THIRD PARTY RELEASES – HERE TODAY, GONE TOMORROW?

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INTRODUCTION

These materials will discuss the present status of a split among federal circuits regarding the authority of bankruptcy courts to authorize and enforce third party releases. As these materials are being prepared, legislation to curb the practice of third party releases has been introduced in Congress ("Stop shielding Assets from Corporate Known liability by Eliminating non-debt debtor Releases Acts" (or more commonly referred to as the "SACKLER Act") and the "Non-debtor Release Prohibition Act of 2021"). The Acts will be briefly discussed in these materials, and more likely discussed more fulsomely in the course of the presentation of these materials. Finally, these materials will touch upon some related activity that is early in the process of attracting attention, and some novel notions for perhaps obtaining third party releases in unconventional ways.

First, let's examine the three common types of third party releases frequently seen in Chapter 11 plans.

LEVEL I - EXCULPATION

Exculpation provisions are intended to protect certain parties from claims that are based on actions that relate to restructuring and the Chapter 11 process. Some exculpation provisions also seek to protect from collateral attack, court-supervised and court-approved transactions. The court supervised fiduciaries subject to an exculpation provision typically include the debtor, it's officers and directors, members of an unsecured creditors committee, lenders, asset purchasers, and professionals retained by the foregoing, including financial advisors and attorneys. A common exception to a properly drafted exculpation provision is the exception of claims that are based on allegations of fraud, willful misconduct, or gross negligence. The Office of the United States Trustee in some regions have also insisted that exculpation provisions except claims relating to violations of the Rules of Professional Conduct by lawyers protected under the provision. The theory under which exculpation provisions are approved is that court supervised fiduciaries are entitled to some form of qualified immunity for their actions. In re PWS Holding Corp., 228 F.3d 224 (3rd Cir. 2000). With respect to court-approved transactions, the theory is that the parties to those transactions should not be subject to claims that effectively seek to undermine or second guess the determination of the court approving the transaction. Airadigm Communications, Inc. vs. FCC, 19 F.3d 640 (7th Cir. 2008). Exculpation provisions are not terribly controversial, and rarely draw objection. When they do, it is usually because the released parties have been defined too broadly, the scope of the exculpation goes beyond activities that occurred during the pendency of the case or were not sufficiently related to case activities. When an exculpation provision is drafted too broadly, it begins to look like more expansive relief that is…

LEVEL II - DEBTOR RELEASES

Chapter 11 plans often contain provisions under which a debtor agrees to release all of its own claims against a broad group of released parties, including third parties. Those releases often cover any kind of claim that a debtor could conceivably have asserted. They include such types of claims as piercing the corporate veil, breach of fiduciary duty, and fraudulent transfer, among others. The release by a debtor of its own claims against third parties is rarely controversial. After all, those claims are the debtor's property. However, there are many types of debtor claims for which a debtor may own the claim and be primarily or, during the pendency of its Chapter 11 case, exclusively entitled to assert, but third parties may also be empowered to assert. These would include derivative actions, in some cases fraudulently transfer actions, and the like. So, although initially not terribly controversial, a very broadly drafted debtor release provision can start to encroach upon…

LEVEL III - RELEASES BY NON-DEBTOR THIRD PARTIES AGAINST NON-DEBTOR THIRD PARTIES

This where the federal circuits begin to split on their view of the authority by which, and under what circumstances, a bankruptcy court may compel releases by non-debtors of claims against other non-debtors. We have within this category a non-controversial exception. There is no prohibition or perceived problem with a provision under which consenting third parties release claims against non-debtor third parties. This is simply a matter of contract. A party can agree to release another party from claims that it may be entitled to assert. However, the devil is in the details, and these materials will briefly explore what constitutes a consensual versus a non-consensual release of third party claims. This leaves non-consensual releases by non-debtor third parties against non-debtor third parties as the focal point of the controversy. The remainder of this paper will focus exclusively on these non-consensual releases by non-debtor third parties against non-debtor third parties (in the way of shorthand reference, this narrow class of releases will be referred to hereafter as "third party releases").

THE CIRCUIT SPLIT

The majority view, espoused by the 2nd, 3rd, 4th, 6th, 7th, and 11th Circuits, are that third party releases may be permissible in rare or unusual circumstances. Each Circuit has expressed that view with different tests or formulations of the rule, with a common admonition that these third party releases should be the exception, not the rule, and allowed only in rare or exceptional circumstances.

