THE CONTROVERSIAL ROLE OF THIRD-PARTY RELEASES IN BANKRUPTCY

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INTRODUCTION

Bankruptcy is intended to benefit the "honest but unfortunate debtor."[1] Inherent in this truism is that the intended beneficiary of bankruptcy proceedings is the debtor. However, chapter 11 cases are multi-party proceedings in which deal-making and compromises are part and parcel of the process. Therefore, it is not surprising that plans of reorganization provide benefits to many different constituencies. However, when plans attempt to prevent third-party creditors from suing non-debtor parties, they raise the question of whether the collective deal-making process is being abused. Professor Melissa Jacoby criticizes third-party releases as a feature of "off-label bankruptcy" where "expansive add-ons to bankruptcy relief purported to be essential to keeping the deal together" are tacked on to the express provisions of the Bankruptcy Code.[2] Several bills have been introduced to Congress to ban or restrict the practice, including the Stop Shielding Assets From Corporate Known Liability by Eliminating Nondebtor Releases (SACKLER) Act and the non-debtor Release Prohibition Act.[3] The District Court for the Southern District of New York recently reversed confirmation of Purdue Pharma's plan because it found that the third-party releases in favor of the Sackler family were not authorized by the Bankruptcy Code.[4] Despite these critiques, plan provisions, that benefit third parties, come in many different varieties with various levels of legal justification. This article will examine some of the different flavors of third-party provisions[5] and their statutory and case law justifications (or lack thereof).

While most of this paper will deal with third-party provisions contained in plans, they can be granted in other orders as well. Third-party claims have been restricted in other orders such as an order to lift stay[6] or an order granting sale free and clear of liens.[7] Thus, while plans are the most common vehicle for third-party provisions, they could be found in any order capable of binding effect.

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[1] Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007) (citing Grogan v. Garner, 498 U.S. 279, 287 (1991)).

[2] Melissa B. Jacoby, *Shocking Business Bankruptcy Law*, 131 YALE L.J.F. 409, 411, 419 (2021).

[3] H.R. 2096, 117th Cong. (2021); S. 2472, 117th Cong. (2021); H.R. 4777, 117th Cong. (2021); S. 2497, 117th Cong. (2021).

[4] *In re* Purdue Pharma, L.P., 635 B.R. 26, 78 (S.D.N.Y. 2021), *appealed*, to the Second Circuit Court of Appeals on Dec. 16, 2021, *argued*, Apr. 29, 2022.

[5] These will be referred to simply as "third-party provisions" rather than using an acronym.

[6] *See* VSP Labs, Inc. v. Hillair Cap. Invs., L.P. (*In re* PFO Global, Inc.), 26 F.4th 245, 253 (5th Cir. 2022). While the opinion affirmed an award of attorneys' fees for violating the third-party provision, it illustrates how third-party relief could arise in a context other than a plan.

[7] *See In re* Camp Arrowhead, Ltd., 451 B.R. 678 (Bankr. W.D. Tex. 2011). The opinion enjoined pursuit of claims that "are or may be property of the estate." *Id.* at 702.

I. WHAT DO THE CODE AND THE RULES SAY?

A. Sections 524(e) and 1141

Many discussions of third-party provisions begin and end with 11 U.S.C. § 524(e) which states 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."[8] This is fine as far as it goes, but it assumes that a third-party provision is a discharge. However, if it is a provision which can properly be included within a plan, it may be enforceable by virtue of 11 U.S.C. § 1141(a) which states:

> Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan.[9]

The discharge provision for chapter 11 plans is 11 U.S.C. § 1141(d),[10] which is separate and apart from § 1141(a). Granted, section 1141(a) does incorporate section 1141(d)(2) (which addresses debts of an individual which are not dischargeable under 11 U.S.C. § 523(a)) and (d)(3) (which addresses debts of a liquidating entity which would not be dischargeable under 11 U.S.C. § 727).[11] However, both provisions apply to debtors and not to third parties.

Thus, the express language of the Code states that, with the exception of two limitations on discharge applicable to debtors, what the plan says is binding on six classes of parties: the debtor, any entity issuing securities under a plan, any entity acquiring property under a plan, creditors, equity security holders, and general partners.[12] This brings us to the first rule of third-party provisions: a third-party provision is not enforceable against a stranger to the plan (that is, someone who does not fit within the six categories of section 1141(a)). Who is a stranger to the plan? Consider this hypothetical: the debtor's CEO owns a $40 million mansion. The mansion is encumbered by a lien in favor of ABC Credit Union. ABC Credit Union is neither scheduled by the debtor as a creditor nor does it file a proof of claim. A plan provision purporting the restructure of the lien on the CEO's mansion would not

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[8] 11 U.S.C. § 524(e) (2018).
[9] *Id.* § 1141(a).
[10] *See id.* § 1141(d).
[11] *See id.* §§ 523(a), 727, 1141(a), 1141(d)(2)–(3).
[12] *See id.* § 1141(a).

be enforceable under 11 U.S.C. § 1141(a). However, if ABC Bank extended a line of credit to the debtor and held the mortgage on the CEO's mansion, section 1141(a) would not be a prohibition, although as we will see later, there would be other problems.

Some courts have been inconsistent in their understanding of section 524(e). In *Republic Supply Co. v. Shoaf*,[13] the Fifth Circuit sensibly stated: "Although section 524 has generally been interpreted to preclude release of guarantors by a bankruptcy court, the statute does not by its specific words preclude the discharge of a guaranty when it has been accepted and confirmed as an integral part of a plan of reorganization."[14]

Later, the Fifth Circuit said the exact opposite, namely, that section 524(e) did preclude release of third parties under a plan.[15]

B. Section 105(a)

Section 105(a) of the Bankruptcy Code is an overworked provision of the Bankruptcy Code. In many instances, the invocation of section 105(a) means that there is no authority for the action sought to be taken. Section 105(a) states:

> (a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.[16]

Section 105(a) can best be understood as having two purposes. First, it provides the procedural mechanism for carrying out the substantive provisions of the Code. This is shown by the reference to "any order . . . that is necessary or appropriate to carry out the provisions of this title."[17] It can also be understood to authorize those powers which are implied by the structure of the Bankruptcy Code. Thus, section 105(a) has been understood to authorize sanctions under the court's inherent authority,[18] and certain first day orders such as payment of employee wages.[19]

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[13] 815 F.2d 1046 (5th Cir. 1987).

[14] *Id.* at 1050 (footnote omitted).

[15] Bank of N.Y. Tr. Co., NA v. Off. Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 251–53 (5th Cir. 2009).

[16] 11 U.S.C. § 105(a).

[17] *Id.*

[18] *See* Grossman v. Wehrle (*In re* Royal Manor Mgmt.), 652 F. App'x 330, 342 (6th Cir. 2016).

[19] *See* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 985 (2017).

However, section 105(a)'s substantive component may not override the express provisions of the Code.[20]

C. Section 1123

There are several other statutory sections which influence third-party provisions. Section 1123 includes the following provisions:

> (a) Notwithstanding any otherwise applicable non-bankruptcy law, a plan shall —
>
> (5) provide adequate means for the plan's implementation
>
> (b) Subject to subsection (a) of this section, a plan may —
>
> (3) provide for —
>
> (A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate
>
> (6) include any other appropriate provision not inconsistent with the applicable provisions of this title.[21]

These clauses are a bit like the Necessary and Proper Clause of the Constitution.[22] They require the plan proponent to provide adequate means for the plan's implementation and to include any other appropriate provision not inconsistent with the rest of the Code.[23] If a plan sponsor is contributing capital to make a plan possible, and will only do so if released from liability, it is arguable that including a third-party provision releasing the plan sponsor from the claims of creditors who are getting paid under the plan is part of providing adequate means for the plan's implementation. The authority to compromise claims belonging to the estate arguably implies that the plan may not compromise claims belonging to third parties, but this is not explicit.

D. Section 524(g)

11 U.S.C. § 524(g) contains extensive provisions allowing plans to include what are known as "channeling injunctions":

> (g)
>
> (1)
>
> (A) After notice and hearing, a court that enters an order confirming a plan of reorganization under chapter 11 may issue, in connection with such order, an injunction in accordance with this subsection to

[20] *See* Law v. Siegel, 571 U.S. 415, 421 (2014).
[21] 11 U.S.C. § 1123.
[22] U.S. CONST. art. I, § 8, cl. 18.
[23] *See* 11 U.S.C. § 1123.

supplement the injunctive effect of a discharge under this section.

(B) An injunction may be issued under subparagraph (A) to enjoin entities from taking legal action for the purpose of directly or indirectly collecting, recovering, or receiving payment or recovery with respect to any claim or demand that, under a plan of reorganization, is to be paid in whole or in part by a trust described in paragraph (2)(B)(i), except such legal actions as are expressly allowed by the injunction, the confirmation order, or the plan of reorganization.

