or not it is more efficient to reorganize the firm.[23] As a group, however, creditors have the incentive to allow the firm to reorganize when it will result in greater value than would result from liquidation.[24] The bankruptcy system attempts to solve this coordination problem among creditors through mechanisms that disable creditors from racing to collect on their individual claims and also determine the means of producing the most value from the firm, either through reorganization or through liquidation.[25]

A. Basics of a Chapter 11 Proceeding

This Note will focus on Chapter 11 reorganizations; therefore, a cursory explanation of the bankruptcy process under this title may be of use. Unlike a Chapter 7 case, in which the debtor's assets are liquidated and proceeds are distributed to its creditors on a pro rata basis,[26] a debtor in Chapter 11 continues to operate while attempting to reorganize itself.[27] Creditor claims will be satisfied under the reorganization plan typically through current assets as well as future earnings of the reorganized debtor.[28]

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19. Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1807 (1998). This is often referred to as "piecemeal liquidation." *See* Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 360 n.62 (1997).

20. *See* Schwartz, *supra* note 19.

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.* at 1807-09 ("Business bankruptcy systems attempt to solve a coordination problem for the creditors of insolvent firms."); *see also* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 377-78 (explaining that the collective nature of bankruptcy proceedings avoids a race to the debtor's assets that results in some creditors being paid in full and some creditors receiving only partial or no payment on their debts).

26. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 377.

27. *Id.*

28. *Id.*

1. Bankruptcy Courts' Traditional Exercise of Jurisdiction Under Chapter 11

Upon filing of the petition, the debtor's legal and equitable interests become property of the estate.[29] The Bankruptcy Code's definition of property of the estate is intentionally broad.[30] Congress wanted to give the bankruptcy trustee control over as much of the debtor's assets as possible in order to maximize the assets available for distribution to creditors.[31] The definition of property of the estate is also intentionally broad in order to bring property that is best administered in a collective proceeding into the estate.[32]

In addition, a stay is instituted that prevents actions against the debtor and against the property of the estate for the duration of the proceeding.[33] This automatic stay provides the debtor with "a breathing spell from his creditors."[34] It also helps to ensure the equitable distribution of the debtor's assets among creditors.

The automatic stay contemplates actions against the debtor and the property of the estate; therefore, co-debtors or other third party debtors are generally not given protection under this provision.[35] Because the automatic stay does not protect these parties, claimants often attempt to collect from these entities when they are prevented from pursuing the debtor.[36] In these instances, the bankruptcy court exercises a less traditional jurisdictional power, explored in Part I.A.2, by drawing on its section 105 powers, which give the court the power to take any action "necessary or appropriate" to carry out the provisions of the Code.[37]

Another benefit to a debtor of Chapter 11 is that upon confirmation of the plan, section 1141(d)(1) discharges the debtor from any debt that arose

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29. *See* 11 U.S.C. § 541(a) (2006) (debtor's estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case").

30. H.R. REP. NO. 595, at 367 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963.

31. *Id.* at 175-76.

32. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 387-88. As discussed below, the definition of property of the estate has great impact on the position of third party nondebtors. *See infra* notes 169-174 and accompanying text. For example, disagreement as to whether insurance proceeds are considered "property of the estate" has implications for whether the bankruptcy court has power over the property in order to distribute the proceeds to creditors. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 378-79.

33. *See* 11 U.S.C. § 362.

34. H.R. REP. NO. 595, at 340.

35. 11 U.S.C. § 362; *see* Barry L. Zaretsky, *Co-Debtor Stays in Chapter 11 Bankruptcy*, 73 CORNELL L. REV. 213, 217 (1988) [hereinafter Zaretsky, *Co-Debtor Stays*] (explaining that by its language, section 362 applies only to debtors).

36. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 383.

37. *See* 11 U.S.C. § 105.

before the date of the confirmation.[38] This is a powerful tool for the debtor because the statute indicates that claims are dischargeable whether or not proof of claim is filed, the claim is allowed, or the claimant has voted in favor of the plan.[39] In addition to requesting temporary stays, analogous to the automatic stay provided to the debtor, nondebtor third parties sometimes also request permanent injunctions or releases, similar to the discharge provided to debtors under section 1141(d)(1). However, because the language of section 1141(d)(1) refers only to debtors, bankruptcy courts must find their power to grant permanent injunctions on behalf of nondebtor third parties elsewhere in the Bankruptcy Code. The justifications used by bankruptcy courts to extend permanent injunctions and releases to nondebtor third parties vary greatly and are discussed in the next section.

2. Bankruptcy Courts' Equitable Powers Under Section 105

Bankruptcy courts may exercise control over property that is not considered "property of the estate" and is, therefore, not covered by the section 362 automatic stay. A trustee or debtor may seek an injunction under the court's section 105 equitable powers.[40] There are two types of injunctions under section 105, temporary[41] and permanent.[42]

Section 105 gives bankruptcy courts the power to enact discretionary stays.[43] Unlike the automatic stay, a request for relief under section 105 must typically meet the traditional requirements for an injunction.[44] Courts will consider whether the party seeking a preliminary injunction is likely to succeed on the merits, whether irreparable harm is likely if preliminary relief is denied, whether the balance of equities tips in the moving party's favor, and whether the injunction is in the public interest.[45] The court need not consider all of the factors; if one is particularly strong, the court may

38. 11 U.S.C. § 1141(d)(1) (granting discharge to debtors that are not individuals).

39. 2 COLLIER ON BANKRUPTCY ¶ 1141.05 (16th ed. 2009).

40. *See* 11 U.S.C. § 105 (a bankruptcy court may take any action "necessary or appropriate" to effect the provisions of the Code); COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 105.04 ("The most notorious use of section 105 has been to seek to enjoin actions which, for one reason or another, are not stayed by the automatic stay of section 362.").

41. Temporary injunctions are also referred to as "preconfirmation injunctions" or "temporary stays."

42. Permanent injunctions are also referred to as "postconfirmation injunctions." It is important to note that in the context of Chapter 11 cases, the injunction is typically temporary, meaning it carries on only for the duration of the bankruptcy proceeding. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 400.

43. COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 105.03.

44. *Id.*

45. *Id.*

issue or deny an injunction based upon that factor alone.[46] Some courts have reformulated this traditional test to comport with the language of section 105 by removing the factors relating to irreparable harm and lack of an adequate remedy at law.[47] The revised test requires that there be: first, a danger of irreparable harm to the estate or the debtor's ability to reorganize; second, a reasonable likelihood of reorganization; third, a balance of the relative harm between the debtor and the creditor who would be restrained; and fourth, consideration of whether the injunction is in the public interest.[48]

For permanent injunctions, the tests that courts employ also vary. Some courts ask if the injunction requested is "necessary or appropriate to carry out" the discharge provisions of Chapter 11.[49] Other courts approve releases only if the affected creditors and parties consent.[50] One of the most authoritative tests, the *Master Mortgage* test, includes five factors: first, there must be an identity of interest between the debtor and the third party such that a suit against the third party is, in essence, a suit against the debtor or will deplete assets of the estate; second, the third party must contribute "substantial assets" to the reorganization; third, the success of the plan must hinge on granting the release; fourth, a substantial majority of the creditors must agree to the release; and finally, the plan must provide for payment of all or substantially all of the claims of the classes affected by the third party release.[51]

There are definite limits to courts' section 105 powers. A Chapter 11 plan of reorganization may only be confirmed if the court finds it complies with all provisions of the Code;[52] therefore, a court cannot confirm a plan containing a third party discharge unless it conforms with all applicable provisions. Thus, as the Supreme Court has held: "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."[53] Although bankruptcy courts are courts of equity, the power to issue injunctive relief under section 105 is limited to matters within the confines of the Code.[54]

46. *Id.*

47. *Id.*

48. *Id.*; *see, e.g.*, *In re* Monroe Well Serv., Inc., 67 B.R. 746, 752-54 (Bankr. E.D. Pa. 1986).

49. 11 U.S.C. § 105(a) (2006); COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 105.04.

50. *See, e.g.*, *In re* DBSD N. Am., Inc. 419 B.R. 179 (Bankr. S.D.N.Y. 2009).

51. *See In re* Master Mortg. Inv. Fund, Inc., 168 B.R. 930, 936 (Bankr. W.D. Mo. 1994).

52. *See* 11 U.S.C. § 1129(a)(1).

53. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988).

54. *See* Howard C. Buschman III, *The Power and Propriety of Bankruptcy Court Intervention in Actions Between Nondebtors*, 47 BUS. LAW 913, 922 (1992).

B. Which Nondebtor Third Parties Request Releases and Injunctions?

When a debtor files a Chapter 11 petition, various parties associated with the debtor seek the benefits of the bankruptcy proceeding, including temporary and permanent injunctions and releases. Nondebtor third parties in the bankruptcy context consist mainly of insiders of the debtor and the debtor's insurers. Insiders of the debtor, including directors and officers, often seek protection from the bankruptcy courts even though they themselves have not filed for bankruptcy.[55] A debtor's insurers will frequently seek releases or injunctions in exchange for contributions to the plan or, in the case of a bankruptcy precipitated by mass tort claims, a trust upon which the tort claimants may draw.[56]

II. SEMINAL DECISIONS AND REASONS FOR AND AGAINST NONDEBTOR THIRD PARTY RELEASES AND INJUNCTIONS

This part explores the seminal decisions of both "pro-release" and "anti-release" courts. Since the bankruptcy court's jurisdiction is limited by statute,[57] pro-release courts rely on several provisions in the Bankruptcy Code[58] and the Bankruptcy Rules[59] in approving Chapter 11 plans containing these releases and injunctions. Anti-release courts point instead to a provision of the Bankruptcy Code that states, "[D]ischarge of a debt of the

55. *See, e.g.*, SEC v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 130 B.R. 910, 913-14 (S.D.N.Y. 1991), *aff'd*, 960 F.2d 285 (2d Cir. 1992) (allowing releases of most of the securities claims asserted against debtor's directors and officers).