The Second Circuit in Deutsche Bank AG, London Branch vs. Metromedia Fiber Network, Inc., 416 F.3d 136 (2nd Cir. 2005) held that a third party 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" and that the release itself is necessary to the plan of reorganization. Id at 143. The 7th Circuit in Airadigm Communications, Inc. vs. FCC, 19 F.3d 640 (7th Cir. 2008) aligned itself with the majority of circuits approving third party releases. The 7th Circuit found that the grant of authority in Section 105(a) of the Bankruptcy Code to enter any order necessary to carry out the provisions of the Code, in addition to the provision in Section 1123(b)(6) of the Bankruptcy Code that Chapter 11 plans may include any other appropriate provision not inconsistent with the applicable provisions of this title, "was sufficient authority to empower the court to compel releases of third parties if the release is 'appropriate' and not inconsistent with any provision of the Bankruptcy Code." As to whether the release is appropriate, the 7th Circuit found that to be a fact intensive analysis that relates to the nature of the reorganization. The 7th Circuit created a multifactor test:

(1) narrowly tailored in that "it applies only to claims 'arising out of or in connection with' the reorganization itself and does not include 'willful conduct;'"

(2) may not provide "blanket immunity"; and

(3) must be essential to debtor's reorganization.

Other test formulations of the majority view for determining whether a third party release is appropriate have been espoused. An early case out of Missouri developed a multifactor test that has been cited with approval in other circuits, and in other lower court decisions in the 1st, 8th, and D.C. Circuits. In re Master Mortgage Investment Fund, Inc., 168 B.R. 930 (Bankr. W.D.Mo. 1994). The *Master Mortgage* multifactor test is that;

(1) There is an identity of interest 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 assets of the estate.

(2) The non-debtor has contributed substantial assets to the reorganization.

(3) The injunction is essential to reorganization. Without it, there is little likelihood of success.

(4) A substantial majority of the creditors agree to such injunction, specifically the impacted class, or classes, have "overwhelmingly" voted to accept the proposed plan treatment.

(5) The plan provides a mechanism for the payment of all, or substantially all, of the claims of the class, or classes, affected by the injunction.

Another oft-cited multifactor test comes out of the 6th Circuit. Class 5 Nevada Claimants vs. Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002). The 6th Circuit adopted a 7-factor test to determine when there are "unusual circumstances" where a court "can endorse enjoining non-consenting creditors' claims against a non-debtor":

(1) There is an identity of interest 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 the reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;

(4) The impacted class, or classes, has overwhelming 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 for specific factual findings that support its conclusions.

The minority view comes primarily from two circuits, the 5th and the 10th, that have held that bankruptcy courts may not order third party nonconsensual releases. In so holding, those courts believe that Section 105(a) is insufficient to vest the court with such extraordinary equitable powers. Those courts also read Section 524(e) of the Bankruptcy Code as precluding the third-party releases, so that, without any clear statutory authority to the contrary, Section 105(a) is simply not sufficient to overcome the prohibition of Section 524(e). In In re Pacific Lumber, Co., 584 F.3d 229 (5th Cir. 2009), the 5th Circuit held that a Chapter 11 plan could not be confirmed with non-consensual non-debtor releases. In In re W. Real Estate Fund, Inc., 922 F.2d 592 (10th Cir. 1990), the 10th Circuit held that Section 524(e) prohibited a discharge of a non-debtor for liability owed to a creditor of the debtor. The 9th Circuit initially was squarely within the minority view camp. Resorts Int'l, Inc. vs. Lowenschuss, 67 F.3d 1394 (9th Cir. 1995). Like the 10th Circuit, the 9th Circuit in *Lowenschuss* interpreted Section 524(e) to prohibit any non-consensual release of third parties. However, more recently the 9th Circuit approved a non-consensual third party exculpation clause that covered only "closely involved" parties and was limited to acts and omissions arising out of the Chapter 11 cases. Blixseth v. Credit Suisse, 961 F.3d 1074 (9th Cir. 2020). Although the *Blixseth* court exclusively noted that its holding did not permit sweeping global releases of third parties, it represents a thawing of its once blanket opposition to any form of third party release.

