Educational Materials

Tuesday, October 10, 2017 | 10:45 – 11:45 AM

Effective Use of Non-Debtor Third Party Releases

Presented by:

NCBJ | National Conference of Bankruptcy Judges

NCBJmeeting.org

91st Annual National Conference of Bankruptcy Judges

October 8-11, 2017 Las Vegas, NV

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Effective Use of Non-Debtor Third Party Releases

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Releases & Exculpations in Chapter 11 Plans

- Typically, chapter 11 plans provide for three types of relief from liability:
  - **Estate Releases**: Extinguish claims held by the debtor against specified non-debtor parties.
    - *Released Parties*: Creditors and/or other third parties and their advisors who have contributed to the reorganization (*e.g.*, by participating in a broader settlement, supporting the plan, accepting a discount on their claims, or providing new value).
    - *Released Claims*: Claims arising before or during the chapter 11 case.
    - *Purpose*: Estate releases tend to arise in the context of plan negotiations and provide an incentive for non-debtor parties to contribute to a reorganization.
    - Estate releases tend to be non-controversial because they are specifically authorized by Bankruptcy Code section 1123(b)(3)(a).
    - Courts tend to evaluate estate releases using the standard for approving settlements set forth in Bankruptcy Rule 9019: generally, such releases will be approved unless the decision to grant the release falls below the lowest point in the range of reasonableness.

Releases & Exculpations in Chapter 11 Plans, cont'd.

- **<u>Third Party Releases</u>**: Extinguish claims held by non-debtor third parties against other non-debtor third parties.
  - *Released Parties*: Creditors and/or other third parties who have contributed to the reorganization.
  - *Released Claims*: Claims arising before or during the chapter 11 case (note that the breadth of the third party release may be limited or prohibited if it is non-consensual).
  - *Purpose*: Similar to estate releases, third party releases are often used as an incentive for non-debtor parties to settle claims, support a plan, provide funding or otherwise contribute to a reorganization.
  - As described in greater detail in this presentation, third party releases are particularly controversial where a debtor seeks to implement a third party release through a chapter 11 plan without the consent of the non-debtor third parties whose claims are being released.

Releases and Exculpations in Chapter 11 Plans, cont'd.

- **Exculpation**: Provides qualified immunity to certain parties for actions taken during the chapter 11 case.
  - *Exculpated Parties*: Exculpation is generally limited to "estate fiduciaries," such as estate professionals, official committees and their members, and the debtor's directors and officers.
  - *Exculpated Conduct*: Actions taken in connection with the chapter 11 case. Generally, conduct taking place before the chapter 11 case may not be exculpated. Further, exculpation does not extend to claims for fraud, gross negligence and willful misconduct.
  - *Purpose*: Exculpation protects estate fiduciaries in the exercise of their fiduciary duties. Generally, exculpation provisions are consistent with the standards to which estate fiduciaries are held under chapter 11.
- Chapter 11 plans also include a permanent injunction, which typically prevents any party from attempting to commence or prosecute, after the conclusion of the chapter 11 case, claims that were released or exculpated by the plan.
- Typically, the plan proponent, which often is the debtor, controls the grant of releases and exculpation through the chapter 11 plan process, with input from the U.S. Trustee and oversight by the bankruptcy court.

Third Party Releases Generally

- Often, as an incentive for third parties to fund or otherwise support a chapter 11 plan of reorganization, debtors will seek to implement a release extinguishing a non-debtor's claims against such third parties without the consent of the releasing claimholder (such release, a "Third Party Release").
- The Circuit Courts of Appeals have split regarding the question of whether a bankruptcy court may confirm a chapter 11 plan of reorganization that includes Third Party Releases.
  - The Fifth, Ninth and Tenth Circuits have held that Bankruptcy Code section 524(e) specifically prohibits Third Party Releases (the "Minority View").
  - The Second, Third, Fourth, Sixth, Seventh and Eleventh Circuits have held that Third Party Releases may be permissible in certain circumstances (the "Majority View").
  - Lower court decisions in the First, Eighth and D.C. Circuits have indicated agreement with the Majority View.

