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On the Edge

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I "Noticed" You Want a Third-Party Release…

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Practitioners continue to navigate the developing case law with respect to nondebtor third-party releases in chapter 11 plans. Such releases, while not expressly authorized or prohibited by the Bankruptcy Code, are generally considered to fall within a bankruptcy court's powers under § 105(a), which states that the court has the power to "issue any order ... that is necessary or appropriate to carry out the provisions of this title." In *Behrmann v. National Heritage Foundation Inc.*,[2] the Fourth Circuit stated that a "bankruptcy court is authorized to approve equitable relief in the form of [nondebtor release provisions] when circumstances warrant."[3] Such releases should be "granted cautiously and infrequently," and when the surrounding circumstances are unique.[4] The recent confirmation of a chapter 11 liquidating plan in *In re Neogenix Oncology Inc.*[5] suggests that consent to the nondebtor releases, or at least notice to the releasors, can play an increasingly significant role in this analysis.

First Amended Plan Was Denied Due to Lack of Informed Consent

Neogenix Oncology Inc. was a former clinical stage, pre-revenue generating biotechnology company that was focused on developing therapeutic and diagnostic products for the early detection and treatment of cancer — particularly pancreatic and colorectal cancer. Due to its pre-revenue status, Neogenix funded these efforts and operations almost exclusively from grants and the sale of its common stock. Problems arose due to the sale of its common stock through individuals who were unlicensed, compensated finders — an issue that later hindered Neogenix's ability to raise capital and ultimately led it to seek chapter 11 protection. At the time of its filing, Neogenix had approximately 950 shareholders, nominal debt, and directors and officers who held contingent, unliquidated claims for indemnification in the event any claims were filed against them.

Neogenix's operating assets were sold at a § 363 sale to Precision Biologics Inc. The primary consideration for the sale of all but certain reserved assets of Neogenix was 5.5 million shares of Precision Biologics stock, to be subsequently distributed on a *pro rata* basis to Neogenix's former shareholders pursuant to an anticipated confirmed liquidation plan. Neogenix filed its first amended plan on March 11, 2013, which provided for the payment in full of unsecured claims and for the distribution of the Precision Biologics stock to Neogenix's former shareholders. However, due to the absolute priority rule, such distributions to equity could not occur unless and until the directors' and officers' indemnification claims were resolved. Accordingly, rather than require that the distribution of the Precision Biologics stock be delayed for an extended period until all potential statutes of limitations regarding potential claims against the directors and officers ran, the first amended plan proposed to release the directors and officers such that the distributions to shareholders could occur on a more expedited basis (the "third-party releases").

The ballot used for solicitation of the first amended plan provided for voters to either *accept* or *reject* the first amended plan, but it did not contain any information regarding the third-party releases. Included instead in the solicitation package was a confirmation hearing notice that contained, in conspicuous, italicized language, a statement that the first amend-

1 This article is presented for informational purposes only and it is not intended to be construed or used as general legal advice nor as a solicitation of any type.
2 663 F.3d 704 (4th Cir. 2011).
3 *Id.* at 711. When referring to *Behrmann v. National Heritage Foundation*, courts seem to use both *Behrmann* and *National Heritage*. Accordingly, both will be used throughout this article.
4 *Id.* at 712.
5 Case No. 12-23557-TJC (Bankr. D. Md. 2016).

ed plan proposed the third-party releases. The first amended plan received overwhelming support from Neogenix's former shareholders, with 95.6 percent voting in favor of the plan (or 99.59 percent of the voting shares of stock).

However, the U.S. Trustee objected to confirmation due to the inclusion of the third-party releases, arguing that they did not satisfy the factors required by *National Heritage*. Both Neogenix and the official committee of equity interest-holders (the "committee") asserted that the applicable criteria had in fact been satisfied. The seven factors required by *National Heritage*, which are pulled from *In re Dow Corning Corp*.,[6] are:

> (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The nondebtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full; and (7) The bankruptcy court made a record of specific factual findings that support its conclusion.[7]

After a disputed confirmation hearing, the court found that the debtor had satisfied all of the elements under 11 U.S.C. § 1129(a) for confirmation of the first amended plan, with the exception of the third-party releases — finding them inappropriate under applicable law because it was not necessary for Neogenix's liquidation. The court explained, "An alternative, albeit less-preferred plan is available to be confirmed," meaning that Neogenix could continue to hold the Precision Biologics stock until all potential statutes of limitations had expired on any possible claims against the directors and officers.[8]

The court further explained that "this case is more akin to cases that consider whether third-party releases should be allowed by consent, rather than to *Behrmann*-type cases. This is because the primary factors in support of the [third-party releases] are the overwhelming vote in favor of the [first amended plan] ... and the lack of objection by a releasing party."[9] Further, the court stated, "It is well recognized that, where the application of the *Dow Corning* or other applicable factors leads to the conclusion that the third-party releases should not be approved, the court can nevertheless approve the releases with the consent of the releasing parties."[10] "The rationale for allowing consensual third-party releases," the court explained, "is that the affected parties are bound by their consensual agreement."[11]