It does bear noting that all of the authorities cited above predate the Supreme Court decision in Law v. Siegel, 571 U.S. 415 (2014). One of the popular quotes from that opinion is that "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code" Law v. Seigel, 571 U.S. at 421 (internal quotations and citations omitted). Parties opposing non-consensual third party releases often point to this quotation and the law of the *Seigel* opinion for the proposition that Section 105(a) cannot authorize a non-debtor release where the Bankruptcy Code does not authorize such relief (such as the specific authorization in Section 524(g) for asbestos cases) and where such a release would contravene Section 524(e).

WHEN IS A THIRD PARTY RELEASE "NON-CONSENSUAL'?

At the core of the consensual vs. non-consensual release debate, is the mechanism by which a plan purports to obtain the "consent" to the release. Specifically, most if not all debtors start out with a solicitation and ballot mechanism which includes a "check the box" opt out option for those creditors returning a ballot. That is, so long as notice is adequate and the third party release feature of the plan is conspicuously disclosed, creditors of a voting class are deemed to have consented to the third party release if that class has voted to accept the plan, and the creditor did not "check the box" to indicate its desire to opt out of the third party release. Some plans have a form of "death trap" feature, by which creditors who do not opt out receive in some form or another treatment more favorable than creditors who choose to opt out of granting the third party release. This is a very unsettled area of law. Those opposing third party releases often advocate for "opt in" provision in order to demonstrate consent to giving the third party release. Under an opt in structure, releases are only granted if: (1) a ballot is returned by the creditor, and (2) the creditor checks the box to affirmatively indicate its consent to granting the third party release.

In both Delaware and New York, where a significant number of larger, more complex cases are filed where third party releases are a prominent feature of the Chapter 11 plan, lower courts have come to different conclusions as to the efficacy of opt out provisions. In Delaware, for example, in the case of <u>In re Emerge Energy Services LP</u>, the Honorable Karen Owens denied confirmation of a plan with an opt out mechanism for, among others, a class of equity interests that would receive no distribution, was therefore not entitled to vote, and deemed to reject the plan under Section 1126(g) of the Bankruptcy Code. <u>In re Emerge Energy Services LP</u>, 2019 WL 7634308 (Bankr. D. Del. December 5, 2019). The court acknowledged that it was admittedly among the minority of judges in Delaware on this issue, but nevertheless determined that in order to imply consent from non-responsive creditors and equity holders, a debtor must show under "basic contract principles that the court may construe silence as acceptance." A few weeks later, the debtors in In re Insys Therapeutics Inc. proposed a plan that included an opt out mechanism for, among others, a class of equity interest not receiving any distribution, therefore not voting, and deemed to reject the plan. Failure to return the ballot, with the opt out box checked, was deemed to be consent to the third party release. There, the Honorable Kevin Gross found that not only was the notice in the solicitation materials and the ballot conspicuous, but as well, the case was quite notorious. Creditors and stakeholders knew they would need to act due to the case's notoriety. Moreover, Judge Gross found that the releases were very instrumental to the plan, and the released parties equally as instrumental to the settlement underlying the plan, making the third party releases essential. Judge Gross confirmed the plan and the third party releases over the objection of certain parties. In re Insys Therapeutics Inc., et al., Case No. 19-11563 (Bankr. D. Del. Jan. 16, 2000). A few months later, in In re Melinta Therapeutics Inc., the Honorable Laura Silverstein confirmed a plan with an opt out third party consensual release provision. In re Melinta Therapeutics Inc., Case No. 19-12748 (LSS) (Bankr. D. Del. April 2, 2020). Judge Silverstein rejected the argument that the opt out feature of the plan violated basic contract principles and therefore was not enforceable. Rather, Judge Silverstein focused on Section 1141(a) of the Bankruptcy Code, which provides the authority for a confirmed plan to bind, among others, any creditor, equity security holder, or general partner in the debtor…whether or not such claim or interest is impaired under the plan and whether or not such parties have accepted the plan. Judge Silverstein found Section 1141(a) to create a "super-contract" based on principles of claim preclusion and res judicata, that is unique to federal bankruptcy law and not reliant upon state law basic contract principles.

New York courts have a similar diversion of view and reliance upon legal principle. cf.

In re Sun Edison Inc., 576 B.R. 453 (Bankr. S.D.N.Y. 2017) (a non-voting releasors' silence does not constitute implied consent to a plan's third party release) with In re Tops Holding II Corp., Case No. 18-22289 (RDD) (Bankr. S.D.N.Y. November 9, 2018) (Silence can be deemed consent because Section 1141(a) provides the "source of the duty to speak").

