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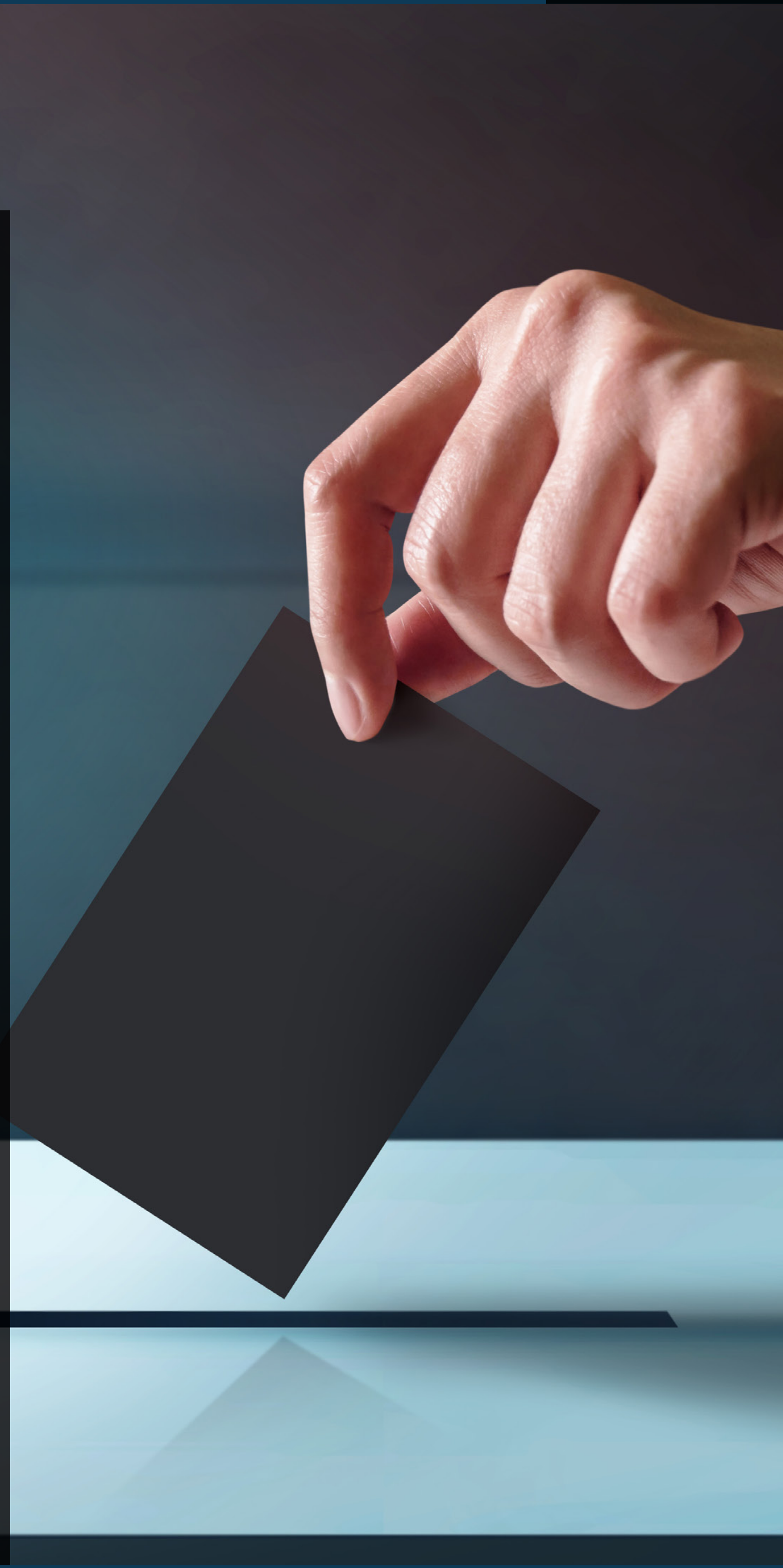

WHAT'S INSIDE

THIRD-PARTY RELEASES? – NOT SO FAST!

