

Third-Party Releases

By

Donald L. Gaffney
A. Evans O'Brien
SNELL & WILMER L.L.P.
Phoenix, Arizona

“[A] nondebtor release is a device that lends itself to abuse. 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.” *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142 (2nd Cir. 2005).

I. INTRODUCTION

A. Do bankruptcy courts have the authority to enjoin a non-consenting creditor's claims against a non-debtor to facilitate a Chapter 11 reorganization plan?

1. Question is now before the Supreme Court because of a twenty-year old circuit split
 - a. Ninth and Tenth Circuits hold that third-party releases are invalid
 - *See In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995); *In re American Hardwoods, Inc.*, 885 F.2d 621 (9th Cir. 1989); *Underhill v. National Mortgage Exchange, Inc.*, 769 F.2d 1426 (9th Cir. 1985); and *In re Western Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1991)
 - b. Other circuits to have decided the issue permit them to varying degrees using a variety of tests
 - *See, e.g., Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973 (1st Cir. 1995); *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285 (2nd Cir. 1992); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89 (2nd Cir. 1988); *In re A. H. Robins Co.*, 880 F.2d 694 (4th Cir. 1989); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Specialty Equip. Cos.*, 3 F.3d 1043 (7th Cir. 1993) (approving of consensual third-party release provision in reorganization plan)

B. Types of third-party releases

1. Releases of creditor claims against non-debtor over the objections of the creditor
 - These represent the most controversial form of release since the court is being requested to grant release from a creditor claim against an entity or party not within the normal protections of a bankruptcy estate or a debtor's discharge.
 - For a thorough treatment, see generally Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolves the Debate Over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 Emory Bankr. Dev. J. 13, 22-25 (2006).
2. Non-debtor releases of derivative claims and rights under a debtor's insurance policies
 - Derivative claims are property of the estate, and courts may issue permanent injunctions to resolve them pursuant to § 1123(b)(3)(A)
 - A debtor's insurance policies are generally property of the estate. *MacArthur Co. v. Johns-Manville, Corp.*, 837 F.2d 89, 90-91 (2nd Cir. 1988). Claims against these policies are essentially claims against the estate itself, and these types of releases, although not universally accepted, are less controversial than involuntary non-debtor releases of direct claims.
3. Provisional injunctions shielding non-debtors
 - A postconfirmation injunction that has a definite duration. *See, e.g., In re Rohnert Park Auto Parts, Inc.*, 113, B.R. 610, 612 (B.A.P. 9th Cir. 1990).
 - This is a less extreme release that places the risk of default on plan obligations on the debtor rather than on the creditor
4. Voluntary non-debtor releases of direct claims
 - Generally governed by contract principles and widely accepted. *See In re Specialty Equip. Cos.*, 3 F.3d 1043 (7th Cir. 1993).

II. THRESHOLD CONSIDERATIONS

A. Subject Matter Jurisdiction

1. Traditionally thought to exist under the "related to" or "arising under" analysis

- a. 28 U.S.C. § 1334(b)
 - Grants district courts subject matter jurisdiction over “all civil proceedings arising under title 11, or arising in or related to cases under title 11.”
 - b. 28 U.S.C. § 151
 - Designates bankruptcy courts as units of the district courts
 - c. 28 U.S.C. § 157(a)
 - Grants to bankruptcy courts jurisdiction over “any and all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11.”
 - d. *See generally In re American Hardwoods, Inc.*, 885 F.2d 621, 623 (9th Cir. 1989) (finding that §§ 1334(b) and 157(a) conferred subject matter jurisdiction over debtor’s motion for permanent injunction against third-party where injunction “could conceivably” affect the plan, but ultimately holding that the court lacked the power to enjoin the third-party).
2. Focus may be shifting to the concept of bankruptcy estates’ *res*
 - a. *See In re Johns-Manville Corp.*, 517 F.3d 52, 66 (2nd Cir. 2008) (“[A] bankruptcy court only has jurisdiction to enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate.”) and C.R. “Chip” Bowles Jr., *What Do Asbestos, Jurisdiction and Long-Dead Chapter 11 Cases Have in Common?*, American Bankruptcy Institute Journal, April 2008

B. Power

1. Potential sources of power to grant third-party releases
 - a. 11 U.S.C. § 105(a)
 - Gives courts the authority to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”
 - For example, § 105 permits courts to temporarily stay a creditor’s suit against a non-debtor during a bankruptcy proceeding if doing so would facilitate the reorganization. *See In re Western Estate Fund, Inc.*, 922 F.2d 592, 601-02 (10th Cir. 1991)

Process be Used to Release Nondebtor Parties?, 71 Am. Bankr. L.J. 1, 32-33 (1997).

- However, this argument is undermined by the “Rule of Construction” included with the amendment, which provides that “[n]othing in [524(g)] ... shall be construed to modify, impair, or supercede any other authority the court has to issue injunctions in connection with an order confirming a plan of reorganization.” See Silverstein, 23 Emory Bankr. Dev. J. 13, 50 n.204.

III. TESTS FOR OBTAINING THIRD-PARTY RELEASES

A. “Unusual Circumstances” Test

1. Identity of interest between the debtor and the third party
 - Typically an indemnity relationship where a suit against the third-party will effectively deplete assets of the estate
2. Third-party contributes substantial assets to the reorganization
3. Injunction is essential to the reorganization
 - Reorganization hinges on the release of parties who would have indemnity or contribution claims against the debtor
4. Impacted classes vote overwhelmingly to accept the plan
5. Mechanism in plan to pay all, or substantially all, of the classes affected by the injunction
 - In effect, this provision means that all permissible releases will be channeling releases, not actual releases
 - The plan proposed in *In re A. H. Robins Co.*, 880 F.2d 694 (4th Cir. 1989) went so far as to provide for full payment to a class of late claimants, and the court affirmed injunction of suits
6. Opportunity for claimants who choose not to settle to recover in full
 - This factor was added to the “unusual circumstances” test by *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002)
7. Specific factual findings to support bankruptcy court’s conclusions

NOTE: Courts following the “unusual circumstances” test are divided whether this is a balancing test, *In re Master Mortgage*, 168 B.R. 930, 935 (W.D. Mo.

1994), or whether all factors must be satisfied in order to uphold a non-debtor release, *In re Dow Corning Corp.*, 280 F.3d at 658

B. The *Drexel* Test

1. “In 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.” *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293 (2nd Cir. 1992) (affirming bankruptcy court ruling that benefits of non-debtor releases included (1) the continued cooperation of the debtors’ ongoing employees in prosecuting pooled claims; (2) an incentive to third parties to settle; (3) elimination of competition over particular funds, and (4) protection of the debtors’ estates from piecemeal dismemberment through indemnity claims).
2. The less stringent *Drexel* test may be of limited use, however, since it was articulated in the context of the approval of a settlement agreement and not in plan confirmation