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NON-DEBTOR LIABILITY IN CHAPTER 11: VALIDITY OF THIRD-PARTY DISCHARGE IN BANKRUPTCY

PETER M. BOYLE

INTRODUCTION

In response to the recent explosion in the number of bankruptcy filings, creditors are increasingly seeking protection from debtor insolvency by securing guarantors and co-obligors. A creditor's reliance on such guaranties may be frustrated, however, when a bankruptcy court exercises jurisdiction over a third-party guarantor or obligor—referred to in this context as the non-debtor—and releases that non-debtor from liability.¹ Discharges of non-debtors in bankruptcy proceedings have implications not only in the realm of guarantors and co-obligors but also in many other areas such as cases involving joint tortfeasor liability when liability is shared by a bankrupt entity and a non-debtor. Indeed, “[e]liminating [non-debtor] personal liability through confirmation of corporate plans of reorganization . . . tends to undermine the policy considerations underlying joint and several liability.”²

Section 524(e) of the Bankruptcy Reform Act of 1978³ (the “Bankruptcy Code” or “Code”) provides that the discharge of a debtor in bankruptcy does not affect the liability of any other party.⁴ Accordingly, courts have unanimously held that where a Chapter 11 plan of reorganization is silent on a non-debtor's liability, section 524(e) applies

1. See Richard N. Tilton & Brian D. Wild, *Protecting Co-Obligors And Non-Debtor Guarantors*, N.Y. L.J., Nov. 14, 1991, at 5. Non-debtors in the bankruptcy context include but are not limited to guarantors of the debtor, the debtor's insurer, partners in a debtor partnership, see Michael L. Cook & Stanley D. Brenner, *Third-Party Releases in Chapter 11 Reorganization Plans*, 611 PLI/Corp. 369 (1992), available in, Westlaw, TP-ALLREV database, at *1 (PLI Order No. A4-4374), and parties that may be joint and severally liable along with the debtor, see, e.g., *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694, 700 (4th Cir.) (non-debtors included several parties that shared joint tortfeasor liability with the debtor), *cert. denied*, 493 U.S. 959 (1989).

2. Objection of the Securities and Exchange Commission to the Confirmation of the Debtor's Plan of Reorganization Unless a Plan Provision Which Purports to Release Non-Debtor Third Parties is Deleted from the Plan at 7, *In re The Southland Corp.*, 124 B.R. 211 (Bankr. N.D. Tex. 1991) (No. 390-37119-HCA-11) [hereinafter SEC Brief] (citation omitted) (amicus brief of SEC).

3. Bankruptcy Reform Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988)) [hereinafter Bankruptcy Code]. The Bankruptcy Code of 1978 became effective for petitions filed after October 1, 1979. See Kenneth M. Cushman & J. Gregg Miller, *Effect of the New Bankruptcy Law on Traditional Surety Rights*, 16 Forum 1011 (1980-1981). The Bankruptcy Code replaced the Bankruptcy Act of 1898 as amended. See Grady L. Pettigrew, Jr., *Federal Bankruptcy Code: Theory into Practice 1* (1982).

4. See 11 U.S.C. § 524(e) (1988). A discharge in bankruptcy is the release of the debtor from its debts. See Black's Law Dictionary 463 (6th ed. 1990). Section 524, applicable to all cases under Chapter 7, 11, 12 and 13 of the Code, see 11 U.S.C. § 103(a) (1988), governs the affect of discharges in a Chapter 11 proceeding. See 11 U.S.C. § 524 (1988).

to bar the discharge of the non-debtor.⁵ Where the plan purports to release a non-debtor from liability, however, the courts have differed on the validity of such a plan.⁶ Determining the validity of Chapter 11 plans of reorganization calling for third-party discharges is significant because a plan of reorganization may only be confirmed if it complies with all applicable provisions of the Code.⁷

While section 524(e) restricts discharges of non-debtors, section 105(a)⁸ of the Code vests the bankruptcy courts with broad equitable powers.⁹ Pursuant to its equitable powers, a bankruptcy court may take any action "necessary or appropriate" to effect the provisions of the Code.¹⁰ Courts have invoked their section 105(a) equitable powers to issue permanent injunctions thereby releasing non-debtors from liability.¹¹ Permanently enjoining third parties, however, runs contrary to the mandate of section 524(e).

The respective applications of section 105(a) or section 524(e) to non-debtor discharges under Chapter 11 embody certain potential benefits depending upon which provision is favored. On the one hand, allowing the courts to use their broad equitable powers to discharge non-debtors may facilitate the reorganization of the debtor, ensure cooperation of third parties whose assistance is essential for a successful reorganization, possibly generate non-debtor contributions to the reorganization that the non-debtor otherwise would not have made, and cut off any claim for indemnification or contribution that the non-debtor may have against the debtor. On the other hand, precluding third-party discharges will maintain the integrity of guaranties which in turn will have a beneficial impact upon the costs of financing, increase the probability that victims of joint tortfeasors will receive full compensation, and remove a sanctuary for culpable officers and directors of corporations. Moreover, precluding

5. See Richard F. Broude, *Recent Developments in the Chapter 11 Plan Process*, C638 ALI-ABA 251 (1991), available in Westlaw, TP-ALLREV database (citing *Inforex Inc. v. Burrige (In re Inforex)*, 26 B.R. 515 (Bankr. D. Mass. 1983); *United States ex rel. Small Business Admin. v. Kurtz*, 525 F. Supp. 734 (E.D. Pa. 1981), *aff'd mem.*, 688 F.2d 827 (3d Cir.), *cert. denied*, 459 U.S. 991 (1982)). *But see* *Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, 21 B.R. 777 (Bankr. D.N.M.) (the court, prior to confirmation of the reorganization plan, issued a permanent injunction barring enforcement of a state court judgment against a non-debtor), *aff'd*, 25 B.R. 1018 (D.N.M. 1982). Section 524(e) is codified in Chapter 5 of the Code. Chapter 5 is applicable to Chapter 11 cases by way of § 103(a). See 11 U.S.C. § 103(a) (1988).

6. See Broude, *supra* note 5.

7. See 11 U.S.C. § 1129(a)(1) (1988).

8. Section 105(a) is codified in Chapter 1 of the Code. See 11 U.S.C. §§ 101-109 (1988). Section 103(a) provides that Chapter 1 is applicable to cases under Chapter 11. See 11 U.S.C. § 103(a) (1988).

9. See Manuel D. Leal, *The Power of the Bankruptcy Court: Section 105*, 29 S. Tex. L. Rev. 487, 489-90 (1988).

10. See 11 U.S.C. § 105(a) (1988).

11. See Joel C. Shapiro, *Non-Debtor Third Parties and the Bankruptcy Code: Is Protection Available Without Actually Filing?*, 95 Com. L.J. 345, 347 (1990). For purposes of this Note, a "non-debtor discharge" is a permanent injunction issued pursuant to the bankruptcy court's § 105(a) equitable powers.

non-debtor discharges ensures that only parties that have submitted to the jurisdiction of the bankruptcy court will receive the benefits intended under the Code.

This Note addresses the central question that arises as a result of inconsistent interpretations of sections 524(e) and 105(a) of the Bankruptcy Code: Whether the bankruptcy court has the authority under section 105(a) to discharge a non-debtor via confirmation of a Chapter 11 plan of reorganization in spite of section 524(e)'s mandate that a discharge shall not affect the obligations of non-debtors. Part I of this Note discusses sections 524(e) and 105(a) in light of each respective provision's plain meaning and statutory context, the Bankruptcy Act of 1898¹² (the "Act" or "Bankruptcy Act"), and the Code's legislative history. Part II examines the manner in which courts have interpreted the Code with respect to the discharge of third-party non-debtor liability. Part III argues that the language, nature, and statutory context of the Code preclude a non-debtor discharge. Further, this Part urges Congress to codify the bankruptcy court's powers over insurance proceeds in order to restrict access to liability insurance proceeds to aggrieved parties and ensure equitable distribution of such funds in cases with multiple tort claimants. Finally, this Note concludes that the broad equitable powers of the bankruptcy court should not be extended to protect third party non-debtors who have not subjected themselves to the bankruptcy court's authority.

I. BACKGROUND TO SECTIONS 524 AND 105 OF THE BANKRUPTCY CODE: ORDINARY MEANING AND LEGISLATIVE HISTORY

A. Section 524(e)

1. Statutory Language

The language and purpose of the Code are the initial points of inquiry in determining whether section 524(e) operates as a bar against a non-debtor discharge under section 105(a). It is well settled that the plain meaning of the Code controls unless the provision of the Code in question produces a result that is contrary to established legislative intent.¹³

Section 524(e) reads as follows: "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."¹⁴ Thus, in light of the fact that a discharge only affects the personal liabilities of a debtor,¹⁵ an ordinary reading of the section results in a construction that would operate to preclude a section 105(a) discharge of a non-debtor.

12. Act of July 1, 1898, ch. 541, 30 Stat. 544 [hereinafter Bankruptcy Act] (repealed 1978) (formerly codified at 11 U.S.C. §§ 1-1103).

13. See *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989) (citing *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982)).

14. 11 U.S.C. § 524(e) (1988) (emphasis added). Section 524(a)(3) deals with community claims—claims relating to a marital settlement. See 11 U.S.C. § 524(a)(3) (1988).

15. See 11 U.S.C. § 524(a)(1)-(2) (1988).

2. The Bankruptcy Act of 1898

Section 524(e) is the successor statute to section 16 of the Bankruptcy Act.¹⁶ Section 16 provided: "The liability of a person who is co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankrupt."¹⁷ In addition, section 4(b) of the Bankruptcy Act provided that a corporate debtor's discharge in bankruptcy shall not vitiate the liability of the debtor's officers, directors, stockholders, or other controlling entities.¹⁸ These provisions of the Bankruptcy Act seemingly would have prevented the discharge of a debtor from affecting the liability of specific third parties. Section 524(e), on the other hand, is applicable to "any entity" other than the debtor.¹⁹ Section 524(e) is broader than its predecessor and should, therefore, be applied broadly to restrict discharges of third parties.²⁰

3. Legislative History

Section 524(e)'s legislative history is sparse and offers little interpretative insight. The only reference to this section in the House or Senate Reports on the then-pending bankruptcy reform legislation is found in the Senate Judiciary Committee Report, which simply states that "[s]ubsection (d) [sic] provides the discharge of the debtor does not affect co-debtors or guarantors."²¹ This sole mention of the section by Congress, albeit incorrectly referenced, was simply a paraphrase of the section itself. Therefore, one may presume that Congress believed either that the subsection was so straightforward that it needed no extended discussion, or that Congress consciously ignored the subsection.

B. Section 105(a)

1. Statutory Language

In contrast to section 524(e), section 105(a) contains a blanket provision to effectuate the provisions of the Bankruptcy Code. Section 105(a) provides, in pertinent part, that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provi-

16. See *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985).

17. Act of July 1, 1898, ch. 541, § 16, 30 Stat. 544, 550 (repealed 1978).

18. See *Underhill*, 769 F.2d at 1432 (quoting Act of June 22, 1938, ch. 575, § 4(b), 52 Stat. 840, 845 (repealed 1978) (formerly codified at 11 U.S.C. § 22(b) (1976))).

19. Compare Act of July 1, 1898, ch. 541, § 16, 30 Stat. 544, 550 (repealed 1978) (providing that a discharge of debtor does not affect the liability of co-debtors, guarantors and sureties) with 11 U.S.C. § 524(e) (1988) (maintaining that a debtor's discharge does not affect the liability of any entity other than the debtor).

20. Indeed, as one court noted, "[i]t is hard to view this change as anything but a legislative mandate further to constrict the effect of a discharge." *Kathy B. Enters., Inc. v. United States*, 779 F.2d 1413, 1415 (9th Cir. 1986).

