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Navigating the Conflicting Views on Third-Party Releases in Bankruptcy Restructuring Plans, Part II

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In 2022, we published Part I of this article examining the role of third-party releases in successful Chapter 11 reorganizations. That article evaluated whether and to what extent third-party releases are permissible to release nondebtors from liabilities that are intertwined with the debtor's liabilities. That analysis revealed an important circuit split in which the majority of circuits allow third-party releases in limited circumstances based on factual findings supporting a different multi-factor analysis in each jurisdiction. However, a minority of courts—specifically, the Fifth, Ninth and Tenth Circuits—disallow nonconsensual third-party releases entirely. We noted that the U.S. Supreme Court has not yet weighed in on this issue, and suggested that either the Supreme Court or the U.S. Congress should intervene to resolve the confusion and uncertainty surrounding the use of third-party releases as a tool for resolving complex Chapter 11 restructurings.

In this article, we continue the analysis of Part I by evaluating two constitutional issues arising from third-party releases: whether creditor consent to be bound by a third-party release is required to satisfy the due process clause of the Fifth and Fourteenth Amendments to the U.S. Constitution; and whether bankruptcy courts have constitutional authority to issue final orders granting third-party releases in a plan of reorganization under *Stern v. Marshall.*

Due Process Consent Requirements

The Fifth and Fourteenth Amendments to the U.S. Constitution prohibit both federal and state governments, respectively, from "depriv[ing] any person of life, liberty, or property, without due process of law." The Supreme Court has interpreted this to mean—among providing other protections—that individuals have a right to petition courts for redress of their claims. Generally, the satisfaction of this right requires "some form of hearing … before an individual is finally deprived of a property interest." In the bankruptcy context, creditors may have several federal and/or state causes of action against a debtor—such as claims for breach of fiduciary duty, personal injury, and other torts—that require adjudication by a court of competent jurisdiction. The issue of due process for granting third-party releases arises when a plan attempts to resolve these claims by releasing nondebtor plan contributors without the consent of all affected creditors.

Under the Bankruptcy Code, creditors vote on a proposed plan and, if approved by a majority of creditors holding at least two-thirds in dollar amount and more than one-half in number of allowed claims within an impaired class, the plan becomes binding on the debtor, all creditors, and any related plan beneficiaries, including the dissenting creditors. If a plan approves third-party releases, even nonconsenting creditors could be

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prohibited from pursuing claims against certain third-party nondebtors, which can include insurance companies or nondebtor tortfeasors such as the debtor's officers and directors. This results in those creditors losing a legitimate state or federal right to petition a court to adjudicate their underlying cause of action against nondebtors based on the acceptance of the plan by a majority of other claimants. In other words, in jurisdictions where third-party releases are permitted, a majority of creditors can potentially deprive the minority of their right to sue and recover from nondebtors on their claims.

Courts have addressed this due process problem by evaluating how consent is provided during the plan voting process on a case-by-case basis. Several court opinions discuss how such consent must be obtained to achieve an enforceable third-party release. But those opinions do not establish a clear standard, which differs across district courts and even among judges within the same district.

The Opt-In or Opt-Out Mechanism

In the bankruptcy plan context, courts that allow third-party releases will evaluate the manner in which notice and consent were accomplished to determine whether the release will apply to a specific creditor. The most prolific method for soliciting consent is through a bankruptcy plan ballot's opt-in or opt-out mechanism. When included on a ballot, the opt-in or opt-out mechanism is generally utilized by adding a checkbox on the ballot for creditors to either affirmatively opt-in or opt-out of the release. After solicitation, the ballot returns result in a myriad of individual creditor scenarios, including: votes in favor of the plan while opting into the release; votes in favor of the plan while opting out of the release; votes in favor of the plan or rejecting the plan while leaving the release option blank; votes to reject both the plan and the release; votes to reject the plan, but opt-in to the release; or abstaining from voting altogether.

The easiest scenario occurs when a voting creditor returns a ballot and either affirmatively consents to the release by opting in or affirmatively rejects the release by opting out. In those cases, if the plan is confirmed, the third-party release will apply to consenting creditors who affirmatively opted in or chose not to opt out, but will not apply to nonconsenting creditors who affirmatively chose to opt-out.

