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Expert Analysis

Navigating Views on Third-Party Releases in Restructuring Plans

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For nearly three decades, courts have wrestled with whether and to what extent the U.S. Bankruptcy Code authorizes non-debtor, third-party releases in a Chapter 11 plan of reorganization. The results over that time have yielded continuing confusion and uncertainty. While three of the 11 Circuit Courts are united in disallowing third-party releases entirely, the other eight provide separate justifications for allowing them, and their differing standards are often disjointedly applied. Although such releases are supposed to apply only in "rare and unique" cases, as one judge observed, "almost every proposed Chapter 11 Plan that I receive includes proposed releases." *In re Aegean Marine Petroleum Network*, 599 B.R. 717, 726 (S.D.N.Y. 2019).

Given the increased frequency of this issue in recent cases and the continued uncertainty over when third-party releases can be properly granted under a Chapter 11 plan (if at all), we thought it timely to review the current state of the law on the topic and provide an examination of potential ways to resolve the controversy.

This two-part article will examine the role of third-party releases in successful Chapter 11 reorganizations. This article will address the factors considered in each Circuit where such releases have been deemed permissible within the confines of the Bankruptcy Code, evaluate several recent cases highlighting the uncertainty created by the current Circuit split, and consider options for creating a clear, nationwide standard. Part two will evaluate the Circuit Courts' differing consent requirements for third-party releases and whether bankruptcy courts have the constitutional authority to issue final orders granting third-party releases under *Stern v. Marshall*, 564 U.S. 462 (2011).

Third-Party Releases in Chapter 11 Reorganizations

One of the primary purposes for a Chapter 11 filing is for the debtor to be discharged and released from its debts and other liabilities that would otherwise limit the debtor's ability to continue business as a going concern. That is why the Bankruptcy Code specifically provides that the confirmation of a

> The current Circuit split also creates unworkable confusion and uncertainty as to when third-party releases are appropriate and, in some instances, promotes judicial forum shopping in those jurisdictions where it is expected third-party releases are more readily granted by the courts.

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plan effectuates a discharge of the debtor's obligations. See 11 U.S.C. §1141(d). But often the debtor's liabilities are substantially intertwined with a non-debtor's liability, such that a viable Chapter 11 plan of reorganization can only be achieved through the simultaneous release of certain non-debtors who provide substantial financial contributions ("pay for play") that fund creditor recoveries.

This issue most frequently arises in the context of mass torts cases (such as those involving asbestos, environmental liability, medical devices and other product liability, the opioid crisis, and sexual abuse cases) in which directors, officers, other insiders and insurers may share liability with the debtor. In those cases, non-debtors with liability exposure may be willing to provide substantial financial contributions to the estate that will make a plan possible, which avoids piecemeal liquidation and nationwide litigation. In exchange for their substantial contribution, these non-debtor third parties want assurances that they will be released from liability to the same extent as the debtor.

In recent years, third-party releases have become a widely used tool to promote the successful reorganization of corporate debtors in Chapter 11 plans by facilitating non-debtor financial contributions. But the Bankruptcy Code is silent on whether courts have the authority to grant third-party releases to non-debtor plan contributors. The only express authorization is in §524(g), but it is limited to establishing a channeling injunction to protect non-debtors from asbestos-related liabilities. See id. §524(g). Because bankruptcy court authority must be statutorily derived from the Bankruptcy Code, courts have primarily relied upon the following Bankruptcy Code sections for "implied" authority, including: (1) §105(a), which empowers the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code; (2) §524(e), which provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on … such debt"; and (3) §1123(b)(6), which allows a plan to "include any other appropriate provision not inconsistent with the applicable provisions of" the Bankruptcy Code.

> Some have argued that removing this tool entirely would significantly hinder the ability of many large debtors to reorganize by disincentivizing broad-based settlements of complex litigation that fund creditor recoveries.

As a result of the ambiguity inherent in these Bankruptcy Code provisions, the Circuit Courts have adopted varying approaches and standards for when third-party releases are permissible, resulting in a significant Circuit split on this issue.