(2)

. . .

(B) The requirements of this subparagraph are that —

(i) the injunction is to be implemented in connection with a trust that, pursuant to the plan of reorganization —

(I) is to assume the liabilities of a debtor which at the time of entry of the order for relief has been named as a defendant in personal injury, wrongful death, or property-damage actions seeking recovery for damages allegedly caused by the presence of, or exposure to, asbestos or asbestos-containing products;

(II) is to be funded in whole or in part by the securities of 1 or more debtors involved in such plan and by the obligation of such debtor or debtors to make future payments, including dividends;

(III) is to own, or by the exercise of rights granted under such plan would be entitled to own if specified contingencies occur, a majority of the voting shares of —

(aa) each such debtor;

(bb) the parent corporation of each such debtor; or (cc) a subsidiary of each such debtor that is also a debtor; and

(IV) is to use its assets or income to pay claims and demands; and

(ii) subject to subsection (h), the court determines that —

(I) the debtor is likely to be subject to substantial future demands for payment arising out of the same or similar conduct or events that gave rise to the claims that are addressed by the injunction;

(II) the actual amounts, numbers, and timing of such future demands cannot be determined;

(III) pursuit of such demands outside the procedures prescribed by such plan is likely to threaten the plan's purpose to deal equitably with claims and future demands;

(IV) as part of the process of seeking confirmation of such plan —

(aa) the terms of the injunction proposed to be issued under paragraph (1)(A), including any provisions barring actions against third parties pursuant to paragraph (4)(A), are set out in such plan and in any disclosure statement supporting the plan; and

(bb) a separate class or classes of the claimants whose claims are to be addressed by a trust described in clause (i) is established and votes, by at least 75 percent of those

> voting, in favor of the plan; and
>
> (V) subject to subsection (h), pursuant to court orders or otherwise, the trust will operate through mechanisms such as structured, periodic, or supplemental payments, pro rata distributions, matrices, or periodic review of estimates of the numbers and values of present claims and future demands, or other comparable mechanisms, that provide reasonable assurance that the trust will value, and be in a financial position to pay, present claims and future demands that involve similar claims in substantially the same manner.[24]

The excerpt quoted above is not the full provision but gives an idea of its terms. The short version is that under certain exacting standards, an injunction protecting third parties may be included in a plan where there is a trust created to pay claims resulting from asbestos.[25] Given that this provision is so specific and so exacting, some courts have held and practitioners have argued that the statutory provision of *expressio unius est exclusio alterius* applies, meaning that the inclusion of one is the exclusion of another.[26] However, the problem with canons of construction is that they are merely guides to construing statutory language. It is possible to argue that Congress included these specific provisions because it thought that asbestos cases required more stringent requirements for third-party provisions than other cases. Of course, the fact that it can be argued does not mean that it would be successful.

E. Rule 3016(c) and Rule 7001(7)

Rule 3016(c) of the Federal Rules of Bankruptcy Procedure deals with injunctions under plans. This is a curious rule because there is not an explicit statutory authorization for injunctions under plans. It states:

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[24] 11 U.S.C § 524(g).

[25] *See id.*

[26] *See In re* Purdue Pharma L.P., 635 B.R. 26, 92 (S.D.N.Y. 2021) ("The language of the statute plainly indicates that Congress believed Section 524(g) created an exception to what would otherwise be the applicable rule of law.").

> (c) Injunction Under a Plan. If a plan provides for an injunction against conduct not otherwise enjoined under the Code, the plan and disclosure statement shall describe in specific and conspicuous language (bold, italic, or underlined text) all acts to be enjoined and identify the entities that would be subject to the injunction.[27]

Rule 7001(7) contains a complementary rule. It states that requests for injunctions must be sought in an adversary proceeding "except when a chapter 9, chapter 11, chapter 12, or chapter 13 plan provides for the relief . . . ."[28] At a minimum, these two rules establish that procedurally a plan of reorganization may include an injunction without the necessity of filing an adversary proceeding. They also imply that injunctions in plans are proper. While the discharge under 11 U.S.C. § 1141(d) operates as an injunction, there probably would not be a reason to include specific language referring to injunctions if the discharge was the *only* injunction permissible under a plan.

II. Specific Third-Party Provisions

This section will examine six types of third-party provisions. These include releases of estate claims, exculpation clauses, res judicata releases, consensual releases, injunctions, and non-consensual third-party releases. While the final category is what practitioners commonly think of as third-party releases, the other categories will help illustrate options which might be useful in jurisdictions that do not allow the non-consensual variety of release.

A. Release of Estate Claims

Allowing releases of claims held by an estate is the easiest case since it is expressly authorized by the Code.[29] Indeed, estate claims can even be released inadvertently by failure to adequately retain them.[30]

However, there are cases where releases of estate claims can preclude actions by creditors against the released parties. In some courts, claims to recover fraudulent transfers,[31] and claims for alter ego,[32] are considered property of the estate. However,

[27] Fed. R. Bankr. P. 3016(c).

[28] Fed. R. Bankr. P. 7001(7).

[29] 11 U.S.C. § 1123(b)(3)(A).

[30] *See* Wooley v. Haynes & Boone, LLP (*In re* SI Restructuring, Inc.), 714 F.3d 860, 865–66 (5th Cir. 2013); Nat'l Benevolent Ass'n of the Christian Church v. Weil Gotschal & Manges, LLP (*In re* Nat'l Benevolent Ass'n of the Christian Church), 333 F. App'x 822, 826 (5th Cir. 2009).

[31] *See, e.g.*, French v. Liebmann (*In re* French), 440 F.3d 145, 152 (4th Cir. 2006); Am. Nat'l Bank of Austin v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1275 (5th Cir. 1983).

[32] *See, e.g.*, Kalb, Voorhees & Co. v. Am. Fin. Corp., 8 F.3d 130, 133–35 (2d Cir. 1993); S.I. Acquisition, Inc. v. Eastway Delivery Serv., Inc. (*In re* SI Acquisition, Inc.), 817 F.2d 1142, 1151–53 (5th Cir. 1987).

outside of bankruptcy, these are claims which may be pursued by creditors. Additionally, there are cases where creditors can pursue claims which belong to the debtor on a derivative basis.[33] An express release of estate claims in a plan should be sufficient to bar creditors from pursuing those same claims.

A release of estate claim in a plan should meet the same standards as a compromise and settlement under Rule 9019 of the Federal Rules of Bankruptcy Procedure.[34] A plan which proposed to gratuitously release claims against officers and directors was denied.[35] Courts generally evaluate a proposed compromise and settlement by evaluating whether it is "fair and equitable" and "in the best interest of the estate."[36] To determine whether a compromise is fair and equitable, bankruptcy courts consider the following factors:

> (1) the probability of success in litigating the claim subject to settlement, considering the attendant uncertainties in fact and law;
> (2) the complexity and likely duration of litigation and any attendant expense, inconvenience, and delay, if any, to be encountered in the matter of collection;
> (3) the best interests of the creditors, with proper deference to their reasonable views;
> (4) "the extent to which the settlement is truly the product of arms-length bargaining, and not of fraud or collusion"; and
> (5) all other factors bearing on the wisdom of the compromise.[37]

B. Bar Orders

In connection with a compromise and settlement, a bankruptcy court in some jurisdictions may enter what is known as a bar order, preventing third parties from asserting claims against a settling defendant.[38] In the Eleventh Circuit, the criteria for entering a bar order include: [(1)]"the interrelatedness of the claims that the bar order precludes"[; (2)] "the likelihood of the nonsettling defendants to prevail on the barred

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[33] *See, e.g.*, Artesanias Hacienda Real S.A. de C.V. v. N. Mill Cap., LLC (*In re* Wilton Armetale, Inc.), 968 F.3d 273, 282–83 (3d Cir. 2020).

[34] *In re* Boy Scouts of Am. and Del. BSA, LLC, 642 B.R. 504, 622 (Bankr. D. Del. 2022).

[35] *See In re* Genesis Health Ventures, Inc., 266 B.R. 591, 608–09 (Bankr. D. Del. 2001).

[36] *See* Conn. Gen. Life Ins. Co. v. United Cos. Fin. Corp. (*In re* Foster Mortg. Co.), 68 F.3d 914, 917 (5th Cir. 1995) (citing *In re* Jackson Brewing Co., 624 F.2d 599, 602 (5th Cir. 1980)); *In re* Alfonso, No. 16-51448, 2019 WL 4254329, at *3 (Bankr. W.D. Tex. Sept. 6, 2019) (citing Fifth Circuit instruction from *In re* Foster Mortg. As reason for denying proposed settlement).

