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Fourth Circuit Declines to Adopt Blanket Rule against Nonconsensual Nondebtor Releases

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A three-judge panel of the Fourth Circuit recently held that although bankruptcy courts may authorize nonconsensual nondebtor releases under appropriate facts and circumstances, bankruptcy courts must make specific factual findings and explain why such findings support the releases.[1]

Bankruptcy Court Proceedings


Jason W. Harbour

National Heritage Foundation (NHF), the debtor, is a nonprofit public charity that administers and maintains Donor-Advised Funds. NHF filed for bankruptcy protection in 2009 after a Texas state court entered judgment against it in an amount in excess of $6 million and a subsequent turnover order, which resulted in a freeze on NHF's operating account.[2]

NHF's proposed reorganization plan included a broad, nonconsensual third-party release, indemnification and exculpation provisions (the "third-party releases").[3] The third-party releases generally applied to the debtor, the committee, members of the committee, officers, directors and professionals. The plan released those parties from claims arising before and through the effective date of the plan, and related to or arising out of the operation of the debtor's business or the chapter 11 case. The released parties made no monetary contribution toward plan distributions, and the plan contained no opt-in or opt-out provisions.[4]

Certain creditors and the U.S. Trustee[5] objected to the proposed plan, arguing, among other things, that nondebtor releases are prohibited by § 524(e), and that there were not sufficiently unique circumstances to justify the third-party releases.[6] The impaired claimants voted overwhelmingly in favor of the plan.[7] Certain objecting parties, including the Berhmanns[8] (the appellants), were classified as unimpaired and therefore were not entitled to vote.

The debtor argued that the third-party releases were appropriate because, among other things, (1) the plan proposed to satisfy all allowed claims in full shortly after the effective date, (2) the debtor provided appropriate notice, (3) there was a close connection between the debtor and the released parties and (4) claims against the released parties subject to the third-party releases could have been asserted against the debtor.[9] The debtor also argued that the third-party releases were essential to avoid indemnification claims of officers and directors that could threaten the ability of the reorganized debtor to effectively resume its charitable operations.[10] The bankruptcy court approved the plan, including the proposed third-party releases.[11]

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District Court Proceedings

The appellants argued to the district court that the plan was unconfirmable under § 1129(a)(1) because the third-party releases are inconsistent with § 524(e) of the Bankruptcy Code.[12] In support of their argument, the appellants distinguished the *A.H. Robins* case, in which the Fourth Circuit affirmed a plan that approved third-party releases in the form of channeling injunctions in the mass tort context.[13] The appellants argued that the *A.H. Robins* plan was fundamentally different from the debtor's plan because in *A.H. Robins*, (1) the beneficiaries of the injunction contributed substantial sums to the trust in order to satisfy claimants, (2) the plan afforded all parties (including

Cover Feature

1 *Berhmann v. National Heritage Foundation Inc.*, 663 F.3d 704 (4th Cir. 2011) (*Behrmann*).
2 Third Amended and Restated Disclosure Statement in Support of Fourth Amended and Restated Plan of Reorganization of the Debtor, No. 09-10525-SSM, filed Sept. 4, 2009 (D.I. 578), at § 4.2.
3 Fourth Amended and Restated Plan of Reorganization of the Debtor, No. 09-10525-SSM, filed Oct. 13, 2009 (D.I. 665), at §§ 7.19, 7.20 and 7.21.
4 *Id.* at § 7.19.
5 Objections were filed by the U.S. Trustee (D.I. 548), Larry Renick (D.I. 562), Highbourne Foundation, Townsley Foundation, and the Dodie Anderson Foundation (D.I. 584, 585, 648, 649, 650, 651), John Goodson (D.I. 608), and Scott Simpson and Deanna Nord Nogel (D.I. 596).
6 *See generally* D.I. 548.
7 The debtor's summary of ballots shows approval by 96.47 percent of Class III(B) creditors, with 82 of 85 ballots returned voting to accept the plan. No. 09-10525-SSM, filed on Oct. 14, 2009 (D.I. 670).
8 The Highbourne Foundation, John Behrmann and Nancy Behrmann, Townsley Foundation, and the Dodie Anderson Foundation (collectively, the "Behrmanns" or "appellants").
9 D.I. 666 at 47.
10 *Id.*
11 Findings of Fact, Conclusions of Law and Order under 11 U.S.C. § 1129(a) and Fed. R. Bankr. P. 3020 Confirming the Fourth Amended and Restated Plan of Reorganization of the Debtor, No. 09-10525-SSM, Oct. 16, 2009, D.I. 687, at § SS.
12 Appellants' Opening Brief, No. 1:10-cv-40-CMH, Feb. 22, 2010, D.I. 9 at page 12.
13 *Id.* at page 12 (distinguishing *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694, 701 (4th Cir. Va. 1989)).

