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Third-Party Releases in Bankruptcy Plans

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This Practice Note discusses consensual and non-consensual third-party releases in bankruptcy plans, including their legality, procedural requirements, and the various standards courts use for approving non-consensual third-party releases.

What is a Third-party Release?

Purpose of Third-Party Releases

Legality of Third-Party Releases

Procedural Requirements

Consensual Third-Party Releases

What is Consent?

Non-Consensual Third-Party Releases

The Majority View

The Minority View

Jurisdiction

Constitutional Authority

Res Judicata

Strategies

ABI Commission Recommendations on Third-Party Releases

Plans of reorganization may include releases of non-debtors from claims and causes of action held by creditors and other stakeholders. The three types of non-debtor releases are:

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- **Estate** releases, by which a debtor releases a non-debtor from both **prepetition** and **postpetition** claims.
- Third-party releases, by which a non-debtor releases another non-debtor from both prepetition and postpetition claims.
- **Exculpation clauses**, by which a debtor or a non-debtor releases professionals and other fiduciaries of the estate, such as officers and directors. These clauses specify the scope of, or the **standard of care** governing, an exculpated party's liability (for example, ordinary negligence, gross negligence, or willful misconduct) for conduct during the course of the case.

This Note focuses on third-party plan releases and discusses:

- The purpose of third-party releases.
- The legality of third-party releases.
- The procedural requirements governing third-party releases.
- Consensual third-party releases and what is consent.
- Non-consensual third-party releases, including the various standards for approval.
- Courts' jurisdiction to issue third-party releases.
- Challenges to third-party releases after **confirmation** of a plan.
- Strategies for proponents of third-party releases.

Third-party releases contained in settlement agreements approved by a court outside of a plan under Federal Rule of Bankruptcy Procedure 9019 are outside the scope of this Note (for more information, see Practice Note, Rule 9019 Settlements: Scope of Releases).

What is a Third-party Release?

Third-party plan releases are provisions in a plan that release or limit the liability of non-debtor parties to other non-debtor parties. These releases are implemented by plan provisions that enjoin future litigation against the released parties for their pre-confirmation actions. Third-party releases are becoming increasingly common, even though the **Bankruptcy Code** only specifically provides for third-party releases in connection with asbestos liability (§ 524(g), Bankruptcy Code).

Released third parties may include a debtor's:

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- Principals.
- Guarantors.
- **Affiliates**.
- Officers.
- Directors.
- Insurers.
- Creditors.
- Shareholders.

Third-party releases are either:

- Consensual (see Consensual Third-Party Releases).
- Non-consensual (see Non-Consensual Third-Party Releases).

Courts generally agree that third-party releases are permissible to the extent that creditors consent to the release. However, courts disagree about what is consent (see What is Consent?) and whether non-consensual third-party releases are permissible under the Bankruptcy Code (see Legality of Third-Party Releases). Even courts that do permit non-consensual third-party releases only do so in limited circumstances and their approaches are inconsistent (see The Majority View).

Purpose of Third-Party Releases

Third-party releases are often justified on the basis that they promote an efficient and timely resolution of plan issues. Because bankruptcy cases involve many different constituencies, certain issues between non-debtor parties often must be resolved to favorably resolve the affairs of the estate. For example, in some cases, such as mass tort cases, the release of third parties is a key element of the compromise needed to confirm a plan. Third-party releases may also be granted to avoid litigation that may hinder the reorganized debtor.

In cases where the debtor has an obligation to **indemnify** a third party, that party's release may be justified by the fact that the release will prevent an indemnification claim from arising against the debtor. This justification is strongest in cases in which creditors, including the indemnified party, will receive a significant distribution from the estate.

Despite these legitimate purposes, courts are reluctant to approve third-party releases because they:

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- Are not explicitly authorized in the Bankruptcy Code, except in asbestos cases under certain conditions, including the creation of a trust to satisfy future claims.
- Can be potentially abused by non-debtors to shield themselves from liability to third parties, and may effectively operate as a bankruptcy **discharge** without a filing and without the safeguards of the Bankruptcy Code.

(see *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 142 (2d Cir. 2005)).

Legality of Third-Party Releases

Courts generally agree that consensual third-party releases are legal as a matter of contract law, although they disagree about what is consent (see Consensual Third-Party Releases).

The legality of non-consensual third-party releases is less clear. While the Bankruptcy Code does not explicitly prohibit third-party releases, it also does not specifically authorize them, except in the asbestos context (§ 524(g), Bankruptcy Code). The legality of non-consensual third-party releases in any other context is controversial because of the apparent statutory conflict between section 105(a) and section 524(e) of the Bankruptcy Code.

Section 105(a) gives bankruptcy courts broad equitable powers to issue "any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." While section 105(a) confers courts with the equitable power to issue **injunctions** when necessary to the **reorganization**, this provision does not create substantive rights and does not allow courts to order relief that is inconsistent with other provisions of the Bankruptcy Code. Section 524(e) provides that the "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."

