VENUE CONSIDERATIONS:

Differences among the Circuits on
Common Recurring Issues in Chapter 11 Cases

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The Statutory Scheme:

Jurisdiction

Section 1334(a) of title 28 of the United States Code empowers the federal
district courts with original and exclusive jurisdiction over all cases under title 11 of the
United States Code (the "Bankruptcy Code").

Pursuant to 28 U.S.C. § 157(a), each district court may provide that any
or all bankruptcy cases filed with the district court be referred to the bankruptcy courts
within that district. Thus, the bankruptcy courts within a district operate as "units" of the
district court.

Venue

Pursuant to 28 U.S.C. § 1408, a case under the Bankruptcy Code may be
commenced in the district court for the district in which:

(1) the domicile (i.e., state of incorporation), residence, principal place of
business or principal assets in the United States of the debtor have been
located for the 180 days prior to commencement of the case, or for a
longer portion of such 180-day period than the domicile, residence or
principal place of business or principal assets in the United States of the
debtor were located in any other district; or

(2) a case under the Bankruptcy Code is pending with regard to the
debtor’s affiliate, general partner or partnership.

Pursuant to 28 U.S.C. § 1412 and Bankruptcy Rule 1014, even if a
bankruptcy case is filed in a proper district, the district court may, in the interest of justice
or for the convenience of the parties, transfer the case to a district court for another
district. If a case is filed in an improper district, the district court may, in the interest of
justice or for the convenience of the parties, dismiss the case or transfer the case to a
district court for another district. A bankruptcy court may also exercise such power to
transfer.

The factors that a court may consider before exercising its discretion to
transfer venue include, among others, the location of the debtor’s assets and creditors, the
location of witnesses, whether local law of another district would apply, and where the
case may be administered more economically.
**Venue Considerations:**

Generally speaking, cases involving small business debtors present little or no issue about where they should file for bankruptcy relief, as most of them file in the district where they are located geographically. However, multi-state business enterprises with assets and operations in various locations in the United States may have a broader choice of venue alternatives for bankruptcy relief. Moreover, the "affiliate rule" under 28 U.S.C.§ 1408(2) permits a debtor’s affiliates to file for bankruptcy relief in the same venue as the debtor’s case regardless of whether the court is a proper venue for the debtor’s affiliates. Thus, the affiliate rule potentially provides an even broader range of venue choices than those provided under 28 U.S.C. § 1408(1).

To the extent a debtor has a choice of venue for bankruptcy relief, the debtor and its counsel typically examine the following non-exclusive factors before choosing a particular venue: (1) the location of the debtor’s executive offices (its nerve center); (2) the principal location of the debtor’s operations and employees (its manufacturing plants, for example); (3) the location of major creditors of the debtor (its secured lenders, for example); (4) the accessibility of the bankruptcy court and the experience and track record of its judges; and (5) the case law of the bankruptcy court and the appellate courts with respect to legal issues that are important to the debtor. The selection of an appropriate and favorable venue (or forum) may enhance the prospects of the debtor in achieving a successful reorganization.

Whether a particular forum has a well-developed body of law with respect to those issues that are germane to the debtor’s is the primary consideration. The legal precedents of the forum and the proclivity of its judges on particular subjects may be critical. For example, certain federal circuits have well-established case law regarding the dischargeability of environmental claims or the modification of collective bargaining agreements. Courts with favorable precedents under §105(a) implementing the so-called "doctrine of necessity," may enable a debtor to have a smoother transition at the outset of its case. Such courts would likely have a favorable track record on "first day" motions seeking authorization to pay employee prepetition wages, continue employee benefit plans and policies, or implement critical vendor or customer programs. The court’s precedents or guidelines on approval of a debtor in possession facility may also be a critical venue consideration.

The following chart is illustrative of a "Venue Analysis" and reflects the case law holdings in various federal circuits with respect to certain issues, including, the doctrine of necessity, the dischargeability of environmental claims, the standard for rejecting collective bargaining agreements, the treatment of claims arising from the rejection of collective bargaining agreements and the postpetition treatment of severance contracts, the permissibility of non-debtor releases, and the assumption of non-assignable contracts. A more detailed explanation of the case law considered and the relevant case citations are annexed at the end of the chart, beginning on the following pages:
### Venue Analysis

**Key:**
- **CIR** = Circuit Court Decision
- **BAP** = Bankruptcy Appellate Panel Decision
- **DC** = District Court Decision
- **BC** = Bankruptcy Court Decision
- * = No relevant case law

Cases that have been questioned, distinguished, or otherwise undercut by a subsequent court in the same circuit will be marked with "-".

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- Assumption of Non-Assignable Executory Contracts
- Recharacterization of Debt as Equity Infusion
**Doctrine of Necessity**

The "doctrine of necessity" (or "necessity of payment" doctrine) refers to the basis for a court to permit a debtor to make postpetition payment to critical vendors or other essential parties on account of prepetition amounts due as may be necessary to keep such debtor viable as a going concern. Some courts have endorsed this doctrine, while others have found such use of the bankruptcy court’s equitable power as undercutting the Bankruptcy Code’s explicit priority scheme and thereby impermissible.

**Second Circuit:**

In re Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989) (holding the paramount policy and goal of chapter 11 is debtor rehabilitation, which may supersede the policy of equality of distribution among creditors, and a bankruptcy court may use its equitable power to restructure a debtor’s finances in order to enable the debtor to operate productively, provide jobs for employees, pay creditors, and produce a return for stockholders).

**Third Circuit:**

In re Just for Feet, Inc., 242 B.R. 821 (D. Del. 1999) (approving payment of prepetition claims to vendors who are critical to the debtor’s reorganization).

**Fourth Circuit:**

In re NVR L.P., 147 B.R. 126, 127 (Bankr. E.D. Va. 1992) (under section 105(a) of the Code, a court "can permit pre-plan payment of a prepetition obligation when [such payment is] essential to the continued operation of the debtor"); see also Kucin v. Devan, 251 B.R. 269, 273 (D. Md. 2000) (bankruptcy court’s approval of postpetition payment to critical vendors on account of prepetition claims and debtor’s actual payment to such critical vendors does not elevate such claims to administrative expense priority).

**Fifth Circuit:**

In re Oxford Mgmt., Inc., 4 F.3d 1329 (5th Cir. 1993) (finding a bankruptcy court acted beyond the scope of its equitable powers when it approved the pre-confirmation payment of a prepetition claim to the debtor’s leasing agent).

In re Coserv, L.L.C., 273 B.R. 487 (Bankr. N.D. Tex. 2002) (emphasizing that payment of prepetition claims should be allowed only under "extraordinary circumstances" and in "rare cases," and to permit otherwise would be an "inappropriate adjustment of congressionally established priorities" and succumbing to "economic blackmail" and creates a three part test).

In re Mirant Corp., 296 B.R. 427 (Bankr. N.D. Tex. 2003) (reinterpreting the test laid out in Coserv as not requiring a debtor to prove the CoServ test’s elements prior to each payment but that debtor’s reasonable belief on advice from counsel that the elements are met is enough to allow payment).
Sixth Circuit:

In re Eagle-Picher Indus. Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (quoting In re Chateaugay Corp., 80 B.R. 279, 287 (S.D.N.Y. 1987) and holding that "a bankruptcy court may exercise its equity powers under § 105(a) to authorize payment of pre-petition claims where such payment is necessary to 'permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately.'").

In re Structurelite Plastics Corp., 86 B.R. 922, 931 (Bankr. S.D. Ohio 1988) ("a bankruptcy court may exercise its equity powers under section 105(a) to authorize payment of prepetition claims where such payment is necessary to ‘permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately.’")

