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2009

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Non-Consensual Third Party Releases in Chapter 11 Bankruptcy

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The Seventh Circuit, in *Airadigm Communications, Inc. v. Federal Communications Comm'n. (In re Airadigm Commc'n, Inc.)*, 519 F.3d 640 (7th Cir. 2008), has joined the circuits permitting the non-consensual releases of non-debtor third parties from their obligations to creditors in chapter 11 reorganizations. In *Airadigm*, the court considered the validity of releasing a guarantor and major reorganization financier, Telephone and Data Services (hereinafter TDS), from liability resulting from the reorganization of debtor Airadigm Communications. The Court came to three conclusions on the subject: 1. Bankruptcy code section 524(e) does not prevent bankruptcy courts from granting third-party releases; 2. Bankruptcy courts have the affirmative power to grant third-party releases; and 3. The applicable standard for granting a third-party release is that the release must be necessary for the reorganization and the release must be as narrowly tailored.

This article will begin by describing the statutory framework for third party releases. Next, the article will examine the factual background of the *Airadigm* case. Then, the article will explore the reasoning other circuits have used to either grant or deny non-consensual third-party releases and the reasoning the Seventh Circuit used in coming to the three conclusions stated above in *Airadigm*. Finally, the article will briefly conclude on what *Airadigm* adds to the discussion on non-consensual third party releases.

Statutory Basis

The questions provoked by third-party releases arise from the interpretation of and possible conflicts between three sections of the bankruptcy code and the pervasive conception of the bankruptcy courts as courts of broad equitable powers. The first section, section 524(e), can be interpreted as prohibiting the courts from making determinations regarding the liabilities of parties other than the debtor. The section provides that the “discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.” 11 U.S.C. § 524(e). However, sections 105(a) and 1123(b)(6) seem to grant the bankruptcy courts broad powers in dealing with all aspects of a reorganization, including liabilities of third parties on debt involved in the reorganization. Section 105(a) grants bankruptcy courts the power to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this code.” 11 U.S.C. § 105(a). Similarly, section 1123(b)(6) allows a bankruptcy court to “include any other appropriate provision not inconsistent with the applicable provisions of this title.” 11 U.S.C. § 1123(b)(6). Furthermore, these two sections are buttressed by the pervasive view of bankruptcy courts as courts of broad equitable power.

Therefore, a bankruptcy court considering granting a third-party release must answer three questions. First, does section 524(e) of the bankruptcy bar the court from granting this type of relief? Second, if the court is not explicitly barred from granting this relief, does section 105(a) and/or section 1123(b)(6) grant the bankruptcy court the affirmative power to grant this relief? Third, if granting this form of relief is within the power of the court, what standard should be used to justify this relief?

Factual Background

The case revolved around Airdigm's 1996 purchase and financing of fifteen personal communications services (PCS) from the Federal Communication Commission (FCC). The FCC and Airadigm executed security agreements on all fifteen licenses in order to ensure payment. Under the security agreements, the FCC could cancel the licenses if Airadigm was unable to pay. In 1999, Airadigm filed for bankruptcy. Upon Airadigm's filing, the FCC cancelled Airadigm's licenses but allowed Airadigm to continue to use the portion of the spectrum the licenses secured. Because the licenses were cancelled, the FCC filed a claim against Airdigm's estate for 64.2 million dollars as an unsecured creditor. However, the FCC included a provision in their claim that argued that should it have to reinstate the licenses it would become a secured creditor for 33.3 million dollars, market value of the licenses at the time of the reorganization.

TDS provided the pivotal financing for Airdigm's 1999 reorganization. Under the reorganization plan, TDS would be liable to the FCC for varying amounts of money if and when the FCC reinstated the PCS licenses. TDS would pay out the full amount of the FCC's claim if the licenses were reinstated by February 2001 and would have the option to pay the FCC's if the licenses were reinstated by June 2002. The reorganization proceeded under the assumption that the FCC cancellation of the licenses was proper and the FCC did not reinstate the licenses before June 2002.

