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## 4th Circ. Provides Guidance On Nondebtor Releases

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On June 27, 2014, the Fourth Circuit issued its second opinion in the National Heritage Foundation Inc. case on the issue of nonconsensual nondebtor releases.<sup>1</sup> Although the Fourth Circuit reiterated that nonconsensual nondebtor releases may be approved in appropriate circumstances, in affirming the district court's opinion, the Fourth Circuit analyzed the six Dow Corning<sup>2</sup> factors and again held that NHF failed to provide adequate factual evidence to support the nonconsensual nondebtor releases included in its Chapter 11 plan.

### Case Background

In October 2009, the bankruptcy court approved NHF's<sup>3</sup> fourth amended plan, which contained a nonconsensual release of nondebtor entities, including the unsecured creditors committee and its members, designated representatives of the committee, officers, directors or employees of NHF, and their successors and assigns (the "released parties").<sup>4</sup> The release provided that the released parties:

shall not have or incur, and are hereby released from, any claim, obligation, cause of action, or liability to any party in interest who has filed a claim or who was given notice of the Debtor's Bankruptcy Case (the "Releasing Parties") for any act or omission before or after the Petition Date through and including the Effective Date in connection with, relating to, or arising out of the operation of the Debtor's business, except to the extent relating to the Debtor's failure to comply with its obligations under the Plan.<sup>5</sup>

In NHF I, the Fourth Circuit vacated the portion of the district court's judgment affirming the nondebtor releases and remanded the case for further factual findings.<sup>6</sup> In NHF I, the Fourth Circuit instructed the bankruptcy court to make specific factual findings on remand — if the record permitted it — supporting its conclusions that the nondebtor release provision contained in the NHF plan was valid.<sup>7</sup>

### The Lower Court Decisions

On remand, the bankruptcy court<sup>8</sup> gave the parties the option of reopening the record to present more evidence, but they declined to do so.<sup>9</sup> On remand, multiple parties opposed the nondebtor releases in the bankruptcy court, and in the subsequent appeals, including the Behrmanns, who were the appellants in NHF I. After reviewing the existing record, the bankruptcy court made factual findings with respect to the six Dow Corning factors, which consider whether:

(1) There is an identity of interests between the debtor and the third party ... ; (2) the nondebtor has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization ...; (4) the impacted class, or classes, has overwhelmingly voted to accept the plan; (5) the plan provides a mechanism to pay for all, or substantially all, of the class or classes

affected by the injunction; [and] (6) the plan provides an opportunity for those claimants who choose not to settle to recover in full.<sup>10</sup>

The bankruptcy court concluded that only the first Dow Corning factor clearly weighed in favor of the releases and therefore determined that the nonconsensual nondebtor releases were unenforceable.<sup>11</sup>

The district court affirmed, concluding that the nonconsensual nondebtor releases were not essential to the plan.<sup>12</sup> In particular, the district court noted the absence of any evidentiary support on remand for NHF's position as to the likelihood of lawsuits, the effects of such lawsuits on NHF and the unsupported conclusion that NHF's reorganization would fail without the release provisions.<sup>13</sup>

### **The Fourth Circuit Decision**

The Fourth Circuit affirmed, finding the nonconsensual nondebtor releases to be unenforceable. Although the Fourth Circuit agreed that NHF had demonstrated an identity of interests between itself and the released parties, thereby satisfying the first Dow Corning factor, the Fourth Circuit also agreed with the conclusions of the bankruptcy court and the district court that only this factor weighed strongly in favor of the releases.<sup>14</sup>

As to the second Dow Corning factor (whether the party to be released contributed substantial assets to the reorganization) the Fourth Circuit rejected NHF's argument that the officers and directors satisfied the requirement by promising to continue serving NHF.<sup>15</sup> The Fourth Circuit determined that NHF failed to support this argument with evidence that the officers and directors actually promised to continue serving NHF.<sup>16</sup> The Fourth Circuit also determined that the officers and directors (all insiders) did not provide meaningful consideration for the releases because they performed their duties as a result of either being paid or having fiduciary obligations.<sup>17</sup>

Regarding the third Dow Corning factor (whether the injunction is necessary to a successful reorganization), the Fourth Circuit rejected NHF's claims that the reorganization is doomed without the release provision. In support of this factor, NHF primarily argued that the risk of litigation from its donors renders the release essential.<sup>18</sup>

The Fourth Circuit found that NHF "provided little to no evidence regarding the number of likely donor claims, the nature of such claims, or their potential merit" or conclusive evidence that the officers and directors would leave without the release provision.<sup>19</sup> Further, the Fourth Circuit agreed with the bankruptcy court that "the risk of NHF's insiders 'abandon[ing] ship' is particularly low, given that most of them are members of a single family."<sup>20</sup>

