2022

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Megan O’Connor, J.D. Candidate 2023


Introduction

Under Title 11 of the United States Code (the “Bankruptcy Code”), a debtor will generally be released or discharged from certain liabilities. In addition, a plan confirmed under Chapter 11 of the Bankruptcy Code may provide for a “third-party release,” pursuant to which a non-debtor, like a senior officer or shareholder, may be released from certain liabilities by creditors. There is currently a split between United States Courts of Appeals regarding the scope of who can be bound by a release by creditors: some courts permit such a release in the plan where each creditor has affirmatively consented to the release, while others approve nonconsensual third-party releases.

For authority to grant nonconsensual releases, bankruptcy courts generally rely on Section 105(a) of the Bankruptcy Code which provides that:

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.\(^1\)

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This memorandum analyzes the split among the United States Courts of Appeals and what factors each Court of Appeals considers in deciding whether to approve a nonconsensual third-party release. Today, the dispute among circuit courts can be attributed to each circuit’s perspective on the statutory relationship between section 524(e) and section 105(a) of the Bankruptcy Code. Section 524(e) provides that a “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 debts.”

Courts in the Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits hold the majority view and consistently agree that section 524(e) is not an explicit limitation on the courts’ section 105(a) equitable powers. Whereas the Fifth, Ninth, and Tenth Circuits hold the minority view that the statutory language of section 524(e) provides a strict prohibition against third-party releases. This Circuit split is not new, but rather has been afflicting the federal circuit courts since the early 1980s. However, recently with the public outrage surrounding the Purdue Pharma bankruptcy, and specifically the Sackler family’s role in effectuating the opioid crisis, there is suddenly much publicity and controversy surrounding nonconsensual third-party releases as a matter of law and public policy.

Discussion

I. Circuit Split on Nonconsensual Third-Party Releases

A. Majority View

The majority of the United States Courts of Appeals – the Second, Fourth, Sixth, Seventh, and Eleventh Circuits – employ various tests to determine whether nonconsensual third-party releases and injunctions are permissible. Further, the First and D.C. Circuits have

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3 See SEC v. Drexel Burnham Lambert Grp., Inc. (In re Drexel Burnham Lambert Grp., Inc.), 960 F.2d 285, 293 (2d Cir. 1992); In re Cont’l Airlines, 203 F.3d 203, 213 (3d Cir. 2000); In re A.H. Robins Co., Inc., 880 F.2d 694 (4th Cir. 1989).
indicated they also find such releases permissible; however, neither circuit has addressed the issue of nonconsensual third-party releases head on.  

a. Integral to the Plan of Reorganization

The United States Court of Appeals for the Second Circuit finds nonconsensual third-party releases permissible when supported by specific details about necessity and importance to the plan. In In re Drexel Burnham Lambert Grp., Inc., the Second Circuit upheld an injunction against creditors from suing a third-party, given that the injunction played an “important role” in the debtor’s reorganization. However, in 2005, with In re Metromedia Fiber Network, Inc., the Second Circuit established a more restrictive application of its “importance” requirement. The Metromedia Court found the nonconsensual third-party releases impermissible because they were not supported by specific details about necessity and importance to the plan. The Metromedia Court cited Drexel in its finding that the releases were impermissible, however the requirement of specificity is seemingly one that the Drexel opinion lacks. While the Metromedia Court does not mention the Sixth Circuit Dow Corning opinion, the requirement of specificity perhaps indicates the Second Circuit’s movement toward the Dow Corning factors.
More recently, in *In re Millennium Lab Holdings II, LLC*, the United States Court of Appeals for the Third Circuit affirmed the majority of circuits’ approval of nonconsensual third-party releases; finding them to be a constitutional exercise of a bankruptcy court’s authority where “integral to the restructuring of the debtor-creditor relationship.”\(^{11}\) There, the court relied on whether the nonconsensual third-party release was “critical to the success of the plan” meaning the releases were “necessary to both obtaining the funding and consummating a plan,” and “without [prepetition shareholders’] contributions, there [would be] no reorganization.”\(^ {12}\)