Third Party Releases: The Minority View

- Rationale: Courts taking the Minority View believe that the specific language of Bankruptcy Code section 524(e) prohibits Third Party Releases.[1]
  - Bankruptcy Code section 524(e) provides 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." 11 U.S.C. § 524(e).
  - Further, under the Minority View, the general equitable powers granted to bankruptcy courts by Bankruptcy Code section 105(a) ***do not*** permit a bankruptcy court to approve a Third Party Release and thus circumvent Bankruptcy Code section 524(e).[2]

[1] *See, e.g., In re Pacific Lumber Co.,* 584 F.3d 229, 252 (5th Cir. 2009) (holding that the plan could not be confirmed with non-consensual non-debtor releases); *Resorts Intl. v. Lowenschuss (In re Lowenschuss),* 67 F.3d 1394, 1401-02 (9th Cir. 1995) (same); *see also In re W. Real Estate Fund, Inc.*, 922 F.2d 592, 601-02 (10th Cir. 1990) (holding that Bankruptcy Code section 524(e) prohibits a discharge of a non-debtor for liability owed to a creditor).

[2] *See In re Am. Hardwoods, Inc.*, 885 F.2d 621, 626 (9th Cir. 1989) ("Section 524(e), therefore, limits the court's equitable power under section 105 to order the discharge of the liabilities of nondebtors . . . .").

Third Party Releases: The Majority View

- Rationale: Courts taking the Majority View believe that Third Party Releases are permissible under certain circumstances.
  - While the Minority View interprets Bankruptcy Code section 524(e) as prohibiting Third Party Releases, courts adopting the Majority View interpret Bankruptcy Code section 524(e) as merely providing that a debtor's discharge in bankruptcy does not ***affect*** the liability of third parties. Therefore, Bankruptcy Code section 524(e) does not limit the bankruptcy court's ability to approve a Third Party Release.[3]
  - Courts that adopt this view also rely on the "broad authority" granted to bankruptcy courts by Bankruptcy Code section 105(a) to "reorder creditor-debtor relations needed to achieve a successful reorganization."[4] Among other things, "enjoining claims against a non-debtor so as not to defeat reorganization is consistent with the bankruptcy court's primary function."[5]

[3] *In re Dow Corning Corp.*, 280 F.3d 648, 657 (6th Cir. 2002); *see also Matter of Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993) (concluding that Bankruptcy Code section 524(e) "does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party").

[4] *Dow Corning.*, 280 F.3d at 656.

[5] *Id.*

Third Party Releases: The Majority View - Limitations

- The Majority View is not a broad rule sanctioning all Third Party Releases. Rather, Third Party Releases are to be approved only in "unusual circumstances."[6]
- The Sixth Circuit proposed a multi-factor test (the "*Dow* Factors") (as discussed below) and held that if a bankruptcy court found all of the *Dow* Factors to be present, the bankruptcy court could enjoin a non-consenting creditor's claims against a non-debtor.[7]
- The Fourth and Eleventh Circuits have adopted the *Dow* Factors when determining whether a Third Party Release is permissible;[8] however, each of the *Dow* Factors is not necessary in every case to grant a Third Party Release.[9]

[6] *Dow Corning*, 280 F.3d at 658; *see also In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 143 (2d Cir. 2005) (holding that a "nondebtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to the success of the plan").

[7] Note that other bankruptcy courts have applied the substantially similar multi-factor test set forth in *In re Master Mortg. Inv. Fund, Inc.*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994) (such test, the "*Master Mortgage* Factors") to evaluate whether a Third Party Release is permissible. *See, e.g.*, *In re Millennium Lab Holdings II, LLC*, No. 15-12284 (Bankr. D. Del. Dec. 11, 2015); *In re U.S. Fidelis, Inc.*, 481 B.R. 503, 519 (Bankr. E.D. Mo. 2012).

[8] *See Natl. Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 348 (4th Cir. 2014); *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying. Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070, 1077 (11th Cir. 2015).

[9] *See* Slide 10 *infra.*

Third Party Releases: The Majority View – Sixth Circuit (Dow Factors)

- The *Dow* Factors:

  (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.