those holding late-filed claims) an opportunity to be paid in full from the trust and (3) the channeling injunction was critical to avoid suits against third parties whose contribution rights against the debtor would have defeated the prospects of a successful organization.[14]

The appellants also distinguished cases in other circuits approving plans with nondebtor releases, noting that courts regularly emphasize that such releases should be given "careful scrutiny."[15] The appellants identified the seven-factor test employed by the Sixth Circuit in *Dow Corning*, concluding that the NHF plan did not satisfy the requirement that nondebtor releases be "necessary and fair."[16] The *Dow Corning* factors were whether:

> (1) a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the debtor; (2) the nondebtor has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization, namely, that 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 have overwhelmingly voted to accept the plan; (5) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) the plan provides an opportunity for those claimants who choose not to settle to recover in full; and (7) the bankruptcy court made a record of specific factual findings that support its conclusions.[17]

The appellants alleged that the plan satisfied none of the *Dow Corning* factors and that the bankruptcy court failed to make specific findings of fact or conclusions of law supporting the third-party releases. The appellants argued that the bankruptcy court's findings were conclusory and not supported by the record.[18]

In response, the debtor argued that the factual record supported a finding by the bankruptcy court that the third-party releases were appropriate because (1) the plan pays all allowed claims in full, (2) an indemnity relationship exists between the debtor and the released parties, (3) the third-party releases are necessary to enjoin actions against third parties in order to avoid creditors attempting to end run around the plan injunction through lawsuits against the indemnified parties, and (4) the plan was overwhelmingly approved.[19] NHF argued that these findings support a conclusion that this plan is a "unique case" in which the third-party releases were appropriate.[20]

[P]lan proponents in the Fourth Circuit seeking approval of nonconsensual nondebtor releases should both present sufficient evidence to allow a bankruptcy court to make such findings and, importantly, include detailed factual findings in any proposed findings of fact and conclusions of law approving a confirmation order.

NHF further argued that the record supported a finding that the third-party releases were essential to the debtor's successful reorganization because there were 9,000 potential parties-in-interest who, without the third-party releases, might be able to proceed in suits against the released parties.[21] NHF claimed that without the third-party releases, its officers and directors might otherwise be unwilling to continue their service to NHF.[22] Further, NHF argued that a financial contribution by the released parties was unnecessary because the plan already provided for full recovery of all allowed claims.[23] The district court affirmed the bankruptcy court's confirmation order without issuing a written opinion, finding that it was neither clearly erroneous nor contrary to law.[24]

Fourth Circuit Proceedings

On appeal, the parties made arguments similar to those they made to the bankruptcy and district courts. The Fourth Circuit concluded that the bankruptcy court's approval of the third-party releases lacked adequate factual support and vacated the decision of the district court, remanding the case to the bankruptcy court for further factual findings justifying the nonconsensual nondebtor releases.[25] The Fourth Circuit noted that the bankruptcy court made factual findings that

> (1) NHF's bankruptcy was "quite a unique case"; (2) there were "legitimate interests" for approving the Release Provisions in the reorganization plan; (3) the "potential for mischief" was "very, very high" for a dissatisfied party whose claim was disallowed in the bankruptcy proceeding to sue NHF's officers and directors "seriatim"; (4) NHF's obligations to indemnify its officers and directors could cause it to incur substantial legal costs in defending such claims; and (5) the Release Provisions served the purpose of "preventing an end-run around the plan" by not allowing dissatisfied claimants to attempt "second and third bites at the apple in another forum."[26]

Nevertheless, the Fourth Circuit held that

> to conclude, as the bankruptcy court did, that the Release Provisions (1) were "essential" to NHF's reorganization and appropriate given NHF's "unique circumstances"; (2) were an "essential means" of implementing the confirmed plan; (3) were an "integral element" of the transactions contemplated in the Confirmed Plan; (4) conferred a "material benefit" on NHF, its bankruptcy estate and its creditors; (5) were "important" to the plan's overall objectives; and (6) were "consistent" with applicable provisions of the Bankruptcy Code, is meaningless in the absence of specific factual findings explaining why this is so.[27]

Thus, the Fourth Circuit held that a bankruptcy court must make specific factual findings to support the conclusion that nonconsensual nondebtor releases are appropriate under the circumstances of a given case. Because it concluded that the bankruptcy court's findings were too general, the Fourth Circuit remanded the case. In addition, the Fourth Circuit rejected the argument

14 *Id.* at page 13 (citing *A.H. Robins*, 880 F.2d at 700-2).
15 *Id.* at page 13.
16 *Id.* at pages 14-18 (citing *Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir.), *cert. denied*, 537 U.S. 816 (2002)).
17 *Dow Corning*, 280 F.3d at 658.
18 *Id.* at 18.
19 Brief of Appellee, No. 1:10-cv-40-CMH, March 23, 2010, D.I. 16 at page 13-14.
20 *Id.* at 17 (citing *In re Mac Panel Co.*, 2000 Bankr. LEXIS 1694, *23-25 (E.D.N.C. 2000)).
21 *Id.* at page 20.
22 *Id.*
23 *Id.* at page 17, n. 6.
24 1:10-cv-40 at D.I., 22, Aug. 17, 2010.
25 *Behrmann*, 663 F.3d at 712.
26 *Id.* at 708.
27 *Id.* at 712-13.

that nonconsensual nondebtor releases are never permissible *per se* and discussed the applicable standards for approving such releases.

