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The Permissibility of Chapter 11 Non-Debtor Release Provisions

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Cite as: *The Permissibility of Chapter 11 Non-Debtor Release Provisions*, 7 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 16 (2015).

Introduction

Generally speaking, bankruptcy proceedings do not impact non-debtor third parties liabilities.¹ However, bankruptcy courts are courts of equity. This raises the issue of what provisions may be included in a confirmable plan. Specifically, there is the issue of whether a bankruptcy court can confirm a plan if it contains a non-debtor release provision which impacts non-debtor third party liabilities.

A non-debtor release provision shields third parties who share an identity of interest with the debtor, usually corporate officers and directors in a Chapter 11 proceeding, from any claim, obligation, cause of action, or liability to any party in interest who has filed a claim or been given notice of the debtor's bankruptcy. Directors and officers want these provisions included in the reorganization plan to shield themselves from liability and the crux of their argument is that these provisions are essential to a successful reorganization. Critics of the non-debtor release provision argue that altering third-party rights in a bankruptcy proceeding is unfair to claimants, and usually does not provide any real benefit to the debtor or the bankruptcy estate.

1 "The general rule is that a discharge in bankruptcy does not affect a guarantor's liability." *In re Applewood Chair Co.*, 203 F.3d 914 (5th Cir. 2000).

Currently, there is a staunch circuit split as to whether non-debtor release provisions are permissible under the Bankruptcy Code. Some circuits, such as the Fifth, Ninth, and Tenth Circuits have refused to allow non-debtor releases under any circumstances.² The Fifth Circuit views such provisions as outside of the scope of the subject matter jurisdiction of the bankruptcy courts. The Ninth Circuit refuses to allow them because it believes that such provisions are beyond the scope of the section 524 of the Code. Likewise, the Tenth Circuit refuses to allow them because they view such provisions as beyond the scope of section 524 of the Code.³

Thus, under the varied reasoning of these Circuits, a bankruptcy court has no power to permanently effect the liability of third parties with respect to an obligation of the debtor. Other jurisdictions, such as a the Second, Sixth, and Seventh Circuit, have allowed non-debtor release provisions in limited circumstances and require the parties advocating for the release to show that the non-debtor release is essential to a successful reorganization.⁴

This Article discusses the current circuit split over the permissibility of non-debtor releases. Part I discusses the case law from the circuits that have held that non-debtor releases are per se

² See *In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995) (finding that because a permanent injunction improperly discharged a potential debt of a non-debtor the bankruptcy court exceeded its powers under Section 105); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995) (affirming the district court’s decision to vacate a release provision because the bankruptcy court lacked the power to approve a provision); *In re W. Real Estate Fund*, 922 F.2d 592 (10th Cir. 1990) (holding that a permanent injunction relieving a non-debtor from its liability to a creditor is inappropriate).

³ However, and as will be further discussed later on in the paper, the Tenth Circuit would allow a temporary injunction if such an injunction would help facilitate the bankruptcy proceedings.

⁴ See *In re Metromedia Fiber Network*, 416 F.3d 136, 141 (2d Cir. 2005) (“[I]t is clear that such a release is proper only in rare cases.”); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Specialty Equip. Co.*, 3 F.3d 1043, 1047 (7th Cir. 1993) (“[The language of Section 524(e)] does not purport to limit or restrict the power of the bankruptcy court to otherwise grant a release to a third party.”).

impermissible. Part II discusses the case law and respective standards from the circuits that permit non-debtor releases. Part III discusses the implications of the circuit split.

I. Circuits have held non-debtor releases to be impermissible

As aforementioned, some Circuits do not allow non-debtor release provisions under any circumstances. The Circuits that do not permit non-debtor release provisions have articulated different reasons for not permitting the provisions to be included in a bankruptcy plan. Some believe that these types of provisions are an impermissible use of the court's equity powers while others believe that the bankruptcy courts lack the subject matter jurisdiction to confirm bankruptcy plans containing such provisions.

For example, in *in re Zale Corp.*, the Fifth Circuit held that non-debtor release provisions were beyond the scope of a bankruptcy court's subject matter jurisdiction. The Fifth Circuit stated that the "related to" jurisdiction of the bankruptcy court should be defined so as to avoid inefficiencies of piecemeal adjudication and to promote judicial economy by aiding inefficient and expeditious resolution of all matters connected to debtor's estate.⁵

A matter is "related to" the bankruptcy case, and is one over which the bankruptcy court can exercise subject matter jurisdiction, if the outcome of the proceeding could have any conceivable effect on the estate being administered in bankruptcy.⁶ In other words, bankruptcy jurisdiction is proper if the outcome of the dispute in question could alter the bankruptcy estate's rights, liabilities, options, or freedom of action and/or in any way impacts the handling and administration of the bankruptcy estate.⁷

⁵ *In re Zale Corp.*, 62 F.3d 746, 751 (5th Cir. 1995).

