AMERICAN BANKRUPTCY INSTITUTE

# 2018 New York City Bankruptcy Conference

# Third-Party Releases

CONCURRENT SESSION


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This panel will discuss Chapter 11 Plan Releases, including recent decisions in the *Millennium Lab* and *SunEdison* cases.

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# Chapter 11 Plan Releases

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## Introduction[1]

There was a time not too long ago when feasibility, value, classification, and cram-down issues were the *sine qua non* of a contested chapter 11 plan confirmation hearing. The focus was on the evidence necessary to prove up the requirements of section 1129 of the Bankruptcy Code.

Fast forward to 2017 and now 2018. The focus of contested confirmation hearings has shifted from the traditional reorganization-driven issues of section 1129, to the resolution of disputes over the propriety of release and exculpation provisions that are now found in virtually every chapter 11 plan.

There are any number of reasons for this shift. First, and foremost, the shift in the focus of confirmation litigation reflects the way chapter 11 practice has changed over the years.[2] Second, modern, complex capital structures have increased the likelihood of inter-creditor disputes playing themselves out in the milieu of chapter 11. Third, the way claims are owned has changed. Trade claims are bought and sold, so that the holders of similarly situated claims will have a purely financial stake in the outcome of a chapter 11 case and no preexisting or business relationship to the debtor or its other stakeholders. Funded debt, whether public or private, readily changes hands, so that the owners of the different pieces of debt may have purchased their piece of the debt at different prices and therefore have different goals and competing interests with respect to a restructuring process that will play itself out in the context of a chapter 11 case. Fourth, in the past, most funded debt was held institutionally and by traditional lenders. Presently, hedge funds and private equity firms dominate the capital stack. Hedge funds and PE firms behave differently than traditional lenders. Fifth, litigation risk is "top of mind" in virtually every reorganization case. We do live in a litigious society. This is by no means an exhaustive list of reasons for the shift.

Today, chapter 11 plans, in addition to affording relief to debtor entities by enjoining future actions against them as reorganized debtors or against their successors in interest (such as a liquidation or creditors trust), typically contain three forms of relief from actual or potential liability in favor of non-debtors: (a) estate releases, (b) third party releases, and (c) exculpation provisions crafted to provide qualified immunity for actions taken during the administration of a chapter 11 case. The discussion that follows addresses each of these forms of relief and the reasons they should or should not be "blessed" by a bankruptcy court in the context of plan confirmation.

### Estate Releases

An estate release extinguishes claims held by the debtor(s) against identified non-debtor parties.

The claims subject to an estate release may arise before or during the administration of a chapter 11 case.

An estate release may be drawn in favor of creditors, other capital providers, directors, officers, employees, and advisors who have contributed to the reorganization (e.g., by participating in a broader settlement, supporting the plan, accepting a discount on their claims, or funding the plan).

An estate release provides an incentive for non-debtor parties to contribute to a reorganization effort (or at least not oppose that effort).

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[1] The opinions expressed are those of the author and do not necessarily reflect the views of the firm, its clients, or any of its or their respective affiliates. These materials are for general informational purposes and are not intended to be and should not be taken as legal advice.

[2] *See generally* Comm'n to Study the Reform of Ch. 11, Am. Bankr. Ins., Final Report & Recommendations (2014).

An estate release often is included as a key element of a Plan/Restructuring Support Agreement negotiated pre-petition.

Estate releases generally are not controversial, as they are specifically authorized by Bankruptcy Code section 1123(b)(3)(A).

As a rule, courts evaluate a proposed estate release using the standard employed for approving settlements under Bankruptcy Rule 9019. Therefore, absent unusual circumstances, a court will approve an estate release, unless the decision to authorize the release falls below the lowest point in the range of reasonableness.[3]

## Third Party Releases

Third Party Releases extinguish claims held by non-debtor third parties against other non-debtor third parties.

Third Party Releases may be drawn in favor of creditors and other parties who have contributed to a reorganization.

Claims subject to Third Party Releases may arise before a filing or during the pendency of a chapter 11 case.

A Third Party Release may be used as an incentive for non-debtor parties to settle claims, support a plan of reorganization, provide funding to effectuate a plan of reorganization, or otherwise contribute to a reorganization effort.

A Third Party Release may be consensual or non-consensual. In this context, the consent referenced is that of the party whose rights are being terminated by virtue of the Third Party Release.

Courts, as will be discussed in detail below, scrutinize the propriety of consensual and non-consensual Third Party Releases very differently.

Not all courts will confirm a plan of reorganization that includes a Third Party Release. Rather, the Circuit Courts and the lower courts in the Circuits that have not decided the issue are split on the question of whether bankruptcy courts may confirm a plan of reorganization that includes Third Party Releases.

Courts that will confirm a plan that includes Third Party Releases may restrict the use and scope of such releases, especially when the releases are non-consensual releases.

There is a rapidly growing body of case law regarding the appropriateness of confirming a plan of reorganization that includes non-consensual Third Party Releases. Similarly, there is a growing body of case law concerning consent. What constitutes consent? Can consent be inferred? Can consent be obtained by providing negative notice or by a failure of a party provided with notice to affirmatively opt out?

## Exculpation

Exculpation is designed to provide qualified immunity for actions taken during the administration of a chapter 11 case, although pre-petition acts relating to the reorganization usually are included in a proposed exculpation. The obvious examples of pre-petition conduct that may be subject to exculpation include the formulation, negotiation, and implementation of the plan of reorganization a court will be asked to confirm, the RSA, PSA, or similar agreement, and other matters directly relating to a proposed reorganization.

[3] *E.g.*, *In re Capmark Fin. Grp. Inc.*, 438 B.R. 471, 514–15 (Bankr. D. Del. 2010).

The beneficiaries of exculpation generally are "estate fiduciaries," including estate professionals, official committees and their members, and a debtor's directors, officers, and key employees.

Claims asserted against estate fiduciaries for fraud, gross negligence, and willful misconduct are carved out and are not subject to exculpation.

An exculpation provision is used to protect estate fiduciaries in the exercise of their duties. Generally, exculpation provisions are crafted consistent with the applicable governance standards to which estate fiduciaries are held in connection with activities that are part of the chapter 11 process and in particular with regard to the administration of a case. Thus, generally, the business judgment rule will apply in most jurisdictions, including New York and Delaware, but if the plan includes a self-interested transaction, then the heightened "entire fairness" standard likely would be applicable.[4]

## Understanding the Difference Between Consensual and Non-Consensual Third Party Releases

Third Party Releases have to be divided into two sub-types: consensual and non-consensual.

This is a very important distinction.

A consensual Third Party Release may look like this:

"Upon the Effective Date, in consideration for the obligations of the Debtors and Reorganized Debtors under the Plan . . . to be delivered in connection with the Plan, all Holders of Claims or Equity Interests ***that vote in favor of the Plan*** shall be deemed to unconditionally, forever release all claims . . . against [(i) any individual serving on the Confirmation Date as an officer, director, or manager of any of the Debtors . . . (iii) the Prepetition Lenders . . . (v) the Plan Proponents . . . .]"

A non-consensual Third Party Release may look like this:

"Upon the entry of the Confirmation Order, for good and valuable consideration . . ., ***to the fullest extent permitted under applicable law*** . . . ***each Holder of a Claim or Equity Interest that has received distribution(s) made under the Plan*** . . . shall be deemed to have . . . forever released . . . the Released Liabilities against [the Committee, the Pre-Petition Lenders, the Agent, the D&Os, and the Debtors] . . . and forever covenanted . . . not to sue, assert any claim, causes of action, or liabilities against or otherwise seek recovery from any of the [Released Parties]."

## Consensual Third Party Releases

A party is deemed to consent to Third Party Releases embedded in a plan of reorganization if it affirmatively votes to accept or reject the plan and does not opt out of granting the proposed releases. What happens, however, if a creditor

[4] *See Erie Cty. Emps. Ret. Sys. v. Blitzer (In re Kenneth Cole Prods., Inc.)*, 52 N.E.3d 214, 274–75 (N.Y. 2016) (stating "the substantive determination of a committee of disinterested directors is beyond judicial inquiry under the business judgment rule, but that 'the court may inquire as to the disinterested independence of the members of that committee and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee,'" such that certain transactions may be subject to the entire fairness doctrine); *Chen v. Howard-Anderson*, 87 A.3d 648, 666–67 (Del. Ch. 2014) (discussing the application of the different "tiers of review," including the business judgment rule and the entire fairness doctrine); *In re Innkeepers USA Tr.*, 442 B.R. 227, 231 (Bankr. S.D.N.Y. 2010) (citations omitted) (noting disagreement between the parties regarding whether the debtors' assumption of the PSA was subject to the business judgment rule or the "heightened scrutiny" of the entire fairness doctrine, "which closely examines transactions involving insiders," and suggesting the entire fairness doctrine "may apply in this situation," but declining to decide which standard is applicable because the debtors failed to satisfy either standard).

is solicited and does not return a ballot, either when (a) such creditor is impaired, but fails to vote and opt out of a proposed release; or (b) such creditor is unimpaired and is deemed to accept the proposed plan of reorganization pursuant to section 1126(f) of the Bankruptcy Code? An impaired creditor's voting failure can be deemed consent if adequate notice of the releases and detailed opt-out instructions are provided.[5]

"[S]imply classifying a party as unimpaired does not mean that they should be somehow automatically deemed to grant a release . . . ."[6]

"Failing to return a ballot is not a sufficient manifestation of consent to a third party release."[7]

**Unimpaired Creditors Deemed to Accept**

Unimpaired creditors are deemed to accept a Third Party Release proposed in a plan of reorganization as a quid pro quo for the payment in full of their claims.[8]

In order to provide creditors adequate notice of a proposed Third Party Release:

(i) highlight the release provision in the plan and disclosure statement by using **bold** text; and

(ii) explain to voters on the ballot, in **bold** and CAPITALIZED text, the effect a failure to vote will have.

In *In re SunEdison*,[9] Judge Bernstein considered whether the non-voting releasors consented to the releases. The debtors contended that the "conspicuous warning" in the disclosure statement and on the ballots was sufficient to find "deemed consent." The court found the argument unpersuasive, stating that absent a duty to speak, a party's silence cannot be translated into consent, and the debtors failed to identify the source of any duty to speak by the non-voting releasors.

In the aftermath of Judge Bernstein's decision in *SunEdison*, Judge Silverstein, sitting in the Bankruptcy Court for the District of Delaware, addressed the notice the debtors proposed giving with respect to a proposed Third Party Release. The colloquy below illustrates the concerns courts may have regarding the adequacy of notice in the form proposed by plan proponents.[10]

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[5] *In re Indianapolis Downs, LLC*, 486 B.R. 286, 304–06 (Bankr. D. Del. 2013); *In re DBSD N. Am., Inc.*, 419 B.R. 179, 218–19 (Bankr. S.D.N.Y. 2009), *aff'd on other grounds*, No. 09 CIV. 10156 (LAK), 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in part and rev'd in part on other grounds*, 634 F.3d 79 (2d Cir. 2011); *In re Calpine Corp.*, No. 05-60200 (BRL), 2007 WL 4565223, at *10 (Bankr. S.D.N.Y. Dec. 19, 2007).

[6] *In re Genco Shipping & Trading Ltd.*, 513 B.R. 233, 270 (Bankr. S.D.N.Y. 2014).

[7] *In re Washington Mut., Inc.*, 442 B.R. 314, 355 (Bankr. D. Del. 2011) (Walrath, J.). *Compare Washington Mut.*, 442 B.R. at 352 (non-consensual releases must be by specific consent either by contract or in the ballot used for voting on the plan), *with Indianapolis Downs*, 486 B.R. at 305–06 (taking a more "flexible approach in evaluating whether a third party release was consensual," so that creditors who "were provided detailed instructions on how to opt out," but did not, were consensually bound by the releases), *and DBSD N. Am.*, 419 B.R. at 218–19 (consent implied by voting yes or by abstaining and failing to opt out); *In re Conseco, Inc.*, 301 B.R. 525, 528 (Bankr. N.D. Ill. 2003) (consensual release bound only those creditors who voted for the plan or failed to opt out of the release). *See generally* Hesse, "Silence as Deemed Consent to Voluntary Third-Party Releases in a Chapter 11 Plan," 30-2 Am. Bankr. Inst. J. 50 (2011).

