THIRD-PARTY RELEASES AND CONTROVERSIAL PLAN PROVISIONS

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I. Introduction

The culmination of a successful restructuring in Chapter 11 is confirmation of a plan of reorganization. A crafty plan of reorganization can serve as a vehicle for some pretty amazing results, including not only substantial debt restructuring, but also sales of all of the debtors' assets, compromises of significant litigation, and channeling injunctions for certain mass-tort claims, to name a few. Of course, creditors that are impacted by the plan often disagree with plan proponent's approach and commence confirmation litigation to drive toward a different outcome. In this paper, we address four plan-related issues that have created much controversy in the past few years: the often misunderstood plan releases and exculpations, the infamous "Texas Two-Step", the ominously-worded "Deathtrap" provisions, and the now ubiquitous rights offerings.

II. Exculpations, Debtor's Releases, and Third-Party Releases

Frequently a fundamental component of a chapter 11 bankruptcy is the exculpation and releases provided in a plan of reorganization or liquidation. Historically, exculpation and releases have not garnered much attention because both typically focused on relieving the debtor or professionals of the estate from liability. However, in recent years broad exculpation provisions

and third-party releases have become increasing popular, which has led to a flurry of plan objections and case law addressing the concerns of absolving a non-debtor of liability. There are three primary mechanisms for relieving an individual of liability pursuant to a bankruptcy plan—(1) exculpations, (2) debtor's releases, and (3) third-party releases. Attached as **Appendix A** is a chart further explaining exculpations, debtor's releases, and third-party releases.

a. Exculpations

An exculpation absolves a party's liability for conduct during the course of the bankruptcy case. Typically, exculpation provisions exclude acts that were willful misconduct, gross negligence or bad faith. Exculpations are intended to provide qualified immunity to those constituents and parties who served as fiduciaries during the case or made substantial and critical contributions, without which the key constituents may have been reluctant to participate in the case. Individuals typically protected by an exculpation provision include the debtor, the debtor's officers and directors, members of an official committee, lenders, asset purchasers and professionals retained by the foregoing. While exculpations are usually noncontroversial, objections may arise when the provision is drafted too broadly, the scope of the exculpation goes beyond activities that occurred during the pendency of the case or the exculpation was not sufficiently related to case activities. Pursuant to the Fifth Circuit's *Pacific Lumber* opinion, an exculpation provision must be narrowly tailored so that it does not provide a nonconsensual release to a third-party, as discussed in Section II(c) of this paper. When bankruptcy courts evaluate whether to approve a plan's exculpation provision, the court may ask whether the proposed exculpation is reasonably limited to protect estate and court approved actions?[1]

[1] *In re Bainbridge Uinta, LLC*, No. 20-42794 (MXM) (Bankr. N.D. Tex. July 7, 2021) [Dkt. 366].

b. Debtor's Release

A debtor's release may release both prepetition and post-petition claims belonging to the debtor against various non-debtors. A debtor's release is intended to provide protection for those parties that substantially contribute to the bankruptcy case from potential prosecution of causes of action, which may otherwise discourage their participation. Notably, a debtor's release typically excludes chapter 5 causes of actions (avoidance actions). The individuals protected by a debtor's release vary but typically include parties that participated in the debtor's restructuring process. Debtor's releases are usually noncontroversial, but an objection may be raised when the debtor attempts to release a claim that a third party is entitled to assert such as a derivative action or fraudulent transfer. When evaluating whether to approve a debtor's release, the bankruptcy court may ask whether the proposed releases of the debtor's claims constitute an exercise of the debtor's reasonable business judgment, is fair and equitable, and is in the best interest of the debtor's estate, given all of the relevant facts and circumstances of the case?[2]

c. Third-Party Release

Potentially, the most controversial component of a plan may be a third-party release. Third-party releases are either consensual or nonconsensual. Every circuit permits consensual third-party releases, but there is a circuit split on whether nonconsensual third-party releases are permissible. Circuits that permit nonconsensual third-party releases *in unusual circumstances* include the Second, Third, Fourth, Sixth, Seventh and Eleventh. While the Fifth and Tenth Circuits do not permit nonconsensual third-party releases.[3]

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[2] *Id.*

[3] *Bank of New York Trust Co. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229, 251 (5th Cir. 2009); *In re Bigler*, 442 B.R. 537, 543–44 (Bankr. S.D. Tex. 2010).

