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The Battle Over 3rd-Party Releases Continues

By **Matthew Kelsey, J. Eric Wise and Matthew Porcelli**
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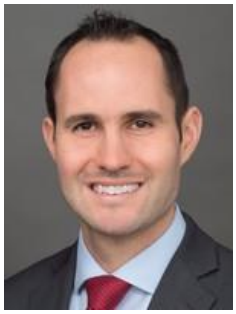
As discussed in our prior Law360 article, "A Tale of 2 Cases on 3rd-Party Releases," bankruptcy courts considering whether to approve nonconsensual third-party nondebtor releases included in a plan of reorganization have taken divergent approaches to determine which "operative proceeding" is appropriate for analyzing whether the court has jurisdiction or constitutional authority to approve the releases.[1] The question before these courts is whether the relevant operative proceeding is (1) the actual proceeding before the bankruptcy court (i.e., a confirmation hearing involving a plan that includes such releases)[2] or (2) a separate proceeding (whether actual or hypothetical) in which a third party has asserted or could assert claims to be released under a proposed plan.[3]


J. Eric Wise

On Nov. 8, 2017, the U.S. Bankruptcy Court for the Southern District of New York issued a decision and order invalidating certain nonconsensual third-party nondebtor releases included in SunEdison Inc.'s confirmed plan of reorganization.[4] In so doing, the court followed the second approach to the operative proceeding analysis recently articulated in the Midway Gold case, essentially holding that it lacked subject matter jurisdiction to grant releases that would enjoin unasserted potential claims held by nonobjecting third parties against nondebtor parties.

Overview of the SunEdison Decision


Matthew Porcelli

The SunEdison nonconsensual third-party release dispute arose in an unusual procedural context. The debtors' plan of reorganization contained a broad third-party release provision in favor of certain nondebtors, and the parties who were deemed to grant releases under the plan included all holders of claims entitled to vote on the plan who did not vote to reject the plan (the "nonvoting releasors). No nonvoting releasors objected to the plan's release provisions. Nevertheless, in connection with the confirmation hearing, the court sua sponte raised the issue of whether it should approve the releases by the nonvoting releasors. The court confirmed the debtors' plan on July 28, 2017, reserving decision on the release issue.[5]

After supplemental briefing, the court declined to approve the releases in their proposed form. First, the court rejected the debtors' argument that the nonvoting releasors had implicitly consented to the releases. The debtors contended that the conspicuous warning included in the disclosure statement and ballots regarding the effect of the releases on nonvoting releasors was sufficient to deem them as having consented to the nondebtor release.[6] The court rejected this position, concluding that, under New York law, silence cannot be deemed to be consent unless the silent party is under a duty to speak. As the court noted, the debtors failed to identify any such duty of the nonvoting releasors.[7]

Next, the court held that the debtors had not met their burden of showing that the court had subject matter jurisdiction to approve the nondebtor releases. The debtors argued that the court's jurisdiction was supported by the debtors' potential indemnification obligations to the released parties under their charters, indemnification agreements and the debtor-in-possession credit agreements.[8] While the court acknowledged that, generally, such indemnification obligations would be sufficient to establish jurisdiction, the court also noted that the releases granted under the plan were broader than the debtors' potential indemnification obligations.[9]

For example, the indemnification obligations under the DIP credit agreement related solely to post-petition acts, but the plan releases enjoined claims taking place on or before the effective date of the plan — i.e. "claims … that arose from the beginning of time to an unspecified date in the *future* when the Effective Date occurs."[10] Further, the plan release covered more parties than were covered by the potential indemnification obligations cited by the debtors, including underwriters, arrangers, and placement agents for the prepetition second-lien notes and current and former affiliates, subsidiaries, advisers, management, employees, and other representatives and professionals of each of the released parties.

