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BANKRUPTCY PRACTICE

Expert Analysis

Extent of Non-Debtor Parent Exposure Under Channeling Injunctions

On April 10, 2012, the U.S. Court of Appeals for the Second Circuit in *In re Quigley*[1] issued an opinion adopting a narrow interpretation of Section 524(g)(4) of the Bankruptcy Code, which allows a bankruptcy court to enter an injunction that bars certain actions brought by plaintiffs against non-debtor third parties, such as a non-debtor parent company. *Quigley* reminds solvent corporate parent companies that there are limits to bankruptcy courts' injunctive powers to insulate such parent companies from potential claims when their subsidiaries file for bankruptcy to restructure asbestos-related tort liabilities.

By
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Channeling Injunctions

Section 524(g) of the Bankruptcy Code was enacted to address the unique issues that arise in bankruptcies involving numerous tort claims related to exposure to asbestos, which was prevalent in numerous industrial products and processes in decades past. Because some claimants exposed to asbestos do not experience symptoms until many years after exposure, they may not know that they have a claim against a debtor until after the debtor's estate has been depleted by claimants whose symptoms became apparent years earlier. Section 524(g) solves this problem by allowing a bankruptcy court to enter an injunction in connection with a plan of reorganization in addition to the general Chapter 11 discharge injunction that channels certain classes of claims to a trust established pursuant to such plan.[2] Such a future claimant trust is structured to make distributions to both present and future claimants.[3]

To encourage parent companies to contribute to a future claimant trust, §524(g)(4) contains a provision permitting the bankruptcy court to enter an injunction barring certain actions against non-debtor third parties if the non-debtor third party is alleged to be liable "for the conduct of, claims against, or demand on" the debtor, and if that liability arises "by reason of" one of four relationships between the third party and the debtor, including the third party's ownership of a financial interest in the debtor or the third party's involvement in the management of the debtor.[4]

> The 'Quigley' decision is a cautionary tale that there are certain limitations to the discharge powers of bankruptcy courts when the parent-subsidiary tie is severed via bankruptcy.

The Decision

In *Quigley*, the Second Circuit addressed whether an injunction issued by the bankruptcy court under §524(g)(4) prohibited certain plaintiffs (the plaintiff group) from bringing multiple lawsuits against Pfizer Inc., the solvent parent of Quigley Inc. under the "apparent manufacturer" theory of liability, which is set forth in section 400 of the Restatement (Second) of Torts. The key issue for analysis was whether the parent's alleged apparent manufacturer liability arose "by reason of" its ownership or management of the debtor, which is an essential element to enjoin a claim against a non-debtor third party under a §524(g)(4) injunction.

Quigley had manufactured certain products containing asbestos and was acquired by the parent in 1968. After this acquisition, Quigley began to use the Pfizer name, logo and trademark on marketing materials for its products. As a result of its mounting asbestos liabilities, Quigley filed for bankruptcy in 2004.

Under the apparent manufacturer theory of liability proffered by the plaintiff group, "one who puts out as his own product a chattel manufactured by another is subject to the same liability as though he were its manufacturer."[5] The parent argued that, under Bankruptcy Code §524(g)(4), third-party liability arises "by reason of" a relationship between the debtor and the third party if the relationship is a "but for" factual cause of the liability. The parent asserted that the debtor would not have included the Pfizer name, logo and trademark on its products but for the parent's ownership or management of the debtor. As a result, the parent argued that its liability arose "by reason" of its ownership or management of the debtor, and therefore the injunction shielded the parent from the plaintiff group's lawsuits based on the apparent manufacturer theory.

On the other hand, the plaintiff group argued that under §524(g)(4) third-party liability arises "by reason of" a relationship between the debtor and the third party only if the liability is a legal consequence of the relationship. The plaintiff group argued that the parent's apparent manufacturer liability was founded on the debtor's use of the Pfizer name, logo and trademark on its products, and that the parent's ownership or management of Quigley was legally irrelevant. Thus, the plaintiff group asserted that the channeling injunction did not enjoin its "apparent manufacturer" claims against the parent.

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The U.S. Bankruptcy Court for the Southern District of New York agreed with the parent, concluding that the injunction covered apparent manufacturer liability. However, the U.S. District Court for the Southern District of New York reversed, holding that the relevant question was whether the parent's apparent manufacturer liability arose, as a legal matter, from its ownership or management of the debtor. The district court found that the parent's liability did not arise from its ownership or management of the debtor, and held that the parent "breached an independent legal duty not to employ its name and logo in the marketing of a defective product."[6] Thus, the district court found that the plaintiff group's claims fell outside of the scope of the channeling injunction.

