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Third-Party Releases?—Not So Fast! Changing Trends and Heightened Scrutiny

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In an effort to provide corporate debtors with a fresh start, free from the grips of suffocating debt and the threat of litigation in connection with their financial troubles, the Bankruptcy Code[1] offers numerous benefits and protections to those who submit to the bankruptcy process. However, as corporate structures have become more complex and corporate scandals more prevalent, legislation aimed at curbing corporate abuses has correspondingly expanded and developed. Additionally, the trend of judicial decisions defining the scope of corporate bankruptcy protections has evolved.

This reevaluation of the scope of available bankruptcy protections is particularly evident in cases where the Bankruptcy Code and federal securities laws[2] intersect. Somewhat challenging is the interplay between these two statutory schemes, one that sets out to provide the "honest but unfortunate debtor"[3] with a fresh financial start, "unhampered by the pressure and discouragement of pre-existing debt,"[4] and the other, which seeks to establish accountability for securities fraud and other corporate malfeasance.[5] In recent times, these two statutory schemes increasingly target the same suspect.[6] At first blush, it seems unlikely that the honest, unfortunate debtor and the securities fraud defendant could be closely intertwined, but corporate scandals including *Enron*, *WorldCom*, *Global Crossing*, and *Adelphia Communications* are cases in point.

When a debtor is concomitantly the subject of both statutory frameworks — in one, seeking relief, and in the other, the accused, a tension is created with respect to liability. The competing policies of relieving a debtor from the pressure of its preexisting liabilities under the Bankruptcy Code on one hand and providing maximum investor recovery for securities fraud violations under the securities laws on the other force a spotlight to shine on the propriety of court-approved releases from liability in chapter 11 plans. These tensions come to a head when Bankruptcy Code provisions are invoked to protect not only corporate debtors and their affiliates, but also their current and former officers and directors who face some form of independent liability relative to the company's downfall.

The trend of corporate bankruptcies increasingly involving securities fraud litigation against the bankrupt[7] has sharpened judicial acuity in evaluating the scope of Bankruptcy Code protections afforded to the ostensibly honest debtor, its debtor affiliates, and most controversially, its non-debtor affiliates. In the wake of the large corporate securities scandals of the early 2000s, bankruptcy courts have begun to reel in the once liberally cast line of authorizing third-party releases in favor of both former and current directors and officers.

Third-Party Releases Defined

The chapter 11 bankruptcy process culminates with the confirmation of a plan — the document that works, in effect, as a contract between the debtor and its stakeholders, setting out the treatment of the debtor's obligations with respect to each class of creditors and interest holders. One of the primary rehabilitative features the Bankruptcy Code provides is the chapter 11 discharge received upon confirmation of the plan — a benefit reserved solely for the debtor that files for chapter 11 protection and reorganizes.

However, situations arise where a debtor attempts to extend releases to certain affiliated non-debtor parties whose participation in or impact on the chapter 11 process will allegedly affect the debtor's ability to reorganize — the "non-debtor" or "third-party" release. A debtor might seek to extend third party releases to co-debtors, officers, directors, lenders, parents, guarantors, sureties, or insurance carriers where those parties could assert post-confirmation indemnification claims against the debtor, or where the non-debtor party is a potential source of funding for the plan of reorganization. Unlike their less controversial counterpart, these non-debtor releases, in essence, seek to allow non-debtors to reap the benefits of the Bankruptcy Code without undertaking the obligations. Cue the third-party release debate.

The judicial discord regarding third-party releases likely stems from statutory conflict with respect to the permissibility of third-party releases and each court's perception of how those conflicting statutes interact. The Bankruptcy Code provides that upon the court's confirmation of the plan, the debtor receives a discharge of all pre-confirmation debt.[8] Further, Bankruptcy Code section 524(e) provides that the "discharge of a debt of a debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."[9] Additionally, under section 105(a),

1 11 U.S.C. §§ 101 – 1330, *et. seq.*

2 The Sarbanes-Oxley Act, Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, Trust Indenture Act of 1939, Investment Company Act of 1940 and Investment Advisers Act of 1940. *See Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

3 *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

4 *Id.*

5 *Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) ("A fundamental purpose, common to [the series of Acts designed to eliminate certain abuses in the securities industry], was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.").

6 Mark S. Beasley et al., *Fraudulent Financial Reporting 1998-2007, Committee of Sponsoring Organization of the Treadway Commission* at 1 (2010), *available at*, http://www.coso.org/documents/ COSOFRAUDSTUDY2010 _001.pdf. ("Companies engaged in fraud often experienced bankruptcy, delisting from a stock exchange, or material asset sales following discovery of fraud – at rates much higher than those experienced by no-fraud firms.").

7 *See supra note 6.*

8 11 U.S.C. § 1141(d)(1).

9 11 U.S.C. § 524(e).

a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title,"[10] but does not allow the bankruptcy court "to create substantive rights that are otherwise unavailable under applicable law."[11]

Facially, section 524(e) appears to create a specific prohibition on discharging non-debtor liabilities. However, the broad equitable powers of the bankruptcy court under section 105(a) present an alternative route that some debtors have taken to evade the apparent prohibition of non-debtor releases under section 524(e). Thus, in cases where a court deems non-debtor releases necessary or appropriate in carrying out a debtor's plan of reorganization, those releases may be permitted under section 105(a). The crux of the debate often turns on how courts perceive the breadth of their section 105(a) equitable powers, and on whether courts interpret the restriction on scope in 524(e) as limiting section 105(a).

Third-party releases come under a court's consideration in various factual contexts that may impact a court's decision to approve the releases at issue. In order to define the focus of this article, and to most efficiently navigate the nuances of judicial opinions on third-party releases, these factual variables must be identified.