[37] *See* Off. Comm. Of Unsecured Creditors v. Cajun Elec. Power Coop., (*In re* Cajun Elec. Power Coop.,), 119 F.3d 349, 356 (5th Cir. 1997).

[38] *See, e.g.*, Papas v. Buchwald Cap. Advisors, LLC (*In re* Greektown Holdings, LLC), 728 F.3d 567, 571 (6th Cir. 2013).

claim"[; (3)] "the complexity of the litigation"[;] and [(4)] "and the likelihood of depletion of the resources of the settling defendants."[39]

Several other circuits have allowed bar orders as well.[40] Bar orders are also a common feature in class action litigation.[41]

The Fifth Circuit appears to have rejected the bar order concept. In *Feld v. Zale Corp.*,[42] the bankruptcy court approved a settlement between certain former officers and directors and the insurance company holding the D & O coverage.[43] The settlement barred third parties from asserting claims against the debtor, the settling officers and directors, and the primary D & O carrier that would undermine or collaterally attack the settlement.[44] A non-settling officer and the excess D & O carrier appealed, contending that the bankruptcy court lacked jurisdiction to prevent them from pursuing bad faith and breach of contract claims against the primary D & O carrier.[45] The Fifth Circuit found that the bankruptcy court lacked jurisdiction over claims between non-debtor parties and voided the injunction.[46] The Fifth Circuit recently followed this logic in striking down a bar order in a receivership case.[47]

C. Exculpation Clauses

An exculpation clause is a provision included in a plan which provides that certain persons participating in the plan process can only be held liable for their actions in the case based on willful conduct or gross negligence.[48] Stated another way, an exculpation clause prohibits negligence claims against certain defined persons for actions taken in the bankruptcy case. An exculpation clause in a recent Ninth Circuit case provided:

> None of [the Exculpated Parties, including Credit Suisse, CrossHarbor, and Edra Blixseth], shall have or incur any liability to any Person for any act or omission in connection with, relating to or arising out of the Chapter 11 Cases, the formulation, negotiation, implementation, confirmation or consummation of this Plan, the

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[39] Reply Brief of Defendants-Appellants at 19, Papas v. Buchwald Cap. Advisors, LLC (*In re* Greektown Holdings, LLC), 728 F.3d 567 (6th Cir. 2013) (No. 12-2434) (citation omitted).

[40] *See, e.g.*, Betker v. U.S. Tr. Corp., N.A. (*In re* Heritage Bond Litig.), 546 F.3d 667, 678–79 (9th Cir. 2008) (determining Ninth Circuit standard for proper scope of bar order); Gerber v. MTC Elec. Techs. Co., 329 F.3d 297, 307 (2d Cir. 2003) (providing example of bar order acceptable under Second Circuit guidelines).

[41] *See, e.g., Betker*, 546 F.3d at 678–79 (9th Cir. 2008); *Gerber*, 329 F.3d at 307 (2d Cir. 2003) (Sotomayor, J.).

[42] *In re* Zale Corp., 62 F.3d 746 (5th Cir. 1995).

[43] *Id.* at 749–50.

[44] *Id.*

[45] *See id.* at 751.

[46] *See id.* at 766.

[47] *See* SEC v. Stanford Int'l Bank, Ltd., 927 F.3d 830, 836 (5th Cir. 2019).

[48] *See* Blixseth v. Credit Suisse, 961 F.3d 1074, 1081–82 (9th Cir. 2020).

> Disclosure Statement, or any contract, instrument, release or other agreement or document entered into during the Chapter 11 Cases or otherwise created in connection with this Plan; provided, however, that nothing in this Section 8.4 shall be construed to release or exculpate any Exculpated Party from willful misconduct or gross negligence as determined by a Final Order or any breach of the Definitive Agreement or any documents entered into in connection therewith.[49]

An exculpation clause is a release of negligence claims arising out of the bankruptcy case. The propriety of an exculpation clause depends on whose claims are being released and who is getting the release. Consider the following scenarios:

1. The bankruptcy estate releases negligence claims against the parties with whom it negotiated the plan. This would be a straightforward example of releasing an estate claim as permitted by section 1123(b)(3)(A). This can clearly be seen as a proper incentive to the debtor's counterparties in negotiating the plan and should be acceptable.

2. The bankruptcy estate releases negligence claims against its own professionals. This is a problem, at least for attorneys. The ABA Model Disciplinary Rules state that a lawyer shall not "make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement" or "settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith."[50] An exculpation clause in favor of an attorney representing the estate is an agreement to limit the lawyer's liability for negligence and may be unethical unless the client is separately advised. It is also foolish since a final order on a fee application will have the same effect.[51]

3. The counterparties to the plan release their negligence claims against the debtor and its professionals. This would seem to be a negotiated contractual provision between two parties entering into an agreement and should not pose a problem.

4. An exculpation clause releases negligence claims by third parties against the Exculpated Parties. This is a form of third-party release. In the *Blixseth* case, Timothy Blixseth objected to the Exculpation Clause insofar as it applied to Credit Suisse, the largest creditor in the case.[52] The opinion does not disclose why Mr. Blixseth thought that he might have a negligence claim against Credit Suisse for its role in the bankruptcy process. Generally, parties to contracts may not assert tort claims against

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[49] *Id.* at 1078–79.

[50] MODEL RULES OF PRO. CONDUCT r. 1.8(h) (AM. BAR ASS'N 2002).

[51] Cap. Hill Grp. v. Pillsbury, Winthrop, Shaw, Pittman, LLC, 569 F.3d 385, 491 (D.C. Cir. 2009).

[52] *See Blixseth*, 961 F.3d at 1078, 1079, 1084.

each other with regard to the performance of those contracts.[53] However, the Ninth Circuit found that the Exculpation Clause did not violate 11 U.S.C. § 524(e) because it was "'narrow in both scope and time,' [and] limited to releasing the parties from liability for 'any act or omission in connection with, relating to or arising out of the chapter 11 cases' or bankruptcy filing."[54]

The Fifth Circuit, on the other hand, has treated exculpation clauses as improper third-party releases and has banned them, except as to members of a creditors' committee.[55] In the *Pacific Lumber* case, two creditors, MRC and Marathon, proposed a plan of reorganization.[56] The plan included an Exculpation Clause which barred claims (other than for willfulness or gross negligence) against MRC, Marathon, two companies created under the plan, and the Unsecured Creditors' Committee for their role in proposing, administering and implementing the plan.[57] Certain noteholders appealed.[58] The Fifth Circuit found that the Exculpation Clause was an improper third-party release as to MRC and Marathon, the two plan proponents.[59] The court's explanation for its decision is less than clear. Under what circumstances could MRC or Marathon be sued for negligence in proposing, administering, and implementing the plan? Wouldn't the proper remedy be to enforce the default remedies under the plan? This short segment of the opinion does not appear to be very clear in its reasoning. On the other hand, the court did find that the Unsecured Creditors' Committee and its members should be protected against claims for negligence based on 11 U.S.C. § 1103(c), which the court said granted qualified immunity to the committee members.[60]

The dispute over the validity of exculpation clauses appears to be a controversy in search of meaning. It seems likely that the amount of time and expense spent arguing over Exculpation Clauses exceeds any benefit they might provide. I am willing to be persuaded, but I do not see a great risk of parties being sued for negligence in negotiating, preparing, and executing a contract.

D. Release by Res Judicata

Plans are confirmed by entry of a confirmation order.[61] Once a plan has been confirmed and the confirmation order is final, 11 U.S.C. § 1141(a) states that it is

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[53] Creighton Prop. Holdings, LLC v. Lewis Bros., Inc., No. 2:21-CV-279, 2021 WL 4523797, at *2–3 (W.D. Pa. Oct. 4, 2021).

[54] *Blixseth*, 961 F.3d at 1081 (citation omitted).

[55] *See, e.g.*, Bank of N.Y. Tr. Co., NA v. Off. Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 252–53 (5th Cir. 2009).

[56] *Id.* at 237.

[57] *See id.* at 251–52.

[58] *See id.* at 239.

[59] *Id.* at 252–53.

[60] *See id.* at 253.

