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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Case Study: In Re Lower Bucks Hospital

Law360, New York (June 13, 2012, 12:29 PM ET) -- A recent decision by a Philadelphia bankruptcy judge highlights the obstacles faced by an indenture trustee seeking to obtain, through a Chapter 11 plan, a third-party release from its bondholders. In In re Lower Bucks Hospital, et al.[1], the judge, citing what he felt was inadequate disclosure, denied the release, even though the judge had previously approved a settlement incorporating the release, and despite the fact that the affected bondholders had overwhelming voted in favor of the plan which included the release.

The lesson learned (the hard way) by the indenture trustee in this case, is that where a plan provides for a release of an indenture trustee by its bondholders, the holders must be "conspicuously" informed that if the plan is confirmed they will be deemed to have released the indenture trustee from any potential claims. The decision is noteworthy not just for its holding, which is not necessarily novel, but also because of its criticism of the indenture trustee's conduct, and because it touches (albeit in dicta) on many issues with which indenture trustees frequently grapple.

In Lower Bucks Hospital, the indenture trustee was acting as a successor trustee for about $36 million of municipal revenue bonds. The bonds were secured by a first priority lien on the hospital's gross revenues. In 2006, the hospital changed its name, but apparently did not notify the indenture trustee of the change. The indenture trustee filed an amended financing statement soon after it learned of the name change, in 2009, but within 90 days after the amended UCC's were filed, the hospital filed for bankruptcy protection. The debtor promptly initiated a lawsuit to avoid the perfection of the lien as a preference, under § 547 of the Bankruptcy Code.

Following mediation, the debtor, the unsecured creditors committee, certain significant creditors and the indenture trustee reached a settlement, which provided the bondholders, among other things, an $8 million secured claim. The settlement also called for the indenture trustee to waive its indemnity claim under the indenture against the debtor and for the debtor to include a third-party release for the benefit of the indenture trustee in its plan of reorganization. After a hearing in which the judge probed the parties about the consequences of the release, the court approved the settlement and thereafter approved a disclosure statement for the plan, which incorporated the third-party release promised by the settlement.

Soon after the disclosure statement was approved, an individual bondholder holding a tiny fraction (approximately .35 percent) of the outstanding bonds filed a motion asking the bankruptcy court to

reconsider its order approving the settlement. The motion was withdrawn with full reservation of rights for the bondholder to object to the release at confirmation. In the meantime, and prior to the confirmation hearing, the individual initiated a class action lawsuit against the indenture trustee in district court and filed an objection to confirmation.

After the Bankruptcy Court expressed its concern with the confirmability of the plan due to the third-party release issues raised by the bondholder, the parties agreed to proceed with confirmation but leave for a later day a determination of the legality of the third-party release. The plan was confirmed, and the court scheduled further briefing and a hearing on the propriety of including the third-party release in the plan.

In its 77-page decision, the court refused to approve the third-party release. After analyzing the five (5) factor test, as articulated by the Third Circuit in the Continental Airlines[2] decision, regarding the release's fairness and necessity, the court concluded that the indenture trustee had failed to satisfy the third factor: whether a large majority of the creditors in the case have approved the plan.

The court so held even though 95 percent in number and 98 percent in amount of the voting bondholders voted to accept the plan. The court reasoned that because bondholders were not provided "sufficient and conspicuous" notice that they would be releasing the indenture trustee if the plan was confirmed, the court could not be sure that the voting bondholders understood that they would be releasing their individual claims against the indenture trustee upon confirmation.

The court based its opinion in large part on Rule 3016 (c) of the Federal Rules of Bankruptcy Procedure, which requires a disclosure statement to "describe in specific and conspicuous language (bold, italic, or underlined text) all acts to be enjoined and the entities that would be subject to injunction." The disclosure statement here did not highlight the third-party release to be granted by bondholders to the indenture trustee and the court felt that no effort was made to bring the existence of that release to the attention of bondholders.

A number of times in its opinion, the court emphasized that the release was imbedded within the "boilerplate" disclosures concerning plan release provisions pertaining to the debtor and its affiliates. In addition, the court felt that the debtor should have included information in the disclosure statement regarding the merits or value of the potential claims being released by the bondholders against the indenture trustee.

The court was not moved by the fact that bondholders had been kept apprised of the litigation and settlement by the indenture trustee for over a year and a half, were encouraged to participate, and were provided with repeated notices updating them on the status of the bankruptcy case, the lien avoidance litigation and the plan.