Although the precise meaning of "consensual" is still up for debate, bankruptcy courts have considered an individual to have consented to a third-party release if the party (1) votes in favor of the plan and (2) receives consideration in exchange for the release.[4] Additionally, bankruptcy courts within the Fifth Circuit may approve a third-party release as "consensual" if the plan's ballot provides an option to opt-out.[5]

In contrast, a nonconsensual third-party release is one that binds a party who specifically objects to the provision.[6] No uniform test has been adopted by bankruptcy courts for the evaluation of a nonconsensual release, but many courts utilize the *Master Mortgage* test, including the Northern District of Texas Bankruptcy Court.[7] The *Master Mortgage* test considers the "(1) identity of interest between the debtor and the third-party, (2) substantial contribution of assets to reorganization, (3) release is necessary to the reorganization, (4) majority of affected creditors have overwhelmingly accepted plan treatment, and (5) plan provides payment of all, or substantially all, of affected classes' claims."[8] The opposition to nonconsensual third-party releases stems from the release absolving or, at minimum, limiting a third party's liability to another third party. In addition, parties are concerned that third-party releases are not explicitly authorized in

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[4] *In re CJ Holding Co.*, 597 B.R. 597, 609 (S.D. Tex. 2019).

[5] In the following cases, the bankruptcy court approved third-party releases when the parties were entitled to opt-out: *In re Bainbridge Uinta, LLC*, No. 20-42794 (MXM) (Bankr. N.D. Tex. June 28, 2021) [Dkt. No. 358]; *In re Studio Movie Grill Holdings, LLC*, No. 20-32633 (SGJ) (Bankr. N.D. Tex. Mar. 31, 2021) [Dkt. No. 875]; *In re Highland Capital Management, LP*, No. 19-34054 (SGJ) (N.D. Tex. Feb. 22, 2021) [Dkt. No. 1943]; *In re TriVascular Sales LLC*, No. 20-31840 (SGJ) (Bankr. N.D. Tex. Sept. 16, 2020) [Dkt. No. 390; *In re McDermott Int'l Inc.*, No. 20-30336 (DRJ) (Bankr. S.D. Tex. Mar. 14, 2020) [Dkt. No. 684]; In re EP Energy Corp., No. 19-35654 (MI) (Bankr. S.D. Tex. Mar. 12, 2020) [Dkt. No. 1049]; *In re Think Finance, LLC*, No. 17-3394 (HDH) (Bankr. N.D. Tex. Dec. 5, 2019) [Dkt. No. 1671]; *In re Legacy Reserves Inc.*, No. 19-33395 (MI) (Bankr. S.D. Tex. Nov. 15, 2019) [Dkt. No. 838; *In re Bristow Group Inc.*, No 19-32713 (DRJ) (Bankr. S.D. Tex. Oct. 8, 2019) [Dkt. No. 825]; *In re iHeartMedia, Inc.*, No 18-31274 (MI) (Bankr. S.D. Tex. Jan. 22, 2019) [Dkt. No. 2525].

[6] *In re Pilgrim's Pride Corp.*, No. 08-45664, 2010 WL 200000, at *5 (Bankr. N.D. Tex. Jan. 14, 2010) (Under *Pacific Lumber* "the court may not, over objection, approve through confirmation of the Plan third-party protections").

[7] *In re Wool Growers Cent. Storage Co.*, 371 B.R. 768, 777 (Bankr. N.D. Tex. 2007).

[8] *Id.; In re Master Mortg. Inv. Fund, Inc.*, 168 B.R. 930, 934 (Bankr. W.D. Mo. 1994).

the Bankruptcy Code, except in asbestos cases under certain conditions and that the releases can be potentially abused by non-debtors to shield themselves from liability to third parties, which may effectively operate as a bankruptcy discharge without a filing and without the safeguards of the Bankruptcy Code. Whether a third-party release will be approved by the bankruptcy court is a factually intensive analysis that focuses on the breadth of and basis for the particular release.

