

BY SCOTT A. WOLFSON

Plan's Release of Nondebtors Invalid under *Dow Corning*

In *National Heritage Foundation Inc. v. Highbourne Foundation*,¹ the Fourth Circuit Court of Appeals recently held a chapter 11 plan's non-consensual, third-party release of nondebtors as invalid because the release lacked adequate factual support. The circuits remain split on whether the Bankruptcy Code permits a plan to release nondebtor parties.²

Those allowing such releases do so only in limited circumstances because the releases test "the outer reaches of a bankruptcy court's jurisdiction."³ The Fourth Circuit applied *Dow Corning*'s six substantive factors test for nondebtor releases⁴ and struck the release of the debtor's officers and directors in *National Heritage Foundation*. This article analyzes the Fourth Circuit's decision and provides practical suggestions for objecting to third-party releases in plans.



Scott A. Wolfson
Wolfson Bolton PLLC
Troy, Mich.

Scott Wolfson is a member of Wolfson Bolton PLLC in Troy, Mich.

Return Trip to the Fourth Circuit

The *National Heritage Foundation* case has a long procedural history previously detailed in the *ABI Journal*.⁵ The case was before the Fourth Circuit a second time, following its remand to the bankruptcy court to make specific factual findings and to explain why the findings support the plan's nondebtor releases.⁶

National Heritage Foundation (NHF) is a nonprofit public charity that administers and maintains donor-advised funds.⁷ These are funds in which donors relinquish all rights and interests

in the assets they donate.⁸ NHF owns and controls all of the donated assets, but the donors can make nonbinding recommendations regarding the use of the assets.⁹

NHF filed a voluntary chapter 11 petition in 2009 after a state court entered a multimillion-dollar judgment against it.¹⁰ The bankruptcy court approved NHF's fourth amended and restated reorganization plan.¹¹ The reorganization plan contained a provision releasing NHF, the unsecured creditors' committee and its members, any designated representatives of the committee, and any officers, directors or employees of NHF, the committee, or their successors and assigns (collectively, the "released parties") from all claims relating to the debtor's business.¹² The reorganization plan's release provision 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.¹³

Several NHF donors challenged the reorganization plan's confirmation on the grounds that the release provision was invalid.¹⁴ The district court initially affirmed the bankruptcy court's confirmation of the reorganization plan.¹⁵

In the first appeal, the Fourth Circuit vacated that portion of the district court's judgment affirming the release provision, holding that the bankruptcy court failed to make sufficient factual findings to support its conclusion that the release provision was essential.¹⁶ "Although we reiterated this circuit's longstanding rule that nondebtor releases may be enforced in appropriate circumstances, we cautioned that they should only be approved 'cautiously and

8 *Id.*
9 *Id.*
10 *Id.*
11 *Id.*
12 *Id.* at *2-3.
13 *Id.* at *3.
14 *Id.*
15 *Id.*
16 *Id.* at *4.

1 2014 WL 2900933 (4th Cir. June 27, 2014).

2 Prohibiting nondebtor releases: *See, e.g., Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401 (9th Cir. 1995) ("[Section] 524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors."); *Landsing Diversified Properties II v. The First Nat'l Bank and Trust Co. of Tulsa (In re Western Real Estate Fund)*, 922 F.2d 592, 600-02 (10th Cir. 1990) (citing § 524(e) in refusing to enjoin creditor's suit against nondebtor post-confirmation because permanent injunction "effectively relieves the nondebtor from its own liability to the creditor"). Section 524(e) provides that "[e]xcept as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." No *per se* bar against nondebtor releases: *See, e.g., Deutsche Bank AG, London Branch v. Metromedia Fiber Network Inc. (In re Metromedia Fiber Network Inc.)*, 416 F.3d 136, 141 (2d Cir. 2005) ("[S]uch a release is proper only in rare cases."); *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 217 (3d Cir. 2000) (holding that lower courts lacked sufficient evidentiary and legal basis to authorize nondebtor release); *Nat'l Heritage Found. v. Highbourne Found.*, 2014 U.S. App. LEXIS 12144 (4th Cir. June 27, 2014) (allowed in "exceptional circumstances"); *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002) ("[E]njoining a nonconsenting creditor's claim is only appropriate in 'unusual circumstances.'").

3 *Johns-Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.)*, 517 F.3d 52, 55 (2d Cir. 2008), *rev'd sub nom., Travelers Indemn. Co. v. Bailey*, 129 S. Ct. 2195 (2009).

4 *Dow Corning*, 280 F.3d at 658.

5 *See* Jason W. Harbour, "Fourth Circuit Declines to Adopt Blanket Rule against Nonconsensual Nondebtor Releases," *ABI Journal*, Vol. XXXI, No. 2 (March 2012).

6 *Nat'l Heritage Found.* at *2.