[8] *Indianapolis Downs*, 486 B.R. at 306; *U.S. Bank Nat'l Ass'n v. Wilmington Tr. Co. (In re Spansion, Inc.)*, 426 B.R. 114, 144 (Bankr. D. Del. 2010).

[9] 576 B.R. 453 (Bankr. S.D.N.Y. 2017).

[10] Transcript 19:10–22:2, *In re Panda Temple Power, LLC*, No. 17-10839 (LSS) (Bankr. D. Del. June 29, 2017) [Docket No. 238].

*IN RE: PANDA TEMPLE POWER, LLC, et al,.*
Case No. 17-10839(LSS) Tuesday, June 27, 2017

TRANSCRIPT OF DISCLOSURE STATEMENT HEARING
BEFORE THE HONORABLE LAURIE SELBER SILVERSTEIN
UNITED STATES BANKRUPTCY JUDGE

THE COURT: Okay. The ballot that is Exhibit 3(c), which is a ballot for holders of Class 7, old parent interests.
(Pause in proceedings)
THE COURT: So my first question, again, is: Why is this a ballot? Because they're not voting on anything. And I don't know that there's another term, but it just -- when I hear the term "ballot," it makes me think that I'm voting on something, and I don't think they're doing that.
MS. REILLY: And then we can revise to call it, you know, an "opt-out notice," or something like that.
THE COURT: Okay. And then the first thing you see, in bold, which has really any kind of explanation, is on Page 2. And what's emphasized there is that, by checking the box, you will not receive a release. That's the first thing that's done. But there's nothing that emphasizes that you will be giving a release, more importantly, or as importantly. So I

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don't know. And maybe people think that this is the right thing to emphasize, and I'll let the U.S. Trustee raise it, and I'll, you know, weigh on that.
I do think both are important; that, even though you're not voting, and even though you're not getting anything under the plan, you are giving a release, and who you're giving it to, in some kind of English language thing, which I don't really see; and who are you -- who are they getting a release from, in English language, so they can evaluate whether or not they want to do that.
But I guess we don't get to the fact that you're giving one until -- I mean, I don't think a person who opens this just say, oh, third-party release, I know what that means. So where does it actually say, in English, that they're giving a release?
MS. REILLY: Well, on Page 3, it says: "Check the box if you elect not to grant the third-party releases."
THE COURT: Yeah, but --
MS. REILLY: And --
THE COURT: -- that doesn't tell me what that is because, so far, all I've heard is, if I don't check the box to opt out, I will not receive a release. That's the bolded part on Page 2. Before you have to check the box, where does it

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tell you that what you're really opting out of is, not only not

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receiving a release, but giving a release? You're emphasizing a certain part, presumably to induce people to provide a release because they think they're getting one, and they don't -- shouldn't opt out of it. But where does it say they're giving one?

MS. REILLY: I mean --

THE COURT: And using the term "third-party release," to me, doesn't mean anything one way or the other.

(Participants confer)

MS. REILLY: Yeah. I mean, I think we -- the section on Page 3, we can move up, if it's helpful, where we say, if you fail to return the ballot, you'll be deemed to have consented to the third-party release. You know, then: "Please be advised that, by returning the ballot and not checking the box below or failing to return the ballot, you elect to grant the third-party release."

THE COURT: Yeah. But I think, somewhere before that, you need to explain that, by that, you mean they are giving a release to people, just like you said here, you will not receive a release. But we haven't said, anywhere, you're giving one, and who you're giving it to. And that's about as English language as we get, actually, is the bolded sentence on Page 2. And we don't have an equivalent English language sentence that explains to people they're actually providing a release, unless they check the box.

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MS. REILLY: Okay. We can add additional language in that section, on Page 2.

**Non-Consensual Releases**

The courts are split on the issue of whether bankruptcy courts can confirm a plan of reorganization that includes Third Party Releases.

The Fifth, Ninth, and Tenth Circuits have held that Bankruptcy Code section 524(e) specifically prohibits Third Party Releases (the "Minority View").

The Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits have held that Third Party Releases are permissible in certain circumstances (the "Majority View").

Lower court decisions in the First, Eighth, and D.C. Circuits indicate agreement with the Majority View.

The D.C. Circuit has permitted consensual Third Party Releases and not ruled on non-consensual Third Party Releases.[11]

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[11] *See In re AOV Indus., Inc.*, 792 F.2d 1140, 1143, 1145–46 (D.C. Cir. 1986) (finding the bankruptcy court had jurisdiction to, *inter alia*, approve a chapter 11 plan, including its release provisions pursuant to which unsecured creditors were required to release their claims against third parties in order to receive distributions under the plan).

Courts following the Minority View base their refusal to confirm plans that include Third Party Releases on the language of Bankruptcy Code section 524(e).[12]

Bankruptcy Code section 524(e) provides that "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." 11 U.S.C. § 524(e).

Further, under the Minority View, the general equitable powers granted to bankruptcy courts by Bankruptcy Code section 105(a) ***do not*** permit a bankruptcy court to approve Third Party Releases as a means to circumvent the Bankruptcy Code section 524(e) prohibition.[13] However, as discussed in detail below, even the Ninth Circuit, a court that follows the Minority Rule, has found justification to allow Third Party Releases, not under Bankruptcy Code section 524(e), but under provisions of the Bankruptcy Code or Bankruptcy Rules.[14]

Courts following the Majority View hold that Third Party Releases are permissible under certain circumstances and interpret Bankruptcy Code section 524(e) as merely providing that a debtor's discharge in bankruptcy does not affect the liability of third parties. Therefore, Bankruptcy Code section 524(e) does not limit a bankruptcy court's ability to approve a Third Party Release.[15]

Courts following the Majority View also rely on the "broad authority" granted to bankruptcy courts by Bankruptcy Code section 105(a) to "reorder creditor-debtor relations needed to achieve a successful reorganization."[16] Among other things, "enjoining claims against a non-debtor so as not to defeat reorganization is consistent with the bankruptcy court's primary function."[17]

The Majority View is not a broad rule sanctioning all Third Party Releases. Rather, Third Party Releases, as one court stated, are to be approved only in "unusual circumstances."[18] In practice, plan proponents have aggressively pursued the sanction of Third Party Releases, so that stating that Third Party Releases are only available in "unusual circumstances" may overstate the limits courts currently place on the allowance of Third Party Releases.

The Sixth Circuit proposed a multi-factor test (the "*Dow* Factors") (as discussed below) and held that if a bankruptcy court found all of the *Dow* Factors to be present, the bankruptcy court could enjoin a non-consenting creditor's claims against a non-debtor.[19]

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[12] *See, e.g.*, *Bank of New York Tr. Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 252 (5th Cir. 2009) (holding that the plan could not be confirmed with non-consensual non-debtor releases); *Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401–02 (9th Cir. 1995) (same); *see also Landsing Diversified Properties-II v. First Nat'l Bank & Tr. Co. of Tulsa (In re W. Real Estate Fund, Inc.)*, 922 F.2d 592, 601–02 (10th Cir. 1990) (holding that Bankruptcy Code section 524(e) prohibits a discharge of a non-debtor for liability owed to a creditor).

[13] *See Am. Hardwoods, Inc. v. Deutsche Credit Corp. (In re Am. Hardwoods, Inc.)*, 885 F.2d 621, 626 (9th Cir. 1989) ("Section 524(e), therefore, limits the court's equitable power under section 105 to order the discharge of the liabilities of nondebtors . . . .").

[14] *See* pp. 13–14, *infra*.

[15] *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 657 (6th Cir. 2002); *see also In re Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993) (concluding that Bankruptcy Code section 524(e) "does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party").

[16] *Dow Corning*, 280 F.3d at 656.

[17] *Id.*

[18] *Id.* at 658; *see also Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 143 (2d Cir. 2005) (holding that a "nondebtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to the success of the plan").

[19] Note that other bankruptcy courts have applied the substantially similar multi-factor test set forth in *In re Master Mortg. Inv. Fund, Inc.*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994) (such test, the "*Master Mortgage* Factors") to evaluate whether a Third Party Release

The Fourth and Eleventh Circuits have adopted the *Dow* Factors when determining whether a Third Party Release is permissible;[20] however, each of the *Dow* Factors is not necessary in every case to grant a Third Party Release.[21]

**The *Dow* Factors**

The *Dow* Factors are as follows:

1) an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;
2) the non-debtor has contributed substantial assets to the reorganization;
3) the injunction is essential to 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;
4) the impacted class, or classes, has overwhelmingly voted to accept the plan;
5) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction;
6) the plan provides an opportunity for those claimants who choose not to settle to recover in full; and
7) the bankruptcy court made a record of specific factual findings that support its conclusions.

In *Dow*, the Sixth Circuit held that the record produced by the bankruptcy court ***did not*** support a finding of "unusual circumstances" warranting the approval of a Third Party Release, since the bankruptcy court provided no explanation or discussion of the evidence underlying the *Dow* Factors and did not discuss specific facts as they related to the released parties.[22]

In *National Heritage Foundation*, the Fourth Circuit applied each of the *Dow* Factors to a proposed Third Party Release and affirmed the lower court's holding that only the first *Dow* Factor was present, the debtors having failed to present sufficient evidence to prove the other *Dow* Factors.[23] However, the Fourth Circuit did note that a "debtor need not demonstrate that every [*Dow* Factor] weighs in its favor" for a Third Party Release to be approved. However, the Court went on to say, "a debtor must provide adequate factual support to show that the circumstances warrant such exceptional relief."[24]

The Seventh Circuit allows Third party Releases in appropriate circumstances, although it has eschewed use of the *Dow* factors and crafted its own multi-factor test (the "*Airadigm* Factors") for determining whether a Third Party Release is permissible: The Third Party Release must be (1) narrowly tailored, (2) must not constitute a "blanket immunity," and (3) must be essential to the debtor's reorganization.[25]

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is permissible. *See, e.g.*, Bench Ruling, *In re Millennium Lab Holdings II, LLC*, No. 15-12284 (Bankr. D. Del. Dec. 11, 2015) [Docket No. 206]; *In re U.S. Fidelis, Inc.*, 481 B.R. 503, 519 (Bankr. E.D. Mo. 2012).

[20] *See Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 348 (4th Cir. 2014); *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying., Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070, 1077 (11th Cir. 2015).

[21] *See* Slide 10 *infra*.

[22] *Dow Corning*, 280 F.3d at 658.

[23] *Nat'l Heritage Found.*, 760 F.3d at 351.

[24] *Id.* at 352.

[25] *Airadigm Commc'ns, Inc. v. FCC (In re Airadigm Commc'ns, Inc.)*, 519 F.3d 640, 657 (7th Cir. 2008); *see also In re Ingersoll, Inc.,* 562 F.3d 856, 864 (7th Cir. 2009) (applying the factors set forth in *Airadigm* and approving a Third Party Release).

In *Airadigm*, the Seventh Circuit Court of Appeals approved a Third Party Release in favor of the plan sponsor because:

(i) The Third Party Release was narrow, since it applied only to claims arising out of or in connection with the reorganization and did not apply to claims for "willful misconduct;"

(ii) The Third Party Release did not constitute a "'blanket immunity' for all times, all transgressions, and all omissions;" and

(iii) The bankruptcy court had found sufficient evidence to support the finding that the plan sponsor required the Third Party Release before it would provide the financing that was essential to the debtor's reorganization.[26]

Courts in the Third Circuit generally allow non-consensual Third Party Releases, subject to restrictions that have been developing in the case law.

