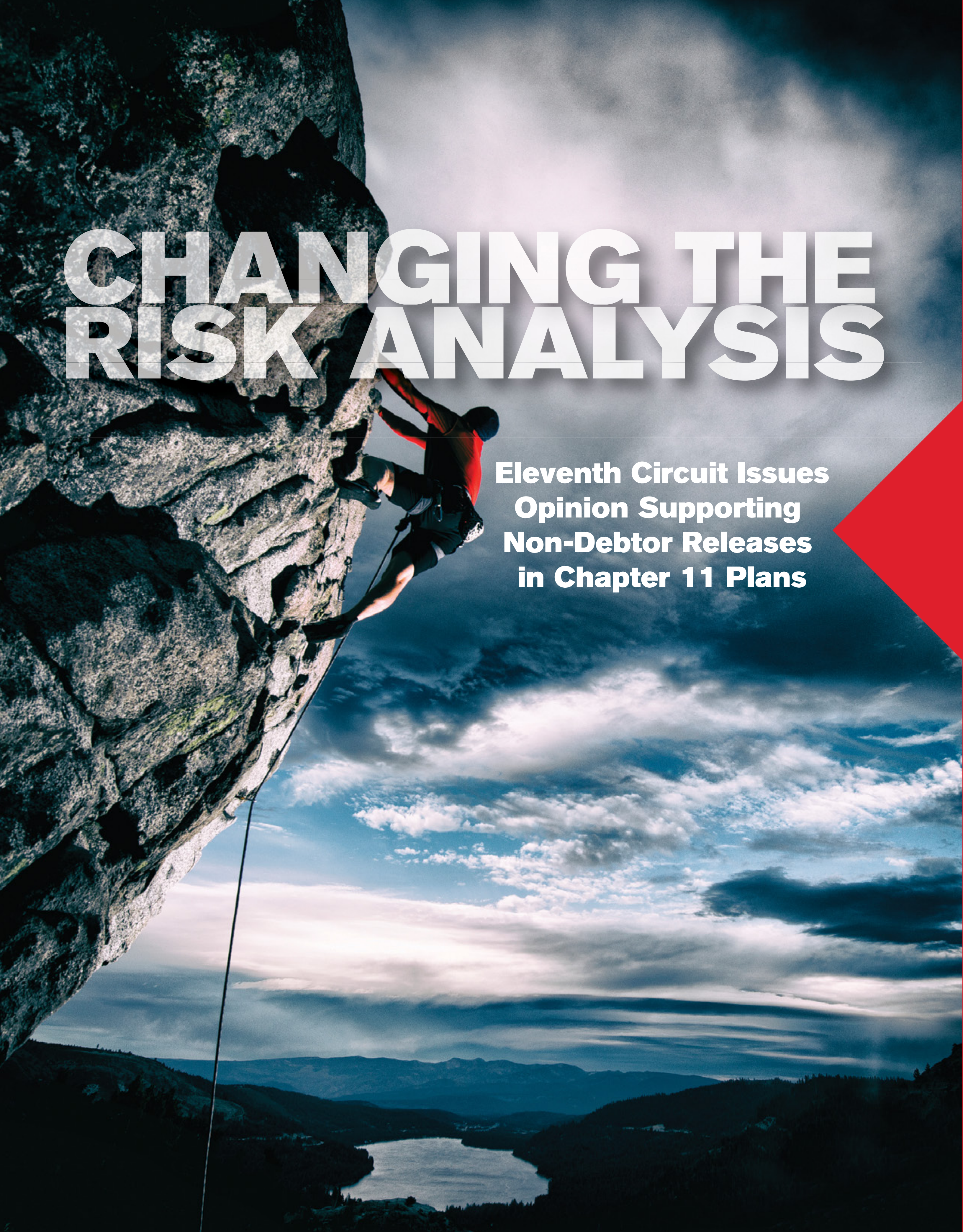

CHANGING THE RISK ANALYSIS

Eleventh Circuit Issues Opinion Supporting Non-Debtor Releases in Chapter 11 Plans

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The Eleventh Circuit Court of Appeals, which presides over appeals from federal courts in Alabama, Florida, and Georgia, recently approved of non-debtor releases in Chapter 11 bankruptcy plans. The decision sets out a test for bankruptcy courts to use when reviewing release provisions. This article discusses the case's relevance and steps lenders can take to mitigate its effect.