56. *See, e.g.*, Menard-Sanford v. Mabey (*In re* A. H. Robins Co.), 880 F.2d 694 (4th Cir. 1989); MacArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89, 91 (2d Cir. 1988).

57. *See* 28 U.S.C. § 1334 (2006).

58. As discussed *supra* in Part I.A.2, the courts use their equitable powers under section 105 of the Bankruptcy Code. *See* 11 U.S.C. § 105 (2006) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."). In addition, pro-release courts rely on section 1123(b)(6), which, like section 105, has been construed to broaden the courts jurisdictional power. *See* 11 U.S.C. § 1123(b)(6) (2006). In laying out contents of a plan, this provision states, "[s]ubject to subsection (a) of this section, a plan may—(6) include any other appropriate provision not inconsistent with the applicable provisions of this title." *Id.*

59. Pro-release courts point to Bankruptcy Rule 3016(c) as support that Congress contemplated bankruptcy courts' exercising jurisdiction over nondebtor releases and injunctions. FED. R. BANKR. P. 3016(c) (stating that if a plan provides for an injunction not specifically authorized in the Code, such provision and the affected parties must be identified in the plan and disclosure statement).

debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."[60]

Part II then discusses the reasons that have been asserted by courts and scholars for and against granting releases to insiders[61] and debtors' insurers.[62]

A. Judicial Disagreement on the Treatment of Nondebtor Third Party Releases and Injunctions in Chapter 11 Plans

Courts are divided on whether bankruptcy courts have the power to grant nondebtor third party releases and injunctions.[63] Although some circuits have shown more willingness than others to grant nondebtor third party releases, there is not a strict divide. The Second Circuit, for example, has produced some of the most creative solutions to settling mass tort litigation in bankruptcy by granting permanent releases and injunctions to nondebtor third parties.[64] On the other hand, the Second Circuit has criticized releases to nondebtor third parties in at least one case because the bankruptcy court failed to find that the release was essential to the success of the plan.[65] This tension, even within each circuit, is instructive. Far from being contradictory, these varying opinions indicate that the courts are struggling to articulate a seamless policy that underlies their decisions in varying circumstances to grant or deny releases to nondebtor third parties. Part III will attempt to elucidate this underlying policy; but first, some of the seminal decisions in this area of law are discussed.

1. Seminal Pro-Release Decisions

Pro-release courts reason that section 105 grants bankruptcy courts equitable powers, and that these powers are not constrained by the lan-

60. 11 U.S.C. § 524(e).

61. *See infra* Part II.B.1.

62. *See infra* Part II.B.2.

63. *Compare* SEC v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 960 F.2d 285, 293 (2d Cir. 1992) (approving bankruptcy courts' power to grant injunction to nondebtor third party), *with* Resorts Int'l, Inc. v. Lowenschuss (*In re* Lowenschuss), 67 F.3d 1394, 1401 (9th Cir. 1995) (explaining that the Ninth Circuit has repeatedly held that bankruptcy courts do not have the power to discharge the liabilities of nondebtor third parties).

64. *See* MacArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89, 91 (2d Cir. 1988).

65. *See* Deutsche Bank AG v. Metromedia Fiber Network, Inc. (*In re* Metromedia Fiber Network, Inc.), 416 F.3d 136, 143 (2d Cir. 2005) (affirming confirmation regardless of this oversight because the appeal was equitably moot as no stay of the confirmation order was obtained).

guage of section 524(e) so long as the enjoining of claims is essential to the reorganization of the debtor.[66] It is important to note, however, that the more permissive views of the Second and Fourth Circuits discussed below have not generally been construed by courts to give them "unfettered discretion to discharge non-debtors from liability."[67]

a. In re Johns-Manville Corp.

One of the leading pro-release decisions comes from the Second Circuit.[68] Johns-Manville Corporation ("Johns-Manville" or "Manville") produced products containing asbestos and faced numerous product liability lawsuits by asbestos health claimants.[69] Manville believed that its insurance would indemnify it against asbestos liability and defense costs, but Manville's insurers disagreed, launching Manville into costly litigation with its insurers over the scope of the policies.[70] This litigation, in addition to several large liability awards and studies estimating that Manville faced $1.9 billion in liability from over 52,000 asbestos claims, led Manville to file for Chapter 11.[71]

In the plan of reorganization, Manville's insurance companies agreed to pay $770 million in exchange for releases from future liability and an injunction against all future suits.[72] Claims were not extinguished, but rather were channeled into a trust for successful claimants.[73] The court relied in part on section 363(f), which permits the sale of estate property "free and clear" of any third party interest such as a lien in certain circumstances.[74] The court reasoned that the insurance policies belonged to the estate, and thus that section 363(f) allowed the court to dispose of the insurance

66. *See, e.g*, *In re* Drexel Burnham Lambert Grp., Inc., 960 F.2d at 293 ("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."); Menard-Sanford v. Mabey (*In re* A. H. Robins Co.), 880 F.2d 694, 702 (4th Cir. 1989).

67. *See* LTV Corp. v. Aetna Cas. & Sur. Co. (*In re* Chateaugay Corp.), 167 B.R. 776, 780 (S.D.N.Y. 1994) (noting that bankruptcy courts have granted permanent injunctions to nondebtor third parties only when essential to plan confirmation).

68. *See Johns-Manville Corp.*, 837 F.2d 89.

69. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 405 n.77 (citing *Johns-Manville Corp.*, 837 F.2d at 91) (approximately 17,000 suits were pending against Manville by 1982).

70. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 405.

71. *Id.* at 405-06.

72. *Johns-Manville Corp.*, 837 F.2d at 90.

73. *Id.* at 91.

74. *Id.* at 93-94; *see also* 11 U.S.C. § 363(f) (2006) (outlining the circumstances under which the trustee may sell property of the estate "free and clear of any interest in such property of an entity other than the estate").

proceeds through the settlement trusts and channel the claims to the trusts.[75]

b. In re Drexel Burnham Lambert Group, Inc.

In the bankruptcy of Drexel Burnham Lambert Group ("Drexel Burnham" or "Drexel"), the Second Circuit allowed releases of most of the securities claims against the debtor's directors and officers.[76] The Securities and Exchange Commission ("SEC") had filed a civil enforcement action against Drexel Burnham and several of its high-level employees, including Michael Milken ("Milken"), head of the High Yield and Convertible Bond Department, based on massive securities fraud allegations stemming from illegal activities of Milken and other Drexel employees in the junk bond market.[77] Drexel Burnham agreed to settle the SEC action by paying $350 million into a civil disgorgement fund, which would be used to satisfy the securities claims.[78] Milken also agreed to settle the SEC action by paying $400 million into the fund.[79] Drexel's plan of reorganization released Milken and approximately two hundred other employees from all personal liability.[80] As part of the plan confirmation, creditors filing claims against Drexel for securities law violations were certified as a class.[81] The securities litigation claimants were not provided with an option to opt out of the settlement.[82] In approving the settlement, the lower court reasoned that estimating the claims could take years, deplete the estate's assets, and burden the court system, and that without the settlement "there could be no Plan and indeed, no successful and prompt resolution of these Chapter 11 cases."[83] The court also reasoned that the settlement would facilitate cooperation between the debtor and its employees, induce the debtor's directors and officers to settle certain claims with the debtors, which would provide

75. *Johns-Manville Corp.*, 837 F.2d at 94 (noting that it was not exactly the same, but "the underlying principle of preserving the debtor's estate for the creditors and funneling claims to one proceeding in the bankruptcy court remains the same").

76. SEC v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 960 F.2d 285 (2d Cir. 1992).

77. *Id.* at 287-88; SEC v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 130 B.R. 910, 913 (S.D.N.Y. 1991), *aff'd*, 960 F.2d 285 (2d Cir. 1992); *see also* Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 961-62 (1997) [hereinafter Brubaker, *Bankruptcy Injunctions*].

78. *Drexel Burnham Lambert Grp., Inc.*, 130 B.R. at 913.

79. *Id.*

80. *See* Brubaker, *Bankruptcy Injunctions*, *supra* note 77, at 962-63.

81. *Drexel Burnham Lambert Grp., Inc.*, 130 B.R. at 912, 923-24.

82. *Id.*

83. *Id.* at 926-27.

more funds for the reorganization, eliminate competition over particular assets, and protect the debtor's estate by preventing indemnity claims that insiders would assert if they were sued by the securities claimants.[84] On appeal, the Second Circuit affirmed the lower court's holding, stating that "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."[85] The court reasoned that the settlement "is unquestionably an essential element of Drexel's ultimate reorganization" because without it the officers and directors were unlikely to settle.[86] Despite Milken's contributions to the settlement fund, Milken retained substantial personal wealth.[87] In 2009, Milken ranked 158th on the Forbes list of the 400 richest Americans, with a net worth of approximately $2 billion.[88]

c. In re A. H. Robins Co.

The Fourth Circuit granted releases to various nondebtor third parties in the bankruptcy of the A. H. Robins Company ("A. H. Robins" or "Robins").[89] A. H. Robins manufactured the Dalkon Shield, a birth control device that was found to cause serious injuries to women who used it. In response to mounting litigation, A. H. Robins filed a Chapter 11 petition. A number of parties were potentially jointly liable with A. H. Robins, including the officers and directors responsible for the company's misconduct, and Aetna Casualty and Surety Company ("Aetna"), the company's prod-

84. Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolves the Debate Over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 EMORY BANKR. DEV. J. 13, 69 (2006).

85. SEC v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 960 F.2d 285, 293 (2d Cir. 1992).

86. *Id.* This test, asking whether the release or injunction is essential to the reorganization of the debtor, is controlling in the Second Circuit. It is less demanding than the often-cited *Master Mortgage* test. *See In re* Master Mortg. Inv. Fund, Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994); *see also supra* text accompanying note 51.