III. Divisional Mergers (aka, the "Texas Two-Step")

Perhaps no restructuring strategy has garnered more attention over the past few years than a divisional merger promptly followed by the chapter 11 filing of one of the survivors of the merger, often referred to as the "Texas Two-Step".[9] This strategy is not necessarily a new one as this feature has existed in corporate law in Texas and elsewhere for decades; however, several recent cases, along with an unusual amount of media and industry press coverage, has placed divisive merger bankruptcies at the forefront of chapter 11 controversy in 2021 and 2022.

The Texas Two-Step strategy is based upon certain features of the Texas Business Organizations Code (the "**TBOC**"). Like most (if not all) states, Texas corporate law facilitates corporate mergers.[10] However, the TBOC is unique because under Texas law, the term "merger" includes not only the common understanding of the term as the combination of two or more entities, but also the ***division of one entity into two or more new entities*** (the "**Texas Divisive Merger Statute**").[11] Texas law permits the organizations involved in the merger to create a "plan

[9] Of course, not all corporations that wish to take advantage of the Texas Two-Step are organized under Texas law. To take advantage of Texas's favorable law on this subject, some non-Texas organizations have reincorporated in or otherwise "legally relocated" to Texas, completed the divisive merger process, and then changed the state of incorporation of one or more of the surviving entities to another jurisdiction. Johnson & Johnson took this approach to create LTL Management, LLC, the debtor, in what has become one of the highest-profile Texas Two-Step cases in recent history.

[10] See generally Tex Bus. Orgs. Code Ann. § 10.

[11] See Tex. Bus. Orgs. Code Ann. § 1.002(55)(A), (B) (2019).

of merger" that dictates the allocation of assets and liabilities among the surviving entity or entities, [12] and provides that the property allocated to a surviving entity vests without any transfer having deemed to occur.[13] Of particular relevance to corporations facing significant liabilities, "where the dividing entity does not survive . . . and the plan of merger allocates a particular liability or obligation to a single new entity, that designated new entity is ***exclusively*** liable for the debt or other obligation."[14]

The ability to use the Texas Divisive Merger Statute to allocate liabilities to a single entity while maintaining assets in other members of a corporate family can be an attractive strategy for companies facing mass tort liabilities. Use of the Texas Divisive Merger Statute is a central feature of at least four recent chapter 11 filings: *In re LTL Mgmt., LLC*, Case No. 21-30589 (Bankr. D.N.J. 2021); *In re Aldrich Pump LLC*, Case No. 20-30608 (Bankr. W.D.N.C. 2020); *In re DBMP LLC*, Case No. 20-30080 (Bankr. W.D.N.C. 2020); *In re Bestwall LLC*, Case No. 17-31795 (Bankr. W.D. N.C. 2017). In each of these cases, the debtors were created under Texas corporate law and saddled with mass tort liabilities previously held by affiliated entities. The debtors then each filed a chapter 11 bankruptcy case with an agreement in place with a solvent member of their corporate family to fund the chapter 11 case, including a plan of reorganization.

In each of the "Big Four" cases noted above, while the debtors are engaging their tort claimants in negotiations or otherwise crafting an overall reorganization solution, they are facing an array of challenges from their tort-claimant creditors. Attached as **Appendix B** is a chart summarizing the most common opposition pleadings faced in a divisive merger bankruptcy.

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[12] See Tex. Bus. Orgs. Code Ann. § 10.008(a)(2), (3) (2019).

[13] Tex. Bus. Orgs. Code Ann. § 10.008(a)(2)(c).

[14] *In re LTL Mgmt., LLC*, 637 B.R. 396, 422 (Bankr. D. N.J. 2022) (emphasis added).

Despite the challenges posed by tort claimants, so far, none of the Big Four cases have been derailed.