In *Continental Airlines*, the Third Circuit reversed a decision approving Third Party Releases. In *Continental*, the plan proposed to release and permanently enjoin shareholder suits against certain of the debtor's present and former directors and officers.[27]

Specifically, the Third Circuit held that such releases "did not pass muster under even the most flexible tests . . . . The hallmarks of permissible non-consensual releases—fairness, necessity to the reorganization, and specific factual findings to support these conclusions—are all absent here."[28]

The District Court for the Eastern District of Pennsylvania in *Lower Bucks* explained the *Continental Airlines* hallmarks of "**necessity**" and "**fairness**" as follows:

(i) "necessity" comprises (a) a sufficient relationship between the success of the reorganization and the release and (b) the released party "provided critical financial contribution . . . necessary to make the plan feasible;" and

(ii) "fairness" comprises the non-consenting party was given "reasonable consideration in exchange for the release."[29]

Although the Third Circuit declined to create a bright-line rule for the allowance of Third Party Releases, the Court did discuss the factors providing the rationale for its decision to deny allowing the Third Party Release at issue, including:

- the lack of consideration given in exchange for the proposed releases;
- the lack of evidence that the success of the reorganization was related to the proposed releases;
- the directors and officers did not contribute financially to the plan;
- the plan would be feasible without the proposed releases;
- the lack of evidence of the prospect of future litigation sufficient to justify the proposed releases; and

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[26] *Airadigm,* 519 F.3d at 657.
[27] *See Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 214 (3d Cir. 2000).
[28] *Id*.
[29] *Bank of New York v. Becker (In re Lower Bucks Hosp.)*, 488 B.R. 303, 323–24 (E.D. Pa. 2013) (internal citations omitted).

- lack of "identity of interest" between the debtors and the directors and officers sufficient to justify the release.[30]

Bankruptcy courts in the Third Circuit have regularly been called upon to consider the permissibility of Third Party Releases.[31]

For example, in *Washington Mutual*, the bankruptcy court for the District of Delaware held that proposed Third Party Releases must be based on the "affirmativ[e] consent" of the releasing party and could not be non-consensual.[32]

In addition to various modifications to the Third Party Releases discussed below, the bankruptcy court in *Washington Mutual* held that it was not sufficient for a plan of reorganization to contain an opt-out for Third Party Releases.[33] Instead, the court held that Third Party Releases would only be effective where the releasing party both affirmatively voted in favor of the plan and did not opt-out of the release.[34]

**Judicial Authority and Jurisdiction: The *Millennium Lab* Case**

In *In re Millennium Lab Holdings II, LLC*, No. 15-12284 (Bankr. D. Del.), the Bankruptcy Court for the District of Delaware, in a bench ruling, confirmed the debtors' chapter 11 plan, overruling the objection of certain lenders to, among other things, the Third Party Releases in the plan.

**Factual Background**

Millennium was a San Diego-based provider of laboratory-based diagnostic testing services. A significant portion of its revenue was derived from Medicare/Medicaid reimbursements.

Early in 2012, DOJ began a multi-year investigation of billing practices, including allegations of Medicare fraud. In December 2014, DOJ provided notice it would pursue claims. In February 2015, Millennium was notified that its Medicare billing privileges would be revoked. Finally, in March 2015, DOJ filed a complaint against Millennium, asserting claims for violations of various federal laws.

In April 2014, Millennium completed a dividend recapitalization (while the DOJ investigation was ongoing). To complete the recapitalization, Millennium borrowed $1.825 billion from several lenders, including $106.3 million from certain investment funds and accounts managed by Voya Investment Management Co. LLC and Voya Alternative Asset Management LLC (collectively, "Voya"), under a senior-secured credit facility (the "Credit Agreement"). Millennium used $1.3 billion of the loan proceeds to fund a dividend to non-debtors Millennium Lab Holdings, Inc., and TA Millennium, Inc.

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30 *See Cont'l Airlines*, 203 F.3d at 214. Interestingly, in *Lower Bucks* the bankruptcy court used a different five factor test to determine the permissibility of the release, whether: (1) the released party made an important contribution to the reorganization; (2) the release was essential to confirmation of the plan; (3) a large majority of the creditors in the case approved the plan; (4) there was a close connection between the case against the third party and the debtor; and (5) the plan provided for the payment of substantially all of the affected claims. 488 B.R. at 323 (citing *In re S. Canaan Cellular Invs., Inc.,* 427 B.R. 44, 72 (Bankr. E.D. Pa. 2010)).

31 *See* pp. 10–13, *infra*, discussing the bankruptcy case of Millennium Lab Holdings II, LLC. *But see Washington Mut.*, 442 B.R. at 355; *Indianapolis Downs*, 486 B.R. at 304 ("Courts in this jurisdiction have consistently held that a plan may provide for a release of third party claims against a non-debtor upon consent of the party affected.").

32 *Washington Mut.*, 442 B.R. at 351, 355.

33 *Id.* at 355.

34 In *Millennium Lab*, the Bankruptcy Court for the District of Delaware, in a bench ruling, confirmed the debtors' chapter 11 plan, overruling the objection of certain lenders to, among other things, the Third Party Releases in the plan.

(collectively, the "Non-Debtor Equity Holders"). The DOJ and Millennium settled their litigation, with Millennium agreeing to pay $256 million, in exchange for regaining Medicare billing privileges.

Prior to filing its voluntary chapter 11, Millennium entered into an RSA, that among other things, provides for: the payment of $325 million by the Non-Debtor Equity Holders to Millennium; the conversion of the Credit Agreement into $600 million in new term loans; the transfer of Millennium's equity interests to the lenders; a full recovery for all creditors except the lenders; and third-party releases of Non-Debtor Equity Holders and Millennium's D&Os (the "Millennium Releases").

On November 10, 2015, Millennium filed its voluntary chapter 11 case, with a prepackaged plan (the "Millennium Plan"). Under the Millennium Plan, the lenders, including Voya, would receive allowed claims under § 502 and a *pro rata* share of:

(i) the new $600 million term loans;

(ii) 100% of the equity in reorganized Debtors; and

(iii) any recoveries from a trust created by the Millennium Plan to pursue Millennium's retained causes of actions.

Voya objected to confirmation based on inclusion of the Releases, arguing:

(i) the Bankruptcy Court lacks subject matter jurisdiction to grant non-consensual third-party releases;

(ii) the Millennium Releases are impermissible;

(iii) the Millennium Plan must permit parties to opt-out of the Millennium Releases; and

(iv) the Millennium Releases do not meet standards set forth in *Continental*, i.e., "fairness" and "necessity to the reorganization."

**The RICO Action**

Voya filed a complaint against the Non-Debtor Equity Holders in DCT asserting common law fraud and RICO claims, alleging the Non-Debtor Equity Holders:

(i) Orchestrated the Medicare fraud; and

(ii) Made false representations and warranties in the Credit Agreement that Millennium was not the subject of material litigation/ investigations and had not suffered a material adverse effect.

**The Rulings: From Bankruptcy Court to District Court and Back**

In oral ruling, the Bankruptcy Court held that it has jurisdiction to approve the Releases and that they were fair and necessary to the Debtors' reorganization, thereby satisfying the *Continental* standards.

The lenders subsequently sought certification directly to the Third Circuit with respect to, among other things, the issue of whether bankruptcy courts have the authority to release a third party's non-bankruptcy claims against non-debtors without the third party's consent.

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Specifically, the lenders challenged the bankruptcy court's authority under Article III of the Constitution in light of the Supreme Court's ruling in *Stern v. Marshall*,[35] that bankruptcy courts do not have constitutional authority to adjudicate "private rights."

The Bankruptcy Court agreed with the lenders that the question regarding the authority of bankruptcy courts to approve Third Party Releases warranted certification. However, the Third Circuit denied the petition for certification, and the appeal was subsequently docketed with the United States District Court for the District of Delaware.

On appeal, the lenders argued that the bankruptcy court lacked authority to release the lenders' direct, state law, and federal RICO claims against other non-debtors.

The district court agreed with the bankruptcy court that it had "related to" subject matter jurisdiction over the lenders' released claims. However, the district court held that the bankruptcy court must also have Article III authority to enter a final order discharging the lenders' non-bankruptcy claims against non-debtors without the lenders' consent. The district court ultimately declined to rule with respect to the bankruptcy court's constitutional authority because the bankruptcy court had not considered the issue and, therefore, the district court remanded the case to the bankruptcy court to make such a determination.

Notwithstanding the remand, the district court considered—and appeared to agree with—the lenders' arguments:

(i) The district court noted that, per the Supreme Court's ruling in *Stern*, the lenders' state law and RICO claims are non-bankruptcy claims between non-debtors and that the lenders "appear to be entitled to Article III adjudication" of such claims.

(ii) Thus, the district court was "persuaded" by the lenders' argument that the Third Party Release embodied in the plan is "tantamount to resolution of those claims on the merits" against the lenders.

(iii) Further, the district court was not persuaded by the debtors' argument that such a jurisdictional flaw could be remedied by de novo review of the Bankruptcy Court's decision to confirm the plan because there had been no adjudication on the merits of the claims released by the plan. Accordingly, the district court requested that the bankruptcy court consider, on remand, whether it has constitutional authority to approve the plan's Third Party Releases, and if it lacks such authority, to either submit proposed findings of fact and conclusions of law regarding the final disposition of the lenders' claims or strike the release of the lenders' claims.

In so ruling, the district court suggested that bankruptcy courts lack the constitutional authority under *Stern* to approve the non-consensual release of certain non-bankruptcy claims (here, common law fraud and RICO claims).

Bankruptcy courts may thereby be precluded from entering final orders approving Third Party Releases of such claims and an Article III court (i.e., a district court) would be required to review and adjudicate the merits of such claims before they could be released without the consent of the party asserting the claims.

Note that the debtors sought to dismiss the appeal as equitably moot due to the substantial consummation of the plan, but the district court held that it could not consider the debtors' equitable mootness challenge before it was determined whether there was a constitutional defect in the bankruptcy court's decision approving the Third Party Releases. However, the district court did not appear to foreclose the possibility of an equitable mootness argument being raised at a later point in the case, after the issue regarding the bankruptcy court's authority has been determined.

[35] 546 U.S. 462 (2011).

On remand, the Bankruptcy Court held it had constitutional authority to approve the Releases, but even if not, Voya waived and forfeited its *Stern* argument by failing to raise the issue at the confirmation hearing.

The Bankruptcy Court's rationale for this decision:

(i) "The operative proceeding for purposes of a constitutional analysis is confirmation of a plan;"

(ii) Under any interpretation of *Stern*, Bankruptcy Courts have Constitutional authority to approve non-consensual Third Party Releases;

(iii) Plan confirmation is a "quintessential 'core' proceeding" and a "matter[] of administration" that is "unique to bankruptcy cases;"

(iv) "[I]n confirming a plan, even one with releases, the judge is applying a federal standard;"

(v) The *Continental* and *Master Mortgage* factors are "federal, judicially-created yardstick[s] against which a third party release is measured;"

(vi) There is no state-law equivalent to confirmation of a plan; and,

(vii) Third Party Releases do not exist without regard to the bankruptcy proceeding;

**Voya's *Stern* Arguments Rejected**

*Stern* permits bankruptcy courts to enter a final order on a core bankruptcy matter even if it precludes or otherwise has a collateral impact on a third-party's state law claims; and

Voya's interpretation of *Stern* would dramatically change the division of labor between bankruptcy and district courts and provide leverage to holdouts.

**The Minority View: Ninth Circuit Jurisprudence**

While the Minority View appears to be an absolute bar to Third Party Releases, the Ninth Circuit Court of Appeals has approved Third Party Releases in chapter 11 plans where the justification for those releases was not dependent upon Bankruptcy Code section 524(e), but was instead tied to a different legal justification, such as a Rule 9019 settlement.