Third Party Releases: The Majority View - Application of the Dow Factors

- In *Dow Corning*, the Sixth Circuit held that the record produced by the bankruptcy court ***did not*** support a finding of "unusual circumstances" warranting the approval of a Third Party Release because the bankruptcy court provided no explanation or discussion of the evidence underlying the *Dow* Factors and did not discuss facts as they related specifically to the various released parties.[10]
- In *National Heritage Foundation*, the Fourth Circuit applied each of the *Dow* Factors to a proposed Third Party Release and affirmed the lower court's holding that only the first *Dow* Factor was present and that the debtors failed to present sufficient evidence in support of the other *Dow* Factors.[11] The Fourth Circuit did note, however, that a "debtor need not demonstrate that every [*Dow* Factor] weighs in its favor" for a Third Party Release to be approved. However, "a debtor must provide adequate factual support to show that the circumstances warrant such exceptional relief."[12]

[10] *Dow Corning*, 280 F.3d at 658.

[11] *Nat'l Heritage Found.*, 760 F.3d at 351.

[12] *Id.* at 352.

Third Party Releases: The Majority View – Seventh Circuit (Airadigm Factors)

- The Seventh Circuit has not adopted the *Dow* Factors, but instead has applied its own multi-factor test (the "*Airadigm* Factors") for determining when a Third Party Release is permissible: The Third Party Release must be (1) narrowly tailored, (2) must not constitute a "blanket immunity," and (3) must be essential to the debtor's reorganization.[13]
- In *Airadigm*, the Seventh Circuit Court of Appeals approved a Third Party Release of the debtor's plan sponsor because:
  - The Third Party Release was narrow in that it is applied only to claims arising out of or in connection with the reorganization and did not apply to claims for "willful misconduct";
  - The Third Party Release was not a "'blanket immunity' for all times, all transgressions, and all omissions"; and
  - The bankruptcy court had found adequate evidence that the plan sponsor required the Third Party Release before it would supply the financing which was essential to the debtor's reorganization.[14]

[13] *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 657 (7th Cir. 2008); *see also In re Ingersoll, Inc.*, 562 F.3d 856, 864 (7th Cir. 2009) (applying the factors set forth in *Airadigm* and approving a Third Party Release).

[14] *Airadigm*, 519 F.3d at 657.

Third Party Releases: The Majority View - Third Circuit

- Notwithstanding varying decisions (discussed in further detail below), courts within the Third Circuit generally accept that Third Party Releases may be permissible in certain circumstances.
  - In *Continental Airlines*, the Third Circuit overturned a decision approving a Third Party Release. There, the plan proposed to release and permanently enjoin shareholder suits against certain of the debtor's present and former directors and officers.[15]
  - Specifically, the Third Circuit held that such releases "did not pass muster under even the most flexible tests . . . . The hallmarks of permissible non-consensual releases – fairness, necessity to the reorganization, and specific factual findings to support these conclusions – are all absent here."[16]
    - The District Court for the Eastern District of Pennsylvania in *Lower Bucks* explained the *Continental Airlines* hallmarks of "**necessity**" and "**fairness**" as follows:
      - "necessity" comprises (a) a sufficient relationship between the success of the reorganization and the release and (b) the released party "provided critical financial contribution . . . necessary to make the plan feasible"; and
      - "fairness" comprises the non-consenting party was given "reasonable consideration in exchange for the release."[17]

[15] *See In re Cont'l Airlines*, 203 F.3d 203, 214 (3d Cir. 2007).

[16] *Id.*

[17] *In re Lower Bucks Hosp.*, 488 B.R. 303, 323-24 (E.D. Pa. 2013) (internal citations omitted).

Third Party Releases: The Majority View - Third Circuit, cont'd.

- Although the Third Circuit declined to create a bright-line rule for the evaluation of Third Party Releases, the Court did discuss numerous factors that contributed to its decision to deny the Third Party Release at issue in *Continental Airlines* including:
  - lack of consideration given in exchange for the release;
  - lack of evidence that the success of the reorganization was related to the release;
  - the directors and officers did not contribute financially to the plan;
  - the plan would be feasible without the release;
  - lack of evidence of an eventual litigation sufficient to justify the release; and
  - lack of "identity of interest" between the debtors and the directors and officers sufficient to justify the release.[18]

[18] *See In re Cont'l Airlines*, 203 F.3d 203, 214 (3d Cir. 2000). Interestingly, in *Lower Bucks* the bankruptcy court used a different five factor test to determine the permissibility of the release, whether: (1) the released party made an important contribution to the reorganization; (2) the release was essential to confirmation of the plan; (3) a large majority of the creditors in the case approved the plan; (4) there was a close connection between the case against the third party and the debtor; and (5) the plan provided for the payment of substantially all of the affected claims. 488 B.R. at 323 (citing *In re South Canaan Cellular Invs., Inc.*, 427 B.R. 44, 72 (Bankr. E.D. Pa. 2010).

