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Expert Analysis

Third-Party Protections In Mass Tort Chapter 11 Cases

A defendant facing thousands of mass tort lawsuits in federal and state courts throughout the country often will seek to address the litigation by seeking Chapter 11 relief under the Bankruptcy Code. The Chapter 11 process provides the debtor with an opportunity to develop a global solution for the mass tort litigation. The automatic stay under Section 362 of the Bankruptcy Code will effectively stay all pending actions against the debtor, which provides the debtor with the necessary breathing space to formulate a plan.

The mass tort debtor's ability to propose a confirmable plan will largely be driven by its ability to provide meaningful distribution to the tort victims. Typically, the mass tort debtor will not have sufficient immediate assets with which to satisfy the victims' claims. Thus, a significant component to any distribution made to creditors necessarily will include the debtor's claims against third parties (who may have played a role in triggering the mass tort) as well as the debtor's liability insurance. These claims, however, are difficult to monetize. Third-party defendants will defend against any claims asserted by the debtor, and insurers typically have coverage defenses.

In order to turn these claims into actual assets that can be distributed to creditors, the debtor has to successfully prosecute its claims, which generally means significant litigation expenses and delay. Thus, the most efficient solution for the debtor is to settle its claims, which will bring funds into the estate, without the inevitable delay, uncertainty and cost of litigation. But, settling the debtor's claims poses a serious challenge, because no third-party defendant will pay the debtor to settle the estate's claims, only to remain a defendant in the tort system for the same claims. Likewise, no insurance carrier will settle the debtor's coverage claim, only to be named as a defendant in direct action lawsuits by tort victims based on the same insurance coverage it just settled with the debtor.

By **John H. Bae**

Historically, courts have addressed this problem by approving third-party releases of claims against the settling parties and implementing channeling injunctions, which have the effect of shielding the settling parties from further litigation by enjoining claims against them and redirecting or "channeling" such claims to a trust that is established to address and pay those claims. Providing such protections remains an important component to successful mass tort restructurings. This article provides a summary of the jurisprudence on this topic, and highlights the various factors that courts have considered when determining whether such third-party relief is appropriate.

Authority to Approve

A majority of the circuit courts of appeals that have addressed the issue, including the Second, Fourth, Sixth, Seventh, Eleventh and the District of Columbia, have ruled that the bankruptcy court has the authority to approve third-party releases and channeling injunctions for the benefit of non-debtors. The Ninth and Tenth circuits, however, have ruled that such third-party relief is not permissible under the Bankruptcy Code. See *American Hardwoods v. Deutsche Credit* (*In re American Hardwoods*), 885 F.2d 621, 626 (9th Cir. 1989); *Landsing Diversified Properties-II v. The First National Bank* (*In re Western Real Estate Fund*), 922 F.2d 592, 600 (10th Cir. 1990).

In refusing to approve third-party releases and injunctions, these courts relied on Section 524(e) of the Bankruptcy Code, which provides in pertinent part, "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."

The majority of the circuits, however, have rejected the Ninth and Tenth Circuits' approach, reasoning that Section 524(e) only addresses the impact of a discharge of the debtor on other creditors, and does not address the bankruptcy court's authority to grant third-party releases and injunctions. As the Sixth Circuit explained in *In re Dow Corning*, "These courts primarily rely on *Section 524(e)* of the Code, which provides that 'discharge of the debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.'… However, this language explains the effect of a debtor's discharge. It does not prohibit the release of a non-debtor." 280 F.3d 648, 657 (6th Cir. 2002) (emphasis in original) (internal citations omitted).

The Seventh Circuit in *Airadigm Communications v. Federal Communications Commission* (*In re Airadigm Communications*), further explained, "*§524(e)* does not purport to limit the bankruptcy court's powers to release a non-debtor from a creditor's claims. If Congress meant to include such a limit, it would have used the mandatory terms 'shall' or 'will' rather than the definitional term 'does.'" 519 F.3d 640, 656 (7th Cir. 2008) (emphasis in original).

> A significant component to any distribution made to creditors necessarily will include the debtor's claims against third parties.

The six circuit courts that have approved third-party releases and injunctions have principally relied on Section 105(a) of the Bankruptcy Code, which provides in part that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." But even these courts have cautioned that approving third-party releases and channeling injunctions should be limited to unique situations where the facts presented warrant such relief.

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The Factors

In determining whether third-party releases and channeling injunctions should be approved, courts generally consider six separate factors, which are not exclusive or conjunctive. See *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002); *In re A.H. Robins Co*., 880 F.2d 694, 701-02 (4th Cir. 1989); *MacArthur v. Johns-Manville, Corp.*, 837 F.2d 89, 92-94. The six factors are intended to balance the interests of claimants, who are forced to relinquish their claims against third parties, against the necessity of the contributions for the successful confirmation of a plan. Factors 2, 4, 5 and 6 specifically focus on the interests of claimants, whereas factors 1 and 3 are focused on the necessity of the contribution to plan confirmation. Courts have not articulated how each of these factors should be weighed, or whether one factor should be given greater importance over any other factor. Each of these factors is discussed in turn.

Factor 1: Identity of Interest. This factor relates to whether the third party being released has an identity of interest with the debtor. Generally, this factor is satisfied if the party being released would have an indemnity claim against the debtor, such that a claim against the third party would be tantamount to a claim against the debtor. Insurers of the debtor readily satisfy this factor, insofar as the tort claimants' claims against the insurers will result in the erosion of the debtor's insurance policy, which is an asset of the estate.