[61] *See* Bank of N.Y. Tr. Co., NA v. Off. Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 240 (5th Cir. 2009).

binding on the parties.[62] This is true even if the provision would not have withstood scrutiny had a party in interest filed a timely objection.[63] For years, creditors had argued that bankruptcy courts lacked subject matter jurisdiction to take actions not authorized by the Bankruptcy Code. However, this ignored the statutory text of 28 U.S.C. § 1334 which states that there is subject matter jurisdiction over bankruptcy cases and matters arising under the Bankruptcy Code, matters arising in a bankruptcy case, and matters related to a bankruptcy case.[64]

In addition to invoking section 1141(a), a confirmation order also gives rise to res judicata.[65] The doctrine of res judicata prevents a party from relitigating a matter which has been previously decided.[66] As the Supreme Court stated in a case involving release of a guarantor in a reorganization proceeding, under the Bankruptcy Act:

> Courts to determine the rights of parties are an integral part of our system of government. It is just as important that there should be a place to end as that there should be a place to begin litigation. After a party has his day in court, with opportunity to present his evidence and his view of the law, a collateral attack upon the decision as to jurisdiction there rendered merely retries the issue previously determined. There is no reason to expect that the second decision will be more satisfactory than the first.[67]

The elements necessary to invoke res judicata have been described as follows:

> First, the prior judgment must be valid in that it was rendered by a court of competent jurisdiction and in accordance with the requirements of due process. Second, the judgment must be final and on the merits. Third, there must be identity of both parties or their privies. Fourth, the later proceeding must involve the same cause of action as involved in the earlier proceeding.[68]

There is little dispute that chapter 11 and chapter 13 confirmation orders meet the requirements for res judicata. As discussed above, *Espinosa* put to rest any concerns

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[62] 11 U.S.C § 1141(a) (2018).
[63] *See* United Student Aid Funds v. Espinosa, 559 U.S. 260, 275 (2010).
[64] *See* 28 U.S.C. § 1334(a)–(b).
[65] *See In re* Sandia Resorts Inc., 557 B.R. 217, 221 (Bankr. D.N.M. 2016) (citing *In re* K.D. Co., 254 B.R. 480, 490 (B.A.P. 10th Cir. 2000)).
[66] *See In re* Brown, 615 B.R. 725, 741 (Bankr. S.D.N.Y. 2020).
[67] Stoll v. Gottlieb, 305 U.S. 165, 172 (1938).
[68] Wallis v. Justice Oaks II, Ltd. (*In* re Justice Oaks II, Ltd.), 898 F.2d 1544, 1550 (11th Cir. 1990) (citations omitted).

about jurisdiction.[69] Confirmation orders have uniformly been found to be final judgments entitled to res judicata effect.[70] One who participates in a confirmation hearing, or has the right to participate, is considered a named party for res judicata purposes.[71] Whether a proceeding involves the same cause of action depends on the specificity of the plan.[72]

The Fifth Circuit has three decisions dealing with the res judicata effect of a third-party release which are instructive. The first case was *Republic Supply Co. v. Shoaf*.[73] *Shoaf* involved a negotiated plan of reorganization between several parties other than Republic Supply.[74] The facts are somewhat complicated. Shoaf had been a shareholder of Command.[75] He had given a revocable guaranty to Republic Supply.[76] When he was bought out, he gave notice to Republic Supply that he was cancelling his guaranty.[77] However, Republic claimed it did not receive the notice.[78] Meanwhile, Command had paid for a life insurance policy on its remaining shareholder, Mergner.[79] When Mr. Mergner died, Mrs. Mergner was his beneficiary.[80] The company claimed that it was entitled to the proceeds because it had paid the premiums.[81] Mrs. Mergner agreed to release most of the insurance, but only if various guaranties were abrogated.[82] She wanted Shoaf's guaranty canceled so that he could not seek indemnity from the estate.[83] In return, Shoaf released his claims against the company.[84] A plan was drafted which contained express terms abrogating the guarantees as per the agreement.[85] Republic objected to the release of guarantees at the disclosure statement hearing but failed to object to confirmation.[86] After the plan was confirmed, Shoaf amended his answer in the case where he had been sued on his

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[69] *See* U.S. Aid Funds v. Espinosa, 559 U.S. 260, 273–74 (2010) (holding section 523(a)(8) does not limit a bankruptcy court's jurisdiction over student loan debts or "impose requirements that, if violated, would result in a denial of due process").

[70] *See, e.g., Stoll*, 305 U.S. at 170–71; Finova Cap. Corp. v. Larson Pharmacy Inc. (*In re* Optical Techs., Inc.), 425 F.3d 1294, 1301 (11th Cir. 2005).

[71] *See In re* Justice Oaks II, Ltd., 898 F.2d at 1551 ("[O]ne who participates in a chapter 11 plan confirmation proceeding becomes a party to that proceeding even if never formally named as such."); *see also* Corbett v. McDonald Moving Servs., Inc., 124 F.3d 82, 89 (2d Cir. 1997) ("[A]ll persons present and having an opportunity to challenge the bankruptcy court's jurisdiction to approve or implement each component of the plan must raise subject matter jurisdiction at that time or on direct appeal or not at all.").

[72] *See In re* Futter Lumber Corp., 473 B.R. 20, 30 (E.D.N.Y. 2012).

[73] 815 F.2d 1046 (5th Cir. 1987).

[74] *Id.* at 1047.

[75] *See id.*

[76] *Id.*

[77] *See id.*

[78] *See id.* at 1047–48.

[79] *See id.* at 1048.

[80] *See id.*

[81] *Id.*

[82] *Id.*

[83] *See id.*

[84] *Id.*

[85] *See id.*

[86] *See id.*

guarantee to claim res judicata.[87] The district court rejected this defense, but the Fifth Circuit reversed.[88]

On appeal, Republic Supply claimed that the bankruptcy court lacked authority to include the third-party release.[89] The Fifth Circuit found that regardless of whether the release was proper, it was still part of the confirmed plan:

> Although section 524 has generally been interpreted to preclude release of guarantors by a bankruptcy court, the statute does not by its specific words preclude the discharge of a guaranty when it has been accepted and confirmed as an integral part of a plan of reorganization. Regardless of whether that provision is inconsistent with the bankruptcy laws or within the authority of the bankruptcy court, it is nonetheless included in the Plan, which was confirmed by the bankruptcy court without objection and was not appealed. Republic, in effect, is now seeking to appeal the confirmed Plan and asking us to review it on its merits. Questions of the propriety or legality of the bankruptcy court confirmation order are indeed properly addressable on direct appeal. Republic, however, is now foreclosed from that avenue of review because it chose not to pursue it.[90]

The court found that it was "indisputably clear" that the guaranty was released by the plan and that the court had subject matter jurisdiction to confirm the plan with the release language.[91]

Two subsequent decisions addressed whether unobjected-to release language was sufficiently clear to be enforceable. In *Matter of Applewood Chair Company*,[92] the plan provided for release of officers, shareholders, and directors.[93] This language was not sufficient to release a guaranty claim even when the guarantors were also officers, directors, and shareholders.[94] However, in *FOM P.R. S.E. v. Dr. Barnes Eyecenter Inc.*,[95] a plan provided that the debtor's insiders would subordinate their claims to other creditors and that in return:

> Debtor's insiders shall not have or incur any liability to any person for any claim, obligation, right, cause of action or liability, whether

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[87] *Id.* at 1049.
[88] *See id.* at 1047, 1054.
[89] *Id.* at 1049.
[90] *Id.* at 1050 (citations omitted).
[91] *Id.* at 1054.
[92] Applewood Chair Co. v. Three Rivers Plan. & Dev. Dist., 203 F.3d 914 (5th Cir. 2000) (per curiam).
[93] *Id.* at 919.
[94] *See id.*
[95] 255 F. App'x 909 (5th Cir. 2007).

> known or unknown, foreseen or unforeseen, existing or hereafter arising, based in whole or in part on any act or omission, transaction, or occurrence from the beginning of time through the Effective Date in any way relating to DBEI, its Bankruptcy Case, or the Plan; and all claims based upon or arising out of such actions or omissions shall be forever waived and released.[96]

The creditor did not object to the plan.[97] The Fifth Circuit found that while the release was not as clear as the "indisputably clear" release in *Shoaf*, using standard principles of contractual interpretation, "any claim" encompassed the guaranty in question.[98]

The *Shoaf* line of cases stands for two propositions. First, a third-party release may be included as a negotiated term of a plan.[99] Thus, consensual releases are permissible. Second, where a party that did not agree to the release fails to object to the plan, the plan will be enforceable under the doctrine of res judicata so long as its terms are sufficiently clear.[100]

E. Consensual Releases

It seems clear that a plan may include a consensual release of third-party claims. Therefore, the question is what is necessary to establish consent. The easiest case is where the affected creditor has signed a settlement agreement which has been incorporated into the plan. The next level is the "opt in" release, where a creditor voluntarily chooses to grant a release, usually in return for some additional consideration.[101] Finally, there is the "opt out" release in which a creditor must make a conscious decision to reject the release.[102] The opt out release has some elements of both the res judicata release discussed above[103] and is a close cousin of the true third-party release discussed below.