The court questioned whether the indenture trustee's notices were a sufficient substitute for the disclosure requirements of the Bankruptcy Code and the Bankruptcy Rules, but declared that, even if they were, the notices themselves did not satisfy the "conspicuous"-ness requirements of Rule 3016(c). The court also found the notices to be potentially misleading and ambiguous with regard to the third-party release.

Perhaps even more importantly, the court seemed particularly bothered by the fact that no party to the settlement had articulated at the settlement hearing the fact that the settlement called for the plan to include the bondholders' release of the indenture trustee, and that counsel did not flag this issue for the

court when given the opportunity. In fact, the court went to great lengths to hold the indenture trustee accountable for the fact that the court itself did not pick up on the third party release in three separate documents that it reviewed:

"In a perfect world, in which it were possible for the court to engage in hyper-meticulous, word-by-word review of the 9019 Motion, the Settlement Stipulation and the DS, the existence of the Third Party Release would have been apparent to the court before the entry of the 9019 Order and the DS Approval Order. However, given the bankruptcy court's workload and the subtle drafting techniques employed by sophisticated counsel, it is unrealistic to expect that bankruptcy judges can digest and effectively 'audit' the lengthy documents submitted by the parties in a relatively complex chapter 11 case such as this and identify all of the important issues that may be lurking in the documents."

While it was only necessary for the judge to decide whether the third-party release could stand, the court nevertheless waded into another area of particular importance to an indenture trustee: its fiduciary duties to its bondholders. Without issuing any ruling on the subject, the court expressed grave concern regarding the dual roles played by the indenture trustee in settlement negotiations.

On the one hand, the indenture trustee was representing the interests of the bondholders in negotiating on their behalf, but on the other hand, the indenture trustee was also looking out for its own interests and therefore conditioned the settlement on obtaining third-party release protections, at least in part because it was giving up its indemnity rights against the debtor. The court strongly suggested that in such an instance, where the interests of the indenture trustee arguably conflict with those of the bondholders, it may be best for the indenture trustee to step aside and appoint a third-party representative to negotiate on behalf of bondholders.

The court was troubled by the indenture trustee's suggestion that it had a right to condition the settlement on obtaining the third-party release. The indenture trustee reasoned that it had this right because there could have been no settlement without the indenture trustee's participation, since it was the only party under the indenture with authority to settle the litigation. The indenture trustee further argued that under the indenture it was not obligated to take any action whatsoever and that it had a right to put its interests ahead of those of the bondholders.

The court flatly rejected these arguments. Without deciding whether the indenture trustee was acting in a fiduciary capacity (although suggesting that it was so acting), the court concluded that once the indenture trustee participates in settlement negotiations on behalf of the bondholders, it is obligated to represent them faithfully and put their interests ahead of its own. (The court even questioned whether proceeds of the indenture trustee's charging lien could be used by the indenture trustee to defend itself against claims that it breached its duties.)

Ultimately, the holding in Lower Bucks Hospital is a narrow one: bondholders must clearly and prominently (e.g. in BOLD CAPITAL LETTERS) be apprised in a disclosure statement of any third-party releases being given for an indenture trustee's benefit, and the debtor should also disclose the merits or value of the potential claims against the indenture trustee that the bondholders are being asked to release.

While this task may not be an easy one in some instances and is obviously quite subjective, counsel to the indenture trustee will most likely be afforded (and should in any case insist upon) the opportunity to provide its own disclosure alongside that of the debtor. Notices to holders should highlight the third-party release provisions by directing holders to the appropriate sections of the disclosure statement.

And in those instances where a third-party release is critical for the indenture trustee and a topic over which it negotiates, serious thought should be given to the appointment of an independent fiduciary to represent the interests of bondholders.

--By Walter H. Curchack and Vadim J. Rubinstein, Loeb & Loeb LLP

*Walter Curchack is a partner in Loeb & Loeb's New York office and chairman of the firm's bankruptcy, restructuring and creditors' rights groups. Vadim Rubinstein is a New York partner in the firm's bankruptcy, restructuring and creditors' rights group*s.

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[1] United States Bankruptcy Court, Eastern District of Pennsylvania, May 10, 2012, 10-10239 (ELF) [Docket No. 2040]. The decision has been appealed.

[2] 203 F.3d 203,214 (3d Cir 2000).