87. *See* Brubaker, *Bankruptcy Injunctions*, *supra* note 77, at 998 n.139.

88. *See The 400 Richest Americans*, FORBES.COM (Sept. 9, 2009), http://www.forbes.com/lists/2009/54/rich-list-09_Michael-Milken_SSM6.html.

89. *In re* A. H. Robins Co., 880 F.2d 709 (4th Cir. 1989); *see also* Ralph Brubaker, *Nondebtor Releases and Injunctions in Chapter 11: Revisiting Jurisdictional Precepts and the Forgotten* Callaway v. Benton *Case*, 72 AM. BANKR. L.J. 1, 5 (1998) [hereinafter Brubaker, *Nondebtor Releases*] (explaining that nondebtor releases even precluded injured women from suing their doctors for medical malpractice claims).

uct liability insurer.[90] The court granted a temporary injunction preventing suits against these parties during the course of the reorganization.[91]

The plan had to take into account approximately 195,000 eligible claims, not including future claims.[92] Future claimants, though a larger issue in the asbestos industry, also had to be contended with in the A. H. Robins case. Approximately 3.6 million women used the Dalkon Shield worldwide, many of them in Third World countries where Robins had not published notices urging removal of the devices.[93]

Aetna's potential liability was not limited to the remaining coverage under the insurance policies.[94] Aetna was alleged to have conspired with Robins to destroy documents that indicated that Robins knew of dangers associated with the Dalkon Shield well before Robins finally warned doctors.[95] It was also alleged that Aetna had commissioned and then concealed the results of studies questioning the safety of the Dalkon Shield.[96] Lastly, some allegations arose that Aetna had played a major role in deciding not to issue a recall because it knew doing so would increase the number and value of Dalkon Shield injury claims.[97] Women injured by the Dalkon Shield, therefore, filed suit against Aetna on a theory of joint liability, claiming that their injuries could have been avoided by a prompt recall of the device or a disclosure of the relevant facts.[98]

90. RICHARD B. SOBOL, BENDING THE LAW: THE STORY OF THE DALKON SHIELD BANKRUPTCY 63 (1991).

91. *Id.* at 63-64. ("The primary reason put forward for this request was that the claims against third parties were actually claims against Robins's assets, either because the judgments would be satisfied through unused product liability insurance (Robins's officers and directors were insured persons under the company's agreement with Aetna) or because Robins's [sic] was contractually obligated to indemnify (reimburse) its officers and directors for any liability imposed against them. Robins's unused product liability insurance was an asset of the estate, and if Dalkon Shield claimants could be paid out of insurance proceeds during the bankruptcy, there would be unequal treatment of similarly situated creditors in violation of one of the basic precepts of bankruptcy law. And even apart from the insurance, judgments against Robins's officers and directors that resulted in claims for indemnity against the company provided a mechanism for the liquidation of some Dalkon Shield injury claims but not others outside the bankruptcy process.").

92. *Id.* at 106.

93. *Id.* at 107.

94. *Id.* at 116.

95. *Id.*

96. *Id.*

97. *Id.* In prebankruptcy cases, Aetna either settled with claimants or the cases were dismissed before trial on the narrow ground that an insurer does not owe a duty to consumers to disclose defects in the products it insures. *Id.* However, these did not address the other reasons for potential liability. *Id.*

98. *Id.*

Although Aetna maintained that it had no responsibility for the Dalkon Shield injuries, the allegations were distressing to Aetna because they exposed Aetna to potential liability once Robins' liability was discharged.[99] Aetna was therefore willing to contribute to a fund to compensate Dalkon Shield victims in exchange for protection from future liability. Aetna agreed to pay $75 million in cash into a trust for the benefit of Dalkon Shield victims.[100] In addition, in exchange for a release from future liability, Aetna was willing to write two insurance policies: first, $100 million in outlier insurance; and second, $250 million in excess insurance in the event the trust was unable to pay all claims from the initial $75 million.[101]

In the *Robins* case, the issue arose as to whether tort claimants must be given an opt-out provision that would let them waive any recovery from the trust and bring their claims directly. Aetna was not opposed to a proposed settlement that allowed claimants to opt out and pursue Aetna directly because the settlement would preclude the recovery of punitive damages, thereby reducing the intensity of the Dalkon Shield litigation.[102] In addition, the claimants trust would take care of most of the litigation, decreasing the frequency of claims.[103]

The *Robins* case also dealt with the issue of whether insiders of the debtor could be granted releases from all future liability. Although legal proceedings related to A. H. Robins and Dalkon Shield had been stayed, one proceeding, an investigation by the Department of Justice into possible criminal activity by A. H. Robins' officers and directors had not. A district judge denied a motion by Robins to quash a subpoena issued by a grand jury, explaining that there was substantial evidence that "Robins and its employees and officers participated in the commission of crimes and fraud during the promotion, marketing and sale of the Dalkon Shield, and used its attorneys to perpetuate and cover-up [this conduct] through the commission of frauds on the court, obstruction of justice, and perjury."[104] Since the standard of proof is lower for civil liability, the officers and directors of Robins were rightfully concerned that they would face liability once the company was discharged.[105] As part of the plan of reorganization, Robins was to merge with a subsidiary of American Home Products, and the Rob-

99. *Id.* at 117.
100. *In re* A. H. Robins Co., 880 F.2d 709, 722 (4th Cir. 1989).
101. *Id.*
102. See SOBOL, *supra* note 90, at 218-19. The settlement depended on the judge's willingness to certify a mandatory class for punitive damages. *Id.* at 250.
103. *Id.* at 219.
104. *Id.* at 220.
105. *Id.*

ins family was expected to receive over $300 million in American Home Products stock, so there would be assets from which claimants could recover.[106] Although the insiders maintained that they were not liable, under the settlement agreement, two members of the Robins family, both of whom held senior management positions, agreed to personally make a combined payment of $10 million to the trust in exchange for an injunction and full release from all future tort liability.[107] Although the claimants committee was not pleased with the release, they decided to accept it because the value of the overall agreement with American Home Products was worth it.[108]

In approving the plan, the court reasoned that the release was essential to reorganization because it required the debtor to be free from indemnity and contribution lawsuits that third parties would have brought had they been sued by Dalkon Shield claimants. Creditors voted overwhelmingly in favor of the plan, the plan provided Dalkon Shield claimants with the opportunity to receive payment in full, and Aetna made substantial contributions to the plan.[109] Although the Fourth Circuit noted that the contribution of $10 million by the Robins family was only "minimal," it still affirmed the settlement.[110]

2. *Seminal Anti-Release Decisions*

Many courts refuse to approve Chapter 11 plans containing nondebtor releases and injunctions.[111] These courts reason that section 105 equitable

106. *Id.* at 221. American Home Products contributed $2.155 billion to the trust. *Id.* at 311. American Home Products was willing to do this because, as one drug analyst said at the time, other profitable Robins products such as Robitussin and Chapstick made the acquisition the "steal of the century." *Id.* at 334-35 (quoting Malcolm Gladwell, *American Home's "Steal" of a Deal for A.H. Robins*, WASH. POST, Dec. 15, 1989, at F1).

107. *Id.* at 221-22. Although the Robins family were named as defendants in the class action and were granted nondebtor releases, the judicial approvals of the settlement do not address their potential liability. *See* Brubaker, *Nondebtor Releases*, *supra* note 89, at 5 n.16 (citing Dalkon Shield Claimants' Comm. v. Aetna Cas. & Sur. Co. (*In re* A. H. Robins Co.), 88 B.R. 755, 758-63 (E.D. Va. 1988), *aff'd*, 880 F.2d 709, 748-52 (4th Cir. 1989); Menard-Sanford v. Mabey (*In re* A. H. Robins Co.), 880 F.2d 694, 700-01 & n.6 (4th Cir. 1989)).

108. SOBOL, *supra* note 90, at 221.

109. *See* Silverstein, *supra* note 84, at 64.

110. *A. H. Robins*, 880 F.2d at 722 & n.15. The family received American Home Products stock worth $385 million as a tax-free distribution on their A. H. Robins stock under the reorganization plan. *See* Brubaker, *Bankruptcy Injunctions*, *supra* note 77, at 993 n.124.

111. *See, e.g.*, 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 nondebtors."); Landsing Diversified Props. v. First Nat'l Bank & Trust Co. (*In re* W. Real Estate Fund, Inc.), 922 F.2d 592, 600 (10th Cir. 1990) (refusing to grant a permanent injunction that would relieve the third

powers are limited by section 524(e) of the Bankruptcy Code, which provides that discharge of a debtor in bankruptcy does not affect the liability of any other party.[112]

a. In re American Hardwoods, Inc.

In the Chapter 11 case of *American Hardwoods* ("American"), the Ninth Circuit denied a motion for a permanent injunction that would have barred Deutsche Credit Corporation ("Deutsche") from enforcing a state court judgment against the Keelers, who as officers and shareholders of the debtor had personally guaranteed its debt to Deutsche.[113] At no point did the Keelers offer to contribute assets to American's reorganization.[114] American brought an adversary proceeding in the bankruptcy court, seeking both a temporary and permanent injunction staying Deutsche's efforts to enforce the judgment against the Keelers.[115] The bankruptcy court did temporarily enjoin Deutsche from enforcing the state court judgment against the Keelers.[116] However, the bankruptcy court found that while American's reorganization plan would likely fail if the state court judgment against the Keelers was enforced, the court did not have the power or jurisdiction to grant a permanent injunction against Deutsche.[117] The district court affirmed the bankruptcy court's holding,[118] rejecting American's argument that the bankruptcy court had power to permanently enjoin Deutsche pursuant to its section 105 powers.[119] The Ninth Circuit, in affirming the holdings of both the bankruptcy court and district court, distinguished this case from *In re A. H. Robins Co.*, stating that there were no such unusual cir-

party of liability to the creditor, reasoning "it is the debtor, who has invoked and submitted to the bankruptcy process, that is entitled to its protections; Congress did not intend to extend such benefits to third-party bystanders"); Am. Hardwoods, Inc. v. Deutsche Credit Corp. (*In re* Am. Hardwoods, Inc.), 885 F.2d 621 (9th Cir. 1989); Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985) (finding release of debtor's founder and other related parties from all claims arising from notes executed by the debtor was unenforceable and eventually entering judgment against the debtor's founder for securities law violations relating to the note); Whispering Pines Estates, Inc. v. Flash Island, Inc. (*In re* Whispering Pines Estates, Inc.), 370 B.R. 452 (B.A.P. 1st Cir. 2007) (reversing bankruptcy court order confirming plan which included a release of the creditor who proposed the plan).

