Current Issues with Nonconsensual Third Party Releases in Bankruptcy (ECB221110-1B)

Thursday, November 10, 2022
11:15 a.m. – 12:15 p.m.

St. Clements Castle & Marina
Portland,CT

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LAWYERS' PRINCIPLES OF PROFESSIONALISM

As a lawyer, I have dedicated myself to making our system of justice work fairly and efficiently for all. I am an officer of this Court and recognize the obligation I have to advance the rule of law and preserve and foster the integrity of the legal system. To this end, I commit myself not only to observe the Connecticut Rules of Professional Conduct, but also conduct myself in accordance with the following Principles of Professionalism when dealing with my clients, opposing parties, fellow counsel, self-represented parties, the Courts, and the general public.

Civility:

Civility and courtesy are the hallmarks of professionalism. As such,

- I will be courteous, polite, respectful, and civil, both in oral and in written communications;
- I will refrain from using litigation or any other legal procedure to harass an opposing party;
- I will not impute improper motives to my adversary unless clearly justified by the facts and essential to resolution of the issue;
- I will treat the representation of a client as the client's transaction or dispute and not as a dispute with my adversary;
- I will respond to all communications timely and respectfully and allow my adversary a reasonable time to respond;
- I will avoid making groundless objections in the discovery process and work cooperatively to resolve those that are asserted with merit;
- I will agree to reasonable requests for extensions of time and for waiver of procedural formalities when the legitimate interests of my client will not be adversely affected;
- I will try to consult with my adversary before scheduling depositions, meetings, or hearings, and I will cooperate with her when schedule changes are requested;
- When scheduled meetings, hearings, or depositions have to be canceled, I will notify my adversary and, if appropriate, the Court (or other tribunal) as early as possible and enlist their involvement in rescheduling; and
- I will not serve motions and pleadings at such time or in such manner as will unfairly limit the other party's opportunity to respond.

Honesty:

Honesty and truthfulness are critical to the integrity of the legal profession – they are core values that must be observed at all times and they go hand in hand with my fiduciary duty. As such,

- I will not knowingly make untrue statements of fact or of law to my client, adversary or the Court;
- I will honor my word;
- I will not maintain or assist in maintaining any cause of action or advancing any position that is false or unlawful;

- I will withdraw voluntarily claims, defenses, or arguments when it becomes apparent that they do not have merit or are superfluous;
- I will not file frivolous motions or advance frivolous positions;
- When engaged in a transaction, I will make sure all involved are aware of changes I make to documents and not conceal changes.

Competency:

Having the necessary ability, knowledge, and skill to effectively advise and advocate for a client's interests is critical to the lawyer's function in their community. As such,

- I will keep myself current in the areas in which I practice, and, will associate with, or refer my client to, counsel knowledgeable in another field of practice when necessary;
- I will maintain proficiency in those technological advances that are necessary for me to competently represent my clients.
- I will seek mentoring and guidance throughout my career in order to ensure that I act with diligence and competency.

Responsibility:

I recognize that my client's interests and the administration of justice in general are best served when I work responsibly, effectively, and cooperatively with those with whom I interact. As such,

- Before dates for hearings or trials are set, or if that is not feasible, immediately after such dates have been set, I will attempt to verify the availability of key participants and witnesses so that I can promptly notify the Court (or other tribunal) and my adversary of any likely problem;
- I will make every effort to agree with my adversary, as early as possible, on a voluntary exchange of information and on a plan for discovery;
- I will attempt to resolve, by agreement, my objections to matters contained in my opponent's pleadings and discovery requests;
- I will be punctual in attending Court hearings, conferences, meetings, and depositions;
- I will refrain from excessive and abusive discovery, and I will comply with all reasonable discovery requests;
- In civil matters, I will stipulate to facts as to which there is no genuine dispute;
- I will refrain from causing unreasonable delays;
- Where consistent with my client's interests, I will communicate with my adversary in an effort to avoid needless controversial litigation and to resolve litigation that has actually commenced;
- While I must consider my client's decision concerning the objectives of the representation, I nevertheless will counsel my client that a willingness to initiate or engage in settlement discussions is consistent with zealous and effective representation.

Mentoring:

I owe a duty to the legal profession to counsel less experienced lawyers on the practice of the law and these Principles, and to seek mentoring myself. As such:

- I will exemplify through my behavior and teach through my words the importance of collegiality and ethical and civil behavior;
- I will emphasize the importance of providing clients with a high standard of representation through competency and the exercise of sound judgment;
- I will stress the role of our profession as a public service, to building and fostering the rule of law;
- I will welcome requests for guidance and advice.

Honor:

I recognize the honor of the legal profession and will always act in a manner consistent with the respect, courtesy, and weight that it deserves. As such,

- I will be guided by what is best for my client and the interests of justice, not what advances my own financial interests;
- I will be a vigorous and zealous advocate on behalf of my client, but I recognize that, as an officer of the Court, excessive zeal may be detrimental to the interests of a properly functioning system of justice;
- I will remember that, in addition to commitment to my client's cause, my responsibilities as a lawyer include a devotion to the public good;
- I will, as a member of a self-regulating profession, report violations of the Rules of Professional Conduct as required by those rules;
- I will protect the image of the legal profession in my daily activities and in the ways I communicate with the public;
- I will be mindful that the law is a learned profession and that among its desirable goals are devotion to public service, improvement of administration of justice, and the contribution of uncompensated time and civic influence on behalf of those persons who cannot afford adequate legal assistance; and
- I will support and advocate for fair and equal treatment under the law for all persons, regardless of race, color, ancestry, sex, pregnancy, religion, national origin, ethnicity, disability, status as a veteran, age, gender identity, gender expression or marital status, sexual orientation, or creed and will always conduct myself in such a way as to promote equality and justice for all.

Nothing in these Principles shall supersede, supplement, or in any way amend the Rules of Professional Conduct, alter existing standards of conduct against which a lawyer's conduct might be judged, or become a basis for the imposition of any civil, criminal, or professional liability.

Faculty Biographies

Chief Judge Christopher J. Panos

Hon. Christopher J. Panos was appointed as a United States Bankruptcy Judge in 2015. He serves as the Chief Judge of the United States Bankruptcy Court for the District of Massachusetts and on the Bankruptcy Appellate Panel for the First Circuit. Prior to his appointment, Judge Panos practiced at Craig and Macauley P.C. in Boston for more than twenty-five years and served as its Managing Shareholder until 2014, when attorneys at that firm joined Partridge Snow & Hahn LLP to open its Boston office. He served as partner-in-charge of the Boston office until his appointment to the bench. Judge Panos had a diverse practice focusing on business restructuring and insolvency, mergers and acquisitions, commercial finance, business litigation, and general business law. He represented public and privately held companies, individuals, governmental entities, banks, hedge funds, and private equity funds in matters involving many different business sectors, including financial services, biotech, energy, pharmaceuticals, manufacturing, retail, and real estate development. He was regularly recognized in peer-review publications such as *Chambers*® and *Best Lawyers in America*® and was selected Boston "Lawyer of the Year" in the area of bankruptcy and restructuring by *Best Lawyers in America* in 2012 and 2016. *Law & Politics* and *Boston Magazine* designated him as a Super Lawyer each year of publication of that list and several times named him a "Top 100 Attorney" in Massachusetts and New England. Judge Panos was elected as a Fellow of the American College of Bankruptcy in 2008 and served on its First Circuit council from 2012 to 2015. He served as chair of the Bankruptcy Law Section of the Boston Bar Association and on the board of trustees of the Boston Bar Foundation. Judge Panos is a graduate of Georgetown University and Boston University School of Law, *cum laude*, where he later taught courses in legal research, writing, and advocacy.

Irve J. Goldman

Irve J. Goldman serves as chair of Pullman & Comley's Bankruptcy, Creditors' Rights and Financial Restructuring practice. He has practiced in the areas of bankruptcy law and commercial litigation for more than 30 years and has represented a diversity of interests in bankruptcy proceedings, including companies reorganizing under Chapter 11, secured creditors, equipment lessors, franchisees, landlords and other creditor groups and asset purchasers in 363 sales. In a case that has received national attention, he represented the State of Connecticut and a group of other states in the Chapter 11 case of *In re Purdue Pharma, L.P. et al.*

This year, Irve has been commended by The American Board of Certification for 30 years as a Business Bankruptcy Specialist, a symbol of professionalism and achievement in the bankruptcy and creditors' rights law fields. He was one of the first attorneys in Connecticut to become a certified specialist in business bankruptcy, in July 1993. Irve was recently named 2023 "Lawyer of the Year" for Litigation-Bankruptcy in the Stamford area by *The Best Lawyers in America*. In

2022, he received “Lawyer of the Year” in the area of Bankruptcy and Creditors Rights/Insolvency and Reorganizational Law.

William K. Harrington

William K. Harrington is the United States Trustee for Region 1 and Region 2. Mr. Harrington was appointed as the United States Trustee for Region 1 on November 8, 2010 and as the United States Trustee for Region 2 on November 26, 2013. Prior to his appointment as the United States Trustee for Region 1, Mr. Harrington was the Assistant United States Trustee for the District of Delaware. Prior to joining the Office of the United States Trustee, he practiced bankruptcy and reorganization law at Duane Morris LLP. Mr. Harrington is a member of the Boston Bar Association, the Delaware State Bar Association, the American Bar Association, the American Bankruptcy Institute and the Delaware Bankruptcy American Inn of Court. He received his undergraduate degree from the University of Pennsylvania and his J.D. from Villanova University School of Law.

Current Issues with Nonconsensual Third-Party Releases in Bankruptcy

2022 5th Annual Connecticut Bankruptcy Conference
Saint Clements Castle and Marina
Portland, CT
November 10, 2022

Agenda

Presenters:

Chief Judge Christopher J. Panos, U.S. Bankruptcy Court, District of Massachusetts, Boston, MA
William K. Harrington, U.S. Trustee (Region 2), Office of the U.S. Trustee, New York, NY
Irve Goldman, Pullman & Comley LLC, Bridgeport

11:15 a.m. – 11:20 a.m.:	Welcome and Introductions – I. Goldman
11:20 a.m. – 11:30 a.m.:	Overview of Issues – Hon. C. Panos
11:30 a.m. – 11:40 a.m.:	Review of Recent Cases – I. Goldman/W. Harrington
11:40 a.m. – 11:55 a.m.:	Arguments in Favor of Nonconsensual Releases - Panel
11:55 a.m. – 12:10 p.m.:	Arguments against Nonconsensual Releases - Panel
12:10 p.m. – 12:15 p.m.:	Best Interests Test; Releases Approved Via Rule 9019 - Panel

CURRENT ISSUES WITH NONCONSENSUAL THIRD-PARTY RELEASES IN BANKRUPTCY

(PART I – DEFINING TYPES OF RELEASES, EXCULPATIONS AND PLAN INJUNCTIONS IN CHAPTER 11)

For:

Connecticut Bar Association
Commercial Law and Bankruptcy Section

The Fifth Annual Connecticut Bankruptcy Conference
St. Clements Castle
Portland, CT
November 10, 2022

Panelists:

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Materials Prepared By:
William Harrington, Esq.,
US Trustee (Region 2).

I. Types of Releases and Injunctions in Chapter 11

- Debtor discharge under 11 U.S.C. § 1141(d) – A bankruptcy discharge "is an involuntary release by operation of law of asserted and non-asserted claims by a creditor against an entity who has filed a petition under the Bankruptcy Code and who has abided by its rules." *In re Yellowstone Mt. Club, LLC*, 460 B.R. 254, 268 (Bankr. D. Mont. 2011) (citing *In re Arrowmill Dev. Corp.*, 211 B.R. 497, 504 (Bankr. D.N.J.1997)).