For example, in *In re Yellowstone Mountain Club, LLC* ("*Yellowstone I*"),[36] the Bankruptcy Court for the District of Montana confirmed the debtors' chapter 11 plan, which incorporated a settlement and included an "*Exculpation and Limitation of Liability Clause*" exculpating, among others, certain settlement parties and the buyer of the reorganized debtors, from liability for any acts arising out of the debtor's chapter 11 cases or the negotiation and consummation of the debtor's plan (except for acts constituting willful misconduct or gross negligence).

The debtors' founder appealed the bankruptcy court's confirmation order, arguing that the plan inappropriately exculpated and released his claims against the third parties.

On remand, the bankruptcy court held that the exculpation clause in the debtors' plan *did not* implicate Bankruptcy Code section 524(e) or violate established Ninth Circuit precedent.

[36] 460 B.R. 254 (Bankr. D. Mont. 2011).

The bankruptcy court found that the exculpation provision was “not a broad sweeping provision that seeks to discharge or release nondebtors from any and all claims that belong to others,”[37] but instead was narrow in both scope and time, as it only applied to certain acts or conduct related to the reorganization itself.[38]

The bankruptcy court held that, on the particular facts of the case, the exculpation as to the non-debtor third parties was appropriate, as those third parties had “vigorously negotiated” the terms of a settlement, which was incorporated into the debtors’ plan, in a particularly litigious case. “Because the [settlement] and the exculpation clause were cornerstones of the Plan and were highly negotiated,” the narrow exculpation of the third parties was appropriate.[39]

Further, a broad release may be permissible for post-petition conduct of certain officers appointed by the bankruptcy court, as suggested by the Ninth Circuit’s holding in *In re Yellowstone Mountain Club, LLC* (“*Yellowstone II*”).[40]

In *Yellowstone II*, one of the debtors’ founders sought to sue his former attorney—and member of the official unsecured creditors' committee—for both pre- and post-petition conduct outside of the bankruptcy court.

The Ninth Circuit held that, under the *Barton* doctrine,[41] the plaintiff was required to seek the bankruptcy court’s permission to sue the attorney for the attorney’s post-petition conduct outside of the bankruptcy court.[42]

However, the Ninth Circuit also held that the *Barton* doctrine did not preclude the plaintiff from pursuing claims against the attorney arising out of wrongful *pre-petition conduct*, before the attorney became a member of the creditor’s committee.[43]

Parties seeking to effectuate a release of third-party claims in the Ninth Circuit should be mindful of the rule set forth in *Williams v. California 1st Bank*,[44] which provides that a trustee cannot pursue or settle the claims of the estate’s creditors against third parties, even if those creditors have assigned their claims to the trustee.[45]

However, notwithstanding the result in *Williams*, trustees have been successful in enjoining third-party claims against the debtors’ former directors in connection with a settlement—in practice effectuating a Third Party Release.[46]

In *Smith v. Arthur Andersen*, the Ninth Circuit held that the trustee had standing to pursue claims against the debtors’ former directors and to seek to enjoin claims of certain non-settling directors against settling directors. The trustee had standing because it was seeking to rectify injuries caused to the debtors by the defendants’ improper expenditure of the debtors’ assets prior to the debtors’ bankruptcy filing. Thus, the trustee was not pursuing claims of creditors, but was pursuing claims of the estate.[47]

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[37] *Id.* at 270.
[38] *Id.* at 272.
[39] *Id.* at 277.
[40] 841 F.3d 1090 (9th Cir. 2016).
[41] The *Barton* doctrine provides that plaintiffs must obtain the authorization of the bankruptcy court before initiating an action in another forum against certain officers appointed by the bankruptcy court for actions taken in their official capacities. *Id.* at 1094 (citing *Barton v. Barbour*, 104 U.S. 126 (1881)).
[42] *Id.* at 1095.
[43] *Id.* at 1096.
[44] 859 F.2d 664 (9th Cir. 1998).
[45] *Id.* at 666.
[46] *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1002 (9th Cir. 2005).
[47] *Id.* at 1003–04.

**The Issue of Standing to Object**

Among the Circuits to address standing to object to plan confirmation, the Ninth Circuit's opinion in *Motor Vehicle Casualty Co. v. Thorpe Insulation Co.* (*In re Thorpe Insulation Co.*),[48] is the most comprehensive. In *Thorpe Insulation*, the court states that a party must: (1) be a "statutory 'party in interest' . . . under § 1109(b) of the [B]ankruptcy [C]ode," (2) make the showing necessary to satisfy the "Article III constitutional requirements," and (3) satisfy the "federal court prudential standing requirements," to have standing to object to plan confirmation in a chapter 11 case.[49]

There is no dispute among the Circuits that to establish standing, parties must meet the statutory party in interest and Article III constitutional requirements.[50] Moreover, parties in interest almost always satisfy the requirements of Article III.[51]

Section 1109(b) provides that "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter."[52] The list is not exhaustive and includes anyone who "has a sufficient stake in the proceeding so as to require representation."[53]

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[48] 677 F.3d 869 (9th Cir. 2012).

[49] *Id.* at 884. The precise nature of the Article III constitutional requirements and prudential standing requirements is beyond the scope of these materials. However, the former can briefly be summarized as requiring that a plaintiff, at a minimum, "demonstrate that he has suffered 'injury in fact,' that the injury is 'fairly traceable' to the actions of the defendant, and that the injury will likely be redressed by a favorable decision," *Bennett v. Spear*, 520 U.S. 154, 162 (1997), and the latter can briefly be summarized as requiring that a plaintiff "assert his own legal rights and interests" that are not "'abstract questions of wide public significance' which amount to 'generalized grievances'" and that "fall within 'the zone of interests to be protected or regulated by the statute or constitutional guarantee in question.'" *Valley Forge Christian Coll. v. Americans United for Separation of Church & State, Inc.*, 454 U.S. 464, 474–75 (1982).

[50] *See Assured Guar. Corp. v. Fin. Oversight & Mgmt. Bd. (In re Fin. Oversight & Mgmt. Bd.)*, 872 F.3d 57, 63–64, 64 n.7 (1st Cir. 2017); *Savage & Assocs., P.C. v. K & L Gates LLP (In re Teligent, Inc.)*, 640 F.3d 53, 60 & n.3 (2d Cir. 2011); *In re Glob. Indus. Techs., Inc.*, 645 F.3d 201, 210 (3d Cir. 2011); *St. Paul Fire & Mar. Ins. Co. v. Labuzan*, 579 F.3d 544, 538–39 (5th Cir. 2009); *In re James Wilson Assocs.*, 965 F.2d 160, 169 (7th Cir. 1992); *Motor Vehicle Cas. Co.*, 677 F.3d at 884; *Auld v. Sun W. Mortg. Co., Inc. (In re Auld)*, 689 F. App'x 623, 626–27 (10th Cir. 2017); *Basson v. Fed. Nat'l Mortg. Ass'n (In re Basson)*, No. 17-10309, 2018 WL 985754, at *1 (11th Cir. Feb. 20, 2018).

[51] *See Assured Guar. Corp.*, 872 F.3d at 64 n.7 (stating "Article III standing is 'almost always satisfied with respect to any party in interest in a chapter 11 case"); *Glob. Indus. Techs.*, 645 F.3d at 211 & n.25 (holding that standing under the Bankruptcy Code and under Article III "are effectively coextensive," but doubting that section 1109(b) is stricter than Article III); *Basson*, 2018 WL 985754, at *1 n.2 (concluding "our determination that Fannie Mae had statutory standing is enough for us to determine that it had Article III standing"). *But see Hughes*, 803 F.3d at 457 n.6 (disagreeing and noting that it "must give some effect to Congress's words").

[52] 11 U.S.C. § 1109(b).

[53] *Glob. Indus. Techs.*, 645 F.3d at 210; *see also Savage & Assocs.*, 640 F.3d at 60 (stating that "the categories mentioned in Section 1109 are 'not meant to exclude other types of interested parties from the purview of that section'"); *Kipp Flores Architects, L.L.C. v. Mid-Continent Cas. Co.*, 852 F.3d 405, 413 n.10 (5th Cir. 2017) ("The list of potential parties in interest in [11 U.S.C.] § 1109(b) is not exclusive."); *Hughes v. Tower Park Props., LLC (In re Tower Park Props., LLC)*, 803 F.3d 450, 457 (9th Cir. 2015) ("Because the list of parties is preceded by the word 'including,' the list is illustrative, and not exhaustive."); *Kaiser Aerospace & Elec. Corp. v. Teledyne Indus. (In re Piper Aircraft Corp.)*, 244 F.3d 1289, 1304 n.11 (11th Cir. 2001) (stating that a party in interest is defined non-exclusively in § 1109(b)).

The First and Eleventh Circuits have held that under section 1109(b), a party in interest for one purpose is a party in interest for all purposes.[54] In contrast, the Second, Third, Fifth, Seventh, and Ninth Circuits have taken a more restrictive approach. Under this approach, a party in interest for the purposes of a given proceeding is limited to "anyone who has a legally protected interest that could be affected by [the] bankruptcy proceeding."[55] The definition of a legally protected interest employed by the Second, Third, Fifth, Seventh, and Ninth Circuits for the purposes of the section 1109(b) analysis is "analogous" to the "zone of interests" prudential standing requirement.[56] As a result, although, in addition to the Ninth Circuit, only the Second and Fifth Circuits clearly require that parties meet each of the prudential standing requirements, [57] the Third and Seventh circuits incidentally apply at least one of the requirements. The First Circuit also recognizes that, "[w]hile Article III standing is 'almost always satisfied with respect to any party in interest in a chapter 11 case,' courts have additionally required that 'the interests of a party seeking to participate lie within the "zone of interests" protected by the particular statute or legal rule implicated in the given proceeding.'"[58]

Finally, the general intent of section 1109(b) is to confer a broad right of participation "to insure fair representation and prevent excessive control by insider groups."[59] For example, where "the integrity of the bankruptcy proceeding is called into question by non-frivolous allegations of collusion" between the debtor and other parties, which allegations "apparently no one has incentive to pursue" except the objecting party, it is "particularly appropriate" to

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[54] *See Assured Guar. Corp.*, 872 F.3d at 63 (holding that section 1109(b) "imposes no conditions whatsoever on the ability of a party in interest to raise issues"); *Basson*, 2018 WL 985754, at *2 (holding that a party in interest can "raise and be heard on 'any issue'—including relief from the automatic stay—in the bankruptcy court").

[55] *James Wilson Assocs.*, 965 F.2d at 169; *see also Savage & Assocs.*, 640 F.3d at 60 (stating that, "[a]lthough parties in interest typically have a financial stake in the outcome of the litigation, under certain limited circumstances, courts have recognized that a party with a legal (as opposed to financial) interest may appear," and that a party in interest "must be interpreted in terms of the specific provision in which it appears"); *Glob. Indus. Techs.*, 645 F.3d at 210 (adopting the standard articulated in *James Wilson Associates* as consistent "with our own definition of a 'party in interest' as one who 'has a sufficient stake in the proceeding so as to require representation'"); *St. Paul Fire & Mar. Ins.*, 579 F.3d at 538–39 (reading sections 362(k) and 1109(b) in conjunction and concluding a party in interest for the purposes of the former is a party "whose grievances fall 'within the zone of interests' protected by § 362(k)"); *Hughes*, 803 F.3d at 457 & n.6 (holding that an entity must have a legally protected interest to have standing under section 1109(b) and noting that "[i]f we adopted a broader reading, we would effectively collapse the § 1109(b) requirements into Article III standing requirements").

[56] *Motor Vehicle Cas. Co.*, 677 F.3d at 888.

[57] *See Savage & Assocs.*, 640 F.3d at 60 & n.3 (noting that the bankruptcy court concluded "K & L Gates could not have appeared before the bankruptcy court to challenge the settlement agreement because K & L Gates lacked both Article III and prudential standing to object . . . and was not a 'party in interest' under 11 U.S.C. § 1109(b)," but withholding judgment as to the constitutional and prudential questions because it agreed K & L Gates was not a party in interest); *St. Paul Fire & Mar. Ins.*, 579 F.3d at 538–39 (requiring the counterclaimants to "meet both constitutional and prudential requirements").