The Fourth Circuit also noted that NHF did not suggest that it would be difficult to recruit new officers or directors.<sup>21</sup> The Fourth Circuit concluded that NHF failed to carry its burden concerning the third Dow Corning factor.<sup>22</sup>

With respect to the fourth Dow Corning factor (whether the impacted class overwhelmingly voted to accept the plan), the Fourth Circuit questioned whether deemed acceptance by an unimpaired class is sufficient to satisfy this factor.<sup>23</sup> The Fourth Circuit declined to squarely address this issue, however, concluding that even if deemed acceptance satisfied the fourth factor, “[c]reditor support does not make up for the fact that most of the other Dow Corning factors weigh against enforcing the release provision.”<sup>24</sup>

The Fourth Circuit concluded that NHF did not satisfy the fifth and sixth Dow Corning factors (whether the plan provides mechanisms to pay all or substantially all of the claims of the affected class, and for nonsettling parties to recover in full) because (1) the plan made no provision for payment of the affected claims, such as a channeling trust, and (2) NHF provided no evidence that it employed a process to adequately protect the interests of affected claimants.<sup>25</sup> In fact, the Fourth Circuit stated that certain provisions of the disclosure statement concerning the affected class “hardly strikes us as a bona fide effort to ensure consideration of nearly all of the donor class’s claims.”<sup>26</sup>

Having found evidence to clearly support only one of the Dow Corning factors, the Fourth Circuit agreed with the district court and the bankruptcy court that NHF failed to demonstrate that the circumstances justified approving the nonconsensual nondebtor releases.

## **Implications**

NHF II reiterates that in the Fourth Circuit, it is imperative that the proponent of a nonconsensual nondebtor release provide appropriate evidence to establish the facts and circumstances that justify approving such a release. Although the Fourth Circuit analyzed the Dow Corning factors, it did not draw a bright line as to how many of the six factors must be satisfied in order to support a nonconsensual nondebtor release. In fact, the Fourth Circuit stated that “[a] debtor need not demonstrate that every Dow Corning factor weighs in its favor to obtain approval of a nondebtor release.”<sup>27</sup> Further emphasizing the potential availability of nonconsensual nondebtor releases under appropriate facts and circumstances, in NHF II, as it had in NHF I, the Fourth Circuit expressly stated that its decision not to enforce the nondebtor release was rooted in NHF’s failure of proof.<sup>28</sup>

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<sup>1</sup> The first case was *Behrmann v. National Heritage Foundation Inc.*, 663 F.3d 704 (4th Cir. 2011) (NHF I).

<sup>2</sup> *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002).

<sup>3</sup> NHF is a nonprofit charitable organization that administers and maintains donor-advised funds. *National Heritage Foundation Inc. v. Highbourne Foundation et al.* No. 13-1608, 2014 U.S. App. LEXIS 12144, at \* 2 (4th Cir. June 27, 2014) (NHF II). While donors retained the right to make nonbinding recommendations regarding the use of donated assets, NHF owned and controlled all of the assets. *Id.* NHF commenced its Chapter 11 bankruptcy case in 2009 after a state court awarded a multimillion-dollar judgment against it. *Id.* The IRS revoked NHF's status as a Section 501(c) public charity in November 2011. *Id.* at \* 2, n. 1.

<sup>4</sup> 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.

<sup>5</sup> NHF II, 2014 U.S. App. LEXIS 12144, at \* 3 (quoting J.A. 1059).