Seventh Circuit:

Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 822 (N.D. Ill. 2003) (abrogating the doctrine of necessity by concluding that payment of prepetition claims to critical vendors under section 105(a) to authorize upset the bankruptcy code’s priority scheme and should not be permitted).

Eighth Circuit:

In re Payless Cashways, Inc., 268 B.R. 543, 546 (Bankr. W.D. Mo. 2001) ("Since enactment of the Code, various courts have permitted debtors-in-possession to pay prepetition debts on the grounds that payment of such claims was necessary to effectuate a successful reorganization, or at least to give the debtor the opportunity to propose any type of plan at all.").

Ninth Circuit:

In re B & W Enters., Inc., 713 F.2d 534 (9th Cir. 1983) (recognized that necessity of payment doctrine was equitable in nature but declined to extend the doctrine beyond railroad cases); but see In re Adams Apple, Inc., 829 F. 2d 1484, 1490(9th Cir. 1987) (stating in dicta that "Courts have permitted unequal treatment of pre-petition debts when necessary for rehabilitation, in such contexts as . . . debts to providers of unique and irreplaceable supplies.") (citations to Bankruptcy Act cases and materials omitted).

Environmental Claims Dischargeability

Courts are divided on when a claim for environmental damage arises under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. §§ 9601 et seq. ("CERCLA") and other applicable law, and whether a claim arising from such environmental damage is dischargeable. Typically a claim will be found where the governmental authority could have "fairly contemplated" that a debtor’s conduct would have caused a violation leading to damages. With respect to injunctive relief regarding environmental violations, some courts have held such relief to be non-dischargeable.

First Circuit:
Waterville Indus., Inc. v. First Hartford Corp., 124 B.R. 411 (D. Me. 1991) (holding claims known by the debtor but not scheduled are not discharged because no notice was given to the claimant).

Mesiti v. Microdot, Inc., 156 B.R. 113, 117 (D.N.H. 1993) (under the Bankruptcy Act, adopting the foreseeability test as to the timing when a claim "arose").

Second Circuit:
In re Chateaugay Corp., 944 F.2d 997 (2d Cir. 1991) (holding CERCLA claims arising from a debtor’s prepetition "release or threatened release" of hazardous substances, even if the state has not yet incurred response costs, are discharged upon confirmation).

Texaco, Inc. v. Sanders (In re Texaco, Inc.), 182 B.R. 937 (Bankr. S.D.N.Y. 1995) (employing two part test: when did the claim arise, i.e. when did the events giving rise to the claim occur, and if the claim arose prepetition, was there sufficient notice to the claimant?); see also Solow Bldg. Co. v. ATC Assocs. Inc., 175 F. Supp. 2d 365 (E.D.N.Y. 2001)

Third Circuit:
In re Torwico Elec., Inc., 8 F.3d 146 (3d Cir. 1993) (stating CERCLA claims arising from prepetition release or threatened release of hazardous substances where claimant can tie the debtor to a known release or threatened release that will result in response costs are dischargeable in bankruptcy, but holding that the state’s attempt to force the debtor to cleanup a waste site which poses an ongoing hazard is not a "claim" as defined in the Bankruptcy Code because the state is not attempting to get money from the debtor, but rather is an exercise of its inherent regulatory and police powers).

Kilbarr Corp. v. Gen. Servs. Admin. (In re Remington Rand), 836 F.2d 825, 827 n.7 (3d Cir. 1988) (holding that a dischargeable claim arises when a party knows or should know of its right to payment).
Fifth Circuit:

Louisiana Dept. of Envtl. Quality v. Crystal Oil Co. (In re Crystal Oil Co.), 158 F.3d 291 (5th Cir. 1998) (holding that a dischargeable regulatory claim arises when a potential claimant can tie the debtor to a known release of a hazardous substance that the claimant knows is an environmental violation).

In re National Gypsum Co., 139 B.R. 397 (N.D. Tex. 1992) (holding only those CERCLA claims arising from a release or threat of release of hazardous materials that could have been fairly contemplated by the parties upon the commencement of chapter 11 should be discharged in bankruptcy). This is a more limited discharge than available in the Second Circuit and this holding was questioned by In re Crystal Oil Co.

Sixth Circuit:

United States v. Northernaire Plating Co., 670 F. Supp. 742 (D.W.D. Mich. 1987) (holding a dischargeable CERCLA claim does not arise until all four elements giving rise to a legal obligation under CERCLA have been met: (i) existence of a facility, (ii) release or threatened release of hazardous substance at the facility, (iii) existence of a statutory "responsible person," and (iv) the incurrence by the U.S. of response costs).


Seventh Circuit:

In the Matter of Chicago, Milwaukee, St. Paul & Pacific Railroad Co., 974 F.2d 775 (7th Cir. 1992) (under the Bankruptcy Act, finding a CERCLA claimant, who can tie a debtor to a known release of a hazardous substance the claimant knows will lead to CERCLA response costs and who has conducted tests with regard to the contamination problem, holds a claim that can be discharged); see also In re CMC Heartland Partners, 966 F.2d 1143 (7th Cir. 1992) (stating that "by authorizing cleanup orders to current owners [of contaminated sites], CERCLA § 106 creates a claim ‘running with the land,’ and a ‘statutory obligation attached to current ownership of the land survives bankruptcy.’").

Eighth Circuit:

United States v. Union Scrap Iron and Metal, 123 B.R. 831 (D. Minn. 1990) (finding a dischargeable CERCLA claim does not arise until all four elements giving rise to a legal obligation under CERCLA are established: (i) existence of a facility, (ii) release or threatened release of hazardous substance at the facility, (iii) existence of a statutory "responsible person," and (iv) the incurrence by the U.S. of response costs).

Sylvester Bros. Dev. Co. v. Burlington N.R.R. (In re Sylvester Bros. Dev. Co.), 133 B.R. 648, 653 (Bankr. D. Minn. 1991) (when debtor has not disclosed potential environmental liabilities to the proper parties in a long-since closed bankruptcy proceeding and the claimant has no actual knowledge of the potential claim in time to file a proof of such claim in that proceeding, such potential liability is not discharged).
Ninth Circuit:

California Dep’t of Health Servs. v. Jensen (In re Jensen), 127 B.R. 27, 33 (B.A.P. 9th Cir. 1991) (adopting "conduct" test, BAP held that CERCLA claims arising from a debtor's prepetition release or threatened release of hazardous substances are dischargeable in bankruptcy), aff’d on other grounds, 995 F.2d 925, 930 (9th Cir. 1993) (adopting "relationship" or "fair contemplation" test, Ninth Circuit held that where state had sufficient prepetition knowledge of debtor’s potential liability giving rise to contingent claims for cleanup cost, such claims are dischargeable in debtor’s bankruptcy).

Hexcel Corp. v. Stepan (In re Hexcel Corp), 239 B.R. 564 (N.D. Cal. 1999) (rejecting the "debtor conduct test" by holding that a third party claim, even if clearly stemming from prepetition conduct, still may not be discharged if the parties could not "fairly contemplate" its potential existence during the bankruptcy case).

Tenth Circuit:

In re Cottonwood Canyon Land Co., 146 B.R. 992, 998 (Bankr. D. Colo. 1992) (holding liability under CERCLA arises at the time of disposal of hazardous substance and such liability can be discharged in bankruptcy even before funds were expended in cleanup, and that any other holding would not be supported by the Bankruptcy Code).