A RELATED AND EMERGING ISSUE

In virtually all of the third party release cases, there are underlying, often times significant, claims against the debtor and third parties that must be resolved as part of the plan confirmation process and the debtors exit from Chapter 11. These claims can be against shareholders for receipt of fraudulent transfers, dividend recapitalizations, and similar debtor asset depletions which, as some creditors would claim, contributed to or precipitated the debtor insolvency and need for Chapter 11 relief. These claims are more often than not settled either prior to or during the pendency of the Chapter 11 case. Recently, creditors and academics have taken greater notice of how that settlement is reached, and who is responsible for it.

At least in the area of claims against shareholders, those claims usually belong in the first instance to the debtor. There are mechanisms by which a party other than the debtor, such as an unsecured creditors committee, can obtain standing to investigate and pursue such claims, if the debtor fails or refuses to investigate or pursue those claims. Professor Jared A. Ellias recently published an article, *The Rise of Bankruptcy Directors*[1], in which Professor Ellias sheds light on an evolving bankruptcy practice under which distressed companies, especially those controlled by private equity sponsors, often prepare for a Chapter 11 filing by appointing bankruptcy experts to their Boards of Directors and giving them the Board's power to make key bankruptcy decisions. Those so-called bankruptcy directors can play helpful

[1] An electronic copy of the article is available at https://ssrn.com/abstract=3866669.

roles in the bankruptcy planning and implementation process. For example, they can evaluate restructuring proposals, negotiate with creditors, run a sale process, or provide fiduciaries to manage intercompany conflicts. However, some of their activities are potentially more problematic. For example, appointing the bankruptcy directors to form a committee to investigate claims against the very shareholders who voted to put those bankruptcy directors on the Board to begin with. Professor Ellias further points out that the community of bankruptcy directors are rather small. There are repeaters and "super-repeaters". That is, individuals identified by Professor Ellias have served as bankruptcy directors for several insolvent companies. Moreover, the companies for whom the bankruptcy directors serve are represented by an even smaller community of law firms providing restructuring services. As a result, the settlement, which ultimately leads to the proposal of a plan containing third party releases, may have been reached without adequate or sufficient participation by the impacted class of creditors (generally defined as the "fulcrum debt/security" in the debtor's capital structure).

The third party release is only the last mechanical step of implementing a reorganization by way of global and often complex settlements. Professor Ellias argues that questions about the independence of the bankruptcy directors causes questions about the fairness of the bankruptcy process which can destabilize or cause lack of trust and confidence in the settlement process and the ultimate settlement achieved. Professor Ellias recommends that bankruptcy directors should be empowered only if the creditors or the holders of the fulcrum debt/security, supports their appointment. Courts should closely scrutinize the bankruptcy directors' relationships for conflicts and qualifications. Finally, Professor Ellias recommends that the fulcrum debt/security class should be permitted to investigate and prosecute claims over the objection of the bankruptcy directors, or at least participate in that investigation in a meaningful way.

THE RESPONSE OF CONGRESS

The recent rise of high profile mass tort litigation cases such as USA Gymnastics, Boy Scouts of America, and Purdue Pharma L.P. have caught the attention of Congress. On March 19, 2021, Congresswoman Maloney, introduced the bill cited as the "Stop shielding Assets from Corporate Known Liability by Eliminating non-debtor Releases Act", or as it has become more commonly known, the SACKLER Act. (For those who do not know, the Sackler family, with a purported net worth of in excess of $11 billion, are the founders and principals of Purdue Pharma L.P., the manufacturer of Oxycontin and the primary target of governmental units and individuals asserting claims for the opioid epidemic that has roiled through this country for several years). The SACKLER Act would simply prohibit non-debtor releases from being effective against a state, municipality, federally recognized Tribe, or the United States against a non-debtor, except as provided by Section 524(g) of the Bankruptcy Code. The SACKLER Act would also limit for a period not to exceed 90 days, an injunction staying the commencement or continuation of actions against non-debtor entities that could have been commenced before the commencement of the debtor's bankruptcy case.[2]

More recently, on July 28, 2021, Representative Nadler and Senator Warren each introduced identical bills cited as the "Non-debtor Release Prohibition Act of 2021". The Non-debtor Release Prohibition Act goes much further than the SACKLER Act. It would prohibit third-party releases entirely, except for co-debtor relief provisions under Chapter 12 and Chapter 13, and the asbestos exceptions contained in Section 524(g) of the Bankruptcy Code. It would similarly limit to 90 days any post-bankruptcy injunction to stay the commencement or continuation of cases against non-debtors, but would expand that limitation