An Update on Releases and Warnings on Common Related Pitfalls

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In a previous article "*Third-Party Releases? – Not So Fast!*", members of the Lowenstein team wrote regarding the changing trends and heightened scrutiny of nonconsensual third-party releases across jurisdictions in a post-Enron world.[1] At the time that article was published, three circuits–the Fifth, Ninth, and Tenth Circuits–had been labeled "Prohibition Circuits," that is, those that generally held nonconsensual third-party releases are barred by the Bankruptcy Code without exception.[2] The remaining jurisdictions, labeled "Permissive Circuits," generally permitted nonconsensual third-party releases under certain conditions set forth by case law within the circuit.[3] Although none of the circuits entirely switched perspectives over the past five years, courts have been active and vocal in this area, and parties have been creative in finding new ways to present these releases to the court. This article examines significant case law updates, as well as common pitfalls which practitioners should be aware of when analyzing "release" issues on behalf of their clients.

With limited exception, nonconsensual third-party releases are still rejected across the board in the Prohibition Circuits.[4] These courts have held steadfastly to the premise that nonconsensual third-party releases violate section 524(e) of the Bankruptcy Code and must be barred in all circumstances. Even these jurisdictions acknowledge, however, that third-party releases may be permitted when they are consented to by all parties granting the release.

That being said, the Ninth Circuit has begun to dance around the idea of permitting third-party releases in certain specific instances. First, the Ninth Circuit acknowledged that because section 524 does not apply to cases arising under Chapter 9 of the Bankruptcy Code, nonconsensual third-party releases may be permissible in the reorganization of a municipality under Chapter 9.[5] This decision should *not* be viewed as a sea change in the Ninth Circuit's mindset, as the Ninth Circuit has limited the releases to cases arising under Chapter 9, and Bankruptcy Courts in the circuit still routinely acknowledge that nonconsensual third-party releases are not permitted in Chapter 11.[6]

Even more recently, the Ninth Circuit has strayed from related holdings in other Prohibition Circuits by holding that a third-party exculpation clause that is "narrow in both scope and time" does not violate section 524(e).[7] In *Blixseth v. Credit Suisse*, the Ninth Circuit permitted the exculpation of the debtors' largest creditor,[8] which

[1] Michael S. Etkin & Nicole M. Brown, *Third-Party Releases? – Not So Fast! Changing Trends and Heightened Scrutiny*, AIRA Journal, Vol. 29, No. 3, 2015.

[2] *Id.* at 23, 25.

[3] *Id.* at 25.

[4] Cases in the Prohibition Circuits still overwhelmingly rely on the case law cited in our 2015 article for the proposition that nonconsensual third-party releases are invalid in light of section 524(e) of the Bankruptcy Code, and therefore are never permissible. *See e.g., Dragnea v. Dragnea (In re Dragnea)*, 609 B.R. 239, 251 (Bankr. E.D. Cal. 2019) (citing *Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401-02 (9th Cir. 1995), and *Am. Hardwoods, Inc. v. Deutsche Credit Corp. (In re Am. Hardwoods, Inc.)*, 885 F.2d 621, 624-27 (9th Cir. 1989)); *Webster Capital Fin., Inc. v. Newby*, No. 12-2290-EFM, 2013 U.S. Dist. LEXIS 19703, at *17 (D. Kan. Feb. 14, 2013) (citing *In re W. Real Estate Fund*, 922 F.2d 592, 600-01 (10th Cir. 1990)); *In re Patriot Place, Ltd.*, 486 B.R. 773, 822-23 (Bankr. W.D. Tex. 2013) (citing, for example, *In re Vitro SAB de CV*, 701 F.3d 1031 (5th Cir. 2012), and *In re Pac. Lumber Co.*, 584 F.3d 229 (5th Cir. 2009)).

[5] *See, e.g., DeCampo v. Potts*, 836 F.3d 1134, 1143 (9th Cir. 2016) (noting, but not making any determination, that because Chapter 9, unlike Chapter 11, does not incorporate section 524(e), section 105 *might* authorize a bankruptcy court to confirm a plan that adjusts or discharges debts owed by non-debtor third parties).