Factor 2: Substantial Contribution by Released Parties. Whether the contribution being made by the third party and the insurer is "substantial" is driven by the facts and circumstances of each case, and is left to the judgment of the court. Courts have not agreed on a specific formula that would help define the amount of contribution that would be required to satisfy the "substantial contribution" requirement. Generally, when determining whether this factor has been satisfied, courts have often recited the amount that was being contributed, the importance of the contribution to the plan and the ultimate treatment of creditors under the plan in comparison to how they would be treated in the tort system.

Factor 3: Necessity for Reorganization. Although this factor requires that the releases and injunctions be necessary for the "reorganization" of the debtor, courts have not limited granting such relief to only Chapter 11 reorganization cases. Indeed, the courts that focused on the "reorganization" of the debtor did so because they were presented with a reorganization plan and not a liquidating plan. When considering this factor, courts have used the term "reorganization" interchangeably with "success of the plan." Thus, courts presented with liquidating plans have found that this factor was satisfied, provided that the releases and injunctions were critical to the confirmation and success of the plan.

For example, in the recent decision, *In re Blitz U.S.A.*, the U.S. Bankruptcy Court for the District of Delaware confirmed the debtors' and creditors committee's joint plan of liquidation containing both releases and channeling injunctions to protect both non-debtors and insurers. Case No. 11-13603(PJW), 2014 Bankr. Lexis 2461 (Bankr. D. Del. Jan. 30, 2014). In concluding that the releases and channeling injunction contained in the plan of liquidation were necessary to the "reorganization," the court found that both the releases and channeling injunction were "critical to the success of the plan," and that without them, the protected parties would not be willing to make their contributions to the plan. Id. at *18.

Similarly, in *In Re Chiles Power Supply*, the court upheld a channeling injunction contained in the debtor's Chapter 11 plan of liquidation in favor of insurance carriers that established a fund for dealing with product liability claims against the debtor. 264 B.R. 533 (Bankr. D. Mo. 2001). In so doing, the court found that the injunctive provisions were an "integral part" of the plan of liquidation and "essential to its implementation." Id. at 539. Thus, courts have approved releases and channeling injunctions in the context of liquidating plans, so long as the releases and injunctions were necessary to the feasibility and implementation of the liquidating plan.

> The principles underlying the Johns-Manville decision and the releases and channeling injunction approved under Section 105(a) of the Bankruptcy Code remain equally relevant to all mass tort cases.

Factor 4: Creditors 'Overwhelmingly' Support the Releases and Injunctions. Under section 1126(c) of the Bankruptcy Code, a particular class of creditors has voted to accept a plan if more than half of the creditors in the class holding more than two-thirds in the dollar amount of the claims in the class vote in favor of the plan. This factor does not refer to the voting requirements of section 1126(c), and instead, requires that creditors must "overwhelmingly" support the plan. Thus, this factor presumably requires acceptance of the plan (or the releases and injunctions contained in the plan) by a greater number of creditors than required under section 1126(c). How much more support would be required to satisfy the "overwhelming" support requirement would be left to the discretion of the court.

Factors 5 and 6: Payment of all or Substantially all Classes of Claims and Opportunity for Nonsettling Claimants to be Paid In Full. While these two factors are self-explanatory—i.e., claims should be paid in full or substantially in full, and creditors who choose not to participate must be given an opportunity to obtain full payment—they are also the two factors that have no practical purpose in certain circumstances. For example, if the debtor's limited assets, together with the third-party defendants' contribution of virtually all of their assets and the settlement amount from the insurers are not sufficient to satisfy substantially all claims of the tort victims, requiring the debtor to satisfy these two factors becomes nonsensical. Under these facts, the claimants could not obtain any better recovery on account of their claims under any other scenario.

If the releases and channeling injunction are not approved, the result would be to require the debtor to litigate its claims against the third parties, and to participate in coverage litigation with the insurers. In addition to the time and cost of litigation, the debtor's ultimate recovery would be uncertain. And, to the extent the third-party defendants are contributing substantially all of their assets under the plan, the creditors will not recover any more from them through litigation in the tort system.

Similarly, in a coverage litigation, the debtor could recover much less than the amount the insurers are contributing under the plan. Under these circumstances, it makes little sense to not approve the releases and injunctions in the plan and require the debtor to litigate, when doing so would provide no more recovery to creditors, and potentially a much lower recovery.

Conclusion

The importance of third-party releases and channeling injunctions in mass tort bankruptcy cases was recognized long ago. Long before Section 524(g) of the Bankruptcy Code was enacted to address asbestos-related bankruptcies, the court in *Johns-Manville* cited Section 105(a) of the Bankruptcy Code to approve third-party releases and channeling injunctions to confirm a plan that best served the interests of the creditors.

While the enactment of Section 524(g) provides a statutory basis for approving channeling injunctions for the benefit of non-debtors in asbestos cases, no similar statute exists for other mass tort bankruptcy cases. However, the principles underlying the Johns-Manville decision and the releases and channeling injunction approved under Section 105(a) of the Bankruptcy Code remain equally relevant to all mass tort cases, and remain an important tool for the debtor to confirm a plan that best serves the interests of its creditors.