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Eleventh Circuit Holds That Bankruptcy Reorganization Plan Does Not Bar Intercreditor Claims between Debtor's Lenders

2006-10-03

In an important decision recognizing the limitations on a bankruptcy court's power to affect litigation between non-debtors, the US Court of Appeals for the Eleventh Circuit recently held that confirmation of a Chapter 11 plan of reorganization did not bar—under the doctrine of res judicata—a lawsuit between two of the debtor's lenders, in which one lender (Eastman Kodak Company) alleged fraud and breach of intercreditor duties by the other (Wachovia Bank, N.A., f/k/a First Union). *Eastman Kodak Co. v. Atlanta Retail, Inc.*, 456 F.3d 1277 (11th Cir. 2006).

WilmerHale represented Eastman Kodak Company on the appeal. (Philip Anker argued and Craig Goldblatt and Joel Millar were on the briefs.)

When Bankruptcy Affects Claims between Non-debtors

Though bankruptcy generally involves a restructuring of debtor-creditor rights, at times a bankruptcy case may also affect creditor rights against other non-debtors.

One example is a "third party release," which is a provision in a reorganization plan that purports to release claims of the debtor's creditors against another creditor or non-debtor party. Though some courts have questioned the authority of bankruptcy courts to approve non-consensual third-party releases, others have permitted such releases in exceptional cases or enforced them against parties who failed to object to such releases during the bankruptcy case. *See,* e.g., *In re Lowenschuss*, 67 F.3d 1394, 1401-02 (9th Cir. 1995) (non-debtor releases impermissible under section 524(e) of the Bankruptcy Code); *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141-43 (2d Cir. 2005) (non-debtor release "is proper only in rare cases" where "truly unusual circumstances render the release terms important to success of the plan"); *Republic Supply Co. v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987) (plan release of non-debtor guarantor enforced against creditor who failed to object to release at confirmation).

A second way bankruptcy may be argued to affect rights among non-debtors is through the application of res judicata. Under the doctrine of res judicata, or claim preclusion, a court's judgment—such as a bankruptcy court's order confirming a plan of reorganization—can, under certain circumstances, bar a party from subsequently asserting claims arising out of the same "cause of action" involved in the court's order. Where applicable, this doctrine has the potential to function like a release, as res judicata may bar claims the party **could have** brought in the first action even if it did not actually do so. It thus encourages litigants to raise all related claims in a single action, a practice that is thought to promote judicial efficiency, repose for the defendant, and reliance on court judgments. In a bankruptcy case, however, it is not always apparent that a creditor's independent claims against another non-debtor are so related to the issues involved in the bankruptcy—and capable of being adjudicated there—that the creditor must assert them in the bankruptcy case or risk forfeiting them under res judicata.

Addressing this issue in the *Kodak* case, the Eleventh Circuit made clear that creditors are not required to assert claims against other creditors in a bankruptcy case if the governing bankruptcy procedure would deny them the opportunity to obtain the full relief they seek under applicable law, or if the facts underlying their claims are not matters the bankruptcy court must consider under the Bankruptcy Code in order to confirm a plan or decide the other issues before it.

The Eleventh Circuit Limits the Res Judicata Effect of Bankruptcy Court Orders as a Bar to Non-debtor Litigation

In the *Kodak* case, the bankruptcy court confirmed a plan of reorganization for Wolf Camera, Inc. The plan subordinated Kodak's claims against Wolf to Wachovia's claims, in accordance with a pre-bankruptcy intercreditor subordination agreement. In a separate action outside bankruptcy court, Kodak sued Wachovia for damages, asserting, among other claims, that Wachovia breached the intercreditor agreement and fraudulently induced Kodak to lend the debtor $30 million that was used to pay down Wachovia's loan rather than expand the debtor's business as Kodak had required. The bankruptcy court enjoined the suit, holding that Kodak's claims were barred under res judicata by its plan confirmation order. The bankruptcy court reasoned that Kodak could have asserted its claims to object to the debtor's reorganization plan, which enforced Kodak's contractual subordination to Wachovia, or to seek "equitable subordination" of Wachovia's claims to Kodak's claims (an equitable remedy under section 510(c) of the Bankruptcy Code that reorders contractual priorities to distributions). The district court affirmed.

But the Eleventh Circuit reversed, holding that Kodak's suit was not barred because at least two requirements for the application of res judicata were not met.

First, Kodak could not have received a full remedy. "Under the most basic principles of res judicata, Kodak did not have to sue Wachovia in a forum where it could not receive full relief." Under bankruptcy procedure, the only relief available in a plan confirmation hearing was denial of confirmation of Wolf's plan, but Kodak could not have obtained an award of damages against Wachovia (or equitable subordination), which must be pursued in a separate "adversary proceeding" *See* Fed. R. Bankr. P. 7001. Since Kodak could not have recovered damages by objecting to confirmation, the confirmation order did not bar Kodak from seeking such relief in a separate lawsuit.

Second, Kodak's claims against Wachovia were not based on the same "cause of action" as Wolf's bankruptcy plan of liquidation, and Kodak had no obligation under res judicata to assert, in the plan confirmation proceedings, claims that did not arise out of the same cause of action. In determining what "cause of action" (or "nucleus of operative fact") was at issue in the confirmation proceedings, the Eleventh Circuit looked to what facts the bankruptcy court was required to consider under section 1129 of the Bankruptcy Code in order to confirm the plan. Because the bankruptcy court was not required to (and did not) consider the key facts underlying Kodak's claims against Wachovia in order to confirm the plan, the Eleventh Circuit concluded that Kodak's suit was not based on the same cause of action as the confirmation proceeding. The plan only purported to resolve claims against the debtor, Wolf, not Kodak's independent claims against Wachovia. Noting the absence of an express release in the plan, the Eleventh Circuit emphasized that "Wachovia should not receive more repose from the other creditors in the bankruptcy than it would have received through a release, which while legally questionable, would at least have the advantage of providing notice to Kodak."

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