However, in 2003, the Supreme Court decided *FCC v. NextWave Personal Communications, Inc.*, 537 U.S. 293 (2003), which held that in a situation factually identical to Airdigm's, it was a violation of the bankruptcy code for the FCC to cancel PCS licenses. Thus, the FCC reinstated Airadigm's licenses as if they had never been cancelled and once again became a secured creditor for 33.3 million dollars. Airadigm's original reorganization plan had

not planned for this for this contingency. Due to the legal ramifications of this reinstatement, Airadigm was forced to re-file for chapter 11 reorganization in 2006.

TDS once again provided major financing during Airadigm's second reorganization. TDS's support was extremely important because Airadigm owed a vast amount of secured debt. Airadigm owed 188 million dollars in secured debt to TDS and 33 million dollars in secured debt to the FCC. Due to this large amount of secured debt, the bankruptcy court found that Airadigm would not be able to find a financier other than TDS. Similarly, the bankruptcy court found that due to the large amount of debt owed to TDS by Airadigm already, TDS would not participate in the second reorganization without assurances that it would not be held liable for all of Airadigm's debt, especially the 64.2 million that the FCC could claim as an unsecured creditor. Therefore, the bankruptcy court granted TDS a limited release. This released assured TDS that they would not be liable for any debt associated with the reorganization that was not created by its own willful misconduct. However, the bankruptcy court held that the release did not terminate the FCC interests in the licenses. Thus, TDS would have to follow all regulations set forth by the FCC and would be subject to the FCC's conditions on the sale of the licenses.

The FCC objected to the inclusion of this term in the reorganization plan claiming that it was a violation of 524(e) of the bankruptcy code and that the court did not have the power to grant the release.

Does Section 524(e) bar all non-debtor third party releases?

There is a dispute between the circuits about the effect Congress intended section 524(e) to have on non-debtor liability.

Yes, Section 524(e) bars all non-debtor third party releases.

The Ninth and Tenth Circuits both hold that section 524(e) bars any type of the non-debtor release. For example, in *Resorts International, Inc. v. Lowenschuss*, (*In re Lowenschuss*), 67 F.3d 1394 (9th Cir. 1995), the Ninth Circuit refused to confirm a reorganization plan that contained a global release provision that released a non-debtor from any liability to creditors. There, the debtor sought to preclude creditors from pursuing a fraud claim against his pension plan, which had previously been exempted from the debtor's estate. The bankruptcy court confirmed a plan that granted a global release to both the parties included in the reorganization and the debtor's pension plan, which was no longer a party to the reorganization. On appeal, the district court vacated the global release. The Ninth Circuit affirmed the district court's decision and rejected the debtor's contention that the bankruptcy court had the power to approve the third-party release under section 105(a). The court held that the section 524(e) specifically limited the bankruptcy courts power to modify third-party liability on debt. The court dispensed with the argument that section 105(a) might grant a bankruptcy court the power to release a third party by opining that 105(a) does not grant the bankruptcy court the power to provide relief inconsistent with the code.

Similarly, in *Landsing Diversified Properties-II v. First National Bank and Trust Company of Tulsa* (*In re Western Real Estate Fund, Inc.*), 922 F.2d 592 (10th Cir. 1990), the Tenth Circuit refused to approve a reorganization plan that released a non-debtor from liability resulting from an attorney's lien seeking payment from settlement proceedings. There, the debtor's reorganization plan called for the complete release of a third party to a settlement agreement with the debtor and who was subject to an attorney's lien indemnified by the debtor. Although the debtor argued that 105(a) gives the bankruptcy court the power to release a third

party from liability, the court disagreed. The court reasoned that section 524(e) expresses Congress's intention to deny bankruptcy courts the power to extend the protections of bankruptcy to non-debtors. The court explained that 105(a) could not apply because the relief sought would be inconsistent with the section 524(e) of the code.

Also, in *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203 (3d Cir. 2000), the Third Circuit suggested that it might agree with the Ninth and Tenth Circuit in barring all third-party releases. However, the court was able to dispense with the third-party release on other grounds and stopped short of aligning itself with those circuits that bar all third-party releases.

No, 524(e) does not prohibit the bankruptcy from granting non-debtor releases.