Whether section 105(a) and section 524(e) are reconcilable depends on whether courts interpret section 524(e) broadly or narrowly. Courts that interpret section 524(e) broadly to prohibit a plan from granting a release or injunction to any party other than the debtor are precluded from using their equitable powers under section 105(a) to grant third-party releases. As a result, plans providing for non-consensual third-party releases are problematic under this view because courts cannot confirm plans that do not comply with applicable provisions of the Bankruptcy Code (§ 1129(a), Bankruptcy Code). This is the minority position (see The Minority View).

However, the actual language of section 524(e) does not explicitly address whether a plan can grant a release to any entity other than the debtor. Some courts believe that section 524(e) merely explains the effect of a debtor's discharge and was intended to insure that a debtor's discharge does not automatically release any third party's liability for the discharged debt. Therefore, courts that interpret section 524(e) narrowly can use their equitable powers under section 105(a) to grant releases to third parties when necessary to carry out the purposes of **Chapter 11**. As a result, plans providing for non-consensual third-party releases are confirmable under this view because courts can confirm plans that include any appropriate provision that is not inconsistent with the applicable provisions of the Bankruptcy Code (§ 1123(b)(6), Bankruptcy Code). This is the majority position (see The Majority View).

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Procedural Requirements

In general, the disclosure of injunctions provided for in a plan against conduct not otherwise enjoined under the Bankruptcy Code is governed by:

- Federal Rule of Bankruptcy Procedure 3016(c), which requires that the plan and **disclosure statement** must:
  - describe in specific and conspicuous language (bold, italic, or underlined text) all acts to be enjoined; and
  - identify the entities subject to the injunction.
- Federal Rule of Bankruptcy Procedure 2002(c)(3), which requires that the notice of time fixed for filing objections to the plan and the hearing to consider confirmation of the plan must:
  - include in conspicuous language (bold, italic, or underlined text) a statement that the plan proposes an injunction;
  - describe briefly the nature of the injunction; and
  - identify the entities subject to the injunction.
- Federal Rule of Bankruptcy Procedure 3020(c)(1), which requires that the plan confirmation order must:
  - describe in reasonable detail all acts enjoined;
  - be specific in its terms regarding the injunction; and
  - identify the entities subject to the injunction.

The Advisory Committee Note to Rule 3016 explains that the purpose of the rule is to give "adequate notice" of a plan injunction that is not "substantially the same" as an injunction provided under the Bankruptcy Code. If courts interpret Rule 3016(c) literally, they can construe the rule as applying only to plan provisions specifically designed as injunctions. However, courts do not interpret Rule 3016(c) so narrowly, and instead have assumed that the rule encompasses third-party releases (see *In re American Media, Inc.*, 2010 WL 5483463, at *6 (Bankr. S.D.N.Y. Dec. 20, 2010)). For example, one court found that a disclosure statement that placed a third-party release along with **boilerplate** disclosures of a plan release provision relating only to the debtors "obscured the existence and significance" of the third-party release in violation of Rule 3016(c) (see *In re Lower Bucks Hosp.*, 471 B.R. 419, 460, n. 62 (Bankr. E.D. Pa. 2012), *aff'd*, *Bank of NY, Mellon Trust Co., NA v. Becker (In re Lower Bucks Hosp.),* 488 B.R. 303 (E.D. Pa. 2013), *aff'd*, *In re Lower Bucks Hosp.,* 571 F. App'x 139 (3d Cir. 2014) and Legal Update, In re Lower Bucks Hospital: Inadequate Disclosure Invalidates Third-party Release).

In another example, the US Court of Appeals for the Fifth Circuit applied its "specificity test" to reject a third-party release which did not specify the type of claims being released, nor identify the released third-party by name, holding that the

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"boilerplate release language was not sufficiently specific to release claims against a third-party" (*Hernandez v. Larry Miller Roofing, Inc.*, 628 F. App'x 281, 287-88 (5th Cir. 2016)).

If adequate notice of the third-party release is not provided, then courts cannot determine whether a large majority of creditors, by supporting the plan, knowingly agree to the release of their potential claims, a factor that many courts consider in determining the validity of third-party releases (see The Majority View).

Consensual Third-Party Releases

Courts generally agree that consensual third-party releases are permissible to the extent they bind only those creditors who affirmatively consented to the release (see *In re Specialty Equip. Cos., Inc.,* 3 F.3d 1043, 1047 (7th Cir. 1993)). Some courts reason that consensual releases are permissible as a matter of contract law, and a plan containing a third-party release is a contract that binds those who vote in favor of it (see *In re Coram Healthcare Corp.,* 315 B.R. 321, 336 (Bankr. D. Del. 2004)). Creditors receive property under the plan as consideration for consenting to the plan's provisions, including those provisions that release third parties. When a third-party release is voluntary, "it is no different from any other settlement or contract and does not implicate [section 524(e)]" (*In re Arrowmill Dev. Corp.,* 211 B.R. 497, 506 (Bankr. D.N.J. 1997)).