The first factual issue relevant to a court's decision on whether to approve the releases is whether the creditor consents to the non-debtor release. If a creditor affirmatively votes in favor of a plan containing third-party releases, or otherwise does not object to the non-debtor's release, such a release is said to be consensual. So long as the release constitutes a binding agreement under basic contract law, most courts take no issue with a consensual third-party release.[12] As such, consensual third-party releases are not within the scope of this analysis. Whether the release is, in fact, consensual is another debate for another article.

The second factual variable of note is whether the claim being released is property of the estate as opposed to a truly direct and independent claim of a creditor. Derivative claims that are property of the debtor's estate include, for example, pre-petition claims for breach of fiduciary duty by officers and/or directors or alter-ego claims[13] asserted by a debtor-in-possession.[14] Since the Bankruptcy Code provides that a plan may provide for the settlement or adjustment of a claim belonging to the debtor or the estate,[15] the issue as to whether derivative claims can be released in a debtor's plan is far less controversial.

Additionally, there is a legal distinction to be made between third-party releases and exculpation provisions. Third-party releases contemplate releases of claims or causes of action held by a non-debtor against another non-debtor, while exculpation provisions encompass releases of claims by both the debtor and non-debtor against professionals and other bankruptcy estate fiduciaries for ostensibly post-petition conduct.[16] Third-party releases offer protection to non-debtors for pre-confirmation liability, whereas exculpation provisions provide estate professionals with qualified immunity covering their reasonable conduct in connection with the bankruptcy case.[17]

Further, even within the particular nonconsensual third-party releases of independent claims that are the focus of this article are releases varying in scope, breadth, and application. For these reasons, generalizations with respect to an analysis of third-party releases is especially perilous and attention to detail is vital in characterizing judicial trends.

Propriety of Third-Party Releases Pre-Enron

The contentious history of third-party releases reaches back nearly thirty years[18] and can generally be attributed to each Circuit's interpretation of the statutory interplay between sections 524(e) and 105(a). In order to evaluate the post-Enron judicial trend towards restrictive interpretation of third-party release law, a survey of each Circuit Court's opinions *pre*-2000 is crucial.

Pre-Enron Courts: Prohibition View of Third-Party Releases

Courts in the Ninth[19] and Tenth[20] Circuits expressed staunch opposition to the allowance of third-party releases since the debate's inception. These courts both held the view that the statutory language of section 524(e) provides a strict prohibition against third party releases — a view that completely removes the court's equitable powers from the equation (the "Prohibition Circuits").

Pre-Enron Courts: Permissive View of Third-Party Releases

The Second,[21] Third,[22] and Fourth[23] Circuits adopted a less restrictive approach — each opining that third-party releases are

[10] 11 U.S.C. § 105(a).

[11] *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142 (2d Cir. 2005).

[12] Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolved the Debate over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 Emory Bankr. Dev. J. 13, 22-25 (2006).

[13] *Steyr-Daimler-Puch of Am. Corp. v. Pappas*, 852 F.2d 132, 136 (4th Cir. 1988) (holding trustee but not creditors could bring an alter ego claim because the claim was property of the estate under Virginia law). Note that the status of an alter ego claim may vary depending upon state law with respect to whether a claim is property of the estate.

[14] Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolved the Debate over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 Emory Bankr. Dev. J. 13, 26-28 (2006).

[15] 11 U.S.C. § 1123(b).

[16] *See In re Exide Technologies*, 303 B.R. 48, 71-75 (Bankr. D. Del. 2003).

[17] 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 at 2 (September 2001).

[18] *Compare Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) ("[T]he bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan"), with *Kane v. Johns-Manville Corp*. (*In re Johns-Manville Corp.*), 843 F.2d 636, 640, 649 (2d Cir. 1988) (allowing third party- releases).

[19] *In re Am. Hardwoods, Inc.*, 885 F.2d 621, 626 (9th Cir. 1989) (holding "[s] ection 524(e), therefore, limits the court's equitable power under section 105 to order the discharge of the liabilities of nondebtors"); *Resorts Int'l, Inc. v. Lowenschuss* (*In re Lowenschuss*), 67 F.3d 1394, 1401 (9th Cir. 1995) ("This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors."); *Underhill v. Royal,* 769 F.2d 1426, 1432 (9th Cir. 1985) ("[T]he bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan.").

[20] *Landsing Diversified Props.-II v. First Nat'l Bank and Trust Co. of Tulsa* (*In re W. Real Estate Fund, Inc.*), 922 F.2d 592, 600–02 (10th Cir. 1990) (discussing section 523 policy, concluding "[o]bviously, it is the debtor, who has invoked and submitted to the bankruptcy process, that is entitled to its protections; Congress did not intend to extend such benefits to third-party bystanders").

[21] *See Securities and Exchange Commission v. Drexel Burnham Lambert Group, Inc.* (*In re Drexel Burnham Lambert Group, Inc.*), 960 F.2d 285, 293 (2d Cir. 1992); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 93 (2d Cir. 1988) ("Additional authority for the injunction is to be found in section 105(a) of the Bankruptcy Code, which permits the Bankruptcy Court to 'issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.'").

[22] *In re Cont'l Airlines*, 203 F.3d 203, 214 (3d Cir. 2000).

[23] *See Menard-Sanford v. Mabey* (*In re A.H. Robins Co.*), 880 F.2d 694, 701-02 (4th Cir.1989) (approving third-party release under 11 U.S.C. § 105(a)).

permissible, at least under certain circumstances (the "Permissive Circuits").

