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Court Rejects Settlement for Inadequate Disclosure

An indenture trustee learned a hard lesson last week when the U.S. Court of Appeals for the Third Circuit held that the description of a feature of its settlement with the debtor in a disclosure statement was inadequate and rendered a key element of the plan and the settlement unenforceable against third-party litigants. It is well established that adequate disclosure of a release provision contained in a reorganization plan is essential to its inclusion in the plan and its enforceability against third parties. In a nonprecedential opinion, the court in *In re Lower Bucks Hospital* (3rd Cir. 2014), No. 13-1311, affirmed the decisions by the lower courts rejecting the proposed third-party release.

The dispute arose from the indenture trustee's alleged failure to maintain perfection of the bondholders' security interest under the Uniform Commercial Code. After filing its chapter 11 case, the debtor initiated litigation against the indenture trustee, challenging its security interest. The debtor and the indenture trustee settled the litigation and resolved the indenture trustee's secured status, materially reducing the amount of the secured claim. The settlement, which was approved by the bankruptcy court, released the indenture trustee from claims by the debtor *and the bondholders*.

Subsequently, the debtor filed its disclosure statement and plan of reorganization, both of which referenced the settlement and the release, but neither highlighted nor emphasized the effect of the release of the claims on the bondholders. Objections to the disclosure statement were raised by one attentive bondholder, who asserted that the third-party release was not crucial to the reorganization and should not be included in the plan.

At this point in the proceedings, it became clear that the bankruptcy court had been unaware of the third-party release in the settlement agreement when it was approved. Rather than scuttle the pending reorganization, the parties agreed to sever the dispute about the enforceability of the third-party release and moved forward on that basis, approving the plan without the offending release provision.

In subsequent proceedings, the bankruptcy court denied approval of the third-party release, acknowledging that it had neither noticed nor appreciated the legal significance of the provisions releasing the indenture trustee from the bondholders' claims when it approved the settlement agreement in the first place. The bankruptcy court was critical of counsel who had presented the settlement agreement for approval for not highlighting this aspect of the settlement. The indenture trustee appealed.

Concluding that the third-party release was effectively an injunction against the bondholders, the Third Circuit agreed that the disclosure statement must contain specific and conspicuous language in bold, underlined, or italicized text describing what acts would be enjoined. In this instance, the disclosure statement did not include conspicuous language, and so was ineffective for this purpose, and the

bondholders could not be bound to the proposed third-party release provisions in the plan.

Although the decision by the Third Circuit is nonprecedential, it serves as a warning to litigants and professionals in bankruptcy cases and a reminder of the importance of full and clear disclosure of all settlement terms in both settlement approval motions and the plan confirmation process. Courts are more likely to enforce settlements if the process of describing their key attributes errs on the side of overdisclosure. If the court has any reason to doubt that disclosure was adequate and that notice was given, the efficacy of a settlement that fairly resolved the dispute may come into question and allow further litigation and the risk of further exposure, just when the settling parties thought they had funded a final disposition.

For more information, please contact:

[Patrick M. Birney](mailto:pbirney@rc.com)
860.275.8275
pbirney@rc.com

[Michael R. Enright](mailto:menright@rc.com)
860.275.8290
menright@rc.com

[Steven J. Boyajian](mailto:sboyajian@rc.com)
401.709.3359
sboyajian@rc.com

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