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If You Want a Third-Party Release, You Have to Prove It

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The Supreme Court has stated that “[w]e are not... at liberty to substitute speculation for evidence.”¹ Courts of appeal are picking up on this sentiment and applying it when reviewing bankruptcy courts' orders confirming Chapter 11 plans. In this respect, circuit courts are requiring plan proponents to prove the essential elements of not only the statutory requirements under [11 U.S.C.A. § 1129](#), but also any other elements required for plan confirmation. For instance, the Eleventh Circuit reversed the bankruptcy court's confirmation of a plan because the bankruptcy court had not received evidence concerning the absolute priority rule.² More recently, the Court of Appeals for the Fourth Circuit similarly reversed a bankruptcy court's confirmation of a plan because the bankruptcy court did not have sufficient evidence to grant the debtor's requested third-party release.³ In *Behrmann*, the court's message to bankruptcy courts was clear: courts must base their findings of fact concerning third-party releases on evidence, not speculation.

I. General Standards for Third-Party Releases

Many courts have recognized a debtor's ability to confirm a plan that includes a third-party release.⁴ However, almost uniformly, these courts state that third-party releases are restricted to unusual situations.⁵ Additionally, the courts developed differing standards for granting a third-party release. The standards range from granting a third-party release when it is “important” to the reorganization⁶ all the way to requiring the debtor to meet a seven-factor test including (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions.⁷

It appears clear that as long as the debtor is able to enter sufficient evidence, courts will grant a third-party release.

II. Evidentiary Requirements for Obtaining a Third-Party Release

While courts generally allow a third-party release as part of a debtor's plan confirmation, the debtor must meet certain evidentiary standards. Generally, a debtor must prove the elements of plan confirmation by a preponderance of the evidence.⁸ More specifically, the debtor must satisfy the standards for obtaining a third-party release by presenting evidence supporting the need for the third-party release.

In *Behrmann*, the debtor was a non-profit public charity that maintained donor-advised funds.⁹ The debtor sought Chapter 11 bankruptcy protection and subsequently filed its plan of reorganization.¹⁰ As part of its plan of reorganization, the debtor sought to release certain of its officers and directors, among others.¹¹ The bankruptcy court received evidence on the release, but ultimately determined that the scope of the release was too broad.¹² The debtor subsequently narrowed the release provisions.¹³ The bankruptcy court confirmed the debtor's plan and approved the narrowed release provisions, finding that the release provisions were essential to plan confirmation.¹⁴ Specifically, the bankruptcy court found that (1) the debtor's bankruptcy was a unique case; (2) there were legitimate interests for approving the release; (3) the "potential for mischief" was "very, very high" for a dissatisfied party whose claim was disallowed in the bankruptcy proceeding to sue the debtor's officers and directors; (4) the debtor's obligations to indemnify its officers and directors could cause it to incur substantial legal costs in defending such claims; and (5) the release 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".¹⁵

Several creditors appealed the confirmation order; specifically, the third-party releases. The district court affirmed the bankruptcy court's confirmation of the plan, and the creditors appealed to the U.S. Court of Appeals for the Fourth Circuit.¹⁶ The court began its review by recounting the circumstances for third-party releases that the court articulated in *A.H. Robins*.¹⁷ However, the court rejected a strict list-based test for determining whether a debtor is entitled to a third-party release, stating "a bankruptcy court need not find a precise fit between the circumstances found in *A.H. Robins* and the case before it as a precondition to granting equitable relief."¹⁸

Substantively, the court found that the bankruptcy court did not base its confirmation of the debtor's plan on sufficient evidence to sustain the third-party release.¹⁹ The court stated that the bankruptcy court's conclusions of law were "meaningless in the absence of specific factual findings explaining why this is so. Indeed, without more, the court's conclusions could apply just as well to any number of reorganizing debtors."²⁰ Accordingly, the court vacated the confirmation because of the third-party release provisions and remanded to the bankruptcy court.²¹