Second Circuit

In *In re Johns-Manville Corporation*,[24] the debtor asbestos manufacturing company entered into settlements with certain of its insurers that provided for the release of all claims against those insurers in exchange for a cash contribution that would become the "cornerstone" of the debtor's plan of reorganization.[25] The plaintiff — a distributor of the debtor's asbestos products and a coinsured under the debtor's insurance policy — argued the release constituted an improper discharge of the insurers.[26]

The Second Circuit held the release of plaintiff's claims against the debtor's insurers was permissible because (i) it did not provide the "umbrella protection of a discharge in bankruptcy;" (ii) it only precluded claims against the settling insurers that arose from or were related to the debtor's insurance policies; and (iii) the plaintiff's claim was not released, but "simply channeled away from the insurers and redirected at the proceeds of the settlement."[27] The Second Circuit's ruling focuses on the narrow application of the releases (only to settling insurers) and the availability of a mechanism for creditor recovery beyond the plan.

In *In re Drexel Burnham Lambert Group, Incorporated*,[28] the Second Circuit approved a release that enjoined any future actions by a class of securities claimants against the debtors' directors and officers in exchange for (i) the debtors' completion of its $350 million payment in connection with a pre-bankruptcy settlement of a Securities and Exchange Commission ("SEC") civil enforcement action; and (ii) a $1.3 billion "pooled recovery" that would be realized as a result of a district-court-approved global settlement of claims against the debtors' directors and officers.[29]

The Second Circuit's paragraph-long analysis of the propriety of the third party-release included a conclusory determination it was an "essential element" of the debtors' plan because "without the injunction, the directors and officers would be less likely to settle."[30] The court's analysis omitted any reference to the fact that the claims against the debtors outnumbered the assets of the estates by tenfold,[31] and thus, a full recovery for creditors was not feasible even taking into account the "essential" concessions offered to obtain the releases. Most importantly, the release was not opposed by the representative of the class of securities fraud claimants.

Fourth Circuit

In *A.H. Robins Company, Incorporated*,[32] the court upheld a non-debtor release that enjoined certain mass tort plaintiffs' claims against the debtor's directors, the debtor's attorneys, the debtor's insurer (Aetna),[33] and Aetna's attorneys. The Fourth Circuit explained the release was permissible because (i) it was essential to the plan since without the releases, the debtor faced potential exposure for future indemnification claims; and (ii) the mass tort claimants would be fully compensated through a claims resolution trust provided for in the plan; and (iii) 94.38% of claimants voted to accept the plan.[34]

Significantly, and illustrative of the then existing judicial attitude toward third-party releases, the court's reasoning assumes that the *capped* estimate of unliquidated and even future claims was sufficient to cover the claimants' damages. The court offered a single analysis for all the releasees, and failed to distinguish between those contributing to the plan and those offering no contribution. Additionally, the court approved the third-party releases in favor of the debtor's noncontributing directors.[35]

Third Circuit

In *In re Continental Airlines*,[36] the Third Circuit refused to issue a bright-line ruling on the propriety of third-party releases, explaining that such a decision was unnecessary to the court's ultimate opinion.[37] However, the court made favorable reference to the Second and Fourth Circuit rulings in *Manville, Drexel*, and *A.H. Robins,* and implied that had the bankruptcy court below made specific findings that the releases were fair and necessary to the debtors' plan of reorganization, the releases might have been permissible.[38] Thus, while the Third Circuit did not expressly rule that section 105(a) allows for the approval of non-debtor releases, the Third Circuit did not adopt the prohibition view, and fell directly in line with the Permissive Circuits.

Subsequently, the District of New Jersey solidified the Third Circuit's alignment with the views of *Manville, Drexel*, and *A.H. Robins* in *In re American Family Enterprises*.[39] The court upheld a release covering a laundry list[40] of parties based on the contribution of one party, explaining "this court must determine only that sufficient compensation is being paid to the class, and need not speculate as to the appropriate contribution of each defendant. The release of noncontributing defendants through a settlement agreement is no

24 *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 90 (2d Cir. 1988).

25 *Id.*

26 It should be noted that although the released claim in *Manville* arguably borders the line between a direct and derivative claim, courts and commentators alike have hesitated to categorize the claim as derivative. *See* Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolved the Debate over Non-Debtor Releases in Chapter 11 Reorganizations,* 23 Emory Bankr. Dev. J. 13, 55 n. 238 (2006).

27 *Johns-Manville Corp.*, 837 F.2d at 91.

28 *In re Drexel Burnham Lambert Group, Inc.* 960 F.2d 285, 293 (2d Cir. 1992).

29 *Id.* at 289 n. 2.

30 *Id. at 293.*

31 *In re Drexel Burnham Lambert Grp., Inc.*, 130 B.R. 910, 914 (S.D.N.Y. 1991) *aff'd*, 960 F.2d 285 (2d Cir. 1992).

32 *In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir.1989).

33 The releases in favor of Aetna do not concern derivative claims because the claimants sought recovery in tort. *Id.* at 700-01.

34 *Id.* at 700-02.

35 *See In re A.H. Robins Co., Inc.*, 88 B.R. 742, 751 (E.D. Va. 1988) *aff'd*, 880 F.2d 694 (4th Cir. 1989) (noting that contributions from the Robins family and Aetna provided adequate consideration for the releases).

36 203 F.3d 203, 214 (3d Cir. 2000).

37 *In re Cont'l Airlines*, 203 F.3d 203, 214 (3d Cir. 2000) ("Given the manner in which the issue has been presented to us, we need not establish our own rule regarding the conditions under which non-debtor releases and permanent injunctions are appropriate or permissible. Establishing a rule would provide guidance prospectively, but would be ill-advised when we can rule on Plaintiffs' appeal without doing so.").