- Debtor or estate release – A debtor release is a contractual relinquishment or extinguishment of claims given by the debtor to third parties, usually through a settlement or a provision in a chapter 11 plan, for direct claims held by the debtor itself or for derivative claims that are property of the estate. A release of claims belonging to the estate is also referred to as an estate release.

- Exculpation provisions for estate fiduciaries or parties to court-supervised and court-approved transactions – Exculpation provisions in a plan set forth the standard for liability that would apply to actions against fiduciaries in the event that they were sued for their participation in the reorganization. *In re PWS Holding Corp.*, 228 F.3d 224, 246–47 (3d Cir. 2000). Exculpation provisions contain temporal limitations related to the time period in which the fiduciary is subject to oversight.

- Injunction provisions established to carry out the plan – An injunction is an order commanding or preventing an action. Chapter 11 debtors often seek approval of one or more injunctive provisions to carry out the terms of the plan. Such provisions may attempt to enjoin or bar creditor claims against non-debtor entities or channel claims away from protected non-debtors to a trust created to pay such claims.

- Third-party releases of non-debtor third parties: consensual and non-consensual. A third-party release is an extinguishment of non-debtors' direct claims against non-debtor third parties. Third-party releases may be consensual, as where a creditor affirmatively manifests its knowing and informed consent to releases contained in a plan by completing a ballot "opting-in" to the release. A non-consensual third-party release is a release that binds a creditor who has not affirmatively given its knowing and informed assent, as where, for example, an impaired creditor votes against confirmation or where creditors do not have the opportunity to affirmatively opt in to a release when voting on a plan.

II. <u>Discharge Under 11 U.S.C. § 1141(d)</u>

- In general, confirmation of a reorganization plan discharges a chapter 11 debtor from liability for most debts that arose before confirmation of the debtor's plan. 11 U.S.C. § 1141(d).[1] Section 524(a) provides that a discharge voids any judgment to the extent that it is a determination of the debtor's personal liability and operates as an injunction against enforcement of debts as a personal liability of the debtor, subject to certain exceptions. *See* 11 U.S.C. § 524(a).

- A bankruptcy discharge "releases a debtor from personal liability with respect to any discharged debt by voiding any past or future judgments on the debt." *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440, 447 (2004); *see, e.g.*, 11 U.S.C. § 727(a) ("The court shall grant the *debtor* a discharge" unless certain conditions are met) (emphasis added). A discharge also "operat[es] as an injunction to prohibit creditors from attempting to collect or to recover the debt." *Hood*, 541 U.S. at 447.

- Creditor claims are replaced by the new contractual obligation created by their treatment under the confirmed plan. *In re New River Shipyard, Inc.*, 355 B.R. 894, 912 (Bankr. S.D. Fla. 2006). Except as set forth in the confirmed plan, any prepetition debts owed by the debtor become "unenforceable as a matter of bankruptcy law." *In re Consumers Realty & Dev. Co., Inc*., 98-40721, 1999 WL 33864, at *7 (Bankr. D. Minn. Jan. 14, 1999), *aff'd*, 238 B.R. 418 (B.A.P. 8th Cir. 1999).

- The relief provided by a bankruptcy discharge is broad, but it is neither unlimited nor unconditional. Foremost, to receive the discharge, a person must file for bankruptcy. 11 U.S.C. 524(e) ("discharge of a debt of the debtor does not affect the liability of any other entity . . .). Those who do must subject themselves to the supervision of the bankruptcy court, provide public disclosure of their finances, and comply with numerous other statutory duties as conditions for receiving bankruptcy relief. *See* 11 U.S.C. § 521. Failing to comply with these duties can lead to dismissal, conversion to a liquidation proceeding under chapter 7, or appointment of a private trustee who assumes management of the estate. *See* 11 U.S.C. §§ 1104, 1108, 1112.

- Not everyone is eligible for bankruptcy relief, *see* 11 U.S.C. §§ 109, 727, 1141(d), and not all debts are dischargeable, *see, e.g.*, 11 U.S.C. § 523(a)(2), (4), (6). A chapter 11 discharge may be granted only after the debtor complies with a detailed set of statutory procedures and requirements, *see* 11 U.S.C. §§ 1129, 1141, and only as part of a public judicial process in which all creditors can participate. *See*

[1] Note that under 11 U.S.C. § 1141(d)(5), individual chapter 11 debtors who do not elect to be subchapter V debtors will not receive a discharge until the completion of plan payments. Subchapter V debtors who confirm consensual plans receive a discharge upon confirmation, while those who confirm non-consensual plans receive a discharge after 3 to 5 years of plan payments. 11 U.S.C. §§ 1181(a), 1192. Under 11 U.S.C. § 1141(d)(3), non-small business debtors who propose liquidating plans do not receive a discharge.

11 U.S.C. §§ 341, 1109.

- With one exception, the Bankruptcy Code discharges only the debtor's liabilities upon plan confirmation. 11 U.S.C. §§ 524(a), 1141(d)(1)(A). The Bankruptcy Code specifies that "[a] 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). The one exception applies exclusively to asbestos-related cases in which the bankruptcy court is authorized to enjoin certain types of claims against a specified set of non-debtors, and only after the court finds an extensive series of statutory requirements are met. 11 U.S.C. § 524(g).

III. <u>Debtor Releases of Claims Belonging to the Debtor or Its Estate</u>

- Section 1123(b)(3)(A) states that a plan may provide for "the settlement or adjustment of any claim or interest belonging to the debtor or to the estate." 11 U.S.C. § 1123(b)(3)(A). Rule 9019 provides "[o]n motion by the trustee and after notice and hearing, the court may approve a compromise or settlement."

- A bankruptcy debtor may settle claims it holds against third parties under Rule 9019 or as part of a debtor's chapter 11 plan pursuant to 11 U.S.C. § 1123(b)(3)(A). *In re Woodbridge Grp. of Cos., LLC*, 592 B.R. 761, 772 (Bankr. D. Del. 2018). The standards for approving settlements under Rule 9019 or as part of a plan are the same. *Id.*

- A debtor may release claims under 11 U.S.C. § 1123(b)(3)(A) if the release is a valid exercise of the debtor's business judgment, fair, reasonable, and in the best interests of the estate. *In re Abeinsa Holding, Inc.*, 562 B.R. 265, 282 (Bankr. D. Del. 2016); *U.S. Bank Nat'l Assoc. v. Wilmington Trust Co. (In re Spansion, Inc.)*, 426 B.R. 114, 143 (Bankr. D. Del. 2010).

- When evaluating a proposed settlement bankruptcy courts consider four factors:

  (1) the probability of success in litigation;
  (2) the likely difficulties in collection;
  (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and
  (4) the paramount interest of the creditor[s].

  In re Woodbridge Grp. of Cos., LLC, 592 B.R. at 772.

- Some courts, however, when evaluating a debtor's release of claims under the business judgment standard have applied the standards some courts use when evaluating non-debtor third-party releases. *In re Washington Mutual, Inc.,* 442 B.R. 314 (Bankr. D. Del. 2011). "The Third Circuit has refused to articulate a test for when releases by Debtors are appropriate in the chapter 11 context. *Continental Airlines*, 203 F.3d at 214. However, the Court continues to believe that the factors articulated in *Master Mortgage* form the foundation for such an analysis, with due consideration of other factors that may be relevant to this case." *Id.* at 346-47.

IV. **Exculpation Provisions for Estate Fiduciaries or Parties to Court-supervised and Court-approved Transactions.**

- Exculpation provisions in a plan set forth the standard for liability that would apply to actions against fiduciaries in the event that they were sued for their participation in the reorganization. *In re PWS Holding Corp*., 228 F.3d 224, 246–47 (3d Cir. 2000).

- Exculpatory clauses differ from estate and third-party releases. *In re Murray Metallurgical Coal Holdings, LLC*, 623 B.R. 444, 500–01 (Bankr. S.D. Ohio 2021). While estate and third-party releases provide for the relinquishment of claims held by the debtor or third parties against certain non-debtor parties, exculpatory clauses establish the standard of care that will trigger liability in future litigation against an exculpated party for acts arising out of a debtor's restructuring. *Id.*

- Courts have permitted the exculpation of estate fiduciaries for actions taken during the bankruptcy case to the extent such provisions merely reiterate the standards to which estate fiduciaries are held in chapter 11. *In re Washington Mut., Inc.*, 442 B.R. 314, 350-51 (Bankr. D. Del. 2011); *In re PWS Holding Corp*., 228 F.3d 224, 246–47 (3d Cir. 2000).

- In *In re PWS Holding Corp*., 228 F.3d 224 (3d Cir. 2000), the Third Circuit upheld a plan provision which limited the liability of the creditors' committee members and professionals from liability for their work in the reorganization except for willful misconduct or gross negligence. 228 F.3d at 246-47. The Court held that the provision was not barred by 11 U.S.C. § 524(e), because it did not alter the liability of those parties, but merely restated the appropriate standard of liability that already applied under the Bankruptcy Code. *Id*. In so ruling, the Court looked to 11 U.S.C. § 1103(c) which "grants to the committee broad authority to formulate a plan and perform 'such other services as are in the interest of those represented,' … [and] has been interpreted to imply both a fiduciary duty to committee constituents and a limited grant of immunity to committee members" for actions within the scope of their duties. *Id.* at 246. *See also In re Pacific Lumber Co.,* 584 F.3d 229, 253 (5th 2009) (relying on section 1103(c) to uphold exculpation for committee members only); *Highland Capital Management, L.P. v. NexPoint Advisors, L.P.,* No. 21-10449, 2022 WL 3571094, --- F.4th ---- (5th Cir. August 19, 2022) (reversing confirmation order with broad exculpation provisions only insofar as the plan exculpates certain non-debtors in violation of 11 U.S.C. § 524(e)).

- Some courts have articulated a second rationale for the approval of exculpation provisions based, not on the status of the protected party as an estate fiduciary, but on its status as a party to a court-supervised and court-approved transaction. *See, e.g., In re Aegean Marine Petroleum Network Inc*., 599 B.R. 717, 720-21 (Bankr. S.D.N.Y. 2019) ("*Aegean*"); *In re Murray Metallurgical Coal Holdings, LLC*, 623 B.R. 444, 500–01 (Bankr. S.D. Ohio 2021). Those courts view the exculpation provision as a

protection not only of court-supervised fiduciaries, but also of the finality of court-authorized transactions. *Aegean*, 599 B.R. at 721.

- In *Aegean*, the bankruptcy court evaluated a plan exculpation provision that insulated estate fiduciaries and non-fiduciaries alike for a wide range of claims related to the restructuring, subject to a general exclusion for fraud, willful misconduct, or gross negligence. 599 B.R. at 720-21. The list of covered parties included the party acquiring assets from the debtor that was also a debtor-in-possession lender, the debtor-in-possession's agents and lenders, the prepetition secured credit facility agents and lenders and the unsecured notes indenture trustees. *Id.* at 721. The court found the wording of the exculpation too broad, and then opined that "an appropriate exculpation provision should say that it bars claims against the exculpated parties based on the negotiation, execution, and implementation of agreements and transactions that were approved by the Court." *Id.* With regard to the extension of such protections to non-fiduciaries, the court indicated if the exculpation provision were limited as described, it could cover non-fiduciaries who were parties to court-supervised and court-authorized transactions. *Id.* The court opined: "In the absence of gross negligence or intentional wrongdoing, parties should not be liable for doing things that the Court authorized them to do and that the Court decided were reasonable things to do." *Id.*

V. **<u>Plan Injunctions</u>**

- An injunction "is a means by which a court tells someone what to do or not to do. When a court employs 'the extraordinary remedy of injunction,' ..., it directs the conduct of a party, and does so with the backing of its full coercive powers." *Nken v. Holder*, 556 U.S. 418, 428 (2009) (citation omitted). *See also* Black's Law Dictionary (11th ed. 2019) (defining "injunction" as "[a] court order commanding or preventing an action.").