Even courts in jurisdictions which generally prohibit non-consensual third-party releases will allow them when they are done on a consensual basis.[104]

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[96] *Id.* at 910.
[97] *Id.*
[98] *Id.* at 913.
[99] *See* Republic Supply Co. v. Shoaf, 815 F.2d 1046, 1050 (5th Cir. 1987).
[100] *See FOM P.R. S.E.*, 255 F. App'x at 911–12.
[101] *See In re* PG & E Corp., 617 B.R. 671, 683–84 (Bankr. N.D. Cal. 2020).
[102] *See In re* Indianapolis Downs, LLC., 486 B.R. 286, 306 (Bankr. D. Del. 2013).
[103] *See supra* discussion Part II, Section D.
[104] *See, e.g., In re* LATAM Airlines Grp., S.A., No. 22-2556, 2022 WL 1471125, at *24–25 (Bankr. S.D.N.Y. May 10, 2022); *In re* CJ Holding Co., 597 B.R. 597, 608 (S.D. Tex. 2019); *In re* PG & E Corp., 617 B.R. at 683; *In re* Sandridge Energy, Inc., No. 16-32488, 2016 Bankr. LEXIS 4622, at *47 (Bankr. S.D. Tex. Sept. 20, 2016). A creditor who votes to accept a plan containing third-party releases will also be deemed to have consented to the releases. *See In re* CJ Holding Co., 597 B.R. at 609; *see also In re* Avianca Holdings, S.A., 632 B.R. 124, 132 (Bankr. S.D.N.Y. 2021); *In re* Chassix Holdings, 533 B.R. 64, 79 (Bankr. S.D.N.Y. 2015).

There are limits to when voting on a plan may constitute consent. If a creditor is unimpaired, it is deemed to have accepted the plan.[105] However, to be unimpaired, the plan must preserve the creditor's legal and equitable rights.[106] Therefore, a plan provision which requires an unimpaired creditor to grant a release would effectively impair the creditor.[107] Some courts have worked around this by allowing the unimpaired creditor to "opt out" of granting the release.[108] However, other courts have stated that creditors who fail to vote on a plan will not be deemed to have consented.[109] In the *Chassix* case, the court stated, "implying a 'consent' to the third party releases based on the creditors' inaction, is simply not realistic or fair, and would stretch the meaning of 'consent' beyond the breaking point."[110]

The United States District Court for the Eastern District of Virginia has recently written a scathing opinion disapproving of "opt out" releases, as well as overly broad releases, finding that in some cases the proposed releases exceeded the jurisdiction of the bankruptcy court.[111] *Mahwah Bergen Retail* involved the owner of the Ann Taylor, LOFT, Lane Bryant, Catherines, Justice, Lou & Grey and Cacique brands.[112] The bankruptcy court confirmed a plan after the company sold its assets for $651.8 million.[113] The plan proposed to distribute funds to various secured and unsecured creditor groups and to cancel the debtor's equity.[114]

The plan had two main releases. The first released the "Released Parties" from any claims which could have been asserted on behalf of the debtors and their estates, including claims that could have been asserted derivatively, "based on any . . . act, omission, transaction, agreement, event, or other occurrence (in each case, related to any of the foregoing) taking place on or before the Effective Date."[115] The plan contained a second release, granted by holders of claims and interests known as the Third-Party release.[116] The Third-Party release:

> [R]eleased and discharged each Debtor, Reorganized Debtor, and each other Released Party from any and all Causes of Action, whether known or unknown, including any derivative claims, asserted or assertable on behalf of any of the Debtors . . . based on or relating to, or in any manner arising from, in whole or in part, the Debtors (including the management, ownership or operation thereof), the purchase, sale, or rescission of any Security of the

[105] *See* 11 U.S.C. § 1126(f) (2018).
[106] *See id.* § 1124(1).
[107] *See In re* Chassix Holdings, 533 B.R. at 81.
[108] *See, e.g., In re* Avianca Holdings, 632 B.R. at 125.
[109] *See, e.g., In re* Wash. Mut., Inc., 442 B.R. 314, 355 (Bankr. D. Del. 2011).
[110] 533 B.R. at 81 (citation omitted).
[111] *See* Patterson v. Mahwah Bergen Retail Grp., 636 B.R. 641, 642 (E.D. Va. 2022).
[112] *Id.* at 656.
[113] *Id.*
[114] *See id.*
[115] *Id.* at 657.
[116] *Id.*

> Debtors or the Reorganized Debtors, the subject matter of, or the transactions or events giving rise to, any Claim or Interest that is treated in the Plan, the business or contractual arrangements between any Debtor and any Released Party, the Debtors' in- or out-of-court restructuring efforts, intercompany transactions, the ABL Credit Agreement, the Term Loan Credit Agreement, the Chapter 11 Cases, the Restructuring Support Agreement and related prepetition transactions, the Backstop Commitment Letter, the Disclosure Statement, the New Corporate Governance Documents, the Exit Facilities, the Plan (including, for the avoidance of doubt, providing any legal opinion requested by any Entity regarding any transaction, contract, instrument, document, or other agreement contemplated by the Plan or the reliance by any Released Party on the Plan or the Confirmation Order in lieu of such legal opinion), the filing of the Chapter 11 Cases, the pursuit of Confirmation, the pursuit of Consummation, the administration and implementation of the Plan, including the issuance or distribution of Securities pursuant to the Plan, or the distribution of property under the Plan or any other related agreement, or upon any other act, omission, transaction, agreement, event, or other occurrence (in each case, related to any of the foregoing) taking place on or before the Effective Date.[117]

The Releasing Parties under the Third-Party release included:

> [A]ll holders of Impaired Claims who voted to accept the Plan; [ ] all holders of Impaired Claims who abstained from voting on the Plan or voted to reject the Plan but did not timely opt out of or object to the applicable release; [ ] all holders of Unimpaired Claims who did not timely opt out of or object to the applicable release; [and] all holders of Interests [among others] . . . .[118]

Thus, all holders of impaired and unimpaired claims who did not opt out or object to the releases, as well as all holders of interests, were bound by the releases.[119]

Two appellants objected to the plan on appeal: the United States Trustee and certain Securities Litigation Lead Plaintiffs.[120] The United States Trustee is granted standing as a matter of right under the Bankruptcy Code.[121] However, the court found that the Securities Litigation Lead Plaintiffs did not have standing.[122] Because they

[117] *Id.* at 657–58.
[118] *Id.* at 658.
[119] *Id.*
[120] *Id.* at 661.
[121] *See* 11 U.S.C. § 307 (2018); *see also Patterson*, 636 B.R. at 663.
[122] *Patterson*, 636 B.R. at 665.

opted out, they were not harmed by the releases.[123] As a result, they could not represent the class of securities litigation parties who did not object or opt out because they had not yet been named as class representatives.[124] As merely potential class representatives, they had no more authority than any other creditor.[125]

The district court had a very long discussion of bankruptcy court jurisdiction and authority, including the *Northern Pipeline*[126] and *Stern v. Marshall*[127] cases. We will not discuss that authority in any depth because it is beyond the scope of this paper, but it is good reading material for anyone interested in these issues. The district court found two problems with the bankruptcy court's jurisdiction over the third-party releases.[128] First, the bankruptcy court failed to give any analysis of whether it had jurisdiction.[129] Second, in the district court's view, the bankruptcy court clearly lacked jurisdiction over some of the releases:

> Although the Court cannot determine precisely which Released Claims the Bankruptcy Court could have adjudicated, it takes only a cursory review of the Third-Party Releases and the Releasing Parties to find released claims that the Bankruptcy Court lacked the authority to adjudicate. The universe of released claims includes claims between non-debtors which may have no connection to the property of Mahwah's bankruptcy estate or the administration of the Bankruptcy Proceeding. For example, the Third-Party Release would bar securities claims, such as those brought by the Securities Plaintiffs, against former directors and officers of Mahwah, even if the claims arose before Mahwah filed for bankruptcy and those directors and officers had no involvement in the Bankruptcy Proceeding. And it bears noting that "federal courts disfavor indemnity for federal securities law violations, calling into question the enforceability of these obligations." Thus, the only type of released claim that the Bankruptcy Court actually considered finds antipathy in the case law.[130]

To reiterate, the district court found that some of the releases granted were so broad that they could not have any conceivable effect on the estate being administered and that the bankruptcy court lacked subject matter jurisdiction to grant them.[131]

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[123] *Id.*
[124] *Id.* at 664.
[125] *Id.*
[126] N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).
[127] 564 U.S. 462 (2011).
[128] *See Patterson*, 636 B.R. at 669–70.
[129] *Id.* at 669.
[130] *Id.* at 669–70 (citation omitted).
[131] *See generally id.*

The district court found that in order to grant third-party releases, it would have to satisfy the *Dow Corning*[132] factors discussed below.[133] Significantly, the court found that failure to opt out was not sufficient to constitute consent to the third-party releases.[134]

The court ultimately voided the third-party releases in their entirety based on lack of jurisdiction in some cases, lack of consent, and failure to apply the proper test for granting third-party releases.[135] The court remanded the case with instruction that it be assigned to a different judge.[136]