112. 11 U.S.C. § 524(e) (2006) ("Except as provided in subsection (a)(3) of this section, 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.").

113. *Am. Hardwoods, Inc.*, 885 F.2d at 622.

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.* at 622-23.

118. *Id.* at 623.

119. *Id.* at 624.

cumstances here warranting the enjoining of claims against nondebtor third parties.[120] Unlike *A. H. Robins*, the Ninth Circuit noted that American did not face mass tort claims estimated at almost $2.5 billion, the permanent injunction was not overwhelmingly approved by American's creditors as it was by A. H. Robins' creditors, and the injunction would affect American's largest creditor, not simply a small fraction of creditors as it had in the *A. H. Robins* case.[121] Lastly, the Ninth Circuit noted that American did not propose, and the district court did not find, that the permanent injunction was "essential" to a successful plan of reorganization, a factor on which the *A. H. Robins* court relied heavily.[122]

b. In re Continental Airlines

The Third Circuit rejected the use of nondebtor third party releases in the reorganization of Continental Airlines ("Continental").[123] Directors and officers of Continental faced several securities fraud class actions.[124] Continental filed for Chapter 11 and the bankruptcy court temporarily enjoined the class actions.[125] Continental, its D&O liability insurers, and its directors and officers entered into a tripartite settlement by which each party released all others from liability.[126] The D&O liability insurers also provided $5 million to Continental to settle all claims and potential claims against the directors and officers.[127] Continental then filed a plan of reorganization that contained provisions releasing and permanently enjoining claims against the directors and officers, including those of the securities fraud class action plaintiffs.[128] The bankruptcy court approved the plan, and the district court affirmed, explaining that the release and permanent injunction of the lawsuits was a "key element" of the reorganization because Continental would have to indemnify its directors and officers, thereby diminishing assets of the estate.[129] In addition, the district court reasoned that the lawsuits would distract the reorganized debtor, but the court did not support its conclusions with any factual evidence in the record.[130] On appeal, the

120. *Id.* at 627.

121. *Id.* (citing Menard-Sanford v. Mabey (*In re* A. H. Robins Co.), 880 F.2d 694 (4th Cir. 1989)).

122. *Id.* (citing *A. H. Robins Co.*, 880 F.2d at 694).

123. Gillman v. Cont'l Airlines (*In re* Cont'l Airlines), 203 F.3d 203 (3d Cir. 2000).

124. *Id.* at 205.

125. *Id.* at 206.

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* at 207-08.

130. *See id.* at 208.

Third Circuit held that the release and permanent injunction of the lawsuits were both "legally and factually insupportable."[131] It questioned the district court's finding that the release and permanent injunction of claims against the directors and officers were actually a key element of the reorganization, noting that federal courts often refuse to recognize indemnity obligations for federal securities law violations.[132] Even if the debtor were to face indemnity obligations, however, the court found that these potential future obligations did not make the release and permanent injunction "necessary" to the successful reorganization of the debtor.[133] The court concluded that "granting permanent injunctions to protect non-debtor parties on the basis of theoretical identity of interest alone would turn bankruptcy principles on their head. Nothing in the Bankruptcy Code can be construed to establish such extraordinary protection for non-debtor parties."[134]

B. Arguments for and Against Granting Nondebtor Releases and Injunctions to Insiders and Insurers in Chapter 11 Plans

Nondebtor releases and injunctions are often requested by insiders of the debtor or, particularly in mass tort cases, the debtor's insurers. Many scholars have weighed in on both sides of this issue, as is discussed in this section.

1. Should Insiders Be Granted Nondebtor Releases or Injunctions?

Insiders of the debtor include directors, officers, and other high-ranking employees of the debtor. Officers and directors may agree not to assert a claim against the debtor in exchange for a release from personal liability. There are various ways in which insiders may be found personally liable. Creditors or shareholders may assert a breach of fiduciary duty claim or attempt to pierce the corporate veil. With regards to tort liability, an insider may have liability distinct from that of the debtor, because employees are still directly liable for their own torts.

Those who benefit from this type of release are most likely the ones asserting that the debtor will be irreparably harmed without it, so courts have held that, in order to prevent self-dealing, they will subject these claims to rigorous scrutiny.[135]

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131. *Id.* at 211-12.

132. *See id.* at 215-16.

133. *See id.* at 216 n.15.

134. *See id.* at 217.

135. *See, e.g.*, Spach v. Bryant, 309 F.2d 886 (5th Cir. 1962); Hopper v. Am. Nat'l Bank (*In re* Smith-Chadderdon Buick, Inc.), 309 F.2d 244 (10th Cir. 1962).

a. Arguments for Allowing Releases and Injunctions to Insiders

First, some argue that there is a need to obtain the release of insiders' indemnity and contribution claims against the debtor. Debtors have argued that suits against insiders will inevitably result in indemnity and contribution claims against the debtor and embroil the debtor in litigation.[136] Granting these injunctions would prevent creditors from pressuring the debtor through its insiders. It would prevent creditors from "doing indirectly what the Code prevents them from doing directly."[137]

A second argument set forth by both courts and scholars is that releases and injunctions are necessary to secure insider assistance and cooperation. In other words, the debtor would suffer irreparable harm if the insiders were tied up in litigation rather than directing their attention towards reorganization of the debtor.[138] The idea is that insiders have the most knowledge about the inner workings of the debtor and are in the best position to lead the reorganization. Courts have even granted releases to employees who have left the company, reasoning that their cooperation is needed for the reorganized entity's pursuit of legal claims against others.[139]

The third main argument asserted for granting releases or injunctions to insiders, and the most common situation in which they are granted,[140] is the "contributing nondebtor theory." Releases or injunctions are granted in exchange for payments to the debtor in order to fund the reorganization.[141]

b. Arguments Against Allowing Releases or Injunctions to Insiders

Many courts and scholars have argued that there is no pressing need to obtain the release of insiders' indemnity and contribution claims against the debtor.[142] For matured indemnity claims—claims on which an insider is

136. *See* Menard-Sanford v. Mabey (*In re* A. H. Robins Co.), 880 F.2d 694, 702 (4th Cir. 1989) (noting that 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").

137. Judith R. Starr, *Bankruptcy Court Jurisdiction to Release Insiders from Creditor Claims in Corporate Reorganizations*, 9 EMORY BANKR. DEV. J. 485, 493 (1993).

138. *Id.* at 497 (citing SEC v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 130 B.R. 910, 928 (S.D.N.Y. 1991), *aff'd*, 960 F.2d 285 (2d Cir. 1992); Otero Mills, Inc. v. Sec. Bank & Trust (*In re* Otero Mills, Inc.), 21 B.R. 777, 778-79 (Bankr. D.N.M. 1982), *aff'd*, 25 B.R. 1018 (D.N.M.)).

139. *Id.* (citing *Drexel Burnham Lambert Grp., Inc.*, 130 B.R. at 928).

140. *Id.* at 498.

141. *But see A. H. Robins Co.*, 880 F.2d at 702 (finding insiders' $10 million contribution to the plan not to be substnatial enough for release, contrary to bankruptcy court's holding).

142. *See, e.g.*, THOMAS J. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 23-25 (1986) (arguing that the policy behind bankruptcy law is to approve a reorganization plan only where the value of the debtor to creditors and shareholders, taking into account all of

jointly liable with the debtor—the insider's claim against the estate is subject to various qualifications.[143] Section 502(e)(1)(A) of the Code provides that if a claim is not allowable against the debtor, any claim for contribution or reimbursement from the disallowed claim must also be disallowed.[144] In addition, section 509(c) provides that if the underlying claim is an allowed claim against the estate,[145] the insider's claim will be subordinated to that allowed claim until the claimant has been paid in full.[146] Lastly, courts have consistently disallowed claims for indemnity or contribution that are inconsistent with substantive non-bankruptcy law.[147] In addition, the Code renders contingent indemnity claims—"indemnity claims based only on the potential liability of the insider to a third party"—worthless if they do not mature prior to confirmation and discharge.[148]

Courts that base injunctions on the need for insider assistance and cooperation often make no findings of the extent of harm the debtor will suffer, the likelihood of the insider refusing to cooperate, or the lack of legal methods to obtain the insider's cooperation.[149] When courts require insiders to do so, they often are unable to demonstrate the probability of irreparable harm to the debtor without their cooperation or assistance.[150] In addition, companies outside of the bankruptcy context are able to function when faced with litigation, so some argue there is no reason to think that companies in bankruptcy are any less capable of dealing with the effects of litiga-

the risks, exceeds the value in liquidation); Starr, *supra* note 137, at 494 n.54 ("To the extent that claims against insiders are so significant and intertwined with claims against the debtor that they threaten the debtor's ability to reorganize, reorganization may not be a feasible alternative to liquidation. In this scenario, the bankruptcy court would not be acting to protect its jurisdiction by enjoining litigation against insiders but would be stacking the deck in favor of a reorganization, when the real world equities favored a liquidation.").

143. *See* Starr, *supra* note 137, at 494.

