

DELAWARE BANKRUPTCY BULLETIN

Delaware Bankruptcy Court Approves Non-Consensual Third Party Releases in Chapter 11 Plan

Recently, in In re Freedom Rings, LLC, Judge Sontchi of the United States Bankruptcy Court for the District of Delaware, approved non-consensual third party releases over the United States Trustee's (the "UST") objection. Judge Sontchi decided that there is no per se rule against non-consensual third party releases, but that the "three hallmarks of a permissible non-consensual release [are]: one, fairness; two, necessity to the reorganization; and three, specific factual findings supporting items one and two." Judge Sontchi also determined that the Court need not examine whether the case is an "extraordinary" one to approve a non-consensual third party release.

At issue was a liquidating chapter 11 plan, which was unopposed but for the UST's objection to the non-consensual third party releases. Those releases flowed to the benefit of the debtor's largest unsecured creditor and debtor in possession lender, Krispy Kreme Doughnut Corporation ("KKDC"), and Credit Suisse, which was the holder of a contingent secured claim against the debtor, as well as each of their affiliates, officers, directors, etc.

The Court rejected the UST's position that the releases were impermissible as a matter of law based upon In re Zenith Electronics Corp., 241 B.R. 92 (Bankr. D. Del. 1999). Reasoning that it had jurisdiction to enter an order providing for non-consensual third party releases, such as in the context of a sale of assets under section 363 of the Bankruptcy Code, the Court determined that it had jurisdiction to consider such releases in the plan confirmation context. Accordingly, applying such a per se rule against non-consensual third party releases would be "inappropriate."

According to Judge Sontchi, the Third Circuit opinion in Gillman v. Continental Airlines (In re Continental Airlines), 203 F. 3d 203 (3d Cir. 2000) applies the framework of a three prong test to approve a non-consensual release. According to the Court:

"In order to meet the burden of establishing that the third party releases are fair and necessary to the reorganization, I hold that the Plan proponents must establish by a preponderance of the evidence that, one, there is material, specific and identifiable consideration flowing from the releasees to the releasors, either directly or through the Plan, that is a fair exchange for the releases being granted, and two, it is unlikely that the Debtor will be able to confirm a Plan, not necessarily the specific Plan before the Court, absent such releases."

The Court also rejected the UST's position that non-consensual third party releases require extraordinary circumstances. Judge Sontchi pointed out that the Third Circuit did not focus on whether such releases are only appropriate in extraordinary cases. He further noted that focusing on whether a case is extraordinary or not is "not particularly helpful" as many times even the "small cases . . . present their own challenges and are in many ways more extraordinary than your run of the mill \$100 million Debtor case."

In approving the non-consensual third party releases, the Court found that: (1) KKDC provided consideration by foregoing certain distributions and waiving its right to share in proceeds of avoidance actions; (2) Credit Suisse was providing consideration in waiving its contingent secured claim; (3) these considerations flow to the benefit of the third party releasors through the Plan because such waived recoveries are available to fund a distribution to unsecured creditors and waiver of the secured claim allows junior creditors to recover monies not available to them if the secured claim were liquidated; (4) the consideration is material, as in this case it enhanced recoveries by three to four times; (5) the consideration is a fair exchange for the releases as there was a release provision in the DIP financing order in the case in favor of KKDC, which rendered claims against the KKDC uncertain and because the claims in the case were small enough that the claimants would unlikely assert claims against the third parties; and (6) the third party releases were the “lynch-pin” to being able to confirm any plan in the case. Because the releasees would demand such releases in exchange for funding any plan in the case, the only other alternative would be to convert the case to a Chapter 7. According to the Court, “while a liquidating plan such as this does not implicate the policies behind rehabilitating businesses under Chapter 11, such as preserving jobs, I believe it does serve the policy of the Code in general, and that is the orderly and efficient liquidation of the Debtor’s estate for the benefit of its creditors.”

Although not binding precedent, this ruling provides a framework for parties to argue in support of non-consensual third party releases. In so doing, further clarity has been given to parties in negotiating acceptable chapter 11 plans in the Delaware Bankruptcy Court.

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