The due process clause issue arises, however, if a creditor votes on the plan, but fails to additionally opt-in or opt-out of the release, is entitled to vote on the plan, but fails to return a ballot, or is unimpaired and not entitled to vote at all. In general, each Bankruptcy Court treats these scenarios differently on a case-by-case basis. We have reviewed some key decisions on how certain jurisdictions treat these scenarios, but there is no standard generally applicable even within a specific district.

Failure to Opt In or Opt Out

The first scenario occurs where a creditor votes on the plan but does not select the opt-in or opt-out option, if present on the ballot. In *Chassix*, Judge Michael Wiles of the U.S. Bankruptcy Court for the Southern District of New York found that where a creditor affirmatively rejects a plan with only an opt-in mechanism, he or she is not required to take additional actions to opt-out of the release. The creditor's rejection of the plan is also deemed a rejection of the release, and that creditor is only bound by the release if he or she affirmatively elects to opt in. Similarly, in that same district, Judge Stuart Bernstein found in *SunEdison* that an affirmative vote in favor of a plan without selecting the opt-out provision is deemed adequate consent to be bound by the release without having to separately indicate that he or she opts into the release. And in 2022, the U.S. Bankruptcy Court for the District of Delaware concluded in *Mallinckrodt* that a plan with an opt-out mechanism for third-party releases was binding on those who failed to opt-out. Although the court noted that "the use of the opt out mechanism as a valid means of obtaining consent is not without controversy" and "many courts are divided on the issue, including this one," it found that the plan's requirement for nonconsenting, voting creditors to opt-out of the release in a "very well-known case with a very active body of creditors and stakeholders" was sufficient to satisfy the due process clause's notice requirement. In that case, only creditors who opted out or otherwise objected to the release were not bound by it and could pursue their tort claims against nondebtors. Later in 2022, this same reasoning was followed in Boy Scouts to approve third-party releases related to sexual abuse claims.

However, the inclusion of an opt-in or opt-out mechanism is not required by all courts. For example, in *Millennium Lab*, the Chapter 11 plan included a third-party release without an opt-in or opt-out mechanism for nonconsenting creditors. The U.S. District Court for the District of Delaware found that the third-party release would be binding on all applicable creditors, including the sole objecting creditor. Notably, that court did not reach the merits of whether an opt-in or opt-out mechanism was necessary to satisfy due process. This case illustrates that in some instances a vote to reject a plan and object to the third-party release does not always save a nonconsenting creditor from being bound by it if the court's applicable factors are otherwise satisfied.

Failure to Return a Ballot

The second scenario occurs when an impaired creditor entitled to vote on the plan fails to return a ballot and, therefore, is silent regarding whether he or she agrees to be bound by the third-party release. Judges in Delaware and New York have found that silence makes the release nonbinding on the nonvoting creditor. For example, in *Washington Mutual*, Judge Walrath of the U.S. Bankruptcy Court for the District of Delaware held that the failure to return a ballot was not "sufficient manifestation" of consent to a third-party release and found that "any third party release is effective only with respect to those who affirmatively consented to it by voting in favor of the Plan and not opting out of the third-party releases." Following *Washington Mutual*, New York Bankruptcy Judge Wiles also held in *Chassix* that "inaction was not a sufficient manifestation of consent to support a release." And New York Bankruptcy Judge Bernstein agreed in *SunEdison*, finding that failure to return a plan ballot would not constitute consent because, relying on New York contract law, "[a]bsent a duty to speak, silence does not constitute consent."

But even in New York the judges disagree. For example, in *Cumulus Media,* New York Bankruptcy Judge Shelley Chapman held that "inaction is action under appropriate circumstances," and found that silence constituted consent for the imposition of a third-party release if the plan provides clear notice that a creditor's failure to act will affect their rights and the ballot clearly directs the creditor to the opt-out section. Similarly, in *TK Holdings,* New York Bankruptcy Judge Brendan Shannon found that creditors who failed to return their ballots would be bound by the plan's third-party releases because the plan and ballots included a warning that silence would bind the parties to the releases. This approach has also been followed in Texas, where Judge Lee Rosenthal of the U.S. District Court for the Southern District of Texas found that a creditor's silence in not returning a ballot despite receiving sufficient notice of the plan and its release provisions warranted its enforcement against the silent creditor.

