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INTRODUCTION

Under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"), a debtor may receive a discharge from claims under its plan of reorganization.[1] A chapter 11 discharge functions as a release of liability for the debtor.[2] Often debtors attempt to include releases for non-debtor parties as part of their reorganization plans to preclude creditors from asserting claims against non-debtors.[3] However, the Bankruptcy Code does not expressly provide for such "third party releases," except in the context of asbestos cases. Nevertheless, bankruptcy courts have approved third-party releases in other circumstances.[4] The courts, however, are divided as to the appropriateness of third-party releases. Indeed, the circuit courts are split, with some reluctantly permitting non-debtor releases while others reject them completely.[5] *Id.* at 734.

This memorandum examines whether bankruptcy courts have jurisdiction to issue third-party releases. Part I is three parts. First, it focuses on the Bankruptcy Code's text and its failure

[1] 11 U.S.C. § 1141(d)(1) (2012). A corporate debtor cannot receive a discharge, under 11 U.S.C. § 1141, if: "(A) the plan provides for the liquidation of all or substantially all of the property of the estate; (B) the debtor does not engage in business after consummation of the plan; and (C) the debtor would be denied a discharge under Section 727(a) of this title if the case were a case under chapter 7." 11 U.S.C. § 1141(d)(3) (2012).
[2] 11 U.S.C. § 524(a)(2) (2012).
[3] *See* Michael S. Etkin & Nicole M. Brown, *Third Party Releases? – Not So Fast!*, 29 AIRA J. 21, 21 (2015).
[4] *See In re FirstEnergy Sols. Corp.*, 606 B.R. 720, 733 (Bankr. N.D. Ohio 2019)
[5] *Id.* at 734.

to provide for third-party releases. Second, it discusses the circuit court split. Third, it lays out the different circuit court tests. Part II is twofold. First, it examines the Second Circuit's test regarding third-party releases. Second, it examines the opinions of Southern District of New York bankruptcy judges.

I. Third-Party Releases Create a Nearly Even Circuit Split

A. The Bankruptcy Code Fails to Provide for Third-Party Releases

Bankruptcy courts have been inconsistent in concluding whether they have jurisdiction to issue third-party releases. This is because the Bankruptcy Code fails to provide for third-party releases, aside from 11 U.S.C. § 524, which permits releases in asbestos cases.[6] Thus, bankruptcy courts examine other provisions of the Bankruptcy Code to determine whether third-party releases are appropriate.[7]

The majority of circuits conclude that third-party releases are allowed under 11 U.S.C. § 105(a), which gives bankruptcy courts broad power to "issue any order" consistent with the Bankruptcy Code.[8] The minority of circuits conclude that 11 U.S.C. § 524(e) prohibits third-party releases.[9] Minority circuits reach this conclusion because 11 U.S.C. § 524(e) states that "[a] discharge of debt of the debtor does not affect the liability of any other entity."[10] One majority court argues that third-party releases could be outside the jurisdiction of bankruptcy courts because they are not "civil proceedings" under 28 U.S.C. § 157 and § 1334.[11] Additionally, the same majority court proposes that third-party releases violate the takings clause of the

[6] *See* Ryan M. Murphy, *Shelter from the Storm: Examining Chapter 11 Plan Releases for Directors, Officers, Committee members, and Estate Professionals*, *20* J. BANKR. L. & PRAC. 4 Art. 7 (2011).
[7] *Id.*
[8] 11 U.S.C. § 105(a) (2012).
[9] 11 U.S.C. § 524(e) (2012).
[10] *See id.*
[11] *See In re Aegean Marine Petroleum Network Inc.*, 599 B.R. 717, 723 (Bankr. S.D.N.Y. 2019).

Constitution.[12] Even so, the majority of courts generally hold favorably for third-party releases because of 11 U.S.C. § 105(a).

B. Circuit Courts Either Reluctantly Accept Third-Party Releases or Absolutely Deny Them

The Courts of Appeals for the Fifth, Ninth, and Tenth Circuits hold that bankruptcy courts do not have power to grant third-party releases.[13] However, the Courts of Appeals for the Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits allow for third-party releases in unique and rare circumstances.[14]

C. The Circuit Courts Have Developed Tests for Third-Party Releases

The Fourth, Sixth, and Eleventh Circuits have adopted the test set forth in *In re Dow Corning* to determine whether third-party releases are appropriate.[15] The *In re Dow Corning* test permits third-party releases in "unusual circumstances," only when the following factors are met:

> (1) There is an identity of interest between the debtor and 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.[16]