21. S. Rep. No. 989, 95th Cong., 2d Sess. 81 (1978), reprinted in 1978 U.S.C.A.N. 5787, 5867. See also Norton *Bankruptcy Law and Practice: Bankruptcy Code 446* (1990-1991 ed.) [hereinafter Norton] (an editor's comment indicates that the Senate Report should actually be read as subsection (e), not (d)).

sions of this title.”²² This subsection is generally regarded as the provision of the Code embodying the bankruptcy court’s equitable powers.²³ Although Congress granted the bankruptcy court broad equitable powers in section 105(a),²⁴ those powers are restricted by the bounds of the language and purpose of the Code.²⁵

The court’s powers are admittedly broad. Indeed, courts have invoked section 105 to control the rehabilitation of a debtor in mass-tort litigation situations,²⁶ stay state court proceedings to prevent obstruction of the reorganization,²⁷ and suspend or sanction inappropriate behavior by attorneys.²⁸ Nevertheless, as one commentator emphasizes, “[i]njunctive remedies under section 105 were not designed to create rights not otherwise available under applicable law. As noted by several circuit courts of appeals, bankruptcy courts are not to function as ‘roving commission[s] to do equity.’ ”²⁹ Thus, although the bankruptcy court’s equitable powers are indeed expansive, they are not boundless.

22. 11 U.S.C. § 105(a) (1988). The effect of § 105(a) is similar to the All Writs Act. See H.R. Rep. No. 595, 95th Cong., 2d Sess. 316-17 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6273-74. The All Writs Act was codified in 1948 at 28 U.S.C. § 1651 and authorized the Supreme Court and all courts created by Congress to issue all writs necessary to assist in the court’s jurisdiction, provided the writ was agreeable with the principles of law. See Leal, *supra* note 9, at 492-93 n.11.

“Section 105 was made part of the Code for the sake of continuity from prior law and ease of reference.” *Id.* at 494 (citing H.R. Rep. No. 595, 95th Cong., 2d Sess. 317 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6274).

23. See Timothy B. DeSieno & Khuong T. Ho, *Section 105—Power of Court*, in 1991 Ann. Surv. Bankr. L. 437, 437 (William L. Norton, Jr. ed.); Leal, *supra* note 9, at 489 n.2.

24. See Leal, *supra* note 9, at 489-90.

25. See Leal, *supra* note 9, at 489 n.2, 490; Cecelia N. Anekwe, Comment, *Responsible Officers Get Green Light at the Intersection of the Tax and Bankruptcy Codes; Bankruptcy Code Section 105 Can Be Used to Order the IRS to Apply Debtor Tax Payments to Trust Fund Taxes*, 21 Seton Hall L. Rev. 868, 868-69 (1991).

26. See *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694, 701 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989); *cf. MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89, 91 (2d Cir.) (“The Bankruptcy Court properly issued the orders pursuant to its equitable and statutory powers . . .”), *cert. denied*, 488 U.S. 868 (1988).

27. See Leal, *supra* note 9, at 497-500.

28. See Desieno & Ho, *supra* note 23, at 443.

29. Leal, *supra* note 9, at 502 (citing Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988); *United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986); *Southern Ry. Co. v. Johnson Bronze Co. (In re Johnson Bronze Co.)*, 758 F.2d 137, 141 (3d Cir. 1985)). The equitable powers of the courts under § 105(a) are not a license to disregard the language and meaning of the Bankruptcy Code. See *id.* at 490 n.6. Indeed, the Seventh Circuit stated, “[T]he fact that a proceedings [sic] is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.” *Id.* at 490-91 n.6 (quoting *In re Chicago, M., St. P. & Pac. R.R.*, 791 F.2d 524, 528 (7th Cir. 1986)); see also *Guerin v. Weil, Gotshal & Manges*, 205 F.2d 302, 304 (2d Cir. 1953) (equitable powers do not confer unfettered discretion upon a court to redistribute rights in any manner it sees fit).

2. The Bankruptcy Act

Section 105(a) is the successor statute to section 2(a)(15) of the Bankruptcy Act.³⁰ Section 2(a)(15) provided that bankruptcy courts may “[m]ake such orders, issue such process, and enter such judgments, in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this Act: *Provided, however, [t]hat an injunction to restrain a court may be issued by the judge only.*”³¹ Thus, section 105(a) contemplates greater equitable powers than those embodied in its predecessor, section 2(a)(15).

3. Legislative History

Both the Senate and the House Reports on the Bankruptcy Reform Act of 1978 noted that section 105(a) contained two changes from section 2(a)(15) of the Act. The most pertinent of these alterations, with respect to a bankruptcy court’s authority to discharge non-debtors, removed the previous limitations on the power of bankruptcy judges to enjoin a court.³² In 1986, Congress amended section 105(a) to add a second sentence authorizing *sua sponte* powers which were designed to selectively broaden the scope of the court’s powers.³³

II. THE TUG-OF-WAR BETWEEN SECTIONS 524 AND 105: RESTRICTIVE VERSUS EXPANSIVE VIEWS OF THE BANKRUPTCY COURT’S EQUITABLE POWERS

A. *Section 524: A Restriction on the Bankruptcy Court’s Equitable Powers*

Courts that favor restricting equitable powers and, thus, precluding non-debtor discharges, cite factors such as a court’s lack of power to

30. Bankruptcy Act § 2(a)(15) (repealed 1978), in *The Bankruptcy Act of 1898 As Amended with Annotations 11* (John Hanna & James Angell MacLachlan eds., 4th ed. 1951) [hereinafter *Hanna & Angell*].

31. Bankruptcy Act § 2(a)(15) (repealed 1978), in *Hanna & Angell, supra* note 30, at 11.

32. See Norton Bankruptcy Law and Practice: Bankruptcy Code and Related Legislation, Legislative History and Editorial Commentary 75-76 (1990-1991 ed.) [hereinafter *Norton Bankruptcy*]. Congress originally granted the courts equitable powers by enacting 28 U.S.C. § 1481 in 1978. See John E. Swallow, Note, *The Power of the Shield—Permanently Enjoining Litigation Against Entities other than the Debtor—a Look at In re A.H. Robins Co.*, 1990 B.Y.U. L. Rev. 707, 709. Section 1481 read as follows: A bankruptcy court shall have the powers of a court of equity, law, and admiralty, but may not enjoin another court or punish a criminal contempt not committed in the presence of the judge of the court or warranting a punishment of imprisonment. Leal, *supra* note 9, at 494 (quoting 28 U.S.C. § 1481 (1982) (repealed 1984)). Section 1481 of title 28 was repealed as part of the 1984 amendments to the Code. See *id.* at 495. As a result, the bankruptcy court’s powers were defined in the Code solely by § 105 without any reference to title 28. See *id.* The House Report points out that § 105(a) authorizes a stay of state court proceedings. See H.R. Rep. No. 595, 95th Cong., 2d Sess. 316 (1977), reprinted in 1978 U.S.C.A.N. 5963, 6273-74.

33. See Leal, *supra* note 9, at 495.

affect a relationship other than that of the debtor and creditor,³⁴ and its inability to bypass section 524(e) by labelling a discharge as a permanent injunction.³⁵ In addition, courts, under both the Bankruptcy Code and the Bankruptcy Act, have pointed to the fact that private parties cannot waive a provision of the bankruptcy laws via consent to a plan of reorganization.³⁶

1. Section 524(e): A Bar to Non-Debtor Discharge

Section 16 of the Bankruptcy Act has been consistently interpreted as blocking bankruptcy courts from discharging non-debtor liabilities.³⁷ Indeed, one circuit court noted that “[t]he bankruptcy court can affect *only the relationship of debtors and creditor*.”³⁸ Section 16 was significant because, pursuant to its terms, operations of the federal bankruptcy laws could not effect the discharge of a co-obligor.³⁹

A substantial number of courts continue to follow this line of reasoning developed under section 16 of the Act.⁴⁰ Section 524(e), similar but not identical to its predecessor, places restrictions on a discharge that prevent the discharge from affecting the obligations of any party other than the debtor.⁴¹ Indeed, “[t]he confirmation of a Chapter 11 plan of reorganization should not release the obligations of non-party entities to

34. See *Mellon Bank v. Siegel*, 96 B.R. 505, 506 (E.D. Pa. 1989); *In re Elsinore Shore Assocs.*, 91 B.R. 238, 254 (Bankr. D.N.J. 1988); *Bill Roderick Distrib., Inc. (In re A.J. Mackay Co.)*, 50 B.R. 756, 761 (D. Utah 1985).

35. See *American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.)*, 885 F.2d 621, 626 (9th Cir. 1989).

36. See *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985); *Union Carbide Corp. v. Newboles*, 686 F.2d 593, 595 (7th Cir. 1982) (decided under the Bankruptcy Act).

37. See *Union Carbide Corp.*, 686 F.2d at 595; *Weber v. Diversey Bldg. Corp. (In re Diversey Bldg. Corp.)*, 86 F.2d 456, 458 (7th Cir. 1936); see also *R.I.D.C. Indus. Dev. Fund v. Snyder*, 539 F.2d 487, 490 n.3 (5th Cir. 1976) (bankruptcy court “has no power to affect the obligation of guarantors”), *cert. denied*, 429 U.S. 1095 (1977). The non-debtors in all of these cases were guarantors on various obligations of the debtors. See *Union Carbide*, 686 F.2d at 594-95; *R.I.D.C.*, 539 F.2d at 490-91; *Diversey Bldg.*, 86 F.2d at 456.

38. *R.I.D.C.*, 539 F.2d at 490 n.3 (emphasis added).

39. See *Union Carbide*, 686 F.2d at 595 (citing *R.I.D.C.*, 539 at 490 n.3).

40. See, e.g., *Lansing Diversified Properties—II v. First Nat’l Bank & Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600-01 (10th Cir. 1990) (a discharge in bankruptcy is available only to a debtor, and therefore, § 524(e)’s mandate prohibiting a discharge from affecting the liability of “any other entity” precludes discharge of non-debtor), *modified sub nom. Abel v. West*, 932 F.2d 898 (1991); *Seaport Automotive Warehouse, Inc. v. Rohnert Park Auto Parts, Inc. (In re Rohnert Park Auto Parts, Inc.)*, 113 B.R. 610, 616-17 (Bankr. 9th Cir. 1990) (an injunction barring actions against co-debtor for five years violated § 524(e) because it affected the liability of an entity other than the debtor); *American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.)*, 885 F.2d 621, 626 (9th Cir. 1989) (specific provisions of § 524 prohibit the court from granting a permanent injunction to guarantors); *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) (bankruptcy court has no power to discharge the liability of non-debtor in plan of reorganization).

41. See *Underhill*, 769 F.2d at 1432; see also *Western Real Estate*, 922 F.2d at 600 (section 524(e) operates to restrict discharges to the debtor who has “invoked and submit-

creditors of a debtor."⁴² Accordingly, courts holding a restrictive view toward discharges reason that a plan of reorganization purporting to discharge a non-debtor violates section 524(e)⁴³ and is invalid under section 1129(a).⁴⁴ Moreover, these courts argue, the equitable powers of the bankruptcy court under section 105(a) must yield to the more specific mandate of section 524(e).⁴⁵

2. Section 524(a): Closing the Door on Permanent Injunctions Barring Claims Against Non-Debtors

A discharge in bankruptcy is available only to parties that submit to the burdens of the bankruptcy laws.⁴⁶ The effect of a discharge, as out-

ted to the bankruptcy process"); *Rohnert Park Auto Parts*, 113 B.R. at 617 (section 524(e) is violated because plan purports to affect liabilities of entities other than the debtor).

42. *In re Texaco Inc.*, 84 B.R. 893, 900 (Bankr. S.D.N.Y. 1988).

43. *See, e.g.*, *Mellon Bank v. M.K. Siegel*, 96 B.R. 505, 506 (E.D. Pa. 1989) (bankruptcy court lacks power to discharge guarantor, who is not a party to the Chapter 11 proceeding, in the plan of reorganization); *In re Elsinore Shore Assocs.*, 91 B.R. 238, 249-50 (Bankr. D.N.J. 1988) (a plan of reorganization that improperly releases a third-party non-debtor cannot be confirmed); *In re Future Energy Corp.*, 83 B.R. 470, 486 (Bankr. S.D. Ohio 1988) (a provision of a plan of reorganization purporting to release non-debtors in consideration for funding of the plan violated § 524(e)); *In re L.B.G. Properties, Inc.*, 72 B.R. 65, 66 (Bankr. S.D. Fla. 1987) (section 524(e) precludes the release of non-debtors in a plan of reorganization); *In re Eller Bros., Inc.*, 53 B.R. 10, 11-12 (Bankr. M.D. Tenn. 1985) (a provision of the plan "requiring the FDIC to release nonparty guarantors . . . abrogated the standard under § 1129(a)(1) by violating the provisions of 11 U.S.C. § 524(e)"); *Bill Roderick Distrib., Inc. v. A.J. Mackay Co. (In re A.J. Mackay Co.)*, 50 B.R. 756, 761 (D. Utah 1985) (bankruptcy court has no power to discharge a non-bankrupt in a plan of reorganization; the only way a person can take advantage of the protection available in bankruptcy is to file for bankruptcy himself or herself); *Hat-Hanseatische Anlage v. Sago Palms Joint Venture (In re Sago Palms Joint Venture)*, 39 B.R. 9, 9 (Bankr. S.D. Fla. 1984) (a provision in the plan purporting to release the principal of the debtor, who was accused of embezzlement, violated § 524(e) and was ineffectual to the extent that it discharged the principal from personal liability); *cf. Inforex, Inc. v. Burrige (In re Inforex, Inc.)*, 26 B.R. 515, 518 (Bankr. D. Mass. 1983) (a plan of reorganization purporting to extinguish all rights of shareholders did not bar shareholders from bringing an action under § 10(b)(5) of the Securities Exchange Act of 1934 because officers and directors of corporations are individually liable for their own tortious conduct).