Third Party Releases: The Majority View - Third Circuit, cont'd.

- Bankruptcy courts within the Third Circuit have issued varying decisions regarding the permissibility of Third Party Releases.[19]
- For example, in *Washington Mutual*, the bankruptcy court for the District of Delaware held that Third Party Releases must be based on the "affirmativ[e] consent" of the releasing party and could not be non-consensual.[20]
  - In addition to various modifications to the Third Party Releases discussed below, the bankruptcy court in *Washington Mutual* held that it was not sufficient for a plan of reorganization to contain an opt-out for Third Party Releases.[21] Instead, the court held that Third Party Releases would only be effective where the releasing party both affirmatively voted in favor of the plan and did not opt-out of the release.[22]

[19] *See* Slides 18-21 *infra* discussing *In re Millennium Lab Holdings II, LLC*, No. 15-12284 (Bankr. D. Del. Dec. 11, 2015) (bench ruling approving Third Party Release) (remand July 27, 2017); *but see In re Wash. Mut.*, 442 B.R. 314, 355 (Bankr. D. Del. 2011); *see also In re Indianapolis Downs*, LLC, 486 B.R. 286, 304 ("Courts in this jurisdiction have consistently held that a plan may provide for a release of third party claims against a non-debtor upon consent of the party affected.").

[20] *In re Wash. Mut.*, 422 at 351, 355.

[21] *Id.* at 355.

[22] *Id.*

Recent Developments in Third Party Release Precedent: In re Caesars Entm't Operating Co., Inc.

- Jurisdiction: Seventh Circuit
- In late 2016, the U.S. Trustee filed an objection to confirmation of the debtors' chapter 11 plan arguing that, among other things, the plan included an impermissible Third Party Release that did not satisfy the *Airadigm* Factors.[23] The U.S. Trustee contended that:
  - The scope of the "Released Parties" under the plan was overly broad and included, among others, the debtors' parent company ("CEC") and its equity sponsors (and their individuals, officers, employees and agents) and the creditor counterparties to the debtors' multiple restructuring support agreements.
  - The scope of the "Releasing Parties" (*i.e.*, the parties giving releases of claims) was overly broad, and the plan sought to bind creditors who did not vote or voted to reject the plan, along with all unknown claimants and "ordinary course creditors" of the debtors and their non-debtor affiliates.
  - The scope of the released claims was overly broad and should have only applied to the claims settled by CEC and its equity sponsors.[24]

[23] *Trustee Plan Objection, In re Caesars Entm't Operating Co., Inc.*, No. 15-01145 (ABG) (N.D. Ill. Dec. 22, 2016) [ECF No. 6145].

[24] *Id.*

Recent Developments in Third Party Release Precedent: In re Caesars Entm't Operating Co., Inc., cont'd.

- Judge Goldgar of the Bankruptcy Court for the Northern District of Illinois indicated at a pre-confirmation status conference that, given that no other party in interest objected to the Third Party Releases, the U.S. Trustee should withdraw its objection:
  - "What purpose is served by your office objecting when no one in the case who actually stands to lose any money or gain any money objects? Everybody here, even the unsecured creditors, have counsel. Everybody has counsel." [25]
  - "That's just fine. But if everybody else is happy except the U.S. Trustee, I cannot understand what purpose is served by your forcing these folks to trial on this issue. But, you know, you certainly have the right to do it. I just don't understand it."[26]
- Despite the court's observation that the U.S. Trustee stood alone as the only party in interest advancing an objection, the U.S. Trustee remained steadfast in opposition because the U.S. Trustee believed that Third Party Releases violated Seventh Circuit law.[27]

[25] *Third Modified Plan, In re Caesars Entm't Operating Co., Inc.*, No. 15-01145 (ABG) , Dec. 6 Hr'g Tr. 12:14-18.
[26] *Id.* 15:18-23.
[27] *Id.*

Recent Developments in Third Party Release Precedent: In re Caesars Entm't Operating Co., Inc., cont'd.