38 *In re Cont'l Airlines*, 203 F.3d 203, 215 (3d Cir. 2000) ("Unlike in cases such as *Manville, Drexel*, and *Robins*, we have found no evidence that the non-debtor D&Os provided a critical financial contribution to the [debtors'] plan that was necessary to make the plan feasible in exchange for receiving a release of liability for Plaintiffs' claims."); *Id.* at 214 (explaining that because the bankruptcy court never addressed the release, the order confirming the plan "was not accompanied by any findings that the release was fair to the Plaintiffs and necessary to the [debtors'] reorganization").

39 While this release was technically decided in the settlement context, the funding agreement releasing the parties was "the essential vehicle by which the Debtors c[ould] obtain the funds needed to perform their monetary obligations under the Plan" and is thus substantially similar to the plan context. *In re Am. Family Enters.*, 256 B.R. 377, 390 (D.N.J. 2000).

40 "Released Persons" was defined as "[all the defendants, their affiliates,] the past, present and future officers, directors, partners, shareholders, members, employees, agents, trustees, legal representatives, insurers and attorneys of all of the foregoing; and the heirs, executors, administrators, successors and assigns of all of the foregoing." *Am. Family Enters.*, 256 B.R. at 431.

reason for disapproving the compromise."[41] The court added that "such injunctions and releases are customary and ordinary in large Chapter 11 cases."[42]

Circuits Offering Additional Guidance

Prior to the early 2000s, the First,[43] Fifth,[44] Seventh,[45] Eleventh,[46] and D.C.[47] Circuits did not address the distinct issue of whether to approve a nonconsensual third-party release of an independent claim in a plan of confirmation. The Sixth and Eighth Circuits did not issue any opinions sufficiently on topic.

Of the additional decisions, only the Court of Appeals for the District of Columbia offered an opinion that expressed a somewhat-restrictive analysis of the propriety of third-party releases. The court held a plan provision which required one creditor to release a direct claim (where all other creditors released derivative claims) against third parties funding the debtor's plan in order to participate in the fund did not constitute the equal treatment of creditors required for purposes of plan confirmation.[48] The opinion suggests a need for proportional contribution by proposed releasees.

The other Circuit courts offered decisions substantially in line with the permissive rulings of the Second, Third, and Fourth Circuits. Specifically, the First Circuit decision offers clear guidance with respect to the views of the Circuit. In *Monarch Life Insurance Company*,[49] the First Circuit upheld a permanent injunction in a plan of reorganization based on promissory estoppel principles because the plaintiff failed to challenge the confirmation order. In determining whether the release issue had been actually litigated for promissory estoppel purposes, the First Circuit explained "the bankruptcy court plainly signaled its endorsement of the Plan proponents' request for a broad injunction extending 'incidental' protection to all noncontributors who might otherwise implead Plan contributors as third-party defendants in subsequent state court actions."[50] While the First Circuit did not address the issue head-on, the court's broad interpretation of the propriety of even incidental third-party releases is evident.

41 *Am. Family Enters.*, 256 B.R. at 428. (citation omitted).
42 *Am. Family Enters.*, 256 B.R. at 406.
43 *Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973, 985 (1st Cir. 1995).
44 *See Feld v. Zale Corp.* (*In re Zale Corp.*), 62 F.3d 746, 760 (5th Cir. 1995) (in the context of a settlement, reversing approval of settlement between debtor, the debtor's directors and officers, and the creditors' committee that permanently enjoined a variety of existing and potential claims against the settling defendants on the ground that the injunction impermissibly discharged non-debtor liabilities).
45 *Matter of Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1049 (7th Cir. 1993) (appeal of confirmation order containing third-party releases equitably moot for substantial consummation).
46 *See Matter of Munford, Inc.*, 97 F.3d 449, 455 (11th Cir. 1996) (in the context of a settlement, affirming a district court's ruling that section 105 authorized a bankruptcy court to permanently enjoin nonsettling defendants from asserting contribution and indemnification claims against a defendant consulting firm when the permanent injunction was integral to the debtor's settlement with the consulting firm and the bar order was fair and equitable).
47 *See In re AOV Indus., Inc.*, 792 F.2d 1140, 1154 (D.C. Cir. 1986) (holding a plan provision releasing the liabilities of non-debtors was unfair because the plan did not provide additional compensation to a creditor whose direct claim against non-debtor was being released, where other creditors' claims were derivative).
48 *See AOV Indus.*, 792 F.2d at 1151-54.
49 *Monarch Life Ins.*, 65 F.3d at 985.
50 *Id.* at 982.

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Enron's Collapse and the Sarbanes-Oxley Act

The collapse of Enron in the fall of 2001 shed light on the corporation's institutionalized, methodical accounting fraud and deceptive business practices. Enron senior management was hit with a plethora of federal charges including conspiracy to commit securities and wire fraud, securities fraud, wire fraud, making false statements to auditors, insider trading, and bank fraud.[51] Former Enron Chief Executive Officer Jeffrey Skilling faced thirty-five criminal securities fraud charges stemming from his misrepresentation of company financials, which included concealing Enron's debt and inflating its profits.[52]

Disclosures throughout Enron's high-profile bankruptcy proceedings led to federal indictments for Enron auditor Arthur Anderson, LLP,[53] which snowballed into "revelations of accounting fraud and insider self-dealing at several large corporations, nearly all of which were thereafter pushed into bankruptcy: Adelphia Communications, Global Crossing, Tyco International, and WorldCom."[54]

51 *Breakdown of the Charges Against Enron's Top Officers*, N.Y. Times, Jan. 18, 2006, at 1-2.
52 *Id.*
53 Ken Brown and Ianthe Jeanne Dugan, *Arthur Andersen's Fall From Grace Is a Sad Tale of Greed and Miscues*, Wall St. J., June 7, 2002, *available at* http://www.wsj.com/articles/SB1023409436545200.
54 Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521, 1545 (2005).