The Second Circuit agreed with the plaintiff group and affirmed the district court, holding that "the phrase 'by reason of' employed in 11 U.S.C. §524(g)(4)(A)(ii) requires that the alleged liability of a third party for the conduct of or claims against the debtor arises, in the circumstances, as a legal consequence of one of the four relationships between the debtor and the third party" enumerated in §524(g).[7] Because the parent did not argue that its ownership or management of Quigley was related in any legal sense to the plaintiff group's claims, the Second Circuit found that the injunction issued by the bankruptcy court pursuant to §524(g)(4) did not protect the parent.

Analysis

Often, this column addresses issues related to the relationship between a debtor and its creditors. While most major Chapter 11 cases involve the filing of an entire corporate enterprise from the parent company down, some cases involve debtors that represent a discrete business unit within a larger and otherwise solvent corporate enterprise. While solvent parent companies find the Chapter 11 process useful to resolve intractable subsidiary liabilities that may be a drag on stock performance, significant and complex issues often arise when a non-debtor parent company attempts to disentangle itself from its debtor subsidiaries. Particularly, courts typically pay close attention to the appropriateness of granting releases to the non-debtor parent and whether prepetition intercompany transactions may be subject to avoidance by unsecured creditors.

In the mass tort context, as *Quigley* demonstrates, the extent of protection afforded to non-debtor parent companies may be robust but not absolute. After *Quigley*, an injunction under §524(g)(4) of the Bankruptcy Code will only protect a parent company if the parent is alleged to be liable for the conduct of or claims against a subsidiary and the parent's relationship with the debtor is a legal consequence of the alleged liability.

In limiting the protections available to parent companies, the Second Circuit considered §524(g)'s competing objectives to "facilitate the reorganization and rehabilitation of the debtor as an economically viable entity" and to "make it possible for future asbestos claimants to obtain substantially similar recoveries as current claimants."[8] After focusing on the language of §524(g), the Second Circuit concluded that barring claims against a non-debtor parent that are only tangentially related to the bankruptcy case is not likely to have a significant impact on the subsidiary's reorganization, but could greatly affect a future asbestos claimant's ability to obtain a recovery comparable to the recoveries obtained by present asbestos claimants. Though the decision hews closely to the statutory language, a consequence of the Second Circuit's decision is that parent companies may become exposed to liabilities that they intended to limit or avoid through the bankruptcy of their subsidiaries.

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As an aside on appellate strategy, *Quigley* also demonstrates how appellate courts reviewing bankruptcy court decisions tend to favor statutory interpretation-focused arguments as opposed to arguments based on equitable principles or reorganization policy interests. This jurisprudential observation is likely a function of differing judicial perspectives. Bankruptcy courts are at the frontline of a debtor's business and have intimate knowledge of a debtor's financial situation and reorganization prospects, which lends itself to favoring the confirmation of a Chapter 11 plan that enjoys the support of key constituencies. In contrast, appellate courts are removed from the complex inter-party dynamics attending the negotiation and confirmation of a Chapter 11 plan and may favor reaching a result that does not square neatly with the parties' intent in reaching agreement on a plan or the practicalities of a case.

Conclusion

A subsidiary bankruptcy is always challenging for a solvent parent company, especially because its assets are outside of the in rem jurisdiction of the bankruptcy court and thus remain a natural target for recovery-hungry creditors. While the extent of liability to which *Quigley* exposed the parent may not ultimately be significant in the wider context of the case, the decision is a cautionary tale that there are certain limitations to the discharge powers of bankruptcy courts when the parent-subsidiary tie is severed via bankruptcy. In addition to many risks that may arise as a result of a subsidiary filing, counsel to non-debtor parent companies are cautioned to examine such limitations carefully when such a filing is being considered.

1. 2012 U.S. App. LEXIS 7167 (2d Cir. April 10, 2012).
2. See 11 U.S.C. §524(g)(1)-(2).
3. Id.
4. *Quigley*, 2012 U.S. App. LEXIS 7167, at *39-40.
5. Id. at *8.
6. Id. at *11-12 (citing *In re Quigley*, 449 B.R. 196, 207 (S.D.N.Y. 2011)).
7. Id. at *48.
8. Id. at *47.

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