The Circuit Split

Fifth, Ninth and Tenth Circuits. There are only three Circuit Courts that disallow third-party releases in all circumstances, and each of them relies on the same justification. According to the Fifth, Ninth and Tenth Circuits, a bankruptcy court does not have authority to issue third-party releases because the Bankruptcy Code §524(e) states that the discharge of a debtor does not affect the liability of any other entity, which displaces the court's general equitable powers under §105(a). See *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995); and *In re Western Real Estate Fund*, 922 F.2d 592 (10th Cir. 1990). The Tenth Circuit notes that, because only the debtor has invoked and submitted to the bankruptcy process and §524(e) provides for a bankruptcy discharge that only applies to the debtor, "Congress did not intend to extend such benefits to third-party bystanders." See *Western Real Estate*, 922 F.2d at 600. However, the Fifth Circuit has acknowledged that §524(g) does extend some of these benefits to third parties in asbestos-related cases, which suggests that third-party releases might be appropriate in other mass tort cases as well. See *Pacific Lumber*, 584 F.3d at 252.

First, Third and Eighth Circuits. The other eight Circuit Courts permit third-party releases in Chapter 11 plans, but only in limited circumstances. In the First, Third

and Eighth Circuits, the courts rely on their broad equitable powers under §105(a) to permit third-party releases. But they do so with "caution" by requiring a factual showing of the "hallmarks" of permissible releases, which include: (1) the fairness of the release, (2) whether the release is necessary to the reorganization, and (3) whether fair consideration has been given in exchange for the release. *In re Millennium Lab Holdings II*, 945 F.3d 126 (3d Cir. 2019); see also *In re Chicago Investments*, 470 B.R. 32 (Bankr. D. Mass. 2012); and *In re U.S. Fidelis*, 481 B.R. 503 (Bankr. E.D. Mo. 2012). (Notably, the First and Eighth Circuits have not weighed in on the validity of third-party releases, but the lower courts generally follow the Third Circuit's approach.) To guide the factual analysis, the courts in these Circuits balance five factors first articulated in *In re Master Mortg. Inv. Fund*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994): (1) whether an identity of interests exists between the debtor and third party; (2) whether the third party has provided a substantial contribution of assets to the debtor's reorganization; (3) whether the release is essential to the reorganization; (4) whether a substantial majority of affected creditors consent to the release; and (5) whether the plan provides for payment of substantially all claims affected by the release.

Second and Seventh Circuits. Although the Second Circuit has expressed reluctance to approve third-party releases due to the explicit authorization for such releases only in the asbestos context under §524(g), it ultimately permits third-party releases under the bankruptcy court's equitable powers under §105(a), but only "when truly unusual circumstances exist." *In re Metromedia Fiber Network*, 416 F.3d 136, 143 (2d Cir. 2005). Rather than adopting a multi-factor test, the Second Circuit only requires parties to show that the third-party release is "important" to the Chapter 11 plan and that its breadth is "necessary" to accomplish the plan's purposes. Id.; see also *In re PT Bakrie Telecom Tbk*, 628 B.R. 859 (Bankr. S.D. N.Y. 2021). In addition, the Second Circuit in *In re Drexel Burnham Lambert Group*. 960 F.2d 285 (2d Cir. 1992), established an early "pay-to-play" model in which the court would allow third-party releases only to beneficiaries who provide a substantial financial contribution that makes the plan possible, and then the resulting pool of assets must be used to fund litigation claimant recoveries. The Seventh Circuit applies the same standard—noting that third-party releases should only be approved in "rare cases" because it is "a device that lends itself to abuse"—but also roots its justification in §1123(b)(6), which provides the court with "residual authority" to "include any other appropriate provision not inconsistent with [the Bankruptcy Code]." *In re Ingersoll*, 562 F.3d 856, 864-65 (7th Cir. 2009).

