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The Fourth Circuit Weighs In on Third-Party Releases in Plans of Reorganization

Section 524 of the United States Bankruptcy Code (the Code) describes the effect of a discharge of a debtor, and in section 524(e), provides that a discharge of a debtor does not affect the liability of any other entity for the debtor's obligations. Today, virtually every plan of reorganization or liquidation includes releases for officers, directors and employees of the debtor, affiliates of the debtor, debtor and committee counsel involved in the case, the members of the creditors committee and plan sponsors, among others. However, courts addressing the enforceability of releases of third parties in plans of reorganization have interpreted section 524(e) in very different ways. On June 27, 2014, the Fourth Circuit Court of Appeals affirmed the bankruptcy and the district courts' determination that certain non-consensual third-party releases of a debtor's officers and directors in a confirmed plan of reorganization were not enforceable, adopting the Sixth Circuit's enumerated factors to be considered when analyzing the appropriateness of such releases.

In National Heritage Foundation v. Highbourne Foundation, No. 13-1608, 2014 WL 2900933 (4th Cir. June 27, 2014), the court considered a confirmed plan that provided for non-consensual releases of officers and directors (among others) of a financially distressed not for profit foundation. Several donors objected to the enforceability of the releases. While the bankruptcy court and the district court initially found the releases enforceable, the Fourth Circuit remanded the case because it found that the bankruptcy court had not made sufficient factual findings to support its conclusions. It directed the bankruptcy court to consider the substantive factors enumerated in Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2002). The six factors include:

1. Whether there is an identity of interests between the debtor and the third party.
2. Whether the non-debtor has contributed substantial assets to the reorganization.
3. Whether the injunction is essential to the reorganization.
4. Whether the impacted class has voted overwhelmingly to accept the plan.
5. Whether the plan provides a mechanism to pay for all, or substantially all, of the class affected by the injunction.

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6. Whether the plan provides for an opportunity for those creditors who choose not to settle to recover in full.

On remand a different bankruptcy judge considered the issue. While the court gave the parties the opportunity to submit additional evidence, they declined to do so. The bankruptcy court subsequently found that under the Dow Corning standards, the releases were unenforceable, and the district court affirmed. The debtor appealed to the Fourth Circuit.

The Circuit Court analyzed each of the Dow Corning factors and found that because there was an indemnification obligation in the Foundation's bylaws, only the first standard was met. Regarding the remaining factors, the court found that the officers and directors did not contribute cash to the plan, and that their service as officers and directors during the reorganization did not constitute contributing substantial assets to the plan, given that they had received salaries and had fiduciary duties to fulfill. Regarding the releases being essential to the plan, the court found that there was minimal evidence demonstrating the alleged risk that the officers and directors would resign. Moreover, the severability provision in the plan providing that the plan would remain in effect even if a particular provision was unenforceable was evidence that the releases were not essential to the plan.

Under the plan, the class which included the objecting donors was paid in full and, consequently, because it was unimpaired, it was deemed to have accepted the plan without a vote. The court said that while that section 1126(f) of the Code provides that unimpaired classes are presumed to accept a plan, the power to authorize non-debtor releases in a plan is based upon the bankruptcy court's equitable authority and not section 1126(f). While the court acknowledged it was a close question, because the affected class did not have the opportunity to vote on the plan containing the releases, it held that this factor was not met. Even if this factor was met because of the deemed acceptance of the plan, said the court, the other factors weighed against enforcing the release.

Regarding the fifth factor, because there was no mechanism to pay creditors which did not have an allowed claim (because it was late filed or otherwise), and because the debtor did not introduce evidence that the claims process it utilized adequately protected the donors' interests, this factor was not met. Finally, pointing to the same absence of any mechanism to pay donors outside of the plan, the court found that the last factor of providing the opportunity of donors affected by the release to be paid in full, was also absent.

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Because only the first factor was demonstrated, the court agreed with the lower courts' determination that the release was unenforceable. However, the court concluded by saying that a debtor need not show that all of the Dow Corning factors are met for a release to be enforceable. Rather, the debtor must show sufficient facts to support the granting of the exceptional relief of a third-party release, and that was not done in this case. The court also found that the debtor had the options to reopen the bankruptcy case or file another Chapter 11 proceeding if donor suits actually materialized which subsequently damaged the debtor.

The Seventh Circuit has also addressed the enforceability of third-party releases. Refusing to read section 524(e) to prohibit all such releases, the Seventh Circuit initially held that consensual releases which are integral to the plan may be enforceable. In In re Specialty Equipment Cos., 3 F.3d 1043 (7th Cir. 1993), the court found that releases binding only those creditors who voted in favor of a plan and which were not dependent upon the vote of a particular class, were not violative of section 524(e) of the Code and therefore were permissible in appropriate circumstances.

Fifteen years later, in Airadigm Communications, Inc. v. Federal Communications Commission (In re Airadigm Communications, Inc.), 519 F.3d 640, 655 (7th Cir. 2008), the court expanded its holding in Specialty Equipment and found that in the appropriate circumstances, non-consensual releases were also not inconsistent with section 524(e) and the general equitable power of the bankruptcy court. In Airadigm, the plan provided for a release of Telephone Data and Systems, Inc. ("TDS") for actions taken or omitted in connection with the plan or the case, but specifically excluded willful misconduct. The court noted the disparity in the various standards applied by other courts, including those articulated in Dow Corning set forth above, contrasted with the position of the Ninth Circuit in In re Lowenschuss, 67 F.3d 1394 (9th Cir. 1995), and the Tenth Circuit in In re Western Real Estate Fund, Inc., 922 F.2d 592 (10th Cir. 1990), which found that non-consensual releases were always impermissible. In upholding the bankruptcy court's approval of Airadigm's release provisions, the court found that the release did not provide blanket immunity but was limited to actions or omission in connection with the plan and the case; it excluded a release of any of TDS's willful misconduct; and the release was essential to the plan, which could not have been confirmed without the substantial contribution of TDS as holder of a secured claim of $188 million.

Today, third-party releases are ubiquitous in plans of reorganization and

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liquidation. In fact, debtors' counsel may be reluctant to exclude them for fear of a subsequent malpractice claim. However, they are subject to review under different standards in different jurisdictions. The Fourth Circuit has joined the Sixth in requiring a very rigorous standard to be met to justify the inclusion of third-party releases in a confirmed plan. While the Seventh Circuit has adopted a different standard, common among the three circuits is the requirement that the release be essential to the plan. This will likely be met by a third party making a monetary contribution which is substantial and so crucial that the plan could not be confirmed without it.

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