Along with the demise of these mega-corporations came widespread financial devastation and uncertainty for investors, employees, and the American public at large. Consequentially, the Gallup Public Opinion Poll measuring confidence in big business between 1990 and 2003 shows the percentage of the public that had "either a great deal or quite a lot of confidence in big business in 2002 — 20% — was the lowest percentage in more than a decade and represented a substantial drop from the relatively high level of confidence — an average of 29% — over the prior five years, 1997 to 2001."[55]

The Sarbanes-Oxley ("SOX") Act of 2002 reflects the legislative reaction to the corporate governance issues exposed by the corporate scandals of the early 2000s. Whereas traditional federal securities law focused predominantly on disclosure requirements and misrepresentations or omissions, SOX marked the federal legislature's transition to regulation through substantive corporate mandates.[56] SOX's new legislation added provisions requiring the independence of corporate auditors, forbidding corporate loans to officers, mandating management certification of corporate financial statements, and applying penalties for executives' misrepresentation in financial statements.[57] One particularly telling reform is SOX's contribution to the Bankruptcy Code's section on exceptions to discharge. Under 11 U.S.C. § 523(a)(19), an individual debtor is prohibited from receiving a discharge of any debt for violation of federal or state securities laws and their related regulations resulting from any pre- *or* post-petition judgment, consent order, decree, settlement or similar penalty.[58]

SOX is a product of the implosion of widespread corruption schemes fueled by the malfeasance of corporate senior management. Significantly, the statute embodies the congressional view that securities law reform was essential to bulk-up corporate governance and curb the financial abuses made evident when the conduct of corporate directors and officers was exposed in the early 2000s. While the judicial branch lacks the institutional ability to enact such sweeping and clearly-intentioned rules of law, post-Enron jurisprudence illustrates a strong attempt by the judiciary to ensure the liabilities of a debtor's senior management are not so readily forgiven through a chapter 11 plan.

Post-Enron Courts Apply Heightened Scrutiny to Third-Party Releases

Today, the discord among Circuit Courts can still be attributed to each Circuit's perspective on the statutory interplay between section 524(e) and section 105(a). For clarity's sake, the changing trend of the courts has not manifested itself in a departure from these general overarching legal principles or from the precedent interpreting statutory authority (i.e. a switch from the Permissive to Prohibition view). Rather, the trend is illustrated more subtly — in the judicial gloss of the increasingly restrictive application of the fluid standards within the Permissive Circuits.

For this reason, a detailed focus on the facts of opinions from Prohibition Circuits is unnecessary. The Prohibition Circuits read section 524(e) as a limitation on section 105(a), and thus, cannot (except in extraordinary circumstances) approve third-party releases consistent with the principle of *stare decisis*. Therefore, the analysis of the trend toward the increasingly restrictive judicial view of third-party releases is focused predominantly on the Permissive Circuits, where judges exercise discretion in applying subjective balancing tests. The Permissive Circuits are governed by the subjective, equitable balancing tests from which the judiciary's true objectives can be gleaned.

Post-Enron Courts: Prohibition Circuits

During the post-Enron period, the Fifth Circuit[59] has joined the ranks of the Ninth and Tenth Circuits, which hold the minority view that the statutory language of section 524(e) provides a strict prohibition against third party releases. While the Fifth Circuit's ruling is not a departure from prior precedent to the contrary, the decision to side with the minority Prohibition Circuits with respect to a matter of first impression is illustrative of the judicial climate following the corporate scandals of the early 2000s.

Post-Enron Courts: Permissive Circuits

Courts in the Second,[60] Third,[61] Fourth,[62] Sixth,[63] Seventh,[64] and Eleventh[65] Circuits consistently agree that section 524(e) is not an explicit limitation on the courts' section 105(a) equitable powers. The post-2000 division between Prohibition and Permissive Circuits clearly does not mark a significant change in third-party release precedent. However, a focus on the courts' application of the standards illustrates the movement of the Permissive Circuits towards a more restrictive view.

Sixth Circuit

In *Dow Corning Corporation*,[66] the Sixth Circuit enumerated seven elements for courts to consider in determining whether to approve third-party releases. These include whether: (1) there is an identity of interests between the debtor and the third party; (ii) the non-debtor has contributed substantial assets to the reorganization; (iii) the injunction is essential to reorganization; (iv) the impacted class, or classes, has overwhelmingly voted to accept the plan; (v) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (vi) the plan provides an opportunity for those claimants who choose not to settle to recover in full; and (vii) the bankruptcy court made specific factual findings.[67] When viewed collectively, the consideration of these factors begins to approach the concept of a consensual release.

Although the *Dow Corning* decision does not mark a 180-degree departure from a broader pre-2000 Sixth Circuit decision, it does reverse a pre-2000 Eastern District of Michigan decision approving the releases.[68] The essence of the court's decision is that third-party releases constitute extraordinary relief only available in unique circumstances which require specific explanations and detailed evidence in support of the findings. The Sixth Circuit

55 *Id.* at 1524 n. 7.
56 *Id.* at 1523.
57 *Id.* at 1527.
58 11 U.S.C. § 523(a)(19).