44. *See* 11 U.S.C. § 1129(a) (1988). A plan of reorganization that violates any provision of the Code may not be confirmed. *See id.*

45. *See Seaport Automotive Warehouse, Inc. v. Rohnert Park Auto Parts, Inc. (In re Rohnert Park Auto Parts, Inc.)*, 113 B.R. 610, 617 (Bankr. 9th Cir. 1990); *cf. In re Golden Plan of California, Inc.*, 829 F.2d 705, 713 (9th Cir. 1986) (the equitable powers of the bankruptcy court are strictly limited by the specific provisions of the bankruptcy laws); *Johnson v. First Nat'l Bank of Montevideo*, 719 F.2d 270, 273 (8th Cir. 1983) (bankruptcy court may only exercise its equitable powers to the extent that it is consistent with the provisions of the Code), *cert. denied*, 465 U.S. 1012 (1984).

46. *See Landsing Diversified Properties—II v. First Nat'l Bank & Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600 (10th Cir. 1990), *modified sub nom. Abel v. West*, 932 F.2d 898 (1991); *Lussier v. Barrup (In re Barrup)*, 51 B.R. 321, 323 (Bankr. D. Vt. 1985); SEC Brief, *supra* note 12, at 4. The Tenth Circuit noted "Congress did not intend to extend such benefits to third-party bystanders." *Western Real Estate*, 922 F.2d at 600 (citing 3 Collier on Bankruptcy ¶ 524.01[3], at 524-16 (Lawrence P. King et al. eds., 15th ed. 1990)).

lined in section 524(a), is limited to obligations that are personal liabilities of the debtor.⁴⁷ Under the restrictive view towards non-debtor discharges, a court cannot circumvent this restriction by labelling the discharge of a non-debtor as a permanent injunction.⁴⁸ In effect, a discharge is an injunction, and any attempt to distinguish the two is an unpersuasive semantic exercise.⁴⁹ Indeed, a permanent injunction "falls squarely within the definition of a discharge under section 524(a)(2),"⁵⁰ and is, therefore, restricted by the provisions of section 524(e).⁵¹

3. Discharges in Bankruptcy Effective Under Operation of Law

Creditor consent to a reorganization plan that purports to discharge a non-debtor does not serve as a waiver of the restrictions imposed by section 524(e). Where a bankruptcy court discharges a party's liability, "it does so by operation of the bankruptcy laws, not by consent of the creditors."⁵² Consent to a Chapter 11 plan does not operate as a "private contract" to release a non-debtor from liability.⁵³ Any contribution that a non-debtor makes to a reorganization cannot serve as consideration for a discharge.⁵⁴

47. See *Barrup*, 51 B.R. at 323. Section 524(a) provides as follows:

A discharge . . . under this title—

(1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the *personal liability of the debtor* with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived;

(2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a *personal liability of the debtor*, whether or not discharge of such debt is waived . . .

11 U.S.C. § 524(a)(1)-(2) (1988)(emphasis added).

48. See *American Hardwoods, Inc. v. Deutsche Credit Corp.* (*In re American Hardwoods, Inc.*), 885 F.2d 621, 626 (9th Cir. 1989).

49. See *id.* In support of its position, the Ninth Circuit points out that § 524(a)(2) describes a discharge as an injunction, and the court concludes that a discharge is a special kind of permanent injunction. See *id.*

50. *Id.*

51. See *id.*

52. *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985); see also *Union Carbide Corp. v. Newboles*, 686 F.2d 593, 595 (7th Cir. 1982) ("A bankruptcy discharge arises by operation of federal bankruptcy law, not by contractual consent of the creditors."); *In re Kornbluth*, 65 F.2d 400, 401 (2d Cir. 1933) (discharge in bankruptcy is effectuated by operation of law, not by contract).

53. See *Underhill*, 769 F.2d at 1432 (citations omitted); *Union Carbide*, 686 F.2d at 595.

54. See *Underhill*, 769 F.2d at 1432 (quoting *Union Carbide*, 686 F.2d at 595). But see *In re AOV Indus., Inc.*, 792 F.2d 1140, 1153 (D.C. Cir. 1986) (in order to draw from a fund contributed to the reorganization by a non-debtor, creditors were obligated to tender releases of the non-debtor's liability); *In re Monroe Well Serv., Inc.*, 80 B.R. 324, 334-35 (Bankr. E.D. Pa. 1987) (concurring with the District of Columbia Circuit's decision in *AOV Indus.* that a voluntary release of a non-debtor in exchange for access to a fund contributed to the reorganization by the non-debtor may be valid).

B. Section 105(a): A Powerful Tool of Equity

With respect to non-debtor discharges, courts that have adopted an expansive view of section 105(a)'s equitable powers typically begin by noting that specific language of section 524(e) does not foreclose the discharge of third parties under an accepted plan of reorganization.⁵⁵ While overcoming the section 524 hurdle seems important, the courts invoking section 105(a) generally focus on the policies and rationales underlying non-debtor discharges.

1. Rationales Underlying Non-Debtor Discharges

Courts that invoke section 105(a) to release the liability of a non-debtor consistently espouse overriding policy concerns. Many of these policies are classic bankruptcy themes that recur throughout cases in which the plan of reorganization provides for the discharge of a non-debtor.⁵⁶ The policies most often cited include the concerns that: (1) a claim against a non-debtor is tantamount to a claim against the debtor where the non-debtor will have a claim of indemnification or contribution against the debtor either through the operation of surety law, the debtor-company's charter, state corporation laws, or by way of agreement between the debtor and the non-debtor;⁵⁷ (2) a non-debtor contributing to the reorganization will not contribute funds if claims against the non-debtor are not enjoined, thereby adversely affecting the reorganization;⁵⁸ and (3) suits against a third party who has a role in restructuring

55. See *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694, 702 (4th Cir.), cert. denied, 493 U.S. 959 (1989); *UNARCO Bloomington Factory Workers v. UNR Indus., Inc.*, 124 B.R. 268, 278 (N.D. Ill. 1990) (quoting *Menard-Sanford*, 880 F.2d at 702); see also *Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1050 (5th Cir. 1987) (section 524(e) "does not by its specific words preclude the discharge of a guarant[or] when [the discharge] has been accepted and confirmed as an integral part of a plan of reorganization"). The Fifth Circuit in *Republic Supply* did not decide the issue of whether § 524(e) prevents a bankruptcy court from discharging the liabilities of a non-debtor under § 105(a) but rather found that the issue of liability of debtor's guarantor was res judicata because a provision discharging the non-debtor guarantor was included in the plan of reorganization, and the plan was confirmed without objection and was not appealed. See *id.* at 1049-50.

56. See generally Shapiro, *supra* note 11, at 347 (noting three situations where courts have utilized § 105(a) powers to discharge guarantors: (1) where guarantor's assets will be a source of funds for debtor's reorganization; (2) where non-debtors time and energy is required for a successful reorganization; and (3) where a finding of liability against non-debtor would, as a practical matter, be imputed to debtor).

57. See, e.g., *Menard-Sanford*, 880 F.2d at 702 ("entire reorganization hinged on the debtor being free from indirect claims such as suits against parties who would have indemnity or contribution claims against the debtor"); *UNARCO*, 124 B.R. at 278 (quoting with emphasis the statement of the *Menard-Sanford* court that reorganization depended upon cutting off claims for indemnification and contribution); cf. *Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills)*, 25 B.R. 1018, 1022 (D.N.M. 1982) (indicating the significance of enjoining claim against party who may assert pressure on debtor).

58. See, e.g., *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89, 90 (2d Cir.) (settlement with insurance companies, which provided for the insurer's contribution of proceeds to a claimant's fund in exchange for discharge of liabilities, was "cornerstone" of reorganization), cert. denied, 488 U.S. 868 (1988); Myerson &

the debtor, but who has incurred personal liability to a creditor, may adversely affect the reorganization because the third party's attention may be distracted from the reorganization efforts or the third party will have no incentive to continue its efforts if claims against it or others are not enjoined.⁵⁹ By releasing non-debtors in these type of cases, courts aim to promote a primary goal of the Bankruptcy Code: provide the debtor with a "fresh start."⁶⁰

2. Mass Tort Claims Versus Non-Mass Tort Claims

a. *Mass Tort Claims: Leading the Charge for Section 105(a) Equitable Powers*

Courts confronted with debtors that were forced into bankruptcy under the pressures of mass-tort claims have significantly expanded the powers of the bankruptcy court by invoking section 105(a) as support for non-debtor discharges under complex circumstances.⁶¹ Some courts believe that, in the face of mass-tort litigation, equity supersedes the strict requirements of the Code.⁶² The two most prominent mass tort bankruptcies are those of the A.H. Robins Company, the manufacturer of the

Kuhn v. Brunswick Assoc. Ltd. Partnership (*In re Myerson & Kuhn*), 121 B.R. 145, 156-57 (Bankr. S.D.N.Y. 1990) (determining that a permanent injunction discharging non-debtor is appropriate where non-debtor is contributing to the reorganization); *UNARCO*, 124 B.R. at 278 (discharge was appropriate for insurance companies contributing monies to the reorganization but would not be appropriate for insurers that did not settle and contribute proceeds); *Otero Mills*, 25 B.R. at 1020-22 (permanent injunction preventing creditor from recovering on a state court judgment against guarantor/president of debtor was appropriate where president intended to contribute the proceeds of the assets that were subject to foreclosure).

59. See, e.g., *In re Original Wild West Foods, Inc.*, 45 B.R. 202, 205 (Bankr. W.D. Tex. 1984) (enjoining the IRS from collecting debtor's trust fund taxes from non-debtor, a "responsible" officer of the debtor, upon officer's threat to "throw in the towel" on debtor's reorganization if the court allowed the IRS to proceed); see also *In re A.H. Robins Co. Inc.*, 88 B.R. 742, 747-48 (E.D. Va. 1988) (testimony had been presented at hearing to confirm plan that acquiror/non-debtor deemed it vital that it be protected from all litigation relating to the Dalkon Shield); Swallow, *supra* note 32, at 713 (American Home Products' proposed acquisition of A.H. Robins was contingent upon discharges of American Home Products, A.H. Robins, and A.H. Robins' affiliates and employees).

60. See *infra* note 95 and accompanying text.

61. See, e.g., *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694, 701-02 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989) (section 105(a) confers power on the bankruptcy court to enjoin suits against third parties); *Johns-Manville*, 837 F.2d at 93-94 (section 105(a) is to be interpreted liberally to enjoin claims that may hinder the reorganization, particularly suits against settling insurers); see also *UNARCO Bloomington Factory Workers v. UNR Indus., Inc.*, 124 B.R. 268, 279 (N.D. Ill. 1990) (noting that § 105(a) confers power upon the bankruptcy court to issue an injunction barring suits against insurer in order to preserve a settlement between debtor and an insurer).

62. See Jack B. Weinstein & Eileen B. Hershenov, *The Effect of Equity on Mass Tort Law*, 1991 U. Ill. L. Rev. 269, 319 (citing *Menard-Sanford*; *Kane v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 843 F.2d 636, 641-47 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988)); see also *Leal, supra* note 9, at 497 (an expansive view toward a bankruptcy court's equitable powers may be appropriate in the case of mass tort litigation).

Dalkon Shield contraceptive device, and the Johns-Manville Corporation, a producer of asbestos.