Eleventh Circuit:

NCL Corp. v. Lone Star Bldg. Ctrs. (Eastern) Inc., 144 B.R. 170 (S.D. Fla. 1992) (holding that "sufficient" or "fair" contemplation of the ultimately maturing payment obligations would make the claim dischargeable in bankruptcy).
**Standard for Rejecting Collective Bargaining Agreements Under Section 1113**

Subject to the requirements and procedures set forth in section 1113 of the Bankruptcy Code, a debtor can reject a collective bargaining agreement ("CBA"). Subsection 1113(b)(1)(A) provides that a rejecting debtor must make a proposal that provides for "necessary modifications" to the subject CBA. Until such rejection, subsection 1113(e) provides that a court will approve a debtor’s proposed interim changes to the CBA if such changes are "essential to the continuation of the debtor’s business." Most courts read "necessary" in subsection (b) to be a lower standard than subsection (e)’s "essential" requirement, while some courts disagree and equate the two terms.

**First Circuit:**

United Food and Commercial Workers Union, Local 328 v. Almac’s Inc., 90 F.3d 1, 6 (1st Cir. 1996) (modifications must be proposed with a view to the long-run success of the debtor’s business and must be necessary to permit debtor’s reorganization).

**Second Circuit:**

Truck Divers Local 807 v. Carey Transp. Inc., 816 F.2d 82, 90 (2d Cir. 1987) (holding that the term "necessary" requires that the debtor’s proposed modifications be "made in good faith, and that it contains necessary, but not absolutely minimal, changes that will enable the debtor to complete the reorganization process successfully").

In re Horsehead Indus., Inc., 300 B.R. 573 (Bankr. S.D.N.Y. 2003) ("necessity" is determined with a view toward the proposal as a whole and whether rejection will increase the likelihood or a successful reorganization, and "good faith" requirement satisfied by offer to discuss modification that was rebuffed by the union).

**Third Circuit:**

Wheeling–Pittsburgh Steel Corp. v. United Steelworkers, 791 F.2d 1074 (3d Cir. 1986) (holding that the term "necessary" as used in section 1113(b) is synonymous with "essential" as used in section 1113(e) and requires that the debtor’s proposed modifications be necessary to prevent the debtor’s liquidation in the short-term); In re Bowen Enters. Inc., 196 B.R. 734 (Bankr. W.D. Pa. 1996) (same).

**Fourth Circuit:**

In re Lady H Coal Co., Inc., 193 BR 233 (Bankr. S.D. Va. 1996) (rejection may be approved if necessary to preserve the reorganizing opportunities of the debtor).

**Fifth Circuit:**

Sixth Circuit:


Seventh Circuit:


Eighth Circuit:


Ninth Circuit:

In re Landmark Hotel & Casino, Inc., 78 B.R. 575, 584 (B.A.P. 9th Cir. 1987) (reiterating the Carey standard that necessary changes are those that will enable the debtor to complete the reorganization process successfully if the contracts were fully rejected).

Tenth Circuit:

In re Mile Hi Metal Sys., Inc., 899 F.2d 887, 893 (10th Cir. 1990) (the word "necessary" does not mean "absolutely necessary" but made in good faith and contains necessary but not absolutely minimal changes).
Priority of Prepetition Claims for Collective Bargaining Agreement Obligations

Upon rejection of a collective bargaining agreement, some courts have held that section 1113 of the Bankruptcy Code gives employees claiming rejection damages a superpriority administrative expense claim over other creditors. Other courts, however, believe such superpriority treatment to be contradictory to the priority scheme set out in section 507 of the Bankruptcy Code.

First Circuit:


Second Circuit:

Air Line Pilots Ass’n, Int’l v. Shugrue (In re Ionosphere Clubs, Inc.), 22 F.3d 403 (2d Cir. 1994) (adopting the reasoning of the Third Circuit in Roth American).

Third Circuit:

In re Roth Am., Inc., 975 F.2d 949 (3d Cir. 1992) (holding that vacation and severance pay should not be granted administrative expense priority to the extent such benefits were earned by prepetition services).

Fourth Circuit:

Adventure Res. Inc. v. Holland, 137 F.3d 786, 796-97 (4th Cir. 1998) (denies superpriority status for employees’ claims because priority status only available to the extent provided for in section 507).

Fifth Circuit:


Sixth Circuit:

United Steelworkers v. Unimet Corp. (In re Unimet Corp.), 842 F.2d 879 (6th Cir. 1988) (elevates all claims, including those arising prepetition, based on a CBA and arising prior to the rejection or modification of the CBA pursuant to section 1113 to at least administrative expense status under section 507(a)(1) of the Bankruptcy Code).

Unimet has been called into question by cases in other circuits and by district courts within the Sixth Circuit. See e.g., In re Acorn Bldg. Components, Inc., 168 B.R. 169 (E.D. Mich. 1994) (prepetition claims under a CBA should not be given administrative status under section 1113); In re the Ohio Corrugating Co., 115 B.R. 572 (N.D. Ohio
1990); but see In re Typocraft Co., 229 B.R. 685 (E.D. Mich. 1999) (criticizing Acorn and Ohio Corrugating because Unimet clearly dictates the result of a superpriority).

**Seventh Circuit:**

Tool & Die Makers Local Lodge Number 113 v. Buhrke Indus., Inc., 1996 WL 131698 (N.D. Ill. 1996) (holding that CBA vacation pay benefits earned prepetition were not entitled to administrative priority).

**Eighth Circuit:**

In re Family Snacks Inc., 249 B.R. 915 (Bankr. W.D. Mo. 2000) ("The better view, however, is that of the Second Circuit, which has held that the broad language used by the Court in Unimet should not be construed to require a superpriority for all claims related to collective bargaining agreements"); cf. In re Jones Truck Lines, Inc., 130 F.3d 323, 329 (8th Cir. 1997) (analogizing to the Second Circuit’s holding in Ionosphere regarding section 507 to conclude that section 1113 does not supersede the avoidable preference provisions in section 547).

**Ninth Circuit:**


**Eleventh Circuit:**

Priority for Postpetition Termination of Severance Contract Claims

When a debtor rejects an employment contract containing severance provisions, some courts have held that the entirety of such severance amounts enjoy administrative expense priority, but most courts have drawn a distinction between severance in lieu of notice, which is treated as an administrative expense arising postpetition, and severance based on duration of service, which is an administrative expense only to the extent the severance accrued postpetition.

First Circuit:

In re Mammoth Mart, Inc., 536 F.2d 950 (1st Cir. 1976) (holding that severance claims of employees terminated postpetition not entitled to administrative priority unless employees performed for debtor in possession).

Second Circuit:

Straus-Duparquet, Inc. v. Local Union No. 3 Int’l Bd. of Elec. Workers, 386 F.2d 649, 651 (2d Cir. 1967) (under the Bankruptcy Act, two weeks’ severance pay was expense of administration because severance pay accrues in the postpetition period when employees are terminated but vacation pay administrative expense only to extent accrued postpetition).

Straus-Duparquet has been criticized by courts even within the Second Circuit. See, e.g., In re Drexel Burnham Lambert Group, Inc., 138 B.R. 687, 711 (Bankr. S.D.N.Y. 1992) (under the Bankruptcy Act, drawing distinction between Act and current Code and between severance pay equal to salary for two weeks versus three years); In re Hooker Invs. Inc., 145 B.R. 138, 147 (Bankr. S.D.N.Y. 1993) (questioning applicability of Straus-Duparquet to executives’ high termination payments); but see In re Spectrum Info. Techs., Inc., 193 B.R. 400, 405-06 (Bankr. E.D.N.Y. 1996) (citing Trustees of Amalgamated Ins. Fund v. McFarlin’s, Inc., 789 F.2d 98 (2d Cir. 1986) (pension withdrawal liability case), as proof that Straus-Duparquet remains the law in the Second Circuit with respect to severance pay being administrative priority).

Third Circuit:

In re Roth Am., Inc., 975 F.2d 949 (3rd Cir. 1992) (holding that union's claims for severance pay only entitled to first priority as administrative expense to extent benefits were earned by services rendered postpetition).