[58] *Assured Guar. Mun. Corp.*, 872 F.3d at 64 n.7.

[59] *Official Unsecured Creditors' Comm. v. Michaels (In re Marin Motor Oil)*, 689 F.2d 445, 456 (3d Cir. 1982); *see also Savage & Assocs.*, 640 F.3d at 61 ("[A]ny construction of the term 'party in interest' must be mindful of the fact that Chapter 11 is structured the way that it is because Congress believed that 'creditors and equity security holders are very often better judges of the debtor's economic viability and their own economic self-interest than courts, trustees, or []governmental agencies"); *Motor Vehicle Cas. Co.*, 677 F.3d at 888 ("Congress intended § 1109(b) to confer broad standing so that those whose rights would be affected by reorganization proceedings could participate and protect their rights."); 7 *Collier on Bankruptcy* ¶ 1109.04[2][b][i] (Richard Levin & Henry J. Sommer eds., 16th ed. 2018) (stating that the participation of a party in interest in a matter "may be necessary not only as a reflection of the significance of the matter to that particular party, but also to police any conflict that might serve to color the course of the proceedings").

recognize such party's "bankruptcy standing."[60] Indeed, "[c]onflicts of interest or other procedural and structural deficiencies are properly raised in proceedings to confirm the reorganization plan."[61]

**Releases by Broad Categories**

Reorganization plan proponents sometimes identify broad categories of releasees to be covered by Third Party Releases. Several cases confirmed by the Delaware Bankruptcy Courts have approved releases set up by category.[62] However, the issue of whether it is appropriate to authorize releases in favor of a broad categories of releasees was not fully contested in most, if not all, of these cases. Therefore, it remains to be seen whether courts will approve releases set up by category if the issue is fully prosecuted by an objecting party.

When recently directly confronted with this issue, Bankruptcy Judge Silverstein, sitting in Delaware, refused to authorize releases set up by category, without inquiry into the propriety of each individual proposed release and releasee. In *In re Panda Temple Power, LLC*, No. 17-10839 (Bankr. D. Del.), the debtors proposed a plan of reorganization providing for Third Party Releases in favor of, *inter alia*: the Debtors; the Reorganized Debtors; Holdings I; the Operator; the Asset Manager; the Ad Hoc Committee and the members thereof in their capacity as such; the Prepetition Agents; the Releasing Prepetition Lenders; the DIP Facility Agent; the DIP Facility Lenders, any Committee and the members thereof in their capacity as such; the Eligible Third Parties; the Distribution Agents, and in each case the respective Related Persons (other than any Person or Entity that is a direct or indirect holder of an Equity Interest in Holdings I to the extent such Person or Entity is not an Eligible Third Party) of each of the foregoing Entities (including, for the avoidance of doubt, the Ad Hoc Committee Professionals).[63]

3M Employee Retirement Income Plan Trust ("3M") objected to confirmation of the plan arguing, among other things, that the court should not approve the proposed Third Party Releases.[64]

At the confirmation hearing, Judge Silverstein sided with 3M, stating, "I need to know every single person and every single affiliation and I can't do it in this broad take because this broad take is, at least, broader than anything that's ever been disclosed to me before as to how far any release could go."[65] Judge Silverstein further stated she would not approve the release, "unless I know why they should be getting a release—what they contributed; [and] how they're entitled to a release."[66] Ultimately, the debtors agreed to amend the proposed plan to satisfy the 3M objection.[67] Accordingly, there is reason to believe, that if challenged, courts will scrutinize the nature and propriety of the individual releases and releasees included within a category of releases proposed by a debtor.

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[60] *Glob. Indus. Techs.*, 645 F.3d at 214–15.
[61] *In re Fed.-Mogul Glob. Inc.*, 684 F.3d 355, 362 (3d Cir. 2012).
[62] *See, e.g.*, *In re GulfMark Offshore, Inc.*, No. 17-11125 (KG) (Bankr. D. Del. Oct. 4, 2017) [Docket No. 328]; *In re Chaparral Energy, Inc.*, No. 16-11144 (LSS) (Bankr. D. Del. Mar. 10, 2017) [Docket No. 958]; *In re Abeinsa Holding Inc.*, No. 16-10790 (KJC) (Bankr. D. Del. Dec. 15, 2016) [Docket No. 1042]; *In re Pac. Sunwear of California, Inc.*, No. 16-10882 (LSS) (Bankr. D. Del. Sept. 6, 2016) [Docket No. 861]; *In re Tuscany Int'l Holdings (U.S.A.) Ltd.*, No. 14-10193 (KG) (Bankr. D. Del. May 21, 2014) [Docket No. 375]; *In re Green Field Energy Servs., Inc.*, No. 13-12783 (KG) (Bankr. D. Del. Apr. 23, 2014) [Docket No. 885]; *In re OnCure Holdings, Inc.*, No. 13-11540 (KG) (Bankr. D. Del. Oct. 3, 2013) [Docket No. 376]; *In re Graceway Pharm., LLC*, No. 11-13036 (PJW) (Bankr. D. Del. Apr. 20, 2012) [Docket No. 722].
[63] Joint Plan of Reorganization, *In re Panda Temple Power, LLC*, No. 17-10839 (Bankr. D. Del. June 29, 2017) [Docket No. 241].
[64] Limited Objection, *In re Panda Temple Power, LLC*, No. 17-10839 (Bankr. D. Del. Dec. 28, 2017) [Docket No. 492].
[65] Transcript 32:12–18, *In re Panda Temple Power, LLC*, No. 17-10839 (Bankr. D. Del. Dec. 28, 2017) [Docket No. 492].
[66] *Id.* at 32:19–33:6.
[67] First Amended Joint Plan of Reorganization, *In re Panda Temple Power, LLC*, No. 17-10839 (Bankr. D. Del. Jan. 11, 2018) [Docket No. 541].

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# PERMISSIBILITY OF THIRD-PARTY RELEASES IN NON-ASBESTOS CASES

*The courts have generally approved third-party releases when there is consent, but without consent only in limited or "extraordinary" circumstances. The author discusses the general standard for approval, the type of consent required, multi-factor tests used by some courts, and the jurisdiction of the bankruptcy court. He then turns to the minority of jurisdictions that have held third-party releases are impermissible as a matter of law, and closes with a discussion of two major recent cases of interest.*

By William P. Weintraub *

For purposes of this article, a third-party release is defined as the release of a claim held by a non-debtor against a party that is not the debtor. Not included in this definition are "debtor releases," which cover the release of claims and causes of action owned or controlled by the debtor, such as avoiding actions, claims that arose prepetition that belong to the debtor and that are property of the estate, and derivative actions such as claims against officers and directors for breach of duty. Nor does the definition include "exculpation provisions" that shelter plan-related conduct by professionals and others involved in the chapter 11 case in the development of the plan of reorganization. Perhaps a suitable but imperfect description would be claims for independent misconduct or wrongdoing by a creditor of the debtor, or by an officer or director of the debtor, that has injured the creditor of the debtor in a particularized way that is unique to that creditor.[1]

## MAJORITY APPROACH: THIRD-PARTY RELEASES ARE PERMISSIBLE IN CERTAIN LIMITED CIRCUMSTANCES

The Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits have permitted third-party releases, but only in limited circumstances.[2]

[1] This article focuses on non-asbestos cases for two reasons. First, third-party releases in asbestos cases are covered by a specific section of the Bankruptcy Code -- section 524(g). Section 524(g) has its own specific requirements. Therefore, the third-party release issues in asbestos cases are a bit more circumscribed and the case law has developed more uniformly

*footnote continued from previous column…*

across the circuits than for non-asbestos cases. Second, non-asbestos cases far outnumber asbestos cases and, because there is no specific Code section for third-party releases in non-asbestos cases, the case law is more varied across the circuits.

[2] *S.E.C. v. Drexel Burnham Lambert Grp., Inc. (In re Drexel Burnham Lambert Grp., Inc.)*, 960 F.2d 285, 293 (2d Cir. 1992) ("a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan."); *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 212-14 (3d Cir. 2000) (non-consensual releases by a non-debtor of non-debtor third parties are to be granted only in "extraordinary cases" and there must be evidentiary findings that the release was "necessary" to confirm

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More recently, the Seventh Circuit clarified that involuntary third-party release may be permissible.[3] Courts have differed regarding the appropriate standard for evaluating whether a third-party release is permissible, but generally have approved such releases only in "extraordinary circumstances."[4]

### *Releases with and without Consent: Type of Required Consent*

Courts have generally held that third-party releases are permissible where the third party consents to the release, including consent by voting affirmatively in favor of a plan containing the releases.[5] However, in *Airadigm*,[6] the Seventh Circuit expanded upon its earlier ruling in *Specialty Equip. Cos., supra* (which permitted consensual third-party releases) and held that consent was not necessary because both Bankruptcy Code sections 105(a) and 1123(b) independently provided the requisite jurisdiction for the bankruptcy court to approve third-party releases in appropriate cases. Each section provides the bankruptcy court with the broad equitable power to confirm a plan. Under the facts of *Airadigm*, without the release, the plan would not have been possible because the plan funding party would not have funded the plan.

Two bankruptcy courts in the District of Delaware have recently issued conflicting decisions concerning the type of the "consent" needed for third-party releases.[7]

In *Washington Mutual*, Judge Walrath held that "affirmative consent" is required for a party to be bound by a third-party release contained in a plan.[8] In that case, after amendments by the debtors to satisfy the concerns of the court, the ballot contained an "opt-out" provision, where affected parties needed to check the opt-out box in order for the release provisions not to apply. Judge Walrath held that consent could not be implied if a party failed to return its ballot, returned a blank ballot, or voted against the plan.[9] Instead, the only way for a party to "consent" to the release was to return the completed ballot voting in favor of the plan and not check the opt-out box. ("[A]ny third-party release is effective only with respect to those who affirmatively consent to it by voting in favor of the Plan and not opting out of the third-party releases.").

In contrast, Judge Shannon in *Indianapolis Downs* (another third-party release case where there was an "opt-out" box on the ballot) held that affirmative consent is not

*footnote continued from previous page…*

the plan and "fair" to the releasing parties); *Menard-Sanford v. Mabey (In re A.H. Robins Co., Inc.)*, 880 F.2d 694, 702 (4th Cir. 1989) (holding that section 524(e) must not be "literally applied in every case as a prohibition on the power of the bankruptcy courts" to approve a third-party release); *but see Nat'l Heritage Foundation Inc. v. Highbourne Foundation*, No. 13-1608, 2014 WL 2900933 (4th Cir. June 27, 2014) (confirming third-party releases are permissible in appropriate circumstances, but affirming *denial* of third-party release because *Dow Corning* factors not met); *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 656-57 (6th Cir. 2002) (holding that section 524(e) merely "explains the effect of a debtor's discharge" and "does not prohibit the release of a non-debtor."); *In re Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993) ("[w]hile a third-party release . . . may be unwarranted in some circumstances, a per se rule disfavoring all releases in a reorganization plan would be similarly unwarranted, if not a misreading of [section 524(e)]."); *SE Prop. Holdings LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015) (approving third-party release using *Dow Corning* factors and noting that the factors are non-exclusive and that not all of the factors must be satisfied).

[3] *In re Airadigm Communications, Inc.*, 519 F.3d 640, 657 (7th Cir. 2007) (citing Bankruptcy Code sections 105(a) and 1123(b)(6)).

[4] *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.),* 416 F.3d 136, 141 (2d Cir. 2005) ("it is clear that . . . [a third-party] release is proper only in rare cases."); *In re Washington Mutual, Inc.,* 442 B.R. 314, 351 (Bankr. D. Del. 2011) (third-party releases "are the exception, not the rule").

[5] *Specialty Equip. Cos.*, 3 F.3d at 1047 ("releases that are consensual and non-coercive . . . [are] in accord with the strictures of the Bankruptcy Code."); *In re Cent. Jersey Airport Servs., LLC*, 282 B.R. 176, 182 (Bankr. D.N.J. 2002); *In re Monroe Well Serv., Inc.*, 80 B.R. 324, 334-35 (Bankr. E.D. Pa. 1987).