Until the March 12, 2015 decision by the Court of Appeals for the Eleventh Circuit in the case of *In re Seaside Engineering & Surveying, Inc. ("Seaside Engineering")*,[1] the question of whether bankruptcy courts in this circuit, which encompasses the states of Alabama, Florida and Georgia, could confirm a Chapter 11 plan containing so-called "non-consensual, non-debtor releases" remained somewhat open. Back in 1996, the Eleventh Circuit case of *In re Munford, Inc.* affirmed a bankruptcy court order that approved settlement of a pending lawsuit and barred nonsettling defendants from pursuing claims against the defendant who did settle.[2] The bankruptcy court order, however, was not part of a comprehensive plan restructuring the debtor's debts; instead, the order only resolved the litigation against the settling defendant.[3] *In Seaside Engineering*, by contrast, the Eleventh Circuit squarely addressed the issue of non-consensual, non-debtor releases in Chapter 11 plans and joined the majority of other circuit courts in holding that bankruptcy courts can approve these releases in certain circumstances.[4]

The non-consensual, non-debtor release in a Chapter 11 plan

To better understand the Eleventh Circuit's analysis, one should know what a "non-consensual, non-debtor release in a Chapter 11 plan" actually means. The term "Chapter 11 plan" refers specifically to the comprehensive plan to restructure a Chapter 11 debtor's debts, on which creditors can vote whether they agree to it or not, and for which a debtor must obtain bankruptcy court approval.[5] A Chapter 11 plan may contain a number of approved provisions, though a non-debtor release is not expressly included or excluded within the text of Title 11 of the United States Code (the "Bankruptcy Code").[6] A "non-debtor" release means a release of someone who is not a debtor in the bankruptcy case. And, finally, a "non-consensual" release is a release to which not everyone agrees—in other words, some party in the case objects to the provision and asks the bankruptcy court to remove it from the plan.

The release provision at issue in *Seaside Engineering* is, in the authors' view, fairly standard in Chapter 11 plans and illustrates the foregoing explanation in practice. The debtor in *Seaside Engineering*, Seaside Engineering & Surveying, Inc. ("Seaside"), filed for relief under Chapter 11 of the Bankruptcy Code and, in the course of the case, filed its Chapter 11 Plan of Reorganization. The Chapter 11 Plan contained a provision that released not just the debtor, the reorganized debtor and the debtor's successor entity, but also "any officer or directors or members" of these entities from "any act, omission, transaction or other occurrence in connection with, relating to, or arising out of the Chapter 11 Case, the pursuit of confirmation of the Amended Plan … or the consummation of the Amended Plan, except and solely to the extent such liability is based on fraud, gross negligence or willful misconduct."[7] Under this language, the officers, directors and members of the debtor (the individuals who also typically serve as guarantors of the debtor-entity's debts) and the debtor's successor entities received the benefit of the release in the debtor's Chapter 11 plan, even though the officers, directors and members were not themselves debtors in the Chapter 11 bankruptcy case. In other words, the non-filing parties stood to reap the benefits of a bankruptcy filing without having to endure the burdens associated with a bankruptcy filing.