In re Hechinger Inv. Co. of Del., Inc., 298 F.3d 219 (3d Cir. 2002) (drawing distinction between payment at termination in lieu of notice, which would be administrative expense, and payment at termination based on length of services, which is administrative expense only to extent accrued postpetition).
Fourth Circuit:

In re Landmark Land Co. of Okla., Inc., 136 B.R. 410, 413 -414 (D. S.C. 1992) (following "the Second Circuit's reasoning that severance pay is designed to compensate employees for the economic disruption and readjustment that follows termination," and allowing the adoption of the existing severance pay scheme to discharged employees"). But see In re LCCH Liquidating Corp., 276 B.R. 106, 113 (Bankr. W.D. Va. 2001) (distinguishing Landmark Land to disapprove a severance payment to single employee based on an employee's entire length of service offered pursuant to post-termination board resolution); see also In re Nomus-American, Inc., No. 01-5025511, 2002 WL 230701 (Bankr. M.D.N.C. Feb. 8, 2002) (severance pay not entitled to administrative expense where entitlement did not arise from agreement with debtor in possession); In re Dornier Aviation (North America), Inc., No. 02-82003-SSM, 2002 WL 31999222, *7 (Bankr. E.D. Va. Dec. 18, 2002) (distinguishing Landmark Land and disallowing administrative claim treatment for prepetition contract-based severance where no evidence that value of services was greater than amount paid in salary).

Fifth Circuit:

In re Phones For All, Inc., 288 F.3d 730 (5th Cir. 2002) (claims arising from prepetition severance agreement not entitled to postpetition administrative priority status – only severance claims arising from transactions with the debtor in possession that then conferred a benefit upon the bankruptcy estate are entitled to such priority).

Sixth Circuit:

In re Russell Cave Co., Inc., 248 B.R. 301, 303 (Bankr. E.D. Ky. 2000) ("Severance pay based on length of service is an administrative expense only to the extent it was earned by service during the bankruptcy case. It is not an administrative expense to the extent it was earned by service before the bankruptcy," citing In re Yarn Liquidation, Inc., 217 B.R. 544 (Bankr. E.D. Tenn. 1997) (adopting majority rule that severance pay is an administrative expense only to the extent earned postpetition and enjoys section 507(a)(3)’s priority treatment only to extent employed ninety days prior to commencement); In re Ohio Corrugating Co., 115 B.R. 572, 578-579 (Bankr. N.D. Ohio 1990); In re Holabird Co., 86 B.R. 111, 114 (Bankr. N.D. Ohio 1988) and out-of-circuit decisions)); cf. In re Sunarhauserman, Inc., 126 F.3d 811, 819 (6th Cir. 1997) ("[a]pplying the principles set forth in . . . Mammoth Mart" to unpaid ERISA minimum funding contributions).

Seventh Circuit:

In re Chicago Lutheran Hosp. Assoc., 75 B.R. 854 (Bankr. N.D. Ill. 1987) (employees' claims for severance pay were not entitled to administrative priority except to the extent accrued postpetition and employee shows benefit conferred was an actual and necessary cost of preserving the bankruptcy estate).

In re Radco, Inc., No. 01-80225, 2003 WL 1785789 (Bankr. N.D. Ill. 2003) (adopting distinction between severance payment in lieu of notice (administrative expense if termination postpetition) and payment based on duration of employment, which is an administrative expense only to the extent accrued postpetition, citing In re Demert & Dougherty, Inc., No. 96-B-00851, 1999 WL 1140859 (Bankr. N.D. Ill. 1999)).

Eight Circuit:

In re Gateway Apparel, Inc., 238 B.R. 162 (E.D. Mo. 1999) (holding that severance claims are not entitled to administrative priority because the claims arose prepetition under debtor's severance policy and criticizing the court's earlier interpretation of the priority of severance pay which was partly based on Straus-Duparquet).


Ninth Circuit:

In re Selectors, Inc., 85 B.R. 843, 845 (B.A.P. 9th Cir. 1988) (stating that in "the Ninth Circuit, the law is clear regarding whether severance pay is an administrative expense. The rule is that ‘pay at termination in lieu of notice’ is considered an administrative expense, but that ‘pay at termination based upon length of employment’ is not," citing, inter alia, In re Health Maintenance Found., 680 F.2d 619, 621 (9th Cir. 1982) (holding that severance pay based on length of service is not entitled to priority status) (Act case); In re Tuscon Yellow Cab Co., 789 F.2d 701, 703 (9th Cir. 1986) (payment in lieu of notice entitled to administrative expense treatment)).

Tenth Circuit:

In re Commercial Financial Servs., Inc., 246 F.3d 1291, 1294 (10th Cir. 2001) (adopting Mammoth Mart’s reasoning to hold that where there was no evidence that the debtor in possession assumed the prepetition contracts providing for a lump sum payment upon termination without cause and debtor’s liability arose prepetition, postpetition work was not consideration for such payments and that employee’s consideration for the promise of lump sum payments (foregoing other employment, promising to work for at least two years in Tulsa) was not beneficial to the estate).
Eleventh Circuit:

In re Rawson Food Servs., Inc., 67 B.R. 351 (M.D. Fla. 1986) (holding that severance pay that arose during chapter 11 proceedings and are computed based upon the length of claimant's employment shall not be awarded first priority).

In re Lykes Bros. S.S. Co., 213 B.R. 401 (Bankr. M.D. Fla. 1997) (granting summary judgment to debtor on issue that only portion of severance pay earned or accrued postpetition enjoys administrative expense priority); but see In re Miami Gen. Hosp., 89 BR 980 (Bankr. S.D. Fla. 1988) (prepetition lump sum severance treated as administrative claim).
Releases of Non-Debtors Under A Chapter 11 Plan

Plan provisions purporting to release third-parties (i.e. non-debtors) without creditor consent is a hotly contested issue. Under section 524(e), a bankruptcy court does not have authority to discharge non-debtors. Some courts have cited that basis to prohibit all creditor releases of non-debtors. Other courts allow consensual releases of such non-debtors by creditors under the general principles of contract law. Other courts will even approve non-consensual releases, but only in extraordinary circumstances where, inter alia, the releases are necessary for the successful reorganization of the debtor.

First Circuit:

Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973 (1st Cir. 1995). The First Circuit refused to overturn non-debtor releases and permanent injunctions, albeit based on grounds other than the merits, because party challenging such releases and injunctions did not oppose or appeal the bankruptcy court’s order confirming the debtor’s plan which provided for such releases and injunctions, but instead sought to collaterally attack order in state court challenging bankruptcy court’s jurisdiction.

The First Circuit concluded that "[b]y citing A.H. Robins . . . and cases of its kind, the bankruptcy court plainly signaled its endorsement of the Plan proponents’ request for a broad injunction extending ‘incidental’ protection to all noncontributors who might otherwise implead Plan contributors as third-party defendants in subsequent state court actions . . . We therefore hold that the issue of the bankruptcy court’s power to enter its so-called ‘incidental’ injunction was precluded, having been conclusively resolved in the confirmation order which Monarch Life neither opposed nor appealed." Id. at 982-983.

The First Circuit also noted, in dicta, that "in extraordinary circumstances, it has been held that a bankruptcy court can grant permanent injunctive relief essential to enable the formulation and confirmation of a reorganization plan if, for example, non-debtors who would otherwise contribute to funding the plan will not settle their mutual claims absent ‘protection’ from potential post-confirmation lawsuits arising from their pre-petition relationship with the chapter 11 debtor". Id. at 980.