- Recognizing the need to resolve the U.S. Trustee's objection, or risk an adverse decision following a lengthy trial on confirmation, the debtors made a series of amendments to the plan in December 2016[28] and January 2017[29] that ultimately resolved the U.S. Trustee's objections.
- Based upon negotiations with the U.S. Trustee, the debtors agreed to amendments to the plan that narrowed the scope of "Released Parties," "Releasing Parties," and the claims to be released. Notably, the Third Party Releases were amended to include a carve out of claims for actual fraud asserted by creditors who voted to reject the plan.
- On January 17, 2017, Judge Goldgar confirmed the plan.[30]

[28] *Third Modified Plan, In re Caesars Entm't Operating Co., Inc.*, No. 15-01145 (ABG) (N.D. Ill. Dec. 29, 2016) [ECF No. 6191].

[29] *Revised Third Modified Plan, In re Caesars Entm't Operating Co., Inc.*, No. 15-01145 (ABG) (N.D. Ill. Jan. 13, 2017) [ECF No. 6191].

[30] *Plan Confirmation Order, In re Caesars Entm't Operating Co., Inc.*, No. 15-01145 (ABG) (N.D. Ill. Jan. 17, 2017) [ECF No. 6339].

Recent Developments in Third Party Release Precedent: In re Peabody Energy Corp.

- Jurisdiction: Eighth Circuit
  - *Note that the Eighth Circuit has not expressed a view with respect to whether Third Party Releases are permissible.*
- In March 2017, the U.S. Trustee filed an objection to confirmation of the debtors' plan on the grounds that the plan included impermissible Third Party Releases.[31] The U.S. Trustee argued that the Eighth Circuit has yet to establish a rule with respect to Third Party Releases, and argued that courts approving non-consensual releases do so only in "rare and exceptional circumstances," such as mass tort cases where claims are channeled to a litigation trust not present in the *Peabody* case.[32]
  - The U.S. Trustee also argued that most courts approving non-consensual Third Party Releases required specific evidence showing that each and every beneficiary of the releases had provided a substantial contribution to the plan.[33]

[31] *Trustee Plan Objection, In re Peabody Energy Corp.*, No. 16-42529 (BSS) (E.D. Mo. March 10,2017) [ECF No. 2665].

[32] *Id.*

[33] *Id.*

Recent Developments in Third Party Release Precedent: In re Peabody Energy Corp., cont'd.

- The debtors argued that the Third Party Releases in the plan were permissible because:
  - The Third Party Releases were consensual. Specifically, only creditors who voted in favor of the plan or that were unimpaired by the plan and deemed to accept the plan would be bound by the Third Party Releases.
  - Even if the Third Party Releases were non-consensual, they were permissible because they satisfied the *Master Mortgage* Factors,[34] which have been applied by other bankruptcy courts in the Eighth Circuit when evaluating Third Party Releases.[35]
- At the confirmation hearing held on March 16, 2017, Judge Barry Schermer overruled the U.S. Trustee's objection, finding that the Third Party Releases were appropriate, and confirmed the plan.

[34] *See* Slide 8, n.7 *supra.*

[35] *Debtors' Reply*, *In re Peabody Energy Corp.*, No. 16-42529 (BSS) (E.D. Mo. March 14,2017) [ECF No. 2697].

Potential Limitations on Bankruptcy Court Authority to Release Claims: In re Millennium Lab Holdings II, LLC

- In *In re Millennium Lab Holdings II, LLC*, No. 15-12284 (Bankr. D. Del.), the Bankruptcy Court for the District of Delaware, in a bench ruling, confirmed the debtors' chapter 11 plan, overruling the objection of certain lenders to, among other things, the Third Party Releases in the plan.
- The lenders subsequently sought certification directly to the Third Circuit with respect to, among other things, the issue of whether bankruptcy courts have the authority to release a third party's non-bankruptcy claims against non-debtors without the third party's consent.
  - Specifically, the lenders challenged the bankruptcy court's authority under Article III of the Constitution in light of the Supreme Court's ruling in *Stern v. Marshall* that bankruptcy courts do not have constitutional authority to adjudicate "private rights."[36]
- The bankruptcy court agreed with the lenders that the question regarding the authority of bankruptcy courts to approve Third Party Releases warranted certification.[37] However, the Third Circuit denied the petition for certification, and the appeal was subsequently docketed with the United States District Court for the District of Delaware.

