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‘Aegean Marine’: Non-Consensual Releases in Bankruptcy

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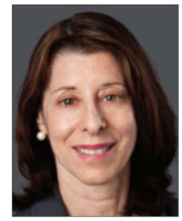

Chapter 11 of the U.S. Bankruptcy Code offers distressed companies the opportunity for a fresh start through a court-approved plan of reorganization. Companies can also efficiently administer their own liquidation under Chapter 11 through a court-approved plan of liquidation. Yet finalizing such plans is no picnic. The process is often contentious, and the plan can be a heavily-negotiated global settlement among many parties with divergent interests. Certain of those parties, such as pre- or post-petition lenders, may have had a long history of involvement with the debtor and may be supporting it financially during and following emergence from bankruptcy.

It comes as no surprise, then, that non-debtor parties involved in the plan process will want the plan to bar other non-debtor parties from bringing claims against them. These release and exculpation provisions have in most cases required the consent of the potential claimants. But debtors have been increasingly requesting non-consensual releases, meaning the releases would be imposed on potential claimants without their consent.

While the Code specifically allows release of a bankrupt debtor through its plan (although not all plans provide for releases), non-debtor parties do not enjoy a similar statutory benefit. To the contrary, §524(e) of the Code provides that discharge of the debtor does not affect the liability of third parties.

Federal circuit courts are divided in their willingness to include non-consensual releases and exculpation provisions in plans. Some courts (e.g., the Fifth, Ninth and Tenth Circuits) believe they do not have jurisdiction over these releases and they should therefore never be allowed. Meanwhile, others (e.g., the Second, Third, Fourth, Sixth, Seventh and Eleventh Circuits) have found authority to approve these releases through the broad statutory equitable powers of bankruptcy courts, albeit in limited circumstances.

As requests for these non-consensual releases, and objections to them, have become more common, courts have struggled to come to a consistent position. In a recent, somewhat strongly-worded decision, New York Southern District Bankruptcy Judge Michael E. Wiles in the case of *In re Aegean Marine Petroleum Network* (No. 18-13374, --- B.R. ---, 2019 WL 1527968 (Bankr. S.D.N.Y. April 8, 2019)) (*Aegean*) lays out in detail the court’s understanding as to the requirements in the Second Circuit for these releases. In so doing, he attempts to send a clear message

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'Aegean'

The *Aegean* case involved the reorganization of a marine fuel logistics company and its affiliates that market and supply refined marine fuel and lubricants. The debtors proposed a plan of reorganization that included both consensual and non-consensual releases, exculpation provisions and injunctions. The plan incorporated, inter alia, an exculpation provision that would, with the exception of claims based on fraud, willful misconduct, or gross negligence, exculpate third parties based on actions relating to the debtors' restructuring. The proposed definition of exculpated parties included the debtors, the unsecured creditors' committee, their respective advisors and employees, three individuals on the audit committee of the debtors' board of directors, as well as prepetition and DIP lenders Mercuria Asset Holdings (Hong Kong) Limited and Mercuria US Asset Holdings (*Mercuria*). Mercuria and its affiliates, one of the world's largest independent energy and commodity companies, was not only a prior lender but proposed to acquire ownership of the debtors pursuant to the plan.

The debtors also asked Judge Wiles to rule that all claims of any creditor, stockholder or other parties in interest against the foregoing entities and individuals that relate in any way to the debtors be released, barred and enjoined regardless of the consent of the potential claimants and without exception for fraud or willful misconduct. Both the U.S. Trustee and the U.S. Securities and Exchange Commission objected to those proposed releases of Mercuria and the audit committee members.

As an initial matter, the court noted that bankruptcy courts have in rem jurisdiction only over a debtor's property as well as claims against that property. In this instance, the claims at issue neither belonged to, nor were potential liabilities of, the debtors. The court observed that the parties were seeking a ruling that "extinguishes one non-debtor's claim against another non-debtor."

> Based on the 'Aegean' decision, a potential claimant may take comfort that, unless the bankruptcy court deems it necessary for a successful debtor reorganization, non-debtor third parties are unlikely to be released under a debtor's plan without notice to such claimant, the opportunity to appear in court and respond, or its consent.