7 *Id.*

infrequently.”¹⁷ To determine whether the appropriate circumstances existed in this case, the Fourth Circuit remanded the case with instructions to the bankruptcy court to consider the six substantive *Dow Corning* factors, specifically, 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 the reorganization;
- (4) the impacted class, or classes 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.¹⁸

A different bankruptcy judge considered the case on remand and gave the parties the option of reopening the record to present more evidence, but they declined to do so.¹⁹ The bankruptcy court concluded that only one *Dow Corning* factor had been met and declared the release provision unenforceable.²⁰ The district court affirmed.²¹

The Fourth Circuit held that NHF failed to carry its burden of proving that the facts and circumstances of the case justified the release provision.²² It found that only the first *Dow Corning* factor, an identity of interests between NHF and the released parties, existed.²³ The court concluded that an expansive indemnity obligation of NHF to the released parties under NHF’s bylaws was sufficient to meet the identity-of-interests factor.²⁴

The second *Dow Corning* factor required NHF to demonstrate that the released parties made a substantial contribution of assets to the reorganization.²⁵ The court found that none of the released parties made any financial contribution to the reorganization.²⁶ The court also dismissed NHF’s assertion that this factor was satisfied by NHF’s officers and directors promising to continue to serve, holding that the assertion lacked factual support and that, even if a promise to continue serving NHF had been made, it would not constitute a substantial contribution of assets,²⁷ nor did their prior service constitute a substantial contribution: “[O]fficers and directors, all of whom are insiders, performed their duties either because they were paid to do so (in the case of [the] officers), or because they had a fiduciary obligation to do so (in the case of the directors).”²⁸

The third *Dow Corning* factor required NHF to demonstrate that the release was “essential” to its reorganization.²⁹ NHF contended that the risk of litigation from its thousands of donors rendered the release provision essential because NHF would likely have to indemnify its officers

and directors for their legal expenses should such suits arise.³⁰ The court recognized the possibility of this indemnity obligation arising, but held that the evidence did not suggest that NHF’s reorganization is doomed without the release.³¹ “NHF has provided little to no evidence regarding the number of likely donor claims, the nature of such claims, or their potential merit.”³²

Nor did the court view the risk of officer and director flight as rendering the release essential to NHF’s reorganization plan.³³ In discounting this risk, the court noted that most of NHF’s insiders are members of a single family, and that the release itself provides little inducement for officers and directors to stay because the release would not shield them from liability for their continued service.³⁴ In addition, if the officers and directors did leave, NHF did not suggest that it would face difficulty recruiting new personnel.³⁵

The court also pointed to the reorganization plan’s severability clause as further support for its holding that the release was not shown to be essential to NHF’s reorganization.³⁶ The severability clause provided that the reorganization plan would remain in effect “[s]hould any provision in this Plan be determined to be unenforceable,” which suggested that the reorganization plan would remain viable absent the release.³⁷

“To satisfy the fourth *Dow Corning* factor, NHF was required to prove that the class” affected by the release — the donors — overwhelmingly voted in favor of the plan.³⁸ The reorganization plan presumed the donor class’s support for it without a formal vote because donor claims were eligible for full payment with interest under the plan.³⁹ NHF also asserted that the donor class’s support for the reorganization plan, if not presumed, was irrelevant because the donors are not actually creditors of NHF, having relinquished their ownership and control over the donated assets and maintaining only the ability to make nonbinding recommendations regarding the use of the assets.⁴⁰

The court did not resolve whether an unimpaired class’s presumed support for the reorganization plan is sufficient to satisfy this *Dow Corning* factor.⁴¹ The court viewed this factor as weighing “only marginally” in NHF’s favor and held that the presumed support “does not make up for the fact that most of the other *Dow Corning* factors weigh against enforcing the Release Provision.”⁴² The court also noted that the equities weighed against NHF in meeting this factor because the donors, those most affected by the release, were not given the opportunity to accept or reject the plan.⁴³

The fifth *Dow Corning* factor addresses whether the debtor’s plan provides a mechanism to consider and pay all or substantially all of the class(es) that were affected by

30 *Nat’l Heritage Found.* at *10.

31 *Id.* at *10–*11.

32 *Id.* at *10.

33 *Id.* at *11–*12.

34 *Id.* at *12.

35 *Id.*

36 *Id.* at *12–*13.

37 *Id.* at *13.

38 *Id.*

39 *Id.* at *13–14.

40 *Id.* at *14.

41 *Id.* at *15.

42 *Id.*

43 *Id.*

17 *Id.* (quoting *Behrmann v. Nat’l Heritage Found. Inc.*, 663 F.3d 704, 712 (4th Cir. 2011) (“NHF I”).)

18 *Id.* at *4–*5 (internal quotations omitted).

19 *Id.* at *5.

20 *Id.* at *5–*6.

21 *Id.*

22 *Id.* at *5.

23 *Id.* at *7–*8.

24 *Id.*

25 *Id.* at 8.

26 *Id.*

27 *Id.* at *8–*9.

28 *Id.* at *9 (quoting *NHF I* at 229).