In In re Boston Harbor Marina, Inc., 157 B.R. 726, 729 (Bankr. D. Mass. 1993), a bankruptcy court in Massachusetts acknowledged the propriety of non-debtor releases in the context of mass tort litigation, but invalidated a non-consensual release of the debtor's insiders where the consideration for the release was inadequate. In a subsequent decision by the same court, In re Salem Suede, Inc., 219 B.R. 922, 936 (Bankr. D. Mass. 1998), the court invalidated a non-consensual release of direct claims against a non-debtor where the debtor’s proposed plan was not overwhelmingly approved by creditors and the failure to grant the releases would not have negatively affected the plan.

Second Circuit:

MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89 (2d Cir. 1988). The Second Circuit held that the bankruptcy court had both jurisdiction and authority to approve a settlement of the debtor’s claims against its insurers, which enjoined future actions by non-consenting creditors against the settling non-debtor insurers. In so holding, the Second Circuit stated: "plaintiffs own claims are inseparable from Manville’s own insurance coverage and are consequently well within the Bankruptcy Court’s jurisdiction over Manville’s assets . . . [Moreover,] the Bankruptcy Court had the authority . . . to channel claims arising under the policies to the proceeds of the settlement. The Bankruptcy Code provides statutory authority for the channeling orders. [citing 11 U.S.C. § 363(f)] . . . The injunctive orders . . . were necessary . . . to make sure that claims to Manville’s insurance proceeds were, in fact, channeled to the settlement fund and could not be asserted directly against the insurers. The authority to issue the injunction is thus a corollary to the power to dispose of assets free and clear and to channel claims to the proceeds . . . [A]dditional authority for the injunction is also to be found in section 105(a) of the Bankruptcy Code." Id. at 93-94.

In re Drexel Burnham Lambert Group, Inc., 960 F.2d 285, 293 (2d Cir. 1992). The Second Circuit held that a court may permanently enjoin lawsuits of non-consenting claimants against non-debtor officers and directors, provided that the injunctions are an important part of the debtor’s reorganization plan. Although the Second Circuit’s discussion on releases and injunctions was brief, the district court found that "[s]ection 105(a) permits the approval of the release and the issuance of the injunction, as provided in the Release and Injunction Provisions, especially where, as here, the Release and Injunction Provisions are an essential means of implementing the Plan as provided in § 1123(a)(5), confer material benefits on the Debtors’ estates, are undoubtedly in the best interest of Creditors and Equity Interest holders and will be instrumental in bringing an end to years of costly litigation over Drexel’s activities, while preserving, increasing, and rationally providing for claimants through the provisions of the Plan that channel recoveries into identifiable funds." 138 B.R. 723, 772 (S.D.N.Y. 1992).

Courts in the Second Circuit will uphold non-debtor releases when circumstances make such releases necessary for an effective reorganization. See, e.g., In re United Health Care Org., 210 B.R. 228, 232-33 (S.D.N.Y. 1997).

Third Circuit:

In re Continental Airlines, 203 F.3d 203, 214 (3d Cir. 2000). The Third Circuit held that where the bankruptcy court had not addressed the propriety of non-debtor releases, where the plaintiffs had been forced to forfeit their claims against non-debtor parties with no consideration, and where no evidence suggested that the plaintiffs’ successful prosecution of the released claims would have unraveled the debtor’s plan of reorganization, a plan provision which proposed to release the debtor’s directors and officers from securities fraud and other claims could be invalidated. After reviewing the various authorities addressing the permissibility of non-debtor releases, the Third Circuit concluded, "we need not establish our own rule regarding the conditions under which non-debtor releases
and permanent injunctions are appropriate or permissible . . . when we can rule on
Plaintiffs’ appeal without doing so . . . Because the release and permanent injunction of
Plaintiffs’ claims are so clearly invalid under any standard, we need not speculate on
whether there are circumstances under which we might validate a non-consensual release
that is both necessary and given in exchange for fair consideration."   Id.

More recently, the bankruptcy courts in the Third Circuit have interpreted Continental
Airlines as leaving open the possibility that "there are circumstances under which [it]
might validate a nonconsensual release that is both necessary and given in exchange for
2001), and this "fair and necessary" standard is appropriate in "extraordinary" situations
such as mass litigation cases. In re American Family Enters., 256 B.R. 377 (D.N.J. 2000)
citing exceptional circumstances in approving creditors’ release of claims against third
parties where debtor had indemnified such released parties) Genesis, 266 B.R. 591 (citing
In re Zenith, 241 B.R. 92 (Bankr. D. Del. 1999) (holding that third party releases should
rarely be granted and should be limited to cases such as Drexel, Manville and Robins and
apparently misapplying the Master Mortgage factors to the debtor’s release of third
parties rather than the creditors’ release of such parties). The "necessary" prong requires
that the success of the reorganization bears a relationship to the release of the non-debtors
and that they would provide a critical financial contribution to the debtor’s plan that is
necessary to the plan’s feasibility. Genesis, 266 B.R. at 607-8 (requiring that the success
of the entire reorganization "hinge" on the third party release, but like Zenith,
misapplying the Master Mortgage factors)). The "fairness" prong requires an assessment
as to whether the non-consenting creditors were given reasonable consideration in
exchange for the release.   Id.

In addition, other bankruptcy courts in the Third Circuit have held that although section
524(e) of the Bankruptcy Code prohibits discharges of non-debtors, consensual non-
debtor discharges are permissible and do not violate the Bankruptcy Code under
principles of ordinary contract law. See In re Arrowmill Dev. Corp., 211 B.R. 497, 506
(Bankr. D.N.J. 1997); In re Elsinore Shore Assoc., 91 B.R. 238, 252 (Bankr. D.N.J.
1988); see also In re Labrum & Doak LLP, 237 B.R. 275 (Bankr. E.D. Pa. 1999)
approving consensual non-debtor releases); In re Zenith Elecs. Corp., 241 B.R. 92, 111
same).

Fourth Circuit:

In re A.H. Robins Co., Inc., 880 F.2d 694, 701 (4th Cir. 1989). The Fourth Circuit held
that the bankruptcy court was empowered to enjoin claimants, who had opted out of a
settlement which would have paid their claims in full, from pursuing non-debtor third
parties where the suits against such third parties would have affected the reorganization
by way of indemnity or contribution.

Although the Fourth Circuit did not articulate a statutory basis for its holding, it
analogized the bankruptcy court’s equitable power to marshal assets to its power to
require opt-out plaintiffs to either resort to the funds provided for them in the settlement or be enjoined from prosecuting actions against non-debtor third parties which would interfere with the reorganization. It also found that Bankruptcy Code § 524(e) did not prohibit non-debtor injunctions where the plan was overwhelmingly approved by creditors, allowed even creditors holding late-filed claims to recover, and where the entire reorganization hinged on the debtor being free of indirect indemnity or contribution claims. Id., at 702; see also In re MAC Panel Co., No. 98-10952C-11G, 2000 WL 33673757 (Bankr. M.D.N.C. 2000) (approving releases).

Fifth Circuit:

In re Zale Corp., 62 F.3d 746 (5th Cir. 1995). The Fifth Circuit ruled that the bankruptcy court did not have jurisdiction over tort actions arising among non-creditors of the estate and a non-debtor where the claims were not property of the estate and had no effect on the estate, and the bankruptcy court also did not have authority under section 105 of the Bankruptcy Code to permanently enjoin third party actions against a non-debtor without channeling the released claims to an alternative source of funding.

Prior to Zale, in Republic Supply v. Shoaf, 815 F.2d 1046 (5th Cir. 1987), the Fifth Circuit upheld the res judicata effect of an approved plan of reorganization which specifically provided for the release of non-debtor guarantor, but the appellant-creditor failed to object to the release provisions at confirmation, and instead sought to collect on the guaranty after plan confirmation.

More recently, however, the Fifth Circuit refused to extend Shoaf to "situations where a plan of reorganization does not contain a specific discharge of the indebtedness of a third party". In re Applewood Chair Co., 203 F.3d 914, 919 (5th Cir. 2000) (per curiam) (concluding that since the debtor’s confirmed plan contained only a general release, not a "specific discharge or release…", it did not release the creditor).