- Congress expressly authorized bankruptcy courts to issue plan injunctions enjoining actions against third parties only under one narrow circumstance set forth in 11 U.S.C. § 524(g), which applies exclusively to asbestos cases. *See, e.g., Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.),* 416 F.3d 136, 142-43 (2d Cir. 2005) (recognizing that while some cases have allowed such releases, "the only explicit authorization in the Code for nondebtor releases is 11 U.S.C. § 524(g)").

- Section 524(g) authorizes bankruptcy courts to enjoin actions against a limited subset of identifiable third parties where the debtor establishes trusts for asbestos claimants to which their claims can be channeled and compensated, and only to the extent the third party is directly or indirectly liable for the debtor's liability "by reasons of" one of four statutory relationships between the third party and the debtor. 11 U.S.C. § 524(g)(2)(B)(i) & (4)(A)(ii); *Travelers Indem. Co. v. Bailey,* 557 U.S. 137, 151-55 (2009).

- Congress did so in response to the decision in *MacArthur Co. v. Johns-Manville Corp. (In re Johns- Manville Corp.)*, 837 F.2d 89 (2d Cir. 1988) ("*Manville I*"). The Manville release was limited to certain actions against debtor's insurers, all of whom had agreed to dedicate the full proceeds of their policies to a settlement fund created to pay asbestos victims' claims. The Court held that the release was justified because the policies at issue were "property of the debtor's estate," *id*. at 90, but did not cite any Code provision authorizing the bankruptcy court to approve the release. Congress enacted § 524(g) in light of doubts that the *Manville I* injunction (and a similar injunction in another large asbestos bankruptcy) was statutorily authorized. *See* H.R. Rep. No. 103- 835, at 41 (1994).

CURRENT ISSUES WITH NONCONSENSUAL THIRD-PARTY RELEASES IN BANKRUPTCY (PART II)

For:

Connecticut Bar Association
Commercial Law and Bankruptcy Section

The Fifth Annual Connecticut Bankruptcy Conference
St. Clements Castle
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November 10, 2022

Panelists:

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I. INTRODUCTION

In bankruptcy parlance, a "third-party release," sometimes called a "nondebtor release," *In re Metromedia Fiber Network, Inc.,* 416 F.3d 136, 141 (2d Cir. 2005), refers to "[a] release provision in a chapter 11 plan [that] relieves the identified nondebtor parties of any liability for any claims or causes of action that third parties might hold against them." ABI Commission to Study the Reform of Chapter 11, AMERICAN BANKRUPTCY INSTITUTE, Final Report and Recommendations, at 253. Examples of the beneficiaries of such a release, the "releasees" or "released parties" as plans often refer to them, are the debtor's officers and directors, a creditors' committee and its members and professionals, a nondebtor plan proponent or plan funder, the debtor's secured lender or exit-financing lender, or others who have in some way contributed to the chapter 11 process.

In general, a third-party release contemplates releasing a nondebtor party from certain obligations and rights based on that party's "material contributions" to the bankruptcy case, so long as the releases are "important" and "necessary" "to accomplish a particular feature of a restructuring." *In re PT Bakrie Telecom Tbk*, 628 B.R. 859, 880 (Bankr. S.D.N.Y. 2021) (quoting *In re Aegean Marine Petroleum Network Inc*., 599 B.R. 717, 727 (Bankr. S.D.N.Y. 2019) (citing *In re Metromedia Fiber Network*, 416 F.3d 136, 143 (2d Cir. 2005)). A third-party release can act as a complete release, waiver, and discharge of the nondebtor party from a claim of any nature (i.e., claims, obligations, rights, causes of action, and liabilities) arising out of or in connection with the debtor and its plan of reorganization. *Id. (citing In re Metromedia Fiber Network*, 416 F.3d at 141, 142 ("By it, a nondebtor can shield itself from liability to third parties. In form, it is a release; in effect, it may operate as a bankruptcy discharge arranged without a filing and without the safeguards of the Code."). Nonconsensual third-party releases are available in bankruptcy cases in some but not all jurisdictions in the United States and were most recently ruled to be unauthorized under the Bankruptcy Code in the case of *In re Purdue Pharma, L.P.*, 635 B.R. 26 (S.D.N.Y. 2021), *appeal filed* Docket Nos. 22-110, 22-85 (2d Cir. Jan. 18, 2022).[1] The nonconsensual third-party release that was challenged in *Purdue* provided, in pertinent part, as follows:

> The "Releasing Parties" release the "Shareholder Released Parties" "from any and all Causes of Action" …:
>
> (x) based on or relating to, or in any manner arising from, in whole or in part, (i) the Debtors, as such Entities existed prior to or after the Petition Date (including the Debtors' Opioid-Related Activities, manufacture, marketing and sale of Products, interaction with regulators concerning Opioid-Related Activities or Products, and involvement in the subject matter of the Pending Opioid Actions, and the past, present or future use or misuse of any opioid by a Releasing Party), (ii) the Estates or (iii) the Chapter 11 Cases and (y) as to which any conduct, omission or liability of any Debtor or any Estate is the legal cause or is otherwise a legally relevant factor.

[1] The Second Circuit argument in *Purdue* took place on April 29, 2022. As of the submission of these materials, the Second Circuit had not yet rendered its decision in *Purdue.*

A. *Consensual vs. Nonconsensual Releases*

For analytical purposes, a distinction must be drawn between consensual and nonconsensual third-party releases. Consensual third-party releases are recognized as permissible and, except as to what might constitute "consent," should not be controversial. *See Metromedia Fiber Network*, 416 F.3d at 142 ("[n]ondebtor releases may also be tolerated if the affected creditors consent"); *Matter of Specialty Equipment Companies, Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993) ("courts have found releases that are consensual and non-coercive to be in accord with the strictures of the Bankruptcy Code"); *In re LATAM Airlines Group, S.A.*, 2022 WL 2206829, at *45 (Bankr. S.D.N.Y. June 18, 2022) ("[i]t is well settled that, as a general proposition, creditors may consent to third-party releases").

As to whether a nondebtor release is "consensual," however, is another matter. The main issue dividing the courts is whether consent can be established by a provision in a ballot requiring creditors to "opt out" of the release in order to escape its effect or whether creditors must affirmatively "opt in" to the release either by so indicating on the ballot or by voting to accept the plan. *Compare In re Emerge Energy Servs. LP,* 2019 WL 7634308, at *18 (Bankr. D. Del. Dec. 5, 2019) (opt-out insufficient to imply consent); *In re SunEdison, Inc.*, 576 B.R. 453, 460 (Bankr. S.D.N.Y. 2017) (same); *In re Washington Mutual, Inc.,* 442 B.R. 314, 355 (Bankr. D. Del. 2011) ("[f]ailing to return a ballot is not a sufficient manifestation of consent to a third party release"); *In re Abeinsa Holdings, Inc.*, 562 B.R. 265, 285 (Bankr. D. Del. 2016) ("[c]onsent to a third-party release is generally determined by voting to accept the plan"); *In re Crabtree & Evelyn, Ltd*., 2010 WL 3638369, at *7 (Bankr. S.D.N.Y. Jan. 14, 2010) (finding that where creditors had accepted the plan and the non-debtor releases were appropriately disclosed by the debtors in both the disclosure statement and the ballot, such creditors had expressly consented to the non-debtor releases) *with In re Boy Scouts of America and Delaware BSA, LLC*, 642 B.R. 504, 674-77 (Bankr. D. Del. July 29, 2022) (approving opt-out provision on ballot as a foundation for consent where it was "prominently placed on the first page of each ballot (carried over to the second page, as appropriate), in bold, all caps and surrounded by a box"); *In re Mallinckrodt PLC*, 639 B.R. 837, 878-880 (Bankr. D. Del. Feb. 8, 2022) (approving opt-out procedure on ballot where there was clear and conspicuous notice and instructions); *In re Avianca Holdings S.A.*, 632 B.R. 124, 136-37 (Bankr. S.D.N.Y. 2021) (opt-out structure is permissible provided that a clear and prominent explanation of the procedure is given); *In re Stearns Holdings, LLC*, 607 B.R. 781, 788 (Bankr. S.D.N.Y. 2019) (same).

B. *Derivative vs. Direct Claims*

The issue of whether nonconsensual third-party releases are permissible under the Bankruptcy Code arises only with respect to claims against the proposed non-debtor releasee that are **direct, as opposed to derivative.** This is because a derivative claim, as a claim "based on rights "derivative" of, or "derived" from, the debtor's typically involves property of the estate," and thus, belongs to and can only be asserted by the bankruptcy estate. *In re Bernard L. Madoff*

Inv. Securities LLC, 740 F.3d 81, 88 (2d Cir. 2014).[2]

The distinction between direct and derivative claims was succinctly captured by Judge McMahon in *In re Purdue Pharma, L.P.*, 635 B.R. 26 (S.D.N.Y. 2021), *appeal filed* Docket Nos. 22-110, 22-85 (2d Cir. Jan. 18, 2022), as follows:

> Derivative" claims are those seek to recover from the estate indirectly "on the basis of [the debtor's] conduct," as opposed to the non-debtor's own conduct. Manville III, 517 F.3d at 62 (quoting MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89 (2d Cir. 1988)). Derivative claims in every sense relate to the adjustment of the debtor-creditor relationship, because they are claims that relate to injury to the corporation itself. If the creditor's claim is one that a bankruptcy trustee could bring on behalf of the estate, then it is derivative. Madoff, 40 F.3d at 90.
>
> By direct claims, I mean claims that are not derivative of Purdue's liability, but are based on the Sacklers' own, individual liability, predicated on their own alleged misconduct and the breach of duties owed to claimants other than Purdue. "Direct" claims are based upon a "particularized" injury to a third party that can be directly traced to a non-debtor's conduct. Id.

Id. at 90.

II. THIRD-PARTY RELEASES

A. *Overview of the Law*

There is no question that "[t]hird-party releases are often problematic in chapter 11 cases – seemingly prohibited entirely in some Circuits but permitted under limited circumstances in other Circuits." *In re Avanti Communications Group PLC,* 582 B.R. 603, 606 (Bankr. S.D.N.Y. Apr. 9, 2018). With nonconsensual releases, at least in those jurisdictions which hold they are

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[2] The third-party release at issue in *Madoff* involved an "injunction, [that] by its own terms, is limited to third-party claims based on derivative or duplicative liability or claims that could have been brought by the Trustee against the Picower releasees." *Id.* Two defrauded investors of Bernard L. Madoff Investment Securities LLC ("BLMIS") sought to escape the effect of that injunction by contending that their civil action against Jeffrey Picower and related defendants, which was based on their having conspired with Madoff to fraudulently withdraw billions of dollars of BLMIS customer funds, asserted "non-derivative conspiracy-based claims predicated upon the Picower defendants' direct participation in the theft of BLMIS customers' funds." *Id.* at 91. The Second Circuit held the claims were derivative, not direct, because they sought to recover for harm that was "general" to all creditors or, as it put it, for "secondary harms flowing from the Picower defendants' fraudulent withdrawals and the resulting depletion of BLMIS funds," for which a recovery was sought by the trustee's fraudulent transfer action. *Id.* at 91-93.

permissible, the criteria used or factors considered for determining whether they should be approved varies by Circuit, but for the most part, are similar.