\(b.\) Balancing Test

The United States Court of Appeals for the Sixth Circuit, in *In re Dow Corning Corp.*, held that section 524(e) merely explains the effect of a debtor’s discharge, but does not prohibit the release of a non-debtor.\(^ {13}\) Further, the Sixth Circuit reasoned that section 105 empowers bankruptcy courts “to take appropriate equitable measures needed to implement other sections of the Code.”\(^ {14}\) In its opinion the Sixth Circuit combined the reasoning of its sister circuits to articulate a seven-factor balancing test for allowing nonconsensual releases:

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

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1. 945 F.3d 126, 135 (3d Cir. 2019).
2. Id. at 137.
3. 280 F.3d 648 (6th Cir. 2002); see 11 U.S.C. § 524(e).
4. *In re Dow Corning Corp.*, 280 F.3d at 656.
support its conclusions.\textsuperscript{15}

The United States Court of Appeals for the Eleventh Circuit has also adopted those factors.\textsuperscript{16} The Eleventh Circuit noted that in determining whether to approve a non-debtor release in a proposed plan, the bankruptcy court should have discretion to decide which of the factors will be relevant in each case.\textsuperscript{17}

In 2014, the United States Court of Appeals for the Fourth Circuit, in \textit{National Heritage Foundation, Inc. v. Highbourne Foundation}, issued an opinion that substantially narrowed third-party release standards set out by prior Fourth Circuit precedent in \textit{In re A.H. Robins Co., Inc.}\textsuperscript{18} In \textit{In re A.H. Robins Co., Inc.}, the Fourth Circuit upheld an injunction barring suits by creditors against certain third-parties including the company’s directors and lawyers.\textsuperscript{19} There, the court rejected a literal application of section 524(e) and instead considered that the plan was “overwhelmingly approved” and that the plan gave a “second chance for late claimants to recover.”\textsuperscript{20} The \textit{In re A.H. Robins} Court elaborated “where the entire reorganization hinges on the debtor being free from indirect claims,” section 524(e) of the Bankruptcy Code does not limit the equitable power of the bankruptcy court from enjoining those claimants.\textsuperscript{21} However, the \textit{National Heritage} Court took a different approach and denied third-party releases that would enjoin claims against the debtor’s directors and officers where application of the Sixth Circuit’s

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\textsuperscript{15} \textit{Id.} at 658 (citing \textit{In re A.H. Robins}, 880 F.2d 694, 701–02 (4th Cir. 1989); MacArthur Co. v. Johns-Manville Corp. (\textit{In re Johns-Manville Corp.}), 837 F.2d 89, 91 (2d Cir. 1988); \textit{In re Cont’l Airlines}, 203 F.3d 203, 213 (3d Cir. 2000)).
\textsuperscript{16} \textit{See In re Seaside Eng'g & Surveying, Inc.}, 780 F.3d 1070, 1079 (11th Cir. 2015).
\textsuperscript{17} \textit{Id.} (“the factors should be considered a nonexclusive list of considerations, and should be applied flexibly, always keeping in mind that such bar orders should be used “cautiously and infrequently,” and only where essential, fair, and equitable.”) (internal citations omitted).
\textsuperscript{18} \textit{See Nat’l Heritage Found., Inc. v. Highbourne Found.}, 760 F.3d 344, 351 (4th Cir. 2014); \textit{In re A.H. Robins Co., Inc.}, 880 F.2d 694 (4th Cir. 1989).
\textsuperscript{19} 880 F.2d at 694.
\textsuperscript{20} \textit{Id.} at 702.
\textsuperscript{21} \textit{Id.}
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Dow Corning factors resulted in the satisfaction of only one factor. The court determined that the releases were not essential. The court explained that despite an identity of interest between the debtor and its directors and officers, there was no evidence the debtor faced “a strong possibility of suits that would trigger its indemnity obligation, much less that such suits would threaten its reorganization.”