[6] 519 F. 3d at 657.

[7] *Compare Washington Mutual*, 442 B.R. at 354-55 with *In re Indianapolis Downs, LLC*, 486 B.R. 286, 304-06 (Bankr. D. Del. 2013).

[8] 442 B.R. at 354-55.

[9] *Id.* at 355.

required for a party to be bound.[10] Instead, consent could be implied if a creditor merely failed to return its ballot (or does not otherwise check the "opt-out" box). "[T]hose who fail to opt out [by checking the opt-out box], or to vote, are 'deemed' to consent to the Third-Party Release."[11] Thus, a creditor will be bound by the third-party release if it (i) does not return its ballot, (ii) votes to accept the plan but does not check the "opt-out" box, (iii) returns a blank ballot, or (iv) votes to reject the plan but does "not otherwise opt out of the releases[.]"[12]

Two bankruptcy courts in the Southern District of New York have also skewed towards requiring some degree of consent in connection with the approval of third-party releases.[13] In each case, the bankruptcy court specifically referenced the high standard set by the Second Circuit for approval of non-consensual third-party releases (discussed below). By focusing upon consent, the plan proponents and the bankruptcy courts were likely tacitly recognizing that, in the absence of compelling circumstances, consent might be the only avenue to obtain approval for the third-party releases that were at issue in each case.

In *Chassix*, Judge Wiles (in the absence of objections and on his own initiative) refused to approve the third-party releases until certain changes were made to the voting procedures. Specifically, the bankruptcy court was concerned that the voting procedures used by the debtors were designed to spread the release as far as possible, based upon how or whether the creditor voted for or against the plan, or whether the creditor voted at all. The bankruptcy court held that an overly expansive view of what constitutes consent would be inconsistent with the Second Circuit's admonition in *Metromedia* that courts should be wary about imposing involuntary releases upon creditors. Therefore, the court redesigned the voting procedures to curtail what actions or inactions would constitute consent. As reconfigured for classes entitled to vote, a vote in favor of the plan was deemed to be consent to the third-party release; a vote against the plan was deemed to be rejection of the third-party release; a vote against the plan but an affirmative opt-in to the third-party release, would constitute consent to the release; and, the failure to vote at all would not be consent to the release. As to non-voting classes, those "unimpaired" classes that are presumed to vote "yes" would not be deemed to have consented to the release because the loss of the claim against the third party would result in the members of that class being actually (albeit, technically) impaired; and those impaired classes that are deemed to vote "no" would not be considered to have consented to the third-party release.[14]

In *Genco*, the only objecting parties were the United States Trustee and the Equity Committee. The objections focused on the deemed consent of non-voting classes and the question of whether the releases were too broad. Judge Lane, also citing to *Metromedia*, began with the proposition that third-party releases may only be approved in "unique circumstances." As would be done in *Chassix* (which was the later of the two cases), the bankruptcy court held that it would not permit non-voting "unimpaired" classes that were presumed to accept the plan, or non-voting impaired classes that were deemed to have rejected the plan, to be deemed to have *automatically* consented to the third-party release. The court also agreed that the scope of the release was too broad and potentially extended to too many parties. In assessing the propriety of the third-party releases, the court looked at the *Metromedia* factors as applied to the evidence before it to determine whether the releases passed muster. Based upon the record before it, the court found "consent" to the releases from any creditor that consented to the plan by voting for it, or that consented to the release by voting against the plan but failing to check the box on the ballot to opt-out of giving the release. As to creditors holding claims against third parties with a right to indemnity or contribution from the debtors, those claimants would be subject to the third-party release even without affirmative consent, provided the indemnity right existed prepetition and was not created in the plan support agreement or under the plan to bootstrap or create an identity of interest between the released parties and the debtors. Lastly, the court approved the third-party releases in favor of parties providing significant financial contributions that made the plan possible.[15]

### ***Second Circuit Test:*** **Metromedia Fiber Network, Inc.**[16]

The law in the Second Circuit has evolved since the *Drexel* case, *supra*. In *Drexel*, the test was whether the release was an "important" part of the plan. Importance connotes the release is a cornerstone or linchpin of the plan, but the decision provided little guidance to future plan proponents and opponents of third-party releases. In disapproving the non-debtor release, the court in *Metromedia* held that "non-debtor release[s] in a plan of reorganization should not be approved absent the finding *that truly unusual circumstances* render the release important to the success of the plan. . . ."[17] In determining whether the release is permissible, the court expounded further that focus should be paid to the following factors:

[10] 486 B.R. at 304-05.

[11] *Id.* at 305.

[12] *Id.* at 304-06.

[13] *In re Chassix Holdings, Inc. et al.*, 533 B.R. 64 (Bankr. S.D.N.Y. 2015); and *In re Genco Shipping & Trading Ltd., et al.*, 513 B.R. 233 (Bankr. S.D.N.Y. 2014).

[14] *See generally* 553 B.R. at 75-82.

[15] *See generally* 513 B.R. at 268-72.

[16] *Supra.*

[17] 416 F.3d at 143 (emphasis added).

- whether estate received substantial consideration;
- whether enjoined claims are channeled to a settlement fund rather than extinguished;
- whether enjoined claims would indirectly impact debtor's reorganization "by way of indemnity or contribution";
- whether the plan otherwise provides for full payment of enjoined claims; and/or
- whether there is consent of affected creditors.[18]

The court noted, however, that whether a non-debtor release is permissible is "not a matter of factors and prongs," and that "[n]o case has tolerated non-debtor releases absent the finding of circumstances that may be characterized as unique."[19] Significantly, the court did not state that consent was a mandatory element for a permissible third-party release.

### *Multi-Factor Tests*

Some courts have adopted a five-factor test for releases as follows:

- identity of interest between debtor and non-debtor such that a suit against the non-debtor will deplete estate resources;
- substantial contribution to the plan by non-debtor;
- necessity of release to the reorganization;
- overwhelming acceptance of the plan and release by creditors and interest holders; and
- payment of all or substantially all of the claims of the creditors and interest holders under the plan.[20]

The court in *Master Mortg. Inv. Fund, Inc., supra,* noted that, "No court has set out a rigid 'factor test' to be applied in every circumstance. Rather, the courts have engaged in a fact-specific review, weighing the equities of each case. The courts seem to have balanced the five listed factors most often. However, these factors do not appear to be an exclusive list of considerations, nor are they a list of conjunctive requirements."[21]

The Sixth Circuit, in *Class Five Nevada Claimants v. Dow Corning Corp.* (*In re Dow Corning Corp.*),[22] adopted a variation of the five-factor test, adding one additional factor, namely, that the plan provides an opportunity for those claimants who choose not to settle to recover in full. The Fourth Circuit recently adopted this six-factor test.[23] Neither case requires the presence of all factors; and neither case makes consent a mandatory prerequisite to approving the release.

Virtually every appellate court emphasizes the additional factor that *evidence* must be proffered by the plan proponent to demonstrate how each factor has been met.

### *Some Corollary Rules*

- Not all factors must be present.
- The consideration paid by the released party does not have to flow directly to the "releasing" party.
- Some factors are more important than others, such as extent of creditor support, the necessity of the release to the success of the plan, and the releasor making a substantial and not token cash contribution.
- Point of interest: The fact that "overwhelming" creditor support is an important factor suggests that unanimity is not required which, in turn, suggests non-consensual releases are indeed permissible in the proper circumstances.
- Identity of interest factor: Does the released party have a right to indemnity from the debtor such that a lawsuit against the third party is tantamount to a claim against the debtor? Some courts refer to this as the "two-lawsuit test." Simply put, if the third party is sued, must it commence, and win, a second lawsuit against the debtor? If so, the identity of interest is lacking. Because the assertion of an indemnity claim will have an effect on the debtor's estate, the bankruptcy court has related-to subject matter jurisdiction to bar the third-party's claim against the non-debtor indemnitee.

### *Subject Matter Jurisdiction*

Even if all of the factors enumerated above have been met, a bankruptcy court *must have subject matter*

[18] *Id.* at 142-43.

[19] *Id.* at 142.

[20] *In re Master Mortg. Inv. Fund, Inc.,* 168 B.R. 930, 934-35 (Bankr. W.D. Mo. 1994) (citing cases applying a variety of the five factors); Indianapolis Downs, 486 B.R. at 303 (applying Master Mortgage test); In re Zenith Elecs. Corp., 241 B.R. 92, 110 (Bankr. D. Del. 1999) (same).

[21] Master Mortg. Inv. Fund, 168 B.R. at 935; *see also* Indianapolis Downs, 486 B.R. at 303 ("[t]hese factors are neither exclusive nor are they a list of conjunctive requirements.").

[22] 280 F.3d 648, 658 (6th Cir. 2002).

[23] *Nat'l Heritage Found., Inc. v. Highbourne Found.*, No. 13-1608, 2014 WL 2900933, at *1-2 (4th Cir. June 27, 2014).

*jurisdiction* over the third-party dispute in order to grant the non-debtor release.[24] In *Manville III*, the Second Circuit held that "a bankruptcy court only has jurisdiction to enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate."[25] Unless the third party has "derivative liability for the claims against the debtor[,]" a channeling injunction is inappropriate.[26] Because the claims at issue were "not derivative of [the debtor's] liability, but rather seek to recover directly from [a third party] for its own alleged misconduct[,]" the court found that the district court lacked subject matter jurisdiction to enjoin such claims.

The Supreme Court in *Travelers* reversed and remanded *Manville III* on "narrow" grounds, finding that the Second Circuit had improperly permitted a collateral attack on the district court's subject matter jurisdiction.[27] Once the 1986 Order became final (the order entered by the Bankruptcy Court in the *Manville* case that approved a key settlement with Manville's insurance carriers) without any party having raised the jurisdictional issue, *res judicata* precluded the court from addressing it.[28] It is notable, however, that the Court expressly stated that it was "not resolv[ing] whether a bankruptcy court . . . could properly enjoin claims against non-debtor insurers that are not derivative of the debtor's wrongdoing."[29] It was merely holding that the issue of whether the court had subject matter jurisdiction was barred by *res judicata* and not subject to collateral attack.

On remand, the Second Circuit in *Johns-Manville Corp. v. Chubb Indem. Ins. Co.* (*In re Johns-Manville Corp.*),[30] held that because Chubb was denied due process, its assertion of lack of subject matter jurisdiction was timely (and therefore not an impermissible collateral attack). The court then held that the order enjoining non-derivative claims by Chubb that sought to impose separate liability on a third-party non-debtor "exceed[ed] the bounds of the bankruptcy court's *in rem* jurisdiction."[31] According to the court, Bankruptcy Code section 524(g), which permits certain channeling injunctions, "does not authorize injunctions of . . . [non-derivative] claims against non-debtor third parties."[32]

It should be noted that *Manville III* was not a plan confirmation case, but rather involved a pre-plan settlement. Therefore, the Second Circuit did not address whether the bankruptcy court had core jurisdiction to confirm a plan of reorganization containing a third-party release. In *Metromedia*, which was decided three years before *Manville III*, the Second Circuit did not reject the release on the ground that the bankruptcy court lacked subject matter jurisdiction; instead, it held the evidence presented did not support the existence of the requisite factors. Interestingly, *Manville III* discusses *Metromedia*, but does not disavow the indication in *Metromedia* that had the requisite factors been met, the third-party release might have been permissible. Nor does *Manville III* address whether subject matter jurisdiction was present or absent in *Metromedia*. Instead, the panel in *Manville III* cited *Metromedia* in conjunction with its observation that conditioning a release on payment was subject to abuse because the debtor could not create subject matter jurisdiction by structuring a settlement or plan in such a way as to make the settlement or plan dependent upon the third-party's contribution, thereby manufacturing subject matter jurisdiction where it might not otherwise exist. This statement can either suggest there is no subject matter jurisdiction in the plan confirmation context to impose a third-party release on claims that do not affect the *res* of the bankruptcy estate *or* that there is subject matter jurisdiction in the context of plan confirmation to impose a third-party

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[24] *Johns-Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.)*, 517 F.3d 52 (2d Cir. 2008) ("*Manville III*"), *rev'd and remanded sub nom Travelers Indem. Co. v. Bailey*, 557 U.S. 137, 129 S. Ct. 2195 (2009) ("*Travelers*"). *See also In re Dreier*, 429 B.R. 112, 132 (Bankr. S.D.N.Y. 2010) ("before the Bankruptcy Court decides whether . . . the 'unusual circumstances' mandated by *Metromedia* [are present], it must first decide whether it has subject matter jurisdiction. . . ."). *See also Metromedia*, 416 F.3d at 142 (stating, in reference to whether Bankruptcy Code section 105(a) by itself supplied the requisite subject matter jurisdiction for approval of a third-party release: " . . . but section 105(a) does not allow the bankruptcy court 'to create substantive rights that are otherwise unavailable under applicable law.'" (citations omitted)).