Seaside Engineering: Background and Decision

The release provision in Seaside's Chapter 11 Plan was not acceptable to SE Property Holdings, LLC and Vision-Park Properties, LLC (collectively, "Vision"), so Vision objected to confirmation of the Chapter 11 Plan. The bankruptcy court held a hearing on confirmation of the Chapter 11 Plan and, after considering the arguments and evidence presented, overruled Vision's objection and confirmed the Chapter 11 Plan. In the first appeal, the U.S. District Court agreed with the bankruptcy court's decision and affirmed. Vision then appealed to the Eleventh Circuit.[8]

As a side note, the relationship between Vision and Seaside is unique and unlike the typical debtor/creditor relationship one sees in Chapter 11 Plan disputes. Vision was an equity interest holder of Seaside, not a creditor. The equity position arose from Vision's financing of real estate ventures with other companies owned by Seaside's principals, with those principals guaranteeing the debt owed to Vision. Seaside was not an obligor on the debts owed to Vision. When the real estate companies defaulted, Vision pursued collection from the guarantors, and when one of the guarantors filed bankruptcy, Vision purchased the guarantor's interest in Seaside at auction and, therefore, obtained standing to participate in Seaside's later filed Chapter 11 case.[9]

The Eleventh Circuit began its analysis by recognizing that precedent in the circuit, specifically the *Munford* case from 1996, does allow non-debtor releases; however, the court noted that *Munford* was a poor fit for the facts before it in *Seaside Engineering*.[10] As a result, the court examined cases from other circuits that had considered the issue and ultimately adopted the following seven-factor test from the Sixth Circuit's *In re Dow Corning Corp*.[11] case for determining when a bankruptcy court can approve a non-consensual, non-debtor release:

(1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;
(2) The non-debtor has contributed substantial assets to the reorganization;
(3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;
(4) The impacted class, or classes, has overwhelmingly voted to accept the plan;
(5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction;
(6) The plan provides an opportunity for those claimants who choose not to settle to recover in full; and
(7) The bankruptcy court made a record of specific factual findings that support its conclusions.[12]

In addition to adopting the above test, the Eleventh Circuit gave bankruptcy courts "discretion to determine which of the *Dow Corning* factors will be relevant in each case," noting that the factors were "nonexclusive" and meant to be applied "flexibly." With that seemingly broad framework in mind, however, the court then admonished that non-consensual, non-debtor releases "should be used cautiously and infrequently, and only where essential, fair, and equitable."[13]

The court then evaluated the bankruptcy court's application of the *Dow Corning* factors to the facts at issue. Among other things, the Eleventh Circuit found that continued litigation against the reorganized debtor and its principals would deplete the estate's assets and distract the engineers who were critical to the reorganized debtor's success. The court also determined that the principals had contributed something significant to the reorganized debtor—their labor and engineering skill—and would continue to do so as the debtor worked to consummate the Chapter 11 Plan. Importantly, the Eleventh Circuit was convinced that the release was essential to allow the engineers to continue their specialized work. The court also took notice of the fact that, while Vision and the bankruptcy trustees for two of the other principals rejected the Plan as equity interest holders, all other creditor classes accepted the Plan. Moreover, the Plan provided for payment "in full" of Vision's interest by way of an unsecured promissory note, with a 4.25% per annum fixed rate of interest, in the amount of its pro rata share of the value of the company. Concluding its analysis, the court recognized that factor six was not applicable and commended the bankruptcy court on its factual findings to satisfy factor seven.[14] Thus, according to the Eleventh Circuit, the release met all of the Dow Corning factors and the bankruptcy court acted appropriately in approving it.[15]

To arrive at its decision, the *Seaside Engineering* court navigated through the texts of Bankruptcy Code Section 524(e), which clearly states that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt"[16] and Bankruptcy Code Section 105(a), which allows bankruptcy courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[17] In so doing, the Eleventh Circuit ultimately concluded that Section 524(e) does not expressly preclude a third-party release as part of a plan and the broad language of Section 105(a) does contemplate such a release.[18]