Treatment of Unimpaired Creditors

Bankruptcy Code section 1126(f) provides that unimpaired creditors under a Chapter 11 plan are not entitled to vote on the plan and deemed to accept it. This poses a unique problem for plans containing third-party releases that apply to an unimpaired creditor who will otherwise be paid in full because they are deemed to consent to the release without an opportunity to affirm or deny their consent. Courts disagree as to whether their deemed consent to the plan should also extend to deemed consent to the third-party release. In *Chassix*, New York Bankruptcy Judge Wiles noted that, if a creditor must release a third party as a condition to payment under a plan, "it is difficult to understand how such a creditor could properly be considered to be 'unimpaired' by the plan in the first place." And as a result, he required unimpaired creditors to opt in to the releases in order to be bound by them. Delaware Bankruptcy Judge Mary Walrath made a similar conclusion in *Southeastern Grocers*, finding that all creditors should be given an opportunity to vote on a third-party release for it to be deemed consensual, including unimpaired creditors.

Conversely, other judges have come to the opposite conclusion. In *Genco Shipping,* New York Bankruptcy Judge Sean Lane found that, although the classification of a claim as unimpaired should not always require a release, a plan may require unimpaired creditors to grant a release to nondebtors even if they were not entitled to vote on the plan and did not otherwise consent to the release. And Delaware Bankruptcy Judge Laurie Silverstein made a similar conclusion in *Millennium Lab*, finding that a third-party release does not itself cause impairment if the creditor is otherwise to be paid in full under the plan and, thus, can be deemed to accept both the plan and the release.

Constitutional Implications Under 'Stern v. Marshall'

If a plan's third-party releases are nonconsensual, an additional jurisdictional issue arises as to whether the Bankruptcy Court has sufficient constitutional authority to enter a final confirmation order approving those nonconsensual releases. Unlike district court and circuit court judges, who are granted their authority under Article III of the U.S. Constitution, the constitutional authority of Bankruptcy Court judges is established under Article I, which gives Congress the power "to establish … uniform Laws on the subject of Bankruptcies throughout the United States." Congress exercised that power by enacting the Bankruptcy Code, which allows each District Court to refer bankruptcy cases to the Bankruptcy Court for their district. That grant of authority limits Bankruptcy Court jurisdiction only to issues "arising under," "arising in," or "related to" a case commenced under the Bankruptcy Code, but Bankruptcy Court judges may only enter final judgments on "core proceedings" that "arise under" or "arise in" a bankruptcy case. One of the Bankruptcy Code's enumerated "core proceedings" is the confirmation of a plan of reorganization.

In 2011, the U.S. Supreme Court entered an opinion in *Stern v. Marshall* that sent shockwaves through the bankruptcy system. The Supreme Court held in *Stern* that a Bankruptcy Court, as an Article I court, lacked sufficient constitutional authority to enter a final judgment on state law counterclaims that did not "stem" from the bankruptcy and would not "necessarily" resolve the creditor's proof of claim. Instead, the Bankruptcy Court only had the statutory authority to issue proposed findings of fact and conclusions of law on the counterclaim, subject to de novo review and a final order by the district court. Notably, despite finding that the underlying counterclaim was a statutorily "core proceeding" under Bankruptcy Code Section 157, the Supreme Court ultimately concluded that the bankruptcy court exceeded its constitutional jurisdiction because it attempted to "resolve and enter final judgment on a state common law claim," which is reserved for Article III courts. Although the Supreme Court later clarified that the *Stern* decision was a narrow holding and that litigants could knowingly and voluntarily consent to the bankruptcy court's adjudication of *Stern* claims, bankruptcy courts have had to wrestle with whether they have constitutional authority to enter final confirmation orders with nonconsensual, third-party releases even though plan confirmation is a "core proceeding" under the Bankruptcy Code. Several recent cases illustrate the disjointed results stemming from the release of *Stern* claims.