144. 11 U.S.C. § 502(e)(1)(A) (2006); *see also Baldwin-United Corp.*, 55 B.R. 885, 893-94 (Bankr. S.D. Ohio 1985).

145. *See* 11 U.S.C. § 502 (explains the allowance of claims).

146. 11 U.S.C. § 509(c); *see also Baldwin-United Corp.*, 55 B.R. at 895.

147. *See, e.g.*, Gillman v. Cont'l Airlines (*In re* Cont'l Airlines), 203 F.3d 203, 215-16 (3d Cir. 2000) (finding indemnification by the debtor not available for securities law violations on the part of officers and directors of the debtor); *Baldwin-United Corp.*, 55 B.R. at 902-03 (disallowing indemnity claims arising from securities fraud suits because indemnity is not permissible under securities law).

148. *See* Starr, *supra* note 137, at 495.

149. *Id.* at 497.

150. *See, e.g.*, JRT, Inc. v. TCBY Sys., Inc. (*In re* JRT, Inc.), 121 B.R. 314, 320 (Bankr. W.D. Mich. 1990); Univ. Med. Ctr. v. Am. Sterilizer Co. (*In re* Univ. Med. Ctr.), 82 B.R. 754, 758 (Bankr. E.D. Pa. 1988); Aboussie Bros. Const. Co. v. United Mo. Bank (*In re* Aboussie Bros. Constr. Co.), 8 B.R. 302, 304 (E.D. Mo. 1981).

tion.[151] Lastly, the Federal Rules of Civil Procedure serve two important functions in this context by protecting certain employees from "unduly burdensome litigation demands" and enabling the reorganized entity to obtain information from unwilling former insiders.[152]

Professor Barry L. Zaretsky argued that if the debtor is the officer's best employment opportunity, then he will remain with the debtor.[153] If it is not, the officer will leave the debtor regardless of whether he receives a discharge.[154] Professor Zaretsky explained that "unless the officer irrationally intends to disregard his own self-interest in favor of destroying the debtor, courts should treat threats to 'throw in the towel' as nothing more than empty threats."[155] Others have gone even further in urging that these individuals should not be able to gain releases or injunctions because they likely played an important role in driving the debtor into bankruptcy.[156]

Critics of insider releases and injunctions have adamantly opposed the theory under which these releases and injunctions are most often granted—the contributing nondebtor theory. Under the Bankruptcy Code, the debtor must disclose all of its assets and submit these assets to the court's control. In exchange, the court can force creditors to take a pro rata distribution and prevent them from taking further action through the discharge provisions.[157] Courts outside of bankruptcy have no power to force claimants to accept monetary settlements that the claimants believe are inadequate.[158]

151. "Non-bankrupt companies cope with the disruptive effects of litigation on a regular basis and there is no reason to assume that reorganized companies are any less able to do so." Starr, *supra* note 137, at 497 (citing *In re* Keyco, Inc., 49 B.R. 507, 510 (Bankr. E.D.N.Y. 1985)).

152. *See* FED. R. CIV. P. 26-37 (governing discovery in civil proceedings in federal courts).

153. *See* Zaretsky, *Co-Debtor Stays*, *supra* note 35, at 272.

154. *Id.*

155. *Id.* "Bankruptcy court is simply not an appropriate forum for stopping the clock on a principal's life in an effort to retain his undivided energy and attention." *Id.* at 230.

156. *See, e.g.*, Peter M. Boyle, Note, *Non-Debtor Liability in Chapter 11: Validity of Third-Party Discharge in Bankruptcy*, 61 FORDHAM L. REV. 421, 447 (1992) ("Bribing a corporate officer with a discharge in order to secure that officer's assistance in a reorganization, when that officer presumably played a role in the debtor's financial demise, is not an equitable solution particularly when such discharge will impair the rights or claims of creditors. The officer's assistance may be desirable and in certain circumstances necessary, but the threat, either expressed or implied, of 'throwing in the towel' is tantamount to extortion, and an extortionist does not deserve equitable relief even if that relief may benefit the debtor.").

157. *See* Starr, *supra* note 137, at 498 ("It is the acceptance of this burden by the debtor, together with the economic reality that a debtor in bankruptcy cannot pay all claims against it in full, which form the basis for the extraordinary power of the court to force a creditor to accept less than full value for its claim.").

158. *Id.*

Judith Starr, formerly Senior Counsel to the Securities and Exchange Commission,[159] questions why courts allow a solvent insider to take the benefits of bankruptcy because of his relationship with the debtor, by forcing a claimant to accept a less than adequate settlement, when he does not have to accept the burdens of the Code such as disclosing all of his assets and submitting them to the control of the bankruptcy court.[160]

Opponents of insider releases and injunctions also argue that they undermine the policy behind joint and several liability, and may present a moral hazard to insiders looking to shield themselves from personal liability.[161] The rationale behind joint and several liability is to ensure that victims are fully compensated in the event one or more of the tortfeasors is unable to pay.[162] An officer or director is liable for her tortious conduct even though the conduct may have been in furtherance of the company's interests and within the scope of employment.[163] This may incentivize insiders to bring the debtor into bankruptcy in order to avoid personal liability.[164]

2. Should Debtors' Insurers Be Granted Nondebtor Releases or Injunctions?

The debtor's insurance is often one of the primary assets for certain types of claimants, such as personal injury claimants, who may be able to recover a greater amount of their claim from the insurance company than the debtor.[165] An insurer may be considered a co-debtor since the insurer

159. *Id.* at 485.

160. *Id.* at 498.

161. *See, e.g.*, *id.* ("A moral hazard is present because insiders may be tempted to engage in high risk behavior by the knowledge that they can protect themselves from its consequences by taking the corporation into chapter 11. This protection from liability may tempt insiders to take the corporation into chapter 11 in circumstances where they otherwise would not do so.").

162. *See* Boyle, *supra* note 156, at 444.

163. *See e.g.,* Inforex, Inc. v. Burridge (*In re* Inforex, Inc.), 26 B.R. 515, 518 (Bankr. D. Mass. 1983).

164. *A. H. Robins* and *Johns-Manville* both involved allegations that corporate management brought the company into Chapter 11 in an effort to limit their own liability. *See* Menard-Sanford v. Mabey (*In re* A. H. Robins Co.), 880 F.2d 694, 702 (4th Cir. 1989); MacArthur Co. v. Johns-Manville Corp (*In re* Johns-Manville Corp.), 36 B.R. 727, 730 (Bankr. S.D.N.Y.), *aff'd*, 837 F.2d 89 (2d Cir. 1988); *see also* SOBOL, *supra* note 90, at 327 (noting that both companies were solvent at the time of filing, but the courts held that if a company foresees insolvency, the company does not have to wait until it is actually insolvent to file. In the case of A. H. Robins, the bankruptcy petition was alleged to be a tactic to consolidate all of the Dalkon Shield litigation before a judge thought to be more sympathetic to the debtor).

165. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 373.

has contracted to fund the debtor's obligations with its own funds to the extent those obligations are covered under the insurance policy.[166] As noted previously, co-debtors are not covered by the automatic stay, so claimants may attempt to recover by pursuing the debtor's insurer directly.[167] The claimants' success depends in part on whether the court treats the insurance proceeds as property of the estate.[168]

Most courts treat liability insurance proceeds as property of the estate.[169] The bankruptcy court, therefore, has the power to control the equitable distribution of the proceeds to all creditors,[170] and the automatic stay prevents creditors from recovering this property outside the bankruptcy proceeding.[171] If proceeds of an insurance policy are not considered property of the estate, the insurance company may be directly liable to the victims.[172] Issues arise when the insurer's liability, which is limited by the terms of the policy, does not cover the amount of all of the claims.[173] Since the insurance proceeds will be distributed according to non-bankruptcy law, a race to the proceeds may ensue.[174]

Unique problems arise in relation to equitable distribution of insurance proceeds when there are claims that "have not yet matured or when some claims have not been reduced to judgment."[175] Future claimants rights to insurance proceeds and the protections afforded to future claimants in bankruptcy proceedings will be addressed in more detail in Part III.[176]

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166. *See id.* at 383.

167. *See supra* text accompanying notes 35-36.

168. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 384 ("[T]he extent to which the bankruptcy court has the power to oversee the allocation of insurance proceeds among claimants, and to prevent a race to recover those proceeds, depends in large part on whether the insurance proceeds become property of the estate.").

169. *See id.* at 395; Silverstein, *supra* note 84, at 27-28; *see also* H.R. REP. NO. 595, at 367-68 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963 (noting Congress intentionally construed the language "property of the estate" broadly).

170. 11 U.S.C. § 541(a) (2006).

171. 11 U.S.C. § 362.

172. *See* Owaski v. Jet Fla. Sys., Inc. (*In re* Jet Fla. Sys., Inc.), 883 F.2d 970, 973 (11th Cir. 1989) (holding claimants are not precluded from proceeding against debtor by section 524(e) where claimant is ultimately trying to collect from the debtor's insurer). Even if insurance proceeds are not treated as property of the estate, the court may still exercise control over the proceeds through its equitable powers. This would require affirmative action on behalf of the trustee to obtain an injunction to prevent distributional problems. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 401 ("In effect, then, a bankruptcy court could provide sufficient protection to a debtor and its insurers even if the insurance proceeds were not considered property of the estate.").

173. *See* Zaretsky, *Co-Debtor Stays*, *supra* note 35, at 276.

174. *See* Boyle, *supra* note 156, at 449.