c. Congressional Intent

The United States Court of Appeals for the Seventh Circuit considered congressional intent when assessing whether section 524(e) barred nonconsensual third-party releases. Relying on Congress’s past specificity with limitations on the bankruptcy court, the Seventh Circuit, in In re Airadigm Commc’ns Inc., hypothesized that if Congress intended to include such a limit, “it would have used the mandatory terms “shall” or “will” rather than the definitional term ‘does’” and that “it would have omitted the prepositional phrase ‘on, or ... for, such debt,’ ensuring that the ‘discharge of a debt of the debtor shall not affect the liability of another entity’” – whether related to a debt or not.” Thus, the Seventh Circuit approves of non-debtor releases where the release is necessary to the reorganization plan and appropriately tailored. However, the court wanted to specifically sidestep blanket immunity and keep its view limited to applicable circumstances such as claims arising out of or in connection with the reorganizing itself.

Ultimately the majority view agrees that nonconsensual third-party releases are permissible in limited and appropriate circumstances. However, among the majority view, there is no uniform standard to follow in determining when nonconsensual third-party releases are

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22 Nat’l Heritage Found., Inc., 760 F.3d at 351.
23 Id.
24 Id.
25 519 F.3d 640, 656 (7th Cir. 2008).
26 Id. at 657.
27 Id.
28 See Third-Party Releases in Bankruptcy Plans, Practical Law Practice Note 3-570-7925.
appropriate. The consensus is that it is fact specific and should be determined on a case-by-case analysis. Some general factors these courts consider in evaluating whether to grant third-party releases or injunctions include “whether they are essential to the reorganization, whether the parties being released have made or are making a substantial financial contribution to the reorganization, and whether affected creditors overwhelmingly support the plan.”

B. Minority View

The minority view, held by the United States Courts of Appeals for the Fifth, Ninth, and Tenth Circuits, bans nonconsensual releases on the basis that they are prohibited by section 524(e) of the Bankruptcy Code, which provides generally 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.”

The United States Court of Appeals for the Fifth Circuit has found that bankruptcy courts lack the authority to grant third-party releases on the basis that the releases have consequences not intended by Congress. The Fifth Circuit acknowledges the exception carved into section 524(g) which permits bankruptcy courts to enjoin third-party asbestos claims under certain circumstances. However, the court distinguished between asbestos claim cases and other cases involving mass tort claims. Despite the similarities between asbestos claim cases and mass tort

29 See id.
30 Id.
32 11 U.S.C. § 524(e); See In re Pac. Lumber Co., 584 F.3d 229 (5th Cir. 2009); Resorts Int’l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394 (9th Cir. 1995); In re W. Real Estate Fund, Inc., 922 F.2d 592 (10th Cir. 1990); see also Zacarias v. Stanford Int’l Bank, Ltd., 945 F.3d 883 (5th Cir. 2019) (third parties making substantial contributions to the receiver in the R. Allen Stanford Ponzi scheme are entitled to an order barring creditors from suing on the creditors' claims), petition for rehearing en banc denied, No. 17-11073 (5th Cir. Jan. 21, 2020).
33 See In re Pac. Lumber Co., 584 F.3d at 252 (“We see little equitable about protecting the released non-debtors from negligence suits arising out of the reorganization.”).
claims cases against debtors, the Fifth Circuit does not believe that 524(g) gives the bankruptcy court authority beyond its power to enjoin mass tort claims in asbestos claims cases.

Similarly, the United States Court of Appeals for the Ninth Circuit has repeatedly held, without exception, that a global non-debtor release in a Chapter 11 case violates section 524(e). In In re Lowenschuss, the Ninth Circuit noted that “section 105 does not authorize relief inconsistent with more specific law,” and concluded that “the specific provisions of section 524 displace the court’s equitable powers under section 105 to order the permanent relief [against a non-debtor] sought by [the debtor].”