In *In re Metromedia Fiber Network, Inc.*, the Court of Appeals for the Second Circuit reached similar conclusions.²² There, the debtor sought to release certain third parties from liability as part of its plan of reorganization. Appellants challenged the third-party release.²³ On appeal, the court held that the bankruptcy court did not receive sufficient evidence to justify confirming the plan including the third-party release.²⁴ The court stated that "there is no finding (or evidence presented) that the [release] was itself important to the Plan--which is what *Drexel Burnham* at a minimum requires. Nor was any inquiry made into whether the breadth of the [release]--which covers numerous third parties in addition to the Kluge Trust, and which covers any and all claims relating to Metromedia-- was necessary to the Plan."²⁵ Accordingly, the court concluded that "the bankruptcy court's findings were insufficient. A nondebtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to success of the plan."²⁶ Despite the court's conclusion that the bankruptcy court did not have a proper factual basis to grant the third-party release, the court did not reverse as the debtor had substantially consummated the plan.

Applying the evidentiary requirements from *Behrmann* and *Metromedia*, bankruptcy courts must be diligent in receiving, and debtors must be diligent in entering, factual evidence to support the relevant standard for third-party releases. Debtors must be prepared to show why the third parties are entitled to the release and how that release will benefit the debtor and the creditors. Several courts have provided guidance for presenting evidence necessary for a third-party release. In *In re Continental Airlines*, the court found that a debtor and a third party do not have an identity of interest merely because of an indemnity obligation of the debtor to the third party.²⁷ Rather, the debtor must show that there is a likelihood or probability that the third parties will call upon the debtor for indemnity.²⁸

Debtors must present similar evidence with regard to the other necessary elements to obtain a third party release. If the debtor desires to release a third party on account of the third party's substantial contribution to the debtor's reorganization based on postconfirmation services, the debtor must show that the third party will make a meaningful contribution post-confirmation.²⁹ A third party's contribution to the debtor during the pendency of the bankruptcy case is likely not sufficient to warrant a release.³⁰ Additionally, the debtor must show that the contribution actually comes from the released third party.³¹ The debtor must likewise present evidence concerning the nexus between the debtor and the released third party.³² The debtor can establish this standard in a smaller case by, among other things, showing that the third party owns 100% of the debtor's equity.³³

When presenting the evidence relating to the propriety of third-party releases, courts and debtor's should avoid a "check the box" recitation of factors relating to the release. While the factors enumerated in *Dow Corning* and similar cases are instructive, debtors should seek to balance the factors, keeping in mind the end they are seeking. As one court has observed, "[t]oo often the factors in a checklist fail to separate the unimportant from the important, or even to set out a standard to make the attempt. This often results in rote following of a form containing factors where courts tally up and spit out a score."³⁴ As opposed to keeping score, debtors should plan their evidentiary strategy to comprehensively show that a third-party release is appropriate. Debtors can use the various factors as guides, but should be willing to give greater weight to some, ignore others, and present evidence of non-factor bases for the release.

III. Conclusion

Above all, a debtor must be prepared to prove the necessity of a third-party release. The evidentiary burden is high because a third-party release is extraordinary relief. However, the debtor may not simply rest on platitudes and unsupported legal conclusions. It must support its request with a sufficient factual basis to enable the bankruptcy court to make the necessary findings of fact. If the debtor fails to meet its burden, even if the bankruptcy court confirms the plan, various courts of appeal may reverse the bankruptcy court's confirmation order because of the inclusion of a release that is not supported by a sufficient evidentiary record and detailed factual findings.