59 *In re Pac. Lumber Co.*, 584 F.3d 229, 253 (5th Cir. 2009); *see also In re Vitro S.A.B. DE C.V.*, 701 F.3d 1031, 1061 (2012) (noting prior Fifth Circuit precedent "seem[s] broadly to foreclose non-consensual non-debtor releases in permanent injunctions").
60 *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005) (determining that 11 U.S.C. § 105(a) permits courts to approve third-party releases in "unique" circumstances).
61 *In re Washington Mut., Inc.*, 442 B.R. 314, 352 (D. Del. 2011).
62 *Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344 (4th Cir. 2014) cert. denied, 135 S. Ct. 961, 190 L. Ed. 2d 833 (2015).
63 *In re Dow Corning Corp.*, 280 F.3d 648, 657-58 (6th Cir. 2002).
64 *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 656 (7th Cir. 2008) ("In any event, § 524(e) does not purport to limit the bankruptcy court's powers to release a non-debtor from a creditor's claims.").
65 *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070, 1078 (11th Cir. 2015).
66 *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002).
67 *Id.* at 658.
68 *See generally, In re Dow Corning Corp.*, 255 B.R. 445, 459 (E.D. Mich. 2000) *aff'd and remanded*, 280 F.3d 648 (6th Cir. 2002).

held the third-party releases were impermissible because the "bankruptcy court provided no explanation or discussion of the evidence underlying these findings. Moreover, the findings did not discuss the facts as they related specifically to the various released parties, but merely made sweeping statements as to all released parties collectively."[69]

The sentiment expressed by the Sixth Circuit in denouncing the use of conclusory statements, mandating specific evidentiary findings, and requiring separate analyses of individual releasees set the stage for the expectations of subsequent post-2000 third-party release decisions across the Circuits.

Second Circuit

The Second Circuit's favorable disposition toward broad third-party releases as established in *Johns-Manville* in 1988 began to recede with its subsequent opinion in *In re Metromedia Fiber Network, Incorporated*.[70] In *Metromedia*, the Second Circuit held the bankruptcy court's findings were insufficient to support the validity of the plan's nonconsensual non-debtor release, but dismissed the appeal of the releases as equitably moot, in order to avoid disturbing the plan of reorganization that had already been implemented.[71] Notwithstanding the procedural disposition, the opinion evidences the Second Circuit's movement towards accepting the *Dow Corning* factors and requiring specific factual findings and detailed evidence supporting the propriety of the releases.

Here, a trust established by insiders of the debtors offered to (i) convert $15.7 million in secured claims to equity in the reorganized debtors; (ii) forgive unsecured claims against the debtors in the amount of $150 million; (iii) invest $12.1 million in the reorganized debtors; and (iv) purchase $25 million of unsold common stock in the reorganized debtors' stock offering (the "Trust Contribution").[72] In return for the Trust Contribution, the trust and certain non-debtor insiders would receive 10.8% common stock in the reorganized debtors and obtain a broad release from "any holder of a claim of any nature . . . any and all claims, obligations, rights, causes of action and liabilities arising out of or in connection with any matter related to [the debtors] . . . based in whole or in part upon any act or omission or transaction taking place on or before the Effective Date."[73]

In evaluating whether the third-party releases were permissible, the court expressed significant hesitance regarding non-debtor releases noting "a nondebtor release is a device that lends itself to abuse . . . . In form, it is a release; in effect, it may operate as a bankruptcy discharge arranged without a filing and without the safeguards of the Code."[74]

The court emphasized that the releases protected against any debtor-related claims "whether for tort, fraud, contract, violations of federal or state securities laws, or otherwise, whether known or unknown, foreseen or unforeseen, liquidated or unliquidated, fixed or contingent, matured or unmatured."[75] The Second Circuit pointed out the District Court's failure to inquire whether such broad releases, including a discharge for noncontributing parties, were actually necessary to the plan. The court went on to note that the lower court's only justification for granting the third-party releases was that the Trust Contribution was a "material contribution" to the estate.[76] A finding that the non-debtors provided a material contribution, the *Metromedia* Court held, was insufficient to satisfy the standard set out in *Drexel*, which requires a finding that the release itself was important to the plan.[77]

While the *Metromedia* Court cited to *Drexel* in finding the releases were impermissible, it plainly engaged in a restrictive application of *Drexel's* "importance" requirement. It would take no stretch of the judicial imagination to find a "material contribution" constitutes an important one.[78] The Second Circuit took issue with the lower court's conclusory statements regarding the propriety of the releases, and effectively decided that releases must be supported by specific details about necessity and importance. The rejection of the third-party releases for want of specificity is simply not a sentiment that can be ascribed to the *Drexel* opinion. [79]

Third Circuit

In direct contravention of the 2000 decision in *In re American Family Enterprises*, the *Washington Mutual* Court denied a third-party release in favor of noncontributing directors and officers. The court provided a separate analysis for each group of similarly situated non-debtors, explaining that a specific analysis of the breadth of the non-debtor releases is necessary, both with respect to the parties and the claims being released. The Court applied the *Master Mortgage* factors,[80] noting first that a director or officer's potential indemnification claim against a debtor is simply an insufficient ground for a release, and that to hold otherwise would, in effect, "justify releases of directors and officers in every bankruptcy case."[81] Next, the court discredited the debtors' assertion that the plan was overwhelmingly accepted by creditors, noting that the fact that creditors would be receiving payment in full was irrelevant to the analysis concerning directors and officers because they made no contribution.[82]

The *Washington Mutual* Court's departure from prior decisions within the Third Circuit favoring incidental releases for noncontributing parties illustrates the heightened judicial awareness of the serious issues with respect to releasing a debtor's senior management without engaging in a complete analysis of the value of each party's contributions to the plan. It is noteworthy that significant securities litigation against Washington Mutual directors and officers was pending during the chapter 11 case.

69 *Id.*

70 *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005).

71 *Id.* at 144.

72 *Id.* 141.

73 *Id.*

74 *Id.* at 142.

75 *Id.*

76 *Id.* at 143.