⁶ *Id.*

⁷ *Id.*

Accordingly, the Fifth Circuit opined that shared facts between a third-party action and a debtor-creditor conflict did not, in and of themselves, suffice to make a third-party action “related to” the bankruptcy proceeding for purposes of permitting a bankruptcy court to exercise subject matter jurisdiction over a non-debtor release provision.⁸ Moreover, for a bankruptcy court to exercise “related to” jurisdiction over third-party claims, the claims must have an effect, not merely on the debtor, but on the bankruptcy estate itself.⁹ Consequently, the Fifth Circuit held that the bankruptcy court did not have the subject matter jurisdiction to enjoin the non-debtor third party tort claims because the claims, while affecting the debtor, would not have affected the bankruptcy estate.¹⁰

The Ninth Circuit came to the same conclusion as the Fifth Circuit but used different reasoning. In *re Lowenschuss*, the Ninth Circuit held that the bankruptcy court lacks the power to confirm plans of reorganization which do not comply with applicable provisions of the Bankruptcy Code, and pursuant to section 524(a) of the Bankruptcy Code, a discharge under chapter 11 only releases the debtor from personal liability for any debts.¹¹ Moreover, the Ninth Circuit opined that section 524 specifically 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.”¹²

Consequently, according to the Ninth Circuit, a bankruptcy court abuses its discretion, and exceeds the powers granted to it by section 524, by allowing a non-debtor third party release provision to be included in a plan.¹³

⁸ *Id.* at 753-4

⁹ *Id.*

¹⁰ *Id.* at 755-7

¹¹ *Id.* at 1399.

¹² *Id.*

¹³ *Id.*

Similarly the Tenth Circuit has held that non-debtor third party releases are impermissible. The reasoning of the Tenth Circuit is largely in line with that of the Ninth Circuit. Moreover, *in re Western Real Estate Fund, Inc.*, the Tenth Circuit noted that while a temporary stay prohibiting a creditor's suit against a non-debtor during bankruptcy proceeding may be permissible to facilitate reorganization process, a stay may not be extended post-confirmation in the form of permanent injunction effectively relieving the non-debtor from its own liability to a creditor.¹⁴

The Tenth Circuit held that neither confirmation of a plan nor a creditor's recovery of partial satisfaction thereunder bars litigation against third parties for the remainder of a discharged debt. The court opinioned that the fact that a debtor may be involved in post-discharge litigation and even named as defendant to enable recovery against a codefendant does not permit invocation of the section 524 of the Bankruptcy Code and thus does not preclude a creditor's post-bankruptcy pursuit of a discharged claim against third party. Essentially, the court held that a non-debtor release provision is beyond the bankruptcy court's powers under section 524 of the Code.

II. Circuits that have held non-debtor releases to be permissible

On the other hand some circuits have allowed non-debtor release provisions in limited circumstances. For example, *in re Metromedia Fiber Network, Inc.*, the Second Circuit held that, in bankruptcy cases, a court may enjoin a creditor from suing a non-debtor third party, as long as the injunction plays a vital part in the debtor's reorganization plan.¹⁵ The Second Circuit however stressed that a non-debtor release in a chapter 11 plan is only proper in rare cases.¹⁶ They held that to confirm a chapter 11 plan containing non-debtor release, the bankruptcy court had to find,

¹⁴ *In re W. Real Estate Fund*, 922 F.2d 592, 601-2 (10th Cir. 1990).

¹⁵ *In re Metromedia Fiber Network*, 416 F.3d 136, 141-4 (2d Cir. 2005)

¹⁶ *Id.*

at minimum, that release itself was crucial to the plan, stressing that it was not enough that one of parties benefiting from the release was making “material contribution[s]” to the estate.¹⁷

While the Second Circuit did not articulated a pronged test like the Fourth and Sixth Circuits have, the Second Circuit did identify several situations where a non-debtor release provision may be appropriate. The Second Circuit stated that “where the estate has received a substantial contribution, when the enjoined claims are channeled to the settlement fund, when the enjoined claims indirectly impact the debtor's reorganization, such as claims for contribution or indemnity, and where the affected creditors consent.”¹⁸

The Second Circuit stressed that a non-debtor release in a plan of reorganization should not be approved absent a finding that truly unusual circumstances, like the ones identified above, render the release terms important to the success of the plan.¹⁹ The court reasoned that at least two considerations justify the reluctance to approve non-debtor releases. First, the only explicit authorization in the Code for non-debtor releases is section 524(g), which authorizes releases in asbestos cases when specified conditions are satisfied, including the creation of a trust to satisfy future claims. Second, a non-debtor release is a device that lends itself to abuse. The court opined that the release, in effect, may operate as a bankruptcy discharge arranged without a filing and without the safeguards of the Bankruptcy Code. Moreover, the potential for abuse is heightened when releases afford blanket immunity. Consequently, bankruptcy courts should approach non-debtor release provisions with a reasonable degree of skepticism and must insure that the bankruptcy process is not being used as a mechanism for abusive practices.

