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Views from the Bench, 2018

Current Issues Involving Third-Party Releases

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U.S. Bankruptcy Court (E.D. Pa.); Philadelphia

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U.S. Bankruptcy Court (D. N.J.); Trenton

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Views from the Bench 2018: Current Issues Involving Third-Party Releases

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Introduction

**American Bankruptcy Institute's *Bankruptcy 2018: Views from the Bench*
Georgetown University Law Center
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- This panel will address a number of current, vital issues concerning the use and permissibility of third-party releases in the context of chapter 11 plans.
- Our panelists:
 - Hon. Ashely M. Chan (U.S. Bankruptcy Court for the Eastern District of Pennsylvania)
 - Hon. Stacey L. Meisel (U.S. Bankruptcy Court for the District of New Jersey)
 - Hon. Michael B. Kaplan (U.S. Bankruptcy Court for the District of New Jersey)
 - Paul M. Basta (*Moderator*), Paul, Weiss, Rifkind, Wharton & Garrison LLP
 - Karen A. Giannelli (*Facilitator*), Gibbons P.C.

Overview – Releases, Exculpation, and Injunctions

- Plans of reorganization typically provide for various releases of liability, including:
 - releases of claims held by the debtor's estate;
 - releases of claims held by third parties; and
 - the exculpation of certain parties for actions taken during the chapter 11 case.
- In order to enforce this relief, plans include injunction provisions, which function to prevent parties from prosecuting claims that were released by the release and exculpation provisions.
- This panel will focus on issues relating to releases of claims held by third parties – “third-party releases.” A brief overview of debtor releases and exculpation provisions, however, will provide useful context.

Overview – Debtor Releases

- **Debtor / Estate Releases:** Pursuant to section 1123(b)(3)(A) of the Bankruptcy Code, a plan of reorganization may provide for “the settlement or adjustment of any claim or interest belonging to the debtor or to the estate.”
- Debtors may agree to release claims against creditors and other third parties in the context of settlement discussions or plan negotiations, in exchange for new value, or otherwise as consideration for a party's contribution to the reorganization of the debtor's estate.
- In assessing whether or not to grant a debtor release, courts consider whether the settlement is fair and equitable and in the best interest of the debtor's estate.
 - Typically, courts will apply the standard applicable to motions made pursuant to Bankruptcy Rule 9019 to determine whether the proposed settlement falls below the lowest point in the range of reasonableness.

Overview – Third-Party Releases

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- **Third-Party Releases:** A plan of reorganization may provide for the extinguishment of claims held by non-debtor third parties against other non-debtor third parties.
 - Third-party releases, like debtor releases, encourage contributions to the reorganization. Such releases may incentivize third parties to settle claims of importance to the estate, provide financing, or support the debtor's plan of reorganization.
 - Unlike debtor releases, there is no statutory predicate for third-party releases. Accordingly, third-party releases are normally subject to considerably greater scrutiny in chapter 11 cases as compared to debtor releases. Indeed, some Circuit Courts have held that non-consensual third-party releases are not permissible under the Bankruptcy Code.
 - Courts carefully consider whether the releases provided for in the plan are *consensual* or *non-consensual*. As we will explore, courts that do allow non-consensual third-party releases only grant them in extraordinary circumstances, if at all.
 - Among the Circuit Courts that have held that non-consensual third party-releases can be lawful, the courts agree that the granting of such releases is a fact-intensive inquiry, but they deploy different standards or multi-factor tests to determine permissibility.

Overview – Exculpation Provisions

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- **Exculpation Provisions:** Plans will typically include provisions that shield select parties from liability for their conduct in connection with the chapter 11 cases.
 - Generally, exculpated parties are limited to estate fiduciaries, including estate professionals, official committees and their membership, the debtor's senior management and directors, or the trustee (if applicable).
 - Release provisions serve to encourage settlement and contribution among debtors, creditors, and other third parties.
 - "Exculpation provisions are frequently included in chapter 11 plans because stakeholders all too often blame others for failures to get the recoveries they desire; seek vengeance against other parties; or simply wish to second guess the decisionmakers in the chapter 11 case." *In re DBSD N. Am., Inc.*, 419 B.R. 179, 219 (Bankr. S.D.N.Y. 2009).

Legality of Third-Party Releases: A Circuit Split

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- Unlike debtor releases, which are permitted as components of plans of reorganization pursuant to section 1123(b)(3)(A) of the Bankruptcy Code, there is no direct statutory basis for the permissibility of third-party release provisions.
 - Courts that hold that third-party releases are lawful rely on section 105(a) of the Bankruptcy Code, which affords bankruptcy courts the broad power to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [title 11].”
 - These sweeping equitable powers are not unlimited, however; courts may not grant relief that runs contrary to the provisions of the Bankruptcy Code.
 - Courts that prohibit non-consensual third-party releases maintain that such releases run afoul of section 524(e), which 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.”
 - These courts, which include the Fifth, Ninth, and Tenth Circuits, maintain that section 524(e) has a substantive effect: it precludes courts from granting releases of third parties without the affirmative consent of the releasing party, as such releases are tantamount to a discharge of non-debtors.
 - Courts that have permitted non-consensual third-party releases—including the Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits—construe section 524(e) more narrowly, as having a clarifying purpose. On this view, section 524(e) simply provides that a debtor’s discharge does not affect the liability of any third parties; it does not, by its terms, prohibit courts from approving provisions that release claims against third parties.
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Consensual vs. Non-consensual Third-Party Releases