A summary of the Circuit authority and notable lower court authority on third-party releases follows.

First Circuit

While the First Circuit Court of Appeals has not directly addressed this issue, lower courts in the First Circuit have held that "a chapter 11 plan may, in appropriate circumstances, include a third-party release, and that the *Master Mortgage* factors are useful considerations in assessing the propriety of a proposed release. *In re Charles Street African Methodist Episcopal Church of Boston*, 499 B.R. 66, 100 (Bankr. D. Mass. 2013) (citing *In re Quincy Medical Center, Inc.*, 2011 WL 559290, at *2 (Bankr. D. Mass.2011)). "'These factors are neither exclusive nor conjunctive requirements'." *Id.* (quoting *In re Washington Mutual, Inc.*, 442 B.R. 314, 346 (Bankr.D.Del.2011)). The *Master Mortgage* factors are:

i. An identity of interests between the debtor and the third party, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;

ii. The non-debtor has contributed substantial assets to the reorganization;

iii. The injunction is essential to the reorganization;

iv. A substantial majority of creditors agree to such injunction, specifically, the impacted class, or classes, has overwhelmingly voted to accept the proposed plan treatment; and

v. 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.

In re Master Mortgage Investment Fund, Inc., 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994).

Second Circuit

It is currently unsettled in the Second Circuit as to whether third-party releases are authorized under the Bankruptcy Code. Proponents of third-party releases maintain that the Second Circuit has authorized them on multiple occasions, most notably in *In re Metromedia Fiber Network, Inc.* 416 F.3d 136 (2d Cir. 2005), where the Second Circuit listed a set of nonexclusive factors for courts to consider in determining whether to approve third-party releases. *Id.* at 141-42. *See also In re Bernard L. Madoff Inv. Securities LLC* 740 F.3d 81, 93 n.12 ("[i]n *In re Metromedia Fiber Network, Inc.*, we held that a bankruptcy court could permit the nonconsensual release of creditors' claims against third parties …." (citing *Metromedia*, 416 F.3d at 143)); *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293 (2d Cir. 1992) ("[i]n bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the

injunction plays an important part in the debtor's reorganization plan."). The *Metromedia* factors are as follows, although as the Second Circuit has stated, whether third-party releases may be authorized in a particular case "is not a matter of factors and prongs" *Metromedia*, 416 F.3d at 142:

i. the estate receives substantial consideration;

ii. the enjoined claims are "channeled" to a settlement fund rather than extinguished;

iii. the enjoined claims would indirectly impact the debtor's reorganization "by way of indemnity or contribution"; and

iv. the plan otherwise provided for the full payment of the enjoined claims

The Second Circuit authority which has been frequently cited as authority for approving nonconsensual third-party releases was called into question in the case of *In re Purdue Pharma, L.P.,* 635 B.R. 26 (S.D.N.Y. 2021) (McMahon, U.S.D.J.), *appeal pending*, because no Second Circuit decision had squarely addressed the issue of whether third-party releases are statutorily authorized. *Id.* at 104 ("[t]he only fair characterization of the law on the subject of statutory authority to release and enjoin the prosecution of third-party claims against non-debtors in a bankruptcy case is: unsettled, except in asbestos cases, where statutory authority is clear," and observing that "[b]ecause the Court of Appeals has decided every other case on non-statutory grounds, its only clear statement is that Section 105(a), standing alone, does not confer such authority on the bankruptcy court outside the asbestos context").

In *Purdue*, Judge McMahon held that nonconsensual third-party releases were not authorized under the Bankruptcy Code. The decision engages in an extensive analysis of the case law and statutory authority bearing on the issue, which can be summarized as follows:

- Section 524(g), passed as part of the Bankruptcy Reform Act of 1994, is the only statutory section that specifically authorizes nonconsensual third-party releases, and it only applies in asbestos cases. Although an uncodified law, Pub. L. 103-394 § 111(b), provides that nothing in the 1994 amendments "shall be construed to modify, impair, or supersede any other authority the court has to issue injunctions in connection with an order confirming a plan of reorganization," Judge McMahon concluded that this provision was included to placate parties in non-asbestos bankruptcies who took the position that § 524(g) was unnecessary because bankruptcy courts already possessed the authority to impose nonconsensual third-party releases. She then turned to the legislative history to Section 111(b), which stated that the Judiciary Committee, while aware that debtors in other industries were beginning to experiment with similar mechanisms, "expresses no opinion as to how much authority a bankruptcy court may generally have under its traditional equitable powers" to approve a nonconsensual third-party release, followed by the salient remark that "[h]ow the new statutory mechanism works in the asbestos arena may help the Committee judge whether the concept should be extended into other areas." *Id.* at 93-94

- In the Second Circuit, the equitable authority of a bankruptcy court under §105(a) can only be used in carrying out the provisions of the Bankruptcy Code, rather than to further the purposes of the Bankruptcy Code generally, or otherwise do the right thing. *Id.* at 99 (quoting *New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc*. (*In re Dairy Mart Conveniences Stores*), 351 F. 3d 86, 92 (2d Cir. 2003)

- Section 1123(b)(6) is not one of the provisions that can used to authorize nonconsensual third-party releases. It provides that a plan may "include any other appropriate provision not inconsistent with the applicable provisions of this title." Because this section is substantively analogous to § 105(a), which alone cannot be used to justify third-party releases, § 1123(b)(6) similarly cannot be read to do so. *Purdue,* 635 B.R. at 106

- The releases in *Purdue* were also inconsistent with nondischargeability sections 523(a)(2), (4), (6) and (7) in that they sought to effectively discharge the objecting states' claims when they would potentially be nondischargeable under either one or more of those sections if the individual releasees filed their own bankruptcies. *Id.* at 106.

- Section 1123(a)(5), providing that a plan "shall … provide adequate means for [its] implementation," also does not provide the requisite statutory authority. It provides a laundry list of examples of doing something with the debtor's assets, not disposing of property belonging to someone else, *viz.,* non-derivative causes of action held by creditors against nondebtors. *Id.* at 108. In addition, the section confers no special power on the court in that the court does not propose the plan and the order the section contemplates is a confirmation order, not an order enjoining claims against nondebtors. *Id.* at 109. Most importantly, as with § 1123(b)(6), § 1123(a)(5) provides no independent statutory authority to issue nondebtor releases, and the mere fact that the plan relies for its implementation on funding from third parties who are demanding releases of claims held against them by nondebtor creditors does not "give the bankruptcy court statutory authority to enter an otherwise impermissible order in order to obtain that funding." *Id.*

- The lack of any statutory prohibition also could not supply the requisite statutory authority because as a "'comprehensive scheme'," the Bankruptcy Code cannot be read in such a way as to allow statutory silence to be equated with authorization for the exercise of such a weighty power. *Id.* at 109-110 (quoting *RadLax Gateway Hotel, LLC v. Amalgamated Bank,* 566 U.S. 639, 645 (2012) and citing *Czyzewski v. Jevic Holding Corp*., 137 S.Ct. 973, 984 (2017)). In addition, it is not reasonable to expect that Congress would have thought it necessary to expressly prohibit third-party releases given the purpose of the Code "'to free the debtor of personal obligations while ensuring that no one else reaps a similar benefit'." *Id* at 110 (quoting *Green v. Welsh*, 956 F.2d 30, 33 (2d Cir. 1992)).

- "Residual statutory authority" does not exist for the issuance of nonconsensual third-party releases. The U.S. Supreme Court's decision in *U.S. v. Energy Resources Co., Inc.*, 495 U.S. 545 (1990) does not provide "residual authority" to approve a plan that includes all "necessary and appropriate" provisions as long as they are not inconsistent with title 11. In *Energy Resources*, the plan proposed that payments to be made on account of the

> IRS's unsecured priority tax claim, then over a period of six years from the date of assessment, 11 U.S.C. § 1129(a)(9)(C) (pre-BAPCPA version), would be applied first to the trust fund portion of the tax, resulting in a faster retirement of that portion of the debtor's liability for which there would be "responsible officer" liability for others. The Supreme Court upheld the plan on the basis that although the Bankruptcy Code does not explicitly authorize a bankruptcy court to approve reorganization plans designating tax payments as either trust fund or nontrust fund, the orders at issue were consistent with the court's broad "residual authority" under the Code to approve plans including 'any appropriate provision not inconsistent with ... this title'," 11 U.S.C. § 1123(b)(5) [now (b)(6)], and to "'issue any order ... necessary or appropriate to carry out the [Code's] provisions'," § 105." *Id.* at 549. Judge McMahon rejected *Energy Resources* as a source of "residual authority" authorizing third-party releases because in *Energy Resources* there was a specific right conferred under the Bankruptcy Code to repay the IRS over time under a plan, without specifying whether or how the payments could be designated, whereas there is no specific right conferred on a plan proponent to impose third-party releases on creditors which purport to release their claims against nondebtors. *Purdue,* 635 B.R. at 113-14.

Notwithstanding the district court's decision in *Purdue,* a number of bankruptcy court decisions have recognized *Metromedia* as controlling authority in the Second Circuit for the approval of nonconsensual third-party releases, but they did not themselves address the issue of statutory authority. *See e.g. In re LATAM Airlines Group, S.A.*, 2022 WL 2206829, at *48 (Bankr. S.D.N.Y. June 18, 2022); *In re Stearns Holdings, LLC*, 607 B.R. 781, 787-88 (Bankr. S.D.N.Y. 2019) (citing to *Metromedia* and collecting cases); *In re Genco Shipping & Trading Ltd.*, 513 B.R. 233, 268-69 (Bankr. S.D.N.Y. 2014); *In re SunEdison, Inc.*, 576 B.R. 453, 461-62 (Bankr. S.D.N.Y. 2017) (determining that the debtors failed to prove that the third-party releases at issue were appropriate under the *Metromedia* standard); *In re Sabine Oil & Gas Corp.*, 555 B.R. 180, 288-89 (Bankr. S.D.N.Y. 2016) (finding the third-party releases to be appropriate under the *Metromedia* standard).

Third Circuit

Although the Third Circuit in *In re Millennium Lab Holdings II, LLC*, 945 F.3d 126, 139 (3d Cir. 2019) held that a bankruptcy court is constitutionally authorized to confirm a plan containing nonconsensual third-party releases, it did not address a bankruptcy court's statutory authority to approve such releases as part of a plan. *Purdue*, 635 B.R. at 104. Nonetheless, the recent decision in *Boy Scouts of America* reads the ruling in *Millennium* as "suggest[ing] an implicit recognition that the granting of third-party releases is still permissible as part of the confirmation process." *In re Boy Scouts of America and Delaware BSA, LLC*, 642 B.R. 504, 594 (Bankr. D. Del. July 29, 2022).[3] *See also In re Mallinckrodt PLC*, 639 B.R. 837, 868 (Bankr. D. Del. Feb. 8, 2022) (citing *Millennium* as support for the inclusion of nonconsensual third-party releases in a plan).

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[3] Inasmuch as the final confirmation order was entered in *Boy Scouts* on September 8, 2022 (Case No 20-10343, ECF No. 10316), notices of appeal were only recently filed by a number of parties, principally insurance companies.