[36] *Stern v. Marshall*, 564 U.S. 462 (2011).

[37] *In re Millennium Lab Holdings II, LLC*, 543 B.R. 703, 717 (Bankr. D. Del. 2016).

Potential Limitations on Bankruptcy Court Authority to Release Claims: In re Millennium Lab Holdings II, LLC, cont'd.

- On appeal, the lenders argued that the bankruptcy court lacked authority to release the lenders' direct, state law, and federal RICO claims against other non-debtors.[38]
- The district court agreed with the bankruptcy court that it had "related to" subject matter jurisdiction over the lenders' released claims. However, the district court held that the bankruptcy court must also have Article III authority to enter a final order discharging the lenders' non-bankruptcy claims against non-debtors without the lenders' consent.
- The district court ultimately declined to rule with respect to the bankruptcy court's constitutional authority because the bankruptcy court had not considered the issue and, therefore, the district court remanded the case to the bankruptcy court to make such a determination.

[38] *See Memorandum Opinion, Opt-Out Lenders v. Millennium Lab Holdings II, LLC*, Civ. No. 16-110-LPS, at 19 (D. Del. Mar. 17, 2017) [ECF No. 46].

Potential Limitations on Bankruptcy Court Authority to Release Claims: In re Millennium Lab Holdings II, LLC, cont'd.

- Notwithstanding the remand, the district court considered—and appeared to agree with—the lenders' arguments:
  - The district court noted that, per the Supreme Court's ruling in *Stern*, the lenders' state law and RICO claims are non-bankruptcy claims between non-debtors and that the lenders "appear to be entitled to Article III adjudication" of such claims.
  - Thus, the district court was "persuaded" by the lenders' argument that the Third Party Release embodied in the plan is "tantamount to resolution of those claims on the merits" against the lenders.
  - Further, the district court was not persuaded by the debtors' argument that such a jurisdictional flaw could be remedied by *de novo* review of the Bankruptcy Court's decision to confirm the plan because there had been no adjudication on the merits of the claims released by the plan.
- Accordingly, the district court requested that the bankruptcy court consider, on remand, whether it has constitutional authority to approve the plan's Third Party Releases, and if it lacks such authority, to either submit proposed findings of fact and conclusions of law regarding the final disposition of the lenders' claims or strike the release of the lenders' claims.

Potential Limitations on Bankruptcy Court Authority to Release Claims: In re Millennium Lab Holdings II, LLC, cont'd.

- In so ruling, the district court suggested that bankruptcy courts lack the constitutional authority under *Stern* to approve the non-consensual release of certain non-bankruptcy claims (here, common law fraud and RICO claims).
- Bankruptcy courts may thereby be precluded from entering final orders approving Third Party Releases of such claims and an Article III court (*i.e.*, a district court) would be required to review and adjudicate the merits of such claims before they could be released without the consent of the party asserting the claims.
- Note that the debtors sought to dismiss the appeal as equitably moot due to the substantial consummation of the plan, but the district court held that it could not consider the debtors' equitable mootness challenge before it was determined whether there was a constitutional defect in the bankruptcy court's decision approving the Third Party Releases. However, the district court did not appear to foreclose the possibility of an equitable mootness argument being raised at a later point in the case, after the issue regarding the bankruptcy court's authority has been determined.

Practical Interpretations of the Minority View in the Ninth Circuit

- While the Minority View appears to be an absolute bar to Third Party Releases, the Ninth Circuit Court of Appeals has approved Third Party Releases in chapter 11 plans where the justification for those releases was not dependent upon Bankruptcy Code section 524(e), but was instead tied to a different legal justification, such as a Rule 9019 settlement.
- For example, in *Yellowstone Mountain Club, LLC* ("*Yellowstone I*"),[39] the Bankruptcy Court for the District of Montana confirmed the debtors' chapter 11 plan, which incorporated a settlement and included an "*Exculpation and Limitation of Liability Clause*" exculpating, among others, certain settlement parties and the buyer of the reorganized debtors, from liability for any acts arising out of the debtor's chapter 11 cases or the negotiation and consummation of the debtor's plan (except for acts constituting willful misconduct or gross negligence).
- The debtors' founder appealed the bankruptcy court's confirmation order, arguing that the plan inappropriately exculpated and released his claims against the third parties.