Moreover, other Fifth Circuit decisions have concluded that the bankruptcy courts do not have subject matter jurisdiction to release non-debtors in a confirmed plan. In re Sandy Ridge Dev. Corp., 881 F.2d 1346, 1351 (5th Cir. 1989); NCNB Texas Nat. Bank v. Johnson, 11 F.3d 1260 (5th Cir. 1994). In addition, the Fifth Circuit has expressly stated that it must overturn any section 105 injunction if it effectively discharges a debtor and only allowed for third-party release where the creditors were provided for by other means. In re Zale Corp., 62 F.3d 746, 760 (5th Cir. 1995).

Sixth Circuit:

In re Dow Corning Corp., 280 F.3d 648 (6th Cir.), cert. den. 123 S.Ct. 85 (2002). The Sixth Circuit affirmed the district court’s decision that under "unusual circumstances", the bankruptcy court may enjoin non-consenting creditors’ claims against non-debtors to facilitate a plan of reorganization. The Sixth Circuit, in summarizing the holdings of its "sister circuits", listed the following seven factors that may constitute unusual circumstances: (1) there is an identity in 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 the reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) the impacted class, or classes, has overwhelmingly voted to accept the plan; (5) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) the plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) the bankruptcy court made a record of specific factual finding that support its conclusion.

See also In re Eagle-Picher Indus., Inc., 963 F.2d 855, 858 (6th Cir. 1992) (approving non-debtor releases where circumstances make such releases necessary for an effective reorganization); In re Richard Potasky Jeweler, Inc., 222 B.R. 816 (S.D. Ohio 1998) (section 524(e) does not prohibit non-debtor injunctions per se, when the injunction serves to facilitate the administration of the debtor’s estate).

Seventh Circuit:

In re Energy Coop. Inc., 886 F.2d 921 (7th Cir. 1989). The Seventh Circuit held that a bankruptcy court has both jurisdiction and authority to enjoin creditors from asserting claims which are property of the estate against non-debtors. The causes of action which were enjoined against the non-debtors included breach of contract, breach of fiduciary duty, equitable subordination, alter-ego, piercing the corporate veil and preference claims. Id. at 923. But the court did not discuss whether other actions might be deemed "property of the estate" and therefore subject to a permanent injunction.

In re Specialty Equip. Co., Inc., 3 F.3d 1043, 1048-1049 (7th Cir. 1993). The Seventh Circuit held that substantial consummation of a chapter 11 plan mooted a party’s challenge to a plan provision which released non-debtor parties where the plan was the subject of lengthy negotiation, the releases were essential to the plan and nullification of the releases would have amounted to imposing a different reorganization plan on the parties which had negotiated the plan. Although Specialty Equipment was decided on mootness grounds, the Seventh Circuit nonetheless unequivocally communicated its approval of the consensual non-debtor releases at issue in the case, but did not rule on the propriety of non-consensual third party releases.

In re Keck, Mahin & Cate, 241 B.R. 583, 592 (Bankr. E.D. Ill. 1999), the bankruptcy court approved a provision which released the individual contributing partners of the debtor law firm from the claims of all creditors who accepted distributions under the plan. Accordingly, at least one court within the Seventh Circuit has extended the Specialty Equipment holding to validate non-debtor releases against parties who have rejected a plan but accepted plan distributions.

Eighth Circuit:

The Eighth Circuit has not yet addressed this issue. However, in the oft-cited decision of In re Master Mortgage Inv. Fund, Inc., 168 B.R. 930, 934-935 (Bankr. W.D. Mo. 1994),
the bankruptcy court held that it has the authority to permanently enjoin creditor actions against non-debtor third parties where (1) there is an identity of interest between the debtor and the third party (usually an indemnity relationship); (2) the non-debtor has contributed substantial assets to the reorganization; (3) the injunction is essential to the reorganization such that without it there is little likelihood of success; (4) a substantial majority of the creditors agree to the injunction; and (5) the plan provides for the payment of all, or substantially all, of the claims affected by the injunction.

Although the bankruptcy court approved the non-debtor injunctions under the facts of the case, it cautioned that "a permanent injunction is a rare thing, indeed, and only upon a showing of exceptional circumstances in which the factors outlined above are present will this Court even entertain the possibility of a permanent injunction."  Id. at 937.

Ninth Circuit:

In re Lowenschuss, 67 F.3d 1394, 1402 (9th Cir. 1995). The Ninth Circuit noted that "Section 524(e) precludes discharging the liabilities of non-debtors", citing American Hardwoods, Inc. v. Deutsche Credit Corp., 885 F.2d 621, 626 (9th Cir. 1989) (section 524(e) specifically displaces the bankruptcy court’s power under section 105(a) to order the permanent injunctive relief sought).  See also Underhill v. Royal, 769 F.2d 1426, 1432 (9th Cir. 1985) ("The bankruptcy court has no power to discharge the liabilities of a non-debtor pursuant to the consent of creditors as part of a reorganization plan"); but see Stratosphere Litig. LLC v. Grand Casinos, Inc., 298 F.3d 1137, 1143 (9th Cir. 2002) (holding that even though Lowenschuss prohibits confirmation of a plan discharging third parties from liabilities, a plaintiff can be barred from collaterally challenging a bankruptcy court’s order confirming a plan containing such releases).

Tenth Circuit:

In re Western Real Estate Fund, Inc., 922 F.2d 592, 601(10th Cir. 1990). The Tenth Circuit held that confirmation of the debtor’s plan could not permanently enjoin a creditor from pursuing his claims against a non-debtor defendant which had settled its claims with the debtor and which was thereafter indemnified by the debtor. Notably, the released non-debtor did not in any way contribute to or fund the debtor’s plan. While the non-debtor did pay the estate approximately $3 million in order to settle its own claims with the debtor, those funds were not used to pay the creditor whose claim was released against the non-debtor under the debtor’s plan. Accordingly, the injunction had the effect of extinguishing the creditor’s claim against the non-debtor without re-directing or channeling the claim to another source for recovery.

On the other hand, at least one bankruptcy court in the Tenth Circuit has interpreted section 524 as not imposing a categorical prohibition against non-debtor releases. In re Digital Impact, 223 B.R. 1, 10 (Bankr. N.D. Okla. 1998). The Digital court held that section 524 was intended merely to "insure that co-debtors or guarantors… and their property, are not automatically released from discharge" and, accordingly, debtor may obtain a release by a creditor’s unambiguous manifestation of assent to the release of a non-debtor from liability on its debt.  Id. at 14. In other words, under this court’s

Eleventh Circuit:

In re Munford, Inc., 97 F.3d 449 (11th Cir. 1996). The Eleventh Circuit held that the bankruptcy court was empowered under Bankruptcy Code § 105(a) and Fed. R. Bankr. P. 7016, to permanently enjoin non-settling defendants from asserting contribution and indemnity claims against a defendant which had settled its claims with the debtor. The court also noted the weakness of the underlying contribution and indemnity claims which were being barred and concluded that because the bar order awarded the non-settling defendants a dollar-for-dollar reduction of the settlement amount for any judgment subsequently awarded against them, it provided them with "a far greater benefit than they would receive from their prospective contribution and indemnity claims." Id. at 455. Thus, the Munford decision stands for the proposition that non-debtor releases may be approved over non-consenting creditors under certain circumstances.