¹⁷ *Id.*

¹⁸ *Id.* at 142-3.

¹⁹ *Id.*

Likewise, the Sixth Circuit in *re Dow Corning Corp.*, found that the Bankruptcy Code does not explicitly prohibit or authorize a bankruptcy court to enjoin a non-consenting creditor's claims against a non-debtor to facilitate a reorganization plan.²⁰ The Sixth Circuit stated that Bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships. The Sixth Circuit however went on to note that an injunction enjoining a non-consenting creditor's claim against a non-debtor is a dramatic measure to be used cautiously and is only appropriate in “unusual circumstances.”²¹

The Sixth Circuit articulated a six factor test for the bankruptcy court to use when determining whether a non-debtor release provision is permissible in a particular plan.²² They stated that when the following six factors are present, there are “unusual circumstances,” and a bankruptcy court may, in its discretion, enjoin a non-consenting creditor's claims against a non-debtor to facilitate a Chapter 11 plan of reorganization: (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 debtor or will deplete the bankruptcy estate assets, (2) the non-debtor has contributed substantial assets to the reorganization, (3) the injunction is essential to reorganization, namely, reorganization hinges on debtor being free from indirect suits against parties who would have indemnity or contribution claims against debtor, (4) the impacted class, or classes, have overwhelmingly voted to accept the plan containing the non-debtor release provision, (5) the plan provides a mechanism to pay for all, or substantially all, of the claims of

²⁰ In *re Dow Corning Corp.*, 280 F.3d 648, 656-8 (6th Cir. 2002)

²¹ *Id.*

²² *Id.* at 658

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.²³

Likewise, the Fourth Circuit's decision in *in re National Heritage Foundation* provides a great illustration of the high burden a third party must meet in order for a court to feel comfortable confirming a plan that contains a non-debtor release provision. There, a non-profit public charity that administered and maintained donor-advised funds voluntarily filed for bankruptcy under chapter 11 of the Bankruptcy Code after a state court entered a multi-million dollar judgment against the charity.²⁴ The charity's proposed plan contained a broad non-debtor release provision that would shield all of the charity's officers, directors, and employees from any lawsuit stemming from the bankruptcy or the actions the charity took prior to the bankruptcy.²⁵

The Fourth Circuit adopted and applied the six factors articulated by the Sixth Circuit in *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)* to determine whether the non-debtor release provision was permissible.²⁶ The only factor that weighed in the charity's favor was the presence of an identity of interests between the charity and the third parties that would be released under the plan.²⁷ Indeed, almost all of the factors weighed in the

²³ *Id.*

²⁴ Nat'l Heritage Found. Inc., 760 F.3d 344 at 346.

²⁵ *Id.*

²⁶ 760 F.3d 344 at 347–8; The *Dow* factors required the charity to show:

(1) There is an identity of interests between the debtor and the third party ...; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization ...; (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; [and] (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full.

²⁷ Nat'l Heritage Found. Inc., 760 F.3d 344 at 347.

favor of the impacted parties.²⁸ In particular, the court expressed concern that the charity's non-debtor provision did not take into account the desires, needs or concerns of the impacted parties.²⁹

Moreover, the provision provided no mechanism to pay for the classes affected by the injunction.³⁰ Nor did the plan provide an opportunity for claimants who chose not to settle to recover in full.³¹ Finally, the charity did not put forth any convincing evidence or facts that showed the provision was necessary to successful reorganization.³² On the contrary, the courts concluded that the charity would be able to reorganize successfully without the provision³³ because the court found that the directors and officers failed to show that they provided any sort of cognizable contribution to the charity as part of the charity's reorganization.³⁴

Similarly, in *Matter of Specialty Equipment Companies, Inc.*, the Seventh Circuit held that a bankruptcy court has the power to confirm a plan that contains a non-debtor release provision.³⁵ The Seventh Circuit, like the Second and Sixth Circuits, stated that non-debtor release provisions are a drastic measure and should only be used when they are necessary for the successful reorganization of the debtor.³⁶

The Seventh Circuit reasoned that in a chapter 11 case, the debtor receives its discharge as to all of its debts, as defined in section 524, upon entry of the order of confirmation. The provisions of the confirmed plan bind all creditors whether or not a particular creditor has voted to accept

28 *Id.* at 348–9.