Fourth, Sixth and Eleventh Circuits. The final three Circuits also allow third-party releases based on §105(a) and have rejected arguments that §524(e) serves as a limitation because that section "says nothing about the authority of the bankruptcy court to release a non-debtor from a creditor's claims." *In re Seaside Engineering & Surveying*, 780 F.3d 1070, 1078 (11th Cir. 2015). In 2002, the Sixth Circuit adopted a seven-factor test to determine whether a plan's third-party release is fair and equitable under the circumstances. Those factors include the five *Master Mortgage* factors adopted by the First, Third and Eighth Circuits, and adds (1) whether the plan provides an opportunity for those claimants who choose not to settle to recover in full, and (2) whether a court made a record of specific factual findings that support its conclusions. *In re Dow Corning*, 280 F.3d 648, 658 (6th Cir. 2002). The Fourth and Eleventh Circuits later adopted this seven-factor framework. See *National Heritage Foundation v. Highbourne Foundation*, 760 F.3d 344, 347 (4th Cir. 2014); *Seaside Engineering*, 780 F.3d at 1078.

Recent Cases Affecting the Use of Third-Party Releases

In the last six months, several courts have rendered decisions with surprising results that further question whether bankruptcy courts can issue third-party releases. These cases highlight the continued confusion that the Circuit split creates.

'In re Purdue Pharma'. On Dec. 16, 2021, the U.S. District Court for

the Southern District of New York overruled the bankruptcy court's confirmation of Purdue's Chapter 11 plan, which included third-party releases for potential claims related to the over-prescription of the company's proprietary opioid medication, OxyContin.

In *Purdue*, the Sackler family—which owned and managed the debtors—upstreamed about $10.4 billion out of the company and deposited the funds offshore or in inaccessible spendthrift trusts, then sought third-party releases in the debtors' Chapter 11 plan by providing $4.5 billion in seed funding for a trust to compensate OxyContin victims. Although the plan settlement garnered support from a supermajority of creditors and was confirmed by the bankruptcy court as reasonable and necessary to the debtor's reorganization, the district court held that §§105(a) and 1123(a)(5) and (b)(6) do not provide a bankruptcy Court with sufficient authority to order third-party releases. The bankruptcy court's failure to identify a specific, substantive grant of such authority in the Bankruptcy Code demonstrated it has no "equitable authority" or "residual authority" to rely upon those sections. As a result, the district court vacated the confirmation order. The decision is currently on appeal in the Second Circuit.

'Ascena Retail Group'. (*Patterson v. Mahwah Bergen Retail Group*, 636 B.R. 641 (E.D. Va. 2022)). On Jan. 13, 2022, the U.S. District Court for the Eastern District of Virginia vacated the bankruptcy court's confirmation order containing third-party releases that would have extinguished the securities litigation claims against Ascena—a clothing retailer—and its officers and directors.

In *Ascena*, the debtors were forced to temporarily close their retail stores due to the COVID-19 pandemic, which resulted in the pre-bankruptcy sale of substantially all of their assets followed by a pre-negotiated Chapter 11 process. The plan provided for full or partial recoveries to all creditors, but nothing to shareholders who had filed a prepetition securities fraud action against Ascena and two of its former executives in the U.S. District Court for the District of New Jersey. The bankruptcy court overruled the shareholders' objections to the plan and its third-party releases that would have extinguished the securities fraud claims, but failed to make specific findings of fact as required by the Fourth Circuit to show why this was an exceptional case warranting the releases. Instead, the bankruptcy court made a cursory statement in a footnote that, if the factors applied, the plan satisfied them. The district court found that such perfunctory treatment of third-party releases in this case shows how significantly the third-party release function can be abused and encourage forum shopping.