77 *Id.*

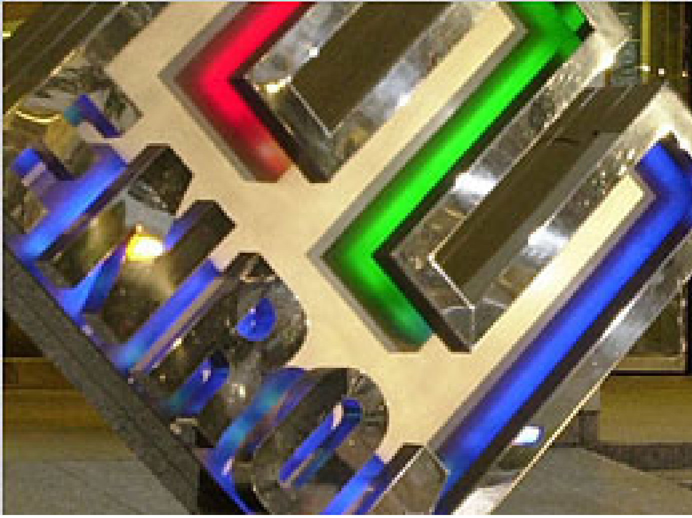
78 *See* Black's Law Dictionary (10th ed. 2014) (defining "material" (in the context of a material fact) as one that is significant or essential to the issue or matter at hand; esp., a fact that makes a difference in the result to be reached in a given case").

79 *See supra* Section III. B. 1.

80 In *In re Master Mortgage Inv. Fund, Inc.*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994), the court cited to several courts that embraced the permissive view of third-party releases, including *A.H. Robins* and *Manville*, and pulled together several factors considered by those courts. The five non-exhaustive *Master Mortgage* factors include whether: (1) there is an identity of interest 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 assets of the estate; (2) the non-debtor has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization. Without it, there is little likelihood of success; (4) a substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has "overwhelmingly" voted to accept the proposed plan treatment; (5) the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction. *Master Mortgage*, 168 B.R. at 935.

81 *In re Washington Mut., Inc.*, 442 B.R. 314, 349 (Bankr. D. Del. 2011).

82 *Id.* at 350.



Significantly, other post-Enron cases within the Third Circuit denied third-party releases for similar reasons.[83] Recent cases from the Third Circuit also confirm the continued application of increasingly tight standards for approving third-party releases: "the plan's proponent must demonstrate that there is a relationship between the debtors' successful reorganization and the non-consensual parties' release, and that the releasees have provided a critical financial contribution to the debtors' plan that is necessary to make the plan feasible in exchange for receiving a release of liability."[84]

Fourth Circuit

In 2014, the Fourth Circuit issued an opinion that marked a substantially narrow interpretation of the third-party release standards set out by prior Fourth Circuit precedent in *A.H. Robins*.[85] The *National Heritage* Court denied third-party releases that would enjoin claims against the debtor's directors and officers where application of the Sixth Circuit's *Dow Corning* factors[86] resulted in the satisfaction of only one factor. The court held (i) the releasees made no substantial financial contribution as continuing to perform debtor-related duties was not a relevant contribution; (ii) the releases were not essential because there was no evidence the plan was "doomed" without them; (iii) the creditors' support of the plan was questionable because the class most affected by the releases was ineligible to vote; (iv) the plan provided no mechanism to pay for the classes affected by the release; and (v) there was no opportunity for non-settling parties to recover in full.[87]

The Fourth Circuit's analysis, specifically with respect to factor (ii) above plainly demonstrates its disfavor for third-party releases. The court explained that although there was 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."[88] Thus, the releases were not essential. The court did not elaborate on its evaluation of risk with respect to the potential future litigation, other than noting the debtor did not provide sufficient evidence of further litigation.

Seventh Circuit

The Seventh Circuit's 2008 decision in *Airadigm*, which approved the release at issue in that case, may be misunderstood as an outlier with respect to the trend toward limiting third-party releases.[89] However, upon closer review, it is important to note that the release approved by the *Airadigm* Court was actually an exculpation clause. As mentioned *supra* section II, exculpation clauses are generally far narrower in both the type of actions released and the subject matter of the releases.[90] Also notable is that the third-party seeking the benefits of the exculpation clause contributed approximately $221 million towards the debtor's plan.

Eleventh Circuit

This year, the Eleventh Circuit confirmed a plan of reorganization containing third-party releases in favor of former principals of the debtor who would act as key employees of the reorganized debtor.[91] The releases were approved even though the only contribution offered by the principals was their labor.[92] Significantly, the language of the opinion suggests the judge's ruling was a product of his complete exasperation with the litigation at hand: "[t]his case has been a death struggle, and the non-debtor releases are a valid tool to halt the fight."[93] The *Seaside Engineering* decision represents an outlier with respect to the trend toward strict judicial application of third-party release tests, for reasons seemingly admitted within the opinion.

Conclusion

The group of pre-Enron opinions on third-party releases is comprised of only two Circuits holding the prohibitive view — the most restrictive view of third-party releases. Further, the opinions authored by Permissive Circuits illustrate a strong inclination toward approving third-party releases with remarkably

[83] *In re 710 Long Ridge Rd. Operating Co., II, LLC*, No. 13-13653 (DHS), 2014 WL 886433, at *18 (Bankr. D.N.J. Mar. 5, 2014) ("Simply put, the record is devoid of proof the individuals seeking to be released have made a necessary contribution toward funding the Plan and, even under the extreme circumstances of this case, without such demonstration, the proposed releases to managers, director, officers, or employees is not warranted and cannot be approved."); *In re Lower Bucks Hosp.*, 488 B.R. 303, 325 (E.D. Pa. 2013) *aff'd*, 571 F. App'x 139 (3d Cir. 2014 (third-party release disallowed with respect to noncontributing releasee); *In re Coram Healthcare Corp.*, 315 B.R. 321, 336 (D. Del. 2004).