In both instances, the question of the liability of the debtors' insurance companies was a significant issue.⁶³ The Fourth Circuit in *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*⁶⁴ and the Second Circuit in *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*⁶⁵ both upheld discharges of the debtors' liability insurers. Relying primarily upon the bankruptcy court's section 105(a) equitable powers, the Fourth Circuit affirmed discharges of not only the insurance-policy liability of the debtor's insurer, but also the joint tortfeasor liability of the debtor's insurer, officers, directors, and attorneys.⁶⁶ The Second Circuit,

63. The issue of whether claimants can proceed directly against a debtor's liability insurer is one that has been arising with increasing frequency in bankruptcy proceedings. See Barry L. Zaretsky, *Insurance Proceeds in Bankruptcy*, 55 Brook. L. Rev. 373, 373 (1989) [hereinafter Zaretsky, *Insurance Proceeds*]. An insurance company's liability for the tortious conduct of the debtor is limited by the terms of the policy. Therefore, where the insurance proceeds payments exceed the policy limits, the insurer will no longer remain liable on the policy.

64. 880 F.2d 694 (4th Cir.), cert. denied, 493 U.S. 959 (1989). A.H. Robins filed for protection under Chapter 11 in response to an avalanche of suits brought by women who sustained injury from use of the Dalkon Shield contraceptive device. The Fourth Circuit upheld a plan of reorganization that discharged the liabilities of entities other than Robins. See *id.* at 700. The entities and individuals which may have been liable, jointly with A.H. Robins, for injuries suffered from use of the Dalkon Shield included: Aetna Casualty and Surety Company, A.H. Robins' product liability insurer; E. Claiborne Robins, Sr., Chairman of the Board and former CEO; E. Claiborne Robins, Jr., President and CEO; other officers and directors responsible for alleged misconduct; and A.H. Robins' law firm, which allegedly conspired with the company to destroy and/or withhold evidence pertaining to the Dalkon Shield. See Richard B. Sobol, *Bending the Law: The Story of the Dalkon Shield Bankruptcy* 63 (1991).

65. 837 F.2d 89 (2d Cir.), cert. denied, 488 U.S. 868 (1988). Manville filed for bankruptcy under Chapter 11 in response to a flood of suits arising out of its asbestos manufacturing business. The court discharged the obligation of the insurer as part of a settlement whereby the insurer would pay approximately \$770 million into a settlement fund in exchange for discharge of obligations under disputed policies. As part of the settlement, the bankruptcy court was to issue injunctions to protect the insurer against claims stemming from the disputed policies. The insurer could terminate the settlement if the injunctive orders were not issued or if they were overturned on appeal. See *id.* at 90.

66. See *id.* at 700, 701-02. The court invoked § 105(a) to justify enjoining suits against the non-debtor entities, noting that the court has the power to implement the equitable doctrine of marshalling of assets. Marshalling of assets, according to the court, occurs when two distinct funds are available from which a creditor can satisfy its claim; the court may order the creditor to recover from one source so as not to impair the claims of other creditors. See *id.* at 701. The rationale of the court was that the only parties who would be adversely affected were the Dalkon Shield claimants who chose to opt out of Class B in the *Breland* settlement. See *id.* The *Breland* settlement was a settlement resulting from a class action suit brought by Dalkon Shield claimants against Aetna on the insurer's independent tort liability. Class B claimants were defined as "those Dalkon Shield claimants who did not meet the filing deadline or like procedural requirements and are therefore not eligible for a non-subordinated recovery from the trust fund for reasons not related to the abstract merits of the claims." Swallow, *supra* note 32, at 715-16 n.40. The *Breland* settlement was upheld by the Fourth Circuit. See *In re A.H. Robins Co.*, 880 F.2d 709 (4th Cir.), cert. denied, 493 U.S. 959 (1989). Allowing Class B claimants to bring a suit in violation of the plan would serve to defeat the plan. See *Menard-Sanford*,

unlike the Fourth Circuit, did not invoke section 105(a) as the primary authority empowering the court to discharge non-debtors. Rather, the court used section 105(a) as additional support to release various liability insurers from obligation on Johns-Manville's insurance policies in exchange for contributions to a claimants' trust fund.⁶⁷ The primary rationale was that the insurance proceeds were property of the debtor's estate and the bankruptcy court, authorized by the Code, could properly exert jurisdiction over all such property.⁶⁸

880 F.2d at 702. Alternatively, they would receive full payment if foregoing their right to opt out. *See id.* In addition, American Home Products had offered to acquire A.H. Robins and contribute \$2.3 billion to a claimants' trust fund. The offer to acquire, and hence the \$2.3 billion contribution, was contingent upon the release of American Home Products, A.H. Robins, and their affiliates and personnel from liability from litigation connected with the Dalkon Shield. *See Swallow, supra* note 32, at 713.

The court's application of the marshalling doctrine was misplaced. A "necessary element" for applying the doctrine of marshalling is that *one debtor* has two funds from which a particular creditor may draw. *See Benjamin Weintraub & Alan N. Resnick, From the Bankruptcy Courts*, 18 UCC L.J. 178, 180 (1985). This "common debtor" element is absent where the creditor has a claim against the assets of the debtor as well as against assets of a non-debtor. *See id.* at 180-81.

67. *See MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89, 93 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988). Noting that the insurance settlement was critical to the reorganization, the Second Circuit held that the bankruptcy court had power to issue the injunctions because the insurance policies were property of the estate as defined in § 541(a)(1) and therefore within the jurisdiction of the bankruptcy court. *See id.* at 91-92. As further support for the bankruptcy court's authority to discharge the insurer, the Second Circuit relied on § 105(a). The equities weighed in favor of granting the injunction because permitting suits against the insurer would adversely affect the property of the estate and would undermine the reorganization. *See id.* at 93. Furthermore, the party seeking relief from the injunction was adequately protected because its claim was not extinguished but merely channeled to the settlement fund. *See id.*

A trust was established funded by the insurance companies' contributions, contributions from the corporation, and 50% of the equity in the reorganized corporation, along with the right to increase the equity stake to 80% if necessary. *See Sobol, supra* note 64, at 57.

68. *See Johns-Manville*, 837 F.2d at 91-92; *see also Zaretsky, Insurance Proceeds, supra* note 63, at 386 (noting that "weight of authority holds that insurance proceeds are property of the estate") (citations omitted). The Second Circuit held that the insurance proceeds were part of the debtor's estate under § 541(a). *See Johns-Manville*, 837 F.2d at 91-92. The court concluded that the bankruptcy court had the authority to enjoin suits against the insurers because the insurance proceeds, as property of the estate, fell within the jurisdiction of the bankruptcy court. *See id.*; *see also A.H. Robins v. Piccinin (In re A.H. Robins Co.)*, 788 F.2d 994, 1001-02 (4th Cir.) (insurance proceeds deemed property of estate), *cert. denied*, 479 U.S. 876 (1986).

The issue of whether insurance proceeds are in fact property of the debtor's estate is beyond the scope of this Note. However, courts that have found insurance proceeds to be property of the estate, "have enjoined any action to recover against the insurance company despite section 524(e)." Charles A. Beckham, Jr., *It's All an Unsecured Claim to Me: The Tortious Interference of Bankruptcy Law with Liability Insurance Proceeds*, 22 Tex. Tech. L. Rev. 779, 797 n.137 (1991) (citing *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694, 702 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989)); *see also UNARCO Bloomington Factory Workers v. UNR Indus., Inc.*, 124 B.R. 268, 278-79 (N.D. Ill. 1990) (bankruptcy court had authority to enjoin actions against insurers that had settled with the debtor because the insurance policies were property of the debtor's estate). Other courts have held that § 524(e) prevents the discharge of the debtor from

In its discussion of section 105(a), the Second Circuit did not mention the conflict between sections 105(a) and 524(e).⁶⁹ The Fourth Circuit, on the other hand, confronted the issue and concluded that section 524(e) should not be literally construed in every case to restrict the equitable powers of the bankruptcy court. The court deemed this conclusion appropriate, particularly in light of the facts in *A.H. Robins*: the plan was overwhelmingly approved; the plan, together with other safeguards, gave late claimants a second chance to recover; certain parties were able to opt out of the settlement to retain rights against certain non-debtors; and the reorganization hinged upon the non-debtor discharges.⁷⁰

b. *Non-Mass Tort Claims: Equity in Action*

Some courts, confronted with issues less complex than those of mass tort bankruptcy, have nonetheless flexed their equitable muscles to discharge non-debtors.⁷¹ *Otero Mills, Inc. v. Security Bank & Trust (In re*

altering the liability of the insurance company. *See Owaski v. Jet Florida Sys., Inc. (In re Jet Florida Sys., Inc.)*, 883 F.2d 970, 976 (11th Cir. 1989); *see also Beckham, supra*, at 797 n.137 (noting that most courts reviewing this issue have found that a discharge of the debtor does not relieve the insurer from liability). The courts, holding that the insurance company's liability is not discharged, did not consider whether insurance proceeds are property of the debtor's estate. *See id.*

Where insurance proceeds are deemed property of the estate, a problem of distributing these proceeds to tort victims exists. The property of the estate is distributed according to the priority rules set forth in the Code. *See* 11 U.S.C. §§ 507, 726, 1129 (1988) (outlining the priorities for distribution under the Code). Several groups of creditors will have priority to these proceeds ahead of the tort claimants. *See Beckham, supra*, at 793.

Courts exerting jurisdiction over insurance proceeds have not always followed this priority scheme. *See, e.g., Johns-Manville Corp.*, 837 F.2d at 93 (proceeds of insurance settlements were channeled to settlement fund); Sobol, *supra* note 64, at 233-34 (in *A.H. Robins*' reorganization, insurer was to pay \$75 million into a claimants' trust for victims of the Dalkon Shield). *But see UNARCO*, 124 B.R. at 279 (insurance proceeds not channeled to a claimants' trust, but rather to the reorganization in general to capitalize debtor's new business operations). For a general discussion of insurance proceeds in bankruptcy reorganizations see Beckham, *supra* (discussing the treatment of insurance proceeds in bankruptcy, problems with such treatment, and a call for reform), and Zaretsky, *Insurance Proceeds, supra* note 63, at 373 (discussing the treatment of insurance proceeds in bankruptcy, problems, and solutions).

69. *See Johns-Manville*, 837 F.2d at 93-94 (the court noted the equitable powers of the bankruptcy court as additional support for its position but did not discuss the potential of § 524(e) to limit such powers). Perhaps the court did not discuss § 524(e) with respect to discharge of insurance companies because the court found that the insurance proceeds were part of the debtor's estate. *See id.* at 91-92.

70. *See Menard-Sanford v. Mabey (In re A.H. Robbins Co.)*, 880 F.2d 694, 702 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989). The court in conclusion stated, "We leave questions concerning cases in which § 524(e) does apply for another day." *Id.*

71. *See, e.g., In re The Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293 (2d Cir. 1992) (although the court did not discuss section 105(a), the court cited *Menard-Sanford* in support of discharges of non-debtors in bankruptcy proceedings); Myerson & Kuhn v. Brunswick Assocs. Ltd. Partnership (*In re Myerson & Kuhn*), 121 B.R. 145, 157 (Bankr. S.D.N.Y. 1990) (section 524(e) will not operate to defeat a court's § 105(a) equitable powers to issue permanent injunctive relief to non-debtor where the non-debtor is contributing to the debtor's reorganization); *In re Monroe Well Serv., Inc.*, 67 B.R. 746, 751 (Bankr. E.D. Pa. 1986) (section 105(a) injunction may be appropriate where

Otero Mills, Inc.)⁷² is the leading case in support of non-debtor discharges⁷³ in the absence of mass-tort considerations. There, the bankruptcy court set forth a balancing test weighing, "1. [i]rreparable harm to the bankruptcy estate if the injunction does not issue; 2. [s]trong likelihood of [a] success[ful plan of reorganization]; and 3. [n]o harm or minimal harm to the other party or parties."⁷⁴ Applying such a test to the facts of the case, the court issued a permanent injunction barring the enforcement of a state court judgment against the president of the debtor.⁷⁵

The United States District Court for the District of New Mexico, in affirming the bankruptcy court's decision in *Otero Mills*, found that, prior to considering the issuance of an injunction barring suits against third parties, the conditions of the case must meet certain threshold jurisdictional requirements.⁷⁶ The claim sought to be enjoined must (1) affect the debtor's estate, and (2) adversely influence the debtor.⁷⁷ Once these threshold requirements are met, the district court held, it is proper for the bankruptcy court to determine whether enjoining claims against non-debtors is necessary and appropriate.⁷⁸ An important element in the

non-debtor's assets are to be used as a source of funds for the debtor's reorganization), *modified*, 69 B.R. 58 (E.D. Pa. 1986); *In re Old Orchard Inv. Co.*, 31 B.R. 599, 602-03 (W.D. Mich. 1983) (bankruptcy court had power under § 105(a) to enjoin suits against non-debtor partners of the debtor partnership that could have been brought against debtor); *Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, 25 B.R. 1018, 1021 (D.N.M. 1982) (an injunction barring suits against a non-debtor may be proper if the claims against non-debtor will affect the debtor's estate and adversely influence debtor); *see also Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, 21 B.R. 777 (Bankr. D.N.M.) (court applied a balancing test to issue injunction barring enforcement of judgment against non-debtor), *aff'd*, 25 B.R. 1018 (D.N.M. 1982).