[6] *See* Memorandum Decision – Confirmation of Debtors' and Shareholder Proponents' Joint Chapter 11 Plan of Reorganization, at 24-25, In re PG&E Corporation, No. 19-30088-DM, (Bankr. N.D. Cal. June 17, 2020), ECF No. 8001 (noting that the releases were permissible only because they are consensual, and section 524(e) and Ninth Circuit case law prohibit nonconsensual third-party releases).

[7] *Blixseth v. Credit Suisse*, No. 16-35304 (9th Cir. June 11, 2020). The *Blixseth* court acknowledged that its decision reached the opposite conclusion from the Fifth Circuit in *Pacific Lumber*. *Id.* at 19, n. 7.

[8] The *Blixseth* Court noted that exculpation could only cover parties "closely involved" in drafting the plan. Because the creditor "had the ability to single-handedly disrupt the entire confirmation process but had become a plan proponent through its direct participation in the negotiations that preceded the adoption of the Plan." *Id.* at 13.

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narrowly focused on the creditor's potential negligent actions (not willful misconduct or gross negligence) relating only to the plan approval process.[9] As we have previously noted, releases and exculpation differ in that releases offer protection for preconfirmation liability, while exculpation protects against liability for acts or omissions in connection with the bankruptcy case.[10] The Ninth Circuit found, consistent with Third Circuit Courts, that "by its terms, 524(e) prevents a bankruptcy court from extinguishing claims of creditors against non-debtors *over the very debt discharged through the bankruptcy proceedings*," and because exculpation does not deal with such debt that is otherwise being discharged in the bankruptcy, 524(e) does not apply a bar to these kinds of releases for third parties.[11]

In the Permissive Circuits, which have applied heightened scrutiny to third-party releases post-*Enron*, courts continue to uphold the general proposition that nonconsensual third-party releases should be permitted sparingly. Courts generally consider the following five factors when determining whether a plan may include third-party releases: (a) identity of interests between debtor and non-debtor releasee; (b) substantial contribution to the plan by third party; (c) necessity of the release to reorganization; (d) overwhelming acceptance of plan and release by creditors; and (e) payment of all of substantially all of the claims of creditors and interest holders granting the release.[12]

9 The court specifically noted that the exculpation provision "does not affect obligations relating to the claims filed by creditors and discharged through bankruptcy proceedings, as it exclusively exculpates actions that occurred during the bankruptcy proceeding, not before." *Id.* at 12.

10 It should be noted, however, that some courts do not pay much attention to the distinction and often refer to exculpation as a release. Etkin & Brown, *supra*.

11 *Blixseth*, at 14 (emphasis added).

12 *In re Tribune* Co., 464 B.R. 126, 186 (Bankr. D. Del. 2011) (citations omitted).

Although the court in *In re Metromedia Fiber Network, Inc.*, acknowledged certain circumstances where non-debtor releases may be approved,[13] subsequent decisions within the Second Circuit routinely focus on the requirement, as noted in *Metromedia*, that nonconsensual third-party releases should only be granted in rare and unusual circumstances.[14] For example, in *In re Aegean Marine Petroleum Network Inc.*, the Court upheld the Second Circuit's stringent standard and discussed, at length, refusal to permit nonconsensual third-party releases without showing that the releases are necessary to the reorganization, adding that permitting such releases would turn third-party releases into "participation awards."[15] In *Aegean*, like many other cases, the debtors' plan proposed releases for non-debtors based on their contribution to the reorganization efforts during the pendency of the bankruptcy case.[16] The Court discussed, at length, the impermissibility of these clauses and the Court's unwillingness to grant them absent a connection between the benefit and the claims released:

13 *Deutsche Banke AG, London Branch v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 142 (2d Cir. 2005) ("Courts have approved nondebtor releases when: the estate received substantial consideration …; the enjoined claims were 'channeled' to a settlement fund rather than extinguished…; the enjoined claims would indirectly impact the debtor's reorganization 'by way of indemnity or contribution'…; and the plan otherwise provided for the full payment of the enjoined claims.") (internal citations omitted).