29 *Id.*

30 *Id.*

31 Nat'l Heritage Found. Inc, 760 F.3d 344 at 348–9.

32 *Id.*

33 *Id.*

³⁴ *Id.* at 349.

³⁵ In re Specialty Equip. Co., 3 F.3d 1043, 1045-7 (7th Cir. 1993).

³⁶ *Id.*

the plan. Since binding confirmation may be achieved over the dissent of individual creditors, and may even be achieved over the objection of an entire class of creditors, a debtor's discharge may occur despite the objection of particular creditors who are affected by non-debtor third party releases.

Essentially, the Seventh Circuit opined that non-debtor releases, like all other claims in a bankruptcy proceeding, fall under the umbrella of section 524 and a bankruptcy court has the power to confirm a plan that contains such releases. As aforementioned, the Seventh Circuit noted that while bankruptcy courts have the power to confirm plans containing non-debtor releases, the releases are a drastic measure that should only be permitted when they are essential to the debtor's successful reorganization.

III. Implications of the Circuit Split on Non-debtor Release Provisions

The most profound implication of the circuit split on non-debtor release provisions is that it creates an incentive to forum shop. Executives and officers of corporations who would like to shield themselves from potential liability to the corporation's creditors will file for bankruptcy in a jurisdiction that allows non-debtor release provisions to be included in the plan.

Although jurisdictions that allow non-debtor releases require a high burden to be met before confirming a plan containing them, the fact that a corporation's officers are able to forum shop still raises questions of equity and fairness to the creditors who are impacted by the releases. It seems inherently unfair that a creditor may lose all or part of his recovery because of the forum that was selected by the debtor. This is especially true when considering the underlying principles and goals of a chapter 11 reorganization.

Chapter 11 reorganization is meant to give a financially distressed corporation a second chance while providing as much protection, and recovery, to its creditors as possible. Forum

shopping in order to limit a creditors recovery runs counter to spirit of a chapter 11 reorganization. Accordingly, forum shopping for a jurisdiction that allows such releases should not be permitted by the courts.

Conclusion

As noted and discussed above, the Circuits' are split as to whether non-debtor releases are permissible. The Fifth, Ninth, and Tenth Circuits have refused to allow non-debtor releases. This is due to the Fifth, Ninth, and Tenth Circuits' narrow interpretation of Bankruptcy Code Section 524(e) and their views on what is "related to" the bankruptcy proceeding.³⁷ Under the reasoning of these Circuits, a bankruptcy court has no power to effect the liability of third parties with respect to an obligation of the debtor.³⁸

Conversely, the Second, Sixth, and Seventh Circuits' have held that, in limited circumstances, a bankruptcy court overseeing a chapter 11 plan can release non-debtors if such a release is essential to, and in the best interest of, the reorganization.³⁹ As noted earlier, even in jurisdictions where non-debtor releases are permissible, the party seeking the release has a high burden to meet. The Circuits that permit non-debtor releases have made it clear that they will not allow an organization's executives to shield themselves from legal recourse unless such a

³⁷ See *In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995) (finding that because a permanent injunction improperly discharged a potential debt of a non-debtor the bankruptcy court exceeded its powers under Section 105); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995) (affirming the district court's decision to vacate a release provision because the bankruptcy court lacked the power to approve a provision); *In re W. Real Estate Fund*, 922 F.2d 592 (10th Cir. 1990) (holding that a permanent injunction relieving a non-debtor from its liability to a creditor is inappropriate).

³⁸ See generally 62 F.3d 745; 67 F.3d 1394; 922 F.2d 592.

³⁹ See *In re Metromedia Fiber Network*, 416 F.3d 136, 141 (2d Cir. 2005) ("[I]t is clear that such a release is proper only in rare cases."); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Specialty Equip. Co.*, 3 F.3d 1043, 1047 (7th Cir. 1993) ("[The language of Section 524(e)] does not purport to limit or restrict the power of the bankruptcy court to otherwise grant a release to a third party.").

shielding would provide a benefit to creditors and other parties impacted by the reorganization.⁴⁰ Thus the purpose of the provision is to provide the best, and most equitable, reorganization possible for all parties involved. This is, as it should be, a high burden to meet.

Moreover, with the split between the Circuits on this issue widening the likelihood that the Supreme Court may weigh in on and decide the issue increases. While the Supreme Court's view on the issue remains unclear, the Supreme Court's resolution of the issue will, at the very least, eliminate the potential for forum shopping by those who seek to increase the likelihood that such releases will be approved.