[25] 517 F.3d at 66.

[26] *Id.* at 68.

[27] 557 U.S. at 152-53 (holding that "[e]ven subject-matter jurisdiction . . . may not be attacked collaterally.") (citations omitted).

[28] *Id.* at 152.

[29] *Id.* at 155.

[30] 600 F.3d 135, 148-49 (2d Cir. 2010).

[31] *Id.* at 153.

[32] As part of the settlement in the *Manville* case, a trust was established to hold the contributions made by the settling parties. In order to enforce the third-party release and make sure that the "releasing" parties were (1) properly compensated and (2) could not sue the settling parties that had made contributions to the trust, an injunction was entered that "channeled" all asbestos-related claims to the trust and barred (enjoined) third parties from suing the contributing parties. The basic structure and paradigm created by the bankruptcy court in the *Manville* case was later codified as part of the Bankruptcy Code as section 524(g).

release provided that the necessity is real rather than manufactured. Because the panel in *Manville III* did not reject the multi-factor approach required by *Metromedia*, or revisit the admonition in *Metromedia* that no single factor (such as identity of interest, which *does* affect the *res*) is mandatory, it appears the latter interpretation is plausible at the very least. Which means that the two lines of cases (*Manville* versus *Metromedia*) can be reconciled by finding subject matter jurisdiction in the context of plan confirmation through use of Bankruptcy Code Section 1123(a)(5) or 1123 (b)(6) for arising-under or arising-in jurisdiction. They may also be reconciled in cases involving identity of interest (such as indemnification claims), through related-to jurisdiction, provided the key factors such as necessity to the plan are present.

In *Continental Airlines*, *supra*, the Third Circuit made the point in footnote 12 that "a court cannot simply presume it has jurisdiction in a bankruptcy case to enjoin third-party class actions against non-debtors. We must remain mindful that bankruptcy court jurisdiction is limited, as is the explicit grant of jurisdiction to bankruptcy courts. We do not treat this very significant issue more fully, however, because the record does not permit us to resolve this issue, and the parties have not raised and discussed it in their appellate briefs."[33]

Nevertheless, although not every court addresses the question of subject matter jurisdiction at length when ruling on third-party releases, most courts rely upon some combination of Bankruptcy Code sections 105, 1123(a)(5) (plan must include adequate means of implementation), or 1123(b)(6) (plan may include any other provision not barred by the Bankruptcy Code) in finding the requisite jurisdiction.[34] Perhaps the existence of core subject matter jurisdiction is presumed under Bankruptcy Code sections 105(a), 1123(a)(5), and 1123(b)(6) because virtually all of the third-party release cases arise in the context of plan confirmation. The necessity requirement found in all of the various tests would supply the nexus between the third-party release and the indispensability of the releases to plan confirmation on the one hand, and the equitable power of the bankruptcy court to implement its order confirming the plan on the other hand. Consequently the bankruptcy court has *core* arising-under and/or arising-in jurisdiction to approve the releases in connection with confirmation of a plan.[35] (The bankruptcy court in *Charles Street* disapproved the release because the evidence presented did not meet the *Master Mortgage* factors, held applicable in *In re Quincy Medical Center, Inc.*[36]).

Other courts reject the notion that Bankruptcy Code section 105(a) by itself can supply the requisite subject matter jurisdiction because section 105 can only implement and assist extant provisions of the Bankruptcy Code but cannot create substantive rights that do not exist.[37] These courts either side with the Ninth Circuit's view that Bankruptcy Code section 524(e) bars third-party releases (in which case section 105 cannot be used to contradict the bar of section 524) or hold that the absence of express authorization for third-party releases prevents the bankruptcy court from using section 105 to bootstrap into jurisdiction whenever parties band together and claim necessity for the release.

Still other courts discuss the limitations of section 105, but do not appear to address whether section 105 in conjunction with section 1123 and the proper evidentiary record would furnish subject matter jurisdiction for the bankruptcy court to approve third-party releases.[38] Notably, these courts did not rule out third-party releases in all cases, but instead rejected the third-party releases in the specific case before it.

### *Power versus Jurisdiction*

A court's jurisdiction is its authority to adjudicate the dispute before it; while a court's power goes to the limits of what the court can do once it has jurisdiction. Subject matter jurisdiction in bankruptcy cases is set forth in 28 U.S.C. section 1334. The district court (and by reference via 28 U.S.C. section 157(a), the bankruptcy court) has jurisdiction over proceedings that arise under title 11, or that arise in or that relate to a case under title 11. For example, a bankruptcy court has the *jurisdiction* to adjudicate a preference action; but it does not have the *power* to order the flogging of the losing party. Because Bankruptcy Code section 105 goes to the *power* of the bankruptcy court, section 105 by itself cannot provide subject matter jurisdiction.

Finally, some courts, such as the court in *Washington Mutual*, *supra*, and *In re Zenith Electronics Corp*,[39] state that non-consensual third-party releases are not "authorized" or are beyond the "power" of the court, without much explanation and little or no discussion of subject matter jurisdiction.

[33] 203 F. 3d. at 214.

[34] *Airadigm,* 519 F.3d at 657; *A.H. Robins,* 888 F.2d at 701-02; *Dow Corning,* 280 F.3d at 656-57; and *Master Mortgage,* 168 B.R. at 934.

[35] 28 U.S.C. § 157(b)(2)(L); *In re Charles Street African Methodist Episcopal Church of Boston*, 499 B.R. 66, 99 (Bankr. D. Mass.) (citing to Bankruptcy Code sections 105 and 1123(a)(5)).

[36] 2011 WL 5592907 (Bankr. D. Mass. 2011).

[37] *See, e.g., Digital Impact, Inc.*, 223 B.R. 1, 14 (Bankr. N.D. Okla. 1998).

[38] *Metromedia*, 416 F.3d at 142; *Cont'l Airlines*, 203 F.3d at 211.

[39] 241 B.R. 92 (Bankr. D. Del. 1999).

## MINORITY APPROACH: THIRD-PARTY RELEASES ARE IMPERMISSIBLE AS A MATTER OF LAW

The Fifth, Ninth, and Tenth Circuits have held that non-debtor third-party releases are impermissible as a matter of law.[40]

These courts have narrowly interpreted Bankruptcy Code section 524(e), which provides that "the discharge of a debt of the debtor does not affect the liability of any other third entity on, or the property of, any other entity for such debt." According to these courts, third-party releases effectively allow the bankruptcy process to discharge non-debtors, a result clearly inconsistent with section 524(e). Courts disagreeing with this approach (*see, e.g.*, *Specialty Equip. Cos.*, 3 F.3d at 1047 *supra*) point out that section 524(e) is not a bar to third-party releases under plans, but instead section 524(e) merely defines and confines the effect of the *debtor's* discharge of *its* debts and clarifies that the debtor's discharge does not *automatically* discharge third parties that are co-liable with the debtor of the third party's own, separate, debts. In this manner, the debtor's discharge does not automatically discharge a guarantor of the debtor.

## IMPACT OF *STERN V. MARSHALL*

In *Stern v. Marshall*,[41] the Supreme Court held that the bankruptcy court lacked constitutional authority to enter a final order in a lawsuit brought by the debtor against a non-debtor even though the matter was designated as core in 28 U.S.C. § 157(b)(2)(C). The Court held that notwithstanding the statutory designation as "core," the debtor's lawsuit (which would exist outside of the debtor's bankruptcy case) was constitutionally non-core. The lawsuit in *Stern* was brought to augment the debtor's estate using private rights that existed outside bankruptcy and was not a claim stemming from the bankruptcy itself; nor did the lawsuit have to be resolved as part of the claims allowance process.[42] The Court relied in large part upon its ruling earlier in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*,[43] and held that the nature of the debtor's claim was such that the judicial power of the United States as exercised by an Article III judge was required to adjudicate the claim.[44] Because the bankruptcy judge was an Article I judge, the court lacked the necessary authority to adjudicate the debtor's lawsuit against the non-debtor.

For a brief time, *Stern v. Marshall* threw into doubt whether the bankruptcy court could enter proposed findings of fact and conclusions of law under 28 U.S.C. § 157(c)(1) for matters that were statutorily core but constitutionally non-core, and whether (and how) parties would be deemed to have manifested consent to the bankruptcy court adjudicating a non-core matter. Both questions were answered (sort of) in the follow-on decisions of the Supreme Court in *Executive Benefits Insurance Agency v. Arkison*[45] and *Wellness International Network Ltd., et al. v. Sharif*.[46] In *Executive Benefits*, the Court confirmed that the so-called statutory gap of how the bankruptcy court could handle "*Stern*-type-matters" that were statutorily core but constitutionally non-core, did not really exist. The Court held that the savings clause in the note following 28 U.S.C. § 151 enabled the bankruptcy court to use 28 U.S.C. § 157(c)(1) (and, hence, Bankruptcy Rule 9033) to issue proposed findings of fact and conclusions of law to the district court for de novo review in statutorily core but constitutionally non-core matters.[47] In other words, the jurisdiction system established by Congress after *Marathon* would indeed survive *Stern v. Marshall*. Notably, the Court also held that, in the case of the specific litigants before it, any constitutional defect was cured because even though the matter was appealed to the district court rather than submitted to the district court as a report and recommendation under Bankruptcy Rule 9033, the defendant received on appeal the same treatment that he would have received under section 157(c)(1) and Bankruptcy Rule 9033 — de novo review and a judgment entered by an Article III court.[48]

In *Wellness*, the Court answered in the affirmative the question of whether the bankruptcy court was structurally permitted to enter an order on a "*Stern*-type-claim" upon

[40] *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746, 760-61 (5th Cir. 1995) (where permanent injunction "provided no alternative means . . . to recover from [third party] . . . [it] improperly discharged a potential debt of [third party]" and "the bankruptcy court exceeded its powers under § 105."); *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401-02 (9th Cir. 1995) (holding that third-party release violates section 524(e), which "precludes bankruptcy courts from discharging the liabilities of non-debtors."); *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) ("the bankruptcy court has no power to discharge the liabilities of a non-debtor pursuant to the consent of creditors as part of a reorganization plan."); *Landsing Diversified Properties-II v. First National Bank and Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600-01 (10th Cir. 1991) ("Congress did not intend to extend such benefits [of discharge] to third-party bystanders.").

[41] 131 S. Ct. 2594 (2011).

[42] 131 S. Ct. at 2618.

[43] 102 S. Ct. 2858 (1982).

[44] 131 S. Ct. at 2611, 2620.

[45] 134 S. Ct. 2165 (2014).

[46] 135 S. Ct. 1932 (2015).

[47] 134 S. Ct. at 2172-73.