14 *See, e.g.*, Transcript of Record at 95, *In re Aegean Marine Petroleum Network Inc.*, No. 18-13374-mew (Bankr. S.D.N.Y. Mar. 26, 2019) ("[T]hird party releases are not a merit badge that somebody gets in return for making a positive contribution to a restructuring, they are not a participation trophy, they're not a gold star for doing a good job on your homework. Doing positive things, even important positive things in a restructuring case is not enough under *Metromedia*.").

15 *Id.*

16 *Id.*

> This notion–this interpretation of *Metromedia* that I get to appoint myself as the arbiter of whether somebody gets a gold star on their report card for the quality of the work that they do, and the payment for that comes at the expense of other people by releasing their third-party claims is wrong. It's 100 percent wrong. I will never approve it. I will never adopt it. You don't get a release just because you did your work. You have to show that there's something about the particular claim that you want released that has to be barred in order to make this reorganization workable. And you have to show that it's fair for me to take that person's claim away from them in light of what they're getting this case. That's not what you're saying. What you're saying is this was a hard case, these people did a good job, give them a bonus, not out of the pockets of the Debtors but out of the pockets of a bunch of third parties. That's not right.[17]

The Third Circuit has also seen several developments since *Washington Mutual*. Although a Permissive Circuit, courts within the Third Circuit also claim to permit nonconsensual third-party releases only in "exceptional" circumstances. In *In re Millennium Lab Holdings II, LLC, et al*, the Third Circuit found its "exceptional" case, and permitted the nonconsensual third-party release of certain non-debtor shareholders in exchange for $325 million.[18] The Court repeatedly emphasized that it was not expanding bankruptcy court authority and that the holding of the case is "specific and limited."[19] Nonetheless, the court confirmed a plan containing nonconsensual third-party releases, based on the fact that granting the releases was "do or die," and they "were heavily negotiated" and "necessary to the entire agreed resolution."[20] Notably, the Court found that absent the releases and payment that was provided in exchange, "liquidation, not reorganization, would have been [the debtors'] sole option. Restructuring in this case was possible only because of the release provisions."[21]

While most courts permit *consensual* third-party releases, the debate continues across jurisdictions about what constitutes consent. For example, while some plans require the creditor to affirmatively "opt-in" to a release, others will consider a creditor to have consented to the third-party release if the creditor has not opted *out* of the release, submitted a ballot to accept or reject the plan, or otherwise objected to the release provision in the plan. What actually constitutes consent is beyond the scope of this article, but is a nuance of which practitioners should beware.

Importantly, a practitioner's analysis does not begin or end at the releases contained in a proposed plan, even though those provisions require significant analysis in their own right. In fact, parties are often tempted to act as proponents, and seek expedited approval of a

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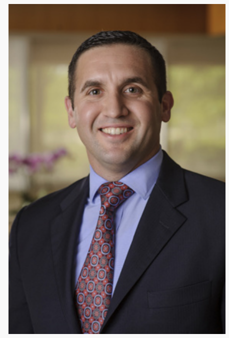

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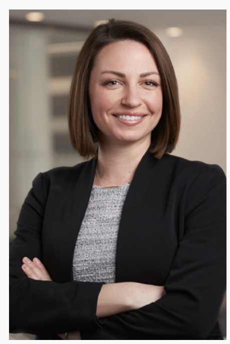

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17 *Id* at 60-61

18 *In re Millennium Lab Holdings II, LLC, et al*, 945 F.3d 126, 130-31 (3d Cir. 2019).

19 *Id.* 140.

20 *Id.* at 131-32.

21 *Id.* at 137.This case leaves open the question of whether a nonconsensual third-party release could be permitted in a plan of liquidation, as opposed to reorganization. Other circuits have acknowledged that third-party releases are questionable in a liquidation scenario. *In re Berwick Black Cattle Co.*, 394 B.R. 448, 461 (Bankr. C.D. Ill. 2008) ("The rationale for granting third-party releases is far less compelling, if it exists at all, in a liquidation than in a reorganization.").