Consensual third-party releases do not bind creditors who rejected the plan, even if they are members of a **class** that voted to accept the plan (see *In re Zenith Elecs. Corp.,* 241 B.R. 92, 111 (Bankr. D. Del. 1999), called into doubt by *In re Exide Techs.,* 303 B.R. 48, 80, n. 40 (Bankr. D. Del. 2003) and declined to follow by *In re W.R. Grace & Co.*, 475 B.R. 34, n. 69 (D. Del. 2012)).

What is Consent?

Courts disagree about what is consent. They are split on whether a creditor that:

- Votes in favor of a plan has consented to a third-party release (see Voting in Favor of a Plan).
- Abstains from voting and fails to return a ballot that allows it to opt-out of a third-party release is deemed to have consented to the release (see Abstaining From Voting and Failing to Opt-Out).

Voting in Favor of a Plan

Some courts have held that voting in favor of a plan which provides for a third-party release indicates consent to the release (see *In re Coram Healthcare Corp.,* 315 B.R. at 336; *In re Zenith Elecs. Corp.,* 241 B.R. at 111; *In re After Six, Inc.,* 1994 WL 45471, at *1 (Bankr. E.D. Pa. 1994)). Conversely, no court has found consent to a third-party release when a creditor votes to reject a plan.

Other courts have held that for a release to be consensual, a creditor must have "unambiguously manifested assent to the release of the nondebtor from liability on its debt" and merely voting in favor of a plan is not enough (see *In re Arrowmill Dev.*

Corp., 211 B.R. at 506-07; see also *First Fid. Bank v. McAteer,* 985 F.2d 114, 118 (3d Cir. 1993); *In re PG&E Corp.*, 617 B.R. 671, 683-84 (Bankr. N.D. Cal. 2020); *In re Digital Impact, Inc.,* 223 B.R. 1, 14 (Bankr. N.D. Okla. 1998)).

Abstaining From Voting and Failing to Opt-Out

The US Bankruptcy Court for the Southern District of New York has taken a flexible approach to consensual third-party releases, finding consent where creditors abstained from voting but had adequate notice of the consequences of abstaining without opting out of the release (see *In re DBSD N. Am., Inc.,* 419 B.R. 179, 217-19 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar 24, 2010), *aff'd in part, rev'd in part on other grounds*, 627 F.3d 496 (2d Cir. Dec 6, 2010), opinion issued, 634 F.3d 79 (2d Cir. 2011); *In re Calpine Corp.,* 2007 WL 4565223, at *10 (Bankr. S.D.N.Y. Dec. 19, 2007)). Under the flexible approach, affirmative consent is not necessary and the burden is on claimholders to take action by affirmatively opting out.

However, more recently, the SDNY Bankruptcy Court found that creditors failing to vote did not implicitly consent to third-party releases, explaining that under generally accepted principles of contract law, silence does not imply consent absent a duty to speak (see *In re SunEdison, Inc.*, 576 B.R. 453, 458-61 (Bankr. S.D.N.Y. 2017)).

The US Bankruptcy Court for the District of Delaware is split on this issue. Some Delaware bankruptcy courts have agreed with the flexible approach taken by the SDNY Bankruptcy Court. In *In re Indianapolis Downs, LLC*, the Delaware Bankruptcy Court permitted third-party releases where creditors failed to opt out of the releases, either by abstaining from voting or by voting against the plan but not otherwise opting out of the releases (see 486 B.R. 286, 306 (Bankr. D. Del. 2013)). The court also found that **unimpaired** creditors, who are deemed to accept the plan because they are paid in full, were bound to the third-party releases without their affirmative consent because these creditors received adequate consideration for the releases. In another case, the Delaware Bankruptcy Court similarly held that unimpaired creditors were bound to a third-party release because they failed to object to the plan, even though the ballot did not give them an opportunity to opt out of the release (see *US Bank Nat'l Ass'n v. Wilmington Trust Co. (In re Spansion, Inc.)*, 426 B.R. 114, 144 (Bankr. D. Del. 2010)).

However, other Delaware bankruptcy courts have required affirmative consent to uphold third-party releases. In *In re Washington Mutual, Inc.*, the Delaware Bankruptcy Court held that "[f]ailure to return a ballot is not a sufficient manifestation of consent to a third party release" such that only those creditors who affirmatively consented by voting in favor of the plan and not opting out of the releases were bound by the release (442 B.R. 314, 355 (Bankr. D. Del. 2011); see also *In re Zenith Elecs. Corp.,* 241 B.R. at 111). The court also held that creditors who were not entitled to vote were also not bound by the third-party releases unless they affirmatively consented (see *In re Washington Mutual, Inc.,* 442 B.R. at 355). Most recently, the court explained that "[a] party's receipt of a notice imposing an artificial opt-out requirement, the recipient's **possible** understanding of the meaning and ramifications of such notice, and the recipient's failure to opt-out simply do not qualify [as consent]" (*In re Emerge Energy Servs. LP*, 2019 WL 7634308, at *18 (Bankr. D. Del. Dec. 5, 2019) (emphasis in original)).

Non-Consensual Third-Party Releases

Courts are divided about whether non-consensual third-party releases are permissible. Even those courts that agree they are permissible disagree about the circumstances under which they can be allowed. While obtaining a third-party release is easier in some jurisdictions than in others, courts generally do not favor them.