72. 21 B.R. 777 (Bankr. D.N.M.), *aff'd*, 25 B.R. 1018 (D.N.M. 1982).

73. *See Monroe Well*, 67 B.R. at 751; Shapiro, *supra* note 11, at 346 (referring to *Otero Mills* as a landmark decision).

74. *Otero Mills*, 21 B.R. at 779. Although, the court issued a permanent injunction, the balancing test promulgated by the court weighs three of the four prongs of the traditional preliminary injunction test. *See Otero Mills*, 25 B.R. at 1021.

75. *See id.* The United States District Court for the District of New Mexico, on appeal, noted that the injunction issued by the bankruptcy court was in the nature of a temporary stay. *See Otero Mills*, 25 B.R. at 1021. The district court, however, earlier in its decision, clearly stated that the injunction issued by the bankruptcy court "permanently enjoined the [creditor] from executing . . . upon its state court judgment against" the debtor's president, *id.* at 1019, and noted that the bankruptcy court's decision converted a preliminary injunction into a permanent order. *See id.* Also, the bankruptcy courts opinion explicitly acknowledged that it was analyzing the propriety of issuing a permanent injunction. *See Otero Mills*, 21 B.R. at 778-79. Perhaps the district court believed the injunction to be in the nature of a temporary stay because the order was issued prior to the filing of the plan of reorganization and the bankruptcy court stated a willingness to consider an application by the creditor to modify or lift the injunction if the creditor believed that it was no longer adequately protected by additional sources of security available at that time. *See Otero Mills*, 25 B.R. at 1021-22. Although, the creditor could freely apply to have the injunction modified or lifted, this does not alter the fact that the injunction issued was indeed permanent.

76. *See Otero Mills*, 25 B.R. at 1021.

77. *See id.*

78. *See id.* The district court in *Otero Mills* determined that the conditions satisfied

court's decision that the particular discharge was appropriate was that the non-debtor intended to contribute the personal assets, upon which the creditor was attempting to foreclose, to the debtor's reorganization. Furthermore, as president and shareholder, the non-debtor could assert adverse influence upon the debtor to satisfy its debt to the creditor if claims against the non-debtor were not enjoined.⁷⁹ Although the decision to discharge a non-debtor under such circumstances involves enormous discretion, the courts following such an approach, apparently have concluded that the policies warrant such discretion.

III. ANALYSIS: THE DOMINANT PULL OF SECTION 524

Although, valid arguments exist to support both sides in the debate over the validity of non-debtor discharges under Chapter 11, proponents of section 524(e), that advocate restricting third-party releases, put forth the more compelling view. Bankruptcy proceedings that are factually or emotionally complex may strengthen the claim for a section 105(a) release due to equitable considerations, but such circumstances can not overcome the dominant pull of section 524. One certainty is that a court cannot exert jurisdiction beyond the Code's limits simply in the name of equity.⁸⁰ In short, the language, purpose, and statutory construction of the Code preclude the discharge of a non-debtor. Moreover, analysis of cases discharging non-debtors suggests that the policies underlying such discharges are unsound and that bankruptcy courts should not overreach their authority under the guise of such policies. Finally, with respect to insurance proceeds in bankruptcy cases,⁸¹ Congress should enact legislation to ensure equitable distribution of proceeds to victims injured by the debtor.

A. *The Language, Nature, and Context of the Bankruptcy Code Preclude Non-Debtor Discharges*

1. Plain Meaning: The Code When Read as a "Holistic Endeavor" Prohibits Discharges of Third Parties

As stated earlier, to resolve discrepancies between sections of the Bankruptcy Code, the starting point must be the language of Code.⁸² Some courts and commentators have espoused a view that section 524(e)

the threshold requirements and affirmed the non-debtor discharge. *See id.* In determining whether to grant the discharge, the court utilized the three part balancing test developed by the bankruptcy court below. The district court noted that the bankruptcy court did not analyze the fourth factor of the usual preliminary injunction test—public interest, but that the factor played a role in the bankruptcy court's decision. *See id.*

79. *See id.* at 1022.

80. *See Leal, supra* note 9, at 490-91 n.6.

81. *See infra* notes 157-61, 163-69 and accompanying text (discussing whether insurance proceeds are property of a debtor's estate and problems arising from excluding and including such proceeds from the estate).

82. *See United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989).

does not by its specific wording preclude the discharge of a non-debtor.⁸³ When read in a vacuum, section 524(e) would appear to leave the door open for discharges of non-debtors because it only purports to restrict the effect of a debtor's discharge and does not provide any insight into the discharge of other entities. This subsection, however, should not be read in a vacuum. Instead, it should be read in conjunction with the entire Code, particularly with subsection (a) of the same section.⁸⁴ Section 524(a) restricts a discharge to debts that are "*personal liabilities of the debtor.*"⁸⁵

Proponents of expansive equitable powers may counter that, while a discharge may be personal to a debtor, an order in the form of a permanent injunction is not.⁸⁶ This argument, however, must fail because a discharge and a permanent injunction are the same exact instrument—if not in name, then in operation.⁸⁷

If section 524(e) should be read as not specifically precluding a third-party discharge,⁸⁸ the language of section 105(a) becomes essential in determining if that provision indeed grants the bankruptcy court the power

83. See *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694, 702 (4th Cir.) (citing *Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1050 (5th Cir. 1987)), cert. denied, 493 U.S. 959 (1989); *UNARCO Bloomington Factory Workers v. UNR Indus., Inc.*, 124 B.R. 268, 278 (N.D. Ill. 1990); *Swallow*, supra note 32, at 710-11.

84. See 11 U.S.C. § 524(a) (1988); supra note 47 and accompanying text. Indeed, the United States Bankruptcy Court for the District of Vermont explicitly referred to § 524(a) in finding that a "discharge is intended for the benefit of the debtor and does not effect the rights of any other parties." *Lussier v. Barrup (In re Barrup)*, 51 B.R. 321, 323 (Bankr. D. Vt. 1985); see also *Owaski v. Jet Florida Sys., Inc. (In re Jet Florida Sys., Inc.)*, 883 F.2d 970, 973 (11th Cir. 1989) (noting that section 524(a) only permits discharges of the personal liabilities of the debtor and "[s]ection 524(e) was intended for the benefit of the debtor but was not meant to affect the liability of third parties" (quoting 3 *Collier on Bankruptcy* ¶ 524.01, at 524-16 (R. Babbitt et al. eds., 15th ed. 1987)); SEC Brief, supra note 2, at 4 ("The Bankruptcy Code . . . contemplates that a discharge only affects the debts of those submitting to its burdens").

85. 11 U.S.C. § 524(a)(1)-(2) (1988) (emphasis added); see also *Landsing Diversified Properties—II v. First Nat'l Bank & Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600 (10th Cir. 1990) (discharge only available to parties filing for bankruptcy), modified sub nom. *Abel v. West*, 932 F.2d 898 (1991); *Schultz v. Shapiro (In re Shapiro)*, 59 B.R. 844, 847 (Bankr. E.D.N.Y. 1986) (discharge only inures to the benefit of the *honest debtor*).

86. The court under § 105(a) may issue any order that is necessary or appropriate. See 11 U.S.C. § 105(a) (1988). An injunction is, after all, a court order.

87. See supra notes 49-50 and accompanying text. A discharge does not extinguish the discharged party's liability; it merely erects a barrier to recovery. See *Western Real Estate Fund*, 922 F.2d at 601-02; *American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.)*, 885 F.2d 621, 626 (9th Cir. 1989); *In re Lembke*, 93 B.R. 701, 702-03 (Bankr. D.N.D. 1988); *Shade v. Fasse (In re Fasse)*, 40 B.R. 198, 200 (Bankr. D. Colo. 1984); *Green v. Yang (In re Green)*, 29 B.R. 682, 685 (Bankr. S.D. Ohio 1983).

88. See, e.g., *Menard-Sanford v. Mabey (In re A.H. Robins, Co.)*, 880 F.2d 694, 702 (4th Cir.) (court found that § 524(e) does not specifically preclude a non-debtor discharge), cert. denied, 493 U.S. 959 (1989); *UNARCO Bloomington Factory Workers v. UNR Indus., Inc.*, 124 B.R. 268, 278 (N.D. Ill. 1990) (same); *Swallow*, supra note 32, at 723 (arguing that the language of § 524(e) does not explicitly preclude a third party discharge).

to discharge non-debtors. The equitable powers of the court under section 105(a) are limited to actions necessary to carry out the provisions and purpose of the Code.⁸⁹ Therefore, in order for a particular application of section 105(a) to carry out a provision of the Code, there must be a section which implies that discharges of non-debtors are necessary or appropriate. No provision, however, applicable to Chapter 11 provides for the discharge of third parties.⁹⁰

One commentator has pointed to section 1123(b)(5) as evidence that the discharge of third parties is appropriate.⁹¹ Section 1123(b)(5) provides that a plan of reorganization may "include any . . . provision not inconsistent with the applicable provisions of this title."⁹² Applying these two sections in tandem would be the equivalent of granting the court the authority to take any action it deems necessary to ensure the success of a plan of reorganization, as long as such action does not violate an express provision of the Code. Advocates of such a combination are essentially proposing the use of one catch-all provision to implement another catch-all provision. This approach results in bootstrapping to exert jurisdiction over the rights a creditor has against a non-debtor.⁹³

2. The Purpose of the Code Does Not Contemplate Applying the Code to Relationships Other than Those Between Debtor and Others

Legislative intent controls where the language of the Code is demonstrably at odds with its purpose.⁹⁴ Even though the plain meaning of section 524 is clear and thus should govern, it is imperative to examine

89. See 11 U.S.C. § 105(a) (1988). The specific language of § 105(a) actually limits the section to actions necessary to carry out the *provisions of this title*. See Desieno & Ho, *supra* note 23, at 437.

90. See, e.g., 11 U.S.C. §§ 101-560, 1101-74 (1988) (no provision included in or pertaining to Chapter 11 specifically permits discharge of a third party); see also Cook & Brenner, *supra* note 1, at *1 ("The Code does not extend the Chapter 11 discharge to nondebtors.").

91. See Swallow, *supra* note 32, at 723; cf. Harvey R. Miller et al., *Formulation of a Confirmable Chapter 11 Plan Under the Bankruptcy Code*, in Practising Law Institute, Secured Creditors and Lessors Under the Bankruptcy Reform Act 1990, at 351 (Commercial Law & Practice Course Handbook Series No. 544, 1990) (section 1123(b)(5) permits a Chapter 11 plan to include any appropriate provision not inconsistent with other provisions of the Code, and therefore a plan may release a third party in exchange for a contribution to a reorganization fund).

92. 11 U.S.C. § 1123(b)(5) (1988).

93. It is worth noting that none of the courts discussed *supra* invoked § 105(a) together with § 1123(b)(5) in this manner. See, e.g., *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694 (4th Cir.) (court did not purport to invoke § 1123(b)(5)), *cert. denied*, 493 U.S. 959 (1989); *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville, Corp.)*, 837 F.2d 89 (2d Cir.) (same), *cert. denied*, 488 U.S. 868 (1988); *Myerson & Kuhn v. Brunswick Assoc. Ltd. Partnership (In re Myerson & Kuhn)*, 121 B.R. 145 (Bankr. S.D.N.Y. 1990) (same); *UNARCO Bloomington Factory Workers v. UNR Indus., Inc.*, 124 B.R. 268 (N.D. Ill. 1990) (same); *Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, 25 B.R. 1018 (D.N.M. 1982) (same).

