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Alert

Fifth Circuit Reverses Officer's Release in Chapter 11 Reorganization Plan

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The release provisions in a corporate debtor's Chapter 11 plan were "not sufficiently specific to release" a plaintiff's Fair Labor Standards Act ("FLSA") claim against the debtor's president ("P"), held the U.S. Court of Appeals for the Fifth Circuit on Jan. 6, 2016. *Hernandez v. Larry Miller Roofing, Inc.*, 2016 WL 67217, at *4 (5th Cir. Jan. 6, 2016). Relying on established precedent to reverse the district court's dismissal of the plaintiff's suit against P, the Fifth Circuit stressed that P "is not identified by name in any of the release language." *Id.* at *6.

Statutory Context

Bankruptcy Code ("Code") Section 524(a) provides in relevant part 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." Thus, the discharge obtained by the corporate debtor in *Hernandez* would not ordinarily "affect the liability of any entity other than the debtor." 4 Collier, *Bankruptcy* ¶ 524.01, at 524-17 (16th rev. ed. 2009). But the plaintiff ("H") never objected to the plan's release provision or appealed from the bankruptcy court's plan confirmation order.

Relevance

Courts have split over whether the provisions of a Chapter 11 reorganization plan may override Code Section 524(e). According to some courts, the Code's express limitation on a debtor's discharge cannot be undermined by the provisions of a reorganization plan. *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) ("court has no power to discharge the liabilities of a nondebtor [with] the consent of creditors as part of a reorganization plan"); *In re Lowenschuss*, 67 F.3d 1394, 1401 (9th Cir. 1995) (same); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 602 (10th Cir. 1990). Other courts will permit third-party release provisions when individual creditors sign releases. *In re Specialty Equip. Cos.*, 3 F.3d 1043, 1047 (7th Cir. 1993). And the U.S. Court of Appeals for the Third Circuit takes a case-by-case approach. *In re Continental Airlines*, 203 F.3d 203, 213-14 (3d Cir. 2000) ("Establishing … a blanket rule prohibiting all non-consensual releases and permanent injunctions of non-debtor obligations … would be ill-advised when we can rule on Plaintiffs' appeal without doing so"; on facts of case, third-party release "does not pass muster under even the most flexible tests. … The hallmarks of permissible non-consensual releases — fairness, necessity to the reorganization, and specific factual findings … — are all absent here."). Of course, individual creditors who simply acquiesce in third-party release provisions and fail to challenge the plan or to appeal from a bankruptcy court's order confirming the plan may not later attack release provisions. *Travelers Indem. Co. v. Bailey*, 129 S. Ct. 2195 (2009).

The Fifth Circuit avoided the overarching statutory issue in *Hernandez*. Instead, it applied principles of contract interpretation to the terms of the reorganization plan to determine whether it released P. 2016 WL 67217, at *3-4. As a practical matter, therefore, if the plan provided no release of P by its precise terms, H would be free to pursue him.

Facts

The plaintiff sued his former employer, the corporate debtor and P, its president, prior to bankruptcy, alleging a failure to pay overtime wages in violation of the FLSA. While the suit was pending, the corporate debtor filed a Chapter 11 petition, resulting in the stay of the FLSA litigation in the district court. The plaintiff later filed a claim in the corporate bankruptcy case, alleging $47,698 in unpaid wages. The debtor filed a reorganization plan. H accepted the plan, and the court confirmed it.

In relevant part, the plan provided that a creditor's receipt of a distribution on its claim would deem the claims to have been "paid in full, including the release of rights to enforce or collect such Claims against non-debtor parties … . The Debtor, Reorganized Debtor, the officers and directors of the Debtor and the shareholders shall be discharged and released from any liability for Claims … except for obligations arising under this Plan." *Id.* at *1-2. H received a 30-percent distribution on his claim for unpaid wages — $14,309.40.

The District Court

H later continued his FLSA suit in the district court against P individually. P moved for summary judgment, arguing that "the FLSA claim against him was discharged under the Plan and that, in the alternative, the doctrine of res judicata precluded [H] from advancing the claim," citing the provisions of the plan. The district court agreed, granted summary judgment in favor of P and dismissed the complaint. When H argued on a motion for rehearing "that bankruptcy courts lacked the authority to discharge the debts of non-debtor third parties, such as [P]," the district court rejected his argument, reasoning that it was "an impermissible collateral attack on the judgment of the bankruptcy court [i.e., the order confirming the Chapter 11 Plan]." *Id.* at *2.