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The Majority View

The majority position is that non-consensual third-party releases are permissible in limited and appropriate circumstances (see Legality of Third-Party Releases). The US Courts of Appeals for the Second, Third, Fourth, Sixth, Seventh, Ninth, and Eleventh Circuits have adopted this view. However, there is no uniform standard to determine when a non-consensual third-party release is appropriate. The only consensus is that this is a case-by-case analysis that is "fact intensive and depends on the nature of the reorganization" (*Aradigm Commc'ns, Inc. v. Federal Commc'ns Comm'n (In re Aradigm Commc'ns, Inc.),* 519 F.3d 640, 657 (7th Cir. 2008)).

The following circuit courts have not directly addressed the issue, but have issued decisions consistent with the majority view:

- The US Court of Appeals for the Eighth Circuit (see *Murray Kentucky Energy Inc. v. Ceralvo Holdings, LLC (In re Armstrong Energy Inc.)*, 613 B.R. 529, 535 (B.A.P. 8th Cir. 2020)). Also, a bankruptcy court within this jurisdiction has issued a leading case supporting the majority view (see Master Mortgage Test).

- The US Court of Appeals for the First Circuit (see *Monarch Life Ins. Co. v. Ropes & Gray,* 65 F.3d 973, 979-80 (1st Cir. 1995)).

- The US Court of Appeals for the District of Columbia (see *In re AOV Indus., Inc.,* 792 F.2d 1140 (D.C. Cir. 1986)).

Master Mortgage Test

In the seminal case of *In re Master Mortgage Investment Fund, Inc.*, the US Bankruptcy Court for the Western District of Missouri set out a five-factor test that many courts have since adopted in determining whether non-consensual third-party releases are appropriate:

- An identity of interests exists between the debtor and the third party, usually an indemnity relationship, where a suit against the third party is in essence a suit against the debtor or will deplete assets of the estate.

- The third party has contributed substantial assets to the reorganization.

- The release is essential to the reorganization, and without it there is little likelihood of success.

- A substantial majority of the creditors agree to the release, specifically, the impacted class or classes, which have "overwhelmingly" voted to accept the proposed plan treatment.

- The plan provides a mechanism to pay for all, or substantially all, of the **claims** of the class or classes affected by the release.

(see 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994)).

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The court explained that while courts have balanced these listed factors most often, they are not an "exclusive list of considerations, nor are they a list of conjunctive requirements" (*In re Master Mortg. Inv. Fund, Inc.,* 168 B.R. at 935). It noted that rather than setting out a "rigid factor test" to be applied in every case, the courts have instead engaged in a fact-specific review and weighed the equities of each case.

The court concluded its analysis by stating that because non-consensual third-party releases, which are a "rare thing," can pose some "knotty" problems, bankruptcy courts have the "discretionary" power to issue them only in appropriate, limited, and exceptional circumstances (see *In re Master Mortg. Inv. Fund, Inc.,* 168 B.R. at 937).

The ABI Commission to Study the Reform of Chapter 11 has endorsed the use of this test in evaluating third-party releases (see Box, ABI Commission Recommendations on Third-Party Releases).

Second Circuit

In *In re Metromedia Fiber Network, Inc.*, the Second Circuit stated that approval of non-consensual third-party releases is "not a matter of factors and prongs," and is "proper only in rare cases" (416 F.3d at 141-42). The Second Circuit explained that a non-debtor release in a plan "should not be approved absent the finding that truly unusual circumstances render the release terms important to success of the plan," focusing on whether:

- The released parties make substantial financial contributions to claimants in exchange for the release of their claims.
- The enjoined claims are channeled to a settlement fund rather than extinguished.
- The enjoined claims indirectly impact the debtor's reorganization by way of indemnity or contribution.
- The plan otherwise provides for the full payment of the enjoined claims.

(see *In re Metromedia Fiber Network, Inc.,* 416 F.3d at 142-43).

The SDNY Bankruptcy Court applied the *Metromedia* test to approve certain non-consensual third-party releases granted by unimpaired creditors and equity holders and held that simply classifying a party as unimpaired does not automatically mean that a third-party release is permissible (see *In re Genco Shipping & Trading Ltd.,* 513 B.R. 233 (Bankr. S.D.N.Y. 2014) and Legal Update, In re Genco Shipping & Trading Ltd: SDNY Bankruptcy Court Approves Non-consensual Third-party Releases Granted by Unimpaired Parties).

Most recently, the SDNY Bankruptcy Court explained that non-consensual third-party releases are not "earned" in return for making a contribution to the case, but instead should only be imposed "in those extraordinary cases where a particular release is essential and integral to the reorganization itself" (*In re Aegean Marine Petroleum Network, Inc.*, 599 B.R. 717, 726 (Bankr. S.D.N.Y. 2019)).