[2] There is typically a significant volume of litigation that exists prior to the filing of a bankruptcy case in these mass litigation cases. In order to avoid continuing legal expense that could diminish a potential settlement pool funded by non-debtor releasees, the debtor will frequently seek and obtain an injunction preventing the commencement or continuation of those actions in order to concentrate efforts on a global resolution of the claims.

to all creditors and parties in interest and not just governmental units. Similarly, if an appeal is taken from an order that provides third party releases or injunctions, a stay upon appeal is automatically terminated and dissolved within 90 days after its issuance by the bankruptcy judge or the district court, unless the appeal is dismissed or the court of appeals affirms the stay order or decree before the expiration of that time period. Finally, the Non-debtor Release Prohibition Act of 2021 addresses the common practice, sometimes referred to as Structural Optimization, of a debtor creating a liability runoff company to be the designated debtor in a case designed to manage these types of mass litigation claims.

Although it can take many forms, a typical Structural Optimization restructuring may look like this. An operating company burdened by litigation claims hires independent valuation experts to value the litigation claim exposure. The operating company then transfers to a new company (often an affiliate within the existing corporate structure) all of the operating and working capital assets that new company would need to continue its business. New company would leave behind (or other entities within the corporate structure would contribute) assets with a value that equals or exceeds the value of the litigation claim exposure (often comprised of insurance assets). In theory, the old, "toxic" company is not rendered insolvent or without adequate capital to continue to operate as a liability run off company. After the passage of time (and the running of fraudulent transfer statutes of limitation), if the amount of claims exceed the original projected value, or if the left behind assets prove insufficient to pay the claims (and associated litigation expense), the "toxic" company can file a Chapter 11 case, negotiate a settlement of the litigation claims, and seek a channeling injunction to protect new company and other affiliates, officers, directors and the like. The Non-debtor Release Prohibition Act of 2021 would allow, under Section 1112 of the Bankruptcy Code, on the request of the party in interest, the dismissal of a case filed by such "toxic" company if that company had been formed for the purpose of being the debtor runoff entity within 10 years before the bankruptcy filing date.

WHERE THERE'S A WILL, THERE IS A WAY…

Experience over the 40 plus years since the Bankruptcy Code was enacted in 1978 has demonstrated that there is a need for an appropriate, convenient, and efficient platform for the resolution of mass litigation claims. Although some may point to specific cases where there might have been a perceived abuse, overreaching, or element of unfairness, by and large Chapter 11 has worked very well as a forum for resolving claims held by thousands or tens of thousands of creditors against debtor entities and hundreds if not thousands of non-debtor related parties. The question is, will clever lawyers figure out a way to continue to use the bankruptcy platform as the convenient forum for the resolution of these type of claims or develop replacement forums. Professor Bruce A. Markell had some interesting thoughts on this, in his recent article "*Domestic Entities as Chapter 15 Debtors: A Possibility?*" (Bankruptcy Law Letter, Volume 41, Issue 7 July 2021).

Professor Markell notes that, although the United States and its bankruptcy code may have been, and may continue to be, a leading innovator in debt restructuring, other jurisdictions have not been standing still. Some of these jurisdictions have developed what Professor Markell refers to as "alien relief". Alien relief is relief granted in a foreign insolvency proceeding that is not cognizable under U.S. insolvency law. He gives two examples. A restructuring that only affects one class of debt is one example. Another example is a plan that incorporates third party releases. Currently the Netherlands, Germany, and the United Kingdom, among European Union Countries, have modified their insolvency laws to specifically permit third party releases against non-debtors.

So the question is, can a domestic United States company, perhaps with an affiliate or subsidiary located in a third party release friendly jurisdiction, initiate an insolvency action in the friendly jurisdiction , and a Chapter 15 foreign non-main proceeding of the U.S. company in the United States? If so, perhaps in that proceeding the U.S. company could obtain recognition and enforcement of the restructuring scheme approved in the foreign non-main proceeding. Such relief would be subject to discretion exercised by the bankruptcy court presiding over the Chapter 15 case, but perhaps possible to achieve. If accomplished, the next question would be whether such an arrangement would be enforceable notwithstanding the potential passage of the bills presently pending before Congress?

One final question with which to conclude these materials: If the pending bills do become law, what other creative and innovative mechanisms might be developed to facilitate restructurings in cases where third party releases are a necessary component?