The Court of Appeals

The Fifth Circuit agreed with the district court that "principles of contract interpretation" should "determine the meaning of the Plan." But it reversed the district court's holding that the plan had released P. *Id.* at *4.

First, it explained, the applicable federal law makes "a corporate officer with operational control" liable as "an employer along with the corporation, jointly and severally liable … for unpaid wages." *Id.* at *3, citing *Donovan v. Grim Hotel Co.*, 747 F.2d 966, 972 (5th Cir. 1984). Thus, because the corporate debtor and P were "jointly and severally liable for any FLSA violation that may have occurred," the language of the reorganization plan was key. *Id.*

The court avoided the application of Code Section 524(e) because H had not challenged the plan or appealed from the bankruptcy court's confirmation order. 2016 WL 67217, at *4, citing *In re Applewood*, 203 F.3d 914, 919 (5th Cir. 2000). Moreover, reasoned the court, "once the time for objecting to, or directly appealing, a plan has passed, parties may not challenge particular provisions of the plan as exceeding the bankruptcy court's authority." *Id.* at n.4. As the court noted, H did not have to "address whether confirmation of the Plan was beyond the authority of the bankruptcy court under" Code Section 524(e). *Id.*

The court then examined "the specificity of the release provisions" to determine whether they were "sufficiently specific to release [H's] FLSA Claim against [P]." *Id.* at *4. It explained the "specificity test" it had developed in earlier cases. *Id.* at *5. In *Republic Supply Co. v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987), the court found "clear and unambiguous" language that "expressly released a third party from liability on a guaranty." 815 F.2d at 1047, 1050. There, the order confirming the reorganization plan expressly stated that it released "any guarantees given to a creditor of the Debtor, which guarantees arose out of the Debtor's business dealings with any creditor of the Debtor." The language was included in the plan at the request of the guarantor who had agreed to release funds in exchange for the release. *Id.* at 1049. Although the creditor had failed to object to the plan or to appeal directly, the Fifth Circuit held the plan's release to be "specific enough to discharge [the defendant] guarantors of liability." 2016 WL 67217, at *4.

But the Fifth Circuit refused to enforce a release against a third-party guarantor in the *Applewood* case when the reorganization plan contained no "specific discharge of the indebtedness of the third party." 203 F.3d at 920. In that case, the release provision "did not specifically release the guarantor, who was also an officer, from his personal guaranties." 2016 WL 67217, at *5. *But see FOM P.R. S.E. v. Dr. Barnes Eyecenter Inc.*, 255 F. App'x 909, 912 (5th Cir. 2007) (plan release provisions held to bar creditor's claims; "release of claims was an integral part of the bankruptcy order"; "release of claims was not simply boilerplate language that was inserted into the [reorganization plan], but rather a necessary part of the [reorganization plan] itself"; language "explicitly mention[ed] [guarantor] as an entity that benefit[ed] from the release").

Applying its "specificity test" in *Hernandez*, the Fifth Circuit held that the release provisions were not "specific enough to release [H's] FLSA claim against [P]." 2016 WL 67217, at *6. First, the release language did not identify P "by name." Also, while P was "an officer of" the debtor, "a party's status as an officer combined with boilerplate release language is not sufficiently specific." Further, "nowhere does the Plan mention anything related to a FLSA claim or employment law violations more generally." "The language in the Plan is, if anything, generic," concluded the court. *Id.*

H was therefore not barred from suing P "simply because he has already received compensation from" the debtor under the plan for "the underlying FLSA violation." *Id.* at *7. Under Code Section 524(e), the debtor's discharge in the plan did not affect the liability of P for the remaining balance of H's claim. Of course, the court was not deciding whether any FLSA violation had occurred, but only whether H could pursue his claim in the district court.

Comments

The lesson for creditors from *Hernandez*: object to any third-party release in a proposed reorganization plan, and appeal if unsuccessful. *See In re Gentry*, 2015 WL 8117969, at *4 (10th Cir. Dec. 8, 2015) (reversed lower courts; individual Chapter 11 debtors' guaranty liability not affected by their corporation's discharge under Chapter 11 plan; corporate debtor's discharge "does not affect a guarantor's liability" under Code Section 524(e); in any event, language of guarantees contained unconditional promise to pay, waiver of defenses and agreement not to assert deductions by way of setoff or counterclaim).

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