<sup>6</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*4 (citing NHF I, 663 F.3d at 712-13). There is a current circuit split regarding nonconsensual nondebtor releases. The Fourth Circuit, along with the Second, Sixth and Seventh Circuits have refused to adopt a blanket rule against nonconsensual nondebtor releases. *In re Drexel Burnham Lambert Group Inc.*, 960 F.2d 285, 293, 26 Collier Bankr. Cas. 2d (MB) 1413, 22 Fed. R. Serv. 3d 1091 (2d Cir. 1992); *In re A.H. Robins Co., Inc.*, 880 F.2d 694, 702, 19 Bankr. Ct. Dec. (CRR) 997, Bankr. L. Rep. (CCH) P 72955 (4th Cir. 1989); *In re Dow Corning Corp.*, 280 F.3d 648, 658, 39 Bankr. Ct. Dec. (CRR) 9, 47 Collier Bankr. Cas. 2d (MB) 1158, Bankr. L. Rep. (CCH) P 78582, 2002 FED App. 0043P (6th Cir. 2002); *Airadigm Communications Inc., v. FCC*, 519 F.3d 640, 656–57 (7th Cir. 2008). In addition, the First Circuit has tacitly refused to hold that nondebtor releases are never permissible. *Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973, 983, 27 Bankr. Ct. Dec. (CRR) 1039, 34 Collier Bankr. Cas. 2d (MB) 313, Bankr. L. Rep. (CCH) P 76634 (1st Cir. 1995). In fact, numerous lower courts in the First Circuit have joined the majority position, finding that, in appropriate circumstances, a nonconsensual nondebtor release may be approved. See e.g., *In re Quincy Med. Ctr.*, Case No. 11-16394, 2011 Bankr. LEXIS 4405, at \*2-5 (Bankr. D. Mass. Nov. 16, 2011) (collecting cases). The Fifth, Ninth and Tenth Circuits, however, have adopted a blanket rule against nonconsensual nondebtor releases. *Matter of Zale Corp.*, 62 F.3d 746, 760-61, Bankr. L. Rep. (CCH) P 76617 (5th Cir. 1995); But cf. *Republic Supply v. Shoaf*, 815 F.2d 1046 (5th Cir. 1987) (holding that released parties will be bound by a nonconsensual nondebtor release due to res judicata if they fail to object to confirmation of a plan containing such a release); *In re Lowenschuss*, 67 F.3d 1394, 1401–02, 34 Collier Bankr. Cas. 2d (MB) 544, Bankr. L. Rep. (CCH) P 76673, 33 Fed. R. Serv. 3d 249 (9th Cir. 1995); *In re Western Real Estate Fund Inc.*, 922 F.2d 592, 601–02, 21 Bankr. Ct. Dec. (CRR) 320, 24 Collier Bankr. Cas. 2d (MB) 1012, Bankr. L. Rep. (CCH) P 73754 (10th Cir. 1990), opinion modified, 932 F.2d 898 (10th Cir. 1991). Although the Third Circuit has addressed nonconsensual nondebtor releases, it has neither approved such releases nor held that such releases are always impermissible. In *Continental Airlines*, the Third Circuit left open the possibility that in the proper circumstances nonconsensual nondebtor releases might be appropriate. *Gilman v. Continental Airlines*, 203 F.3d 203, 14-15 (3d Cir. 2000). However, the Third Circuit subsequently considered the question

of nonconsensual nondebtor releases in the context of 524(g), but approved by the bankruptcy court under Section 105(a), and concluded that “the injunctive action on independent nonderivative claims against nondebtor third parties ... would violate § 524(g)(4)(A), would improperly extend bankruptcy relief to nondebtors, and would jeopardize the interests of future ... claimants” of the nondebtor affiliates. *Combustion Engineering*, 391 F.3d 190, 233-34, 43 Bankr. Ct. Dec. (CRR) 271, Bankr. L. Rep. (CCH) P 80206 (3d Cir. 2004), as amended, (Feb. 23, 2005).

<sup>7</sup> NHF II, 2014 U.S. App. LEXIS 12144, at \*4-6 (citing *Class Five Nevada Claimants v. Dow Corning Corp.* (In re Dow Corning Corp.), 280 F.3d 648, 658 (6th Cir. 2002)).

<sup>8</sup> The Chapter 11 plan was originally approved by Judge Mitchell, who had retired by the time the matter was remanded by the Fourth Circuit. His successor, Judge Kenney, considered the case on remand.

<sup>9</sup> NHF II, 2014 U.S. App. LEXIS 12144, at \*5.

<sup>10</sup> *Id.*, at 4-5 (citing *Dow Corning*, 280 F.3d 658).

<sup>11</sup> *In re National Heritage Foundation, Inc.*, 478 B.R. 216, 232 (Bankr. E.D.V.A. 2012).

<sup>12</sup> *National Heritage Foundation, Inc. v. Behrmann*, 2013 U.S. Dist. LEXIS 49081 (E.D.V.A. Apr. 3, 2013).

<sup>13</sup> *Id.*, 2013 U.S. Dist. LEXIS 49081, at \*24-26.

<sup>14</sup> NHF II, 2014 U.S. App. LEXIS 12144, at \*7-18.

<sup>15</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*8-9.

<sup>16</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*9 (quoting 478 B.R. at 229).

<sup>17</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*9.

<sup>18</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*10.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*12 (citing 478 B.R. at 229).

<sup>21</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*12.

<sup>22</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*13.

<sup>23</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*13-14.

<sup>24</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*15.

<sup>25</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*16-17.

<sup>26</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*17.

<sup>27</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*19.

<sup>28</sup> *Id.*, 2014 U.S. App. LEXIS 12144, at \*19; NHF I, 663 F.3d at 712-13.