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[12] *See id.* at 725.
[13] *See Matter of Zale Corp.*, 62 F.3d 746, 760 (5th Cir. 1995); *Resorts Int'l, Inc v. Lowenschuss* (*In re Lowenschuss*), 67 F.3d 1394, 1401 (9th Cir. 1995); *Landsing Diversified Properties v. First Nat'l Bank & Trust Co. of Tulsa* (*In re Western Real Estate Fund, Inc.*), 922 F.2d 592, 600 (10th Cir. 1991).
[14] *See Sec. & Exch. v. Drexel Burnham Lambert Grp., Inc.* (*In re Drexel Burnham Lambert Grp., Inc.*), 960 F.2d 285, 293 (2d Cir. 1992); *In re Continental Airlines*, 203 F.3d 203, 211 (3d Cir. 2000); *Behrmann v. Nat'l Heritage Found.,* 663 F.3d 704, 711 (4th Cir. 2011); *In re Firstenergy Sols. Corp.*, 606 B.R. at 738; *Airadigm Commc'n, Inc. v. Fed. Commc'n Comm'n* (*In re Airadigm Commc'n, Inc.*), 519 F. 3d 640, 657 (7th Cir. 2008); *SE Prop. Holdings v. Seaside Eng'g & Surveying, Inc.* (*In re Seaside Eng'g & Surveying*), F.3d 1070, 1079 (11th Cir. 2015).
[15] *See Class Five Nevada Claimants v. Dow Corning Corp.* (*In re Dow Corning Corp.*), 280 F.3d 648, 658 (6th Cir. 2002); *Behrmann v. Nat'l Heritage Found.,* 663 F.3d at 712; *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d at 1079.
[16] *Id.*

The Third Circuit uses a different five-step test from in *In re Master Mortgage* to determine if a court has jurisdiction to issue a third-party release.[17] The *In re Master Mortg.* test considers the following five elements:

> (1) An identity of interest between the debtor and non-debtor such that a suit against the non-debtor will deplete the estate's resources; (2) a substantial contribution to the plan by the non-debtor; (3) the necessity of the release to the reorganization; (4) the overwhelming acceptance of the plan and release by creditors and interest holders; and (5) the payment of all or substantially all of the claims of the creditors and interest holders under the plan.[18]

II. The Second Circuit's Approach to Third-Party Releases

In *In re Drexel Burnham Lambert Grp. Inc.*, the United States Court of Appeals for the Second Circuit held that third-party releases are permissible if they are an "important part" of the reorganization plan.[19] The Second Circuit later elaborated on this decision in *In re Metromedia Fiber Network, Inc*.[20] There, the court held that third-party releases should not be allowed absent "unique" and "unusual" circumstances.[21] Unusual and unique circumstances apply depending on the breadth of the release and its importance to the reorganization plan. *Id.* The Second Circuit courts emphasize that this test focuses on the circumstances of the release and is not a "matter of factors and prongs."[22]

Second Circuit courts must examine the facts of each case to decide whether a third-party release should be allowed. Therefore, whether a third-party release will be approved hangs not only "on what jurisdiction you are in, but on the facts of each case, including who is being

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[17] *See In re Washington Mut., Inc.*, 442 B.R. 314 (Bankr. D. Del. 2011).
[18] *Id.*
[19] *See* 960 F. 2d at 288.
[20] *See Deutsche Bank AG v. Metromedia Fiber Network* (*In re Metromedia Fiber Network, Inc.*), 416 F.3d 136, 142 (2d Cir. 2005).
[21] *See id.*
[22] *See In re SunEdison, Inc.*, 576 B.R. 453, 462 (Bankr. S.D.N.Y. 2017).

released, the nature and extent of the claims, the creditors who are being asked to release claims and the amount of the claims relative to recoveries."[23]

A. Bankruptcy Judges in the Second Circuit Take Differing Views on Whether They Have the Appropriate Jurisdiction to Grant Third-Party Releases

Southern District of New York Bankruptcy Court judges have contrasting views on whether bankruptcy courts have jurisdiction to issue third-party releases. Review of recent decisions from the Southern District of New York Bankruptcy Court show the varying opinions. Judge Michael Wiles believes that third-party releases are likely outside the jurisdiction of the bankruptcy court, while Judge Robert Drain, Judge Sean Laine, and Judge Martin Glenn believe third-party releases should be ruled on more liberally.