Apart from *Millennium*, there is Third Circuit authority, beginning with *In re Continental Airlines*, 203 F.3d 203, 214 (3d Cir.2000), suggesting that nonconsensual third-party releases are permissible in the Third Circuit as long as certain exacting standards are satisfied. *See United Artists Theatre Co. v. Walton*, 315 F.3d 217, 227 (3d Cir. 2003) (quoting *Continental*, 203 F.3d at 214-15, as providing that the "'hallmarks of permissible non-consensual releases'" are "'fairness, necessity to the reorganization, and specific factual findings to support these conclusions'," added to which is that the releases must be "given in exchange for fair consideration'."). *See also In re Global Indus. Technologies, Inc.*, 645 F.3d 201, 206 (3d Cir. 2011) (nonconsensual third-party release must be "both necessary to the reorganization and fair") (citing *Continental*); *Continental*, 203 F.3d at 212-13 (stating that fairness dictates that "it is necessary to provide adequate consideration to a claimholder being forced to release claims against non-debtors").

In *Boy Scouts of America*, Judge Silberstein upheld nonconsensual third-party releases over a number of objections. On the statutory authority question, the court relied on §§ 105(a), 1123(a)(5) and 1123(b)(6) as authority for granting third-party nonconsensual releases. *Boy Scouts of America*, 642 B.R. at 594-95. In approving the third-party releases, Judge Silberstein, while acknowledging they were not the law of the Third Circuit, turned first to the *Master Mortgage* factors, then evaluated the factors identified by the Third Circuit authority in *Continental* and later cases and found that all factors were satisfied. *Id.* at 596-619.

The earlier case of *In re Mallinckrodt PLC*, 639 B.R. 837 (Bankr. D. Del. Feb. 8, 2022) also approved a plan's inclusions of nonconsensual third-party releases which ran in favor the debtor's directors, officers and employees, although they did not make any financial contributions to the plan. *Id*. at 867-75.[4] The court went through an extensive analysis of the *Continental* factors of necessity, fairness and reasonableness and held the releases were justified. *Id.* As to the officers, directors and employees, even though they were not contributing anything to the plan financially, the court found the releases were warranted because without them, these released parties would be pulled into lawsuits which would distract them from their work and for which the debtor would owe indemnification obligations. In addition, the court found that continued litigation would "subject the company to reputational uncertainty and overhang," thereby impairing the company's access to capital markets and otherwise impairing its ability to attract necessary funding as well as management talent. *Id.* at 869.

Fourth and Sixth Circuits

In *Behrmann v. National Heritage Foundation*, 663 F.3d 704 (4th Cir. 2011), the Fourth Circuit adopted the Sixth Circuit's test for approving non-debtor releases outlined in *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir.2002). The Fourth Circuit quoted in full from *In re Dow Corning Corp.*:

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[4] It is notable that the only objectors to the third-party releases were the State of Rhode Island and the United States Trustee, *id.* at 866, and that the releases excluded criminal conduct, fraud and gross negligence. *Id.* at 871.

> We hold that when the following seven factors are present, the bankruptcy court may enjoin a non-consenting creditor's claims against a non-debtor:
>
> (1) There is 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.

Behrmann, 663 F.3d at 711-12 (quoting *In re Dow Corning Corp*., 280 F.3d at 658).

A recent district court decision from the Eastern District of Virginia, however, was highly critical of nonconsensual third-party releases. *See Patterson v. Mahwah Bergen Retail Group, Inc.*, 636 B.R. 641 (E.D. Va. Jan. 13, 2022) (Novak, U.S.D.J.). There, Judge Novak vacated the bankruptcy court's order confirming the debtors' plan and voided the purportedly consensual third-party releases contained therein on several grounds. In his excoriating 88-page opinion, Judge Novak said that the releases before him "represent the worst of this all-too-common practice, as they have no bounds," *id.* at 655, and described the releases as releasing the claims of *at least* hundreds of thousands of potential plaintiffs not involved in the bankruptcy …, shielding an incalculable number of individuals associated with Debtors in some form, from every conceivable claim — both federal and state claims — for an unspecified time period stretching back to time immemorial." *Id.* (emphasis original).

Judge Novak said that the bankruptcy court "exceeded the constitutional limits of its authority …, ignored the mandates of the Fourth Circuit …, and offended the most fundamental precepts of due process." *Id.* at 655. Referring to what he called the "ubiquity of third-party releases," *id.,* which were approved by a bankruptcy judge in Richmond who "regularly approves third-party releases," *id.* at 654, Judge Novak said that "[t]his recurrent practice contributes to

major companies like [the debtor] using the permissive venue provisions of the Bankruptcy Code to file for bankruptcy here." *Id.* at 654-55.[5]

In particular, the bankruptcy court failed to identify whether it had jurisdiction over the claims it released by determining if each claim constituted a core claim, a non-core claim, or a claim unrelated to the bankruptcy case. *Id.* at 669. Moreover, many of the released claims included claims between non-debtors which may have no connection to the property of the estate or the administration of the bankruptcy proceeding. *Id.* at 669-670. The Court found that the bankruptcy court erred as a matter of law in finding that failure to return an opt-out form could constitute consent to Article I adjudication of the released claims. *Id.* at 672-75. The Court also found that the failure to opt-out did not evidence consent to the release itself, *id.* at 684-88, and that third-party releases in bankruptcy actions based only on a failure to opt out raised due process concerns. *Id.* at 687-88. Fourth Circuit precedent requires that bankruptcy courts grant non-consensual third-party releases "cautiously and infrequently" and only under unique circumstances, utilizing the seven-factor *Behrmann* analysis to make specific factual findings demonstrating that the granting of such releases is warranted. *Id.* at 688-89. The Court found that the bankruptcy court failed to make detailed findings of fact using the obligatory *Behrmann* factors. *Id.* at 688-90. The Court examined the *Behrmann* factors as applied to the claims to be extinguished and found them to weigh against the granting of the release. *Id.* at 689-91.[6]

Among the most significant take-aways from the *Mahwah* decision are the following:

- Third-party releases are virtually impermissible when the releasing parties are receiving no consideration under the chapter 11 plan and the creditors do not manifest actual consent, under high standards for what constitutes actual consent.

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[5] In a further blow to the filing of mega cases in the Eastern District of Virginia, Judge Novak, after vacating the confirmation order, had ordered in a companion order that "any attorneys' fees approved in this case shall not be for rates that exceed the prevailing market rates in the Richmond Division of the Eastern District of Virginia." *Patterson v. Mahwah Bergen Retail Group, Inc.*, 2022 WL 4287200, at *1 (E.D. Va. Sept. 16, 2022). On remand of the confirmation proceedings, which Judge Novak had ordered must be to another bankruptcy judge in the district, *Mahwah*, 636 B.R. at 703, Chief Bankruptcy Judge Frank J. Santoro recommended that national rates be applied, with some modest discounts negotiated by the United States trustee, because the professionals had relied on getting the higher rates when they were retained. Judge Novak acceded to the recommendation, but directed that "[i]n future mega cases, the 'yardstick' for the rate calculation must begin with the prevailing rates in this District, not a national rate as suggested by Chief Judge Santoro." *Mahwah*, 2022 WL 4287200, at *2.

[6] On remand, Debtors confirmed the identical plan after withdrawing the inappropriate releases rather than trying to litigate whether the releases could satisfy the *Behrmann* factors. *See In re Retail Group, Inc.*, No. 20-33113, Dkt. No. 2611 (Bankr. E.D. Va. Mar. 3, 2022) ("Revised Order (a) Modifying and Confirming the Amended Chapter 11 Plan Consistent with the District Court's Memorandum Opinion . . .").

- Just providing creditors with an ability to opt out does not make the release consensual as a matter of fact and law.

- The limited power of a bankruptcy judge under Article I of the Constitution requires that third-party releases be approved by district judges, and confirmation orders with third-party releases should be reports and recommendations.

- The procedure for approval of third-party releases in a chapter 11 plan must comply with Federal Rule 23, which deals with class actions. Among other things, creditors who are losing the right to sue must be involved in negotiations on the plan and must be adequately represented.

- Like the Eighth Circuit, which limited the doctrine of equitable mootness almost to the vanishing point, equitable mootness will not protect third-party releases from appellate review.

- A creditor who opts out has no standing to appeal.

Bill Rochelle, *Another District Judge Emphatically Rejects a Plan with Non-Debtor Third-Party Releases*, Rochelle's Daily Wire (Jan. 19, 2022), https://www.abi.org/newsroom/daily-wire/another-district-judge-emphatically-rejects-a-plan-with-non-debtor-third-party.

Seventh Circuit

The Seventh Circuit allows approval of nonconsensual third-party releases in a plan of reorganization based upon an amorphous standard which asks whether the releases are "necessary for the reorganization and appropriately tailored." *In re Airadigm Communications, Inc.*, 519 F.3d 640, 657 (7th Cir. 2008). In *Airadigm,* the third-party release was much narrower than what we typically see in the Second Circuit, applying only to release claims against the debtor's most significant secured creditor that arose "out of or in connection with the reorganization itself" and did not include claims for "willful misconduct." *Id.* In one of the only Circuit level decisions to address statutory authority, the Seventh Circuit held that third-party releases are statutorily authorized based on sections 105(a) and 1123(b)(6) of the Bankruptcy Code[7] and the "residual authority" theory first espoused in *Energy Resources*, which it cited for that proposition. *Id.*

Eighth Circuit

The Eighth Circuit Court of Appeals has not yet ruled on the issue, but courts within the circuit approve compelled third-party releases in plans. *In re Master Mtg. Inv. Fund, Inc.*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994) (listing the "Master Mortgage" factors detailed above);

[7] The only other Circuit level decision which specifically cites to sections 105(a) and 1123(b)(6) as authority for third-party releases is *Dow Corning. See In re Dow Corning Corp.*, 280 F.3d 648, 656-57 (6th Cir. 2002).

In re Archdiocese of Saint Paul and Minneapolis, 578 B.R. 823, 833 (Bankr. D. Minn. 2017) (applying a version of the *Master Mortgage/Dow Corning* factors).

Fifth, Ninth, Tenth and D.C. Circuit

The Fifth, Ninth, and Tenth Circuits have held that third-party releases are impermissible by virtue of 11 U.S.C. §524(e), which provides, in relevant part, 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." *In re Pacific Lumber Co.*, 584 F.3d 229, 251–52 (5th Cir. 2009) (stating that Fifth Circuit cases "broadly foreclose non-consensual non-debtor releases and permanent injunctions")[8]; *In re Lowenschuss,* 67 F.3d 1394, 1401-02 (9th Cir. 1995)[9]; *In re W. Real Estate Fund, Inc.*, 922 F.2d 592, 600–02 (10th Cir. 1990) (*per curiam*).

The D.C. Circuit has not explicitly approved or disapproved third-party releases, but has dismissed as moot an appeal from the District Court's ruling that the plan's release provisions, which made available a pool of $3 million to unsecured creditors if they gave a release to certain third parties, "did not constitute an impermissible discharge of … third parties, contrary to Bankruptcy Code §524(e)." *In re AOV Indus., Inc.*, 792 F.2d 1140, 1143, 1147 (D.C. Cir. 1986).