By way of contrast, Bankruptcy Judge John Dorsey allowed opt out releases in the recent case of *In re Mallinckrodt*.[137] Judge Dorsey noted that there were many situations in the legal world where silence equaled consent.[138] He wrote:

> There can be no debate over the proposition that a bankruptcy court can approve a plan that includes third-party releases. The question is, what constitutes consent and can consent be inferred from failure to respond to a notice including an opt out? In other words, can consent be inferred from silence or more accurately, the failure to act?
>
> The notion that an individual or entity is in some instances deemed to consent to something by their failure to act is one that is utilized throughout the judicial system. When a party to a lawsuit is served with a complaint or a motion, they need to file an answer or otherwise respond, or a judgment is automatically entered against them. Within the bankruptcy system, Debtors send out bar date notices and if claimants fail to file a proof of claim by a certain time, they lose the right to assert a claim.
>
> Additionally, if a claim objection is filed and the claimant fails to respond, the claim is disallowed. There is no reason why this principle should not be applied in the same manner to properly noticed releases within a plan of reorganization.[139]

In the *Mallinckrodt* case, the court relied upon the extensive solicitation efforts that were made by the debtor, including mailing solicitation packages to all parties regardless of whether they were entitled to vote, publishing notice along with the

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[132] Class Five Nev. Claimants v. Dow Corning Corp. (*In re* Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2002).

[133] *See Patterson*, 636 B.R. at 681; *see also* text accompanying *infra* note 176 (summarizing the seven factors).

[134] *Patterson*, 636 B.R. at 684.

[135] *Id.* at 703.

[136] *Id.*

[137] 639 B.R. 837 (Bankr. D. Del. 2022).

[138] *Id.* at 879.

[139] *Id.*

necessary form to opt out on a dedicated website, using an easy to read opt out form, and publishing notices in The New York Times, Wall Street Journal, and USA Today.[140] The fact that the debtor received over 2,200 elections to opt out was seen as evidence that the solicitation campaign was effective.[141]

F. Plan Injunctions

The Bankruptcy Rules contemplate that a plan may include an injunction.[142] Can a plan injunction be used to enjoin claims against third parties and, if so, should that injunction be temporary or permanent? A permanent injunction barring pursuit of claims against third parties is effectively the same as a third-party release. However, there may be some circumstances where even a circuit which bars third-party releases will allow a temporary stay.[143] Plan injunctions fall into three main categories. First, there are injunctions which permanently bar pursuit of a claim and are indistinguishable from a third-party release.[144] Second, there are channeling injunctions which require that claims be asserted against a settlement fund.[145] Finally, there are temporary injunctions.[146]

A channeling injunction requires that claims be asserted against a settlement fund.[147] In *MacArthur Co. v. Johns-Manville Corp.*, the debtor's insurers contributed funds to a settlement in return for an injunction precluding claims against them.[148] The court analogized this to a sale, free and clear of liens where lienholders could assert their claims against sales proceeds instead of the original asset.[149] The court in *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*[150] analogized its channeling injunction to common law doctrines requiring marshaling of assets.[151] The court held "[t]he bankruptcy court has the power to order a creditor who has two funds to satisfy his debt to resort to the fund that will not defeat other creditors."[152] A later court stated that injunctions against pursuing claims could be justified where "the estate received

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[140] *Id.* at 879–80.
[141] *Id.* at 879.
[142] *See* FED. R. BANKR. P. 3016(c) (providing for situations in which a "plan provides for an injunction").
[143] *See, e.g., In re* Couture Hotel Corp., 536 B.R. 712, 751–52 (Bankr. N.D. Tex. 2015).
[144] *See generally* Class Five Nev. Claimants v. Dow Corning Corp. (*In re* Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2002).
[145] *See* MacArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89, 91 (2d Cir. 1988); *see also* 11 U.S.C. § 524(g) (2018).
[146] *See In re* Seatco, Inc., 257 B.R. 469, 478 (Bankr. N.D. Tex. 2001).
[147] *See In re* Johns-Manville Corp., 837 F.2d at 93, *cert. denied*, 488 U.S. 868 (1988).
[148] *Id.* at 91.
[149] *Id.* at 93 (citing Fierman v. Seward Nat'l Bank, 37 F.2d 11, 13 (2d Cir. 1930)).
[150] 880 F.2d 694 (4th Cir. 1989).
[151] *Id.* at 701.
[152] *Id.* (citing Columbia Bank for Coops. v. Lee, 638 F.2d 934, 939 (4th Cir. 1966)).

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."[153]

In another case, a Texas judge refused to grant exculpations as requested, but required that any claims against the estate parties be brought in his court.[154] In that respect, he "channeled" the claims to the bankruptcy court.[155]

While the Fifth Circuit does not allow non-consensual third-party releases, it has stated that a temporary injunction may be permissible:

> The impropriety of a permanent injunction does not necessarily extend to a temporary injunction of third-party actions. Such an injunction may be proper under unusual circumstances. These circumstances include 1) when the nondebtor and the debtor enjoy such an identity of interests that the suit against the nondebtor is essentially a suit against the debtor, and 2) when the third-party action will have an adverse impact on the debtor's ability to accomplish reorganization.[156]

Although the *Zale* court reversed the injunction in its case, Judge Barbara Houser approved a temporary injunction in *In re Seatco, Inc*.[157] In that case, the plan provided that CIT would be temporarily enjoined from collecting on its guaranty of the business owner to the extent of amounts to be paid by the debtor under the plan.[158] Judge Houser found that the owner and the debtor satisfied the identity of interest test such that a suit against the owner would essentially be a suit against the business.[159] The court also found that the owner's participation was vital to the debtor's successful reorganization.[160] While many of the cases featuring third-party provisions involve large business entities, Judge Houser's *Seatco* analysis is well suited to the typical small business debtor that relies on an owner-entrepreneur for its success.

G. Non-Consensual Third-Party Releases

There is a significant split among the circuits as to whether non-consensual third-party releases are permissible and under what circumstances.

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[153] Deutsche Bank AG, London Branch v. Metromedia Fiber Network (*In re* Metromedia Fiber Network Inc.), 416 F.3d 136, 142 (2d Cir. 2005) (citations omitted).

[154] *See In re* Pilgrim's Pride Corp., No. 08-45664, 2010 WL 200000, at *3, *6 (Bankr. N.D. Tex. Jan. 14, 2010).

[155] *See id.* at *6.

[156] Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 761 (5th Cir. 1995) (citations omitted).

[157] *See* 257 B.R. 469, 476 (Bankr. N.D. Tex. 2001).

[158] *See id.*

[159] *See id.* at 477.

[160] *See id.* at 476.

Circuit	Allowed?	Discussion
First	Unclear	Within the First Circuit, third-party releases were approved as part of the Puerto Rican restructuring process,[161] but have been questioned in cases under the Bankruptcy Code,[162] This is significant because PROMESA, the statute which allowed Puerto Rico to restructure its debts was based in part on the Bankruptcy Code but was its own independent statute.[163]
Second	Maybe	Releases were found to be permissible in general but not allowed in the specific case of *In re Drexel Burnham Lambert Group, Inc.*[164] However, the recent district court opinion in *In re Purdue Pharma,*[165] said that there was no basis for them.
Third	Yes	Allowed in *In re Millennium Lab Holdings, II, LLC.*[166]
Fourth	Yes	Allowed in *In re A.H. Robins Co., Inc.*[167]
Fifth	No	Prohibited in *Ad Hoc Group of Vitro Noteholders v. Vitro S.A.B. de C.V. (In re Vitro S.A.B. de C.V.).*[168]
Sixth	Yes	Allowed in *In re Dow Corning Corp.*[169]
Seventh	Yes	Allowed in *In re Airadigm Communications, Inc.*[170]
Eighth	Maybe	The Eighth Circuit Bankruptcy Appellate Panel has recently stated that third-party releases "are rare and allowed only in extraordinary cases and only under exceptional circumstances . . . ."[171]

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161 *See In re* Fin. Oversight & Mgmt. Bd., 361 F. Supp. 3d 203, 255 (D.P.R. 2019).

162 *See In re* New Eng. Compounding Pharmacy, Inc., 544 B.R. 724, 729–30 (Bankr. D. Mass. 2016).

163 *See* 48 U.S.C. § 2170 (2018).

164 SEC v. Drexel Burnham Lambert Grp. (*In re* Drexel Burnham Lambert Grp.), 960 F.2d 285, 292 (2d Cir. 1992).

165 *In re* Purdue Pharma L.P., 635 B.R. 26, 37 (S.D.N.Y. 2021).

166 945 F.3d 126, 129 (3d Cir. 2019).

167 *See* 880 F.2d 694, 702 (4th Cir. 1989).