As the court observed, the debtors had "not pointed to any indemnification obligations running in favor of these unidentifiable Released Parties."[11] Accordingly, the court concluded that the debtors had not established subject matter jurisdiction because "[t]he reference to certain indemnity obligations owed to a few parties does not prove that the outcome of the universe of claims the Debtors seek to enjoin will have a conceivable effect on the estate."[12]

Lastly, the court observed that the debtors had also failed to demonstrate that the releases were appropriate under the Second Circuit's Metromedia standard.[13] Accordingly, the court granted the debtors leave to propose a modified form of release within 30 days of the order.[14]

The SunEdison Court's Operative Proceeding Analysis

The SunEdison court's consideration of the "operative proceeding" issue was articulated as follows:

In assessing a court's jurisdiction to enjoin a third party dispute under a plan, the question is not whether the court has jurisdiction over the settlement that incorporates the third party release, but *whether it has jurisdiction over the attempts to enjoin the creditors' unasserted claims against the third party*.[15]

In support of this statement, the court cited a Second Circuit decision from the Johns-Manville bankruptcy case and a decision from Matter of Zale Corp., a Fifth Circuit case relied on by the Johns-Manville court.[16] In Zale, the creditors committee planned to sue the debtor's officers and directors, who were covered by a primary insurance policy with Cigna and an excess policy with the National Union Fire Insurance Co. (NUFIC).[17] The bankruptcy court granted a motion to approve a

multiparty settlement agreement, which included an injunction barring NUFIC from suing Cigna for its actions related to the settlement.[18] On appeal, NUFIC challenged the injunction, arguing that the bankruptcy court did not have jurisdiction over its tort claims against Cigna.[19] The Fifth Circuit agreed, explaining that because NUFIC's claims against CIGNA were not property of the debtor's estate and did not implicate any independent obligation of the debtor in favor of Cigna, "the settlement cannot provide the basis for jurisdiction over the [tort] claims."[20] Following Zale, the Second Circuit in Johns-Manville concluded that the bankruptcy court had no jurisdiction to enjoin third-party plaintiffs' direct action claims against Travelers, a primary insurer of the debtor asbestos manufacturer, in connection with its approval of a settlement agreement.[21]

Thus, in considering its jurisdiction not in the context of the confirmation hearing before it, but by looking at the universe of claims that would be enjoined, the SunEdison court took the approach of the Midway Gold court, rather than the "operative proceeding" analysis in Millennium Labs.[22] In other words, the SunEdison court focused not on the nature of the proceeding before it — a confirmation hearing — but on the nature of separate hypothetical proceedings in which the nonvoting releasors could assert claims against the nondebtor releasees. Like the Midway Gold court, the SunEdison court never used the words "operative proceeding" in its decision, yet implicitly rejected the framework established in Millennium Labs.

Notably, both the Zales and Johns-Manville cases relied upon by the SunEdison court involved approval of a settlement agreement, while the SunEdison plan releases arose in the context of plan confirmation hearing. By relying on these precedents, the SunEdison court did not consider whether this distinction was relevant. By contrast, in Millennium Labs, the court was satisfied that it had subject matter jurisdiction because the challenged releases arose in the context of a confirmation hearing, and confirmation of a plan is a statutorily enumerated "core" proceeding covered by Congress' grant of jurisdiction for cases "arising in" or "arising under" a case under title 11 of the United States Code.[23]

The SunEdison debtors brought the Millennium Labs decision to the court's attention in a supplemental letter brief.[24] Urging the court to approve the releases, the debtors cited the Millennium Labs court's conclusion that "the operative proceeding for purposes of a constitutional analysis [was] confirmation of a plan" and not any actions "that would be released incident to plan confirmation."[25] In a footnote, the SunEdison court acknowledged that the Millennium Labs court concluded that it had the constitutional authority under Stern v. Marshall[26] to enter a final judgment enjoining the assertion of a third-party claim by a nonconsenting creditor, but stated that because it was not approving the releases, it did not need to resolve the question of its constitutional authority. The court did not, however, consider whether the Millennium Labs "operative proceeding" analysis could also be relevant in connection with the related question of whether a court has subject matter jurisdiction to confirm a plan including nonconsensual third-party nondebtor releases.

