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Please Release Me: How To Obtain Or Prevent Third-Party Releases In Bankruptcy

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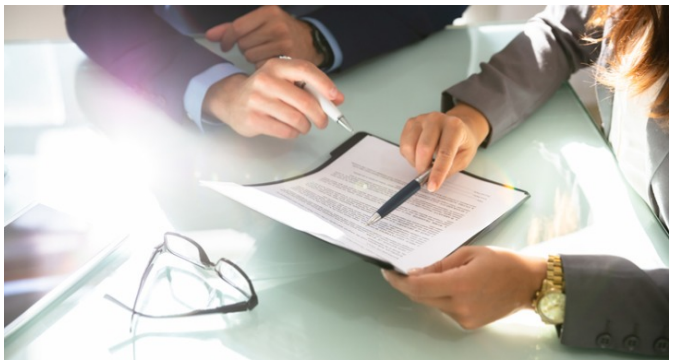

Bankruptcy protection—particularly a Chapter 11 reorganization—can be a powerful tool for a company in financial distress. But can a debtor company go even further and use its plan of reorganization to secure releases not only for itself, but for third parties such as its officers or owners? If a company succeeds in having a bankruptcy court confirm a plan of reorganization, it can—and often will—reduce or eliminate many of its obligations to its creditors. This can occur despite often heated dissent from the affected creditors. Like it or not, that is the reality of the remedies afforded by the Bankruptcy Code.

It will come as no surprise that an owner of a company in bankruptcy would like to secure the owner's own release as part of the company's reorganization. Creditors, on the other hand, will be of a different mind—particularly those creditors with signed guaranty agreements from the owner. If the creditors oppose the confirmation of the company's reorganization plan, they will be looking to the debtor's owners to satisfy the bankrupt company's debt and will vehemently oppose any release of the owner.

So, under what circumstances will a bankruptcy court allow third-party releases as part of the confirmation process?

Recently, the United States Court of Appeals for the Fourth Circuit, whose decisions are binding on all bankruptcy courts in North Carolina, addressed this issue and delivered what can only be described as a victory for creditors. The Court's decision was that bankruptcy courts cannot rubber stamp third-party releases in Chapter 11 plans. A third-party release can survive the confirmation process, but the debtor will have to prove that "unique circumstances" justify the release.

How do you determine if sufficient "unique circumstances" exist to justify a third-party release in a plan? The Fourth Circuit adopted a multi-factor test that will serve as a blueprint for debtors seeking third-party releases and for creditors opposing them.

Here are the factors:

- Do the debtor and the third party share a unity of interest? If there is an indemnity relationship between the third party and the debtor whereby the debtor would be obligated to reimburse the third party for any claims the third party has to pay to the creditor, a release of the third party may be appropriate because a suit against the third party may be tantamount to a suit against the debtor by

virtue of the indemnity.

- Has the third party contributed substantial assets to the debtor company's reorganization? The debtor must prove that the third party whose release is sought made a substantial, cognizable, and valid contribution of assets to the debtor as part of the reorganization. Merely serving as an officer or director of the company will not be enough. The third party needs to provide funding or other asset to the debtor.
- Is the release of the third party essential to the debtor company's reorganization? The debtor must establish that successful reorganization hinges on it being free and clear from indirect suits against parties who would have indemnity or contribution claims against the debtor. Like the first factor, a debtor will be more likely to secure a third-party release if it can prove that there is a risk of significant litigation against the third parties that will directly impact the debtor's reorganization efforts.
- Have the creditors that would be affected by the release overwhelmingly voted in favor of the plan including the release? To determine if the creditors who will be affected by the third-party release approve of it, the Fourth Circuit decision suggests that a debtor should implement a procedure allowing each creditor the right to vote on the release separately from the vote of that creditor's class on the plan as a whole. In other words, courts should be reluctant to presume acceptance of a third-party release by creditors who are not impaired under the plan and deemed to accept it without voting.
- Does the debtor's reorganization plan provide a mechanism to consider and pay substantially all claims of the creditors affected by the third-party release? Here, the debtor must establish that it encouraged the affected creditors' participation in the bankruptcy process and provided a mechanism to ensure that their claims are not extinguished by the third-party release.
- Does the debtor's reorganization plan provide an opportunity for those who choose not to settle to recover in full? This factor overlaps with the previous factor and reiterates the point that a debtor must create a mechanism to pay the creditors affected by the third-party release outside of the bankruptcy—such as through a separate settlement fund. Absent that, the court will frown upon a release that precludes any recovery from third parties outside of the plan.

The Fourth Circuit has now provided a detailed blueprint for debtors seeking third-party releases in reorganization plans and for creditors challenging those releases. As the bankruptcy courts apply these factors to different cases, we will gain more insight into the willingness, or reluctance, of the courts to confirm plans with third-party releases.

If you are involved in a Chapter 11 case where third-party releases are, or may become, an issue, you should contact an experienced creditors' rights bankruptcy attorney for more information on how best to advocate your position.

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