Section 524(e) Does Not Prohibit Nonconsensual Nondebtor Releases

A number of courts, including the Fifth, Ninth and Tenth Circuits, have held that § 524(e) prohibits nonconsensual nondebtor releases.[28] Section 524(e) provides that "[e]xcept as provided in subsection (a)(3)...discharge of the debtor does not alter the liability of any other entity on, or the property of any other entity for, such debt."[29] Such courts have held that § 524(e) prohibits bankruptcy courts from discharging liabilities of nondebtors and therefore precludes § 105(a) from authorizing nonconsensual nondebtor releases. In other words, these courts have concluded that the specific prohibition in § 524(e) concerning discharge displaces the equitable power a bankruptcy court otherwise might have pursuant to § 105(a) to grant such releases.

The Fourth Circuit, however, reaffirmed its rejection of the "notion that 11 U.S.C. § 524(e) forecloses bankruptcy courts from releasing and enjoining causes of action against nondebtors."[30] Its holding is consistent with its prior decisions and similar holdings from other courts, including the Second, Sixth and Seventh Circuits,[31] which have held that § 524(e) "explains the effect of a debtor's discharge. It does not prohibit the release of a nondebtor."[32] These courts distinguish the discharge of a debtor from equitable remedies available to bankruptcy courts pursuant to § 105(a) and hold that § 105(a) grants bankruptcy courts authority to approve nonconsensual nondebtor releases under appropriate circumstances.

Applicable Standard

The Fourth Circuit refused to adopt strict requirements for the approval of nonconsensual nondebtor releases.[33] Specifically, it held that a precise fit with the circumstances in *A.H. Robins* is not required.[34] The Fourth Circuit also addressed the seven *Dow Corning* factors and the following *Railworks* factors:

> (1) overwhelming approval for the plan; (2) a close connection between the causes of action against the third party and the causes of action against the debtor; (3) that the injunction is essential to the reorganization; and (4) that the plan of reorganization provides for payment of substantially all of the claims affected by the injunction.[35]

The Fourth Circuit did not adopt either the *Dow Corning* or *Railworks* factors. Instead, it commended the factors identified in both *Dow Corning* and *Railworks* as instructive, but held that bankruptcy courts may determine which factors are relevant to the facts and circumstances of a particular case.[36]

Conclusion

The Fourth Circuit reaffirmed that nonconsensual nondebtor releases are permissible under appropriate facts and circumstances. In addition, the Fourth Circuit held that a bankruptcy court must make detailed factual findings that justify the releases. As a result, plan proponents in the Fourth Circuit seeking approval of nonconsensual nondebtor releases should both present sufficient evidence to allow a bankruptcy court to make such findings and, importantly, include detailed factual findings in any proposed findings of fact and conclusions of law approving a confirmation order. ■

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28 *In re Zale Corp.*, 62 F.3d 746, 760-61 (5th Cir. 1995); *In re Lowenschuss*, 67 F.3d 1394, 1401-2 (9th Cir. 1995); *cert denied*, 517 U.S. 1243 (1996); *In re Western Real Estate Fund Inc.*, 922 F.2d 592, 601-2 (10th Cir. 1990).

29 11 U.S.C. § 524(e).

30 *Behrmann*, 663 F.3d at 710 (citing *A.H. Robins*, 880 F.2d 694).

31 *See A.H. Robins*, 880 F.2d at 702; *Stuart v. First Mount Vernon Indus. Loan Ass'n*, 3 Fed. Appx 38, 42 (4th Cir. 2001); *SEC v. Drexel Burnham Lambert Group Inc. (In re Drexel Burnham Lambert Group Inc.)*, 960 F.2d 285, 293 (2d Cir. 1992); *In re Dow Corning Corp.*, 280 F.3d 648, 657-58 (6th Cir. 2002); *Airadigm Communications Inc. v. FCC (In re Airadigm Communications Inc.)*, 519 F.3d 640, 656-57 (7th Cir. 2008).

32 *Dow Corning*, 280 F.3d at 657; *see, e.g., Airidigm*, 519 F.3d at 656-57.

33 *Behrmann*, 663 F.3d at 711-12.

34 *Id.* at 711.

35 *Id.* at 712 (citing *In re Railworks Corp.*, 345 B.R. 529, 536 (Bankr. D. Md. 2006)).

36 *Id.* at 711.