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- While non-consensual third-party releases are permissible in certain Circuits, courts are disinclined to grant them barring extraordinary circumstances. The same courts generally allow consensual third-party releases, since they only bind those parties who have manifested their assent to the releases.
 - This raises a widely-debated question: what does it mean for a release to be “consensual” as opposed to “non-consensual”?
 - *Voting on a Chapter 11 Plan as Evidence of Consent*
 - Courts have held that voting in favor of a plan that includes a third-party release is sufficient evidence of the voting claimant’s consent to be bound by the release. *See, e.g., In re Coram Healthcare Corp.*, 315 B.R. 321, 336 (Bankr. D. Del. 2004).
 - Some courts, however, have held that simply voting for a plan that contains third-party release provisions is inadequate to establish consent. *See, e.g., In re Arrowmill Dev. Corp.*, 211 B.R. 497, 507 (Bankr. D.N.J. 1997) (finding that, for purposes of establishing consent to a third-party release, “[i]t is not enough for a creditor to abstain from voting for a plan, or even to simply vote “yes” as to a plan)
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Consensual vs. Non-consensual Third-Party Releases (cont'd)

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- *Abstention and Failure to “Opt out” or Object*
 - Courts are split across circuits, and even within districts, regarding whether abstention from voting (or, in some cases, marking an “opt-out” box) constitutes consent,
 - Compare *In re Indianapolis Downs, LLC*, 486 B.R. 286, 306 (Bankr. D. Del. 2013) (concluding that third-party releases were consensual where creditors had the option to affirmatively opt-out and received notice that abstention constituted consent) with *In re Washington Mutual, Inc.*, 442 B.R. 314, 355 (Bankr. D. Del. 2011) (finding that the proposed opt-out mechanism for a third-party release was inadequate, and holding that the “fail[ure] to return a ballot is not a sufficient manifestation of consent to a third-party release.”).
 - Courts are also divided on the issue of whether unimpaired creditors are deemed to consent to third-party releases unless they affirmatively object to the releases contained in the plan.
 - Compare *In re Spansion, Inc.*, 426 B.R. 114, 144 (Bankr. D. Del. 2010) (finding consent to the third-party release by unimpaired creditors where no member of the class raised objections) with *In re Washington Mutual, Inc.*, 442 B.R. 314, 355 (Bankr. D. Del. 2011) (holding that creditors who were not entitled to vote were not bound by the third-party release provisions).

Consensual vs. Non-consensual Third-Party Releases (cont'd)

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- **Discussion topic:** At bottom, the question for courts in assessing whether a third-party release is “consensual” or “non-consensual” is whether “consent” can be inferred from a creditor’s failure to act (whether it’s abstaining from voting, failing to return a ballot with a marked “opt-out” box, or, for unimpaired creditors, failing to object to the releases at confirmation).

Bankruptcy Court Jurisdiction over the Approval of Non-consensual Third-Party Releases

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- Recently, bankruptcy courts have had to address whether they have subject matter jurisdiction (and constitutional authority, following *Stern*) to approve non-consensual third-party releases.
 - In *In re Millennium Lab Holdings II, LLC et al.*, 575 B.R. 252 (Bankr. D. Del. 2017), the Bankruptcy Court for the District of Delaware, on remand from the District Court, held that it had subject matter jurisdiction over non-consensual third-party releases contained in the debtors' plan of reorganization, finding that the operative proceeding before the court was the confirmation of the plan – a “core” proceeding enumerated in 28 U.S.C. § 157(b)(2)(L). *Id.* at 261-62.
 - Relatedly, the *Millennium* court also held that it had the constitutional authority to approve the releases; this issue is currently the subject of an appeal in the District Court of Delaware.
 - In *In re SunEdison, Inc.*, 576 B.R. 453 (Bankr. S.D.N.Y. 2017), the Bankruptcy Court for the Southern District of New York *sua sponte* examined whether it had subject matter jurisdiction to approve the third-party releases contained in the debtors' plan. *See id.* at 457. For purposes of its jurisdictional analysis, the *SunEdison* court did not consider plan confirmation to be the operative proceeding, but rather, considered whether it had jurisdiction over *the potential proceedings implicated by* the non-consensual third-party releases. *See id.* at 461-62.
 - The court held that the scope of the releases were “much broader than the indemnification obligations the Debtors contend support it,” including (i) causes of action that extend beyond such obligations and (ii) released parties that “added nothing to the cases.” *Id.* at 463.
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Bankruptcy Court Jurisdiction over the Approval of Non-consensual Third-Party Releases (cont'd)

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- Accordingly, the *SunEdison* court found that the debtors failed to meet their burden to prove that the court had subject matter jurisdiction to approve the releases.
 - **Discussion topic:** What are the practical and policy implications if bankruptcy courts lack jurisdiction or the constitutional authority to approve non-consensual third-party releases?
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