Footnotes

- ¹ [Turner Broadcasting System, Inc. v. F.C.C.](#), 520 U.S. 180, 236, 117 S. Ct. 1174, 137 L. Ed. 2d 369, 25 Media L. Rep. (BNA) 1449 (1997) (O'Connor dissenting).
- ² [In re Lett](#), 632 F.3d 1216, 54 Bankr. Ct. Dec. (CRR) 81, Bankr. L. Rep. (CCH) P 81934 (11th Cir. 2011).
- ³ [Behrmann v. National Heritage Foundation](#), 663 F.3d 704, 55 Bankr. Ct. Dec. (CRR) 221, 66 Collier Bankr. Cas. 2d (MB) 1282, Bankr. L. Rep. (CCH) P 82124 (4th Cir. 2011).
- ⁴ See [In re A.H. Robins Co., Inc.](#), 880 F.2d 694, 19 Bankr. Ct. Dec. (CRR) 997, Bankr. L. Rep. (CCH) P 72955 (4th Cir. 1989) (third-party release is permissible when creditors approve of an accept the terms of the plan); [In re Drexel Burnham Lambert Group, Inc.](#), 960 F.2d 285, 26 Collier Bankr. Cas. 2d (MB) 1413, 22 Fed. R. Serv. 3d 1091 (2d Cir. 1992); [In re Airadigm Communications, Inc.](#), 519 F.3d 640, 49 Bankr. Ct. Dec. (CRR) 179, Bankr. L. Rep. (CCH) P 81123 (7th Cir. 2008); [In re Continental Airlines](#), 203 F.3d 203, 35 Bankr. Ct. Dec. (CRR) 176 (3d Cir. 2000); [In re Dow Corning Corp.](#), 280 F.3d 648, 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) (establishing a seven-factor test for third-party release). But see [In re Lowenschuss](#), 67 F.3d 1394, 34 Collier Bankr. Cas. 2d (MB) 544, Bankr. L. Rep. (CCH) P 76673, 33 Fed. R. Serv. 3d 249 (9th Cir. 1995) (finding that plan confirmation cannot limit the liability of third parties); [In re Western Real Estate Fund, Inc.](#), 922 F.2d 592, 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) (same).
- ⁵ [Continental Airlines](#), 203 F.3 at 212-213 (recognizing that third-party releases have been approved only in "extraordinary cases"); [Dow Corning](#), 280 F.3d at 657-658 ("Such an injunction is a dramatic measure to be used cautiously."); [In re Metromedia Fiber](#)

Network, Inc., 416 F.3d 136, 44 Bankr. Ct. Dec. (CRR) 276, 54 Collier Bankr. Cas. 2d (MB) 1033, Bankr. L. Rep. (CCH) P 80397 (2d Cir. 2005) (“a release is proper only in rare cases”).

6 Drexel Burnham Lambert, 960 F.2d at 293 (finding that third-party release is appropriate when such a release is important to a debtor's plan)

7 Dow Corning, 280 F.3d at 658.

8 In re Save Our Springs (S.O.S.) Alliance, Inc., 632 F.3d 168, 54 Bankr. Ct. Dec. (CRR) 56, 64 Collier Bankr. Cas. 2d (MB) 1686, Bankr. L. Rep. (CCH) P 81924 (5th Cir. 2011); In re Ambanc La Mesa Ltd. Partnership, 115 F.3d 650, 30 Bankr. Ct. Dec. (CRR) 1136 (9th Cir. 1997).

9 Behrmann, 663 F.3d at 707.

10 Behrmann, 663 F.3d at 707.

11 Behrmann, 663 F.3d at 707.

12 Behrmann, 663 F.3d at 707-708.

13 Behrmann, 663 F.3d at 708.

14 Behrmann, 663 F.3d at 708.

15 Behrmann, 663 F.3d at 708.

16 Behrmann, 663 F.3d at 708.

17 Behrmann, 663 F.3d at 710-711.

18 Behrmann, 663 F.3d at 711.

19 Behrmann, 663 F.3d at 711.

20 Behrmann, 663 F.3d at 713.

21 Behrmann, 663 F.3d at 713. However, in *Continental Airlines*, 203 F.3d 203, releases for directors and officers were voided by the Circuit Court without reversing the confirmation order issued five years earlier that included the releases at issue on the appeal.