The court ruled that the foregoing consent was lacking in the *Neogenix* case, stating that "despite the [shareholder] support for the [first amended plan] and the lack of objection by a releasing party, the consent of the [shareholders] — or at least *informed consent* to the release of personal claims — has not been obtained."[12] The court did not offer guidance on what type of consent was required, but did note that express consent was not necessarily required. "Even in cases that allow implied consent, the courts require adequate notice on the voting ballot that the releasing parties were giving a release and that their abstention from voting would constitute their consent."[13] As previously noted, the ballots used to solicit the shareholders' votes with respect to the first amended plan did not contain such notice.

Notice to Releasors Should Be the Focus

The debtor and the committee turned their attentions to establishing shareholder consent to the third-party releases and proposed a new ballot that, in addition to providing the opportunity to vote on a second amended plan, would also provide shareholders with the opportunity to opt out of the third-party releases. Such opt-outs would still leave the absolute priority rule as a potential obstacle to distribution of the Precision Biologics stock since the directors and officers could still potentially be subjected to lawsuits by any shareholders who opted out of the third-party releases for which such directors and officers could be indemnified. To address this issue and to attempt to develop a solution that would provide for an earlier distribution of the Precision Biologics stock to Neogenix's shareholders, a cap on opt-outs was agreed to by the directors and officers. In other words, the directors and officers were willing to bear some risk by agreeing to waive their indemnification claims to a certain degree.

The second amended plan provided that if 3 percent or less of the debtor's outstanding shares of stock opted out of the third-party releases, then those shareholders who consented to the third-party releases would receive their *pro rata* share of the Precision Biologics stock. Any shareholder who checked the opt-out box would have their *pro rata* shares of the Precision Biologics stock held in escrow in the eventual liquidating trust so that such stock would be available to satisfy any potential remaining indemnification obligations that could arise with respect to the directors and officers not receiving a complete release.

In the event that more than 3 percent of the debtor's outstanding shares of stock opted out of the third-party releases, then the second amended plan would provide that *all* of the Precision Biologics stock would remain in escrow in the ultimate liquidating trust until all possible statutes of limitations on claims against the directors and officers expired. The U.S. Trustee did not consent to the foregoing proposal and instead argued that express consent to the third-party releases should be obtained.

The court characterized the disputed issues as follows: (1) "The parties disagree over whether the court can approve a plan that provides releases with the 'implied consent' of

6 280 F.3d 648 (6th Cir. 2002).
7 *Id.* at 658.
8 Not all the Neogenix officers and directors were to be released. Certain former officers and directors were specifically omitted from the proposed release and have since been sued by the debtor. The committee conducted an investigation of the then-existing or more recent officers and directors who were to be released, and satisfied itself that no viable claims existed against them.
9 *In re Neogenix Oncology Inc.*, 500 B.R. 345, 361 (Bankr. D. Md. March 11, 2014) ("*Neogenix I*").
10 *Id.*
11 *Id.* (referencing *Flake v. Schrader-Bridgeport Intern. Inc.*, 538 Fed. App'x. 604, 613 (6th Cir. 2013) (Section 524 prevents debtor's discharge from extending to third parties, but parties are free to settle claims); *Food Lion Inc. v. S.L. Nusbaum Ins. Agency Inc.*, 202 F.3d 223, 228 (4th Cir. 2000) (parties are not precluded from settling claims consensually); *In re Arrowmill*, 211 B.R. 497, 506 (Bankr. D. N.J. 1997) ("When a release of liability of a nondebtor is a consensual provision, however, agreed to by the effected creditor, it is no different from any other settlement or contract and does not implicate 11 U.S.C. § 524(e).").
12 *Id.* (emphasis added).
13 *Id.* (citing *In re DBSB N. Am.*, 419 B.R. 179, 218 (Bankr. S.D.N.Y. 2009)).

the releasing parties, that is, where a releasing party received notice that it is giving a release under the plan, is given the opportunity to opt out of providing the release, and does not opt out," and (2) "the parties also disagree over the necessary level of affirmation necessary to obtain express consent — whether a vote in favor of a plan by the releasing party is sufficient, or whether the releasing party must also give express approval of the release in addition to an affirmative vote for the plan."[14] The court noted that the Fourth Circuit had not previously confronted these issues and that no consensus exists among the courts that have.