In re Millennium Lab Holdings II. In 2019, the U.S. Court of Appeals for the Third Circuit affirmed a plan confirmation order containing nonconsensual, third-party releases of the sole objecting creditor's fraud claims against the debtor's officers, directors, and shareholders. Before evaluating the Bankruptcy Court's constitutional authority to enter a final order releasing those claims, the Third Circuit noted three key implications of the *Stern* decision: "bankruptcy courts may violate Article III even while acting within their statutory authority in 'core' matters;" "a bankruptcy court is within constitutional bounds when it resolves a matter that is integral to the restructuring of the debtor-creditor relationship;" and "courts should generally focus not on the category of the 'core' proceeding but rather on the content of the proceeding." When applying these principles, the Third Circuit concluded that the Bankruptcy Court had sufficient constitutional authority under *Stern* to confirm the plan and its releases. The Third Circuit found that, because the Bankruptcy Court made extensive findings of fact and conclusions of law indicating that a restructuring would have been impossible without the releases that induced the nondebtors to make substantial cash contributions to the plan, the releases were sufficiently "integral to the restructuring" and, thus, within Bankruptcy Court's "core" jurisdiction over plan confirmation.

In re Purdue Pharma. In December 2021, the U.S. District Court for the Southern District of New York overruled the bankruptcy court's confirmation of Purdue's Chapter 11 plan, which included third-party releases for potential claims against the debtors' owners and managers related to the over-prescription of the company's proprietary opioid medication, OxyContin. Relying on the Third Circuit's holding in *Millennium Lab*, the Bankruptcy Court concluded that it had constitutional authority under *Stern* to enter a final confirmation order granting the releases because confirming a plan is "the most core of bankruptcy proceedings." The district court disagreed. Noting that "a nonconsensual third-party release is essentially a final judgment against the claimant, in favor of the nondebtor, entered without any hearing on the merits," the district court held that the confirmation order's releases constituted an improper final order on underlying "noncore" claims that did not arise as a result of the bankruptcy process. Importantly, the district court held that, regardless of whether the releases are "integral to the restructuring of the debtor-creditor relationship" under a plan, bankruptcy courts "cannot manufacture constitutional authority to resolve a noncore claim by the artifice of including a release of that claim in a plan of reorganization." As a result, the district court reviewed the Bankruptcy Court's approval of the third-party releases de novo and ultimately vacated the confirmation order. The district court's decision is currently pending appeal to the Second Circuit.

Ascena Retail Group. In January 2022, the U.S. District Court for the Eastern District of Virginia vacated the bankruptcy court's confirmation order containing third-party releases that would have extinguished thousands of claims against Ascena—a clothing retailer—and its officers and directors, including claims for securities fraud, hostile work environment, negligence, slander, breach of contract and malpractice. The district court noted that "*Stern* teaches that courts should focus on the content of the proceeding rather than the category of the proceeding when determining whether a bankruptcy court has acted within its constitutional authority." In other words, the Bankruptcy Court must have an independent source of jurisdiction for each type of claim against a nondebtor before it can enter a valid, final order releasing those claims. The district court found that because "the Bankruptcy Court engaged in none of the content-based analysis demanded by *Stern*" for each type of released claim, the Bankruptcy Court lacked sufficient constitutional jurisdiction to extinguish all of those claims through the plan's broad third-party releases.

Takeaways

Third-party releases play an important role in reorganizing businesses in Chapter 11, especially where the resolution of extensive personal injury, fraud, or similar claims involving the debtors, their insurers, and related third-parties (such as directors and officers) is absolutely necessary for a successful restructuring. But the practical utility of a Bankruptcy Court's approval of third-party releases in a plan of reorganization cannot undermine a creditor's constitutional rights to due process and adjudication of their underlying claims by an Article III court. Finding the appropriate balance between creditor rights and a debtor's ability to restructure is integral to achieving meaningful results in bankruptcy. However, this article underscores how inconsistent results across different jurisdictions (and in some cases even among judges within the same district) creates a disjointed system for approving third-party releases, resulting in inefficiencies and potential forum shopping that could and should be avoided. We believe that more decisions from higher courts on these issues, especially from the U.S. Supreme Court, would help alleviate the confusion and lead to a more efficacious process for the most complex Chapter 11 cases.

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