175. Zaretsky, *Insurance Proceeds*, *supra* note 18, at 405.

176. *See infra* Part III.A.

a. Arguments for Granting Releases and Injunctions to Insurers

Some courts are willing to grant releases to debtors' insurers that agree to contribute to the plan of the reorganization.[177] This is based on the contributing nondebtor theory discussed earlier in relation to insiders.[178] For Chapter 11 debtors facing mass tort claims or securities class actions, various courts have released insurance companies in exchange for contributing funds to a trust upon which the plaintiffs could draw.[179]

b. Arguments Against Granting Releases and Injunctions to Insurers

When there is no dispute as to the distribution of insurance proceeds, scholars argue that the non-bankruptcy policy goal of satisfying tort claimants in a timely manner favors less interference from the courts.[180] Under those circumstances, incentivizing an insurance company to contribute to a plan of reorganization in exchange for a release is misguided because the results will be the same whether the claimants recover inside or outside of bankruptcy, and the debtor does not gain a benefit either.

Another argument asserted by courts and scholars opposed to releasing insurance companies in exchange for contributing to the plan is that insurance companies are simply fulfilling contractual obligations by paying out the amount due under the terms of the insurance policy.[181]

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177. *See, e.g.*, MacArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89, 90 (2d Cir. 1988) (finding that insurer's funding of claimants fund in exchange for discharge of liabilities was a "cornerstone" of the reorganization); UNARCO Bloomington Factory Workers v. UNR Indus., 124 B.R. 268, 278 (N.D. Ill. 1990) (upholding discharge of insurance company that funded the reorganization, but indicating that discharge would not be appropriate for insurers that did not settle and contribute proceeds to the reorganization).

178. *See supra* text accompanying notes 140-141.

179. *See, e.g.*, *Johns-Manville Corp.*, 837 F.2d at 90-91 (third party insurer channeled $770 million settlement fund); SOBOL, *supra* note 90, at 219 (A. H. Robins' reorganization plan provided for a contribution of unused insurance proceeds from the third party insurer).

180. *See* Zaretsky, *Insurance Proceeds*, *supra* note 18, at 414-15.

> However, when multiple claimants seek insurance proceeds that appears [sic] to be insufficient to satisfy the claims, the problem of equitable distribution of the debtor's assets among claimants arises and may outweigh the nonbankruptcy interest in timely satisfaction of claims. In that event, the bankruptcy court may assert jurisdiction over the policy proceeds, both during and, if necessary, after the close of a bankruptcy case, in order to enforce an equitable distribution of the proceeds among the claimants.

Id. at 415.

181. *See, e.g.*, *In re* Mahoney Hawkes, LLP, 289 B.R. 285, 300-01 (Bankr. D. Mass. 2002) (ruling that an insurance company's payment to the estate under the debtor's policy did not constitute a "substantial contribution" for purposes of satisfying the *Master Mortgage* test because the insurance company was just fulfilling its contractual obligation).

III. THE LIMITED POWER OF BANKRUPTCY COURTS TO GRANT NONDEBTOR RELEASES AND INJUNCTIONS

It is my view that bankruptcy courts do have the *authority* to grant nondebtor third party releases and injunctions. As discussed previously, section 105(a) grants the bankruptcy courts broad equitable powers in carrying out the provisions of the Code.[182] Further statutory authority is found in section 1123(b)(6), which provides that a plan may contain "any other appropriate provision not inconsistent with the applicable provisions of this title."[183] And, Bankruptcy Rule 3016(c) indicates that Congress may have considered nondebtor injunctions because the rule states that if a plan provides for an injunction not specifically authorized in the Code, such provision and the affected parties must be identified in the plan and disclosure statement.[184] While section 524(e) has been cited by anti-release courts and academics as a statutory limit on the authority of bankruptcy courts to grant nondebtor third party releases,[185] this section does not expressly limit bankruptcy courts' authority to approve nondebtor third party releases. Section 524(e) 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."[186] As the Seventh Circuit reasoned in a recent case, if Congress intended to limit this authority, it could have "used mandatory terms such as 'shall' or 'will' rather than the definitional term 'does.'"[187] Although section 524(e) clearly should not be read as an automatic release of co-obligors, it does not prohibit a bankruptcy court from taking separate action under its equitable powers to grant these releases.

A 2009 United States Supreme Court decision, in dicta, approved of bankruptcy courts' authority to confirm a plan with a third party release.[188] In *Travelers*, the Supreme Court revisited the approval of the settlement between Johns-Manville and its insurers, which released the insurers from all tort liability in exchange for a contribution by the insurance companies of $770 million to the plan.[189] When asbestos tort claimants attempted to bring action against the insurers sixteen years later, the bankruptcy court

182. *See* 11 U.S.C. § 105 (2006); *supra* note 58 and accompanying text.
183. *See* 11 U.S.C. § 1123(b)(6); *supra* note 58 and accompanying text.
184. *See* FED. R. BANKR. P. 3016(c); *supra* note 59 and accompanying text.
185. *See supra* Part II.A.2.
186. 11 U.S.C. § 524(e).
187. Airadigm Commc'ns, Inc. v. FCC (*In re* Airadigm Commc'ns, Inc.), 519 F.3d 640, 656 (7th Cir. 2008).
188. *See* Travelers Indem. Co. v. Bailey, 129 S. Ct. 2195 (2009).
189. *Id.* at 2199.

enjoined the action.[190] The Supreme Court rejected the argument that the bankruptcy court lacked jurisdiction, noting that "the Bankruptcy Court plainly had jurisdiction to interpret and enforce its own jurisdiction to interpret and enforce its own prior orders."[191] Accordingly, the Supreme Court implied that the bankruptcy court initially had authority to approve the third party release and injunction.[192]

Having come to the conclusion that bankruptcy courts do have the authority to grant nondebtor releases and injunctions, I will now argue that this power should be used only in very rare circumstances.

A. Policy Considerations Dictate that Injunctions and Releases Be Granted to Insurance Companies in Mass Tort and Class Action Cases, Subject to Several Caveats

Under certain circumstances, insurers should be granted releases or injunctions against future suits because doing so will aid the debtor's reorganization and will promote the fair and equitable distribution of assets to creditors.[193] There is a unique need for nondebtor releases and injunctions in class actions and mass tort cases. When insurance proceeds do not cover all potential claims, issues arise. If the insurance proceeds are not considered "property of the estate," there will be a race to the proceeds and the insurance company will simply pay out the proceeds on a first-come, first-served basis. This leaves some claimants paid in full and others without any form of compensation or redress.[194] Thus, it is best to bring the policy proceeds into the bankruptcy proceeding, and an efficient way in which to do this is by channeling the proceeds into a claimants trust. Even when insurance proceeds are considered "property of the estate," it is best to channel the funds into a trust so that the insurance proceeds are available to the victim claimants and not to the general body of creditors.[195]

190. *Id.* at 2201.

191. *Id.* at 2205.

192. *See* Joan N. Feeney, BANKRUPTCY LAW MANUAL § 11A:58 (5th ed. 2010).

193. Tort claimants are not considered creditors by all courts, however they will be included in the definition of creditors for the argument in this Note.

194. *See, e.g.*, Hartford Cas. Ins. Co. v. Dodd, 416 F. Supp. 1216, 1219 (D. Md. 1976), *aff'd*, 568 F.2d 773 (4th Cir. 1978) (insurer is not required to wait until all claimants come forward before distributing proceeds).

195. *See, e.g.*, Boyle, *supra*, note 156, at 448-49 (noting that an interesting effect of including insurance proceeds within the Code's definition of "property of the estate" is that the proceeds become available to "non-victim creditors"). These creditors are essentially granted a windfall as they would otherwise not have access to the insurance proceeds.

Mass tort cases[196] present a unique problem for bankruptcy courts in part because of the need to protect the interests of future claimants. Asbestos claimants and other personal injury claimants may be unaware of their injuries for years, and there is a danger that the Chapter 11 debtor will receive a discharge from liability well before some claimants' injuries are even known.[197] By creating a claimants trust, future claimants' interests can best be protected. The trust, funded in part by insurance proceeds, but often also with a percentage of the reorganized entity's profits, as well as equity in the reorganized entity, can continue to pay out claims as claimants become aware of their injuries.

Circuit courts that have dealt with Chapter 11 debtors facing mass tort and class action litigation have found occasion to grant the debtor's insurers releases in exchange for channeling insurance proceeds into a claimants fund.[198] Going forward, bankruptcy courts confronted with mass tort litigation and class actions that pose insurmountable challenges to a reorganization plan should consider granting releases to insurers who will agree to contribute to a claimants fund, subject to several caveats. These caveats are discussed next.

First, the insurer must contribute some additional value to the plan of reorganization beyond what it is contractually obligated to provide. This may be in the form of a monetary contribution above and beyond what the insurer is contractually obligated to pay under the policy, a promise by the insurer not to litigate whether the claims are actually covered under the policy, or preferably, both. Debtor's insurers will often dispute whether claims are covered.[199] The court must determine whether there is in fact a good faith dispute or whether the insurer is raising a non-meritorious defense. If the insurer's defense is meritless, the court should deny the release or injunction to the insurer because the insurer is simply tying the debtor up in costly litigation. If the insurer's assertion is made in good faith, the court should consider granting a release or injunction to the insurer in exchange for its contribution to the plan. Assets of the estate will not

196. Securities litigation class actions do not raise the same issues because the claimants are generally known.

197. *See, e.g.*, *supra* text accompanying note 93.

198. *See, e.g.*, Menard-Sanford v. Mabey (*In re* A. H. Robins Co.), 880 F.2d 694, 696 (4th Cir. 1989) (third party insurer contributed assets to a claimants fund); MacArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89, 90 (2d Cir. 1988) (third party insurer contributed $770 million to a claimants fund).