Next, the bankruptcy court conducted a survey of conflicting decisions regarding express consent where the "validity of the release hinges upon principles of straight contract law or quasi-contract law rather than upon the bankruptcy court's confirmation," thus requiring "affirmative consent,"[15] and implied consent where courts have "allowed failure to return a ballot to constitute a third-party release when the creditor had received notice of the ramifications of releasing parties."[16] However, the court decided *not* to adopt either side of the implied-vs.-express-consent debate but instead focused on the notice provided to those being asked to provide releases.[17]

Rather than prescribe some form of express or implied consent for the releases, the court turned back to *National Heritage* and its seven factors, stating that the court need not pick sides in the debate because "*Behrmann* provides sufficient guidance on whether a court should approve a release for which there is insufficient affirmation of consent, whether the release is said to be 'nonconsenual' or based on 'implied consent.'"[18] Accordingly, the court pointed to the sixth factor, which asks whether the "plan provides an opportunity for those claimants who choose not to settle to recover in full."[19] "It is a matter of semantics," the court explained, "to say that a release is given by 'implied consent' where the releasing party has the right to opt out but does not do so, as compared to saying a release is 'nonconsenual' under the very same facts."[20] Notice of what is being released and the consequences of such release is what matters.

How to Determine Consent to the Third-Party Releases

Notice to releasors was particularly important in *Neogenix* because of the direct correlation between the third-party releases and shareholder recovery due to the 3 percent opt-out cap included in the second amended plan. Thus, the court had to determine who, in light of the notice of the third-party releases and accompanying consequences that was being provided to voters, would be deemed to have consented to the third-party releases and who will be deemed to have opted out of the third-party releases.

The court framed its analysis by concluding that the second amended plan essentially provided shareholders with a single question: "Do they wish to resolve the [directors and officers indemnification claims] by providing a release, or do they prefer not to provide a release and address those claims in some other fashion[?]" In light of such a question, the court first held that any vote in the plan's favor, without checking the opt-out box, constituted "sufficient agreement to provide the [third-party releases]."[21] Second, the court noted that the flip side is also true; it was "self-evident that a vote against the plan is a decision against providing the [third-party releases], *even if the opt-out box is not checked*."[22] Third, although unlikely to occur, in the event that a shareholder voted to accept the second amended plan but also checked the opt-out box, such would indicate opting out of the third-party releases. Finally, to the extent that no ballot is returned, the court held that as long as the shareholder received "clear and conspicuous notice that they are providing a release under the plan as well as clear and conspicuous notice that they have the right to opt out of the release," then those shareholders who did not return a ballot would be deemed to have consented to the releases.[23]

The debtor resolicited the shareholders and received overwhelming support for the second amended plan, with even more shareholders participating than the first solicitation. The second amended plan was approved by 99.7 percent of the voting shareholders and 97.98 percent of the voting shares of stock. Further, only eight shareholders, comprising 0.2 percent of the shares eligible to vote, elected to opt out or were deemed to have opted out of the third-party releases. Accordingly, on May 24, 2016, the court entered its order confirming the second amended liquidation plan.

Conclusion

As noted in the court's opinion regarding resolicitation, "Chapter 11 provides tools, governed by specific statutory, procedural and judicial rules to be sure, but designed to provide sufficient flexibility so parties can determine the most cost-effective manner of enhancing value for stakeholders. In a unique and appropriate case, the use of third-party releases is included in those tools."[24] Neogenix presented the court with such unique and appropriate circumstances, and the third-party releases were used as a tool to provide flexibility in crafting and providing an alternative for an earlier recovery by shareholders. Notice to these shareholders of their choices and consequences is what allowed Neogenix to obtain this result. abi

14 *In re Neogenix Oncology Inc.*, 2015 WL 5786345 *4 (Bankr. D. Md. Oct. 1, 2015) ("*Neogenix II*").
15 *Neogenix II* at *5 (relying on *In re Congoleum Corp.*, 362 B.R. 167, 194 (Bankr. D. N.J. 2007) (creditor must have "unambiguously manifested assent to the release of the nondebtor from liability on its debt"); *In re Arrowmill Dev. Corp.*, 211 B.R. 497, 507 (Bankr. D. N.J. 1997) (holding that it was "not enough for a creditor to abstain from voting for a plan, or even to simply vote 'yes' to a plan")).
16 *Neogenix II* at *5 (relying on *In re Indianapolis Downs LLC*, 486 B.R. 286, 305 (Bankr. D. Del. 2013); *In re Spansion Inc.*, 426 B.R. 114, 144-45 (Bankr. D. Del. 2010)). The bankruptcy court also noted two other decisions from the Southern District of New York where implied-consent releases were permitted when there was "adequate notice on the voting ballot that the releasing parties were giving a release and the releasing parties were given an opportunity to opt out of the release." Page 11 — referencing *In re DBSB N. Am.*, 419 B.R. 179, 218-19 (Bankr. S.D.N.Y. 2009); *In re Calpine Corp.*, 2007 WL 4565223 (Bankr. N.D. Ill. 2003). *Id.* at *5.
17 *Id.* at *6.
18 *Id.*
19 *Behrmann*, 663 F.3d at 712.
20 *Neogenix II* at *6.
21 *Id.* at *8.
22 *Id.* at *9. (emphasis added).
23 *Id.* at *8.
24 *Id.*

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