The countervailing view to the Fifth, Ninth and Tenth Circuit authority is that "section 524(e) provides only that a discharge does not affect the liability of third parties. This language does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party." *Matter of Specialty Equipment Companies,* 3 F.3d 1043, 1047 (7th Cir. 1993). *See also In re Seaside Engineering & Surveying, Inc.,* 780 F.3d 1070, 1078 (11th Cir. 2015) ("[p]ursuant to § 524(e), the discharge of the debtor's debt does not itself affect the liability of a third party, but § 524(e) says nothing about the authority of the bankruptcy court to release a non-debtor from a creditor's claims"); *In re Airadigm Communications, Inc.*, 519 F.3d 640, 657 (7th Cir. 2008) ("[t]he natural reading of this provision does not foreclose a third-party release from a creditor's claims."). As further elucidated by the bankruptcy court in *Adelphia Communications:*

> Section 524(e) provides that the *discharge itself* does not grant such a release or injunction, and is silent on whether a bankruptcy court can expressly discharge or otherwise affect the liability of a non-debtor. That silence does not mean that third-party releases are always forbidden.

[8] In passing, the Fifth Circuit suggested that "non-debtor releases are most appropriate as a method to channel mass claims toward a specific pool of assets. *Pacific Lumber Co.*, 584 F.3d at 252 (citing *MacArthur Co. v. Johns–Manville Corp.*, 837 F.2d 89, 90 (2d Cir.1988) as describing the channeling function).

[9] A recent Ninth Circuit decision seems to leave open the possibility that a release of third-party claims could, in certain circumstances, be imposed in a plan. *See Blixseth v. Credit Suisse*, 961 F.3d 1074, 1081-85 (9th Cir. 2020)

In re Adelphia Communications Corp., 368 B.R. 140, 266 (Bankr. S.D.N.Y. 2007) (emphasis original), *appeal dismissed* 367 B.R. 84 (S.D.N.Y. 2007).

Eleventh Circuit

In *In re Seaside Engineering & Surveying, Inc.,* 780 F.3d 1070 (11th Cir. 2015), the Eleventh Circuit "commend[ed] for the consideration of bankruptcy courts the factors set forth by the Sixth Circuit in *Dow Corning Corp.* …." *Id.* at 1079. It also agreed with the Fourth Circuit in *Behrmann* that bankruptcy courts should have discretion to determine which of the *Dow Corning* factors will be relevant in each case. *Id.* The factors should be considered a nonexclusive list of considerations, and should be applied flexibly, always keeping in mind that such bar orders should be used "cautiously and infrequently," and only where essential, fair and equitable. *Id.*

While the third-party release in *Seaside Engineering* was a release of any liability to the holder of a claim and ran in favor of the officers and directors of the debtor and to the debtor's "representatives," it was limited to acts or omissions relating to or arising out of the Chapter 11 case or pursuit of a plan, except for willful misconduct and gross negligence. *Id.* at 1076. In analyzing the *Dow* factors, the Eleventh Circuit found that the contribution of the debtor's officers and personnel in the form of labor was the "very lifeblood of the reorganized debtor" and was a factor in favor of the release, as was the importance for them to be free of additional lawsuits in the "labor-intensive" surveying business. *Id.* at 1080.[10]

III. Constitutional Issues

A. *Can Bankruptcy Courts Constitutionally Issue Final Orders Approving Third-Party Releases in Light of Stern v. Marshall*

The narrow holding in *Stern v. Marshall*, 564 U.S. 462 (2011) was that a debtor's counterclaim (tortious interference with an inter vivos gift) to a creditor's proof of claim (for defamation), although statutorily core, could not be constitutionally adjudicated by an Article I court. The constitutional underpinning of the ruling in *Stern* is Article III, § 1 of the Constitution, which provides that the "[t]he judicial power of the United States, shall be vested in one supreme Court, and in such inferior as Congress may from time to time ordain and establish." The same section also provides that the judges of these "constitutional courts" "shall hold their Offices during good Behaviour" and "receive for their Services [ ] a Compensation [ ] [that] shall not be diminished" during their tenure.

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[10] Interestingly, the Fourth Circuit in *National Heritage Foundation, Inc. v. Highbourne Foundation,* 760 F.3d 344 (4th Cir. 2014), specifically rejected the idea that a third-party release of the debtor's officers and directors could be supported by their promise to continue serving the debtor. *Id.* at 348. Such a promise, it held, did not constitute "meaningful consideration" because they were already getting compensated for their services or, as to preconfirmation services, had a fiduciary duty to render them. *Id.*

Stern held that a bankruptcy court, as an Article I court, goes beyond constitutional limits when it "exercise[s] the 'judicial Power of the United States' in purporting to resolve and enter final judgment on a state common law claim." *Stern*, 564 U.S. at 487 (2011). Stated differently, "[w]hen a suit is made of the stuff of the traditional actions at common law tried by the courts at Westminster in 1789," it must be adjudicated by "Article III judges in Article III courts." *Id.* at 484.

The Supreme Court has described a "Stern claim" as a "claim designated for final adjudication in the bankruptcy court as a statutory matter, but prohibited from proceeding that way as a constitutional matter." *Exec. Benefits Ins. Agency v. Arkison*, 573 U.S. 25-30-31 (2014). If third-party releases are statutorily authorized, *Stern* is potentially implicated if one considers the releases to be an adjudication of a common law claim (creditor v. nondebtor) by an Article I court.

There are two divergent views as to whether *Stern* constitutionally prohibits bankruptcy courts from issuing final orders approving third-party releases. Preliminarily, *Stern* teaches that in determining whether a bankruptcy court can constitutionally issue a final order adjudicating a matter, courts should focus on the content of the proceeding rather than the category of the proceeding. *In re Millennium Lab Holdings II, LLC*, 945 F.3d 126, 136 (3d Cir. 2019); *Paterson v. Mahwah Bergen Retail Group, Inc*., 636 B.R. 641, 669 (E.D. Va. Jan. 13, 2022). *Stern's* so-called "two-part disjunctive test" to determine whether bankruptcy courts have constitutional authority to adjudicate a matter is as follows: "the question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process. *Stern*, 564 U.S. at 499.

Stern also suggested that bankruptcy courts have constitutional authority to enter final orders if the matter adjudicated is "integral to the restructuring of the debtor-creditor relationship." *Id*. at 497. The divergent views are the result of courts giving primacy to either the disjunctive test or the latter formulation of a bankruptcy court's constitutional authority.

The divergent views on the constitutional question are principally represented by the following cases:

Constitutional Authority Upheld:

The Third Circuit in *In re Millennium Lab Holdings II, LLC*, 945 F.3d 126, 136 (3d Cir. 2019***), cert. denied sub nom. ISL Loan Tr. v. Millennium Lab Holdings II, LLC***, —— U.S. ——, 140 S. Ct. 2805, 207 L.Ed.2d 142 (2020), looked to "content of the plan," not the content of the claims being released, and then found that the relevant question was whether the bankruptcy court, in approving a third-party release as part of plan, was resolving a matter "integral to the restructuring of the debtor-creditor relationship," *Id*. at 137. *Millennium* specifically rejected the argument that an Article III court must decide or adjudicate the nondebtor claims that were being released – there fraudulent misrepresentation claims of creditor against debtor's equity holders – on the theory that they "do not stem from the bankruptcy itself and would not be resolved in the claims allowance process." *Id*. at 137-38. Instead, it gave controlling significance to the concept articulated in *Stern* that the matter must be "integral to the restructuring of debtor-creditor

relationship" Id. at 138 (reasoning that the reason bankruptcy courts can decide matters arising in the claims allowance process is because they are integral to the restructuring process). It then held that third-party releases were integral to the restructuring because "[r]estructuring in this case was possible only because of the release provisions." *Id.* at 137.

Although Judge McMahon ended up taking a different view in *Purdue,* her decision in *In re Kirwan Offices S.a.r.l.*, 592 B.R. 489 (S.D.N.Y. 2018) can certainly be read as being aligned with *Millennium*. There, Judge McMahon found that a "bankruptcy court's constitutional adjudicatory authority depends, not on the nature of a related claim at issue, but rather on how resolving that claim relates to a core Article I bankruptcy process," i.e., confirmation of a plan. *Id*. at 511. And as in Millennium, she gave controlling significance to the question of whether the third party releases were "integral to the restructuring of debtor-creditor relations," and held that they were because they were "absolutely necessary to the operation" of the plan. Id. Judge McMahon also held that the disjunctive test was satisfied because the third-party releases, having been contained in a confirmed plan subject to content and confirmation requirements, "flow[ed] from a federal statutory scheme." *Id.*

No Constitutional Authority

In *In re Purdue Pharma, L.P*., 635 B.R. 26 (S.D.N.Y. Dec. 16, 2021), appeal pending No. 22-110 (2d Cir.) (argued April 29, 2022), Judge McMahon appears to have reversed course on the constitutional question.[11] In contrast to *Millennium*, which found that the operative proceeding for purposes of the *Stern* analysis was the confirmation proceeding, Judge McMahon looked instead to the underlying third-party claim that was being released under the plan. *Id*. at 81. She also rejected *Millennium*'s focus on whether the matter adjudicated is "integral to the restructuring of debtor-creditor relations," and instead stated that the "correct constitutional question" is whether the third-party claims released "either stem from the bankruptcy itself or would necessarily be resolved in the claims allowance process." *Id*. Third-party claims against nondebtors, she held, neither stem from the bankruptcy nor are resolvable in the claims allowance process. *Id*.

As to the argument that *Stern* only limits a bankruptcy court's authority to "adjudicate" claims, not its authority to release them without an adjudication on the merits, she responded that releasing a non-core claim and enjoining its prosecution is the equivalent of a judgment dismissing the claim, notwithstanding there is no adjudication on the merits. *Id*. at 82. A nonconsensual third-party release, she reasoned, has the effect of a judgment because the release is entitled to res judicata claim preclusion. *Id*.

[11] In footnote 53, however, Judge McMahon offers the following as to why *Kirwan* cannot be read as authorizing bankruptcy courts to release non-core claims: "This court's decision in *In re Kirwan Offices S.à.R.L.*, 594 B.R. 489 (S.D.N.Y. 2018) does not stand for the proposition that *Stern* authorizes a bankruptcy court to release non-core claims because a release is not a final judgment on the merits of the third-party claim. In that case, *Stern* was of no moment because, as this court held and the Second Circuit affirmed, all parties had consented to the bankruptcy court's exercise of jurisdiction. *In re Kirwan Offices S.à.R.L*, 792 F. App'x 99, 103 (2d Cir. 2019)." *Purdue*, 635 B.R. at 82 n. 53.

Effect of Federal Rule of Bankruptcy Procedure 8018.1

Rule 8018.1 provides: "If, on appeal, a district court determines that the bankruptcy court did not have the power under Article III of the Constitution to enter the judgment, order, or decree appealed from, the district court may treat it as proposed findings of fact and conclusions of law." Fed. R. Bankr. P. 8018.1. The effect of the rule is to treat the matter on appeal as if it were a "related to" proceeding for which the bankruptcy court submitted proposed findings of fact and conclusions of law. 28 U.S.C. § 157(c)(1).

Proceeding in this manner on appeal, "the district court may choose to allow the parties to file written objections to specific proposed findings and conclusions and to respond to another party's objections, see Rule 9033; treat the parties' briefs as objections and responses; or prescribe other procedures for the review of the proposed findings of fact and conclusions of law." Advisory Committee Notes to Fed. R. Bankr. P. 8018.1.

B. *Due Process*

Due process challenges to third-party releases come in two forms. The first contends that they result in a denying releasees their day in court and the second revolves around the adequacy of notice of the proposed releases.