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plan that appears to assign "all claims" to a liquidating or litigation trust in hopes of avoiding fees and administrative expenses and preserving value for the larger creditor body. *Not so fast!* Practitioners must also be diligent in avoiding release-related pitfalls in many aspects of a Chapter 11 case, such as in plans, 363 sales, structured dismissals, and settlements.

It is *crucial* that practitioners take a step back and think critically about, for example, (i) whether the specific language used to release or assign those claims encompasses all potential claims without leaving any behind, and (ii) the law of the jurisdiction in which the claims will be brought. Failing to follow either of these steps could release third parties merely because there will not be a party with standing to bring the claims. Whether the releases are accomplished intentionally by the debtors is *almost* irrelevant; instead, focusing on avoiding these pitfalls and potential for ambiguities is key.

When structuring a plan that assigns claims to a liquidating or litigation trust, the parties must think critically about the precise language and evaluate both the explicit and the implied. This calls for careful crafting and reviewing by all parties in interest. Courts differ on the specificity required to assign claims to a liquidating trust, for example. Think you can use a catchall to assign *all* claims and causes of action belonging to the debtor? *Not so fast!* Many courts find that wholesale assignment provisions *do not* permit the bankruptcy court to confer standing to bring these actions on the trustee/assignee.[22] Conversely, provisions that are too narrow or specific risk leaving causes of action behind with the debtors' estate,[23] which, if not discovered in time, could mean there is no entity, counsel, or funds, available to bring these claims for the benefit of creditors. The practical result is a *de facto* release for the third party–with no party to bring the action against them, the claims are released. This risk is especially high when a committee or other creditors are not given a sufficient opportunity to investigate potential claims and causes of action prior to the assignment or plan approval.

Another important factor to consider is the law of the particular jurisdiction. Some jurisdictions *never* allow certain claims to be assigned. For example, the Delaware Limited Liability Company Act prohibits certain third parties from bringing derivative actions relating to a limited liability company under Delaware law.[24] Again, assignment of these claims without considering the law of the jurisdiction could lead to an unfortunate result for creditors–unintentional third-party releases.

The moral of the story is that every case is different, factually and jurisdictionally. Practitioners cannot get complacent when analyzing these issues; it is critical to think carefully and creatively about the specifics of each and every case, including about what is *not* being said, to bring the case to the finish line with the best outcome for your client and highest possible recovery for the creditor body. You just might provide a party with an unintentional, and nonconsensual, third-party release if you do not.

[22] *See, e.g., Gavin Solmonese, LLC v. Shyamsundar (In re AmCad Holdings, LLC)*, 2016 U.S. Bankr. LEXIS 2420 (Bankr. D. Del. June 14, 2016); *Fairchilds Liquidating Trust v. New York (In re Fairchild Corp.)*, 452 FB.R. 525 (Bankr. D. Del. 2011); *Shandler v. DLJ Merc. Banking, Inc. (In re Insilco Techs., Inc.)*, 330 B.R. 512 (Bankr. D. Del. 2005).

[23] *See Sun Microsystems Inc. v. Hynix Semiconductor Inc.*, 534 F. Supp. 2d 1101 (N.D. Ca. 2007) (Claims outside time period were not assigned and court could not provide standing to pursue).

[24] *See* 6 Del. C. § 18-1002; *In re Citadel Watford City Disposal Partners L.P.*, 603 B.R. 897, 907 (Bankr. D. Del. 2019) (holding that litigation trustee lacked standing to bring derivative action against debtor LLC assigned to litigation trust by a creditors' committee pursuant to Chapter 11 plan because creditors' committee lacked standing); *In re HH Liquidation, LLC*, 590 B.R. 211, 285 (Bankr. D. Del. 2018) (holding that official committee of unsecured creditors had no standing to bring breach of fiduciary claims on behalf of debtor LLC); *In re PennySaver USA Publishing, LLC*, 587 B.R. 445 (Bankr. D. Del. 2018) (holding that Chapter 7 trustee lacked standing to sue on behalf of LLC because LLC's creditors also lacked standing).