[84] *In re Lower Bucks Hosp.*, 488 B.R. 303, 323 (E.D. Pa. 2013) *aff'd*, 571 F. App'x 139 (3d Cir. 2014) ((quoting *In re Nickels Midway Pier, LLC*, No. 03–49462, 2010 WL 2034542, at *13 (Bankr. D.N.J. May 21, 2010) (quoting *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 608 (Bankr. D. Del. 2001)); *see also In re Combustion Eng'g, Inc.*, 391 F.3d 190, 236-37 (3d Cir. 2004), *as amended* (Feb. 23, 2005) (vacating a section 105(a) injunction of independent claims against non-debtor parties noting "the general powers of § 105(a) cannot be used to achieve a result not contemplated by the more specific provisions of § 524(g) [the subsection of § 524(g) which specifically allows third-party releases of parties co-liable with the debtor for derivative asbestos-related claims]).

[85] *Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 351 (4th Cir. 2014) *cert. denied*, 135 S. Ct. 961, 190 L. Ed. 2d 833 (2015).

[86] The court seems to have omitted the seventh factor concerning the specificity of the bankruptcy court's findings.

[87] *Nat'l Heritage Found.*, 760 F.3d at, 348-51 (4th Cir. 2014).

[88] *Id.* at 351.

[89] *See Circuits Differ on Nonconsensual Nondebtor Releases*, 49 No. 17 Bankr. Ct. Dec. News 3, April 1, 2008 (classifying the releases as "third-party releases" and not exculpation provisions; Brief of National Labor Relations Board at 20 n. 18, *In re 710 Long Ridge Road Operating Company II, LLC, et al.*, No. 13-13653 (D.N.J. March 5, 2014) ECF No. 854 (while the NLRB did classify the exculpation correctly, it did not point out the significance in the distinction between exculpation provisions and third-party releases).

[90] *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 657 (7th Cir. 2008) ("First, the limitation itself is narrow: it applies only to claims arising out of or in connection with the reorganization itself and does not include willful misconduct. This is not blanket immunity for all times, all transgressions, and all omissions. Nor does the immunity affect matters beyond the jurisdiction of the bankruptcy court or unrelated to the reorganization itself.") (internal citations and quotations omitted).

[91] *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070, 1079 (11th Cir. 2015).

[92] *Id.* at 1080.

[93] *Id.* at 1081.

broad injunctive language. Courts deciding the *A.H. Robins*, *In re American Family Enterprises*, and *Monarch Life Insurance Company* cases approved third-party releases in favor of parties who offered no plan contribution in return. Moreover, pre-Enron courts applied no specific judicial standard, and in most cases, briefly addressed the importance of the releases to reorganization. The propriety of the third-party releases in most cases was evaluated through a collective analysis of all releasees, despite extreme differences in circumstances among the parties. The courts' conclusions did not require any actual evidentiary record for the necessity of third-party releases.

Post-Enron, the Fifth Circuit joined the ranks of the Prohibition Circuits, notwithstanding that the prohibition view is the minority in the circuit split. Starting with the Sixth Circuit's bold expression of disapproval toward conclusory opinions supporting third-party releases, the Permissive Circuits have established a pattern of applying heightened judicial scrutiny and rigorous standards, often referring to non-debtor releases as extraordinary relief. The most cited post-Enron circuit court rulings on third-party releases include thoughtful analyses which reference specific factual evidentiary findings, and include separate evaluations of individual releasees not similarly situated.

Significantly, SOX reform prohibiting an individual debtor from a discharge of his securities-fraud-related debts endorses even further the sentiment that the Bankruptcy Code should not permit third-party releases in favor of non-debtors — and especially corporate directors and officers — without a thorough analysis supported by evidentiary proof that illustrates the propriety of the releases. It is, indeed, difficult to square circumstances where an officer or director can obtain relief in a chapter 11 context involving his employer but is not eligible for such relief in his own bankruptcy proceeding. Numerous other recently proposed reforms have put a spotlight on the need to retract the judicial extension of Bankruptcy Code benefits to parties undeserving of such protection.

For example, the ABI Commission Report released in December 2014 proposes that nonconsensual third-party releases be deemed enforceable, subject to the balancing of five factors — all of which were seen and analyzed at great length by post-Enron courts. The five factors proposed by the ABI Commission include: (i) the identity of interests between the debtor and the third party, (ii) the value contributed by the third party; (iii) the necessity of the release to facilitating the plan of reorganization; (iv) creditor support for the plan; and (v) the payments and protections otherwise available to creditors affected by the release.[94] The Commission's suggested mandate, if adopted, ensures a departure from conclusory opinions and broad allowance of third-party releases.

Emerging from the remaining uncertainty of judicial precedent that comprises the law of third-party releases is one certainty. The post-Enron judiciary has begun to establish a trend toward limiting broad third-party releases, except under unique circumstances or precluding them altogether, especially in favor of a corporate debtor's directors and officers. Whether a work of the judicial subconscious or a response stemming from a renewed or heightened awareness; the pendulum has swung in the wake of the massive corporate malfeasance unearthed in the early 2000s.

[94] Jay M. Goffman, et al., *Overview of the ABI Commission Report and Recommendation on the Reform of Chapter 11 of the Bankruptcy Code*, December 23, 2014, at 11.

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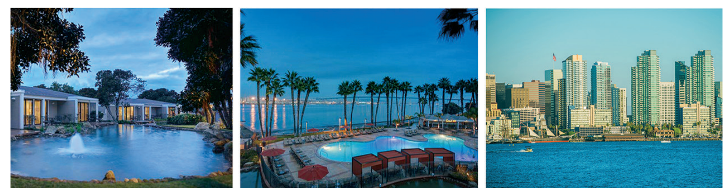

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