199. *See, e.g.*, Cont'l Cas. Co. v. Fibreboard Corp., 762 F. Supp. 1368, 1369 (N.D. Cal. 1991), *aff'd*, 953 F.2d 1386 (9th Cir. 1992), *vacated*, 113 S. Ct. 399 (1992) (insurer brought an action seeking declaratory judgment that it was not obligated to indemnify asbestos manufacturer for punitive damages awarded to personal injury claimants by juries in two states).

be wasted litigating with the insurer over whether the claims actually fall within the insurance policy. The time that is saved by eliminating litigation between the debtor and its insurers will benefit both the debtor, which will be able to focus on the reorganization, and tort claimants, who will be able to recover more quickly for their injuries. In *A. H. Robins*, Aetna initially disputed whether the claims were covered under the policy, but ultimately agreed not only to contribute all of the remaining product liability insurance proceeds to the trust for the benefit of the Dalkon Shield victims, but also to cover an additional $100 million in outlier insurance and $250 million in excess insurance in exchange for a release from future liability.[200] If this additional value is not secured from the insurer, the insurer would gain a release without providing adequate consideration. The additional contribution will be beneficial to the debtor because it will increase the value of the debtor's estate; this, in turn, will benefit creditors through a larger return on their claims.

Second, bankruptcy courts should consider granting claimants an option to opt out of the settlement and to pursue their claims against the insurer separately. To use the case of *A. H. Robins* again as an example, the Dalkon Shield victims were given an option to opt out of the settlement so that they could pursue claims against their medical providers and Aetna.[201] An opt-out provision is important because it protects claimants' due process rights. At the same time, however, courts need to consider whether an insurer will be willing to contribute to the plan of reorganization if the insurer is not assured of a cap on its liability. Claimants who opt out may attempt to recover punitive damages from the insurer, which could deter insurers from agreeing to an opt-out provision. The *A. H. Robins* court handled this issue by allowing Dalkon Shield victims that opted out of the settlement to recover only compensatory damages (not punitive) from Aetna.[202]

Although bankruptcy courts have the power to grant releases to insurance companies in these situations, it is a power that should be exercised with great care. Not every Chapter 11 reorganization is successful and bankruptcy courts must find only by a preponderance of the evidence that a

200. *A. H. Robins Co.*, 880 F.2d at 701 n.6; *cf. In re* Mahoney Hawkes, LLP, 289 B.R. 285, 300 (Bankr. D. Mass. 2002) (holding that an insurance company's payment to the estate under the debtor's policy did not constitute substantial contribution for purposes of satisfying the *Master Mortgage* test because the insurance company was just fulfilling its contractual obligation).

201. *A. H. Robins Co.*, 880 F.2d at 701 & n.7 (noting that of 110,000 class B claims, only 2960 exercised their right to opt out).

202. *See supra* note 102 and accompanying text.

plan is "feasible."[203] Risk is high in mass tort cases where the value of tort claims is unknown; for example, in *Johns-Manville*, far more individuals filed personal injury claims than anticipated and the litigation trust that was set up was eventually able to pay only five percent of a claim's value.[204] Bankruptcy courts, therefore, should be exceedingly cautious in using section 105 powers to approve Chapter 11 plans containing channeling injunctions and releases of debtors' insurers.

B. Policy Considerations and a Changing Landscape Dictate that Releases and Injunctions Not Be Granted to Debtors' Insiders

Although asbestos mass tort litigation may for the most part be behind us, the bankruptcy courts have certainly not been granted any reprieve. In the face of a crippling recession, 89,402 companies filed for bankruptcy in 2009, thirty-eight percent more than in 2008.[205] The year 2009 ushered in a fifty percent increase in the number of public companies filing for bankruptcy from 2008, the highest number since 2002.[206] The number of large companies, with $1 billion in assets or more, that filed was also fifty percent higher than in 2008.[207] The year 2009 witnessed the filings of some of the largest Chapter 11 cases ever: General Motors Corporation, Chrysler LLC, CIT Group, Inc., and General Growth Properties, Inc., to name just a few.[208] These mammoth filings followed the largest corporate bankruptcy in American history, the failure of the Wall Street investment bank Lehman Brothers.[209]

1. Shift Towards Pre-Arranged Bankruptcies and Use of Turnaround Management Renders the Insider Assistance and Cooperation Justification for Insider Releases and Injunctions Moot

Not only has there been a boom in large public company Chapter 11 filings in recent years, there seems to be a fundamental shift, for many, in the

203. *See* 11 U.S.C. § 1129(a)(11) (2006) (laying out the feasibility requirement, that a Chapter 11 reorganization plan cannot be confirmed if it is likely to result in "liquidation, or the need for further financial reorganization of the debtor or its successors").

204. *See* Silverstein, *supra* note 84, at 82-83 (citing Findley v. Trs. of Manville Pers. Injury Settlement Trust (*In re* Joint E. and S. Dist. Asbestos Litig.), 237 F. Supp. 2d 297, 303 (E.D.N.Y. & S.D.N.Y. 2002)).

205. Michael J. de la Merced, *2009: A Banner Year for Bankruptcies*, N.Y. TIMES (Feb. 10, 2010), http://dealbook.blogs.nytimes.com/2010/02/10/2009-a-banner-year-for-bankruptcies.

206. *Id.*

207. *Id.*

208. *Id.*

209. *See id.*

Chapter 11 bankruptcy process. Large public companies are increasingly taking advantage of alternatives to the traditional reorganization process.[210] Prepackaged business bankruptcies ("prepacks") and "363 sales," named for section 363 of the Bankruptcy Code, are both methods of prearranging reorganization, or at least a portion of the reorganization, prior to filing the Chapter 11 petition.

"A prepack 'is negotiated and accepted prior to the filing of a Chapter 11 case but . . . is approved and confirmed by the court in a subsequently filed Chapter 11 case.'"[211] In a prepack, creditors are solicited and the votes are obtained prior to the filing. One of the main benefits of a prepack is the speed with which a debtor can enter and exit the bankruptcy process.[212] CIT Group, Inc. filed a prepack on November 1, 2009 and emerged from bankruptcy just forty days later with $10.5 billion less in debt.[213] This contrasts sharply with the twelve to thirty-six months required for a normal Chapter 11 reorganization.[214] Recent trends have also shown a rise in the number of quick sales of debtor assets, enabling the business to restart under new ownership.[215] Commonly referred to as "363 sales," Chrysler LLC and others have taken advantage of this alternative to the traditionally lengthy reorganization process.[216]

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210. Mike Spector, *Quickie Bankruptcy Filings: Companies Zoom In, Zoom Out*, WALL ST. J. (Jan. 5, 2010), http://online.wsj.com/article/SB10001424052748704789404574636164199387026.html ("In 2009, the number of prearranged bankruptcies, in which many creditors approve a reorganization plan ahead of a filing, tripled to 30 among publicly traded companies compared with the year before . . . .").

211. Rhett G. Campbell, *Prepacks Reduce Time and Costs of Business Filings*, NAT'L L.J. (Mar. 5, 2007), *available at* http://www.tklaw.com/resources/documents/Rhett%20Campbell_National%20Law%20Journal_Prepacks%20Reduce%20Time%20and%20Costs%20of%20Business%20Fiilings.pdf (quoting 4 WILLIAM L. NORTON, NORTON BANKRUPTCY LAW & PRACTICE 2D § 86:1 (2007)).

212. *Id.* ("Speed is a prepack's primary benefit.").

213. *See* Spector, *supra* note 210.

214. *See* Campbell, *supra* note 211 ("The average business bankruptcy in 2005 required 19.5 months to reach confirmation . . . .").

215. *See* William J. Burnett, *Trustee Talk in Troubled Times: A Conversation About Commercial Chapter 7 Cases and the Role of Trustee's Counsel During the Great Recession*, ASPATORE 1 (Mar. 2010), *available at* 2010 WL 895206.

216. *See, e.g.*, Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc., 554 U.S. 33, 37 n.2 (2008) (debtor filed a Chapter 11 liquidation plan after selling substantially all of its assets as a going concern pursuant to section 363(b)(1)); *In re* Chrysler LLC, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009) ("A debtor may sell substantially all of its assets as a going concern and later submit a plan of liquidation providing for the distribution of the proceeds of the sale. This strategy is employed, for example, when there is a need to preserve the going concern value because revenues are not sufficient to support the continued operation of the business and there are no viable sources for financing.").

Additional changes have occurred in recent years that further problematize the practice of granting releases to Chapter 11 debtor insiders. After the Enron scandal, followed closely by the failures of Worldcom, Inc. and Adelphia Communications, actions of insiders became headline news.[217] Although the Bankruptcy Code allows for the appointment of a trustee to take the place of the debtor-in-possession, no one made this motion in the Enron Corporation case, and Ken Lay and other insiders were given time to appoint their own replacement management.[218] Partly in response to the failure to appoint a trustee in the Enron case, the 2005 Amendments to the Bankruptcy Code attempted to encourage courts and the U.S. Trustee's office to appoint trustees in more Chapter 11 cases.[219] Under the new amendments, the U.S. Trustee is required to move for appointment of a trustee "if there are reasonable grounds to suspect that current [management] . . . participated in actual fraud, dishonesty, or criminal conduct."[220] In addition, the bankruptcy court may replace the debtor-in-possession (i.e., the management of the debtor) with a trustee if it "is in the best interests of creditors and the estate."[221] Going forward, existing management may more and more frequently be replaced by trustees.

Recent cases also indicate a surge in the use of Turnaround Management (TM) Specialists. TM temporarily takes over the business in order to restructure and reorganize the company.[222] TM served as trustees and as consensual replacement for management in some of the largest recent reorganizations.[223]

Although the concern always existed that current management was responsible for driving the company into bankruptcy and thus should not be trusted with its reorganization, these recent changes give additional reasons not to view current management as necessary to the reorganization, and therefore, not entitled to releases or injunctions. As previously noted, one reason asserted for granting releases to insiders was to secure the insider's continued support under the assumption that the insider had the most knowledge about the company and was best able to lead the reorganization.[224]

217. ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 436 (6th ed. 2008).

218. *See* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 147 (2005).

219. *See* WARREN & WESTBROOK, *supra* note 217.

220. 11 U.S.C. § 1104(e) (2006).

221. *Id.* § 1104(a)(3).

222. *See* WARREN & WESTBROOK, *supra* note 217, at 438.

