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Expert Analysis

Non-Consensual Third-Party Releases in Chapter 11 Cases

By **Michael Riela**

Troubled businesses have a number of restructuring tools available to them. Among those tools is commencing a bankruptcy case under Chapter 11 of title 11 of the U.S. Bankruptcy Code. In a Chapter 11 case, the debtor benefits from the "automatic stay" while it attempts to formulate and execute upon an exit strategy, which can come in the form of a confirmed Chapter 11 plan of reorganization or liquidation, a sale of all or a substantial portion of the debtor's assets to a third-party, or an orderly liquidation (e.g., a "going out of business sale").

Under a Chapter 11 reorganization plan, the debtor can restructure its debts, even without the consent of many of its creditors. Often (but not always), the outcome of a Chapter 11 reorganization plan is that creditors receive only a portion of the amount of their claims against the debtor, and the equityholders of the debtor receive nothing on account of their shares. And importantly, when the Bankruptcy Court confirms a Chapter 11 plan, the debtor is discharged from debts that arose before the date of the confirmation order. See 11 U.S.C. §1141.

As a general matter, the confirmation of a debtor entity's Chapter 11 plan only discharges claims against that entity itself. In other words, the general rule is that individuals and entities that did not file their own bankruptcy cases (such as non-debtor affiliates and the human shareholders, officers and directors of the debtor entity) cannot take advantage of the bankruptcy discharge.

The logic underlying that general rule is that debtors in bankruptcy are subject to many requirements under the Bankruptcy Code (not the least of which are the duty to disclose their assets and liabilities, and following certain rules to make a Chapter 11 plan confirmable), and that it would be unfair to creditors to permit individuals and entities that did not file bankruptcy (and thus did not have to follow those requirements) to obtain a very important benefit of bankruptcy—a discharge.

Furthermore, a few circuit courts have held that the Bankruptcy Code itself prohibits non-consensual third-party releases. See 11 U.S.C. §524(e) ("… 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."). Many other circuit courts (including the U.S. Court of Appeals for the Second Circuit), on the other hand, have not concluded that §524(e) precludes non-consensual releases.

MICHAEL RIELA *is a partner in Tannenbaum Helpern Syracuse & Hirschtritt's business reorganization, debt restructuring and creditors' rights practice.*

Notwithstanding this general rule, debtors have been able to obtain Bankruptcy Court confirmation of Chapter 11 plans that include *non-consensual* third-party releases. These releases generally preclude creditors of the debtor from pursuing any claims that they may have against the shareholders, officers, directors, non-debtor affiliates and other third parties. These claims could be released even if creditors do not consent to the plan release, and indeed, even if those creditors vociferously oppose the release. The statutory basis for these releases is §105(a) of the Bankruptcy Code, which is a very general provision that provides in part that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

Understandably, non-consensual third-party releases are quite controversial. (Consensual third-party releases, such as release provisions that are embedded within a plan that has broad creditor support, are much less controversial). Courts in the federal judicial circuits where non-consensual releases are permitted tend to approve non-consensual third-party releases in cases where the releases contribute money to fund the debtor's Chapter 11 or agree to provide other contribution to the debtor or its creditors, and if the Chapter 11 plan would not be feasible without that contribution. The releasee, also understandably, would not want to contribute value to a Chapter 11 plan unless it receives the release.

Thus, the bankruptcy judge may be presented with the choice of (a) confirming a Chapter 11 plan that provides substantial recoveries to creditors (but that can only be funded by the proposed third-party release) and that contains a non-consensual third-party release or (b) refusing to approve the non-consensual third-party release, which may (or is likely) to lead to the death of the debtor's proposed Chapter 11 plan, and ultimately to the debtor's liquidation.

Two recent District Court cases, however, have called into question whether Bankruptcy Courts have the authority to approve non-consensual third-party releases.

The Second Circuit has permitted non-consensual third-party releases, where the releases play an important part in the debtor's plan of reorganization, where the released party has made a substantial financial contribution to the debtor's Chapter 11 case, or where the released party provides substantial consideration. See, e.g., *In re Metromedia Fiber Network*, 416 F.3d 136, 142 (2d Cir. 2005). Non-consensual releases have also been approved with respect to claims that would trigger indemnification or contribution claims against the debtor and thus impact the debtor's reorganization. See *In re Genco Shipping & Trading Ltd.*, 513 B.R. 233, 271 (Bankr. S.D.N.Y. 2014).