In his decision, in *In re Aegean Marine Petroleum Network Inc*., Judge Wiles expressed his conservative views on third-party releases.[24] In his holding, Judge Wiles cited why bankruptcy courts should be barred from issuing third-party releases.[25] In particular, Judge Wiles stated that bankruptcy courts lack subject matter jurisdictions to rule on third-party releases because 28 U.S.C. § 157 and § 1334 only give subject matter jurisdiction to civil proceedings.[26]

He further found that bankruptcy courts do not have personal jurisdiction to release non-debtors of liability—despite the parties having notice.[27] In addition, he stated that the court does not have the power to issue these releases because a bankruptcy court lacks power to dictate settlement terms.[28] He also concluded that third-party releases should not be allowed because they violate the Takings Clause of the Constitution.[29] Last, Judge Wiles noted that third-party

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[23] *See* Jill Bienstock & Cole Schotz, *Recent SDNY Decision Adds To The Fray: When Do Courts Approve Non-Consensual Releases?*, JD SUPRA (Mar. 8, 2020 3:01 PM), https://www.jdsupra.com/legalnews/recent-sdny-decision-adds-to-the-fray-86835/.
[24] 599 B.R. at 723.
[25] *See id.*
[26] *See id.* (noting that a potential claim falls short of a civil proceeding).
[27] *See id*. at 724.
[28] *See id.*
[29] *See id.* at 726. (explaining that third-party releases violate the taking clause because they take away creditors rights without a formal hearing).

releases often ask for greater protection than the non-debtor would have received in its own bankruptcy case.[30]

Judge Wiles reiterated that third-party releases are extreme and to be "ordered only when they are actually important and necessary to the accomplishment of the transaction before the Court."[31] He emphasized that releases should not be used as a "gold star" for positively contributing to a reorganization.[32] He further reasoned that third-party releases are not "merit badge[s]" or "participation troph[ies]" for monetary contributions to a reorganization plan.[33] According to him, if bankruptcy courts issue releases to contributing non-debtors in a reorganization liberally, third-party releases would no longer be limited to "rare" and "unusual circumstances."[34] Judge Wiles concludes that third-party releases should be reserved for "extraordinary cases where a particular release is essential and integral to the reorganization itself."[35]

In contrast, Judge Lane is more open receptive to plans inclusive of third-party releases. For example, *In re Genco Shipping & Trading Ltd.*, Judge Lane approved a plan including third-party releases citing the *Metromedia Fiber Network, Inc.* test.[36] In his holding, he explained that bankruptcy courts have jurisdiction to issue third-party releases when non-debtors provide substantial consideration to the reorganization and unique circumstances justify such releases.[37] Judge Lane found that the release was important to the reorganization plan because (1) third-parties consented to the release; (2) the release "trigger[ed] indemnification" against the debtors;

[30] *See id*. (citing that many third-party releases ask for securities discharges prohibited under 11 U.S.C. § 523(a)(19)).
[31] *See id.* at 727.
[32] *See id*.
[33] *See id.*
[34] *See id.*
[35] *See id.*
[36] *See* 513 B.R. 233, 271 (Bankr. S.D.N.Y. 2014).
[37] *See id.* at 272.

and (3) the third-parties provided "substantial consideration" to the reorganization.[38] Additionally, Judge Glenn has allowed third-party releases in several other bankruptcy cases including Chapter 15 cases.[39]

In a somewhat recent oral argument, in *In re Purdue Pharma L.P.*, Judge Drain expressed his concern with parties who believe case law does not give bankruptcy courts power to issue third-party releases.[40] Further, Judge Drain stated that case law has been "miscited," and debtors need to be aware that third-party releases are within the jurisdiction of the bankruptcy court.[41] He believes that the only way to get "true peace" in the confirmation of many reorganization plans is to provide non-debtors with releases with all chapter 11 protections.[42] Judge Drain's opinion can be directly contrasted with Judge Wiles' opinion. Judge Drain appears open to accepting third-party releases more generally, while Judge Wiles believes releases should subject to higher scrutiny.

Despite all three of the abovementioned cases all being heard in the same court, it is apparent that bankruptcy judges have a varying view on whether the Bankruptcy Code gives bankruptcy court's broad jurisdiction to issue third-party releases. Judge Wiles takes the opinion that most third-party releases are likely outside the jurisdiction of bankruptcy courts. Meanwhile, Judge Drain, Lane, and Glenn are more open to such releases.

Conclusion

The Bankruptcy Code's failure to provide for third-party releases has caused a divide among the United States Circuit Courts. The majority of United States Courts of Appeals hold

[38] *See id.*
[39] *See generally In re Avanti Commc'n Grp. PLC*, 582 B.R. 603 (Bankr. S.D.N.Y 2018).
[40] *See* Transcript of Oral Argument at 39, *In re Purdue Pharma L.P.*, No. 19-23649-rdd (Bank. S.D.N.Y. Feb. 21, 2020).
[41] *See id.* at 40.
[42] *See id.*

that third-party releases are within the jurisdiction of bankruptcy courts. While, the minority of United States Courts of Appeals hold that third-party releases are inapplicable to chapter 11 reorganization plans. In particular, the Second Circuit has developed broad case law requirements to help judges decide whether the bankruptcy court has jurisdiction to issue specific releases. Even so, whether a third-party release is approved will largely depend on the views of the judge assigned to the case and the relevant facts and circumstances.