IV. "Deathtrap" Provisions

A so-called "deathtrap" provision in a plan of reorganization is designed to incentivize (or, if you prefer, coerce) creditors to vote in favor of the plan. In its most classic form, a deathtrap provides a creditor class with some compensation if it votes "yes" and denies compensation if it votes "no."[15] Judges and commentators have described this as use of both "carrot" (the compensation provided in exchange for a "yes" vote) and "stick" (denial of compensation as a result of a "no" vote).[16] Starting with this framework, clever restructuring lawyers have created various forms of deathtrap provisions, with a range of positive incentives and several different degrees of potential coercion.[17]

A majority of cases that have ruled or commented on deathtrap provisions have upheld such provisions as permissible under the Bankruptcy Code. In *In re MPM Silicones, LLC* (often referred to as "*Momentive*"),[18] Judge Drain considered the request of the certain secured creditors to change their votes after solicitation had ended. The proposed plan contained a deathtrap mechanism that provided that if specified classes voted to accept the plan, claims would be paid in full in cash but without a premium or make-whole amount. If the classes voted against the plan, however, they would receive multi-year notes in the amount of the allowed claims, and a make-whole amount only if the court so determined. The classes voted to reject the plan, the court

[15] David A. Skeel Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366, 370 (2020).

[16] *See*, *e.g.*, *id*. at 371.

[17] Professor Skeel's article cited herein provides an interesting discussion of what he calls "distortive techniques", including deathtrap provisions, utilized in connection with plan confirmation.

[18] Case No. 14-22503-RDD (Bankr. S.D.N.Y. 2014).

determined that the make-whole amount was not owed, and the classes sought to change their votes in a classic case of "buyers' remorse." In rejecting the request to change votes, the court approvingly commented on deathtrap provisions fostering the overall policy of consensual plan processes. Judge Drain noted that through successful use of a deathtrap provision, the plan proponent "is saved the expense and uncertainty of a cramdown fight".[19]

In *In re Zenith Elecs. Corp.,* 241 B.R. 92, 96 (Bankr. D. Del. 1999), Judge Walrath overruled objections to a deathtrap provision in connection with approval of a disclosure statement and confirmation of a prepackaged plan. The *Zenith* plan provided that if a class of bondholders accepted the plan, they would receive a *pro rata* distribution of a $50 million new debenture but, if they rejected the plan, they would not be entitled to any distribution. According to Judge Walrath, "[t]here is no prohibition in the Code against a Plan proponent offering different treatment to a class depending on whether it votes to accept or reject the Plan…. This is in keeping with the Bankruptcy Code's overall policy of fostering consensual plans of reorganization and does not violate the fair and equitable requirement of section 1129(b)."[20] Accordingly, Judge Walrath confirmed the prepackaged plan.

The most oft-cited case in objections to deathtrap provisions is *In re MCorp Fin., Inc.,* 137 B.R. 219 (Bankr. S.D. Tex. 1992). In *MCorp*, the debtors proposed a plan that included a fairly aggressive deathtrap provision: if a senior class of equity holders voted against the plan, then that class, *as well as two other classes of equity holders*, would not be entitled to any distribution under the plan. Judge Letitia Clark concluded that because there is no express authority in the Bankruptcy

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[19] *See* Transcript of Sept. 9, 2014 Hr'g at 55, *In re MPM Silicones, LLC, et al.*, Case No. 14-22503-RDD.

[20] *Id.* at 105.

Code permitting deathtrap provisions, they are not permissible.[21] Subsequent courts, however, have approved plans containing deathtraps based on the inverse proposition: since the Bankruptcy Code does not expressly prohibit deathtrap provisions, they are permissible.[22]

The propriety of a deathtrap provision recently arose in the Northern District of Texas in the case, *In re Erickson Inc*., Case No. 16-34393-hdh (Bankr. N.D. Tex.). The debtors proposed a plan of reorganization that provided an equity distribution to a class of second lien secured lenders if they voted in favor of the plan.[23] If the class voted to reject the plan, they would instead be treated in the same manner as unsecured creditors and receive only a share of a liquidation trust, a less attractive treatment. Through this deathtrap[24] provision, the debtors hoped to incentivize the second lien secured lenders to vote in favor of the plan. The strategy ostensibly worked, as 94% in number and 98% in amount of votes cast in the class voted to accept the Plan, and the deathtrap was not triggered. However, the debtors faced a confirmation objection accusing them of "illegal coercion" based on the inclusion of the deathtrap.[25] In support, the objector cited *dicta* in *Adelphia* suggesting that deathtraps should only be permitted when the incentive provided is something that

[21] Judge Clark appeared to place some weight on the fact that the vote of the senior equity class not only deprived two other classes of a distribution but also disenfranchised them since, at the time of voting, the two classes were unaware of how the senior equity class would vote. *In re MCorp Fin., Inc.,* 137 B.R. at 236.