Conversely, a majority of circuits have held that section 524(e) does not bar bankruptcy courts from using their equitable powers to release third parties. Earlier cases considering third-party releases have held that 524(e) does not bar third-party releases because in situations where a third-party releases are important to a reorganization 524(e) does not apply. For example, in *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694 (4th Cir. 1989), the Fourth Circuit stated that “where the entire reorganization hinges on the debtor being free from indirect claims such as suits against parties who would have indemnity or contribution claims against the debtor, we do not construe section 524(e) so that it limits the equitable power of the bankruptcy court to enjoin . . .” suits against third parties. 702. Further, in *SEC v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 960 F.2d 285 (2d Cir. 1992), the Second Circuit adopted this view and then affirmed it in the lead case on third-party releases in

the Circuit, *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136 (2d Cir. 2005).

Other courts holding that 524(e) does not prohibit bankruptcy courts from granting third-party releases have been more specific as to why 524(e) does not prevent third-party releases. For example, in *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648 (6th Cir. 2002), the Sixth Circuit concluded that 524(e) does apply to third-party liability even when that third party is essential or important to the reorganization. However, the court explained that the intended operation of 524(e) is not to be a prohibition on the courts from releasing third parties but rather as a saving clause. Therefore, the court reasoned 524(e) only preserves third-party liability in the absence of a court order stating otherwise, the section does not prohibit a court from specifically granting such relief.

In *Airadigm*, the Seventh Circuit adopted a similar analysis to that of the Sixth Circuit, holding that section 524(e) does not bar a bankruptcy court from granting a release to a non-debtor third party. Like the Sixth Circuit, the court reasoned that section 524(e) merely explains the effect of the debtor discharge on third-party debt rather than limits the courts power over the third-party debt. The court set forth two justifications for this holding. First, the court posited that the “natural reading” and wording of the statute lead to this conclusion. The court reasoned that if Congress meant to limit the court’s power Congress would have used the terms “shall” or “will” rather than the word “does”. Further, the court claimed that the prepositional phrase “on . . . for, such debt,” would not have been included if it meant to limit the court’s power. To support this assertion, the court compared the current reading of the statute with the wording of a comparable section from the previous bankruptcy code, which contained the express wording “The liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a

bankrupt shall not be altered by the discharge of such bankrupt.” 11 U.S.C. § 34 (repealed Oct. 1, 1979) (prior version of § 524(e)). Second, the court asserted that where Congress has attempted to limit the equitable power of the bankruptcy court it has done so expressly. The court noted section 105(b), which states “[A] court may not appoint a receiver in a case under this title”, and section 1129(a), which states “The court shall confirm a plan only if the following requirements are met”, as examples of where Congress specifically limited the authority of the bankruptcy court. The court reasoned that because section 524(e) did not contain this express language Congress did not intend for it to limit the court’s power.

Does the Bankruptcy Code give bankruptcy courts the power to release third parties from debt?

Even if the bankruptcy code does not expressly limit the courts power to grant third-party releases, some courts have questioned whether the code gives a bankruptcy the affirmative power to grant a third-party release. For example, in *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203 (3d Cir. 2000), the Third Circuit questioned whether there was any provision in the bankruptcy code that would allow a bankruptcy court to justify this type of release. Although, the court never answered the question, it did state that there was nothing in the bankruptcy code that explicitly grants the bankruptcy courts the power to grant a third-party release. The court reasoned that the only section of the code that might allow for this type of power was section 105(a). However, the court explained that 105(a) does “not create new substantive rights. . . under the bankruptcy code” but rather supplements the bankruptcy’s court’s enumerated powers. The court reasoned that without another section of the code to support 105(a) third-party releases cannot be justified.

Surprisingly, many of the Circuits that have held that third-party releases are permissible have not specifically addressed this question. Rather, those courts have assumed that section 105(a) and the broad equity powers that grant bankruptcy are enough to grant the court the power to release third parties. For example, in *A.H. Robins*, the Fourth Circuit reasoned that 105(a) is the provision that grants the bankruptcy court broad equitable power. Therefore, the court would not need any other provision to justify granting a release as long as the release was granted in the interest of equity. Also, in *Metromedia*, the Second Circuit expressed doubts that 105(a) alone grants bankruptcy courts the power to grant third-party release. However, the court made no attempt to clarify what section of the code would enable a court to grant this type of relief before declaring that it was available in the Circuit. Similarly, earlier cases in the Second Circuit failed to provide any clarification on the matter.