22 *Metromedia Fiber Network*, 416 F.3d at 141.

23 *Metromedia Fiber Network*, 416 F.3d at 141.

24 *Metromedia Fiber Network*, 416 F.3d at 143.

25 *Metromedia Fiber Network*, 416 F.3d at 143 (internal citations omitted)

26 *Metromedia Fiber Network*, 416 F.3d at 143. Cf., *Dow Corning*, 280 F.3d at 658 (requiring the bankruptcy court to make “specific factual findings that support its conclusions” before authorizing third-party releases).

27 *Continental Airlines*, 203 F.3d at 216.

28 *Continental Airlines*, 203 F.3d at 216 (“the fact that the reorganized Continental Airlines might face an indemnity claim sometime in the future, in some unspecified amount, does not make the release and permanent injunction of Plaintiffs' claims ‘necessary’ to ensure the success of the Continental Debtors' reorganization.”). See also *In re Transit Group, Inc.*, 286 B.R. 811, 820, 40 Bankr. Ct. Dec. (CRR) 158, 49 Collier Bankr. Cas. 2d (MB) 971 (Bankr. M.D. Fla. 2002) (“Because there is no imminent threat of any such indemnification claims, there is no real risk that the reorganized debtor will have to pay any indemnity claims made by these officers. Nor is there any evidence regarding the estimated amounts of such claims that Transit could be required to pay. Thus, the debtor's reorganization efforts do not appear impacted. Rather, the request for a non-debtor release appears prophylactic in nature

and designed to insure no such indemnification claims are ever asserted, regardless of whether any exist or not or the amount of any potential liability to the reorganized debtor.”).

29 [In re Condustrail, Inc.](#), 2011 WL 3290389 (Bankr. D. S.C. 2011) (finding that third party was “providing substantial consideration critical to effectuate the Plan through his continued services and dedication to the Debtor.”); [Transit Group](#), 286 B.R. at 818 (“GECC has gone well beyond mere self-preservation by extending substantial new monies needed to fund this Chapter 11 case and to give the debtor the opportunity to reorganize.”); [In re Mercedes Homes, Inc.](#), 431 B.R. 869, 881 (Bankr. S.D. Fla. 2009) (concluding that third-party directors and officers made substantial contribution to the Debtor by “continuing to use their expertise and knowledge to work for the Reorganized Debtors.”).

30 [In re Washington Mutual, Inc.](#), 442 B.R. 314 (Bankr. D. Del. 2011).

31 [In re Hoffinger Industries, Inc.](#), 321 B.R. 498, 514, 44 Bankr. Ct. Dec. (CRR) 120 (Bankr. E.D. Ark. 2005) (finding that third-party release was not appropriate where “What is not known is who or in what proportion [the contribution] will be paid by either the equity owners or the specific class against whom Bunch seeks recovery. Accordingly, the second element weighs against the appropriateness of any release language enuring [sp] to the benefit of third parties.”).

32 [Continental Airlines](#), 203 F.3d at 216 (“we cannot accept the District Court's conclusion that a purported ‘identity of interest’ between the Continental Debtors and the non-debtor D&O defendants, forged by the indemnity obligation or the D&O liability insurance policy, established the necessity of releasing and permanently enjoining Plaintiffs' claims.”).

33 [Condustrail, Inc.](#), 2011 WL 3290389 at *3.

34 [In re Owens Corning](#), 419 F.3d 195, 210, 45 Bankr. Ct. Dec. (CRR) 36, Bankr. L. Rep. (CCH) P 80343 (3d Cir. 2005), as amended, (Oct. 12, 2005) (internal citations omitted); [Behrmann](#), 663 F.3d at 712 (“while we are satisfied to leave to a bankruptcy court the determination of which factors may be relevant in a specific case, the meaningful exercise of appellate review at a minimum requires that the court make specific factual findings in support of its decision to grant equitable relief.”).

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