[22] *See In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 714, 717 (Bankr. S.D.N.Y. 1992) ("[*MCorp*] stand[s] for the proposition that there is 'no authority in the Bankruptcy Code for discrimination against classes who vote against the plan.' Yet, we find no statutory provision that proscribes such discrimination….We do not view the carrot and the stick, factually presented in this case, as forbidden by the Code or any law we know of."); *In re Adelphia Communications Corp.*, 368 B.R. 140, 275 (Bankr. S.D.N.Y. 2007) ("[A] 'carrot and stick' provision such as the one set forth in the Plan is wholly permissible….").

[23] Second Amended Joint Plan of Reorganization of Erickson Incorporated, et al., Pursuant to Chapter 11 of the Bankruptcy Code, at 11-12, *In Erickson Inc., et al.*, Case No. 16-34393-hdh (N.D. Tex. Bankr. Feb. 3, 2017), ECF No. 381.

[24] One of the co-authors of this paper represented the Debtors in the *Erickson* case and insists that the proper term for this type of provision is the more neutral "toggle" rather than the pejorative "deathtrap."

[25] Supplemental Objection of Wilmington Trust, National Association, as Indenture Trustee, to Confirmation of the Second Amended Joint Plan of Reorganization of Erickson Incorporated, et al., *In Erickson Inc., et al.*, Case No. 16-34393-hdh (N.D. Tex. Bankr. Mar.13, 2017), ECF No. 504.

the impacted creditors are not entitled to rather than a threat to take away an existing right.[26] Ultimately, the Debtors and the objecting creditor resolved the objection shortly before the confirmation hearing, so Judge Hale's views on deathtraps may remain forever a mystery.

V. Rights Offerings

Debtors and their professionals often need to take a creative approach to sourcing exit financing in order to emerge successfully from Chapter 11. One form of exit financing that has gained substantial popularity over the past several years is rights offerings. Typically, these offerings permit a defined group of creditors or equity holders to invest new money in the debtors, typically in the form of common or preferred equity in the reorganized company.[27] Debtors can use the capital raised through rights offerings to pay creditors' claims pursuant to the plan or to fund post-confirmation operations, among other purposes.

These arrangements are attractive to debtors because they provide capital without increasing the reorganized debtors' debt load and are usually structured to be exempt from SEC registration requirements pursuant to Bankruptcy Code section 1145.[28] Investors are incentivized to participate because they are typically provided a significant discount on the price of their equity investment. For example, in the *Ultra Petroleum* chapter 11 case, certain lenders were entitled to participate in an equity rights offering that provided the lenders with $900 million of estimated

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[26] *See In re Adelphia Comms. Corp.*, 368 B.R. 140, 276 (Bankr. S.D.N.Y. 2007).

[27] Neither the participants in the rights offering nor the form of securities are necessarily limited, but equity investments by existing stakeholders seem to be the most common situation in chapter 11 rights offerings, partially due to the registration exemption provided in Bankruptcy Code section 1145.

[28] Bankruptcy Code section 1145 provides an exemption to certain securities registration requirements if the offering is (i) made "under a plan"; (ii) in exchange for "a claim against, an interest in, or a claim for administrative expense"; and (iii) "principally in such exchange and party for cash or property". *See* 11 U.S.C. § 1145(a)(1). Bankruptcy Code section 1145(a)(2) provides a similar exemption for rights offerings made via warrants, options, and certain other vehicles. Certain rights offerings may qualify for an exemption as a private placement under Section 4(a)(2) of the Securities Act of 1933, although such offerings could create issues regarding unfair discrimination pursuant to Bankruptcy Code section 1123(a)(4).

value in exchange for an investment of $446 million for a discount of 50.4%.[29] As an additional incentive (albeit a negative one), if the potential participants in the rights offering are also within the same class of creditors or equity holders slotted to receive the remainder of the equity of the reorganized debtors, the failure to participate in the rights offering will result in dilution of the value of the equity distributed to non-participants under the plan. In other words, participation is attractive if it gets you more equity than "the other guy."