'In re Mallinckrodt'. (Case No. 20-12522 (JTD), 2022 WL 404323, at *1 (Bankr. D. Del. Feb. 8, 2022), stay pending appeal denied 2022 WL 1206489, at *1 (D. Del. April 22, 2022)). On Feb. 3, 2022, the U.S. Bankruptcy Court for the District of Delaware confirmed a Chapter 11 plan of reorganization for a global specialty biopharmaceutical company that included third-party releases of both opioid claims and non-opioid claims supported by $1.6 billion in settlement payments. Although the bankruptcy court acknowledged that "this ruling conflicts with those of some of my colleagues," the court found that the volume and complexity of issues presented by cases involving mass tort bankruptcies such as this one allow for broad-based releases because such debtors need "creative solutions … [that] often require flexibility rather than adherence to a strict inflexible model," especially where the plan settlements are supported by every estate fiduciary, nearly all organized creditor groups, and 88% of voting creditors. Id. at *25.

'In re Gulf Coast Health Care'. (Case No. 21-11336 (KBO) (D. Del. May 4, 2022); Rick Archer, "Judge Rejects 3rd-Party Releases in Gulf Coast's Ch. 11 Plan," Law360 (May 4, 2022)). On May 4, 2022, the U.S. Bankruptcy Court for the District of Delaware denied confirmation of a Chapter 11 plan of reorganization that included $11.5 million in cash contributions from the debtors' senior secured lender and equity sponsors in exchange for third-party releases of personal injury claims involving the debtors' skilled nursing facilities. While finding in a bench decision that the plan provided the best possible recovery to unsecured creditor

and otherwise satisfied the Bankruptcy Code's confirmation requirements, the bankruptcy court denied confirmation because the third-party releases for tort claimants did not satisfy the Third Circuit's fairness standard by (1) failing to garner "overwhelming" support from the tort claimant class, (2) failing to analyze the value of potential third-party claims that would be released, and (3) lacking contributions by certain third parties benefiting from the release, such as the debtors' former employees.

Potential Congressional Intervention

To date, the U.S. Supreme Court has not directly addressed whether the Bankruptcy Code authorizes third-party releases under a Chapter 11 plan. Unless that changes, the current Circuit split will continue to cause confusion and uncertainty on this issue. However, congressional intervention through an amendment to the Bankruptcy Code could resolve the conflict.

Congress has already started taking action. On July 28, 2021, two identical bills entitled the "Nondebtor Release Prohibition Act of 2021" were introduced in the House of Representatives (see H.R. 4777 and the Senate (see S.2497). These bills propose to add a new §113 to the Bankruptcy Code that would prohibit courts from approving any provision in a plan of reorganization or otherwise "for the discharge, release, termination, or modification" of non-debtor liabilities or to enjoin non-debtors from taking "any act to assert, assess, collect, recover, offset, recoup, or otherwise enforce" a claim or cause of action against another non-debtor. See H.R. 4777 and S.2497 §113(a). However, the proposed law would allow courts to continue, among other things, (1) authorizing third-party releases in the context of a sale or transfer of property free and clear of claims or interests, and (2) granting the release of non-debtor claims under a plan, as long as each individual creditor provides express consent in a signed writing (which cannot be accomplished simply by accepting a proposed plan, failing to accept or reject a proposed plan, or any other silence or inaction). See id. §113(b)(1), (5).

In essence, these bills are aimed at limiting a debtor's ability to reorganize using the current third-party release mechanisms approved in the Circuit Courts and to restrict judicial discretion beyond narrowly tailored circumstances, especially in the mass torts context where individual written consent for third-party releases of non-debtor tortfeasors and insurers is impossible to achieve.

Takeaways

Third-party releases play an important role in reorganizing businesses in Chapter 11. Some have argued that removing this tool entirely would significantly hinder the ability of many large debtors to reorganize by disincentivizing broad-based settlements of complex litigation that fund creditor recoveries. But the current Circuit split also creates unworkable confusion and uncertainty as to when third-party releases are appropriate and, in some instances, promotes judicial forum shopping in those jurisdictions where it is expected third-party releases are more readily granted by the courts. By resolving the Circuit split, the U.S. Supreme Court could eliminate the controversy by establishing a nationwide standard for approving third-party releases. Alternatively, Congress could intervene to establish a nationwide standard. Either way, the adoption of a single standard for all U.S. jurisdictions would improve the efficiency of the Chapter 11 process in these cases and help avoid abuses.

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