94. See *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989); *supra* note 100 and accompanying text.

the purpose and goals of the Code to ensure that the section's application coincides with the intent of the Code's drafters.

A number of purposes underlie the Bankruptcy Code. Among the goals to which the courts and commentators most often refer are the goals of providing the debtor with a "fresh start,"⁹⁵ maximizing the value of the bankrupt's assets through either reorganization or liquidation,⁹⁶ and providing fair and equitable treatment to all creditors.⁹⁷ Indeed, Congress has indicated in the Code's legislative history that the purpose of a reorganization is to rehabilitate the debtor so that it may continue to provide its employees with jobs, satisfy its debts to its creditors, and yield a return to its shareholders.⁹⁸ While these were lofty aims, the Code's drafters failed to express or imply how these goals were to be weighed against the rights a creditor may hold against a third party. Given this void, this portion of the legislative history is not relevant to the present analysis.

One part of the legislative history does shed some light on the types of relationships upon which the Bankruptcy Code is intended to have an impact. The House Report indicates that the nature of bankruptcy is "to sort out all of the *debtor's legal relationships with others*, and to apply the principles and rules of the bankruptcy laws *to those relationships*."⁹⁹ Although a debtor may have relationships with both a creditor and a third-party non-debtor, a relationship between the creditor and the non-debtor is not the equivalent of a relationship between the debtor and another party. Congress, therefore, could not have contemplated that the bankruptcy laws would have a significant impact upon the relationships between creditors and non-debtors.

95. See *Williams v. United States Fidelity & Guar. Co.*, 236 U.S. 549, 554-55 (1915); H.R. Rep. No. 595, 95th Cong., 2d Sess. 180 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6141; Beckham, *supra* note 68, at 780; Harvey J. Kessner, *Future Asbestos Related Litigants as Holders of Statutory Claims Under Chapter 11 of the Bankruptcy Code and Their Place in the Johns-Manville Reorganization*, 62 Am. Bankr. L.J. 159, 159 (Second Installment); Robert L. Miller, Note, *Chapter 13's Liberal Discharge Provisions and "Willful and Malicious" Tort Judgments: Creditor Classification as Means of Accounting for the Debtor's Egregious Action*, 32 Wm. & Mary L. Rev. 1065, 1068 (1991).

96. See Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* 24-25 (1986); Beckham, *supra* note 68, at 780; Barry L. Zaretsky, *Co-Debtor Stays in Chapter 11 Bankruptcy*, 73 Cornell L. Rev. 213, 228 (1988) [hereinafter Zaretsky, *Co-Debtor Stays*].

97. See Beckham, *supra* note 68, at 780 (citing Mitchell R. Julis, *Classifying Rights and Interests, Under the Bankruptcy Code*, 55 Am. Bankr. L.J. 223, 234 (1981)); Walter A. Effross, *Deprizio's Honor: Lenders, Insider Guarantors and the Prisoners' Dilemma*, 21 Seton Hall L. Rev. 774, 774 (1991).

98. See H.R. Rep. No. 595, 95th Cong., 2d Sess. 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179.

99. H.R. Rep. No. 595, 95th Cong., 2d Sess. 10 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 5971 (emphasis added); see also *Landings Diversified Properties—II v. First Nat'l Bank & Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600 (10th Cir. 1990) (Congress did not intend to extend bankruptcy protection to "third-party bystanders"), modified *sub nom.* *Abel v. West*, 932 F.2d 898 (1991).

3. Additional Canons of Construction: The Statutory Context Implies Congress Did Not Intend for Non-Debtor Discharge

In analyzing the Bankruptcy Code, the Supreme Court has instructed bankruptcy courts to "look at the entire statutory context for interpretory guidance."¹⁰⁰ One section of the Code is particularly germane to the debate over whether section 105(a) overrides section 524(e) with respect to the release of third parties. Upon a filing under Chapter 11, section 362¹⁰¹ operates to automatically stay all actions to collect the debtor's pre-petition debts. Similar to the conflict between section 524(e) and section 105(a), a debate has ensued as to whether the automatic stay may be extended to non-debtors by way of section 105(a).

Consistent with the Supreme Court's mandate to read the Code as a "holistic endeavor,"¹⁰² "[o]ne bankruptcy judge noted that after a review of legislative history, it appeared that Congress considered the issue of a general stay of actions against guarantors but apparently rejected a blanket stay and limited this protection to co-debtors in Chapter 13 cases."¹⁰³ The fact that Chapter 13¹⁰⁴ provides a stay for certain non-debtors¹⁰⁵ indicates that Congress was aware that relationships between creditors and third parties may be implicated during bankruptcy proceedings. By not including a similar provision in Chapter 11, either for a temporary stay or permanent injunction, Congress most likely did not intend that injunctive relief, either preliminary or permanent, be extended to non-debtors.¹⁰⁶

B. *Unsound Policies Underlying Non-Debtor Discharges*

Some courts, in the name of equity, have looked past the specific commands of the Code. These courts have promulgated unsound policies to support non-debtor discharges. The policies are unpersuasive regardless of whether the Code allows for non-debtor discharges.

1. Indemnification/Contribution Theory for Discharge

a. *Guarantors*

The "indemnification/contribution" theory of non-debtor discharges

100. Swallow, *supra* note 32, at 723 (citing *United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 365 (1988)).

101. 11 U.S.C. § 362 (1988 & Supp. II 1990).

102. *See United Sav. Ass'n*, 484 U.S. at 371.

103. Shapiro, *supra* note 11, at 346 (citations omitted); *see also* Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 223-24 (noting the need to reconcile the fact that Chapter 13 provides for a non-debtor stay while Chapter 11 does not); Kimberly Colby Harris, Note, *The Impact of Bankruptcy on Liability of Corporate Directors*, 5 *Bankr. Devs. J.* 289, 291-92 (1987) (same).

104. 11 U.S.C. §§ 1301-30 (1988).

105. *See id.* § 1301.

106. *See* Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 224; *cf.* Harris, *supra* note 103, at 291-92 (arguing that if Congress had intended for the Chapter 11 stay provision to encompass non-debtors, it would have used specific language as it did in Chapter 13).

holds that a claim against a non-debtor is the equivalent of a claim against the debtor where such non-debtor will have a claim of indemnification or contribution against the debtor. A guarantor who pays a debt on behalf of a debtor will, in fact, receive a right of indemnification from the debtor under suretyship law.¹⁰⁷ The guarantor also acquires a right of subrogation to the creditor's rights against the debtor.¹⁰⁸ Under such a framework, the practical effect is that the guarantor assumes the position of the original creditor.¹⁰⁹ Indeed, the Supreme Court, in *Williams v. United States Fidelity & Guaranty Co.*,¹¹⁰ ruled that a surety that pays the debt of a bankrupt may be subrogated to the rights of the creditor.¹¹¹

Equity favors holding the guarantor liable on the guaranty and subrogating the guarantor to the rights of the creditor.¹¹² The sole reason for the creditor obtaining a guaranty is to ensure payment in the event the debtor defaults.¹¹³ Holding the guarantor liable on the debt simply validates the prior agreement among the debtor, creditor and guarantor.

Courts should not release a guarantor from its obligation simply because the guarantor will have a claim against a creditor for indemnification. As one court has explained, "Debtor relief under bankruptcy is personal to the debtor. This is true even when the non-debtor is a surety which will be given a claim for indemnification against the estate [of the debtor]."¹¹⁴ The debtor will be unaffected by enforcement of the guaranty because property of the guarantor will be used to satisfy the creditor's claim under the guaranty.¹¹⁵

Furthermore, the guarantor will be unable to proceed against the debtor on the claim for indemnification during the pendency of the reorganization due to the Code's automatic stay provision. The claim for indemnification will be discharged upon confirmation of the plan of reorganization under section 1141(d)(1)(A).¹¹⁶ Under this provision, the confirmation of a reorganization plan discharges the debtor from all debts arising prior to the confirmation of such plan. Section 524 prevents all parties from attempting to recover from the debtor a debt that has been discharged—including a non-debtor who may seek indemnification.¹¹⁷

107. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 236.

108. See *id.*

109. See *id.*

110. 236 U.S. 549 (1915).

111. See *id.* at 556.

112. See *Cambridge Machined Prods. Corp. v. United States*, 58 B.R. 22, 25 (Bankr. D. Mass. 1985) (a non-debtor who is responsible for the debtor's obligations to creditors may either recover as a subrogee or must, in the alternative, file its own bankruptcy petition).

113. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 236.

114. *Travelers Indem. Co. v. Huddleston (In re Mike Rose Oil Co.)*, No. 90-23604-B, 1991 WL 110209, at *5 (Bankr. W.D. Tenn. June 17, 1991) (citing *Northeast Glass, Inc. v. Alpen, Inc. (In re Northeast Glass, Inc.)*, 112 B.R. 475, 477 (Bankr. D. Mass. 1990)).

115. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 236.

116. See 11 U.S.C. § 1141(d)(1)(A) (1988).

117. See *Landsing Diversified Properties—II v. First Nat'l Bank & Trust Co. (In re*

Some courts have discharged a guarantor's liability, noting that the non-debtor can assert adverse pressure upon the debtor to pay the debt.¹¹⁸ Where the guarantor is not an officer or principal of the debtor, no such power exists because, as discussed previously, the guarantor essentially will be foreclosed from pursuing its claim against the debtor. On the other hand, where the non-debtor is an officer, director, or principal, the non-bankrupt party may be able to exert substantial internal pressure upon the debtor due to its relationship with the debtor.¹¹⁹ Under Chapter 11, however, management has fiduciary obligations to both creditors and shareholders.¹²⁰ A corporate insider who exerts adverse influence upon a debtor breaches this fiduciary obligation, if not to creditors then to shareholders,¹²¹ because the non-debtor would be serv-

Western Real Estate Fund, Inc.), 922 F.2d 592, 600-01 (10th Cir. 1990), *modified sub nom.* Abel v. West, 932 F.2d 898 (1991). There is danger, however, that courts may not view the claim of indemnification as pre-petition debt. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 250-51 n.134. The Third Circuit in Avellino & Bienes v. M. Frenville Co. (*In re* M. Frenville Co.), 744 F.2d 332 (3d Cir. 1984), *cert. denied*, 469 U.S. 1160 (1985), held that a non-contractual claim for indemnification was a post-petition claim. See *id.* at 337. A court that treats a claim for indemnification as a post-petition claim would in effect be granting the guarantor a priority claim or creating a non-dischargeable claim in the bankruptcy reorganization. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 250-51 n.134. This would place the guarantor's claim against the debtor in a superior position than the claim of the creditor. Several courts, however, have rejected *Frenville* and have held that a claim for indemnification is a pre-petition claim. See *In re* Johns-Manville Corp., 57 B.R. 680, 689 (Bankr. S.D.N.Y. 1986); Baldwin-United Corp. v. Named Defendants (*In re* Baldwin-United Corp.), 48 B.R. 901, 903 (Bankr. S.D. Ohio 1985). Courts that view claims for indemnification as pre-petition claims are on "suror footing" with Congressional intent. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 250-51 n.134.

Moreover, in a case decided under the Bankruptcy Act, the Supreme Court found that a discharge in bankruptcy releases the debtor from all provable claims. See *Williams v. United States Fidelity & Guar. Co.*, 236 U.S. 549, 555-56 (1915). In addition, a surety has a "provable claim" against the debtor although at the time of bankruptcy there may have been no default. See *id.* This holding supports the view that a claim for indemnification is indeed a pre-petition claim and therefore dischargeable in bankruptcy. Section 509(a) contemplates subrogation of the surety to the rights of creditors to the extent that the surety has paid the creditor. See *Huddelston*, 1991 WL 110209 at *5. In the event of subrogation, § 509(a) does not require that a priority status be afforded to the surety even where the creditor to whom payment was made enjoyed such status. See *id.*

Subrogating the non-debtor to a non-priority status even when the non-debtor's claim of indemnification may be entitled to priority status is consistent with the provisions of the Code. Section 507(d) provides that a subrogee of a priority creditor is not entitled to the priority status that the creditor enjoyed. See *Woerner v. Farmers Alliance Mut. Ins. Co.* (*In re* Woerner), 19 B.R. 708, 711-12 (Bankr. D. Kan. 1982).