The United States Court of Appeals for the Tenth Circuit has consistently recognized that section 524(e) precludes the debtor’s injunction from extending to non-debtors. In In re W. Real Estate Fund, Inc., the Tenth Circuit stated that “a bankruptcy court’s supplementary equitable powers [under § 105] may not be exercised in a manner that is inconsistent with other, more specific provisions of the Code.” With its decision the Tenth Circuit explicitly indicated that they were following “the lead” of the Ninth Circuit while adding to its reasoning that “not only does such a permanent injunction improperly insulate non-debtors in violation of section 524(e),” but does so also “without any countervailing justification of debtor protection.”

Conclusion

United States Courts of Appeals have been split on the permissiveness of nonconsensual third-party releases since the 1980s. More recently, the high-profile nature of Purdue Pharma’s

34 See Lowenschuss, 67 F.3d at 1401; Am. Hardwoods, Inc. v. Deutsche Credit Corp. (In re Am. Hardwoods, Inc.), 885 F.2d 621, 626 (9th Cir. 1989); Underhill v. Royal, 769 F.2d 1426, 1432 (9th Cir. 1985).
35 Lowenschuss, 67 F.3d at 1402 (citing Am. Hardwoods, Inc., 885 F.2d at 626).
36 922 F.2d 592, 601 (10th Cir. 1990).
37 Id. at 602.
bankruptcy, and its liability in mass tort cases related to the on-going Opioid Epidemic, has spiked interest and outrage in relation to nonconsensual third-party releases.

In September 2021, the United States Bankruptcy Court in the Southern District of New York, confirmed Purdue Pharma’s reorganization plan which contained third-party releases eliminating claims held by creditors of Purdue directly against its owners, the Sackler family, and other non-debtor entities, including claims arising from alleged willful misconduct and fraud.\(^3^8\) In return, the Sackler family agreed to contribute approximately $4.5 billion to fund charities and certain recoveries under the plan.\(^3^9\) On December 16, 2021, the District Court for the Southern District of New York vacated the bankruptcy court’s confirmation and held that the Bankruptcy Code did not grant the bankruptcy court statutory authority to approve nonconsensual third-party releases in Purdue’s Chapter 11 plan.\(^4^0\) This decision upended the understanding of third-party releases within the United States Court of Appeals for the Second Circuit by calling into question previous decisions from the Second Circuit which had been “widely interpreted as having left open a path in bankruptcy for approval of such releases in ‘rare’ or ‘unique’ circumstances.”\(^4^1\)

Most recently, through mediation as well as approval from the bankruptcy court, the Sacklers and Purdue Pharma reached a deal with a group of states that had long resisted the

\(^3^9\) Id.
company’s bankruptcy plan. Under the new settlement, the Sackler family will get their third-party release and an end to all current and future civil claims against them over the company’s prescription opioid business. In return, the Sacklers will boost their cash contribution to as much as $6 billion. An appeal on the new $6 billion settlement is set to be heard by the Second Circuit Court of Appeals on April 29, 2022. Currently, there is little available information as to what may happen to the new settlement on appeal.

Outside of the judiciary, legislative changes are pending with regards to third-party releases. As a direct result of Purdue Pharma case, Democratic members of the U.S. House and Senate introduced legislation intending to curb such releases. If passed into law, The Nondebtor Release Prohibition Act of 2021, will have significant ramifications in many bankruptcy cases going forward.

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44 See id. (indicating the new legislation would virtually eliminate the use of nonconsensual, non-debtor releases in private claims and those brought by the government); see also Clinton E. Cutler, *Is a Legislative Crackdown Coming on Third Party Releases in Bankruptcy Plans?*, FREDRIKSON & BYRON P.A. (Sept. 24, 2021), https://www.fredlaw.com/the_restructuring_report/is-a-legislative-crackdown-coming-on-third-party-releases-in-bankruptcy-plans/.