As to the first, it is well settled that "legal claims are sufficient to constitute property such that a deprivation would trigger due process scrutiny." *Elliot v. General Motors LLC* (*In re Motors Liquidation Co.*), 829 F.3d 135, 158 (2d Cir. 2016). Further, it is "a basic principle of justice … that a reasonable opportunity to be heard must precede judicial denial of a party's claimed rights. *City of New York v. New York, N.H. & H.R. Co*., 344 U.S. 293, 297 (1953). *See also Martin v. Wilks,* 490 U.S. 755, 762 (1989) *(*stating that it is a "deep-rooted historic tradition that everyone should have his own day in court"). The argument is that a nonconsensual release of a creditor's claim against a nondebtor as part of a debtor's plan of reorganization results in a denial of due process by denying the creditor the right to pursue its claim in court.

The bankruptcy court's decision in *Purdue*, however, rejected this challenge and it was not addressed by Judge McMahon on appeal. The decision found that the argument is incorrectly premised on the idea that a release is an adjudication on the merits, which is not an accepted position by courts in the Second Circuit. *In re Purdue Pharma, L.P.*, 635 B.R. 26, 98 (Bankr. S.D.N.Y. 2021), *rev'd on other grounds* 635 B.R. 26 (S.D.N.Y. 2021), *appeal pending*. Rather, Judge Drain held that a third-party release "is part of the settlement of the claim that channels the settlement funds to the estate." (citing *Macarthur Co. v. Johns-Manville Corp*., 837 F.2d at 91-92; *Lynch v. Lapidem*, 592 B.R. at 504-05; and in addition, citing *In re Millennium Lab Holdings II, LLC*, 575 B.R. 252, 273 (Bankr. D. Del. 2017) ("An order confirming the plan with releases does not rule on the merits of the state law claims being released."), *aff'd* 591 B.R. 559 (D. Del. 2018), *aff'd* 945 F.3d 126 (3d Cir. 2019), *cert. denied*, *Loan Tr. v. Millennium Lab Holdings*, ––– U.S. ––––, 140 S. Ct. 2805, 207 L.Ed.2d 142 (2020)).

The notice aspect of the due process challenge in *Purdue* was also rejected by Judge Drain and not decided on appeal. The familiar standard of "what process is due requires a court to ask whether the notice was reasonably calculated under the circumstances to apprise interested parties of the pendency of the plan's proposed release and afford them an opportunity to present their objections." *Purdue*, 633 B.R. at 99 (citing *Mullane v. Cent. Hanover Bank & Trust Co*., 339 U.S. 306, 314, 70 S.Ct. 652, 94 L.Ed. 865 (1950)). Judge Drain held that this standard was satisfied based on the evidence presented of the extensive noticing efforts by publication and otherwise and the prominent display of the release language in the notices. *Id.*

More recently, in *In re Mallinckrodt PLC*, 639 B.R. 837 (Bankr. D. Del. Feb. 8, 2022), the same due process challenge based on adequacy of notice was rejected for similar reasons. *Id.* 875-76 (notice adequate based on broad noticing program which included both a direct notice strategy and a media and community outreach strategy).

IV. Subject Matter Jurisdiction

The relevant jurisdictional statute for purposes of analyzing whether third-party releases fall within a bankruptcy court's subject matter jurisdiction is 28 U.S.C. § 1334(b), which provides, in relevant party, that "the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." Both the bankruptcy court and the district court on appeal in *Purdue* held that the nonconsensual third-party releases at issue were within the bankruptcy court's "related to" jurisdiction under § 1334(b). *Purdue,* 635 B.R. at 73, 83-89.

The expansive scope of "related to" jurisdiction was most recently discussed by the Second Circuit in *SPV Osus Ltd. v. UBS AG*, 882 F.3d 333 (2d Cir. 2018), which was significantly relied upon by Judge McMahon in ruling that the bankruptcy court had "related to" jurisdiction to approve the third-party releases. *Purdue*, 635 B.R. at 84-87. In *SPV Osus,* the plaintiff, SPV, sued UBS AG and others in New York state court for aiding and abetting BLMIS and Madoff by sponsoring and providing support for two feeder funds which channeled billions of dollars to Madoff and BLMIS and allowed them to further their fraud. *SPV Osus*, 882 F.3d at 338. In effect, UBS and the other defendants were alleged to be joint tortfeasors with Madoff and BLMIS. *Id.* at 340.

UBS removed the state court action to the federal district court in the district where BLMIS's bankruptcy was pending based on 28 U.S.C. § 1334(b) and the general removal statute, 28 U.S.C. § 1452(a), and SPV moved to remand based on lack of federal bankruptcy jurisdiction. *Id.* at 338-39. It was in this context in which the bankruptcy court's "related to" jurisdiction over a cause of action by a nondebtor against other nondebtors was called into question. The holding in *SPV Osus* thus relates directly to third-party releases because they purport to release claims of nondebtors against other nondebtors.

The Circuit instructed that "a civil proceeding is related to a title 11 case if the action's outcome might have any conceivable effect on the bankrupt estate," and further explained that an "action is related to bankruptcy if the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the

handling and administration of the bankrupt estate." *Id.* at 340 (internal quotations and citations omitted). The hook for "related to" jurisdiction in *SPV Osus* was UBS's potential claims against BLMIS for contribution. The standard for determining bankruptcy jurisdiction over SPV's claims was thus stated as follows:

> In determining whether potential claims by third party defendants against the debtor for either indemnification or contribution give rise to "related to" jurisdiction over litigation to which the debtor is not a party, courts in this circuit ... have generally found jurisdiction where there is a 'reasonable' legal basis for the claim." [citing authority]. A claim need not be certain to provide a federal court with jurisdiction: contingent outcomes can satisfy the 'conceivable effects' test, so long as there is the possibility of an effect on the estate.

Id. (internal quotations and citations omitted).

In *SPV Osus,* the Circuit found that because UBS and the debtor (Madoff) were alleged to be joint tortfeasors – who, as a matter of state law, have a right of contribution against one another – this provided a "reasonable legal basis" why UBS might someday be able to assert its contingent claim even though the bar date had arguably passed.[12] *Id.* at 340-41. And while it was recognized that "... a payout by the estate to defendants may be improbable, it is not impossible." *Id*. at 342. Concluding that "any claim by defendants potentially alters [the] distribution of assets among the estates' creditors," id., that was all it took to make the contingent claim "conceivably related" to the Madoff bankruptcy and subject to the bankruptcy court's "related to" jurisdiction.

Finally – and of particular importance to Judge McMahon for her ruling in *Purdue*, the *SPV Osus* decision found that the "'high degree of interconnectedness between this action and the Madoff bankruptcies'" supported a finding of "related to" jurisdiction because "'SPV can only proceed on [its claims against UBS] if it establishes that the Madoff fraud occurred'" and "'it is difficult to imagine a scenario wherein SPV would not also sue Madoff and BLMIS, given that SPV alleges that UBS aided and abetted in their fraud'." *Purdue*, 635 B.R. at 85 (quoting *SPV Osus*, 882 F.3d at 342)).

Relying in large part on the standards set out in the Second Circuit's decision in *SPV Osus*, Judge McMahon concluded that the bankruptcy court had "related to" jurisdiction to approve the third-party releases for the following reasons:

- If the released third-party claims were permitted to proceed, it would unravel the entire settlement with the Sacklers and with it, the plan.

[12] The Circuit found that even litigation over whether UBS could assert a late-filed claim would give rise to "related to" jurisdiction because it would cause the estate to incur litigation costs. *Id.* at 341.

- If the released parties were successful on their claims, it could alter or even determine Purdue's own liability because the two sets of claims overlap, and it could also alter the amount owed to the objecting parties as creditors.

- There was a high degree of interconnectedness with the lawsuits against the debtors and the Sacklers, especially where, as here, the shareholder releases only extend to claims where the "debtor's conduct or the claims asserted against it are a legal cause or a legally relevant factor." This meant that pursuing the Sacklers to judgment would necessarily implicate Purdue's liability. And inasmuch as the direct claims against the Sacklers and the derivative claims that would be asserted against them by the estate (faithless service in their corporate roles) are "essentially congruent," allowing the direct claims to proceed would likely have preclusive effect on a case alleging derivative liability against the same people.

- The Sacklers had a "reasonable legal basis" to assert claims for indemnification or contribution from Purdue for defense costs and any liability determination under the operative corporate documents, even though it could ultimately be determined that they were not entitled to indemnification or contribution by reason of having acted in bad faith. The fact that such claims might conceivably have an impact on the estate was enough for "related to" jurisdiction.

V. The Best Interests of Creditors Test

The best interests of creditors test requires that as a condition to confirmation, the bankruptcy court must find that:

> **(7)** With respect to each impaired class of claims or interests--
> **(A)** each holder of a claim or interest of such class--
>
> **(ii)** will receive or retain under the plan ***on account of such claim*** or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would ***so receive*** or retain if the debtor were liquidated under chapter 7 of this title on such date

11 U.S.C. § 1129(a)(7)(A)(ii) (emphasis added).

The best interest of creditors test "is designed to protect individual dissenting members of an impaired, accepting class, establishing the minimum that they must receive or retain under the plan," *In re Quigley Co., Inc.*, 437 B.R. 102, 143-44 (Bankr. S.D.N.Y. 2010), and is "perhaps the strongest protection creditors have in chapter 11." *In re Ditech Holding Corp.*¸ 606 B.R. 544, 607 (Bankr. S.D.N.Y. 2019) (internal quotes omitted). "The plan proponent bears the burden of proof to establish by the preponderance of the evidence that its plan is within the creditors' best interests." *In re W.R. Grace & Co.*, 475 B.R. 34, 142 (D. Del. 2012). *See also Ditech*, 606 B.R. at 606.

The bankruptcy court in *Purdue* suggested that under a plain meaning interpretation, the best interest of creditors test did not require an assessment of the value of claims against non-debtors that are proposed to be released under a chapter 11 plan, even though the holders of those claims would be free to pursue them in a chapter 7 case. Although Judge Drain's ruling on the best interests test was not limited to a plain meaning interpretation of § 1129(a)(7)(A)(ii) [13], his incisive parsing of the language of the section was as follows:

> As a matter of grammar, therefore, the comparison required by section 1129(a)(7) apparently is between the amount that the objecting creditor would receive under the plan on account of its claim and what it would "so" receive -- that is, also on account of its claim -- if the debtor were liquidated under chapter 7. It would not, therefore, require analysis of the claimant's rights against third parties.

In re Purdue Pharma, L.P., 633 B.R. 53, 110 (Bankr. S.D.N.Y. 2021), *rev'd on other grounds* 635 B.R. 26 (S.D.N.Y. 2021), *appeal pending. See also In re Boy Scouts of America and Delaware BSA, LLC*, 642 B.R. 504, 594 (Bankr. D. Del. July 29, 2022) (adopting this plain meaning interpretation).

The plain meaning interpretation of § 1129(a)(7)(A)(ii) that was explained by Judge Drain in *Purdue* and adopted by Judge Silberstein in *Boy Scouts* is at odds with the decisions in *Quigley* and *Ditech.* In *Quigley*, the bankruptcy court held that because the claims of certain non-settling tort claimants against Quigley's non-debtor parent, Pfizer, Inc., would be released under Quigley's plan by a third-party release, but would be "retained" by them in a hypothetical chapter 7 case, the court had to consider the value of those claims in deciding whether the best interests of creditors test was satisfied. *Quigley*, 437 B.R. at 145. This construction of §1129(a)(7)(A) was found to be mandated by the "express language" of the statute. *Id*. at 145-46.