An interesting component of many rights offerings is a backstop commitment. This is a commitment by one or more of the offerees of the rights offering to purchase a specific portion of the offering. Backstop commitments are often critical because they provide debtors with comfort that the rights offering will provide the minimum amount of capital needed to meet the debtors' needs, which is often a key factor in establishing plan feasibility. Typically, the group committing to provide a backstop will insist on receiving a significant fee in exchange for the commitment, usually subject to prior bankruptcy court approval.[30] The backstop commitment fee is often satisfied not by a cash payment, but rather by equity in the reorganized company, usually provided at a discount. In certain circumstances, the backstop commitment parties have the potential to make incredibly healthy returns in exchange for their commitment.[31]

[29] *See* Mark Fischer, *Backstop Return Analysis: Returns on Equity Rights Offerings for Backstop Parties Average 35% at Plan Value; Secured Claims-Funded Backstop Returns Greatly Exceed Those Funded by Unsecured Equity; Adjusted Returns Significantly Higher Than Commitment Agreement Stated Fees*, REORG (Feb. 3, 2022), https://reorg.com/restructuring-analysis/. Mr. Fischer's informative article is reprinted in **Appendix C** hereto with permission.

[30] According to Reorg's recent analysis of cases involving rights offerings since 2020, the median commitment fee was 8.5% of the total rights being offered. However, Reorg also performed an additional calculation of commitment fees including discounts received by the commitment parties and subscription rights reserved for the commitment parties. Reorg concluded that these additional elements resulted in median "effective" commitment fees of 21% of the total rights being offered. *Id.*

[31] According to Reorg, the parties providing the backstop commitment in the *24 Hour Fitness* chapter 11 case had the potential for a whopping return of 134.8% based on the equity value assumed in the plan of reorganization. See *infra* App. C.

While rights offerings may seem like a practical means of raising exit capital, they often become the center of confirmation controversies. Parties that are excluded from the opportunity to participate in rights offerings, creditors that take issue with the discounts and fees provided to the participants, or other stakeholders who simply disagree with the selection of rights offering as the appropriate exit financing vehicle, lodge objections on various grounds including arguments that (i) the plan unfairly discriminates against classes or groups of creditors that were excluded from participating in the rights offering;[32] (ii) the discount provided to offering participants is excessive or otherwise unwarranted;[33] (iii) the debtors did not adequately market the rights before committing to the offering, rendering creditors unable to determine the propriety of the value conferred by the participants and the debtors unable to escape their commitment;[34] and (iv) the treatment or selection of the backstop parties is unfair or the offering is otherwise inappropriate.[35] Despite these challenges, debtors continue to have success in implementing rights offerings across industries and jurisdictions, and this method of exit financing appears to be here to stay.

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[32] *See, e.g.*, *In re Peabody Energy Corp*., 582 B.R. 771, 781-82 (E.D. Mo. 2017) (affirming on appeal plan confirmation order over the objection of creditors that a rights offering resulted in unfair discrimination); Findings of Fact, Conclusions of Law and Order Confirming the Debtors' Fourth Amended Joint Chapter 11 Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code, at 24-26, *In re CHC Group Ltd., et al.,* Case No. 16-31854-BJH-11 (Bankr. N.D. Tex., Mar. 3, 2017), ECF No. 1794.

[33] *See, e.g., In re Peabody Energy Corp*., 582 B.R. at 782.

[34] *See, e.g.,* Objection of the Ad Hoc Committee of Preferred Shareholders to Debtors' Motion for Entry of an Order (i) Authorizing Entry into the Backstop Commitment Agreement; (ii) Approving the Payment of Fees and Expenses Related Thereto, and (iii) Granting Related Relief, *In re Washington Prime Group Inc., et al.*, Case No. 21-31948-MI (Bankr. S.D. Tex. July 7, 2021), ECF No. 246.

[35] *See, e.g.*, Supplemental Objection of CNH Partners, LLC and AQR Capital Management LLC to Confirmation of the First Amended Joint Plan of Reorganization of SunEdison Inc. and its Debtor Affiliates, *In re SunEdison, Inc.*, Case No. 16-10992 (Bankr. S.D.N.Y., July 13, 2017), ECF No. 3592 (objection based on several grounds, including alleged lack of good faith and "illicit vote buying").