[39] *In re Yellowstone Mountain Club, LLC*, 460 B.R. 254 (Bankr. D. Mont. 2011).

Practical Interpretations of the Minority View in the Ninth Circuit, cont'd.

- On remand, the bankruptcy court held that the exculpation clause in the debtors' plan *did not* implicate Bankruptcy Code section 524(e) or violate established Ninth Circuit precedent.
  - The bankruptcy court found that the exculpation provision was "not a broad sweeping provision that seeks to discharge or release nondebtors from any and all claims that belong to others,"[40] but instead was narrow in both scope and time, as it only applied to certain acts or conduct related to the reorganization itself.[41]
  - The bankruptcy court held that, on the particular facts of the case, the exculpation as to the non-debtor third parties was appropriate, as those third parties had "vigorously negotiated" the terms of a settlement, which was incorporated into the debtors' plan, in a particularly litigious case. "Because the [settlement] and the exculpation clause were cornerstones of the Plan and were highly negotiated," the narrow exculpation of the third parties was appropriate.[42]

[40] *Id.* at 270.
[41] *Id.* at 272.
[42] *Id.* at 277.

Practical Interpretations of the Minority View in the Ninth Circuit, cont'd.

- Further, a broad release may be permissible for post-petition conduct of certain officers appointed by the bankruptcy court, as suggested by the Ninth Circuit's holding in *In re Yellowstone Mountain Club, LLC* ("*Yellowstone II*").[43]
  - In *Yellowstone II*, one of the debtors' founders sought to sue his former attorney – and member of the official unsecured creditors' committee – for both pre- and post-petition conduct outside of the bankruptcy court.
  - The Ninth Circuit held that, under the *Barton* doctrine,[44] the plaintiff was required to seek the bankruptcy court's permission to sue the attorney for the attorney's *post-petition* conduct outside of the bankruptcy court.[45]
  - However, the Ninth Circuit also held that the *Barton* doctrine did not preclude the plaintiff from pursuing claims against the attorney arising out of wrongful *pre-petition conduct*, before the attorney became a member of the creditor's committee.[46]

[43] *In re Yellowstone Mountain Club, LLC*, 841 F.3d 1090 (9th Cir. 2016).

[44] The *Barton* doctrine provides that plaintiffs must obtain the authorization of the bankruptcy court before initiating an action in another forum against certain officers appointed by the bankruptcy court for actions taken in their official capacities. *Id.* at 1094 (citing *Barton v. Barbour*, 104 U.S. 126 (1881)).

[45] *Id.* at 1095.

[46] *Id.* at 1096.

Practical Interpretations of the Minority View in the Ninth Circuit, cont'd.

- Parties seeking to effectuate a release of third party claims in the Ninth Circuit should be mindful of the rule set forth in *Williams v. California 1st Bank*, which provides that a trustee cannot pursue or settle the claims of the estate's creditors against third parties, even if those creditors have assigned their claims to the trustee.[47]
- However, notwithstanding the result in *Williams*, trustees have been successful in enjoining third party claims against the debtors' former directors in connection with a settlement – in practice effectuating a Third Party Release.[48]
  - In *Smith v. Arthur Andersen*, the Ninth Circuit held that the trustee had standing to pursue claims against the debtors' former directors and to seek to enjoin claims of certain non-settling directors against settling directors. The trustee had standing because it was seeking to rectify injuries caused to the debtors by the defendants' improper expenditure of the debtors' assets prior to the debtors' bankruptcy filing. Thus, the trustee was not pursuing claims of creditors but was pursuing claims of the estate.[49]

[47] *Williams v. California 1st Bank*, 859 F.2d 664, 666 (9th Cir. 1998).

[48] *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1002 (9th Cir. 2005).

[49] *Id.* at 1003-1004.