The bankruptcy court in *Ditech* followed *Quigley*'s interpretation of §1129(a)(7)(A) on the basis that it was required by the "plain terms of the statute." *Ditech*, 606 B.R. at 613, 614. In *Ditech*, the debtors proposed to sell their numerous consumer credit contracts free and clear of all claims, including "thousands of formal and informal proceedings pending in and out of court in which Consumer Creditors are asserting claims." *Id.* at 552. The *Ditech* court held that because the consumer claims would be retained by the consumer creditors in a hypothetical chapter 7 case, they had to be considered under the test. *Id*. at 608-09. Thus, the *Ditech* court expressly

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[13] Judge Drain ruled, for a number of reasons, that the best interests of creditors test was satisfied even if it was interpreted to require an assessment of the objectors' recoveries on account of their third-party claims against the Sacklers in a chapter 7. *Id.* at 110-12. Among those reasons were the prior settlement history of Purdue and the Sacklers with two other States, which was consistent with the range of recovery projected under the plan, the level of recovery achieved by the principal attorney who had been pursuing Purdue and the Sacklers prepetition on behalf of numerous personal injury claimants, and the "dilutive effect" that competing claims against the Sacklers, including the claims of the estate itself, would have on what the objectors could reasonably recover in a chapter 7.

considered and rejected an interpretation of § 1129(a)(7)(A) equivalent to the one adopted by Judge Drain in *Purdue* and by Judge Silberstein in *Boy Scouts*.

In *Ditech*, the debtors explicitly argued that when applying the best interest test, the court should only consider "the level of recovery from the debtor and not recoveries available to the creditor from third parties." *Id*. at 610-11. The *Ditech* debtors also asked the court to interpret the word "claims" in the statute as referring to claims against the debtor only, and not third parties. *Id*. This interpretation was rejected by the *Ditech* court because it did not properly consider claims that would be "retained" by creditors in a hypothetical chapter 7. *Id*. at 611-12. Rather, the *Ditech* court adopted *Quigley*'s interpretation "that by the plain terms of the statute, in conducting the best interest analysis, the court must consider both the distributions under the plan and in a hypothetical chapter 7 case, and the 'value of the property that each dissenting creditor will retain under the plan and in the hypothetical chapter 7.'" *Id*. (quoting *Quigley*, 437 B.R. at 145-46). *See also Quigley*, 437 B.R. at 145 (agreeing that "the best interests equation … properly mandates consideration of creditors' comparative recoveries on non-debtor claims, to the extent the plan is treating those non-debtor claims by release").

VI. Summaries of Recent Cases

- *In re Boy Scouts of America,* No. 22-10343, 2022 WL 3030138, ---B.R. --- (Bankr. D. Del. July 29, 2022).

  In *BSA*, the plan included several kinds of releases, including non-consensual scouting-related releases for abuse claims, releases for claims other than abuse that included an opt-out provision. The court found statutory authority for the non-consensual releases in sections 105, 1123(a)(5), and 1123(b)(6) and applied the Continental "hallmarks" in approving them. The court also determined that it had *Stern* constitutional authority for and bankruptcy jurisdiction over the releases. But the court refused to approve the release for the Church of Jesus Christ Latter Day Saints ("LDS") because it also included abuse claims for non-scouting claims, which the court said "stretches third-party releases too far." As to the non-abuse claim releases, the court deemed most of them to be consensual based on the right to opt out because the opt-out right was conspicuous, 28,000 opted out, and the releasing parties *generally* had adequate notice. The court, however, found that 22 types of "related releasing parties" did not receive sufficient notice to satisfy due process and refused to approve those releases.

- *In re Mallinckrodt PLC,* 639 B.R. 837 (Bankr. D. Del. 2022).

  This case presented the issue, among others, whether the failure to opt out of a release could be deemed consent. The court ruled that as long as the parties had received sufficient notice of the opt out and the consequences of failing to do so, inaction could be deemed consent, explaining that the judicial system uses the "failure to act" in the context of default judgments, bar dates, and consent to the entry of final orders by a bankruptcy court. But the court did

caution that the result would be very different on a lesser record regarding noticing efforts. Part of the court's findings relied on the evidence that over 2,200 claims did opt out of the releases. In discussing "consensual releases obtained through an opt out process," the Court explained that "[a]lthough the Third Circuit has not explicitly commented on the propriety of non-debtor releases in these circumstances, it has suggested that if they are appropriate anywhere, it would be in a mass tort case like this one." *Id.*, at 881 (citing *Continental*, 203 F.3d at 214 n.11).

- *Patterson v. Mahwah Bergen Retail Grp., Inc.,* 636 B.R. 641 (E.D. Va. 2022) ("*Ascena*").

  In *Ascena*, the Eastern District of Virginia rejected the bankruptcy court's finding that the third-party release contained in the plan was consensual as a matter of fact and of law. On appeal the Court found the third-party releases to be non-consensual, where opt-out notices were not directed to all releasing parties and where the record lacked any information about the success of efforts to reach the targeted group; the record also lacked any information establishing factually that any targeted recipients affirmatively consented to the release. *Id.* at 679-80. The Court rejected the Debtors' contention that failing to opt out of a release evidences consent to that release. *Id.* at 684-685. The Court found "neither Debtors nor the Bankruptcy Court identified any facts that would support the application of an exception to the general rule of contracts that silence cannot manifest assent." *Id.* at 686. "Merely sending an unsolicited offer does not impose upon the party receiving it any duty to speak or deprive the party of its privilege of remaining silent without accepting." *Id.* at 685-86 (quoting 2 Williston on Contracts § 6:50 (4th ed. 1993)).

- *In re Emerge Energy Services LP*, No. 19-11563, 2019 WL 7634308, *18 (Bankr. D. Del. Dec. 5, 2019).

  "Here, the Debtors assert that the third-party releases are consensual and, accordingly they have not attempted to meet the factors set forth in *Continental* required for the approval of nonconsensual releases. [footnote omitted]. The Debtors argue that they should be approved as typical, customary, and routine. The objecting parties disagree, asserting that consent cannot be inferred by the failure of a creditor or equity holder to return a ballot or Opt-Out Form. The Court agrees with the objecting parties."

  "For the reasons highlighted by the objections and those carefully set forth by, among others, the courts in *In re Chassix Holdings, Inc.*, *In re SunEdison, Inc.*, and *In re Washington Mutual, Inc.* [footnote omitted], it cannot be said with certainty that those failing to return a ballot or Opt-Out Form did so intentionally to give the third-party release, and that is what the Court must find under the law to approve a third-party release absent the satisfaction of the *Continental* standard."

"For the Court to infer consent from the nonresponsive creditors and equity holders, the Debtors must show under basic contract principles that the Court may construe silence as acceptance because (1) the creditors and equity holders accepted a benefit knowing that the Debtors, as offerors, expected compensation; (2) the Debtors gave the creditors and equity holders reason to understand that assent may be manifested by silence or inaction, and the creditors and equity holders remained silent and inactive intending to accept the offer; or (3) acceptance by the creditors and equity holders can be presumed due to previous dealings between the parties. [footnote omitted]. The Debtors cannot do so. The Class 6 creditors and Class 9 equity holders are receiving no distribution under the Plan and no previous dealings between the parties are in evidence. Moreover, while the Debtors included on the ballot and Opt-Out Form notice to the recipients of the implications of a failure to opt-out, the Court cannot on the record before it find that the failure of a creditor or equity holder to return a ballot or Opt-Out Form manifested their intent to provide a release. Carelessness, inattentiveness, or mistake are three reasonable alternative explanations."

Overview of Issues

- ➢ Subject matter jurisdiction
- ➢ Statutory Authority
- ➢ Constitutional Authority to Enter Final Orders
- ➢ Due Process
- ➢ Confirmation Requirements, including Good Faith and "Best Interests Test"

Five Buckets

- **Debtor's release of estate claims**
  - Including derivative claims
  - Not a third-party release
- **Non-consensual third-party release**
  - Claims between non-debtors
- **Consensual third-party release**
  - Claims between non-debtors
- **Exculpation**
  - Limited immunity for conduct during case
- **Injunction**
  - Plan injunction to facilitate plan

SUBJECT MATTER JURISDICITON FOR THIRD-PARTY RELEASES

- "Arising in" jurisdiction has been found by some courts. *See e.g. In re Boy Scouts of America*, 642 B.R. 504, 588-89 (Bankr. D. Del. July 22, 2022)
- Most often analyzed and found under "related to" jurisdiction.
- Test for "related to" jurisdiction is "conceivable effects" test
- Principal considerations are:
  - Effect on insurance coverage
  - Indemnification/contribution claims of non-debtor third party
  - High degree of interconnectedness between claim against non-debtor and claim against debtor

Third-Party Releases under Stern v. Marshall

- Basic Issue: Is a third-party release an adjudication of a common-law claim by a non-Article III court?
  - Look to content, not category, of proceeding
  - Stern disjunctive test
  - Is it integral to restructuring?
- Millennium Lab Holdings II, LLC, 945 F.3d 126 (3d Cir. 2019) says no
  - Looked to content of plan, not to content of claims released
  - Release is not adjudication
  - Plan confirmation is integral to debtor-creditor relationship
- In re Purdue Pharma, L.P., 635 B.R. 26 (S.D.N.Y. 2021) says yes
  - For content of proceeding, looked to underlying claims being released
  - Claims fail Stern disjunctive test for Article I decision (stem from bankruptcy or necessarily resolved through claims allowance process)
  - Release is equivalent to judgment; that's an adjudication

Argument against Compelled Third-Party Releases

- Cause of action against non-debtor is property right of creditor
- Debtor discharge provisions (§§ 524(e) and 1141(d)) imply non-debtor discharge would require equally express authority
- Section 524(g)(4) underlines this point
- Sections 1123(a)(5), 1123(b)(6) and 105 do not provide authority
- *United States v. Energy Res. Co.*, 495 U.S. 545 (1990), did not involve a compelled third-party release/injunction
- In any event, third-party releases are inconsistent with §§ 524(g) and (h), 523(a)(2) and (a)(6) and 1141(d)
- Class action cases indicate Supreme Court won't stretch the law to provide a viable system for multi-defendant mass-tort situations

Argument For Compelled Third-Party Releases

- Permitted by large majority of courts of appeal
- Statutory authority: §§ 1123(a)(5), 1123(b)(6) and 105
- *United States v. Energy Res. Co.*, 495 U.S. 545 (1990) supports view of "residual authority" of bankruptcy courts to authorize third-party releases
- Better reading of § 523(e) is that it does not bar compelled third-party releases
- Rule of construction for § 523(g)
- Bankruptcy system offers best way to administer mass-tort cases with multiple sources of recovery including non-debtors

HOW THE BEST INTERESTS TEST RELATES TO THIRD-PARTY RELEASES

- Best interest test requires that a dissenting impaired creditor receive or retain under the plan "on account of [its] claim" property that is not less than what it would "so receive or retain" in a chapter 7
- Narrow view: Claims against third-party releasees do not need to be considered
- Broader view: Claims against third-party releasees must be considered since they are not released in a chapter 7
- Even under broader view, must consider competing claims of estate and other creditors against releasees, defenses and collectibility

Key Recent Cases

- *In re Boy Scouts of America*, 624 B.R. 504 (Bankr. D. Del. July 29, 2022)
- *In re Mallinckrodt PLC*, 639 B.R. 837 (Bankr. D. Del. Feb. 8, 2022)
- *Patterson v. Mahwah Bergen Retail Group, Inc.*, 636 B.R. 641 (E.D. Va. Jan. 13, 2022)
- *In re Purdue Pharma, L.P.,* 635 B.R. 26 (S.D.N.Y. Dec. 16, 2021) (appeal pending and argued Apr. 29, 2022)