118. See *Otero Mills, Inc. v. Security Bank & Trust* (*In re* Otero Mills, Inc.), 25 B.R. 1018, 1022 (D.N.M. 1982).

119. See *id.*

120. See Martin J. Bienenstock, *Bankruptcy Reorganization* 72 (1987).

121. See Alison Grey Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L.Rev. 738, 760 (1975). Professor Grey notes, "Fiduciary duties . . . simply oblig[e] the fiduciary to act in the best interests of his client or beneficiary and to refrain from self-interested behavior." *Id.*

ing its own interests¹²² above those of the shareholders.¹²³

Courts holding that non-debtor guarantors may be discharged in a plan of reorganization tend to ignore the rationale behind guaranties.¹²⁴ The purpose of a guaranty is to ensure that the creditor can collect from the guarantor if the debtor is unable to repay.¹²⁵ A less credit-worthy company may require a guarantor in order to secure adequate financing. The availability of the guaranty may reduce the cost of credit because the interest rate on loans will decrease as the risk of default decreases.¹²⁶

Moreover, the ability to use guaranties of principals or corporate officers may actually benefit a company. Guarantors will presumably only be willing to guarantee financing if the proposed transaction has a reasonable chance of success. Guaranties operate as a "filtering mechanism that will enable the corporate debtor to avoid ventures in which the risks outweigh potential benefits."¹²⁷ Therefore, guaranties benefit a debtor corporation by enabling the debtor to obtain less expensive financing for transactions that have a reasonable chance of success.¹²⁸ "[F]rom the point of view of both the corporate debtor and the guarantor, as well as from their respective creditors' points of view, guaranties are worth protecting."¹²⁹

Courts that allow for the discharge of guarantors in a plan of reorganization do serious damage to the effectiveness of guaranties in general. In the long run, these courts may actually harm debtor corporations by increasing the cost of financing and decreasing its availability. Further, by removing this "filtering mechanism," such courts may unwittingly increase the number of risky transactions. While trying to assist present bankrupt debtors, these courts may be creating a business environment where corporations that may have been able to otherwise survive with lower interest rates and sounder business ventures are forced into bankruptcy.

122. If the debtor pays the creditor, the insider guarantor will be relieved of its obligations.

123. A corporate insider that unduly influences a debtor to pay off a debt, for which the insider would otherwise be liable, will be diminishing the debtor's estate to the detriment of the shareholders for its own benefit.

124. See Robin M. Goldman, *Guarantee Agreements: The Impact of Bankruptcy*, 3 Prob. & Prop., May/June 1989, at 17, 19. As one court noted, "[W]hat good is a [guaranty] if the guarantor escapes liability when the debtor does?" *Bel-Ken Assocs. Ltd. Partnership v. Clark*, 83 B.R. 357, 359 (Bankr. D. Md. 1988).

125. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 236. The recent onslaught of bankruptcy filings has forced lenders to increasingly turn to guarantors for repayment. A lender will view a non-bankrupt guarantor as a secondary source of collection. The lender's expectation that it will be able to collect from the guarantor is frustrated, however, where bankruptcy courts discharge the guarantor's obligations to the lender. See *id.* at 227; Tilton & Wild, *supra* note 1, at 5.

126. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 238. Indeed, one solution to the infirmities of insider-guarantees with respect to preferential transfers is to impose higher interest rates on the debtor. See Effros, *supra* note 97, at 799.

127. Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 239.

128. See *id.*

129. *Id.*

b. *Joint Tortfeasors—Undermining the Policy Behind Joint and Several Liability*

The Securities and Exchange Commission ("SEC") has argued that non-debtor discharges which abrogate the tort liability of third parties undermines the policies underlying joint and several liability.¹³⁰ The underlying rationale is to ensure that victims are fully compensated by the remaining wrongdoers if one of the wrongdoers is unable to pay.¹³¹ Accordingly, an officer or director is individually liable for his or her own tortious conduct, even though such conduct may have arisen in the course of the company's operation and in furtherance of the company's interests.¹³²

Discharging non-debtors from potential tort liability is a dangerous policy to follow. Officers and directors of corporations, who may be culpable along with the debtor for a particular tortious act, may be able to evade liability by causing the debtor to file for bankruptcy under Chapter 11. In fact, in the two largest mass-tort cases, *A.H. Robins Co.* and *Johns-Manville Corp.*, allegations arose that the companies, being solvent, inappropriately filed for protection under Chapter 11 due to a desire on the part of the corporate managements to limit liability.¹³³ In both instances, the respective courts held that insolvency is unnecessary at the time of filing; rather, if a company can foresee insolvency, it need not wait until the company is actually insolvent to file.¹³⁴ Practically, it may be reasonable to allow a solvent company to file for bankruptcy, but this policy together with the policy of permitting discharge of a non-debtor's liability are ill-conceived given the obvious potential for abuse.¹³⁵

130. See SEC Brief, *supra* note 2, at 7.

131. See Sobol, *supra* note 64, at 334. Richard Sobol also suggests that, at least in the case of *A.H. Robins*, relieving the potential co-defendants was not only violative of § 524(e) but also unnecessary to protect the debtor's estate because under Virginia law, a duty to indemnify does not apply if the need for indemnification arises from willful misconduct. Such misconduct had been found to exist in relation to the *Dalkon Shield*. See *id.* at 385 n.21.

132. See *Inforex, Inc. v. Burrige (In re Inforex, Inc.)*, 26 B.R. 515, 518 (Bankr. D. Mass. 1983).

133. See Sobol, *supra* note 64, at 327; Beckham, *supra* note 68, at 788 n.60.

134. See *In re Johns-Manville Corp.*, 36 B.R. 727, 732 (Bankr. S.D.N.Y. 1984); Sobol, *supra* note 64, at 327 (noting that the bankruptcy court in both *A.H. Robins* and *Johns-Manville* permitted the companies to file although neither was technically insolvent). Sobol points out that many parties filed petitions to dismiss the bankruptcy petition on the grounds that *A.H. Robins* was able to withstand the *Dalkon Shield* liability without resorting to bankruptcy. The company's Chapter 11 petition was alleged to be a tactic to consolidate all of the *Dalkon Shield* cases before a judge in the Eastern District of Virginia who supposedly was more sympathetic to the Richmond company's plight. See *id.*

135. Cf. Sobol, *supra* note 64, at 331 (noting that where bankruptcy proceedings wipe out claims for punitive damages, as in *A.H. Robins*, there is a "strong incentive for misuse of Chapter 11").

2. The Contributing Non-Debtor Theory

The "contributing non-debtor" theory¹³⁶ of third party discharges maintains that a discharge of a non-debtor's liability is appropriate where the non-debtor contributes to the debtor's reorganization.¹³⁷ A discharge in bankruptcy, however, is effective by operation of law, not by contract.¹³⁸ Therefore, any payment made by a non-debtor to a debtor's plan of reorganization, for purposes of securing a discharge, is not consideration for a release.¹³⁹ Many of the courts, that have premised third-party releases on the "contributing non-debtor" theory have emphasized the adverse effect on the debtor or the debtor's estate if the party making such a contribution were not discharged.¹⁴⁰

Assets or proceeds that a non-debtor is not legally obligated to pay to the debtor are not property of the debtor's estate under section 541¹⁴¹ and should not be subject to the bankruptcy court's jurisdiction.¹⁴² As one bankruptcy court has stressed, "To hold that the bankruptcy court

136. See Shapiro, *supra* note 11, at 347; Tilton & Wild, *supra* note 1; see also Sobol, *supra* note 64, at 221-22 (noting that, in the case of the A.H. Robins Co., the chairman of the board and the president and CEO, both of whom allegedly committed tortious acts, made a combined payment of \$10 million to a claimants' trust in exchange for release of liability and injunction against suits in connection with the Dalkon Shield).

137. See e.g., *MacArthur Co. v. Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 837 F.2d 89, 90 (2d Cir.) (calling the contributions of non-debtor insurance company a "cornerstone" of reorganization), *cert. denied*, 488 U.S. 868 (1988); *Myerson & Kuhn v. Brunswick Assoc. Ltd. Partnership* (*In re Myerson & Kuhn*), 121 B.R. 145, 157 (Bankr. S.D.N.Y. 1990) (failure to permanently enjoin suits against contributing non-debtor would significantly diminish the total assets of the debtor's estate); *UNARCO Bloomington Factory Workers v. UNR Indus., Inc.*, 124 B.R. 268, 278 (N.D. Ill. 1990) (section 524(e) does not prohibit discharge of a third party where the reorganization "hinges on" the release of a contributing non-debtor); *Otero Mills, Inc. v. Security Bank & Trust* (*In re Otero Mills, Inc.*), 25 B.R. 1018, 1020-21 (D.N.M. 1982) (an aspect to be considered was that enforcement of a state court order against the debtor's president, who intended to contribute to the reorganization, would affect the reorganization).

138. See *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985); *Union Carbide Corp. v. Newboles*, 686 F.2d 593, 595 (7th Cir. 1982); *In re Scranes, Inc.*, 67 B.R. 985, 989 (Bankr. N.D. Ohio 1986).

139. See *Underhill*, 769 F.2d at 1432; *Union Carbide*, 686 F.2d at 595; *Scranes*, 67 B.R. at 989.

140. See *Menard-Sanford v. Mabey* (*In re A.H. Robins Co.*), 880 F.2d 694, 701-02 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989); *Johns-Manville*, 837 F.2d at 93; *Myerson & Kuhn*, 121 B.R. at 157; *Otero Mills, Inc. v. Security Bank & Trust* (*In re Otero Mills, Inc.*), 21 B.R. 777, 779 (Bankr. D.N.M. 1982).

141. See 11 U.S.C. § 541 (1988) ("legal or equitable interests . . . in property" for debtor are considered property of the estate).

142. See *Bill Roderick Distrib. Inc. v. A.J. MacKay Co.* (*In re A.J. MacKay*), 50 B.R. 756, 762 (D. Utah 1985); cf. *Apollo Molded Prods., Inc. v. Kleinman* (*In re Apollo Molded Prods., Inc.*), 83 B.R. 189, 193 (Bankr. D. Mass. 1988) ("[T]he intentions of a debtor's principal to devote personal assets to the reorganization should [not] . . . have the talismatic effect of shielding him from suit on his personal obligations."); *In re Elsinore Shore Assocs.*, 91 B.R. 238, 254 (Bankr. D.N.J. 1988) (bankruptcy court may properly invoke its jurisdiction when "creditors' actions may effect property of the [debtor's] estate"). The bankruptcy court's jurisdiction over property lapses when that property leaves the estate. See *Elscent, Inc. v. First Wis. Fin. Corp.* (*In re Xonics, Inc.*), 813 F.2d 127, 131 (7th Cir. 1987). Therefore, it is inconceivable that a bankruptcy court

. . . has jurisdiction over . . . any property that might 'assist' the debtor in reorganizing is to expand jurisdiction beyond limit. Jurisdiction exists only over the debtor and his property, and no further."¹⁴³ Indeed, in ruling that the bankruptcy court's jurisdiction does not extend to the non-debtor's assets, one court noted its belief that *Otero Mills* and its progeny were wrongly decided because the bankruptcy court only has authority to exert jurisdiction over the debtor and the debtor's property.¹⁴⁴

Moreover, with respect to the bankruptcy court's jurisdiction, it is irrelevant that an assertion of a claim against a non-debtor will adversely affect the debtor's reorganization.¹⁴⁵ Courts that place the debtor's survival above that of the creditor's right to full payment ignore the implicit mandate of the Code's absolute priority rule¹⁴⁶ that the creditor's right to full payment is superior to creating value for the shareholders.¹⁴⁷

3. "Undivided Attention" and "Throw-In the Towel" Theories

The "undivided attention" theory¹⁴⁸ maintains that it is appropriate for a court to invoke its equitable powers under section 105(a) to protect a non-debtor whose participation is required for the debtor's reorganization where claims against the non-debtor impinge upon that non-debtor's participation in the bankrupt's reorganization efforts. The "undivided attention" theory is more applicable to stays than to permanent injunc-

could expand its jurisdiction over property that was never previously a part of the debtor's estate.

143. *A.J. Mackay Co.*, 50 B.R. at 762; see also *Elsinore Assoc.*, 91 B.R. at 255 (quoting *A.J. Mackay*).