Practical Implications

While the SunEdison decision provides another data point regarding courts' analysis of nonconsensual third-party releases, it leaves some questions unanswered. First, by limiting its analysis of the Millennium Labs decision to a footnote on its constitutional authority under Stern, the court declined to consider how the Millennium Labs court's "operative proceeding" analysis would apply in connection with determining whether a court has subject matter jurisdiction to confirm a plan containing a third-party release provision. Second, by concluding that the subject matter jurisdiction analysis was properly focused not on "the settlement that incorporates the third party release" but on "the attempts to enjoin the creditors' unasserted claims against [a] third party,"[27] the court did not expressly consider

whether the context of a plan confirmation (as opposed to approval of a settlement) was relevant to the analysis. Future decisions, including the pending appeal of the Millennium Labs decision, will shed more light on how courts will ultimately bear down on this developing issue.

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[1] https://www.law360.com/articles/984058/a-tale-of-2-cases-on-3rd-party-releases

[2] See In re Millennium Lab Holdings II LLC, No. 15-12284 (LSS), __ B.R.__, 2017 WL 4417562 (Bankr. D. Del. Oct. 3, 2017) ("Millennium Labs").

[3] See In re Midway Gold US Inc., No. 15-16835 (MER), __ B.R. __, 2017 WL 4480818 (Bankr. D. Colo. Oct. 6, 2017) ("Midway Gold").

[4] In re SunEdison Inc., No. 16-10992 (SMB) ("SunEdison"), Dkt. No. 4253 (Bankr. S.D.N.Y. Nov. 8, 2017) (the "Decision").

[5] Specifically, the confirmation order provided that "whether Holders of Claims entitled to vote to accept or reject the Plan that did not in fact vote either to accept or reject the Plan are included as Releasing Parties [] and therefore subject to the releases contemplated in [] the Plan, is reserved by the Court for subsequent determination." SunEdison, Dkt. No. 3735 at ¶ HH (Jul. 28, 2017).

[6] Decision at 6.

[7] Decision at 10-11.

[8] Decision at 13.

[9] Decision at 14-15.

[10] Decision at 15 (emphasis in original).

[11] Decision at 16.

[12] Id.

[13] Id.; see Deutsche Bank AG v. Metromedia Fiber Network Inc. (In re Metromedia Fiber Network Inc.), 416 F.3d 135, 142 (2d Cir. 2005) (in deciding whether a third-party release is appropriate, courts have considered whether the estate has received a substantial contribution, whether the enjoined claims are channeled to a settlement fund rather than extinguished, whether the enjoined claims would indirectly impact the debtor's reorganization through claims of indemnification or contribution, whether the plan otherwise provides for payment in full of the enjoined claims, and whether the creditor has consented).

[14] Decision at 16.

[15] Decision at 12 (emphasis added).

[16] Johns-Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.), 517 F.3d 52, 65 (2d Cir. 2008), vacated & remanded on other grounds, 557 U.S. 137 (2009), aff'g in part & rev'g in part, 600 F.3d 135 (2d Cir.); Feld v. Zale Corp. (In re Zale Corp.), 62 F.3d 746, 755 (5th Cir. 1995). The court separately cited an Eleventh Circuit decision, Shearson Lehman Bros Inc. v. Munford Inc. (In re Munford Inc.), 97 F.3d 449, 454 (11th Cir. 1996).

[17] Zale, 62 F.3d at 749-50.

[18] Id.

[19] Id. at 755.

[20] Id. at 756-57.

[21] Johns-Manville, 517 F.3d at 65. Similarly, the Eleventh Circuit held in Munford that it was "not the language of the settlement agreement that confers subject matter jurisdiction in this case. Rather, it is the 'nexus' of those claims to the settlement agreement ... that the bankruptcy court must approve ...." 97 F.3d at 454.

[22] See Midway Gold, 2017 WL 4480818 at *30-34; Millennium Labs, 2017 WL 4417562 at *14-16.

[23] Millennium Labs at *6.

[24] In re SunEdison, No. 16-10992, Dkt. No. 4139 (Bankr. S.D.N.Y. Oct. 13, 2017).

[25] Id. at 2 (citing Millennium Labs, No. 15-12284, Dkt. No. 476 at 27, 31-33 (Bankr. D. Del. Oct. 3, 2017)).

[26] 131 S. Ct. 2594 (2011).

[27] Decision at 12.