223. *See id.*

224. *See supra* text accompanying notes 138-139; *see also* H.R. REP. NO. 595, at 6192 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963 ("[V]ery often the creditors will be benefitted

But now, with large corporate debtors bringing in turnaround specialists, insider cooperation and assistance is a less pressing concern. A study focusing on large corporate Chapter 11 filings in 2001 found that seventy percent of CEOs were replaced within the two years preceding the filing.[225] "This represents a sharp increase over comparable figures reported in previous studies and suggests strongly that Chapter 11 does not provide a safe harbor for entrenched managers."[226] Between 1990 and the early 2000s, CEO turnover rates in bankruptcy increased sixty-five percent.[227] And, for entrenched managers, meaning those with significant equity holdings, the turnover rate increased by more than 200 percent.[228] Including the two year post-filing period increases the proportion of CEOs replaced from seventy to eighty percent, although this is likely an underestimation because the researchers did not systematically collect post-petition data.[229] These statistics suggest that debtors find that the incremental benefit of keeping existing management in place outweighed by the benefits of bringing in new management. It follows that securing existing management's cooperation and assistance with the plan of reorganization is no longer, and may never have been, a valid reason for granting a release.

In addition, the trend towards pre-packaged bankruptcies and 363 sales places insiders in a position adverse to that of creditors. There is a heightened concern that insiders will not act in the best interests of creditors or the estate. Creditors often prefer prearranged bankruptcies because the creditors are able to recover more quickly and they avoid the risk of any further decline in the company's value. Insiders, on the other hand, may prefer traditional Chapter 11 reorganizations because not only are they able to keep their jobs, but they stand to benefit further if the company is able to rebound over the course of the reorganization. Insiders may act out of self-interest in guiding the debtor into a traditional reorganization and bypass a more efficient and effective pre-arranged bankruptcy. The misalignment of insiders' and creditors' interests provides yet another reason not to grant releases and injunctions to insiders.

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by continuation of the debtor-in-possession, both because the expense of a trustee will not be required, and the debtor, who is familiar with his business, will be better able to operate it during the reorganization case.").

225. Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 513 (2009).

226. *Id.*

227. *Id.* at 516.

228. *Id.* at 516.

229. *Id.* at 552. Ayotte and Morrison attribute this change to increased control of bankruptcies by creditors. *Id.* at 516.

2. Shift Towards Pre-Arranged Bankruptcies and Use of Turnaround Management Renders the Contributing Nondebtor Justification for Insider Releases and Injunctions Moot

Another reason asserted by courts and scholars for granting insiders releases is the contributing nondebtor theory—the idea that insiders should be granted releases in exchange for substantial monetary contribution to the plan.[230] This justification is weak for several reasons.

First, part of the traditional justification for the contributing nondebtor theory is to give insiders an equity interest in the company that would encourage the insiders to make the reorganized company as successful as possible. As recent statistics demonstrate, however, large corporations are not retaining old management, so the need to obtain this incentive structure is no longer a viable justification for releasing an insider.

Second, there have always been concerns that the amount of the monetary contribution did not support a full release of all personal liability, and in response, some courts showed reluctance to accept this justification.[231] The court risks releasing an insider from liability that far exceeds the amount of the monetary contribution to the plan. If the debtor is jointly liable with the insider, the debtor is then faced with potentially footing the bill for claimants who are enjoined from asserting claims against the insider.

Related to this second point is the idea that an insider's willingness to contribute to a plan of reorganization is not a reliable measure of a company's going concern value, and as discussed previously, a goal of bankruptcy is to rehabilitate only those companies with going concern value and to liquidate the rest.[232] Insiders' willingness to commit their own funds is not a good measure of going concern value because an insider's judgment may be clouded by sentimental reasons that do not comport with the actual viability of the company, including the desire to save jobs, an admirable but potentially unrealistic goal. This is particularly prevalent in Chapter 11 filings of smaller companies. It may be better for creditors of these smaller debtors to allow the company to be liquidated and go after the insider personally for the balance of their unpaid claims, for example, if the insider guaranteed the companies debt. More importantly, the insider is essentially

230. *See supra* text accompanying notes 140-141.

231. Consider the example of A. H. Robins, where the Robins family received American Home Products stock worth $385 million as a tax-free distribution on their A. H. Robins stock under the reorganization plan in exchange for a mere $10 million contribution to the plan; but, the Fourth Circuit subsequently found this amount not to be "substantial." *See supra* notes 106-107, 110 and accompanying text.

232. *See supra* text accompanying notes 18-21.

buying her freedom from personal liability, so the price she is willing to pay may not accurately reflect the likelihood that the company will succeed as a going concern.

3. *Need to Obtain Releases from Indemnity and Contribution Claims is an Illusory Justification for Granting Insider Releases and Injunctions*

As discussed earlier in this Note, commentators have aptly addressed the many obstacles facing an insider seeking to obtain indemnification or contribution from the debtor.[233] As these commentators suggest, the debtor is no better off when it grants releases to insiders in exchange for obtaining a release from indemnification or contribution claims by the insider. The reason is that the debtor is only liable for a small number of allowed claims on which it is a co-obligor, and even for those, the insider simply pays the creditor and becomes a general unsecured creditor.[234]

4. *Two Caveats to Refusing Releases and Injunctions to Insiders: Temporary Stays and Consensual Releases*

As discussed in Part I, courts often temporarily enjoin creditors from asserting claims against individual officers, directors, and employees until the plan is confirmed when claims would take insiders' time and energy away from focusing on the reorganization, and "in order to fully effectuate the breathing spell from creditor actions that the automatic stay seeks to afford the debtor."[235] A bankruptcy court may use its equitable powers to impose a temporary nondebtor stay to the extent the stay will aid in the reorganization and ensure fair and equitable distribution to creditors. The Supreme Court implicitly sanctioned temporary nondebtor stays in *Celotex Corp. v. Edwards*.[236]

Temporary stays may in fact benefit the debtor and creditors, because the debtor's indemnification or contribution obligations are discharged upon confirmation of the plan.[237] If the insider is found liable after the plan is confirmed, he or she is foreclosed from seeking contribution or indemnification from the debtor. For this reason, courts should be especially willing to grant temporary stays to insiders.

233. *See supra* text accompanying notes 143-152.

234. *Id.*

235. Brubaker, *Bankruptcy Injunctions, supra* note 77, at 970, 970 n.42 (section 362(c)(2)(C) states that a "stay terminates upon grant of discharge in Chapter 11 case").

236. 514 U.S 300 (1995).

237. *See* 11 U.S.C. § 502(e)(1)(B) (2006).

Additionally, when a release or injunction is consensual, the bankruptcy court need not stand in the way.[238] This enables the creditors to exercise their own discretion over what is in their best interests, without dragging the bankruptcy court into the debate.[239]

CONCLUSION

Although bankruptcy courts do have the authority to approve Chapter 11 plans that contain nondebtor releases and injunctions, this power should be exercised only under extraordinary circumstances.

If a debtor is faced with mass tort or class action litigation that threatens to upend any attempt at reorganization, a debtor's insurers may be released from liability, but only if three conditions are met. First, there must be a substantial risk that the proceeds the insurer is obligated to pay under the policy will not cover the claims. Second, the insurer must contribute more value than it is otherwise obligated to provide under the terms of the insurance agreement. Third, the insurer must contribute the funds to a claimants trust that segregates them from those available to the general pool of creditors so that the ability of the victims of the mass tort or securities fraud to recover on their claims is not disturbed by the overreaching of other creditors.

Public policy considerations and recent changes in the process by which debtors attempt to reorganize weigh against granting insiders permanent injunctions or releases. The increased utilization of prearranged bankrupt-

238. *See* Starr, *supra* note 137, at 501 ("When an insider release is a consensual provision, which a creditor may freely accept or reject, it is no different than any other settlement and does not implicate section 524(e). The bankruptcy court simply exercises its umbrella jurisdiction over the tripartite settlement among the insiders, the debtor, and the creditors. The benefit-burden principle is respected because the insiders must offer sufficient inducement to creditors to achieve settlement, while retaining the risk of claims by objectors. The moral hazard is eliminated because the insiders are not protected from the consequences of prepetition acts by the ability to use the Code to force a discounted settlement on unwilling creditors. Experience shows that the prospect of voluntary releases can be sufficient inducement for settlement and that such settlements fairly serve the interests of all parties . . . in the reorganization.").

239. *See, e.g.*, *In re* AOV Indus., Inc., 31 B.R. 1005, 1008-09 (D.D.C. 1983), *aff'd in part, rev'd in part*, 792 F.2d 1140 (D.C. Cir.), *vacated in part*, 797 F.2d 1004 (D.C. Cir. 1986) (reorganization plan was funded by the two largest creditors who made funds available to other creditors who would grant them a release. No discharge was realized because the creditors were free to reject the funds and maintain their claims.); *In re* Monroe Well Serv. Inc., 80 B.R. 324, 329 (Bankr. E.D. Pa. 1987) (explaining benefits to all parties from plan providing for voluntary releases); Starr, *supra* note 137, at 500 (noting that insider releases given by creditors in exchange for consideration, where objecting creditors have the opportunity to opt out, can effectively serve the interests of all parties involved in a reorganization without expanding the discharge power beyond the limits of its legislative grant).

cies negates the need for insider assistance and cooperation since the plan is arranged prior to the debtor filing the Chapter 11 petition. The use of turnaround management and the replacement of insiders either prior to or following the Chapter 11 filing indicate that large corporations do not see a need to induce insiders to remain with the company by granting insiders releases in exchange for the contribution of new value. Lastly, this Note argues that commentators have been correct in asserting that the need to obtain releases from insiders for indemnity or contribution claims against the debtor is an illusory justification. On the other hand, temporary as opposed to permanent stays for insiders are largely unproblematic. Finally, bankruptcy courts may grant permanent releases or injunctions to insiders when creditors give their consent.