144. See *A.J. Mackay Co.*, 50 B.R. at 762; see also *Venture Properties, Inc. v. Norwood Group, Inc. (In re Venture Properties)*, 37 B.R. 175, 177 (Bankr. D.N.H. 1984) (noting that *Otero Mills* was wrongly decided); *supra* notes 72-79 and accompanying text (discussing *Otero Mills*).

145. See *United States v. Huckabee Auto Co.*, 783 F.2d 1546, 1549 (11th Cir. 1986); cf. *Zaretsky, Co-Debtor Stays*, *supra* note 96, at 228 n.50 (in response to a view that an underlying goal of bankruptcy is to keep the debtor company afloat so that it may provide its employees with jobs, pay its creditors, and generate returns for shareholders, Prof. Barry Zaretsky points out that one commentator maintains that "the notion of keeping firms in business is not a bankruptcy policy" and the firm should only be kept afloat if it maximizes the return to creditors and shareholders (citation omitted)).

146. The absolute priority rule is codified at § 1129(a)(8) of the Code. See 11 U.S.C. § 1129(a)(8) (1988). The absolute priority rule "prevents any distribution to the shareholders unless the plan of reorganization provides for all the payment of the corporation's debts." Sobol, *supra* note 64, at 52.

147. By keeping the debtor afloat at the expense of the creditors, the bankruptcy court is necessarily creating value for the debtor's shareholders while impairing the claims of creditors. A bankruptcy court's emphasis should be on protecting the debtor for the benefit of the creditors and not protecting the debtor for the debtor's own benefit. See *Zaretsky, Co-Debtor Stays*, *supra* note 96, at 228.

148. See *Bienenstock*, *supra* note 120, at 110-11 n.29; *Shapiro*, *supra* note 11, at 347; *Harris*, *supra* note 103, at 293; *Tilton & Wild*, *supra* note 1. But see *Zaretsky, Co-Debtor Stays*, *supra* note 96, at 230 ("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.").

tive relief. Indeed, a temporary stay may be appropriate where the non-debtor's energy and attention is required to assist the debtor through a crucial point in the reorganization proceedings.¹⁴⁹ By its very nature, however, a stay is temporary and will expire according to the terms of the stay or upon confirmation of the plan.¹⁵⁰ Most courts, at least with respect to guarantors, have refused to discharge a non-debtor to facilitate the non-debtor's participation in the reorganization of the debtor.¹⁵¹

A more pressing issue arises when an officer or director threatens to "throw in the towel"—by abandoning the debtor's attempts to reorganize—in the event that the court refuses to discharge the non-debtor officer or director.¹⁵² There is little reason, however, to succumb to such threats. When the debtor is the officer's best employment opportunity, the officer will stay regardless of whether the discharge is granted.¹⁵³ In the event the officer leaves the debtor to work elsewhere, the officer's liability will be unaffected by his or her departure from the debtor¹⁵⁴ and may even grow.

Officers may, in certain circumstances, act irrationally or may desire to avoid the turmoil of reorganization proceedings. The only effective incentive for the officer to remain with the debtor may be the discharge of his or her liabilities. Does a discharge of the officer under such circumstances serve the purposes of equity? 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. In the words of one commentator, "The courts cannot allow legal principles to be shaped by ultimatums from the litigants."¹⁵⁵ Moreover, a party seeking "equitable relief under [section] 105 should follow the equitable maxim 'he who seeks equity must do

149. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 250. Most courts distinguish between a personal creditor of the non-debtor and creditors with a claim arising from the debtor's operations. The consensus is that creditors with a personal claim not arising from debtor's operation should be free from interference from the bankruptcy proceedings. See *id.* at 250 n.133.

150. See *id.* at 231.

151. See *id.* at 250 & n.133.

152. See, e.g., *In re Original Wild West Foods, Inc.*, 45 B.R. 202, 205, 208 (Bankr. W.D. Tex. 1984) (court relieved officer from statutory liability on debtor's trust fund taxes where officer threatened to "throw in the towel" if not released).

153. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 272. Conversely, if the debtor is not the officer's best employment opportunity, the officer will not remain with the debtor even if he or she is discharged.

154. See *id.* Professor Zaretsky states: "[U]nless 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." *Id.*

155. Sobol, *supra* note 64, at 335.

equity.' ”¹⁵⁶

C. *A Note on Insurance and Mass Tort Claims*

Most courts assume that liability insurance proceeds¹⁵⁷ are property of the debtor's estate.¹⁵⁸ Where this is the case, these proceeds may become available to “non-victim creditors.”¹⁵⁹ This, however, would give trade creditors a windfall because the insurance proceeds would not otherwise be available to satisfy the claims of such creditors.¹⁶⁰ Although section 524(e) is not implicated where insurance proceeds are deemed property of the estate, safeguards are necessary, preferably via statutory amendments, to ensure that the intended beneficiaries of the insurance policy, such as tort claimants, have priority with respect to these funds.¹⁶¹ In the two leading mass tort bankruptcies, *A.H. Robins Co.* and *Johns-Manville Corp.*, a fund was established upon which only tort claimants could draw.¹⁶²

Where the proceeds of an insurance policy are not considered property of the estate, the aggrieved parties may be able to proceed against the insurance company, or in some instances, against the debtor, for the purposes of establishing liability to enable victims to collect from the in-

156. *Tilton & Wild*, *supra* note 1.

157. A distinction has been made between insurance policies and insurance proceeds. A debate has ensued as to whether proceeds from certain types of insurance policies are property of the debtor's estate. See *Beckham*, *supra* note 68, at 786-87; *Zaretsky*, *Insurance Proceeds*, *supra* note 63, at 385-86.

158. See *Beckham*, *supra* note 68, at 787; *Zaretsky*, *Insurance Proceeds*, *supra* note 63, at 386.

159. See *Zaretsky*, *Insurance Proceeds*, *supra* note 63, at 398; *Zaretsky*, *Co-Debtor Stays*, *supra* note 96, at 276. Non-victim creditors are creditors having a claim against the debtor that did not arise from a tort committed by the debtor.

160. See *Zaretsky*, *Co-Debtor Stays*, *supra* note 96, at 277; see also *Beckham*, *supra* note 67, at 792-93 (noting that once an asset becomes property of the estate, it is distributed along with the other property of the estate according to the priority rules of bankruptcy, and also noting that tort claimants are not within a priority group). The prevalent view, though, is that liability insurance must be distributed out of the estate directly to tort claimants. See *id.* at 797.

161. Theories that tort claimants are specifically entitled to the insurance proceeds have been based on arguments that the proceeds are held in constructive trust for benefit of the tort claimants, see *Beckham*, *supra* note 68, at 794; *Zaretsky*, *Insurance Proceeds*, *supra* note 63, at 398, and that insurance policies are third-party beneficiary contracts, see *Beckham*, *supra* note 68, at 794. There is no assurance that the courts will accept these theories. See *Zaretsky*, *Insurance Proceeds*, *supra* note 63 at 399; cf. *Beckham*, *supra* note 68, at 794 (these theories are subject to state law interpretation).

162. See *MacArthur v. Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 837 F.2d 89, 90-91 (2d Cir.) (insurance proceeds channeled to a settlement fund), *cert. denied*, 488 U.S. 868 (1988); *Johns-Manville Corp. v. Asbestos Litig. Group* (*In re Johns-Manville Corp.*), 33 B.R. 254, 267 (Bankr. S.D.N.Y. 1983); *Sobol*, *supra* note 64, at 219 (section 6.06 of A.H. Robins' plan of reorganization provided for a contribution of unused insurance proceeds as well as reduced insurance coverage to a claimants trust). *But see, e.g.*, *UNARCO Bloomington Factory Workers v. UNR Indus., Inc.* 124 B.R. 268, 279 (N.D. Ill. 1990) (insurance proceeds were not separate and distinct from the rest of debtor's estate).

surer.¹⁶³ In this context, the problem lies not with the ability to proceed against the insurer, but with equitably distributing the proceeds of the insurance policy among the claimants.¹⁶⁴ The insurer's liability is limited by the terms of the policy, and if the amount of claims is great, the policy most likely will not cover all claims.¹⁶⁵ Moreover, the insurer, unlike a guarantor, will not seek bankruptcy protection because of its limited liability¹⁶⁶ and, consequently, the equitable protection of the courts will be unavailable to the third-party insurance company.¹⁶⁷

Under this scenario, the insurance proceeds will be distributed under non-bankruptcy law¹⁶⁸ and a race to the insurance proceeds may result.¹⁶⁹ The potential for a race to the proceeds stems from the lack of an adequate non-bankruptcy system to equitably distribute insurance proceeds.¹⁷⁰ Claimants who are unable to receive full compensation from the limited pool of insurance proceeds will be restricted from obtaining further, if any, satisfaction from the bankrupt tortfeasor.

Although the insurer does not come within the jurisdiction of the bankruptcy court, when claims may exhaust the maximum policy limits, the most equitable method of distribution would be to require the insurer to pay the amount of the policy limit into a fund to be administered for and distributed to claimants. Such a fund is not contemplated by the Code¹⁷¹ and cannot be established under section 105(a) because it would not be effectuating any provision of the Code. Therefore, in order to

163. See *Owaski v. Jet Florida Sys., Inc. (In re Jet Florida Sys., Inc.)*, 883 F.2d 970, 973 (11th Cir. 1989) (section 524(e) does not preclude a claimant from proceeding against debtor if the ultimate goal is collection from debtor's insurer). Also, in states that allow for direct action against insurers or where the claimant already has a judgment of liability against the debtor, the claimant may proceed directly against the insurer when proceeds are not deemed property of the estate. See Zaretsky, *Insurance Proceeds*, *supra* note 63, at 383.

164. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 276.

165. See *id.*

166. See Zaretsky, *Insurance Proceeds*, *supra* note 63, at 393-95.

167. See *id.* at 395. Professor Zaretsky notes that in this situation claimants will be relegated to the non-bankruptcy doctrine of first in time, first in right. See *id.*

168. Cf. Zaretsky, *supra* note 63, at 384 (the bankruptcy court has power to oversee the distribution of insurance proceeds only to the extent that the proceeds are deemed property of the debtor's estate).

169. One of the enumerated goals of the Bankruptcy Code is to avoid a creditors race to the debtor's assets. See Zaretsky, *Co-Debtor Stays*, *supra* note 96, at 217; John J. Lawson, Note, *Creditors Beware! A Guaranty May Not Be Such a Guarantee*, 94 Dick. L. Rev. 157, 159 (1989). In the event insurance proceeds are not deemed part of the debtor's estate, preventing a run on such proceeds would not fulfill this goal of the Code because the funds in question would be assets of a party other than the debtor.

170. See Zaretsky, *supra* note 63, at 393.

171. See 11 U.S.C. §§ 101-559, 1101-1174 (no provision of the Code applicable to, or included in, Chapter 11 provides for treatment of insurance proceeds in bankruptcy); cf. Zaretsky, *Insurance Proceeds*, *supra* note 63, at 386, 398-99 (noting the Code does not provide for insurance proceeds to be included in the estate and, if proceeds are deemed property of the estate, there is no guaranty that courts would recognize the theory that the funds are held in constructive trust for the tort claimants).

permit such a distribution, Congress must revise the Code so as to provide for such an insurance trust.

CONCLUSION

The language of section 524(a) provides that a discharge is personal to a debtor, and section 524(e) precludes such discharge from affecting the liability of any entity other than the debtor. Consequently, a discharge is only available to those parties that file for protection under the Bankruptcy Code, thereby submitting to its burdens as well as receiving its benefits. This interpretation of section 524(e) is consistent with the congressional mandate that the Code be applied to the relationship between debtors and others, not between creditors and non-debtors. Courts have, however, invoked section 105(a) to circumvent the provisions of section 524.

Discharges of non-debtors under section 105(a) must cease. They are not only violative of the express command of section 524 but are also contrary to public policy. Furthermore, The policies and rationales enunciated by these courts to support the broad equitable powers of the bankruptcy court do not comport with equitable principles or sound business policies.

Although section 524 operates to prohibit discharges of non-debtors, Congress should enact legislation to permit equitable distribution of proceeds from the debtor's insurance policies. Such legislation would ensure that the proceeds are channeled in an even-handed manner to the aggrieved parties and not distributed as part of the debtor's estate in general. Also, amending the Code to grant the bankruptcy court power over insurance proceeds would settle any doubt as to whether these proceeds are part of the bankrupt's estate, and forestall any possibility of a race to these funds in the event there are multiple claimants.