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Third Circuit

In *Gillman v. Continental Airlines (In re Continental Airlines)*, the Third Circuit stated that the "hallmarks" of permissible non-consensual releases are "fairness, necessity to the reorganization, and specific factual findings to support these conclusions" and that it is "necessary to provide adequate consideration to a claimholder being forced to release claims against non-debtors" (203 F.3d 203, 213-14 (3d Cir. 2000)). However, because the release in this case could not stand even under the most flexible standards, the Third Circuit declined to establish its own rule regarding the conditions under which non-consensual, non-debtor releases are appropriate or permissible (see *In re Continental Airlines,* 203 F.3d at 214). The Third Circuit more recently denied approval of an inadequately disclosed non-consensual third-party release because it could not determine whether it displayed the hallmarks of permissibility identified in *In re Continental Airlines* (see *In re Lower Bucks Hosp.,* 571 F. App'x 139 and Legal Update, In re Lower Bucks Hospital: Inadequate Disclosure Invalidates Third-party Release).

In *In re Combustion Engineering, Inc.*, the Third Circuit vacated a section 105(a) injunction in a case where the proposed third-party releases did not satisfy the requirements of a section 524(g) channeling injunction for asbestos-related claims (see 391 F.3d 190, 235-37 (3d Cir. 2005)). The Third Circuit held that "the general powers of [section] 105(a) cannot be used to achieve a result not contemplated by the more specific provisions of [section] 524(g)" and noted that "the practical effect of the [section] 105(a) injunction" was to allow two non-debtors to "cleanse themselves of non-derivative asbestos liability without enduring the rigors of bankruptcy" (*In re Combustion Eng'g, Inc.,* 391 F.3d at 237). In doing so, the Third Circuit implicitly disagreed with the majority view that relies on bankruptcy courts' broad, equitable powers under section 105(a) of the Bankruptcy Code to approve non-consensual third-party releases (see Legality of Third-Party Releases).

While *In re Combustion Engineering, Inc.* is distinguishable as an asbestos case, it raises questions about the validity of non-consensual third-party releases generally in the Third Circuit.

Fourth Circuit

In *Menard-Sanford v. Mabey (In re A.H. Robins Co., Inc.)*, the Fourth Circuit approved a third-party release in a mass tort case, after finding that:

- The plan was "carefully designed" and "overwhelmingly" approved by the affected class of claimants.
- The plan provided for full payment of the creditors' claims, including those with late-filed claims.
- The release only affected a small percentage of creditors.
- The release was essential to the success of the reorganization because it prevented suits against parties who had contribution rights against the debtor.
- The released parties contributed substantial sums to a trust created to satisfy claimants' tort claims.

(see 880 F.2d 694, 702 (4th Cir. 1989)).

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However the Fourth Circuit later clarified in *Behrmann v. National Heritage Foundation, Inc.* that a bankruptcy court "need not find a precise fit between the circumstances found in *In re A.H. Robins* and the case before it as a precondition to granting equitable relief" (663 F.3d 704, 711 (4th Cir. 2011), *aff'd*, 2013 WL 1390822 (E.D. Va. Apr. 3, 2013), *aff'd*, *National Heritage Found. v. Highbourne Found.*, 2014 WL 2900933 (4th Cir. June 27, 2014) and Legal Update, National Heritage Foundation, Inc. v. Highbourne Foundation: Fourth Circuit Rejects Plan's Non-consensual Third-party Release). Instead, the Fourth Circuit explained that the analysis depends on the "particular facts and circumstances of the case" and refused to adopt a specific test for approval of non-consensual third-party releases (*Behrmann,* 663 F.3d at 711-12). However, it found the factors used in the Sixth Circuit's *Dow Corning* test instructive and urged courts to consider them in their analyses (see Sixth Circuit).

The *Behrmann* decision reaffirms that non-consensual third-party releases are permissible in the Fourth Circuit, but should be granted cautiously, infrequently, and only when they are supported by specific factual findings (see *Behrmann,* 663 F.3d at 712).

Sixth Circuit

In *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, the Sixth Circuit held that non-consensual third-party releases are only appropriate in "unusual circumstances" when these seven factors are present:

- There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the third party is, in essence, a suit against the debtor or will deplete assets of the estate.
- The third party has contributed substantial assets to the reorganization.
- The release is essential to the reorganization, namely the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor.
- The impacted class, or classes, has overwhelmingly voted to accept the plan.
- The plan provides a mechanism to pay for all, or substantially all, of the class or classes being affected by the release.
- The plan provides an opportunity for those claimants who choose not to settle to recover in full.
- The bankruptcy court made a record of specific factual findings that support its conclusions.

(see 280 F.3d 648, 658 (6th Cir. 2002)). The first five factors are taken from the *Master Mortgage* test (see Master Mortgage Test).

The Sixth Circuit remanded the case to the bankruptcy court because the bankruptcy court's findings were "no more than conclusory statements that restated the elements of the test in the form of factual conclusions" and the bankruptcy court did not explain or discuss the evidence underlying its findings (*In re Dow Corning*, 280 F.3d at 658). Further, the findings were not sufficiently specific to support a finding of "unusual circumstances" because they "did not discuss the facts as

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they related specifically to the various released parties, but merely made sweeping statements as to all released parties collectively" (*In re Dow Corning*, 280 F.3d at 658).