The court then analyzed whether it had subject matter jurisdiction over the claims. Sections 157 and 1334 of the Bankruptcy Code give bankruptcy courts subject matter jurisdiction over "civil proceedings" related to a bankruptcy case. However, the third-party releases proposed by the debtors did not involve a separate proceeding—in fact, the court had been asked to adjudicate potential claims for which no live proceeding existed.

The court noted that even if there was an actual proceeding, that alone would be insufficient to confer power to adjudicate a claim. Any court would also need personal jurisdiction over the relevant parties. Providing mere notice of the claims and the proposed non-consensual release thereof, without proper service of process, was in the court's view insufficient to give it personal jurisdiction. The court noted that limited exceptions to the need for formal service of process, such as class actions in which absent members are permitted to opt out, were not applicable here. Therefore, the court found that it did not have personal jurisdiction over the third-party claims. It emphasized that a claim belonging to a third party may only be resolved through litigation on the merits, or on terms to which the third party agrees.

Finally, the court turned to the leading Second Circuit decision on this subject, *In re Metromedia Fiber Network*, 416 F.3d 136, 141 (2d Cir. 2005). In the court's view, *Metromedia* required involuntary releases to be "extraordinary" and imposed only in those cases where nondebtor releases are "essential and integral" to the reorganization itself. The court then stated that in practice debtors usually ignore *Metromedia*, and seek non-consensual third-party releases based on the assertion "that anybody who makes a contribution to the case has earned [it]." The court countered that "third-party releases are not a merit badge that someone gets in return for making a positive contribution to a restructuring … not a participation trophy, … not a gold star for doing a good job. Doing positive things in a restructuring case—even important positive things—is not enough."

Instead, the court suggested that the debtors: (1) target particular claims and tailor the releases to those claims, (2) detail the direct connection between those claims and the contributions being made in the reorganization, (3) explain why the release of those particular claims is *necessary* to accomplish a particular feature of the reorganization, or those claims, if pursued, would undermine the restructuring, (4) confirm whether the releasing parties are otherwise getting recoveries on the released claims, (5) explain why an order extinguishing such claims is fair to the party whose claims would be extinguished, and (6) describe how the actions of the parties that would benefit from the releases did something to provide a specific recovery to the potential claimants or otherwise provided value in excess of the claims to be taken away.

Judge Wiles found none of the foregoing items to be present in this case—no specifically-identified claims and no remarkable facts justifying an extraordinary remedy. He received only suggestions that Mercuria and the audit committee members did unspecified things that were positive to the restructuring process and that any potential claims would be meritless anyway (begging the question of why the claims should then be released at all). In fact, to the contrary, the court pointed out that by seeking release for non-debtor officers and directors from non–dischargeable securities law claims, the debtors had "present[ed] the anomalous situation in which the beneficiary … asks for broader protection that he or she could have obtained in his or her own bankruptcy case."

In the end, the court determined that there was a failure of proof of the facts necessary to support the proposed involuntary releases because the relevant claims and owners of the claims could not even be identified, and denied the debtors' request.

Conclusion

The *Aegean* plan denial, one in a long line of opinions on the issue of third-party releases, addressed the key question as to what constitutes sufficient grounds for the "rare case" in which non-consensual third-party releases should be approved. Although courts are still sketching the outlines opinion by opinion, we now have greater guidance from one New York bankruptcy court as to what may be sufficient, at least in the Second Circuit.

Based on the *Aegean* decision, a potential claimant may take comfort that, unless the bankruptcy court deems it necessary for a successful debtor reorganization, non-debtor third parties are unlikely to be released under a debtor's plan without notice to such claimant, the opportunity to appear in court and respond, or its consent. Likewise, debtors and plan proponents—such as DIP lenders and other parties to bankruptcy transactions—may be reassured that releases/exculpations can still be obtained if they are tailored narrowly (including with respect to parties over which the court has jurisdiction) and if they can show the releases to be a necessary inducement for parties contributing to the plan (which more often than not they are). Nonetheless, the circumstances in which these releases will be allowed, even in the jurisdictions which will consider them, remain extremely limited. Importantly, practitioners need to tread carefully in proposing broad non-consensual releases. They could put approval of a plan at risk, which carries with it the possibility of re-opened plan negotiations.