Two recent District Court cases, however, have called into question whether Bankruptcy Courts have the authority to approve non-consensual third-party releases.

First, in *In re Purdue Pharma, L.P.*, 635 B.R. 26 (S.D.N.Y. 2021), District Judge Colleen McMahon held that:

• Pursuant to the Supreme Court's decision in *Stern v. Marshall*, 564 U.S. 462, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011), Bankruptcy Courts (as non-Article III courts) lack the constitutional authority to enter a final order approving non-consensual third-party releases, even though they were incorporated into a proposed plan; and

• The Bankruptcy Code does not authorize a Bankruptcy Court to order the non-consensual release of non-derivative third-party claims against non-debtors in connection with confirmation of a Chapter 11 plan.

With respect to the first issue, Judge McMahon noted that the Bankruptcy Court should have tendered its opinion as proposed findings of fact and conclusions of law, which the District Court could then review de novo. The practical effect of that is that, unlike a Bankruptcy Court's decision that is appealed to the Dis-

trict Court, the District Court would not give deference to the Bankruptcy Court's factual findings with respect to the third-party releases.

With respect to the second (and more important) issue, McMahon concluded that §§105(a) and 1123(b)(6) of the Bankruptcy Code (which are general statutory provisions that allow Bankruptcy Courts and Chapter 11 plans to take appropriate measures to carry out the provisions of the Bankruptcy Code) do not allow a Bankruptcy Court to grant relief beyond the specific provisions of the Bankruptcy Code.

Judge McMahon's decision has been appealed to the Second Circuit, where it remains pending.

Second, in *Patterson v. Mahwah Bergen Retail Group*, 636 B.R. 641 (E.D. Va. 2022), District Judge David Novak voided and severed a non-consensual third-party release provision from the debtors' confirmed Chapter 11 plan, which rendered the third-party release provision unenforceable. Unlike Judge McMahon in the *Purdue Pharma* case, Judge Novak did not hold that the Bankruptcy Code lacks a statutory basis upon which a court may approve non-consensual third-party releases.

However, Judge Novak did conclude that the Bankruptcy Court had failed to properly apply binding U.S. Court of Appeals for the Fourth Circuit law regarding third-party releases. Specifically, in *Behrmann v. Nat'l Heritage Foundation*, 663 F.3d 704 (4th Cir. 2011), the Fourth Circuit announced a seven-part test to determine the appropriateness of non-consensual third-party releases, and cautioned that courts should grant such releases only cautiously and infrequently.

Like the District Court in *Purdue Pharma*, the District Court in *Patterson* concluded that the Bankruptcy Court did not have the constitutional power under *Stern v. Marshall* to approve those releases, absent consent. The District Court concluded that under the facts of that case, the proposed releasing parties did not consent to the adjudication of their claims by an Article I court.

In light of the 'Purdue Pharma' and 'Mahwah' cases and potential action in Congress, the fate of non-consensual third-party releases is murky.

After the District Court remanded the case to the Bankruptcy Court, with instructions to the chief judge of the Bankruptcy Court to reassign the bankruptcy case to a different bankruptcy judge, the debtors agreed to strike the offending third-party release provision from their Chapter 11 plan. The Bankruptcy Court ultimately approved the revised plan, which incorporated the removal of that provision.

The dispute over the propriety of non-consensual third-party releases has reached the halls of Congress. Last year, some members of Congress introduced the *Nondebtor Release Prohibition Act of 2021*, which would amend the Bankruptcy Code to prohibit non-consensual third-party releases in Chapter 11 plans. It appears that the bill has few co-sponsors in Congress and may not become law. However, it demonstrates that the debate over these releases is not confined to the courts.

In light of the *Purdue Pharma* and *Mahwah* cases and potential action in Congress, the fate of non-consensual third-party releases is murky. Business bankruptcy practitioners are now focused on the appeal of the *Purdue Pharma* case to the Second Circuit, as well as the developing case law in other Circuits.