Most recently, the US Bankruptcy Court for the Northern District of Ohio applied the *Dow Corning* factors to reject a broadly worded non-consensual third party release, finding the "least negotiable" factor to be the identity of interest between the debtor and the non-debtor parties (*In re FirstEnergy Solutions Corp*, 606 B.R. 720, 740 (Bankr. N.D. Ohio 2019)).

Seventh Circuit

In *In re Aradigm Communications, Inc.*, the Seventh Circuit held that non-consensual third-party releases are permissible if they are "appropriate and not inconsistent with any provision of the Bankruptcy Code" (see 519 F.3d at 657). The Seventh Circuit approved a non-consensual third-party release after finding that:

- The release was narrowly tailored to cover only claims "arising out of or in connection with" the reorganization itself and did not include "willful misconduct." It was not "blanket immunity for all times, all transgressions, and all omissions" and did not affect matters outside the jurisdiction of the bankruptcy court or unrelated to the reorganization.
- The release was subject to other provisions of the plan, including one that expressly preserved a federal agency's regulatory powers.
- The bankruptcy court found "adequate" evidence that the third party required this release and that its involvement was essential to the reorganization.

(see *In re Aradigm Commc'ns*, 519 F.3d at 657).

In a later case, the Seventh Circuit stated that non-consensual third-party releases are only appropriate in "unique circumstances" and that in most instances they "will not pass muster" (*In re Ingersoll, Inc.,* 562 F.3d 856, 865 (7th Cir. 2009)).

Ninth Circuit

It was previously understood that third-party releases were impermissible in the Ninth Circuit (see *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401 (9th Cir. 1995); *American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods, Inc.)*, 885 F.2d 621, 624-26 (9th Cir. 1989)). However, the Ninth Circuit recently hinted in *Blixseth v. Credit Suisse* that its prohibition against non-debtor releases was not absolute (see 961 F.3d 1074, 1081-85 (9th Cir. 2020) and Legal Update, Blixseth v. Credit Suisse: Ninth Circuit Rules Chapter 11 Plan Can Include Exculpatory Clause Not Related to Discharged Debt). The Ninth Circuit approved provisions exculpating non-debtors after finding that they:

- Were "narrow in both scope and time."
- Were limited to acts and omissions "in connection with, relating to or arising out of the Chapter 11 cases."

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- Only covered those parties who were "closely involved" in drafting the plan.

(*Blixseth v. Credit Suisse*, 961 F.3d at 1081-82).

The Ninth Circuit explained that:

- Section 524(e) of the Bankruptcy Code prohibits the sweeping discharge of non-debtor entities for liability on the discharged debt, but does not bar the narrow release of participants in the plan development and approval process for actions taken during those processes.
- Section 105(a) of the Bankruptcy Code gives the court "authority to approve an exculpation clause intended to trim subsequent litigation over acts taken during the bankruptcy proceedings and so render the [p]lan viable."

(*Blixseth v. Credit Suisse*, 961 F.3d at 1082, 1084).

After *Blixseth*, the US Bankruptcy Court for the Northern District of California found third-party releases permissible where non-debtor parties must affirmatively opt in to a release of their claims (see *In re PG&E Corp.*, 617 B.R. at 682-84). Most recently, the US Bankruptcy Court for the Eastern District of Washington expanded *Blixseth* to approve consensual releases of non-debtors by both the debtor and third parties (see *In re Astria Health*, 623 B.R. 793, 800-03 (Bankr. E.D. Wash. 2021)). However, the Ninth Circuit's approach to non-consensual third-party releases remains unclear.

Eleventh Circuit

In *SE Property Holdings, LLC v. Seaside Engineering & Surveying, Inc. (In re Seaside Engineering & Surveying, Inc.)*, the Eleventh Circuit applied the Sixth Circuit's seven-factor test from *In re Dow Corning* (see Sixth Circuit) and held that non-consensual third-party releases are permissible, but "should be reserved for those unusual cases" where they are:

- Necessary for the success of the reorganization.
- Fair and equitable under all the facts and circumstances, which they were in this case because:
  - the debtor was required to voluntarily release its claims for sanctions against the releasees, which prevented an asymmetrical benefit for the debtor from the plan; and
  - the releases were "narrowly limited in scope to claims arising out of the Chapter 11 case and [did] not include claims arising out of fraud, gross negligence, or willful misconduct."

(780 F.3d 1070, 1075-81 (11th Cir. 2015) and see Legal Update, In re Seaside Engineering & Surveying, Inc: Eleventh Circuit Approves Non-consensual Third-party Releases in Chapter 11 Plan). In adopting the majority view, the Eleventh Circuit extended its precedent from *Munford v. Munford, Inc. (In re Munford)* in which it approved a third-party release in the settlement context (see 97 F.3d 449 (11th Cir. 1996)).

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The Eleventh Circuit explained that while the *Dow Corning* factors are non-exclusive and "should be applied flexibly," third-party releases should not be "issued lightly" (*In re Seaside Eng'g & Surveying, Inc.,* 780 F.3d at 1078-79).