Why this Case Matters

Seaside Engineering appears to emphasize that non-consensual, non-debtor releases should be used "cautiously and infrequently".[20] In practice, though, the *Dow Corning* factors could arguably be applied to any closely held business where the owners are also the principal operators or managers of the business' affairs. Further, while the facts in *Seaside Engineering* were somewhat atypical, one could see an extension of *Seaside Engineering* to a far more typical scenario—a creditor may be permanently enjoined from collecting from a guarantor-principal of the debtor because the debtor's plan includes a release of liability. Indeed, some courts have already reached that conclusion in reliance on *Dow Corning*. Such a decision skews the front-end underwriting risk analysis for secured lenders who anticipate recovering from the guarantor-principals in the event recovery from the entity itself proves impossible.[21]

Mitigating this risk, however, is possible. Because the *Dow Corning* factors rely heavily on identity of interest between the debtor and the third party and the essentiality of the release to continued operation of the business, extending the release to other affiliated entities or to passive investors may require a more flexible interpretation than many bankruptcy courts will allow. As a result, cross-collateralizing and cross-defaulting bankruptcy-remote special purpose entities can provide additional remedies across an entire lending relationship that may survive the *Dow Corning* test if any single entity declares bankruptcy. Similarly, additional guarantees, even limited guarantees, from passive investors (who are not involved in management, like the principals of Seaside were) may provide an additional avenue of recovery that a bankruptcy court cannot or would not prevent. Still, because all loan approvals must be done on a case-by-case basis and are heavily dependent on state-specific laws, we encourage you to talk with counsel before deciding on how to proceed. **TSL**

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1. *SE Property Holdings, LLC v. Seaside Engineering & Surveying, Inc. (In re Seaside Engineering & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015).
2. *Munford v. Munford, Inc. (In re Munford, Inc.),* 97 F.3d 449 (11th Cir. 1996).
3. *Seaside Engineering,* 780 F.3d at 1077 (noting that the facts of Seaside differ from the facts in Munford).
4. *Id*. at 1078-79. Other circuits allowing such releases in the context of a plan include the Second, Third, Fourth, Sixth and Seventh, with the First and D.C. Circuits in agreement that bankruptcy courts have authority to issue non-consensual, non-debtor releases generally; the Fifth, Ninth and Tenth Circuits do not allow such releases. Id. at 1077-78. The U.S. Supreme Court has not addressed the issue, though the losing party in *Seaside Engineering* did recently file a petition asking the Supreme Court to review the case.
5. *See* 11 U.S.C. § 1129.
6. *See* 11 U.S.C. § 1123.
7. *Seaside Engineering*, 780 F.3d at 1076.
8. *Id*. at 1074-75.
9. *Id*.
10. *Id*. at 1076-77.
11. 280 F.3d 648, 658 (6th Cir. 2002).
12. *Seaside Engineering*, 780 F.3d at 1079 (quoting *Dow Corning*, 280 F.3d at 658).
13. *Seaside Engineering*, 780 F.3d at 1079 (internal citations and quotations omitted).
14. *Id*. at 1079-81.
15. For a critique of the court's conclusion that the debtor actually met the *Dow Corning* test, see Eric W. Anderson and Jay Basham, ***Please Release Me, Let Me Go: Eleventh Circuit Embraces Third-Party Release Standards***, 34-JUN AM. BANKR. INST. J. 20, 74 (2015).
16. 11 U.S.C. § 524(e). One of the effects of plan confirmation is discharge of the debtor's pre-bankruptcy debt. 11 U.S.C. § 1141(d)(1).
17. 11 U.S.C. § 105(a)
18. *Seaside Engineering*, 780 F.3d at 1076-77.
19. *Seaside Engineering*, 780 F.3d at 1079 (internal citations and quotations omitted).
20. *See, e.g., In re FFS Data, Inc.*, 509 B.R. 403, 408-09 (Bankr. S.D. Fla. 2014).
21. *See* Ryan M. Murphy, ***Injunctive Relief for Nondebtor Guarantors,*** 22 Norton J. Bankr. L. & Prac. 4 art. 3 (2013) (citing Greer & Moss, Guaranties in Bankruptcy: A Primer, 16 Norton J. Bankr. L. & Prac. 309 (2007)).