[48] *Id.* at 2174-75.

the consent of the litigants. The Court described consent as a "permissible waiver" of the right to adjudication by an Article III judge. Given the pervasive oversight of the bankruptcy court by the district court, the Court held that there would be no constitutional bar to the bankruptcy court adjudicating a non-core matter with the consent of the parties.[49] Lastly, the Court held that consent could be implied from actions or inactions, provided it was knowing and voluntary.[50] Assuming the bankruptcy court has core jurisdiction to approve a third-party release in connection with confirmation of a plan, then the presence or absence of consent (in whatever form) is irrelevant. But, if the bankruptcy court only has "related-to" jurisdiction, then the presence or absence of consent by the objecting involuntary releasor may be highly relevant.

In the context of third-party releases, some courts have raised the issue of whether the bankruptcy court has the authority to enter an order approving a third-party release and issue a bar order/injunction on the theory that the release and corresponding injunction are a final adjudication of the claim of one non-debtor against another non-debtor, which could only be approved by an Article III judge upon a report and recommendation from the bankruptcy court. This argument is premised upon the contention that if subject matter jurisdiction exists at all, it would be related-to (non-core) jurisdiction.[51] Other courts believe that confirmation of a plan is quintessentially core and that the requisite jurisdiction is supplied by Bankruptcy Code sections 105(a), 1123(a)(5), and/or 1123(b)(6) so long as the requisite factors are met.[52] As noted above, outside the context of plan confirmation, in connection with a pre-plan settlement that sought to bar third-party claims that had no effect on the rest of the bankruptcy estate, the Second Circuit has held there is no subject matter jurisdiction at all, not even related-to jurisdiction, to compel the release of third-party claims.[53]

A succinct statement of the case jurisdiction to approve a third-party release in the content of plan confirmation and that rejects a *Stern* challenge is found in *Charles Street*, *supra*:

> The matter before the [c]ourt is not a suit on the [g]uaranty; the merits of the [g]uaranty are not in controversy. To reiterate, the matter before the [c]ourt is the confirmation of a plan, a unitary omnibus civil proceeding for the reorganization of all obligations of the debtor and disposition of all its assets. Confirmation of a plan is not an adjudication of the various disputes it touches upon…[I]t is a total reorganization of the debtor's affairs in a manner available only in bankruptcy. The release may be proposed and approved only as part of a plan and only (if at all) pursuant to powers of adjustment afforded by the []Code, such as in sections 1123(a)(5) and 105(a). Accordingly, the confirmation of a plan — including any third-party release it may propose — is a matter of "public rights" that, under *Stern*, Congress may constitutionally assign to a non-Article III adjudicator.[54]

Given the focus on subject matter jurisdiction, there appears to be a potential question as to whether subject matter jurisdiction can only be found in third-party release cases in which the party to be released has a contractual or statutory indemnification claim against the debtor such that a lawsuit against the proposed releasee would be a lawsuit against the debtor. As stated above, the issue has not been framed this way in most of the third-party release cases. In many cases, the courts focus on the necessity and fairness of the release and do not discuss subject matter jurisdiction in depth. This could be because *core* subject matter jurisdiction is presumed to exist in the context of plan confirmation. It is also notable that virtually all of the circuit-level decisions that hold third-party releases are permissible include among the factors to be considered whether there is an identity of interest between the third party being released and the debtor. The identity of interest factor is almost always framed as whether the third party has an indemnity or contribution claim against the debtor such that a lawsuit against the third party will affect the debtor and the estate by triggering a claim by the third party against the debtor. These cases also make it clear that the factors are not exclusive, and the presence or absence of any particular factor is not required.[55] Consequently, if subject matter jurisdiction only existed as related-to jurisdiction, then the cases would uniformly hold that the identity of interest factor is *mandatory* in order for the court to have jurisdiction to approve a third-party release. Yet, no case has made the presence of that particular factor an absolute requirement. However, even most liberal cases caution the parties that courts will not look kindly upon parties that try to manufacture necessity by reciting its existence without actually proving it through evidence proferred to the trial court.

In any event, assuming there is at least related-to jurisdiction, even in the absence of consent, the ruling in

[49] 135 S. Ct. at 1944-48.

[50] *Id.* at 1948.

[51] *In re Digital Impact, Inc*., 223 B.R. 1, 14 (No. 8) (Bankr. N.D. Okla. 1998).

[52] *See, e.g.*, *Airadigm,* 519 F.3d at 657; *Dow Corning,* 280 F.3d at 656-57; and *Charles Street,* 499 B.R. at 99.

[53] *Manville III*, *supra*.

[54] 499 B.R. at 99.

[55] *Metromedia* (416 F.3d at 142); *Master Mortgage* (168 B.R. at 935).

*Executive Benefits* would permit either a report and recommendation by the bankruptcy court to the district court, or support the release if upheld on appeal to the district court based upon de novo review by the district court and its approval of the release.

## RECENT CASES OF INTEREST

### Millennium Lab Holdings, II, LLC, et al., *Case No. 15-12284 (LSS) (Bankr. D. Del.)*

In this case, the bankruptcy court approved third-party releases over the objection of a dissenting secured lender that was part of a syndicate of almost 100 lenders that made a loan of $1.8 billion to the debtors. The loan transaction (known colloquially as a dividend recap) closed approximately one year before the debtor (a urine drug testing lab and related businesses) was forced into chapter 11 under threat of loss of its Medicare reimbursement privileges due to whistle blower actions and a DOJ lawsuit. The equity holders were paid $1.3 billion from the loan proceeds as a special dividend. The DOJ's claims resulted from an investigation into alleged improprieties by the company that included allegations of billing Medicare for medically unnecessary testing, and allegations that the company provided kickbacks and other incentives to doctors to use the lab for testing. After the DOJ and the company announced an agreement in principle that required the company to enter into a corporate integrity agreement and pay a civil penalty of $256 million in order to preserve its Medicare reimbursement privileges, the company turned to its secured lenders and equity holders for assistance in paying or financing the $256 million penalty.

The equity holders, the secured lenders, and the DOJ engaged in months of heated negotiations in order to avoid the devastating consequences of the loss of Medicare reimbursement privileges, which undeniably would destroy the business and reduce creditor recoveries to almost zero. Eventually, under threat of a deadline to reach an agreement imposed by government regulators, the parties entered into a series of inter-related agreements as part of a global settlement of all claims. Under the global settlement, a prepackaged plan of reorganization was prepared and voted upon. The linchpin of the plan was the payment of $325 million by the equity holders that would be used to pay the government penalty, reimburse the debtors for certain prepayments made to the government, and for working capital. The secured lenders retained $600 million of debt restructured as a new term loan and were given 100% of the equity of the reorganized debtor, which was valued at least at $900 million. Unsecured creditors were to be paid in full and thus were unimpaired. The equity holders insisted on full releases from the debtors and third-party releases from all creditors (including any dissenting lenders) as a condition to paying the $325 million.

The bankruptcy court approved the third-party releases in an oral ruling from the bench. The transcript is available under Docket No. 203. The bankruptcy court held that in the Third Circuit there is no per se bar against third-party releases and looked to *Continental Airlines*, discussed *supra*, as the source for the over-arching requirements for approval of third-party releases. Those requirements are fairness to creditors and necessity for the success of the plan. The court then looked at what lower courts in Delaware had done with third-party releases and observed that most courts that approved those releases applied the factors developed in such cases as *Master Mortgage*, also discussed *supra*. Going through the factors, the bankruptcy court found that, based on the evidence presented by the debtors (and the lack of any evidence or cross-examination by the objectors), the factors were met. Chief among the factors were the substantial payments being made by the equity holders, the threatened (and, the court found, real) Armageddon if the government was not paid its $256 million by the end of the month, the lack of other options for the debtors, the overwhelming support of the impaired class, the payment in full of unsecured creditors, and the identity of interest between the equity holders (all of whom had contractual indemnity claims), the debtors (who would be subject to the indemnity claims), and the secured lenders (whose claims (if any) arose from the loan transaction). Notably, the court did not require an opt-out provision that would have enabled creditors to refuse to provide the releases. Under the circumstances of the case, the court held that the opt-out was not necessary because the unsecured creditors were being paid in full, the secured lenders overwhelmingly supported the global deal, the plan consideration being given to the secured lenders (including the dissenters) was fair and reasonable, and there would be no plan (and a disastrous liquidation) without the involuntary releases that were required by the parties contributing $325 million.

The objecting secured lender did not oppose the overall settlement and did not disclaim its plan distributions. Rather, it made the technical argument that the court lacked subject matter jurisdiction to approve a third-party release. The crux of the argument was that the objecting secured lender had fraud and RICO claims against the equity holders that were independent of any claims of the debtors and therefore the estate would not be affected by the outcome of the secured lender's lawsuit. Apart from plan confirmation being a core matter and the court having the authority to use section 105 in aid of confirmation, the bankruptcy court held that, at the very least, it had related-to jurisdiction because the released parties (and those related to the released parties) had indemnification claims (which included the costs of defense) that made a lawsuit against the released parties equivalent to a claim against the debtor. The objecting secured lender also argued that the bankruptcy court could not approve the third-party releases under the rationale of *Stern v. Marshall*, because the release was tantamount to an adjudication of the merits of its claims against the equity holders. The bankruptcy court rejected the notion that it could not enter an order confirming a plan that contained third-party releases. The objecting secured creditor has appealed. The reorganized debtor has moved to dismiss the appeal as moot.

**New England Compounding Pharmacy, Inc.*, Case No. 12-19882-HJB (Bankr. D. Mass.)***

This was a non-asbestos mass tort case that resulted from the tragic distribution of prescription medication compounded by the debtor that was tainted with fungal meningitis. The distribution of the tainted medication resulted in several deaths, serious injuries, and thousands of lawsuits against the debtor. Through Herculean efforts, the chapter 11 trustee, the committee, several tort lawyers, multiple parties with potential exposure, and insurance carriers for several parties were able to put together a fund of more than $200 million to pay tort claimants through a trust and resolve the chapter 11 case. As would be expected, the "contributing parties" who were settling potential claims against them by making cash payments that would be used to fund the trust each required comprehensive third-party releases as a condition to making the settlement payments. There was no clear guidance in the First Circuit as to whether third-party releases were permissible and, if so, under what circumstances. By any measure, the creation of the $200 million fund from scratch to compensate victims was an extraordinary circumstance, and the linkage of the settlement payments to the delivery of full releases made the third-party releases essential to the plan.

The bankruptcy court approved the third-party releases. No written or oral opinion was issued. In the bankruptcy court's *Findings of Fact, Conclusions of Law and Order Confirming The Third Amended Joint Chapter 11 Plan of New England Compounding Pharmacy, Inc.* (Docket No. 1355), the court appeared to tick off the *Master Mortgage* factors and, as the bankruptcy court did in *Millennium*, focused upon the critical necessity of the funds for the success of the plan,the significant contributions made by the settling parties, the indemnity and contribution claims that would likely be asserted against the debtor by non-debtor parties sued for damages caused by the tainted drugs prepared by the debtor, the overwhelming support for the plan, the absence of any objections from tort claimants, and the significant *near-immediate* recoveries for creditors who (in the absence of the plan) might get little or nothing on their claims or only be paid after years of litigation. The court relied on sections 105, 1123(a)(5)(means of implementation) and 1129 as the basis for jurisdiction. The court also laid the ground work for related-to jurisdiction by focusing on the contribution and indemnification rights of co-liable parties, and the identity of interest shared by all in resolving litigation that was connected to a common nucleus of facts concerning the contamination and distribution of the tainted drugs. Lastly, the court used Bankruptcy Rule 9019 to make the requisite findings as to fairness to approve the multiple settlement agreements approved at the confirmation hearing. Little or no case law was cited in the Findings and Conclusions, but two submissions by the plan proponents (Docket Nos. 1178 and 1310) addressed the applicable case law from the lower courts in Massachusetts (such as *Charles Street*, *supra*, and *In re Quincy Med*. *Ctr. Inc., supra*), and focused on the factors used in the majority rule cases (such as *Master Mortgage*, *supra* and *Dow Corning*, *supra*). The other notable point to be made is that, again, as in *Millennium*, there was no opt-out alternative provided to the releasing parties. ■