The Minority View

The minority position is that non-consensual third-party releases are not permitted by the Bankruptcy Code, except in asbestos cases (see Legality of Third-Party Releases). This view interprets section 524(e) of the Bankruptcy Code as prohibiting the discharge of debts of non-debtors. Therefore, courts cannot use their broad, equitable powers under section 105(a) of the Bankruptcy Code to circumvent section 524(e) because actions taken under section 105(a) must be consistent with the rest of the Bankruptcy Code and cannot alter its provisions.

Courts adopting the minority position also reason that because only the debtor has invoked and submitted to the bankruptcy process, only the debtor is entitled to its protections. This view holds that Congress did not intend to extend this benefit to third parties. Some courts believe that the minority view is supported by the addition of section 524(g) to the Bankruptcy Code by the Bankruptcy Reform Act of 1994, which provides that under certain conditions reorganized debtors and third parties may be released from asbestos liability. These courts argue that the fact that Congress provided explicit authority to bankruptcy courts to allow third-party releases in an extremely limited class of cases implies that section 524(e) denies this authority in other, non-asbestos cases.

This view has been adopted by:

- The Fifth Circuit (see *Bank of NY Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.),* 584 F.3d 229, 252 (5th Cir. 2009); *Feld v. Zale Corp. (In re Zale Corp.),* 62 F.3d 746, 760 (5th Cir. 1995)).
- The US Court of Appeals for the Tenth Circuit (see *Abel v. West,* 932 F.2d 898 (10th Cir. 1991); *Landsing Diversified Props.-II v. First Nat'l Bank & Trust Co. of Tulsa (In re Western Real Estate Fund, Inc.),* 922 F.2d 592, 600 (10th Cir. 1990)).

Jurisdiction

In some cases, bankruptcy courts have considered whether they have jurisdiction to approve third-party releases. One of the central purposes of extending jurisdiction to third parties is to protect the assets of the estate to ensure a fair distribution of those assets in the future (see *Quigley Co., Inc. v. Angelos (In re Quigley Co., Inc.),* 676 F.3d 45, 57 (2d. Cir. 2012)). While bankruptcy courts clearly have jurisdiction to approve settlements of a debtor's claims, their jurisdiction over third parties is less clear. The SDNY Bankruptcy Court recently found that it had a duty to consider its **subject matter jurisdiction**, even in the absence of any objection by a **party in interest** (see *In re SunEdison, Inc.*, 576 B.R. at 455).

The Second Circuit has held that "a bankruptcy court only has jurisdiction to enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate" (*Travelers Cas. & Sur. Co. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.)*, 517 F.3d 52, 66 (2d Cir. 2008), *rev'd on other grounds and remanded*, *Travelers Indem. Co. v. Bailey*, 557 U.S. 137 (2009)). In a later decision, the Second Circuit explained that "the touchstone for bankruptcy jurisdiction remains whether its outcome

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may have any conceivable effect on the bankruptcy estate" (*In re Quigley Co., Inc.,* 676 F.3d at 57). For example, while claims against parties having indemnification rights against the debtor could give rise to jurisdiction, this is not sufficient when the proposed releases are much broader than those claims (see *In re SunEdison, Inc*., 576 B.R. at 462-63).

While courts often consider whether they have jurisdiction over non-debtors when evaluating third-party releases, a full discussion of jurisdictional issues is beyond the scope of this Note. For more information on bankruptcy court jurisdiction, see Practice Note, Bankruptcy Basics: What Commercial Litigators Need to Know: Bankruptcy Court Jurisdiction.

Constitutional Authority

The US District Court for the District of Delaware recently denied without prejudice a debtor's motion to dismiss an appeal of a confirmation order as **equitably moot** without the bankruptcy court first determining whether it had, under the US Supreme Court's decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011), constitutional authority to approve non-consensual third-party releases in a plan (see *Opt-Out Lenders v. Millennium Lab Holdings II, LLC (In re Millennium Lab Holdings II, LLC)*, 242 F. Supp.3d 322 (D. Del. 2017) and Legal Update, In re Millennium Lab Holdings II, LLC: District Court Remands Appeal for Failure to Consider Constitutional Adjudicatory Authority to Under Stern to Approve Non-Consensual Third-Party Releases). The district court remanded the case to the bankruptcy court to rule on this issue.

The bankruptcy court later ruled that bankruptcy courts have the constitutional adjudicatory authority under *Stern* to approve nonconsensual third-party releases of non-bankruptcy claims in connection with plan confirmation (see *In re Millennium Lab Holdings II, LLC*, 575 B.R. 252, 275-85 (Bankr. D. Del. 2017) and Legal Update, In re Millennium Lab Holdings II, LLC: Bankruptcy Court Had Constitutional Adjudicatory Authority Under Stern to Approve Nonconsensual Third-Party Releases). The Third Circuit and the Delaware District Court affirmed (see *In re Millennium Lab Holdings II, LLC*, 945 F.3d 126, 137-40 (3d Cir. 2019); *Opt-Out Lenders v. Millennium Lab Holdings II, LLC (In re Millennium Lab Holdings II, LLC)*, 591 B.R. 559, 573-77 (D. Del. 2018)).