However, in *Dow Corning*, the Sixth Circuit held that section 1126(b)(6) is the provision of the code that grants bankruptcy courts the affirmative power to use its equity powers to grant third-party releases. There, the court explained section 1126(b)(6) allows the court to include any appropriate provision that is not inconsistent with the code. Therefore, the court held in a reorganization the only analysis needed to grant a third-party release is to ensure that the provisions of the release are not inconsistent with the code. Thus, the court reasoned that since 105(a) allows the court to issue any order as long as they are necessary to the reorganization a bankruptcy court possess the affirmative power to grant a third-party release as long as it is necessary.

In *Airadigm*, the Seventh Circuit held that granting third-party releases is within the “residual authority” of the bankruptcy court. The Court reasoned that this “residual authority” is codified in section 105(a) of the bankruptcy code. The court explained that congress gave the

court the affirmative authority to use this equitable “residual authority” in reorganizations through the inclusion of section 1126(b)(6) in the bankruptcy code. Therefore, as the Sixth Circuit did in *Dow Corning*, the Seventh Circuit held that a bankruptcy court has the power to grant third-party releases as long as they are appropriate in terms of section 1126(b)(6), meaning they are necessary as defined by section 105(a), and the releases are not inconsistent with other sections of the bankruptcy code.

What is the applicable standard for granting a third-party release?

The circuits that have held that section 524(e) does not prohibit third-party releases and that bankruptcy courts possess the affirmative power to grant third-party releases, either through 105(a) or a combination of 105(a) and 1126(b)(6), have set forth a variety of standards for determining when a third-party release is “necessary or appropriate.” Every circuit allowing for third-party releases has stated that there is great potential for third-party releases to be abused. Because of this potential for abuse, every circuit agrees that at least two requirements must be met in order for a third-party release to be valid. First, the circuits agree that third-party releases should only be granted in unusual circumstances. Second, every court has agreed that these unusual circumstances must be supported by specific factual findings. However, the circuits are fractured on the extent of the factual findings needed and what constitutes “unusual circumstances.”

Some circuits have predicated their standards for determining the appropriateness of a third-party release on vague concepts of equity and importance to the reorganization. For example, in *A.H. Robins*, the Fourth Circuit focused its standard for granting third-party releases on specific factual findings of both equity for the aggrieved creditors and necessity of the release

to the success of the reorganization. In that case, the debtor's reorganization provided for two classes of creditors. Creditors with potential suits against the debtor and its guarantors were put into one class of creditors and their suits were to be paid in full according to a settlement agreement. However, several creditors in this class opted out of the settlement agreement to pursue their claims against third parties, such as the debtor company's directors and attorneys, who had either indemnified or agreed to contribute to the debtor's liability. The court found that the success of the debtor's reorganization hinged on these third parties being free from liability. The court explained that because the third parties were so closely associated with the debtor that a suit against any of these parties would actually be a suit against the debtor. The court held clauses providing for injunctions barring the creditors suits could be upheld. The court reasoned that because the creditors would have received full payment if they had not opted out of the settlement agreement the injunctions were equitable and because the reorganization could not be successful if they were liable to the creditors, the injunction was both equitable to the creditors and necessary to the reorganization.

Similarly, in *Metromedia*, the Second Circuit held that a third-party release must be important to the debtor's reorganization in order to be appropriate and this importance must be supported by specific factual findings. However, the court did not clearly define when a release is important to a reorganization other than to explain that releases are rarely ever important. In that case, the court stressed that third-party releases have a great potential to be abused because they operate as a bankruptcy release without the safeties of the bankruptcy code. The court worried that these types of releases could be used by non-debtors to unfairly shield themselves from creditors. Therefore, the court required that non-debtor releases be supported by findings that show that the case is unique, meaning that the release was both necessary and important to

the plan. In that case, the court denied the disputed release of a major contributor to the reorganization. The court conceded that the contributor had made “material contributions” to the reorganization and that these contributions were supported by specific factual findings. However, the court explained that the factual findings must show that the release itself, not merely the contribution, was important to the plan. Thus, the court held that a third-party must do more than provide financial support to the reorganization to be important to the reorganization. However, the court failed to give a clear standard as to what might make a third-party release important to a reorganization.