168 *See* 701 F.3d 1031, 1059 (5th Cir. 2012).

169 *See* 280 F.3d 648, 658 (6th Cir. 2002).

170 *See* Airadigm Commc'ns, Inc. v. FCC (*In re* Airadigm Commc'ns, Inc.), 519 F.3d 640, 656–58 (7th Cir. 2008).

171 Murray Ky. Energy, Inc. v. Ceralvo Holdings, LLC (*In re* Armstrong Energy, Inc.), 613 B.R. 529, 535 (B.A.P. 8th Cir. 2020).

Ninth	No	Prohibited by *In re Lowenschuss.*[172]
Tenth	No	Prohibited by *In re Western Real Estate Fund, Inc.*[173]
Eleventh	Yes	Allowed in *SE Property Holdings, LLC v. Seaside Engineering & Surveying (In re Seaside Engineering & Surveying).*[174]
D.C.	Yes	Allowed in *In re AOV Industries.*[175]

Where third-party releases are allowed, the most common test is the *Dow Corning* test, which provides:

> (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.[176]

While many courts state that third-party releases should only be granted in rare instances, in some jurisdictions, they are ubiquitous:

> The issues I have described above ought to illustrate just how extraordinary a thing it is for us to impose involuntary releases and why, as commanded by the Second Circuit in *Metromedia*, we should do so only in those extraordinary cases where a particular release is essential and integral to the reorganization itself.
> Unfortunately, in actual practice the parties usually ignore this portion of the *Metromedia* decision, and often seek to impose

[172] Resorts Int'l, Inc. v. Lowenschuss (*In re* Lowenschuss), 67 F.3d 1394, 1401 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996).
[173] *See* Landsing Diversified Props.-II v. First Nat'l Bank and Tr. Co. of Tulsa (*In re* W. Real Est. Fund, Inc.), 922 F.2d 592, 600–01 (10th Cir. 1990).
[174] *See* 780 F.3d 1070, 1078 (11th Cir. 2015).
[175] *See* Bruce v. Hawley Fuel Coalmart, Inc. (*In re* AOV Indus.), 792 F.2d 1140, 1152 (D.C. Cir. 1986).
[176] Class Five Nev. Claimants v. Dow Corning Corp. (*In re* Dow Corning Corp.), 280 F.3d 648, 658 (6th Cir. 2002) (citations omitted).

> involuntary releases based solely on the contention that anybody who makes a contribution to the case has earned a third-party release. Almost every proposed Chapter 11 Plan that I receive includes proposed releases. Instead of targeting particular claims and explaining why the release of those particular claims is necessary to some feature of the reorganization, the proposed releases usually are as broad as possible in their scope. Parties rare [sic] identify any particular claim that they are even worried about or that has been threatened, and almost never explain why an order extinguishing a particular third-party claim is fair to the party whose claim is being extinguished. Instead, I am usually told that various people have made contributions to the process that have been important in producing a successful outcome, and that they should be rewarded by being given third-party releases.[177]

In the recent decision in *Patterson v. Mahwah Bergen Retail Group, Inc.,*[178] the district court remarked that, "[d]espite these admonitions, the Bankruptcy Court for the Richmond Division of this district regularly approves third-party releases, as acknowledged by debtors' counsel during oral argument."[179] In the *Purdue Pharma* opinion, the court noted that, "[w]hen every case is unique, none is unique."[180]

The *Dow Corning* case has one of the stronger cases for third-party releases. It is unique because the bankruptcy court in that case rejected the third-party release and the court of appeals reversed and found that it was proper.[181] Thus, this was not a case where a court of appeals affirmed a lower court decision without thoroughly examining the issues.[182] The court in *Dow Corning* started with section 105 and section 1123(a)(6):

> Consistent with section 105(a)'s broad grant of authority, the Code allows bankruptcy courts considerable discretion to approve plans of reorganization. Section 1123(b)(6) permits a reorganization plan to "include any . . . appropriate provision not inconsistent with the applicable provisions of this title." Thus, the bankruptcy court, as a forum for resolving large and complex mass litigations, has substantial power to reorder creditor-debtor relations needed to achieve a successful reorganization.[183]

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[177] *See In re* Aegean Marine Petroleum Network, Inc., 599 B.R. 717, 726 (Bankr. S.D.N.Y. 2019).
[178] 636 B.R. 641 (E.D. Va. 2022).
[179] *Id.* at 654.
[180] *In re* Purdue Pharma, L.P., 635 B.R. 26, 37 (S.D.N.Y. 2021).
[181] *See In re* Dow Corning Corp., 280 F.3d at 655–56, 663.
[182] *See id.* at 656.
[183] *Id.* at 656 (citing United States v. Energy Res. Co., 495 U.S. 545, 549 (1990); 11 U.S.C. § 1123(b)(6) (2018)).

The bankruptcy court found that it could not enter the releases because the Supreme Court decision in *Grupo Mexicano de Desarrollo v. Alliance Bond Fund, Inc.*,[184] prohibited courts from using their equitable powers to go beyond the traditional boundaries of equity. The Sixth Circuit disagreed, finding that the third-party releases were based on the Bankruptcy Code, rather than residual equity powers.[185] After concluding that a third-party release was "not inconsistent" with the Code, the court looked to whether the injunction was an "appropriate provision" under section 1123(b)(6).[186] The Sixth Circuit found that the bankruptcy court's fact-finding was not sufficient to justify the injunction against pursuing third-party claims.[187] Among other things, the injunction only applied to creditors who did not consent to the plan.[188] Thus, in *Dow Corning*, releases were found to be permissible but not appropriate in this particular case.[189]

The recent *Mallinckrodt* and *Purdue Pharma* cases offer contrasting views on third-party releases. *Mallinckrodt* takes a functional approach while *Purdue Pharma* treats the issue as one of statutory authority.

In *Mallinckrodt*, the third-party releases were a solution to an existential problem.[190] The debtor was dealing with over 3,000 lawsuits and was spending a million dollars a week in legal fees.[191] Unless the lawsuits could be brought to a stop, the company could not reorganize.[192] Because the lawsuits were brought against not only the debtors but their non-debtor affiliates, directors, officers, and other employees, the debtors would continue to be impacted by the litigation unless all parties were released.[193] The debtors' original plan proposed an opioid claims trust that would be funded with $1.6 billion in cash and warrants to acquire up to 19.99% of the equity in the reorganized debtor.[194] After a mediation with another bankruptcy judge, the debtors agreed to increase the pot to $1.725 billion as well as 50% of the proceeds from certain avoidance actions.[195]

The court found that it had subject matter jurisdiction to approve the releases. Unlike the releases in *Mahwah Bergen*, all of the releases being granted here would have a conceivable impact on the estates of the debtors.[196] Indeed, the court also had

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184 *See* 527 U.S. 308, 322–33 (1999).
185 *See In re* Dow Corning Corp., 280 F.3d at 658.
186 *See id.*
187 *Id.*
188 *See id.* at 672.
189 *See id.* at 680.
190 *See In re* Mallinckrodt PLC, 639 B.R. 837, 873 (Bankr. D. Del. 2022).
191 *Id.* at 851.
192 *See id.*
193 *Id.* at 869.
194 *Id.* at 852.
195 *See id.* at 872.
196 *See id.* at 868–70.

authority to enter a final order because they were "integral to the debtor-creditor relationship."[197]

Under Third Circuit law, third-party releases may only be granted if there is a showing of "fairness, necessity to the reorganization, and specific factual findings to support these conclusions."[198] The court found that this standard was met:

> At the Confirmation Hearing, Debtors offered extensive evidence to demonstrate that the releases were necessary to the reorganization. Specifically, Debtors' position is that without the releases, the Settlements could not have been achieved and that, without the Settlements, the Plan falls apart and Debtors would be forced to sell off the company in pieces. In other words, Debtors argue the Releases, the Settlements, and the Plan are all inextricably intertwined such that the Releases are essential to Plan confirmation.[199]

Mallinckrodt may be the definitive case illustrating when third-party releases may properly be approved. First, it was a negotiated settlement with a significant distribution to claimants.[200] Second, there was an identity of interest between the debtors and the parties being released.[201] Finally, approval of the settlements, including the third-party releases, was the only practical way to confirm a plan in this mass tort case.[202]

The *BSA* case, which involved over 80,000 sexual abuse claims against the Boy Scouts of America, relied on the same Third Circuit authority.[203] The court identified sufficient statutory authority in sections 1123(a)(5), which permits a plan to "provide adequate means for [its] implementation," and 1123(b)(6), which allows "any other appropriate provision not inconsistent with the applicable provisions of this title."[204] The settlement in *BSA* was remarkable for its size and the level of acceptance among claimants. Under the plan, the settling insurers contributed $1.656 billion, certain local scouting counsels contributed $665 million, and certain Methodist entities contributed $30 million.[205] The plan resolved the claims of 82,209 direct sexual abuse claimants.[206] Less than six hundred claimants objected to the releases.[207]

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[197] *Id.* at 866 (internal quotation marks omitted).
[198] *Id.* at 867 (citations omitted).
[199] *Id.* at 868.
[200] *See id.* at 853.
[201] *Id.* at 875 n.103.
[202] *Id.* at 877–78.
[203] *In re* Boy Scouts of Am. and Del. BSA, LLC, 642 B.R. 504, 675 (Bankr. D. Del. 2022).
[204] *Id.* at 594 (internal marks omitted).
[205] *Id.* at 602.
[206] *Id.* at 595.
[207] *Id.* at 596.