The SDNY District Court agreed with the Third Circuit and the Delaware District Court that bankruptcy courts have constitutional power to approve third-party exculpation and injunction provisions in a Chapter 11 plan that are necessary to the operation of that plan (see *Lynch v. Lapidem Ltd. (In re Kirwan Offices S.A.R.L.)*, 592 B.R. 489, 509-12 (S.D.N.Y. 2018)).

For more information on *Stern v. Marshall*, see Legal Update, Stern v. Marshall – Supreme Court Limits Bankruptcy Court's Powers to Adjudicate Debtors' Counterclaims.

Res Judicata

Because courts favor finality, a third-party release in a confirmed plan of reorganization is likely to be upheld even if it was improperly granted, under the doctrine of **res judicata**. For example, the US Supreme Court has held that *res judicata* bars a collateral attack on a court's jurisdiction when a party had the opportunity to raise jurisdictional issues but failed to do so (see *Travelers Indem. Co. v. Bailey,* 557 U.S. 137, 153-54 (2009); *Stoll v. Gottlieb,* 305 U.S. 165, 176 (1938)).

Circuit courts have similarly ruled that *res judicata* barred collateral attacks on third-party releases in confirmed plans to preclude arguments that parties could have raised before confirmation concerning the bankruptcy court's jurisdiction or the propriety of the release on other grounds (see *Corbett v. MacDonald Moving Servs., Inc.,* 124 F.3d 82, 88-89 (2d Cir. 1997);

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Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d at 983-84; *Republic Supply Co. v. Shoaf,* 815 F.2d 1046, 1051-54 (5th Cir. 1987)). The Third Circuit has held that third party releases in a confirmed plan can bar liability for post-confirmation acts and bind post-confirmation purchasers of the debtor's stock under the doctrine of *res judicata* (see *Zardinovsky v. Arctic Glacier Income Fund (In re Arctic Glacier Int'l, Inc.)*, 901 F.3d 162, 166-68 (3d Cir. 2018)).

However, the US Bankruptcy Court for the District of New Jersey stated in dicta that it "disagrees with those circuits which hold that confirmation of a reorganization plan may discharge a non-debtor under principles of *res judicata*" (*In re Arrowmill Dev. Corp.*, 211 B.R. at 507 n.12). This court held that voting in favor of a plan was not a sufficient manifestation of affirmative consent to a third-party release (see Voting in Favor of a Plan). The Fifth Circuit also declined to apply *res judicata* to uphold an improperly granted third-party release (see *Hernandez v. Larry Miller Roofing, Inc.*, 628 F. App'x at 288-89).

A full discussion of *res judicata* is beyond the scope of this Note.

Strategies

Proponents of third-party releases should consider the following strategies:

- Clarify that consent was given by using a form of ballot with a separate box where creditors could accept or reject the third-party release, as courts are more likely to approve third-party releases if they are consensual (see Consensual Third-Party Releases). Ensure that the ballot clearly explains how to give consent. For example, specify whether a creditor has consented to the release if it fails to vote on the plan, or if it votes in favor of the plan but fails to make an election on the release.

- If the released party provides additional consideration to creditors who agree to the release to supplement the distribution these creditors receive under the plan, a court is more likely to view the third-party release as a valid contractual arrangement rather than as a prohibited discharge of a third party under the plan.

- Provide adequate notice of the release in the plan and disclosure statement, using conspicuous language (bold, italic, or underlined text) to describe the nature of the release and specifically identify the entities subject to the release (see Procedural Requirements). Include the description of the proposed releases in the executive summary of the plan and in the ballots. If the releases are consensual, explain how to opt in or opt of the release. If the releases are non-consensual, explain the need for the releases, focusing on the applicable circuit law.

- Because third-party releases are easier to obtain in some jurisdictions than in others and some circuits do not allow non-consensual third-party releases at all (see Non-Consensual Third-Party Releases), consider this factor when making or challenging a case **venue** decision (see Practice Note, Venue in Bankruptcy Proceedings).

- Ensure that third-party releases are narrowly tailored and limited to matters related to the reorganization.

ABI Commission Recommendations on Third-Party Releases

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The ABI Commission to Study the Reform of Chapter 11 has determined in its Final Report and Recommendations that a blanket prohibition on third-party releases was inadvisable, but also recognized that they may not always be appropriate.

The Commission considered and rejected the seven-factor test for evaluating third-party releases adopted by the Sixth Circuit in *In re Dow Corning* (see Sixth Circuit). It instead came out in favor of the five-factor *Master Mortgage* test (see Master Mortgage Test). The Commission specifically emphasized the last factor of the *Master Mortgage* test (whether the plan provides a mechanism to pay for all, or substantially all, of the claims of the class or classes affected by the release) and declined to incorporate a separate requirement of unique or unusual circumstances.

(See Final Report and Recommendations, VI.E.3).

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