The most comprehensive analysis of third-party releases comes from the Sixth Circuit. In *Dow Corning Corp.*, the Sixth Circuit created a seven-factor balancing test evaluating a third-party non-debtor release. The court considers whether:

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 [release] 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 finding that support its conclusions.

In that case, the circuit court explained that the bankruptcy court failed to make specific factual findings about the importance of the releases to the reorganization other than board statements about the need for the releases in general. Further, the circuit court explained that the bankruptcy court did not provided an explanation or discussion for each release but rather dealt with the releases as a group. The court explained that the plan failed in three ways. First, the bankruptcy court's findings that the releases were essential to the plan were ambiguous. The court explained that the plan found that the release only applied to creditors who consented to the plan yet did not apply to creditors who did not consent, which suggests that it was not essential to enjoin non-consenting creditors. Second, the court explained that the bankruptcy court failed to explain why the parties receiving the releases were important to the plan. Third, the court found bankruptcy court's claim that all non-settling creditors would be paid in full was unsupportable. Thus, the court found that the reorganization plan could not be confirmed.

In *Airadigm*, the Seventh Circuit agreed with the other circuits allowing third-party releases that the releases must be justified by fact intensive findings by the bankruptcy court. The court placed special emphasis on findings about whether the release was necessary to the reorganization. There, the circuit court found that the bankruptcy court adequately compiled facts to prove that the release was essential to the reorganization. Specifically, the court explained that because Airadigm owed so much secured debt to both TDS and FCC, TDS was the only likely financier of the reorganization. The court stated, "Absent TDS's involvement, the reorganization simply would not have occurred." Further, the Seventh Circuit found the bankruptcy court's findings that TDS would not participate in the reorganization without the

releases were creditable. Therefore, the court explained that the releases were important and necessary to the reorganization because absent the releases Airadigm would not have been able to finance the reorganization.

Also, the Seventh Circuit added that a third-party release must be appropriately tailored in order to be valid. The court expressed concerns that blanket immunity provisions could be abused because these provisions could affect debt outside the jurisdiction of the bankruptcy court and violate concepts of equity by allowing third parties to skirt responsibility for intentional or reckless acts. In *Airadigm*, the court held that the release was appropriately tailored for two reasons. First, the court explained that the release was narrowly tailored because the release did not exclude TDS's liability for its own willful misconduct or for debt not associated with the reorganization. Therefore, TDS could be held liable for its own misconduct in either of the reorganizations. Further, the bankruptcy court could not disturb any debt that it did not have jurisdiction over. Second, the court reasoned that the release was limited to other provisions of the plan. Thus, TDS was subject to a provision of the plan that preserves the FCC's interest in the licenses. Because of this limitation, TDS would still be subject to all FCC regulations.

Conclusion

In conclusion, in *Airadigm*, the Seventh Circuit seems to broadly validate non-consensual third-party releases, and makes three important contributions to the debate surrounding third-party releases in chapter 11 reorganizations. First, the court gives the most in-depth argument as to why section 524(e) does not bar third-party non-debtor releases of any court considering the issue. The court's analysis of the statutory language both in comparison to the former bankruptcy code and to other sections of the bankruptcy code that are express limitations is the

clearest articulation of why section 524(e) can be interpreted as a saving clause as opposed to an express limitation. The court's analysis could help persuade those circuits still barring third-party releases to allow the practice or perhaps provide guidance for a rewording of 524(e) to more clearly express its intended function. Second, the decision gives a clear example of when a third-party release is necessary to a chapter 11 reorganization. Third, the court adds the important consideration of whether the release is narrowly tailored when considering whether it is appropriate to grant the release.

However, the decision serves to further divide the circuits about the legitimacy of third-party releases. The function of 524(e) on third-party debt and whether the bankruptcy code grants bankruptcy courts the affirmative power to grant third-party releases remains unclear. Further, the standard for when a third-party release becomes necessary under section 105(a) has not been clearly defined. Although the *Airadigm* decision provides a clear example of when a third-party release is important to a reorganization, the Seventh Circuit fails to define a clear test for determining when a third-party is necessary to a reorganization. Rather, like every circuit granting third party release except the Sixth Circuit it bases its standard on broad concepts and case-by-case analysis. A clear test would surely be helpful to both bankruptcy courts and practitioners.