Assumption of Non-Assignable Executory Contracts

Section 365(c)(1) of the Bankruptcy Code prohibits a debtor’s assumption or assignment of executory contracts if applicable nonbankruptcy law would excuse the non-debtor party from accepting performance from an entity other than the debtor. However, the circuits are split concerning the proper interpretation of section 365(c)(1). Some of the circuits use the "hypothetical test" to determine the applicability of this section. The test is called the "hypothetical test" because it does not consider whether the non-assignable contract will actually be assigned. This approach prohibits the debtor from assuming a non-assignable contract even if the debtor has no intention of assigning the contract to a third party. This test relies on a "literal" reading of the statute. Other circuits have used the "actual test", which determines on a case-by-case basis whether the non-debtor would actually be forced to accept performance from someone other the debtor. Under this approach, the debtor is not prohibited from assuming the contract if it intends to continue performance and not assign the contract to a third party.

First Circuit:

**Summit Inv. & Dev. Corp. v. Leroux (In re Leroux)**, 69 F.3d 608, 613-614 (1st Cir. 1995) (rejecting the hypothetical test and explicitly endorsing the actual test, the court stated "Congress did not envision the abstract analysis proposed by [the nondebtor party], but contemplated a case-by-case inquiry into the actual consequences – to the nondebtor party – of permitting these executory contracts to be performed by the debtor party following the institution of bankruptcy proceedings. In other words, where a debtor or debtor in possession bears the burden of performance under an executory contract, the nondebtor party to whom performance is due must make an individualized showing that it would not receive the 'full benefit of [its] bargain' were an entity to be substituted for the debtor from whom performance is due.")

**Institut Pasteur v. Cambridge Biotech Corp.**, 104 F.3d 489, 493 (1st Cir. 1997) ("We rejected the proposed hypothetical test … holding instead that subsection 365(c) … contemplate a case-by-case analysis inquiry into whether the nondebtor party … 'actually was being forced to accept performance … from someone other than the debtor party.’ Where the particular transaction envisions that the debtor in possession would assume and continue to perform under an executory contract, the bankruptcy court cannot presume as a matter of law that the debtor in possession is a legal entity materially different from the prepetition debtor with whom the nondebtor party contracted"), cert. denied, 521 U.S. 1120 (1997).

Second Circuit:

**In re Ontario Loco. & Indus. Ry. Supplies, Inc.**, 126 B.R. 146, 148 (W.D.N.Y. 1991) (concluding that "Congress did not intend to bar assumption of any contract as long as it will be performed by the debtor or debtor in possession … [and that such interpretation] is in harmony with the [Anti-Assignment Act] and § 365 and will never result in the requirement that the non-debtor party to a contract need do business with a stranger").
Third Circuit:

In re West Elecs., Inc. 852 F.2d 78 (3d Cir. 1988). Although the case dealt with a federal statute which barred assignment of federal defense contracts, the Third Circuit held that section 365(c)(1) similarly applied in other instances. In so holding, the court noted that "if nonbankruptcy law provides that the government would have to consent to an assignment of the West contract to a third party, i.e., someone 'other than the debtor or debtor in possession,' then West, as the debtor in possession, cannot assume that contract. This provision limiting assumption of contracts is applicable to any contract subject to a legal prohibition against assignment."  Id. at 83.

In re Access Beyond Techs., Inc, 237 B.R. 32 (Bankr. D. Del. 1999). This Delaware decision indicated that West Electronics is controlling law in the Third Circuit, which has adopted the hypothetical test. In so holding, the Delaware court stated that "[t]he language of section 365(c)(1) also clearly and unambiguously prohibits the assumption of the License Agreement [that is at issue in this case]. . . . Like the language of the statute, the decision in West Electronics is clear and unequivocal. We are bound by Third Circuit law on this point."  Id. at 48-49.

Fourth Circuit:

In re Catron, 158 B.R. 629, 633 (E.D.Va.. 1993), aff'd, 25 F.3d 1038 (4th Cir. 1994). At issue was whether the debtor could assume a partnership agreement without the partners’ consent. The court noted that the partnership agreement was the type of executory contract that could not be assumed under § 365(c)(1) absent the consent of the non-debtor parties. The court ruled that "when an executory contract is nonassignable under applicable law, § 365(c) governs both its assumption and assignment and confers on the nondebtor parties the power to veto its assumption or assignment. Id. at 637; see also In re Neuhoff Farms, Inc., 258 B.R. 343, 350 (Bankr. E.D.N.C. 2000) (utilizing hypothetical test as stated by the Ninth Circuit in Catapult).

Fifth Circuit:

In re Hartec Enters., Inc., 117 B.R. 865 (Bankr. W.D. Tex. 1990), vacated on other grounds, 130 B.R. 929 (W.D. Tex. 1991). The bankruptcy court held that the actual test "better fulfills the purpose of anti-assignment statues", including statutes providing for the non-assignment of government defense contracts, and concluded that under "this [government] non-assignment statute, the prohibition on a transfer is not triggered so long as it is basically the same entity performing under the contract."  Id. at 872.

Texaco Inc. v. Louisiana Land and Expl. Co., 136 B.R. 658, 668-71 (M.D. La. 1992). At issue was whether the debtor could assume Louisiana mineral leases over the objection of the non-debtor mineral interest owners. The district court held that the nondebtor’s resistance to allowing assumption "tends to defeat the basic bankruptcy purpose of enhancement of the bankruptcy estate for the benefit of rehabilitation and the general creditors upon a highly technical hypothetical test which furthers no bankruptcy purpose
It would allow one disgruntled creditor to frustrate payment of claims to other creditors or rehabilitation, contrary to the whole purpose of bankruptcy."  Id. at 671.

In re Mirant Corp., No. 03-46590, 2003 WL 23138490 (Bankr. N.D. Tex. 2003) (adopting actual test and allowing debtor to assume regardless of whether assignment is prohibited under non-bankruptcy law).

Sixth Circuit:

In re Cardinal Indus., Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990). At issue was whether the limited partners could remove the debtor as their general managing partner of the partnerships when the debtor filed for bankruptcy relief, and whether applicable nonbankruptcy law prohibits the operating trustee of the debtor from assuming the partnership agreement if the agreement was not assignable to third parties.

The court observed that "Congress did not intend § 365(c)(1) to preclude assumption of an otherwise nonassignable personal service contract if the performance to be given or received 'will be the same as if no petition had been filed.'"  Id. at 979. Accordingly, the court held that "the hypothetical test established in West is clearly not appropriate under § 365(c)(1)."  Id. The court further opined that where an operating trustee has been appointed to manage a chapter 11 debtor, "the separate entity theory is not applicable in the context of the continued viability of an executory contract . . . In this circumstance, the postpetition debtor . . . is not a different legal entity from its prepetition entity. The contemplated performance of the contract will not be by the Trustee individually, but will be by the Debtor as managed by the Trustee. Therefore, assumption of the contracts by the Trustee on behalf of the estate with performance by the Debtor would not constitute an assignment within the meaning intended by § 365(c)(1)(A)."  Id. at 981.

Eighth Circuit:

In re GP Express Airlines, Inc. 200 B.R. 222, 232 (Bankr. D. Neb. 1996). At issue was whether certain contracts between the debtor airline and another airline regarding services, facilities and charges at certain airports could be assumed by the debtor. After finding that the subject contracts were executory contract, the court held that "[on] the facts like those before this Court, where a debtor in possession simply wants to retain its prepetition executory contracts and perform thereunder, the better reasoned result is to permit assumption, regardless of whether the contract can be assumed and assigned to a third party under applicable law."  Id. at 232.