Mallinckrodt and *BSA* relied on Third Circuit authority. *Purdue Pharma*, on the other hand, found that authority under the Bankruptcy Code and Second Circuit precedent was illusory.[208] The court did not have a problem with derivative claims, that is, those claims that "seek to recover from the estate indirectly 'on the basis of [the debtor's] conduct' as opposed to the non-debtor's own conduct."[209] "Derivative claims in every sense relate to the adjustment of the debtor-creditor relationship, because they are claims that relate to injury to the corporation itself. If the creditor's claim is one that a bankruptcy trustee could bring on behalf of the estate, then it is derivative."[210]

However, when looking at direct, particularized claims against the Sackler's, based on their own conduct, the district court concluded that the emperor had no clothes.[211] To get to this result, the court had to conclude that the Second Circuit precedent in *In re Drexel Burnham Lambert Group, Inc.*,[212] was not applicable.[213] This was remarkable because typically district courts are not permitted to overrule their circuits. The district court explained its disregard for circuit precedent as follows:

> There are numerous reasons why *Drexel* does not answer the question about a court's statutory authority under the Bankruptcy Code to release non-debtors over the objection of third parties who have direct claims against them. Two, however, are dispositive.
>
> First and foremost, the Second Circuit simply did not address this question in *Drexel*. *Drexel* mentioned in passing something about a bankruptcy court's power to enjoin claims but did not identify any source of that power in the Bankruptcy Code. It appears to have assumed sub silentio that such authority existed.
>
> Second, *Drexel* was decided two years before Congress passed Sections 524(g) and (h). The opinion's passing mention of a bankruptcy court's power to enjoin a creditor from suing a non-debtor became far less persuasive after Congress (1) amended the Bankruptcy Code to authorize such injunctions, but only in asbestos cases; (2) expressed agnosticism about whether any such authority existed outside of its new legislation; and (3) indicated its intent to consider at some later time whether to extend this authority to

208 *See In re* Purdue Pharma, L.P., 635 B.R. 26, 97 (S.D.N.Y. 2022).
209 *Id.* at 90 (citation omitted).
210 *Id.*
211 *See id.* at 75.
212 *See* SEC v. Drexel Burnham Lambert Grp. (*In re* Drexel Burnham Lambert Grp.), 960 F.2d 285 (2d Cir. 1992).
213 *See In re* Purdue Pharma, 635 B.R. at 107.

> industries that were "reportedly experimenting" with such injunctions – which it never has.[214]

After extensively discussing subsequent cases, the district court concluded that, within the Second Circuit, the "statutory authority to release and enjoin the prosecution of third-party claims against non-debtors in a bankruptcy case is: unsettled, except in asbestos cases, where statutory authority is clear."[215] Thus, the strongest argument against non-consensual releases comes down to disregarding circuit precedent to find that the Code does not say so.[216] The Supreme Court may ultimately agree with this rationale, but it does not seem like it will be persuasive to the Second Circuit.

H. Revolt of the Article III Judiciary?

The district court opinions in *Purdue Pharma* and *Mahwah Bergen Retail* share a common concern that the bankruptcy courts have gotten too cavalier when handing out third-party releases. It is not hard to see how this situation evolved. When lawyers find a neat trick that works in one case, they try it out in others. When it passes without objection, it becomes part of the boilerplate that associates use in drafting new plans. The unique becomes the commonplace.

Although they are just two decisions, they may well signal a nascent revolt among the Article III judiciary against perceived overreach by the Article I bankruptcy courts. To date, third-party releases seem to have won approval in a majority of circuit courts.[217] District courts play a unique role in the bankruptcy system because they are trial courts which also serve as the first level of appellate review.[218] What may be happening, although it is too soon to tell, is that district courts are viewing bankruptcy courts exercising power that the District Judges themselves would not claim. This could cause the circuit courts to take notice as well. If the circuit courts do not step in, the Supreme Court may find it necessary to pull back the reins on the bankruptcy courts as it did in *Northern Pipeline*[219] and *Stern v. Marshall*.[220]

CONCLUSION

Setting aside the question of whether the Bankruptcy Code actually authorizes the various types of third-party provisions discussed above, they are neither

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[214] *Id.* at 97.
[215] *Id.* at 104.
[216] *See id.* at 107.
[217] *See id.* at 104–05.
[218] 28 U.S.C. § 158(a).
[219] N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).
[220] 564 U.S. 462 (2011).

inherently beneficial nor abusive. Third-party provisions can play an important role in both the largest and the smallest cases.

In mass tort cases (whether they involve asbestos, opioids, or sexual abuse), bankruptcy has the ability to muster funds into a common pot and determine a method for dividing those funds among many claimants.[221] The efficiency of bankruptcy is shown by its alternative — thousands of lawsuits consuming all of the available proceeds until little is left for the victims. Bankruptcy can be made even more effective when outside parties contribute funds to the pot. However, they need an incentive to do so. Releasing insurance companies who have tendered policy proceeds seems to be an easy call. It is a harder call when dealing with insiders and related parties. However, there should be a way to determine how much is enough for the collective benefit to outweigh the inability of some parties to sue.

In smaller cases, granting at least some protection to the entrepreneur who must do the work to generate the money to pay the creditors makes logical sense. If we require the owner to file his own bankruptcy, he may choose to walk away rather than run the risk of losing his assets.

There is an inherent conflict in many small cases between different classes of creditors. It is usually the larger creditors who have guaranties and collateral. In the *Seatco* case, the debtor could pay all secured creditors in full and 35% to unsecured creditors.[222] If CIT had been given the unfettered ability to pursue its guaranty, the owner may have prioritized paying CIT to the detriment of the unsecured creditors.[223]

On the other hand, when there are no real standards or safeguards for utilizing third-party provisions, some constituents will get released without doing anything more than being involved in the case. Giving out third-party releases like party favors is rightly condemned.

There are legislative fixes which could help to clarify these areas. Many of those would build on provisions already in place. Bankruptcy Rule 3016(c) already requires that injunctions in plans be given a distinctive font.[224] Why not require that any provision benefitting a third party be drafted with bold type and a larger font? We already have a good framework for approving compromises under Bankruptcy Rule 9019.[225] Why not require a separate 9019 motion before any third-party provision in a plan can be approved? Substantively, the issues are more difficult. A provision expressly allowing bar orders would be an easy fix. Rather than allowing exculpation clauses, a provision requiring that suits against estate fiduciaries and parties participating in the plan process be brought in the bankruptcy court would be another relatively simple fix. Rules could be drafted to clarify when opt-in or opt-out settlements are permissible.

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[221] *See In re* Mallinckrodt PLC, 639 B.R. 837, 881 (Bankr. N.D. Del. 2022); *see also In re* Boy Scouts of Am. and Del. BSA, LLC, 642 B.R. 504, 541–46 (Bankr. D. Del. 2022).

[222] *In re* Seatco, Inc., 257 B.R. 469, 481 (Bankr. N.D. Tex. 2001).

[223] *See id.* at 476.

[224] FED. R. BANKR. P. 3016(c).

[225] *See* FED. R. BANKR. P. 9019.

The real elephant in the room is whether to expressly allow nonconsensual third-party releases. Perhaps the answer is to import procedures from class action settlements (which are already part of the bankruptcy rules).[226] First, a third-party release must be negotiated between adversarial and independent parties.[227] Second, the court must hold a fairness hearing.[228] Finally, there must be a mechanism for parties to opt out and retain their claims without participating in the settlement pool.[229] Beyond these procedural fixes, it is hard to see how the Code could be amended to provide express authorization for approving a settlement which binds the creditor class. What is needed is a class action type remedy. Perhaps the statutory answer lies in examining other federal statutes which authorize class action relief, such as under securities law,[230] and drafting similar language.

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[226] *See* FED. R. BANKR. P. 7023.
[227] *See* FED. R. CIV. P. 23(e)(2)(a).
[228] *See* FED. R. CIV. P. 23(e)(2).
[229] *See* FED. R. CIV. P. 23(c)(2)(B)(v).
[230] *See* 15 U.S.C. § 78u-4(a) (2018).