29 *Id.* at *9–*10.

continued on page 62

Last in Line: Plan's Release of Nondebtors Invalid under Dow Corning

from page 35

the nondebtor release.⁴⁴ The court held that this factor was not met because NHF's reorganization plan did not include such a mechanism and NHF did not present any evidence, in the form of expert testimony or otherwise, that NHF made a bona fide effort to ensure the consideration of nearly all of the donor class's claims.⁴⁵

The final *Dow Corning* factor is whether the plan provides an opportunity for those who chose not to settle to recover in full.⁴⁶ The court held that this factor, like the fifth factor, was not met, reiterating the import of NHF's failure to provide any mechanism to pay donor claims outside of the bankruptcy proceedings.⁴⁷ "[T]he very purpose of the Release Provision is to preclude any recovery from third-party sources outside of the Plan."⁴⁸

Finding that only one *Dow Corning* factor — the identity of interests between NHF and the released parties due to an expansive indemnity provision — had been met, the Fourth Circuit held that NHF had not established "exceptional circumstances" justifying the nondebtor release.⁴⁹ The court advised that a debtor need not demonstrate that every *Dow Corning* factor weighs in its favor in order to obtain approval of a nondebtor release, but warned that adequate factual support must be shown to warrant such "exceptional relief."⁵⁰

Objecting to Nonconsensual Nondebtor Releases

While objections will be specific to the nature, scope and context of each plan's proposed nonconsensual nondebtor release, the Fourth Circuit's opinion provides guidance for objecting to plan release provisions. The following are considerations to include.

Adequate Factual Findings

The primary lesson of *National Heritage Foundation* is that adequate factual findings must support the jurisdiction's criteria for allowing a plan's release provision. Objectors in bankruptcy court should proffer evidence opposing the release, and the lack of sufficient factual findings should be exploited at trial and in any appeal.⁵¹

Expert Testimony

Objectors should not hesitate to provide expert testimony in opposition to the proposed release. NHF's failure to provide any expert testimony, including in connection with the likely number, nature and potential merits of donor claims, and with respect to the plan's protection of donor's interests,

was held against it.⁵² Objectors should also consider having an expert testify about the alleged substantial contribution by those whom the plan proposes to release.

Plan Severability Clause

Plans routinely contain broad severability clauses, stating that the plan will remain in effect should any provision in it be determined to be unenforceable. A severability clause can be used to an objector's advantage. The Fourth Circuit cited the severability clause in NHF's reorganization plan in holding that the release of nondebtors was not essential to the reorganization plan.⁵³

Equitable Mootness

Equitable mootness was not addressed in the *National Heritage Foundation* case, but it is an important consideration in litigating an objection to a plan's nonconsensual nondebtor releases. The Second Circuit in *Deutsche Bank AG, London Branch v. Metromedia Fiber Network Inc. (In re Metromedia Fiber Network Inc.)*,⁵⁴ citing *Dow Corning*, held that the bankruptcy court's findings were insufficient to support the validity of the plan's nonconsensual nondebtor release, but dismissed the appeal as "equitably moot."⁵⁵ "Equitable mootness is a prudential doctrine that is invoked to avoid disturbing a reorganization plan once [it has been] implemented."⁵⁶ The court explained that "an appeal should ... be dismissed as moot when, even though effective relief could conceivably be fashioned, implementation of that relief would be inequitable."⁵⁷

The *Metromedia* court gave significance to the fact that the appellants did not seek a stay of the confirmation order, nor did they seek an expedited review of their appeal.⁵⁸ The court held that the debtor's plan had been substantially consummated and therefore refused to disturb the bargain that had been struck by the debtor and the released parties.⁵⁹ Consequently, those objecting to plan release provisions should diligently pursue a stay of the confirmation order and expedited consideration of any appeal.

Conclusion

A chapter 11 plan's nonconsensual release of nondebtors will typically face an uphill approval battle. The Fourth Circuit's decision in *National Heritage Foundation* outlines the typical areas of dispute and provides guidance for objecting parties.⁶⁰ **abi**

⁵² *Id.* at *10 and *17.

⁵³ *Id.* at *12-13.

⁵⁴ *Deutsche Bank AG, London Branch v. Metromedia Fiber Network Inc. (In re Metromedia Fiber Network Inc.)*, 416 F.3d 136 (2d Cir. 2005).

⁵⁵ *Id.* at 139.

⁵⁶ *Id.* at 144.

⁵⁷ *Id.* at 143.

⁵⁸ *Id.* at 144.

⁵⁹ *Id.* at 145. The court did not indicate whether the debtor's plan contained a severability clause.

⁶⁰ *Nat'l Heritage Found.* at *20.

⁴⁴ *Id.*

⁴⁵ *Id.* at *17.

⁴⁶ *Id.*

⁴⁷ *Id.* at *17-18.

⁴⁸ *Id.* (citation and internal quotation omitted).

⁴⁹ *Id.* at *18-19.

⁵⁰ *Id.* at *19.

⁵¹ *Id.* at *10.

Copyright 2014

American Bankruptcy Institute.

Please contact ABI at (703) 739-0800 for reprint permission.