Ninth Circuit:

Perlman v. Catapult Entm’t., Inc., (In re Catapult Entm’t., Inc.), 165 F.3d 747, cert. denied, 528 U.S. 924 (1999). At issue was whether the debtor should be authorized to assume certain patent licenses as part of its reorganization plan through a reverse triangular merger with another company where, under federal patent law, nonexclusive patent licenses were personal and nondelegable.
The Ninth Circuit, in rejecting that policy reasons might favor the adoption of the actual test, stated: "Policy arguments cannot displace the plain language of the statute; that the plain language of § 365(c)(1) may be bad policy does not justify a judicial rewrite. And a rewrite is precisely what the actual test requires. The statute expressly provides that a debtor in possession ‘may not assume or assign’ an executory contract where applicable law bars assignment and the nondebtor objects ... Because the statute speaks clearly, and its language does not produce a patently absurd result or contravene any clear legislative history, we must ‘hold Congress to its words’ ... Accordingly, we hold that, where applicable nonbankruptcy law makes an executory contract nonassignable because the identity of the nondebtor party is material, a debtor in possession may not assume the contract absent consent of the nondebtor party." Id. at 754-755.

Eleventh Circuit:

City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534 (11th Cir. 1994). At issue was whether the debtor could assume a cable franchise agreement granted by the City without the City’s consent, where the agreement expressly stated that the rights and privileges under such agreement "shall not be assignable nor transferable in any bankruptcy proceeding ...."

The Eleventh Circuit opined that under § 365(c)(1), the debtor could not assume the franchise agreement if two conjunctive conditions were met: (i) "applicable law" excuses the City from accepting performance from an entity other than the debtor, and (ii) the City did not consent to the debtor’s assumption of the agreement. As to the first condition, the Court characterized § 365(c)(1)(A) as posing a "hypothetical question", and as to the second condition, the City had clearly objected to debtor’s assumption. Id. at 537. The Court found "applicable law" to mean Tennessee law, and because "the City proffers no Tennessee law, other than the general prohibition against assignment found in section 12 of the [City] Ordinance … that would excuse the City from accepting performance from a third party. Accordingly, we conclude that applicable Tennessee law does not excuse the City from accepting performance from an entity other than James Cable [the debtor], that § 365(c)(1) exception does not apply in this case, and that [the debtor] may therefore assume the cable franchise agreement." Id. at 538.
Recharacterization of Debt Instrument as Equity Contribution

Most courts have recognized that a debt instrument may be recharacterized as equity. The debt instrument, while drafted to be treated as debt, may in fact be a disguised capital contribution. Section 510(c) codifies the well-developed doctrine of equitable subordination. Under section 510(c), claims can be subordinated to claims (and interests to interests) in the event of inequitable conduct on the part of the claimant (or interest holder). The Bankruptcy Appellate Panel for the Ninth Circuit has held that section 510 (titled "Subordination") is the sole remedy available for the subordination of claims. In other words, because section 510 is the only congressionally approved method for subordination, recharacterization is an impermissible remedy.

While an outlying decision, the Ninth Circuit’s argument has received some support (by analogy) with the recent Supreme Court decision Grupo Mexicano. See Grupo Mexicano De Desarrollo v. Alliance Bond Fund, 527 U.S. 308, 321-29 (1999) (denying a federal district court’s authority to issue a prejudgment preliminary injunction to prevent a debtor from disposing of assets because such a remedy is not a traditional equitable power and the equitable powers conferred under the Judiciary Act of 1789 did not expressly provide for such a remedy); Klee, Kenneth N., Recharacterization in Bankruptcy, presented to the American College of Bankruptcy (October 15, 2003) (arguing that recharacterization, which is not a traditional equitable remedy and not expressly codified in the Bankruptcy Code, could come under attack by analogy from Grupo Mexicano as support for the Ninth Circuit’s position).

First Circuit:

In re Hyperion Enters., 158 B.R. 559, 561 (D.R.I. 1993) ("where shareholders have substituted debt for adequate risk capital, their claims are appropriately recast as equity regardless of satisfaction of the other requirements for equitable subordination").

In re AtlanticRancher, Inc., 279 B.R. 411 (Bankr. D. Mass. 2002) (applying various standards and exercising power that a bankruptcy court can recharacterize debt as equity even in the absence of grounds for equitable subordination).

Second Circuit:

In re Interstate Cigar Co., 182 B.R. 675, 678-680 (Bankr. E.D.N.Y. 1995) (citing Diasonics, 121 B.R. at 630, for proposition that "where a claim is found to be a capital contribution, and not a debt, equitable subordination lacks relevance" and adopting analysis used by Fifth Circuit in Montclair, Inc. v. Comm’r, 318 F.2d 38, 40 (5th Cir. 1963) (tax case), aff’d without opinion, 166 F.3d 1200 (2d Cir. 1998); see also, In re Lafayette Hotel P’ship, 227 B.R. 445, 453-54 (S.D.N.Y. 1998) (engaging in separate analysis for recharacterization and equitable subordination as set out in Interstate Cigar and by the Fifth Circuit in Herby’s Foods, 2 F.3d at 131).
Third Circuit:

In re Submicron Sys. Corp., 291 B.R. 314, 323 (Bankr. D. Del. 2003) (adopting analysis from Third Circuit tax case, Geftman v. Comm’r, 154 F.3d 61, 75 (3d Cir. 1998) ("In a recharacterization analysis, if the court determines that the advance of money is equity and not debt, the claim is recharacterized and the effect is subordination of the claim"), but finding a contribution to an insolvent, undercapitalized corporation unable to pay interest or obtain outside financing was in fact debt).

Fourth Circuit:

In re Cold Harbor Assocs., 204 B.R. 904, 915 (Bankr. E.D. Va. 1997) (adopting analysis from Hillsborough Holdings, but primary factor that courts should consider is "whether the transaction bears the earmarks of an arm’s length transaction" and that "the more such an exchange appears to reflect the characteristics of an arm’s length negotiation, the more likely such a transaction is to be treated as debt").

Fifth Circuit:

In re Herby’s Foods, 2 F.3d 128, 133 (5th Cir. 1993) (bankruptcy court is authorized to recharacterize a loan as equity contribution even in the absence of grounds for equitable subordination).

Sixth Circuit:

Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.), 269 F3d 726, 750 (6th Cir. 2001) (holding that recharacterization is available in addition to equitable subordination because inquiry for recharacterization is whether debt existed ab initio as opposed to inquiry into inequitable conduct, and adopting framework as set out in tax case, Roth Steel v. Tube Co. v. Comm’r., 800 F.2d 625, 630 (6th Cir. 1986)).

Seventh Circuit:

Herzog v. Leighton Holdings Ltd. (In re Kids Creek Partners), 212 B.R. 898, 931 (Bankr. N.D. Ill. 1997) (recognizing recharacterization as separate cause of action from equitable subordination); see also Moglia v. Quantum Indus. Partners (In re Outboard Marine Corp.), No. 02-C-1594, at *11 (N.D. Ill. 2003) (establishing list of factors by combining those set out in Autostyle and Hyperion).

Eighth Circuit:

In re Vanguard Airlines, Inc., 302 B.R. 292, 300-01 (Bankr. W.D. Mo. 2003) (adopting recharacterization analysis as set out by the Sixth Circuit in Autostyle, but noting that option to convert debt to equity indicative of equity).
Ninth Circuit:

Pacific Express Holding, Inc. v. Pioneer Comm. Funding Corp. (In re Pacific Express Holding, Inc.), 69 B.R. 112, 115 (9th Cir. B.A.P. 1986) (holding that recharacterization is precluded because it is inconsistent with bankruptcy code; equitable subordination under section 510(c) is the only provision under which subordination is allowed).

Tenth Circuit:

United States v. Colo. Invesco, Inc., 902 F. Supp. 1339, 1342 (D. Colo. 1995) (a bankruptcy court’s ability to recharacterize a loan as equity stems from the bankruptcy court’s power to ignore the form of a transaction and give effect to its substance).

In re Medical Software Solutions, 286 B.R. 431 (Bankr. D. Utah 2002) (establishing list of factors for recharacterization as distinct from equitable subordination).

Eleventh Circuit: