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Third-Party Relief for Municipal Debtors: 'Necessity' in the Chapter 9 Context

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THIRD-PARTY RELIEF FOR MUNICIPAL DEBTORS: "NECESSITY" IN THE CHAPTER 9 CONTEXT

ABSTRACT

"Third-party releases" are a longstanding—although non-statutory—form of relief in chapter 11 bankruptcy cases. Bankruptcy courts use them to relieve non-debtors of liability for certain debts. For example, directors of a debtor corporation might propose to contribute assets to a settlement fund in exchange for tort plaintiffs giving up their claims against the directors. Although circuits are currently split on whether to allow third-party relief at all, the majority agree that it falls within bankruptcy courts' § 105(a) equitable authority in certain circumstances. Courts make this determination using a variety of tests, most notably the "Dow Corning factors."

With the recent uptick in municipal bankruptcy cases, some debtors have attempted to extend third-party relief to chapter 9 bankruptcy. These cases fall roughly into two categories. In the first, a state provides funds to assist in a reorganization in return for certain creditors giving up claims against the state. In the second, a city attempts to relieve its police officers of liability for civil rights violations by including injunctions against the plaintiffs in the city's plan of reorganization. If the officers themselves had filed for bankruptcy, these lawsuits would be nondischargeable claims arising from personal physical injury under § 523(a)(6). While courts have so far applied the Dow Corning factors correctly to the first category of cases, a series of decisions in the Fifth and Ninth Circuits have led to a much more lenient standard (the "necessity standard") for the second.

This Comment argues that the second series of decisions has ignored fundamental limitations on the permissibility of third-party relief. First, courts should not allow it to be used as a loophole for discharging otherwise non-dischargeable debts. Second, by removing substantive limitations on third-party relief the necessity standard both ignores the limits of a bankruptcy court's equitable powers and incentivizes over-reliance by municipalities. This Comment advocates discarding the necessity standard and returning to established standards that limit third-party relief to situations in which it is consistent with the Code.

INTRODUCTION

In October 2016, Korey King, a San Bernardino, CA resident, filed suit against three city police officers.[1] In his complaint, King alleged that the officers had violated his civil rights, and King requested damages under 42 U.S.C. § 1983.[2] He did not include the city as a defendant.[3] However, King soon received notice that his suit had been stayed pending the resolution of San Bernardino's chapter 9 bankruptcy case.[4] The confirmation of the city's plan of reorganization several months later brought even worse news.[5] Because San Bernardino had undertaken the officers' defense in King's case, California law obligated the city to indemnify them for any damages awarded.[6]

San Bernardino, accordingly, had proposed in its plan of reorganization to enjoin King and numerous other civil rights plaintiffs from collecting damages on their claims against indemnified police officers.[7] The city claimed that this injunction—referred to as a "third-party release"—was necessary to free up funds for its continued operations, including a $56.5 million "Police Resources Plan" targeting the city's high crime rates.[8] The bankruptcy court agreed with San Bernardino and approved its plan of reorganization.[9] In October 2017 the district court affirmed that King's suit was subject to the plan injunction.[10] King's right to receive compensation was effectively erased by the bankruptcy of a city that was not a party to his suit.

Chapter 9 of the United States Bankruptcy Code applies to municipalities.[11] While municipal bankruptcies have historically been rare,[12] the recent recession

[1] King v. San Bernardino Police Officers, 2017 U.S. Dist. LEXIS 102424 *1 (C.D. Cal. 2017).

[2] *Id.*; 42 U.S.C. § 1983 (2012).

[3] King, 2017 U.S. Dist. LEXIS 102424, at *1.

[4] *Id.*

[5] *Id.*

[6] *In re* City of San Bernardino, 566 B.R. 46, 49–50 (Bankr. C.D. Cal. 2017). *See* CAL. GOV'T CODE § 825 (Deering 2018); CAL. GOV'T CODE § 825.2(b) (Deering 2018).

[7] King, 2017 U.S. Dist. LEXIS 102424, at *1.

[8] *In re* City of San Bernardino, 566 B.R. at 61.

[9] *Id.* at 63.

[10] King, 2017 U.S. Dist. LEXIS 102424, at *14.

[11] 11 U.S.C. § 109(c) (2012). A municipality is a "political subdivision or public agency or instrumentality of a State." 11 U.S.C. § 101(40) (2012). This includes cities, towns, villages, boroughs, townships, incorporated authorities, and commissions. 2 COLLIER ON BANKRUPTCY ¶ 109.04[3][a][i]–[ii] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

[12] John Patrick Hunt, *Taxes and Ability to Pay in Municipal Bankruptcy*, 91 WASH. L. REV. 515, 516 (2016) (*citing* Juliet M. Moringiello, *Chapter 9 Plan Confirmation Standards and the Role of State Choices*, 37 CAMPBELL L. REV. 71, 72 (2015)).

prompted several major cities,[13] a county,[14] and a host of other entities to seek relief under chapter 9.[15] Many of these financially troubled municipalities entered bankruptcy bearing obligations to indemnify their employees against personal liability for acts committed in their professional capacities.[16] Chapter 9 generally gives debtors great flexibility to modify their obligations in tailoring plans of reorganization, without balancing the interests of creditors.[17] Accordingly, several of these municipalities, including San Bernardino, sought to extend the Code's protections to their indemnified employees.[18]

A bankruptcy court's ability to release non-debtor parties from debts is a powerful but infrequently-invoked measure.[19] Debtors may offer what this Comment will refer to as "third-party relief" to creditors in exchange for continued financing or consent to less-favorable terms,[20] or to their own officers who play an important role in reorganization.[21] Circuits are currently split on whether this relief is permissible under chapter 11, with the majority allowing it in certain unusual circumstances.[22] The seven *Dow Corning* factors form the

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13 *See, e.g.*, *In re* City of Detroit, 524 B.R. 147, 277 (Bankr. E.D. Mich. 2014); *In re* City of San Bernardino, 566 B.R. at 48; *In re* City of Stockton, 493 B.R. 772, 783 (Bankr. E.D. Cal. 2013) (June 28, 2012); *In re* City of Vallejo, 2008 Bankr. LEXIS 4433, at *53 (Bankr. E.D. Cal. 2008).

14 *In re* Jefferson County, 491 B.R. 277, 283 (Bankr. N.D. Ala. 2013).

15 *See* Andrew B. Dawson, *Beyond the Great Divide: Federalism Concerns in Municipal Insolvency*, 11 HARV. L. & POL'Y REV. 31, 34 (2017) (noting the "recent municipal insolvency crisis" involving "an unprecedented number of municipal bankruptcy filings"); *Bankrupt Cities, Municipalities List and Map*, GOVERNING (Sep. 14, 2017), http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html (noting that 61 municipalities have filed for bankruptcy since 2010).

16 *See, e.g.*, *In re* City of San Bernardino, 566 B.R. at 54 (*citing* CAL. GOV'T CODE § 825(a), obligating a public entity "to indemnify its employees for judgments against the employees based upon employee acts or omissions arising within the scope of employment").

17 6 COLLIER ON BANKRUPTCY ¶ 900.01[1] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

18 *See In re* City of San Bernardino, 566 B.R. at 48–49 (seeking an injunction preventing civil rights plaintiffs from collecting on judgments against city police officers); *In re* City of Detroit, 524 B.R. at 262–63 (seeking to discharge civil rights claims against city police officers).

19 *See generally* 8 COLLIER ON BANKRUPTCY ¶ 1141.02[5][c] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010). ("Nonconsensual Release of Third Parties").

20 Deryck A. Palmer et al., *Third Party Releases Survive Supreme Court's Decision in Travelers Indemnity Co. v. Bailey*, 5 PRATT'S J. BANKR. L. 554, 555, 562 (2009) ("[R]eleases of claims against officers, directors or other employees may be critical to a debtor's successful continuation of business after confirmation of its plan."). *See, e.g.,* Menard-Sanford v. Mabey (*In re* A.H. Robins Co.), 880 F.2d 694, 702 (4th Cir. 1989) (holding that "reorganization hinge[d] on the debtor being free from … suits against parties who would have indemnity … claims").

21 Palmer et al., *supra* note 20. *See, e.g.,* Class Five Nev. Claimants v. Dow Corning Corp. (*In re* Dow Corning Corp.), 280 F.3d 648 (6th Cir. 2001) (approving plan enjoining claims against debtor's shareholders and insurers).

22 *See, e.g.*, *In re* City of San Bernardino, 566 B.R. at 52 (noting the circuit split); Resorts Int'l v. Lowenschuss (*In re* Lowenschuss), 67 F.3d 1394, 1402 (9th Cir. 1995) (holding that the specific rule in 11 U.S.C. § 524(e) (2012) "displace[d]" the bankruptcy courts' general "equitable powers" granted by 11 U.S.C. § 105 (2012), and listing Ninth Circuit precedent); *In re* Dow Corning Corp., 280 F.3d at 657–58 (holding that

most notable standard.[23] The Ninth Circuit, which has adopted the minority position, has also indicated that its prohibition of third-party relief in chapter 11 bankruptcy will not extend to chapter 9 cases.[24]

In the recent wave of municipal bankruptcies, several cities unable to indemnify law enforcement officers for civil rights lawsuits instead sought third-party relief in the form of injunctions against the plaintiffs.[25] Drawing from chapter 11 case law, courts in these cases have converged on a standard basing the availability of third-party relief on its "necessity" to reorganization.[26] As a result, municipal debtors now enjoy a great degree of freedom to modify their employees' obligations to third parties. These decisions, however, have not addressed two important considerations that should limit the availability of third-party relief.

First, bankruptcy courts have failed to consider whether they possess the authority to release third parties from debts that would be nondischargeable in the third-party's own bankruptcies. These include debts listed under § 523(a) as "exceptions to discharge," such as those arising from "fraud . . . embezzlement, or larceny," "domestic support obligations," "willful or malicious injury" to another's person, or for benefits obtained under "false pretenses."[27] The § 523(a) exceptions reflect a Congressional policy of "not allowing a debtor to use the bankruptcy system to avoid debts when the debtor acted wrongfully in incurring those debts."[28]

Second, courts have not justified the introduction of a new, necessity-based, standard for chapter 9. The constitutional status of municipalities precludes

11 U.S.C. § 524(e) (2012) only limits the scope of the debtor's discharge, not a court's authority to issue injunctions affecting third parties under 11 U.S.C. § 105 (2012)).

[23] *In re* Dow Corning Corp., 280 F.3d at 657–58.

[24] Deocampo v. Potts, 836 F.3d 1134, 1143 (9th Cir. 2016) (holding that its reasoning in *In re* Lowenschuss precluding third-party relief in chapter 11 "does not apply in Chapter 9 proceedings").

[25] *See* V.W. v. City of Vallejo, 2013 U.S. Dist. LEXIS 109145 at *1 (E.D. Cal. 2013) ("This civil rights lawsuit . . . against the City of Vallejo . . . and its Chief of Police . . . alleges that the City's police officers killed the decedent while they were using a taser gun during his arrest."); Deocampo, 836 F.3d at 1137 ("Plaintiffs asserted excessive-force and other constitutional claims against the Officers."); *In re* City of Detroit, 524 B.R. at 263 ("[The plaintiffs'] lawsuits allege . . .officers' various violations of their constitutional rights"); *In re* City of San Bernardino, 566 B.R. at 50 ("[Plaintiffs] alleged the officers had violated their civil rights").

[26] *In re* City of Detroit, 524 B.R. at 266–67 (applying a test from *In re* Dow Corning Corp. to hold that Detroit must show the "necessity" of third-party relief "to … the success of the plan").

[27] 11 U.S.C. § 523(a)(2), (4), (5), (6) (2012).

[28] Theresa J. Pulley Radwan, *With Malice Toward One–Defining Nondischargeability of Debts for Willful and Malicious Injury Under § 523(A)(6) of the Bankruptcy Code*, 7 WM. & MARY BUS. L. REV. 151, 151 (2016).

"failure" in the chapter 11 sense, removing any objective measure of necessity.[29] Furthermore, the ubiquity of indemnification obligations will lead most municipal debtors to request, and qualify for, third-party relief, destroying its status as a dramatic measure reserved for unusual circumstances.[30] This will invite abuse by allowing municipal officials to regularly avoid debts they could not discharge individually, extending municipal bankruptcy beyond the bounds contemplated by the Bankruptcy Code.

This Comment begins by outlining the structure and goals of chapter 9 bankruptcy, as well as several state-law alternatives available to municipalities. Next, it discusses the prevalence of municipal indemnification obligations and the circumstances which give rise to these obligations. This Comment then provides an overview of the case law governing third party relief in chapter 11, which courts have imported into chapter 9 cases. It continues by examining in detail the use of third-party relief to shield police officers from liability for civil rights violations in recent chapter 9 cases.

This Comment establishes that the § 523(a) exceptions to discharge overrule bankruptcy's general policy of giving the debtor a "fresh start," which is also the justification for third-party relief. Next, it argues that the necessity standard is not appropriate for chapter 9 because it removes crucial limiting factors from *Dow Corning*, and because a municipality's indissolubility precludes an objective measure of necessity. Combined with the ubiquity of municipal indemnification obligations, these omissions leave a municipal debtor with almost no substantive limitations on the availability of third-party relief.

Finally, this Comment examines the *Dow Corning* factors' suitability for municipal bankruptcy and conclude that they reflect basic Code requirements equally applicable to chapters 11 and 9. Because so little precedent exists, courts can easily resume restricting third-party relief to truly unusual circumstances. This Comment also notes possible legislative solutions. For instance, Congress could expand the scope of chapter 9 if it decides that protecting public employees is crucial to successful reorganization. States could also amend their

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29 *See In re* Addison Community Hosp. Auth., 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994) (quoting "[N]either Congress nor the courts can change the existing system of government in this country . . . . One of the powers reserved to the states is the power to create and govern municipalities."); 6 COLLIER ON BANKRUPTCY ¶ 900.01[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("[T]he Supreme Court has upheld municipal debt adjustment legislation . . . at least in part on the premise that the legislation involves no possibility of . . . liquidation of [a municipality's] assets.").

30 For instance, a recent study found that "police officers are virtually always indemnified." Joanna C. Schwartz, *Police Indemnification*, 89 N.Y.U. L. REV. 885, 885 (2014).

indemnification laws to directly protect employees of financially-troubled municipalities.

I. BACKGROUND

A. Chapter 9 Bankruptcy and Municipal Alternatives

Chapter 9 bankruptcy "permit[s] a financially distressed public entity to seek protection from its creditors."[31] It is primarily in this context that the necessity standard and the possibility of releasing third parties from nondischargeable debts arises. However, financially distressed municipalities have additional non-bankruptcy options, so this section will place chapter 9 in the context of state solutions, such as receiverships.

1. Overview of Chapter 9 Bankruptcy

In contrast to the other Code chapters, chapter 9 provides "systematic advantages for debtor municipalities,"[32] such as limited control by the bankruptcy court,[33] little consideration of creditors' interests,[34] and the debtor municipality's exclusive right to propose a plan of reorganization.[35] These advantages are consequently reserved for a very narrow class of entities: insolvent municipalities that states have "specifically authorized" to be debtors.[36] Currently, twenty-seven states authorize at least some municipalities

[31] 6 COLLIER ON BANKRUPTCY ¶ 900.01[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

[32] Heith M. Frost, *States as Chapter 9 Bankruptcy Gatekeepers: Federalism, Specific Authorization, and Protection of Municipal Economic Health*, 84 MISS. L.J. 817, 820 (2015). *See also* Elizabeth M. Watkins, *In Defense of the Chapter 9 Option: Exploring the Promise of a Municipal Bankruptcy as a Mechanism for Structural Political Reform*, 39 J. LEGIS. 89, 93 (2013) (characterizing the benefits of chapter 9 bankruptcy as "similar to those offered . . . under Chapter 11, but more extensive").

[33] 6 COLLIER ON BANKRUPTCY ¶ 900.01[2][c] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) (quoting *In re* Willacy County Water Control & Improvement District No. 1, 36 F. Supp. 36, 39 (S.D. Tex. 1940)); 11 U.S.C. § 904 (2012) ("[U]nless the debtor consents or the plan so provides, the court may not . . . interfere with–(1) any of the political or governmental powers of the debtor; (2) any of the property of revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property.").

[34] Christopher J. Tyson, *Exploring the Limits of Municipal Bankruptcy*, 50 WILLAMETTE L. REV. 661, 678 (2014).

[35] 11 U.S.C. § 941 (2012) ("The debtor shall file a plan for the adjustment of the debtor's debts . . . with the petition [or] at such later time as the court fixes.").

[36] 11 U.S.C. § 109(c) (2012) ("An entity may be a debtor under chapter 9 of this title . . . only if such entity . . . is specifically authorized . . . to be a debtor . . . by State law").

to be debtors.[37] Because of the specific authorization requirement, states lacking such laws prohibit municipalities from becoming debtors by default.[38]

Many of chapter 9's unique characteristics stem from Tenth Amendment federalism considerations, which prevent bankruptcy courts from interfering with or usurping state sovereignty.[39] The approval requirement, noted above, avoids this problem by allowing states to "[invite] the intervention of the bankruptcy power."[40] A chapter 9 case starts when an insolvent municipality files a petition for relief with the bankruptcy court.[41] In chapter 9, "insolvent" means that the debtor is "generally not paying" or "unable to pay" its debts as they become due.[42] While the case is pending, the debtor may continue its operations and incur new debts, subject to limited court oversight.[43] After the municipality has proposed a plan of reorganization, the bankruptcy court largely resigns to approving its plan of reorganization or dismissing the case.[44]

Tenth Amendment considerations also give rise to important conceptual differences between chapter 9 and chapter 11 bankruptcy. Because only states

37 CHAPMAN & CUTLER LLP, MUNICIPALITIES IN DISTRESS? HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES app. B (2012), *available at* http://blogs.reuters.com/alison-frankel/files/2013/12/chapmanandcutlerchapter9.pdf. *See also* Tom D. Hoffman, Note, *Municipal Bankruptcy Authorization Under Chapter 9: A Call for Uniformity Among States*, 34 ST. LOUIS U. PUB. L. REV. 215, 223–25 (2014) (outlining state policies regarding municipal bankruptcy).

38 CHAPMAN & CUTLER LLP, *supra* note 37.

39 6 COLLIER ON BANKRUPTCY ¶ 900.01[2][c] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) (noting the "severe" limitations placed upon bankruptcy courts by the Tenth Amendment and related Supreme Court cases.). *See generally* Colin McGrath, *Municipal Bankruptcy and the Limits of Federalism*, 18 U. PA. J. CONST. L. 1265, 1283–96 (2016) (explaining chapter 9 restrictions in light of Tenth Amendment doctrines of commandeering, coercion, and comity).

40 United States v. Bekins, 304 U.S. 27, 54 (1938). *See* 11 U.S.C. § 109(c) (2012) ("An entity may be a debtor under chapter 9 of this title . . . only if such entity . . . is specifically authorized . . . to be a debtor . . . by State law").

41 11 U.S.C. § 921 (2012); 6 COLLIER ON BANKRUPTCY ¶ 921.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

42 11 U.S.C. § 101(32)(C) (2012). *See also* 6 COLLIER ON BANKRUPTCY ¶ 900.02[2][c] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

43 6 COLLIER ON BANKRUPTCY ¶ 900.01[2][b]–[c] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

44 6 COLLIER ON BANKRUPTCY ¶ 900.01[1] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("If the case is not successful, or if the plan cannot be implemented as confirmed, the court's remedy is limited to dismissal of the case pursuant to section 930."); *In re* Willacy County Water Control & Improv. Dist., 36 F. Supp. at 38–39 ("The court is merely authorized to determine insolvency, or inability to meet debts as they mature, and whether the plan proposed is in accordance with the provisions of the statute [and the criteria for plan approval].").

can create or dissolve municipalities,[45] chapter 9 has no analog to the "conversion" of a chapter 11 case to chapter 7 for liquidation.[46] Without a liquidation option, the confirmation requirement that a plan be in the "best interests of the creditors" simply requires it to provide a better alternative to creditors than individual recovery efforts outside of bankruptcy.[47]

As in cases brought under other chapters of the Code, a bankruptcy court in a chapter 9 case has "broad [equitable] authority to modify creditor-debtor relationships."[48] Section 105(a) in particular authorizes courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[49] The "Grand Bargain" reached in Detroit's bankruptcy case between the city, pension plan claimants and trustees, the Detroit Institute of Arts, and the state of Michigan provides an excellent example of the bankruptcy court's ability to implement creative solutions that balance competing interests.[50] However, as the Third Circuit has pointed out, § 105(a) "does not create substantive rights that would otherwise be unavailable under the Bankruptcy Code."[51] For example, a court's equitable authority is limited by the confirmation requirement that a plan of reorganization must comply with all applicable Code provisions.[52] Chapter 9's confirmation requirements also include § 943(b)(4) and (6), which dictate that a plan of reorganization cannot require actions that violate applicable state or nonbankruptcy federal law.[53]

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[45] *See In re* Addison Community Hosp. Auth., 175 B.R. at 649 (quoting "[N]either Congress nor the courts can change the existing system of government in this country . . . . One of the powers reserved to the states is the power to create and govern municipalities.").

[46] 6 COLLIER ON BANKRUPTCY ¶ 900.01[1] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("[T]he Supreme Court has upheld municipal debt adjustment legislation … at least in part on the premise that the legislation involves no possibility of . . . liquidation of [a municipality's] assets."); *In re* Richmond Unified School Dist., 133 B.R. 221, 225 (1991) ("A municipal unit cannot liquidate its assets to satisfy its creditors . . . . Therefore, the primary purpose of Chapter 9 is to allow [it] to continue operating while it adjusts or refinances its creditor[s'] claims").

[47] 6 COLLIER ON BANKRUPTCY ¶ 900.01[7][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010); 11 U.S.C. § 943(7) (2018). On municipal creditors' remedies outside of bankruptcy, *see* C. Scott Pryor, *Municipal Bankruptcy: When Doing Less is Doing Best*, 88 AM. BANKR. L.J. 85, 122–23 (2014).

[48] United States v. Energy Resources Co., 495 U.S. 545, 549 (1990).

[49] 11 U.S.C. § 105(a) (2018).

[50] *In re* City of Detroit, 524 B.R. at 169–70. *See generally* Maureen B. Collins, *Pensions or Paintings: The Detroit Institute of Arts from Bankruptcy to Grand Bargain*, 24 U. MIAMI BUS. L. REV. 1 (2015) (providing an overview of the Detroit Institute of Arts' role in the Grand Bargain).

[51] Gillman v. Continental Airlines (*In re* Continental Airlines), 203 F.3 203, 211 (3rd Cir. 2000).

[52] 11 U.S.C. § 943(a)–(b) (2012).

[53] 11 U.S.C. § 943(b)(4), (6) (2018). *See* 6 COLLIER ON BANKRUPTCY ¶ 943.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

Several Code provisions outside of chapter 9 are also relevant to an analysis of third-party relief in chapter 9 cases. The most relevant of these is § 524(e),[54] which some circuits have held limits a court's authority to grant relief to non-debtors.[55] Section 524(e) disclaims any effect on other parties' liabilities from the discharge of a debtor's obligation.[56] The majority of circuits have interpreted this provision narrowly to restrict only the effects of the discharge of any particular debt, not the bankruptcy court's ability to modify other parties' obligations.[57] For example, discharging an individual's debt would not affect a guarantor's liability on that debt. However, § 524(e) would not prevent the court from separately releasing the guarantor from liability.

Chapter 9 also does not incorporate § 523(a), entitled "exceptions to discharge."[58] Section 523(a) states, in part, that "[a] discharge under [this title] does not discharge an individual debtor from any debt . . . for willful and malicious injury by the debtor to another entity or to the property of another entity[.]"[59] Other excepted debts include those "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny; . . . for a domestic support obligation;" or "for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft if such operation was unlawful because the debtor was intoxicated."[60] Despite the general bankruptcy policy favoring dischargeability of debts,[61] this section reflects a congressional policy of "not allowing a debtor to use the bankruptcy system to avoid debts when the

[54] 11 U.S.C. § 524(e) (2012) ("[D]ischarge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."); 11 U.S.C. § 901(a) (2012) (incorporating provisions of other Code chapters).

[55] *See In re* Lowenschuss, 67 F.3d at 1402 (holding that the specific rule in 11 U.S.C. § 524(e) (2012) "displace[d]" the bankruptcy courts' general "equitable powers" granted by 11 U.S.C. § 105 and listing consistent Ninth Circuit precedent).

[56] 11 U.S.C. § 524(e) (2012) ("[D]ischarge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt"); 11 U.S.C. § 901(a) (2012) (incorporating provisions of other Code chapters).

[57] *Compare In re* Dow Corning Corp., 280 F.3d at 657–58 (holding that 11 U.S.C. § 524(e) (2012) only limits the scope of the debtor's discharge, not a court's equitable authority to issue injunctions affecting third parties under 11 U.S.C. § 105 (2012)), *with In re* Lowenschuss, 67 F.3d at 1402 (holding that the specific rule in 11 U.S.C. § 524(e) (2012) "displace[d]" the bankruptcy courts' general "equitable powers" granted by 11 U.S.C. § 105 (2012), and listing consistent Ninth Circuit precedent).

[58] 11 U.S.C. § 523(a) (2012) (applicable to chapters 7, 11, 12, and 13).

[59] 11 U.S.C. § 523(a)(6) (2012). *See also* V.W., 2013 U.S. Dist. LEXIS 109145, at *6–7 (citing 11 U.S.C. § 523(a)(6) (2012) and its application in Gee v. Hammond (*In re* Gee), 173 B.R. 189, 193 (B.A.P. 9th Cir. 1994) and other cases).

[60] 11 U.S.C. § 523(a)(4)–(5), (9) (2018).

[61] *See* Grogan v. Garner, 498 U.S. 279, 287 (referring to the "general policy of discharge" in the interest of providing debtors a "fresh start").

debtor acted wrongfully in incurring those debts."[62] The Supreme Court even held in *Archer v. Warner* that pre-petition settlements releasing the debtor from liability in suits that would have given rise to non-dischargeable debts fall under the scope of § 523(a).[63] According to Justice Stevens, writing for a unanimous court in *Grogan v. Garner*, "Congress evidently concluded that the creditors' interest in recovering full payment of debts in these categories outweighed the debtors' interest in a complete fresh start."[64]

2. *Alternatives to Chapter 9*

A financially distressed municipality's unsecured creditors generally have few options for repayment outside of bankruptcy.[65] Because a municipality's "principal asset . . . is its taxing power," as the Supreme Court once noted, a "municipal security is merely a draft on [its] good faith in exercising" that power.[66] States also generally prohibit the procurement of judicial liens on public property.[67] A creditor may have the right to petition for a writ of mandamus "to compel the levying of authorized taxes" in the event of default,[68] but in practice this is merely "an empty right to litigate."[69] For example, the city's experts in *In re Detroit* estimated that, ignoring the difficulty in obtaining the necessary voter approval, raising taxes would simply precipitate the erosion of the city's tax base.[70] The experts predicted that these effects would cancel each other out, producing no net revenue gains with which to pay creditors.[71]

Most states provide an alternative to bankruptcy for financially-troubled municipalities in the form of receiverships.[72] Once state officials determine that a municipality's situation is sufficiently dire, they may appoint a receiver to take

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62 Radwan, *supra* note 28.

63 4 COLLIER ON BANKRUPTCY ¶ 523.33 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) (citing Archer v. Warner, 538 U.S. 314, 323 (2003)) (holding that although a "settlement agreement and releases may have worked a kind of novation, . . . that fact does not bar [the creditor] from showing that the settlement debt arose out of false pretences, a false representation, or actual fraud, and consequently is nondischargeable").

64 Grogan, 498 U.S. at 287.

65 Pryor, *supra* note 47.

66 Faitoute Iron & Steel Co. v. City of Ashbury Park, 316 U.S. 502, 509–10 (1942).

67 *See, e.g.*, *In re* City of Detroit, 524 B.R. at 213 (citing MICH. COMP. LAWS § 600.6021(1) (2012)); Parker v. Klochko Equipment Rental Co., 590 F.2d 649, 653 (6th Cir. 1979) (noting the "well-understood and established" principle "that it is contrary to public policy to allow private liens on public property").

68 *In re* City of Detroit, 524 B.R. at 213 (citing MICH. COMP. LAWS § 600.6093(1) (2012)).

69 *Id.* at 215 (citing Faitoute Iron & Steel Co., 316 U.S. at 510).

70 *Id.*

71 *Id.*

72 Lyle Kossis, Note, *Examining the Conflict Between Municipal Receivership and Local Autonomy*, 98 VA. L. REV. 1109, 1110 (2012).

over its operations until the municipality is adequately rehabilitated.[73] The receiver has largely unrestricted power during this period to modify a municipality's obligations, fire employees, and sell its property.[74] A defaulting municipality's secured creditors, including bondholders, may alternatively be permitted to obtain a court-appointed receiver, who will attempt to raise sufficient revenue to repay its debts.[75] Authors have criticized municipal receivership for allowing drastic measures and undermining local self-governance, and courts have acknowledged that chapter 9 bankruptcy may be more desirable for creditors and municipalities alike.[76]

B. *Municipal Indemnification Obligations*

The literature regarding municipal obligations to indemnify employees centers around police officers liable under 42 U.S.C. § 1983 for civil rights violations.[77] Section 1983 subjects an official acting "under color of" state authority to civil liability for violating any person's Constitutional "rights, privileges, or immunities."[78] Section 1983 advances the twin goals of compensation and deterrence.[79] Because the doctrine of sovereign immunity does not generally protect municipalities unless they are acting as "arms of the state," they may also be subject to suit under § 1983.[80]

The counterpoising doctrine of qualified immunity comes into play as well, shielding "government officials performing discretionary functions . . . from liability for civil damages insofar as their conduct does not violate clearly established statutory or constitutional rights of which a reasonable person would

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73 Kossis, *supra* note 72.

74 *Id.*

75 *See, e.g.*, *In re* Pleasant View Utility Dist., 24 B.R. 632, 637 n.4 (Bankr. M.D. Tenn. 1982) (citing TENN. CODE § 7-82-505 providing municipal bondholders with statutory liens and prescribing receivership in case of default).

76 Kossis, *supra* note 72; *In re* Pleasant View Utility Dist., 24 B.R. at 637 n.4 (citing *In re* North & South Shenango Joint Muni. Auth., 14 B.R. 414, 421 (Bankr. W.D. Pa. 1981) on the inferiority of creditor-initiated receiverships to chapter 9 bankruptcy).

77 *See generally* Schwartz, *supra* note 30 (providing a doctrinal overview of police indemnification and an empirical study of its prevalence); Martin A. Schwartz, *Should Juries be Informed That Municipality Will Indemnify Officer's § 1983 Liability for Constitutional Wrongdoing?*, 866 IOWA L. REV. 1209 (2001).

78 42 U.S.C. § 1983 (2012).

79 Schwartz, *supra* note 30 (citing City of Monterey v. Del Monte Dunes, 526 U.S. 687, 727 (1999) (Scalia, J., concurring) ("like other tort causes of action, it is designed to provide compensation for injuries arising from the violation of legal duties, and thereby, of course, to deter future violations.")).

80 Northern Ins. Co. v. Chatham County, 547 U.S. 189, 193 (2006) ("refus[ing] to extend sovereign immunity to counties" because "only States and arms of the State possess immunity from suits authorized by federal law").

have known."[81] As an "immunity to suit," the doctrine "ensure[s] that 'insubstantial claims' against government officials [will] be resolved prior to discovery."[82] Thus, § 1983 claims resulting in damage awards have likely survived assertions of qualified immunity.[83]

The deterrence prong of § 1983 assumes that imposing monetary penalties will dissuade officials from violating civil rights.[84] Indemnification dampens this effect by using public funds to pay damage awards, ensuring that the employees themselves will not suffer financial loss. However, proponents argue that without indemnification the specter of liability will make officers hesitant to "zealously enforce" the law, even with the partial shield of qualified immunity.[85] Because officers often lack the means to satisfy judgments against them, indemnification also advances § 1983's compensatory goal.[86] To these ends, many states and local governments have passed statutes and ordinances obligating municipalities to defend or indemnify their employees against certain lawsuits.[87] Other municipalities may incur indemnification obligations by entering into collective bargaining agreements with employee organizations,[88]

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81 Harlow v. Fitzgerald, 457 U.S. 800, 818 (1982); *see also* Pearson v. Callahan, 555 U.S. 223, 231 (2009) (rejecting a rigid framework for applying qualified immunity and noting its role in balancing the "need to hold public officials accountable when they exercise power irresponsibly and the need to shield officials from harassment, distraction, and liability when they perform their duties reasonably.").

82 Pearson v. Callahan, 555 U.S. at 231.

83 *See, e.g.*, Aaron L. Nielson & Christopher J. Walker, *The New Qualified Immunity*, S. CAL. L. REV. 1, 3–4 (2015–2016) (describing recent "constitutional stagnation," where many cases with the potential to develop constitutional rights doctrines are instead dismissed due to qualified immunity); John C. Williams, *Qualifying Qualified Immunity*, 65 VAND. L. REV. 1295, 1297 (2012) (positing that overly-protective application of qualified immunity was responsible for the lack of First Amendment cases regarding Iraq war protests).

84 Schwartz, *supra* note 30, at 892 (citing City of Monterey, 526 U.S. at 727 (Scalia, J., concurring) ("like other tort causes of action, it is designed to provide compensation for injuries arising from the violation of legal duties, and thereby, of course, to deter future violations.")).

85 *See id.* at 887 (quoting Harlow, 457 U.S. at 818 ("fear of being sued will 'dampen the ardor of all but the most resolute, or the most irresponsible [public officials] in the unflinching discharge of their duties.'")); *In re* City of San Bernardino, 566 B.R. at 55 (quoting Sinclair v. Arnebergh, 36 Cal. Rptr. 810, 813 (Cal. Ct. App. 1964) (justifying California's police indemnification statute)).

86 Schwartz, *supra* note 30, at 952 (explaining why plaintiffs have often urged indemnification, even dropping requests for punitive damages in return).

87 *See* Schwartz, *supra* note 30, at 905–06 n.93, 94 (providing examples of state and local indemnification laws in Ohio, Arizona, Texas, and Missouri); *In re* City of San Bernardino, 566 B.R. at 50 (discussing Cal. Government Code § 825, requiring municipalities to "indemnify their employees for claims against them arising from the scope of their employment").

88 *See, e.g.*, *In re* City of Detroit, 524 B.R. at 266–67 ("[t]he City's assumption of its contractual indemnity obligations will result in the City's full payment of valid § 1983 claims against employees in their individual capacity"); *In re* City of San Bernardino, 566 B.R. at 51 (noting that, although already obligated by state law, "[t]he settlements the City negotiated with its employee unions and the operative collective bargaining agreements required the City to reaffirm its obligation to indemnify the employees").

or decide whether to indemnify on a "case by case" basis.[89] In fact, some have argued that the system of municipal police indemnification is so widespread,[90] and municipalities are sufficiently unresponsive to its expense,[91] as to virtually eliminate § 1983's deterrent effect, thus functioning as a form of vicarious liability.[92]

California's indemnification statute is illustrative of state efforts to shield public employees:

> § 825 (a) . . . [I]f an employee or former employee of a public entity requests the public entity to defend him . . . against any claim or action against him or her for an injury arising out of an act or omission occurring within the scope of his or her employment as an employee of the public entity . . . and the employee . . . reasonably cooperates in good faith in the defense of the claim or action, [or if] the public entity conducts the defense of an employee . . . against any claim or action with his or her reasonable good-faith cooperation, the public entity shall pay any judgment based thereon or any compromise or settlement of the claim or action to which the public entity has agreed.[93]
>
> [A] public entity is authorized to pay that part of a judgment that is for punitive or exemplary damages if the governing body of that public entity . . . finds all of the following:
>
> (1) The judgment is based on an act or omission of an employee . . . acting within the course and scope of his or her employment as an employee of the public entity.
>
> (2) At the time of the act giving rise to the liability, the employee . . . acted, or failed to act, in good faith, without actual malice and in the apparent best interests of the public entity.
>
> (3) Payment of the claim or judgment would be in the best interests of the public entity. [94]
>
> § 825.2 (b) If the public entity did not conduct his defense against the action or claim . . . an employee or former employee of a public entity may recover from the public entity . . . only if he establishes that the

89 Schwartz, *supra* note 30, at 906 n.96.

90 *See id.* at 885 (revealing results of a nationwide study indicated that "police officers are virtually always indemnified").

91 *Id.* at 952 (arguing that "governments do not appear to be collecting enough information about lawsuits to make educated decisions about whether or how to reduce the police activities that prompt these suits").

92 *Id.* (quoting Bd. County. Comm're v. Brown, 520 U.S. 397, 436 (1997) (Breyer, J., dissenting) ("states' indemnification statutes 'mimic respondeat superior by authorizing indemnification of employees found liable under § 1983 for actions within the scope of their employment.'")).

93 CAL. GOV'T CODE § 825(a) (2012).

94 CAL. GOV'T CODE § 825(b).

> act or omission upon which the claim or judgment is based occurred within the scope of his employment as an employee of the public entity and the public entity fails to establish that he acted or failed to act because of actual fraud, corruption or actual malice or that he willfully failed or refused to conduct the defense of the claim or action in good faith[.][95]

The statute requires a municipality that undertakes the defense of a current or former employee in a suit arising from the employee's scope of duty to pay any judgment or settlement amount reached therein.[96] If the municipality does not defend the employee, it must still pay any judgment or settlement unless the employee acted "because of fraud, corruption, or actual malice" or failed to "conduct the defense in good faith."[97] The statute also permits, but does not mandate, municipal payment of punitive or exemplary damages in certain circumstances.[98]

Despite the widespread protection of public employees, this author has not found any opinion deciding whether municipal indemnification obligations (contractual or statutory) are dischargeable in chapter 9 bankruptcy. California's Eastern District Court came close to addressing the issue in *V.W. v. City of Vallejo*, a case related to the city of Vallejo's bankruptcy.[99] There, the court opined that municipal obligations to indemnify public employees arising pre-confirmation were "arguably" dischargeable by the confirmation of a plan of reorganization.[100] However, the court declined to rule on dischargeability in *V.W.*, instead deciding the case on other grounds.[101] The Ninth Circuit also noted in *Deocampo v. Potts* that a municipality's obligation to indemnify does not arise under California law until it undertakes an employee's defense.[102] Because a municipal plan of reorganization can only affect debts arising before plan confirmation, the point at which state law or contract imposes an obligation will

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[95] CAL. GOV'T CODE § 825.2(b).

[96] CAL. GOV'T CODE § 825(a).

[97] CAL. GOV'T CODE § 825.2(b). *See also* Rivas v. City of Kerman, 13 Cal. Rptr. 2d 147, 151—55 (Cal. Ct. App. 1992) (interpreting California municipalities' obligations towards employees under Cal. Government Code §§ 825 & 825.2 (2012)).

[98] CAL. GOV'T CODE § 825(b), (f).

[99] V.W., 2013 U.S. Dist. LEXIS 109145, at *21.

[100] *Id.*

[101] *Id.*

[102] Deocampo, 836 F.3d at 1145 (noting that, because Vallejo did not actually become obligated to certain officers until after the plan confirmation date, their claims against the city for indemnification were not discharged).

set the baseline for its dischargeability.[103] This uncertainty is only compounded when municipal debtors attempt to leverage their indemnification commitments to extend bankruptcy relief to public employees.

D. Third-Party Relief

Third-party relief originated in chapter 11 cases involving mass tort claims.[104] As a court-created solution never explicitly endorsed by the Supreme Court, approaches to third-party relief remain fragmented by circuit.[105] In the last decade, courts have extended the doctrine to municipal bankruptcy cases, while questioning the extent to which the limitations on third-party relief imposed by chapter 11 case law are transferable to chapter 9.[106]

1. Third-Party Relief in Chapter 11

In a chapter 11 bankruptcy case, a debtor may ask the court to release claims against related parties if doing so will help the debtor reorganize.[107] This ability can be an important bargaining chip, allowing debtors to induce "lenders, equity investors, and other third parties" to provide necessary financing and "[agree] to participate in [the] plan."[108] Bankruptcy courts have "related to" jurisdiction over "suits between third parties which have an effect on the bankruptcy."[109] However, § 524(e) of the Code provides that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."[110] Circuit courts are currently split on whether § 524(e) denies bankruptcy courts the authority to approve third-party relief under chapter

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103 *See* 11 U.S.C. § 944(b) (2012). *See also* O'Loghlin v. County of Orange, 229 F.3d 871, 877 (9th Cir. 2000) (holding that plaintiff's ADA violation claims arising pre-confirmation were discharged, while an identical claim arising post-confirmation from the same "series of violations" was not).

104 *See, e.g.*, *In re* Dow Corning Corp., 280 F.3d at 654–55.

105 *See In re* Lowenschuss, 67 F.3d at 1402 (holding that 11 U.S.C. § 524(e) (2012) prohibits third-party relief); *In re* Dow Corning Corp., 280 F.3d at 658 (holding that § 524(e) does not prohibit third-party relief and announcing a seven-factor standard); *In re* Continental Airlines, 203 F.3d at 214 (listing three "hallmarks of permissible non-consensual releases"); Palmer et al., *supra* note 20, at 555–56.

106 *See In re* City of San Bernardino, 566 B.R. at 59–60 (distilling a new three-factor test based on necessity to the municipality's reorganization).

107 Palmer et al., *supra* note 20.

108 *Id.*

109 *In re* City of San Bernardino, 566 B.R. at 56–57 (quoting Celotex Corp. v. Edwards, 514 U.S. 300, 307 n.6 (explaining the scope of bankruptcy court jurisdiction under 28 U.S.C. § 1334(b) (2012))); *see also In re* Pacor, Inc., 743 F.2d 984 (3d Cir. 1984) (proposing that a "civil proceeding is related to bankruptcy" if "the outcome . . . could conceivably have any effect on the estate being administered in bankruptcy.").

110 11 U.S.C. § 524(e) (2012).

11.[111] The Ninth and Tenth Circuits hold that § 524(e) prohibits third-party relief entirely.[112] The other circuits, however, agree that § 524(e) only limits the scope of a debtor's bankruptcy discharge, and does not affect the bankruptcy court's power to order other relief in chapter 11.[113] Bankruptcy courts in these circuits use a variety of standards to determine whether "unusual circumstances" exist that justify the "dramatic measure" of third-party relief.[114]

a. Dow Corning*: Third-party Releases Allowable Under the Code*

The seven factors the Ninth Circuit applied in In re *Dow Corning* are typical of the majority standards. The *Dow Corning* factors considering whether:

> (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor . . . ; (2) The non-debtor 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 . . . has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for . . . the class . . . 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 conclusions."[115]

Not all circuits require every factor to be present to justify third-party relief, and there is no consensus regarding which factors are more or less important than others.[116]

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[111] *See, e.g.*, *In re* City of San Bernardino, 566 B.R. at 52 (noting the circuit split); *In re* Lowenschuss, 67 F.3d at 1402 (holding that the specific rule in 11 U.S.C. § 524(e) (2012) "displace[d]" the bankruptcy courts' general "equitable powers" granted by 11 U.S.C. § 105 (2012), and listing consistent Ninth Circuit precedent); *In re* Dow Corning Corp., 280 F.3d at 657–58 (holding that 11 U.S.C. § 524(e) (2012) only limits the scope of the debtor's discharge, not a court's equitable authority to issue injunctions affecting third parties under 11 U.S.C. § 105 (2012)).

[112] Palmer et al., *supra* note 20, at 555–56.

[113] *Id.*

[114] *In re* Dow Corning Corp., 280 F.3d at 658 ("[O]ur sister circuits have considered a number of factors, which are summarized in our holding below.").

[115] *Id.*

[116] Nat'l Heritage Found. v. Highbourne Found., 2014 U.S. App. LEXIS 12144 at *19 (4th Cir. 2014) ("A debtor need not demonstrate that every Dow Corning factor weighs in its favor . . . [b]ut . . . a debtor must provide adequate factual support to show that the circumstances warrant such exceptional relief[.]").

The facts of *Dow Corning* exemplify situations in which bankruptcy courts may release claims against third parties to assist debtors' reorganization efforts.[117] Faced with an unprecedented number of product liability suits, Dow Corning's shareholders and insurers established a $2.35 billion fund to pay the company's tort claimants.[118] In return, Dow Corning's plan of reorganization released the company and its shareholders and insurers from all future liability.[119] Under the plan, claimants who decided not to settle could still litigate separately.[120]

After articulating the *Dow Corning* factors, the Sixth Circuit remanded the case to Michigan's Eastern District Court for additional factfinding.[121] On remand, the district court found that all seven factors were met.[122] First, Dow Corning and its subsidiaries, shareholders, and insurers had identical interests—avoiding product liability claims.[123] The shareholders and insurers were also contributing substantial assets via the settlement fund, without which Dow Corning would be unable to satisfy future claims.[124] Moreover, by the date of the decision all affected classes of creditors eligible to vote on the plan had approved it.[125] Lastly, the plan's settlement fund ensured that substantially all affected classes would be paid, whether they chose to settle or litigate.[126] The district court accordingly ruled that Dow Corning's proposed release complied with the Code.[127]

b. National Heritage Foundation *and* Gillman*: Third-Party Releases That Fail to Conform with the Code*

The Fourth Circuit's reasoning in *National Heritage Foundation v. Highbourne Foundation* shows an application of the *Dow Corning* factors that

117 *In re* Dow Corning Corp., 287 B.R. 396, 416 (E.D. Mich. 2002) (approving the release of Dow Corning stakeholders from liability for defective products).

118 *In re* Dow Corning Corp., 280 F.3d at 653–54.

119 *Id.* at 654–55.

120 *Id.* at 655.

121 *Id.* at 658–59; *In re* Dow Corning Corp., 287 B.R. at 401 (noting that the bankruptcy judge recused himself after the Sixth Circuit ruling, prompting the district court to pick up the case).

122 *In re* Dow Corning Corp., 287 B.R. at 416.

123 *Id.* at 402–04.

124 *Id.* at 404–13 (comprising the second and third Dow Corning factors).

125 *Id.* at 413–14.

126 *Id.* at 414–16.

127 *In re* Dow Corning Corp., 287 B.R. at 416. The seventh factor, "a record of specific factual findings," was satisfied by creating a record on the other six factors, so the court did not discuss it explicitly. *In re* Dow Corning Corp., 287 B.R. at 399.

led to the opposite conclusion.[128] In *National Heritage Foundation* the debtor, a non-profit organization, included a blanket release (the "plan release") of its directors and creditors (the "released parties") from liability arising from the debtor's preconfirmation activity.[129] The plan release was designed to prevent large donors from suing the released parties for misusing donations.[130] National Heritage Foundation (NHF) argued that the plan release was necessary because indemnifying the released parties would be prohibitively expensive, and without indemnification it would be unable to find qualified directors.[131]

Although NHF's indemnification commitments created an identity of interests with the released parties, the circuit court ruled that continuing to work for NHF did not constitute additional consideration for the plan release.[132] Without additional consideration, the directors had not made "substantial contribution[s]" to the reorganization.[133] The court did not find the debtor's "necessity" argument convincing either, pointing out that NHF could simply discharge its obligation to indemnify the current directors for pre-confirmation acts, leaving its future commitment to indemnifying directors intact.[134] The court also refused to presume the impacted donors' consent, because they did not have an opportunity to vote on the plan.[135] Lastly, the plan did not compensate the donors at all or offer non-consenting donors an opportunity to recover.[136] Reiterating its prior holdings that such releases should be used "cautiously and infrequently," the court found that the plan release was not appropriate under the *Dow Corning* factors.[137]

Some circuits that do not explicitly follow *Dow Corning* nevertheless closely track its principles.[138] The Third Circuit, for instance, recognizes several "hallmarks of permissible non-consensual releases" and imports reasoning from

[128] Nat'l Heritage Found., 2014 U.S. App. LEXIS 12144, at *19.
[129] *Id* at *3.
[130] *Id* at *7–8.
[131] *Id* at *9–13.
[132] *Id* at *7–9.
[133] *Id.* at *7–9.
[134] Nat'l Heritage Found., 2014 U.S. App. LEXIS 12144, at *9–13.
[135] *Id.* at *13–15.
[136] *Id.* at *15–18.
[137] *Id.* at *4 (citing Behrmann v. Nat'l Heritage Found., 663 F.3d 704, 712 (4th Cir. 2011)). *See also* Deutsche Bank AG v. Metromedia Fiber Network Inc. (*In re* Metromedia Fiber Network Inc.), 416 F.3d 136, 142 (2nd Cir. 2005) ("No case has tolerated non-debtor releases absent the finding of circumstances that may be characterized as unique.").
[138] *In re* Dow Corning Corp., 280 F.3d 658 ("[O]ur sister circuits have considered a number of factors, which are summarized in our holding below.").

Dow Corning jurisdictions.[139] In *Gillman v. Continental Airlines*, the circuit court rejected a release enjoining shareholder class-action suits against indemnified directors and officers of the debtor.[140] The court's rejection was based on the release's lack of "fairness, necessity to the reorganization, and specific factual findings."[141] The plan was unfair to the class-action plaintiffs because it did not offer them any consideration for giving up their claims.[142] It was unnecessary both because the directors and officers were not making any financial contributions crucial to the plan's feasibility, and because the expense of indemnification was both highly contingent and insignificant relative to the debtor's other obligations.[143]

2. *Third-Party Relief in Chapter 9*

While courts developed standards for third-party relief in chapter 11 bankruptcy, very few municipalities were filing cases under chapter 9.[144] Unsurprisingly, then, municipal requests for third-party relief only began to appear after the recent recession and its corresponding wave of municipal bankruptcies.[145] Although the uses of third-party relief under both chapters share many common characteristics, some courts have expressed reservations about the applicability of their chapter 11 rules to chapter 9.[146]

a. Connector 2000*: The Introduction of Third-Party Relief to Chapter 9 Bankruptcy*

In re Connector 2000 was the first chapter 9 bankruptcy case to rule on third-party relief, and its reasoning has influenced subsequent rulings on the subject.[147] Connector 2000 was a non-profit corporation created to construct and

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139 *In re* Continental Airlines, 203 F.3d at 214.

140 *Id.* at 216–18.

141 *Id.* at 214.

142 *Id.* at 215.

143 *Id.* at 215–17 ("we find it difficult to conceive that Plaintiffs' lawsuits were anything more than a flea").

144 From 1934 to 2012, when the recession-precipitated wave of municipal bankruptcies was already under way, "only forty-nine cities, counties, and towns" had filed for chapter 9 bankruptcy, although about 600 special-purpose entities had also done so. Juliet M. Moringiello, *Chapter 9 Plan Confirmation Standards and the Role of State Choices*, 37 CAMPBELL L. REV. 71, 72 (2015). However, the number of cases resulting in published opinions is likely much lower due to dismissals.

145 *Bankrupt Cities, Municipalities List and Map*, GOVERNING (Sep. 14, 2017), http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html (noting that sixty-one municipalities have filed for bankruptcy since 2010).

146 *See In re* City of San Bernardino, 566 B.R. at 59–60 (distilling a new three-factor test based on necessity to the municipality's reorganization).

147 *See, e.g.*, *In re* City of Detroit, 524 B.R. at 173–76 (invoking *Connector 2000* to enunciate a rule based on the *Dow Corning* factors); Oppenheimer AMT-Free Municipals v. ACA Fin. Guar. Corp., 971 N.Y.S.2d 95,

administer toll roads in conjunction with South Carolina's Department of Transportation (SCDOT).[148] In 1998, Connector 2000 issued bonds to finance a road near Greenville.[149] After completion, however, the toll road failed to generate sufficient revenue to service the bonds.[150] This prompted Connector 2000 to file for chapter 9 bankruptcy in 2010.[151]

During the bankruptcy proceeding, bondholders alleged that they had causes of action against SCDOT for failing to maintain appropriate toll rates on the Greenville road, precipitating Connector 2000's default.[152] In return for assuming the toll road's maintenance and releasing its claims for licensing fees against Connector 2000 (among other concessions), the plan of reorganization proposed to release SCDOT from liability to the bondholders.[153] The bondholders, in turn, would receive smaller "Amended and Restated bonds" that Connector 2000 could feasibly repay.[154]

The bankruptcy court did not decide whether the *Dow Corning* factors were necessary for chapter 9 cases, but nevertheless discussed them briefly.[155] The court decided that the *Dow Corning* factors were satisfied because of the close ties between Connector 2000 and SCDOT, the quid-pro-quo nature of the release, and the fact that all affected classes had consented to the plan.[156] It excused the absence of an "opt-out" clause for bondholders by reasoning that this factor had been intended for mass-tort situations, in which each party had a cause of action arising from separate facts.[157]

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99 (N.Y. App. Div. 2013) (acknowledging the bankruptcy court's power to enjoin claims against non-debtors, although it had not done so).

148 *In re* Connector 2000 Ass'n, 447 B.R. 752, 754 (Bankr. D.S.C. 2011).

149 *Id.* ("$200,177,680 original principal amount").

150 *Id.*

151 *Id.* Despite being a nonprofit corporation, Connector 2000 qualified as a municipality under chapter 9 because it was "subject to control by [a] public authority, state or municipal[ity]" *In re* Connector 2000 Ass'n, 447 B.R. at 758 (quoting *Ex parte* York Co. Natural Gas Auth., 238 F. Supp. 964, 976 (D.C.S.C. 1965)).

152 *In re* Connector 2000 Ass'n, 447 B.R. at 766.

153 *Id.* at 766–67.

154 *Id.* at 766.

155 *Id.* at 767 ("The third party releases and injunctions contained in the Plan may be proper without regard to the [*Dow Corning* factors] because § 901 does not incorporate § 524(e). However, even applying the factors discussed above to this case, I find . . . that the third party releases . . . are appropriate and necessary").

156 *Id.* at 768 ("First, . . . SCDOT owns the [toll road] and provides Debtor the right to operate the road . . . . Second, SCDOT and the Bondholders are providing substantial consideration critical to effectuat[ing] the Plan . . . . Third, the releases are necessary to support all the parties' giving of such consideration . . . . Fourth, all of the impacted classes of creditors overwhelmingly support and have voted in favor of the Plan. Fifth, the Plan provides for the [impacted classes] to receive payment").

157 *In re* Connector 2000 Ass'n, 447 B.R. at 768.

Connector 2000 represents a consensual use of a third-party release in a situation where the difference between the debtor (Connector 2000) and the third party (SCDOT) was almost a technicality.[158] The other parties to the release, the bondholders, were also directly compensated by receiving new bonds.[159] These facts stand in stark contrast to the line of cases that followed, where proposed releases would harm parties potentially unrelated to the bankruptcies and benefit parties distinctly separate from the debtor.[160]

b. The Vallejo *Cases: Lawsuits Against Indemnified Municipal Employees Do Not Fall Within the Scope of a Municipality's Discharge*

The issue of third-party relief in the context of chapter 9 surfaced again recently during the city of Vallejo's bankruptcy proceeding.[161] While the case was pending, police officer defendants in several civil rights lawsuits to which the city was also a party[162] requested (and some received)[163] the protection of Vallejo's automatic stay. After the bankruptcy court confirmed the city's plan of reorganization in 2011, adjusting the civil rights claims against Vallejo, [164] the officers contended that the claims against them personally were likewise discharged.[165] They reasoned that, because the city would be obligated to indemnify them under California law, the lawsuits were essentially against Vallejo for bankruptcy purposes.[166]

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158 *In re* Connector 2000 Ass'n, 447 B.R. at 754 ("The Debtor was formed to assist the South Carolina Department of Transportation ("SCDOT") in the financing, acquisition, construction, and operation of turnpikes, highway projects, and other transportation facilities.").

159 *Id.* at 766.

160 *See* V.W., 2013 U.S. Dist. LEXIS 109145, at *10–11; Deocampo, 836 F.3d at 1139; *In re* City of Detroit, 524 B.R. at 263; *In re* City of San Bernardino, 566 B.R. at 50.

161 *See generally* Deocampo, 836 F.3d at 1136–39 (outlining the course of Vallejo's bankruptcy from filing on May 23, 2008 to plan confirmation on August 4, 2011).

162 V.W., 2013 U.S. Dist. LEXIS 109145, at *1 ("This civil rights lawsuit . . . against the City of Vallejo . . . and its Chief of Police . . . alleges that the City's police officers killed the decedent while they were using a taser gun during his arrest."); Deocampo, 836 F.3d at 1137 ("Plaintiffs asserted excessive-force and other constitutional claims against the Officers.").

163 Deocampo, 836 F.3d at 1136–39 ("the parties stipulated in writing that Vallejo's bankruptcy filing triggered an automatic stay"); *but see* V.W., 20133 U.S. Dist. LEXIS 109145, at *22 (quoting Maddalone v. Solano County, 2009 U.S. Dist. LEXIS 2116 (E.D. Cal.) ("in the context of a request for a stay, claims against employees of bankrupt city are not claims against the bankrupt city")).

164 Deocampo, 836 F.3d at 1142 (citing Demery v. Kupperman, 735 F.2d 1139 (9th Cir. 1984); Ronwin v. Shapiro, 657 F.2d 1071 (9th Cir. 1981)) ("[A] claim against a City official is not essentially one against the City for bankruptcy discharge purposes, even if state law requires the City to indemnify the official.").

165 Deocampo, 836 F.3d at 1139; V.W., 2013 U.S. Dist. LEXIS 109145, at *10–11.

166 Deocampo, 836 F.3d at 1141 (citing CAL. GOVERNMENT CODE § 825(a), obligating a public entity "to indemnify its employees for judgments against the employees based upon employee acts or omissions arising within the scope of employment"); V.W., 2013 U.S. Dist. LEXIS 109145, at *10–11.

In both cases, the district court and the Ninth Circuit rejected these arguments, holding that the lawsuits were not against the city, and were therefore not discharged in bankruptcy.[167] The district court achieved this result in *V.W.* by extending to bankruptcy the rule that a federal lawsuit against a state employee "is not essentially one against the state" for purposes of sovereign immunity.[168] The court noted that Vallejo's "indemnification obligation[s] w[ere] arguably discharged by the bankruptcy."[169]

The court also discussed an "alarming" result regarding indemnified employees and the § 523(a)(6) exception to discharge.[170] Bankruptcy courts have often held that claims arising from injurious civil rights violations are non-dischargeable "debts . . . for willful and malicious injury" in individual bankruptcies.[171] However, chapter 9 does not incorporate that exception, which in any case applies only to individual debtors.[172] Thus, shielding city employees from liability using third-party releases would essentially circumvent federal civil rights and bankruptcy laws.[173] The court unfortunately declined to rule on this issue.[174]

In *Deocampo*, the Ninth Circuit implicitly endorsed the *V.W.* court's reasoning. It began by establishing that, because chapter 9 does not incorporate 11 U.S.C. § 524(e),[175] its holdings barring third-party relief under chapter 11 did not necessarily translate to chapter 9.[176] Even so, the court used the same rule as *V.W.* to hold that the lawsuits were not claims against the city.[177] Lastly, the court examined Vallejo's plan of reorganization and found that it lacked an

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167 Deocampo, 836 F.3d at 1136; V.W., 2013 U.S. Dist. LEXIS 109145, at *24.

168 V.W., 2013 U.S. Dist. LEXIS 109145, at *21.

169 *Id.*; *but cf.* Deocampo, 836 F.3d at 1145 (noting that, because Vallejo did not actually become obligated to the officers until after the plan confirmation date, their claims against the city for indemnification were not discharged).

170 V.W., 2013 U.S. Dist. LEXIS 109145, at *8–10 (citing 11 U.S.C. § 523(a)(6) (2012)).

171 *Id.* (citing 11 U.S.C. § 523(a)(6) (2012) and its application in *In re* Gee, 173 B.R. at 193).

172 V.W., 2013 U.S. Dist. LEXIS 109145, at *8 (citing 11 U.S.C. § 523(a) (2012), referencing chapters 7, 11, 12, and 13, but not chapter 9).

173 *Id.* ("This extraordinary result would appear to exalt the bankruptcy laws over the civil rights laws (even though the civil rights laws, like the bankruptcy laws, are anchored in the constitution)."). *See* 42 U.S.C. § 1983 (2012); 11 U.S.C. § 523(a)(6) (2012).

174 V.W., 2013 U.S. Dist. LEXIS 109145, at *8–10.

175 11 U.S.C. § 524(e) (2012) ("discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."); 11 U.S.C. § 901(a) (2012) ("Applicability of other sections of this title").

176 Deocampo, 836 F.3d at 1143 (holding that its reasoning in *In re* Lowenschuss, 67 F.3d at 1401 precluding third-party relief in chapter 11 "does not apply in Chapter 9 proceedings").

177 *Id.* at 1142–43 (citing Demery, 735 F.2d at 1147 and holding that its analysis of "the attribution of liability between public entities and their officers" in the context of sovereign immunity "is equally applicable" to bankruptcy).

"express"[178] release of the officers from liability, "supported by specific factual findings."[179]

c. Detroit*: The Grand Bargain and Indemnified Police Officers*

Detroit's chapter 9 bankruptcy is the country's largest to date.[180] In its plan of reorganization, the city proposed multiple third-party releases.[181] It attempted to release the claims that civil rights plaintiffs (the "§ 1983 creditors") were asserting against indemnified police officers, as in *Vallejo*.[182] Detroit also asked to release the state of Michigan from liability for claims relating to Detroit's endangered pension funds.[183] The latter resembled *Connector 2000* in that it was part of a mostly-consensual deal that benefitted all parties, including those whose claims would be impaired.[184]

Detroit pointed to *Connector 2000* as proof that the *Dow Corning* factors were inapplicable to chapter 9 bankruptcy.[185] It relied on the opinion's remark that, if § 524(e) made the *Dow Corning* factors necessary, its absence in chapter 9 bankruptcy could make them unnecessary.[186] The *Detroit* court immediately rejected this argument without discussing the merits of the factors themselves, reiterating the Sixth Circuit's stance that § 524(e) has no implications for third-party relief.[187] Accordingly, it evaluated each proposed release under the *Dow Corning* factors.[188]

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[178] Deocampo, 836 F.3d at 1144 (citing *In re* Applewood Chair Co., 203 F.3d 914, 919 (5th Cir. 2000)).

[179] Deocampo, 836 F.3d at 1144 (citing Behrmann, 663 F.3d at 712–13).

[180] *See generally* Zoe Thomas, *Detroit Bankruptcy*, 33 INT' FIN. L. REV. 17 (2015); Scott A. Krystiniak, *From Wreckage Comes Reason: How Detroit's Chapter 9 Filing Helps Develop a Practicable and Principled Good Faith Standard*, 7 WM. & MARY BUS. L. REV. 235, 256–64 (2015).

[181] *In re* City of Detroit, 524 B.R. at 172, 262–63.

[182] *Id.* at 262–63 (summarizing "lawsuits seeking damages against the City under 42 U.S.C. § 1983" and "against the City's officers in their individual capacity.").

[183] *Id.* at 172 ("[E]ach holder of a pension claim releases the State and its related entities from all liabilities arising from or related to the City, this case, PA 436, or article IX, § 24 of the Michigan constitution.").

[184] *Id.* at 174–75 ("[T]he release and injunction are essential to the reorganization of the City[,] . . . the impacted classes have overwhelmingly voted to accept the plan[, and] . . . the plan provides a mechanism to pay a substantial portion of the claims in the classes affected by the release.").

[185] *Id.* at 173 (citing *In re* Connector 2000 Ass'n, 447 B.R. at 767 ("The third party releases and injunctions contained in the Plan may be proper without regard to the [*Dow Corning* factors] because § 901 does not incorporate § 524(e).")).

[186] *In re* City of Detroit, 524 B.R. at 173 (citing *In re* Connector 2000 Ass'n, 447 B.R. at 767 ("The third party releases and injunctions contained in the Plan may be proper without regard to the [*Dow Corning* factors] because § 901 does not incorporate § 524(e).")).

[187] *In re* City of Detroit, 524 B.R. at 173 (citing *In re* Dow Corning Corp., 280 F.3d at 657).

[188] *In re* City of Detroit, 524 B.R. at 172, 262–63.

The pension plan release was a component of the "Grand Bargain" struck between Michigan, Detroit, and Detroit's claimholders to provide for the city's pensioners and save its extensive art collection.[189] Some pensioners claimed that Michigan's constitution gave them a cause of action against the state for deficiencies in their pension funds.[190] In return for contributing almost $200 million to rescue the pension funds, Michigan asked to be formally released from liability for any claims arising from the funds.[191] This agreement, along with significant philanthropic contributions made through the Detroit Institute of Arts, made the Grand Bargain possible.[192]

Analogizing these facts to *Connector 2000*, the court quickly determined that all *Dow Corning* factors except the "opt-out" provision were satisfied, and approved the pension plan release.[193] Although it nominally accepted *Dow Corning*, the court also invoked *Highbourne*'s statement that "[a] debtor need not demonstrate that every . . . factor weighs in its favor to obtain approval of a non-debtor release" as authority to adapt the factors to chapter 9.[194] Recognizing the *Dow Corning* factors' origins in mass-tort liability in business bankruptcies, the court further noted that "[m]uch debate could be had regarding which of the . . . factors should apply in a chapter 9 case and whether any other factors should apply."[195] This uncertainty forms the basis for the relaxed standards applied later in the opinion and in *San Bernardino*.[196]

As in the *Vallejo* cases, Detroit was obligated to indemnify its police officers for damages awarded to civil rights plaintiffs. Here, however, the city's obligation stemmed from a contract it assumed under the plan of

189 *Id.* at 169–70.

190 *In re* City of Detroit, 524 B.R. at 170 (citing MICH. CONST. art. 9, § 24).

191 *Id.* at 169–70. The plan would also halt any ongoing litigation against Michigan on account of the pension funds.

192 *Id.* For an overview of the Detroit Institute of Arts' role in the Grand Bargain, *see generally* Collins, *supra* note 50.

193 *In re* City of Detroit, 524 B.R. at 174–75 ("First, . . . [t]he City is a political arm of the State . . . created to further the objectives of the State . . . . Second, the State is contributing substantial assets to the reorganization . . . . Third, the release and injunction are essential to the . . . Grand Bargain, which . . . is the cornerstone of the City's plan . . . . Fourth, the impacted classes have overwhelmingly voted to accept the plan . . . . Fifth, the plan provides a mechanism to pay a substantial portion of the claims in the classes affected by the release[.] Finally, . . . this opinion contains the specific findings of facts supporting the Court's conclusion that the non-consensual releases . . . are appropriate.").

194 *Id.* at 174 (quoting Nat'l Heritage Found., 2014 U.S. App. LEXIS 12144, at *6).

195 *In re* City of Detroit, 524 B.R. at 174.

196 *See id.* at 266 (holding *Dow Corning*'s fourth ("essential to reorganization") factor alone to be dispositive in rejecting a third-party release); *In re* City of San Bernardino, 566 B.R. at 57–58 (enunciating a three-factor test based on Detroit, requiring a release to be express, integral to reorganization, and supported by specific factual findings).

reorganization[197] instead of a statute. Detroit's plan of reorganization also specifically proposed to discharge the officers from individual liability, citing "the effective and efficient functioning of the police department" as consideration for the releases.[198] Accordingly, upon the § 1983 creditors' objection, Detroit "attempted to distinguish [*V.W.*] on the grounds that the Vallejo plan did not include a discharge or release of claims against officers."[199]

The court rejected Detroit's argument using its modified *Dow Corning* rule.[200] The *Dow Corning* opinion stated that a "bankruptcy court's power to order a third-party release is based on its 'power to reorder creditor-debtor relations *needed to achieve a successful reorganization*.'"[201] Thus, the *Detroit* court went a step further and reasoned that the "necessity" factor alone could be determinative.[202] Finding that the city had not established that its proposed release was "essential to the success of the City's plan," the court sustained the § 1983 creditors' objection.[203] In doing so, the court acknowledged that it was "effectively creat[ing] a class of creditors that will be paid in full" but held that this was a proper result.[204] Because Detroit had voluntarily assumed the underlying contract in its plan of reorganization, it was bound to comply with the terms it had negotiated.[205]

d. San Bernardino*: The Necessity Standard Emerges*

San Bernardino's bankruptcy, the most recent chapter 9 case to bring up third-party relief, follows directly from *Vallejo* and *Detroit*. The city was obligated to indemnify a group of police officer defendants against judgments entered against them for civil rights violations.[206] Like in *Vallejo*, the city's

197 *In re* City of Detroit, 524 B.R. at 266–67.

198 *Id.* at 266 ("[T]he City responds that its plan properly seeks to release [the § 1983] claims.").

199 *Id.* at 265–66.

200 *Id.* at 266 (adopting the third factor from the test for third-party relief used in *In re* Dow Corning Corp., 280 F.3d 648).

201 *In re* City of Detroit, 524 B.R. at 266 (emphasis added).

202 *Id.* at 266–67.

203 *Id.* ("Absent demonstrated necessity, the bankruptcy code does not allow the impairment and discharge of unsecured claims against third parties . . . [t]herefore, the Court sustains the § 1983 creditors' objections.").

204 *Id.*

205 *Id.* ("[A] debtor's assumption of an executory contract requires the debtor to comply with the contract . . . and presumably the City entered into the contract and assumed it precisely because it concluded that it is mission-justified.").

206 *In re* City of San Bernardino, 566 B.R. at 49–50 ("Civil Rights Claimants who … asserted litigation claims not only against the City but also against it employees acting in the normal course of their employment, in particular members of the Police Department . . . . At the time of confirmation . . . , the City had approximately 115 lawsuits pending against it and more than 200 other Claimants who had . . . not yet initiated litigation. More than half of the lawsuits and many of the other Claimants asserted claims against the Indemnified Parties.").

obligations arose from California law regarding public employee indemnification,[207] and similar to *Detroit*, the city reaffirmed its obligations in the plan as a result of collective bargaining agreements it reached with employees.[208]

San Bernardino, apparently learning from its predecessors, provided for an injunction in its plan of reorganization ("the plan injunction").[209] The plan injunction would "shield the City's employees, specifically its police officers, from litigation exposure and liability for damages of Claimants who alleged the officers had violated their civil rights."[210] The plan injunction was expressly featured[211] and accompanied by specific factual findings that the city would not be able to afford its proposed annual budgets without the plan injunction.[212] These findings included the city's unsuccessful attempts to eliminate its operating deficit by "dramatically reduc[ing] expenses and work[ing] diligently to increase revenues" and its decision to allocate "additional funds of $56.5 million over five years" to implement a "Police Resources Plan" targeting the city's high crime rates.[213]

The bankruptcy court agreed,[214] first citing the Ninth Circuit in *Deocampo* that third-party relief was not per se impermissible under chapter 9.[215] The court next combined the *Deocampo* and *Detroit* reasoning into a three-part test, permitting third-party relief under chapter 9 if the injunction is: "(i) . . . express; (ii) . . . an integral part of the reorganization; and (iii) . . . supported by specific

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[207] *In re* City of San Bernardino, 566 B.R. at 50 (noting that CAL. GOV'T CODE § 825(a), among other state statutes, obligates municipalities "to indemnify their employees for claims against them arising from the scope of their employment, such indemnification to cover both the costs of defense and any damage award against the employee").

[208] *Id.* at 51 ("The settlements the City negotiated with its employee unions and the operative collective bargaining agreements required the City to reaffirm its obligation to indemnify the employees . . . in the Plan.").

[209] *Id.* at 49.

[210] *Id.* at 50 (citing San Bernardino's plan providing that "[e]ntities who have held, hold, or may hold Pre-Confirmation Date Claims shall be permanently enjoined from . . . commencing or continuing in any manner, directly or indirectly, any suit, action or other proceeding of any kind against . . . any or all of the Indemnified parties or any of their property . . ." and defining "litigation claims" to include "lawsuits against any of the Indemnified Parties, whether filed prior to the Confirmation Date or on or after the Confirmation Date based on acts, claims or omissions that occurred or arose prior to the Confirmation Date, as to which lawsuits the City . . . becomes obligated to pay any judgment arising therefrom . . .").

[211] *In re* City of San Bernardino, 566 B.R. at 59 ("the Plan Injunction was expressly set forth in the Plan . . . as required by the [Fed. R. Bankr. P. 3016(c)] applicable to third-party injunctions").

[212] *Id.* at 59–61.

[213] *Id.* at 60–61; *see also In re* City of San Bernardino Cal., 499 B.R. 776, 778–79 (Bankr. C.D. Cal. 2013) (describing the city's financial hardships leading up to its bankruptcy filing).

[214] *In re* City of San Bernardino, 566 B.R. at 59 ("[T]he first[,] . . . second[,] and third factors are . . . satisfied.").

[215] *Id.* at 57–58 (Bankr. C.D. Cal. 2017) (citing Deocampo, 836 F.3d at 1143; 11 U.S.C. § 524(e) (2012)).

factual findings[216] regarding [its necessity] to the City's efficient and effective functioning, to its revitalization, or to the success of the plan."[217]

Using this standard, the court found that the plan injunction was express and featured sufficient "specific factual findings."[218] The feasibility of the city's proposed annual budgets was also enough of a "necessity" to satisfy the second and third factors' substantive requirements.[219] Additional facts favoring confirmation included the city employees' cooperation in negotiating collective bargaining agreements and accepting reduced payouts on their claims, the plan's "narrow tailor[ing]" to "only" enjoin collection on the judgments, not the lawsuits themselves, and an insurance settlement that would provide some compensation for claimants with "catastrophic injuries."[220] The court concluded hopefully that, with its plan injunction in place, San Bernardino could "turn around its fiscal crisis, provide sufficient municipal services to its residents, and make the streets safe for economic development and greater personal prosperity."[221]

II. ANALYSIS

The necessity-based standard for third-party relief that has developed in recent chapter 9 cases is improper for two reasons. First, it opens a loophole for parties related to municipal debtors to be relieved of otherwise non-dischargeable debts, contravening congressional intent as embodied in the Code's exceptions to discharge. Second, it removes any objective limitations on third-party relief by eliminating key *Dow Corning* factors and by ignoring the difficulties of measuring necessity without a municipal liquidation option. The *Dow Corning* factors already guide courts to approve third-party releases consistent with the Code and offer the experience of over thirty years of case law. Nevertheless, circumstances common to municipal bankruptcies may suggest adjustments to certain factors, as the courts in *Connector 2000* and *Detroit* noted.[222]

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216 *In re* City of San Bernardino, 566 B.R. at 58 (citing Fed. R. Bankr. P. 3016 requiring "specific and conspicuous language" for plan injunctions "against conduct not otherwise enjoined under the Code").

217 *Id.* at 57–58 (citing *In re* City of Detroit, 524 B.R. at 266; Deocampo, 836 F.3d at 1144–45).

218 *In re* City of San Bernardino, 566 B.R. at 59–60.

219 *Id.* at 56 ("The unrefuted evidence . . . shows that the City does not and will not have the funds necessary to both pay the judgments against the City's employees and invest in the Police Resources Plan, among other things.").

220 *Id.* at 61–62.

221 *Id.* at 63.

222 *In re* Connector 2000 Ass'n, 447 B.R. at 768; *In re* City of Detroit, 524 B.R. at 174.

As an initial matter, the *V.W.* court speculated that Vallejo's obligations to indemnify its officers might themselves have been dischargeable in bankruptcy.[223] If so, similarly situated municipalities will have no case for a third-party release's necessity to begin with. As the *Detroit* court pointed out, a debtor that voluntarily assumes indemnification obligations instead of discharging them has only itself to blame for the financial consequences.[224]

Of course, a debtor could argue in the alternative that indemnification is necessary for recruitment. San Bernardino, for instance, predicted that its police department would be unable to hire or retain officers unless they were shielded from liability.[225] However, the court in *Highbourne* refuted this same argument with respect to the company's directors.[226] It pointed out that discharging the debtor's existing obligations in bankruptcy did not affect its commitments going forward.[227] The reorganized debtor would retain its policy of indemnifying directors, so future directors would still expect to be indemnified.[228] In the same way, California's indemnification statute still applies to San Bernardino post-bankruptcy, so police officers can count on being indemnified in the future.

Nevertheless, this Comment continues with the assumption that indemnification obligations cannot readily be discharged except through third-party relief. This allows this Comment to address the arguments that parties have and probably will continue to rely on, absent rulings that directly address the treatment of statutory indemnification obligations in bankruptcy.

A. Granting Relief to Non-Debtors for Non-Dischargeable Debts is Inconsistent with the Bankruptcy Code

Although the court in *V.W.* worried that releasing officers from liability for civil rights judgments was contrary to federal policy, none of the other chapter 9 opinions considered that the officers' debts would not be dischargeable had they filed for bankruptcy individually.[229] This is not entirely surprising, as

223 V.W., 2013 U.S. Dist. LEXIS 109145, at *21.

224 *In re* City of Detroit, 524 B.R. at 266–67 ("[A] debtor's assumption of an executory contract requires the debtor to comply with the contract . . . and presumably the City entered into the contract and assumed it precisely because it concluded that it is mission-justified.").

225 *In re* City of San Bernardino, 566 B.R. at 55–56.

226 Nat'l Heritage Found., 2014 U.S. App. LEXIS 12144, at *9–13.

227 *Id.*

228 *Id.*

229 V.W., 2013 U.S. Dist. LEXIS 109145, at *8 ("This extraordinary result would appear to exalt the bankruptcy laws over the civil rights laws (even though the civil rights laws, like the bankruptcy laws, are anchored in the constitution).").

outside of chapter 9 no case appears to have addressed third-party releases of nondischargeable debts. Chapter 9's omission of the § 523(a) exceptions, expanding the scope of a debtor's discharge, also indicates that Congress considered municipal rehabilitation to be paramount.[230] However, there is no indication that Congress intended for third-parties to share in this "super-discharge" merely by association with the debtor. The case law surrounding § 523(a) instead shows an intent to keep individuals who have incurred certain kinds of debt from receiving the benefit of the bankruptcy discharge.

1. *Third-Party Relief is Justified by the Code's "Fresh Start" Policy*

One of the bankruptcy system's central goals is to provide the debtor—whether an individual, a business entity, or a municipality—with the opportunity to start over, unimpeded by the effects of its past financial mistakes.[231] This idea, commonly called the "fresh start," underlies a history of Code provisions and case law that favors dischargeability and construes provisions to benefit the "honest but unfortunate" debtor.[232] Thus, even though the Code makes no mention of a bankruptcy court's ability to release third-parties from debts, many courts have interpreted § 105(a)'s broad grant of equitable power to encompass such relief.[233] But because courts are limited in exercising this power to carrying out the Code's provisions, § 105(a) does not give them free reign to release third parties.[234]

When the debtor is an entity instead of an individual, many non-debtors may also be burdened by obligations arising from their relationship with the debtor. For instance, a corporation's directors may face liability for misusing funds, or a municipality's police officers for injuries caused in the line of duty.[235] All else equal, the debtor would prefer to simply release its directors or officers from liability so that they can continue to serve without the distraction of litigation.

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230 *See* V.W., 2013 U.S. Dist. LEXIS 109145, at *8 (citing 11 U.S.C. § 523(a) (2012), referencing chapters 7, 11, 12, and 13, but not chapter 9).

231 Grogan, 498 U.S. at 286–87 ("[I]n the same breath that we have invoked this fresh start policy, we have been careful to explain that the Act limits the opportunity for a completely unencumbered new beginning to the honest but unfortunate debtor.") (internal quotations omitted).

232 *Id.*; 4 COLLIER ON BANKRUPTCY ¶ 523.05 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("[T]he exceptions should be . . . strictly construed against the objecting creditor and liberally in favor of the debtor.").

233 *In re* Dow Corning Corp., 280 F.3d at 565.

234 11 U.S.C. § 105(a); *see In re* Dow Corning Corp., 280 F.3d at 565.

235 *See, e.g.*, Nat'l Heritage Found., 2014 U.S. App. LEXIS 12144 (denying debtor non-profit organization's proposed release of its directors from potential liability for misusing donations).

However, such a release may contravene the Code by treating the directors' or officers' creditors unfairly, placing it outside the debtor's reach.

To this end, courts have developed standards, such as the *Dow Corning* factors, to limit third-party relief to situations in which it is instrumental to the debtor's fresh start and consistent with the Code's provisions.[236] Mass tort claims against indemnified parties tend to fall here, because the number and amounts of claims may be difficult to estimate, exposing the debtor to uncertain obligations going forward.[237] Although a debtor can discharge its duty to indemnify, it may need the indemnified parties to contribute substantially to the reorganization. If, for example, the debtor instead establishes a settlement fund to pay the claims, releasing third parties from personal liability can secure their cooperation without treating creditors unfairly. This result is desirable because the debtor has a better chance of recovery, and allowable because it is consistent with the Code.

2. The § 523(a) Exceptions Overrule the General Policy Favoring Dischargeability

Congress has decided that individuals who incur debts through certain types of "wrongful acts" cannot use laws enacted to help the "honest but unfortunate" debtor to discharge those debts.[238] Although courts construe these excepted categories narrowly, they enforce the exceptions rigorously.[239] For instance, the Supreme Court found that a creditor who accused a debtor of fraud (excepted under § 523(a)(2)(A)) but settled before trial could still show that the debt arose from non-dischargeable conduct.[240] And courts have repeatedly found that debts arising from civil rights violations fall under the § 523(a)(6) exception for injuries caused by "willful and malicious conduct."[241]

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236 *In re* Dow Corning Corp., 280 F.3d at 565 (justifying its ruling under 11 U.S.C. § 105(a) (2012)'s grant of "power to take appropriate equitable measures needed to implement other sections of the Code.").

237 *See, e.g.*, *In re* Dow Corning Corp., 280 F.3d 648 (granting debtor manufacturer's request to release parties from product liability as a "quid pro quo" for contributions to a settlement fund).

238 Radwan, *supra* note 28; Grogan, 498 U.S. at 286–87.

239 4 COLLIER ON BANKRUPTCY ¶ 523.05 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("[T]he exceptions should be . . . strictly construed against the objecting creditor and liberally in favor of the debtor.").

240 Archer, 538 U.S. at 323 (holding that although a "settlement agreement and releases may have worked a kind of novation, . . . that fact does not bar [the creditor] from showing that the settlement debt arose out of false pretences [sic], a false representation, or actual fraud, and consequently is nondischargeable.").

241 *See, e.g.*, *In re* Gee, 173 B.R. at 193 (concerning sex discrimination); Avery v. Sotelo (*In re* Sotelo), 179 B.R. 214, 218 (Bankr. S.D. Cal. 1995) (concerning sexual harassment); *In re* Moore, 1 B.R. 52, 54 (Bankr. C.D. Cal. 1979) (concerning racial discrimination).

A bankruptcy court cannot use its equitable powers in ways that are contrary to the Code's provisions, and the Code indicates a clear policy that certain debts should not be discharged.[242] Although § 523(a)'s exceptions only explicitly apply to debtors, the Code only contemplates releasing debtors from debts in the first place. Without a provision granting bankruptcy courts the ability to release third parties from debts, there would be no reason to include language limiting that ability. Courts already agree that the Code's silence on third-party relief does not grant them free reign to use it—hence the *Dow Corning*-based standards. Requiring debtors' requests for third-party relief to follow some of the Code's relevant requirements but not others is inconsistent and vulnerable to abuse.

Through this limited application of the restrictions on dischargeability, recent cases have suggested a loophole through which nondischargeable debts—here arising from civil-rights violations—may be indirectly discharged.[243] Although these cases are brought under chapter 9, the reasoning is equally applicable in any chapter of the Code. For example, a business owner who faces liability for obtaining money through fraud (excepted by § 523(a)(2)), could not discharge that liability by filing for bankruptcy as an individual.[244] However, the same person could direct his or her business to file for bankruptcy under chapter 11, and include a release of the same liability in its plan of reorganization. Of course, this plan would only work in circuits that allow third-party relief, and it would need to satisfy the requirements of the circuit in which the business is located. Nevertheless, it opens a possible end-run around the policies built into the Code. While the beneficiaries of such releases are not technically "debtors", they are receiving the benefits of the bankruptcy discharge for debts which Congress has explicitly excepted from discharge.[245] Because the court's equitable powers are limited by the Code, and releasing nondischargeable debts is contrary to its provisions, bankruptcy courts' equitable powers do not extend to releasing non-debtors from debts excepted by § 523(a).

[242] A bankruptcy court's powers under 11 U.S.C. § 105(a) (2012) are limited to enforcing the Code's provisions. *See In re* Dow Corning Corp., 280 F.3d at 565. On non-dischargeable debts, *see* Grogan, 498 U.S. at 287; Radwan, *supra* note 28.

[243] Deocampo, 836 F.3d at 1143; *In re* City of Detroit, 524 B.R. at 266–67; *In re* City of San Bernardino, 566 B.R. at 56.

[244] 11 U.S.C. § 523(a) (2018) (applying to discharges obtained under chapters 7 and 13).

[245] Grogan, 498 U.S. at 287.

B. The Necessity Standard is Inappropriate for Chapter 9 Bankruptcy

Third-party relief is not limited to the areas of products liability and insider indemnification in chapter 11 cases, and municipal debtors will likewise find many uses for it under chapter 9.[246] The releases involving state liability to municipal creditors, as in *Connector 2000* and the pension fund release in *Detroit*, have been consensual and mutually-beneficial.[247] Accordingly, both releases easily satisfied the *Dow Corning* factors.

On the other hand, the releases of municipal employees have been constructed primarily to benefit those employees, at the expense of parties potentially unrelated to the bankruptcy.[248] After *Detroit* and *San Bernardino*, the precedent concerning this second category conditions relief on its "necessity" to the reorganization.[249] While a municipality's request for third-party relief must also be clearly displayed in its proposed plan of reorganization and accompanied by "specific factual findings" of necessity, these requirements are merely procedural and do not rely on the debtor's underlying situation.[250]

This "necessity" standard is problematic because it is neither consistent with prior case law nor specifically adapted to the needs of municipal debtors. Necessity, in particular, lacks teeth when the municipality cannot face dissolution.[251] This uncertainty encourages municipal debtors to over rely on third-party releases, once reserved for unusual circumstances, instead of addressing their own obligations.

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[246] *See In re* Connector 2000 Ass'n, 447 B.R. 752 (approving consensual plan releasing state Department of Transportation from claims of municipal debtor's bondholders).

[247] *Id.* at 768; *In re* City of Detroit, 524 B.R. at 174–75.

[248] Deocampo, 836 F.3d at 1139; V.W., 2013 U.S. Dist. LEXIS 109145, at *10–11; *In re* City of Detroit, 524 B.R. at 263; *In re* City of San Bernardino, 566 B.R. at 50.

[249] *In re* City of Detroit, 524 B.R. at 266–67; *In re* City of San Bernardino, 566 B.R. at 57–58; Deocampo, 836 F.3d at 1144–45.

[250] *In re* City of Detroit, 524 B.R. at 266–67; *In re* City of San Bernardino, 566 B.R. at 57–58; Deocampo, 836 F.3d at 1144–45.

[251] 6 COLLIER ON BANKRUPTCY ¶ 900.01[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("[T]he Supreme Court has upheld municipal debt adjustment legislation . . . at least in part on the premise that the legislation involves no possibility of . . . liquidation of [a municipality's] assets."); *In re* Richmond Unified School Dist., 133 B.R. 221, 225 (1991) ("A municipal unit cannot liquidate its assets to satisfy its creditors[.] . . . Therefore, the primary purpose of Chapter 9 is to allow [it] to continue operating while it adjusts or refinances its creditor[s'] claims").

1. *Third-Party Relief is a Dramatic Measure Reserved for Unusual Circumstances*

Chapter 9, like other chapters of the Code, centers around adjusting a debtor's obligations to its creditors.[252] The Code provides bankruptcy courts with various tools that can accomplish this, including the authority to use equitable remedies (such as temporary and permanent injunctions) under § 105(a).[253] However, "[s]ection 105 is not an independent source of jurisdiction," and must be exercised subject to the Code's provisions[254] and the other limits on equitable remedies.[255] Furthermore, equitable doctrines traditionally restrict the use of injunctions to extraordinary situations where there is "no adequate remedy at law."[256] Courts on both sides of the circuit split have acknowledged that this doctrine influences third-party relief in bankruptcy, rendering it a "dramatic measure" reserved for "unusual circumstances."[257]

Early in its opinion, the *Detroit* court rejected the argument that, because chapter 9 does not incorporate § 524(e), the *Dow Corning* factors were irrelevant.[258] It noted that, under Sixth Circuit law, § 524(e) only limited the scope of the debtor's discharge.[259] Releasing third parties from debts did not expand the debtor's own discharge, so § 524(e) was never an obstacle to third-party relief.[260] Accordingly, the court held that *Dow Corning* applied equally to chapters 9 and 11.[261] Acknowledging that individual factors could hold different relevance in chapter 9, and aided by the example of *Connector 2000*, it found

[252] *In re* Addison Community Hosp. Auth., 175 B.R. at 649 ("The general policy considerations underlying . . . chapter 9 are the same as [those] of chapter 11 reorganization: to give the debtor a breathing spell from debt collection efforts and establish a repayment plan with creditors.").

[253] 11 U.S.C. § 105 (2012) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").

[254] Celotex Corp., 514 U.S. at 327 (citing 2 COLLIER ON BANKRUPTCY ¶ 105.01[1] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("Section 105 is not an independent source of jurisdiction, but rather it grants the courts flexibility to issue orders which preserve and protect their jurisdiction")); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) ("whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.").

[255] 2 COLLIER ON BANKRUPTCY ¶ 105.03[3] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("Statutes Affecting the Availability of Injunctive Relief").

[256] Samuel L. Bray, *The System of Equitable Remedies*, 63 U.C.L.A. L. REV. 530, 550 (2016).

[257] *See, e.g.*, *In re* Dow Corning Corp., 280 F.3 at 658; *In re* American Hardwoods, 885 F.2d 621, 626–27 (9th Cir. 1989).

[258] *In re* City of Detroit, 524 B.R. at 173 (citing *In re* Dow Corning Corp., 280 F.3d 648).

[259] *Id.*

[260] *Id.*

[261] *Id.*

the plan injunction's lack of necessity to be dispositive.[262] *Detroit*, therefore, should not be read to introduce a new standard for third-party relief.

The *Detroit* court's holding is relevant to this analysis for two additional reasons. First, it shows that third-party relief remains a "dramatic measure" reserved for "unusual circumstances" in chapter 9, as it is in chapter 11.[263] Second, the court points out that the *Dow Corning* factors are not the only considerations limiting third-party relief—the Code's plan confirmation requirements, namely "good faith" proposal of and "fair and equitable" treatment under a plan, always apply.[264]

However, although the *San Bernardino* court purported to follow the reasoning in *Detroit*, it did not consider the applicability of the other *Dow Corning* factors.[265] Instead, it interpreted the single factor that proved sufficient to reject a request for third-party release in *Detroit* as the sole substantive requirement.[266] This new standard constitutes a break from precedent without any reasoning supporting its particular applicability to chapter 9 bankruptcy or limitations reserving third-party relief for unusual circumstance.

2. *The Necessity Standard Imposes no Substantive Limitations on the Availability of Third-Party Relief*

The indissolubility of municipalities means that no chapter 9 plan is "necessary" in the chapter 11 sense—that is, the municipality will continue to function until the state dissolves it, regardless of what happens in bankruptcy.[267] This leaves the bankruptcy court without an objective measure of necessity, forcing it to base its decision upon some other criterion. For instance, the *San Bernardino* court substituted the feasibility of the city's proposed budget.[268]

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[262] *In re* City of Detroit, 524 B.R. at 173 (citing *In re* Dow Corning Corp., 280 F.3d 648).

[263] *In re* Dow Corning Corp., 280 F.3d at 658.

[264] *In re* City of Detroit, 524 B.R. at 173.

[265] *In re* City of San Bernardino, 566 B.R. at 57–58. The court inadvertently incorporated the seventh *Dow Corning* factor, the procedural requirement that findings be supported by findings of fact, from Deocampo, 836 F.3d at 1144 (citing Fed. R. Bankr. P. 3016). *See In re* Dow Corning Corp., 280 F.3d 648.

[266] *In re* City of San Bernardino, 566 B.R. at 57–58.

[267] *See In re* Addison Community Hosp. Auth., 175 B.R. at 649 (quoting "[N]either Congress nor the courts can change the existing system of government in this country . . . . One of the powers reserved to the states is the power to create and govern municipalities."); 6 COLLIER ON BANKRUPTCY ¶ 900.01[1] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("[T]he Supreme Court has upheld municipal debt adjustment legislation . . . at least in part on the premise that the legislation involves no possibility of . . . liquidation of [a municipality's] assets.").

[268] *In re* City of San Bernardino, 566 B.R. at 56 ("The unrefuted evidence . . . shows that the City does not and will not have the funds necessary to both pay the judgments against the City's employees and invest in the Police Resources Plan, among other things.").

That measure is problematic because it does not need to reflect anything about the municipality's underlying financial situation.

Any budget can presumably allocate the entirety of a municipality's expected income for purposes other than indemnification. And if the budget leaves no room for indemnification, indemnifying employees will jeopardize its success. Under the *San Bernardino* court's formulation, this almost-tautological relation, combined with factual findings about the municipality's dire financial straits, could be sufficient to secure releases for the debtor's employees, and deny compensation to victims of civil rights violations. The lack of an objective measure of necessity therefore transforms the necessity standard into an exercise in budget drafting.

In other words, the debtor has a conflict of interests. The bankruptcy court may have an idea of the municipality's future earning potential but relies on the municipality to accurately project its "necessary" expenses. The possibility of pushing some costs onto third parties (in this case by leaving civil rights plaintiffs uncompensated) creates a "use-it-or-lose-it" budgeting problem.[269] If the debtor doesn't ask for third-party relief, it will be effectively shrinking its own budget. In similar circumstances involving conflicts of interests, courts have avoided interpreting Code provisions in ways that allow debtors to control the narrative. For example, courts in many circuits prevent debtors from gerrymandering classes of creditors in chapter 11 to meet the Code's consent requirements.[270] This policy is based on judicial recognition that debtors have an incentive to act in ways that are inconsistent with fundamental bankruptcy principles, rather than any particular Code provision.[271]

When the availability of third-party relief depends primarily on the story a debtor can tell, failing to request it is like leaving money on the table. Future municipal debtors thus have every incentive to emulate the *San Bernardino* plan. And they would appear to be eligible if they can produce budgets disposing of all projected revenues, explicit requests for third-party relief, and factual

[269] *See generally* Jeffrey B. Liebman & Neale Mahoney, *Do Expiring Budgets Lead to Wasteful Year-End Spending? Evidence from Federal Procurement* 1 (National Bureau of Economic Research Working Paper No. 19481, September 2013), *available at* http://www.nber.org/papers/w19481.pdf.

[270] Russell M. Blain & Daniel R. Fogarty, *Paths and Obstacles to Chapter 11 Confirmation: Artificial Impairment, Gerrymandering, and Section 1111(b)* 16 (Southeastern Bankruptcy Law Center Seminar, 2014), *available at* http://www.sbli-inc.org/archive/2014/documents/Paths_and_Obstacles_to_Chapter_11_Confirmation_etc.pdf.

[271] *Id.*

findings about the crucial roles of the indemnified employees.[272] All are procedural limitations that a debtor may be able to satisfy regardless of its underlying need. In practice, the necessity standard would impose no substantive limitations on many municipal debtors.

3. *The Necessity Standard Fails to Reserve Third-Party Relief for Unusual Circumstances*

The ubiquity of police indemnification alone suggests that many future municipal debtors will follow *Detroit*'s and *San Bernardino*'s leads.[273] However, third-party relief is by no means limited to indemnified police officers. Any indebted public employee who is making ongoing, substantial contributions to a city's operation by virtue of his or her employment is eligible for the same treatment. In an extreme case, indebted officials could even send their own municipal employer into an unnecessary bankruptcy proceeding solely to free themselves or their businesses from nondischargeable debts, or to save themselves the embarrassment of declaring bankruptcy individually.

These examples suggest a few of the countless situations in which a debtor municipality can (and has every incentive to) request third-party relief. Assuming its plan of reorganization satisfies the procedural requirements, the necessity standard gives no reason to deny these requests. The fundamental objection to the necessity standard, then, is that it does not limit third-party relief to unusual circumstances. This subverts the roles of both bankruptcy, as a forum for adjusting the relations between the "honest but unfortunate" debtor and its creditors,[274] and equitable remedies, as extreme solutions to problems for which the law does not adequately provide.[275] If bankruptcy courts wish to limit third-party relief in accordance with bankruptcy and equitable principles, they must look to something other than the necessity standard.

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[272] *In re* City of San Bernardino, 566 B.R. at 57–58 (citing *In re* City of Detroit, 524 B.R. at 266; Deocampo, 836 F.3d at 1144–45).

[273] *See* Schwartz, *supra* note 30 (revealing results of a nationwide study indicated that "police officers are virtually always indemnified," although often by unofficial arrangements).

[274] *In re* Addison Community Hosp. Auth., 175 B.R. at 649 ("The general policy considerations underlying . . . chapter 9 are the same as [those] of chapter 11 reorganization: to give the debtor a breathing spell from debt collection efforts and establish a repayment plan with creditors."); Grogan, 498 U.S. at 286–87.

[275] *See, e.g.*, *In re* Dow Corning Corp., 280 F.3d at 658 (internal quotations omitted) ("Because such an injunction is a dramatic measure to be used cautiously, . . . enjoining a non-consenting creditor's claim is only appropriate in unusual circumstances.").

C. An Appropriate Standard for Third-party Relief in Chapter 9 Must Impose Substantive Limitations

The Code restricts the dischargeability of certain debts, and equitable doctrines limit a court's ability to approve creative solutions to a debtor's financial woes. In the realm of third-party relief, standards such as the *Dow Corning* factors help to ensure that plans of reorganization conform with both legal and equitable principles. Recently, courts have questioned the suitability of *Dow Corning* for chapter 9 bankruptcies. The alternative that has emerged—the necessity standard—fails to restrict third-party relief in accordance with the Code. This section explains why the *Dow Corning* factors remain applicable. It also considers legislative options for removing the uncertainty surrounding third-party relief and protecting indemnified public employees.

1. *The* Dow Corning *Factors*

The seven *Dow Corning* factors consider whether (1) "[t]here is an identity of interests" between the debtor and non-debtor, (2) "[t]he non-debtor has contributed substantial assets," (3) the release "is essential to reorganization," (4) the impacted class has accepted the plan, (5) the plan would pay the impacted class, as well as (6) allow objecting claimants to opt out, and (7) the bankruptcy court has made "a record of specific factual findings."[276] All of these factors remain relevant to chapter 9 bankruptcy, including the sixth, which has received the most criticism.[277]

As an initial matter, the seventh factor (a "record of specific factual findings") is required by Bankruptcy Rule 3016 for plan injunctions "against conduct not otherwise enjoined under the Code."[278] The merits of a factual record have not been questioned in any case involving third-party relief. Far from it, courts following *Dow Corning* have specifically noted its practical importance in the event of an appeal.[279]

The first *Dow Corning* factor, the existence of "an identity of interests between the debtor and the third party," is a source of the bankruptcy court's authority to release claims against third-parties.[280] The effect of plan confirmation in chapter 11 is to bind the debtor, its owners, and its creditors to

276 *In re* Dow Corning Corp., 280 F.3d at 658..
277 *In re* Connector 2000 Ass'n, 447 B.R. at 768; *In re* City of Detroit, 524 B.R. at 174–75.
278 Fed. R. Bankr. P. 3016.
279 *In re* Dow Corning Corp., 280 F.3d at 653 (remanding due to lack of specific factual findings).
280 *Id.* at 658.

the plan's terms.[281] The Code defines a creditor as an "entity that has a claim against the debtor," and a debtor as an entity "concerning which a case under this title has been commenced."[282] Thus, unless a claim is essentially against the debtor, the claimholder is not a "creditor," and a plan of reorganization is not binding with respect to that claim.[283]

Although the effect of plan confirmation in chapter 9 is also to bind the "debtor and any creditors" to its terms, the inapplicability of § 524(e) complicates the picture.[284] The result, however, is the same. Assuming § 524(e)'s omission is not superfluous suggests that in some instances discharging a municipality's debt can also affect a non-debtor's liability. However, a court applying this interpretation must nevertheless find that a debt is the *municipality's debt* in the first place.[285] This leaves the task of determining which debts are the municipality's. The court could either take a literal approach or consider, as the *Dow Corning* court did, debts that are nominally against non-debtors but essentially against the municipality.[286] Either way, the result will be at least as restrictive as the first *Dow Corning* factor.

The fourth and fifth *Dow Corning* factors would remain relevant to municipal bankruptcy if only because chapter 9 provides few other safeguards of non-debtors' rights.[287] The factors require some combination of impacted parties' consent to their treatment under a plan of reorganization, and compensation for giving up their claims.[288] The Code requires a municipality's plan to be in its creditors' best interests, meaning that its treatment is preferable to their non-bankruptcy options.[289] Although the parties affected by third-party releases need not be creditors, the first *Dow Corning* factor and the situations in which such releases arise generally ensure that this will be the case.[290]

[281] 11 U.S.C. § 1141(a) (2018).

[282] 11 U.S.C. § 101(10), (13) (2018).

[283] *See, e.g.*, Deocampo, 836 F.3d at 1136; V.W., 2013 U.S. Dist. LEXIS 109145, at *24.

[284] 11 U.S.C. § 944(a) (2018); 11 U.S.C. § 524(e) (2018) ("[D]ischarge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.").

[285] 11 U.S.C. § 524(e) (2018).

[286] *In re* Dow Corning Corp., 280 F.3d at 658 ("There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor.").

[287] *See* Tyson, *supra* note 34.

[288] *In re* Dow Corning Corp., 280 F.3d at 658.

[289] 6 COLLIER ON BANKRUPTCY ¶ 900.01[7][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010); *see* Pryor, *supra* note 47 (discussing municipal creditors' remedies outside of bankruptcy).

[290] *See In re* Dow Corning Corp., 280 F.3d at 658 ("There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor."). *See, e.g.*, *In re* Connector 2000 Ass'n, 447 B.R. at 766 (bondholders with claims against

With respect to claims against a municipality directly, almost anything is better than the creditors' nonbankruptcy options, because creditors cannot usually force a municipality to liquidate or raise additional revenue.[291] However, an indemnified third party—such as a municipal employee—does not receive the same protections.[292] With respect to its own creditors, an indemnified party is no different than any other debtor. Creditors can obtain judgment liens on its assets, garnish its wages, and possibly force it into bankruptcy. Parties impacted by a third-party release are giving up real rights to payment and must be compensated accordingly. Otherwise, the plan is not in their best interests. Thus, the fourth and fifth *Dow Corning* factors remain a meaningful measure of plan confirmability in chapter 9 bankruptcy.[293]

The courts in both *Connector 2000* and *Detroit* noted that the sixth (opt-out) factor may be of limited usefulness in municipal bankruptcy.[294] This position appears to be based on the bankruptcy policy that a creditor has no right to select which of two equal sources of payment will satisfy its claim.[295] In the context of mass product liability suits where third-party relief originated, each injured party's claim could be based on entirely different circumstances and harms.[296] Those differences could result in vastly different damage judgments if the claims were litigated instead of settled. Thus, because some plaintiffs could recover much more (or less) by litigating, forcing all of them into the same settlement would not be the equivalent of choosing between equal sources of repayment.

With § 1983 civil rights claims, however, the opt-out factor finds new relevance for chapter 9 bankruptcies. As with products liability claims, the facts and injuries are specific to each plaintiff, with damage awards varying accordingly.[297] A bankruptcy court, then, cannot rely upon its authority to direct

both debtor and state); *In re* City of Detroit, 524 B.R. at 170 (pensioners with claims against both debtor and state).

[291] *See* Parker, 590 F.2d at 653 (noting the "well-understood and established" principle "that it is contrary to public policy to allow private liens on public property"); *In re* City of Detroit, 524 B.R. at 215 (citing Faitoute Iron & Steel Co., 316 U.S. at 510).

[292] *See* 11 U.S.C. § 109(c) (2012) ("An entity may be a debtor under chapter 9 of this title . . . only if such entity . . . is a municipality.").

[293] *In re* Dow Corning Corp., 280 F.3d at 658; 11 U.S.C. § 943(7) (2018).

[294] *In re* Connector 2000 Ass'n, 447 B.R. at 768; *In re* City of Detroit, 524 B.R. at 174–75.

[295] *See In re* A.H. Robbins Co., 880 F.2d at 701 ("A creditor has no right to choose which of two funds will pay his claim. The bankruptcy court has the power to order a creditor who has two funds to satisfy his debt to resort to the fund that will not defeat other creditors.").

[296] *See In re* Connector 2000 Ass'n, 447 B.R. at 768.

[297] Schwartz, *supra* note 30, at 892 (citing City of Monterey, 526 U.S. at 727 (Scalia, J., concurring) ("like other tort causes of action, it is designed to provide compensation for injuries arising from the violation of legal duties, and thereby, of course, to deter future violations.")).

creditors between equal sources of repayment when it forces civil rights plaintiffs to accept the same payout (or lack thereof). As in chapter 11 cases, it must either insist that civil rights claimants have the ability to opt out of a third-party release or find a different source of authority for mandating equal treatment.

Dow Corning's second and third factors consider whether the non-debtor has contributed substantial assets and whether protecting the debtor from indirect liability is essential to the reorganization.[298] They reflect that a bankruptcy court's equitable power is based on a remedy's necessity to carrying out the Code's provisions.[299] This suggests that the factors are interchangeable to some degree—indeed, courts have considered releases justified primarily by either one.[300] Regardless, § 105(a), the Code provision granting courts necessity-based equitable powers, applies to both chapters 9 and 11 equally.[301]

The "necessity" standard's single substantive factor is like *Dow Corning*'s second and third factors.[302] However, as this Comment has argued, it must instead measure necessity against something other than the municipality's ability to continue operating, such as its proposed budget. This narrower characterization completely misses the point of necessity: determining whether a release falls within the court's equitable powers under § 105(a).[303] Because municipalities cannot face failure in the same way as businesses, this determination will remain difficult and highly subjective in chapter 9 bankruptcies. However, basing third party relief on a municipality's budgeting skill does not justify a court's use of its equitable power either.

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298 *In re* Dow Corning Corp., 280 F.3d at 658.

299 *See* 11 U.S.C. § 105(a) (2018).

300 *See, e.g.*, *In re* Dow Corning Corp., 287 B.R. at 404–13 (release intended to secure on non-debtor contributions to reorganization); Nat'l Heritage Found., 2014 U.S. App. LEXIS 12144, at *9–13 (release intended to shield debtor from indemnification expenses).

301 11 U.S.C. § 105(a) (2018); 11 U.S.C. § 103(a), (f) (2018) (applying chapter 1 to chapters 11 and 9, respectively).

302 *Compare In re* City of San Bernardino, 566 B.R. at 57–58 (considering "the necessity of the injunction to the City's efficient and effective functioning, to its revitalization, or to the success of the plan."), *with In re* Dow Corning Corp., 280 F.3d at 658 ("Whether . . . [t]he non-debtor has contributed substantial assets to the reorganization [and whether 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.").

303 11 U.S.C. § 105(a) (2018). *See In re* City of Detroit, 524 B.R. at 266.

2. *Legislative Alternatives*

Congress ultimately determines whether and in what circumstances bankruptcy courts should grant relief to third parties. Its policies as they are currently expressed in the Code speak against granting third-party relief for nondischargeable debts. But because so few bankruptcy cases have been brought under chapter 9, many of its provisions are still unexplored and open for interpretation. Doctrines developed elsewhere but not prohibited by the Code or chapter 9, like third-party relief, will become better fitted to municipalities' needs as new cases arise. Considering that Congress has tolerated conflicting standards for third-party relief in chapter 11 for several decades, there is no reason to expect that it will amend the Code to provide a definite standard for chapter 9 any time soon.

However, state legislatures have every incentive to proactively address the plight of public servants in bankruptcy. The widespread indemnification of police officers suggests that the public values both compensating victims of civil rights violations and encouraging officers to zealously enforce the law. State governments can support these values without interposing their sovereign immunity by, for example, assuming insolvent municipalities' obligations to indemnify employees.[304] This solution would resemble *Detroit*'s Grand Bargain, where Michigan rescued underfunded pension funds. The consideration given to parties whose rights are affected would make any such plan more likely to satisfy the *Dow Corning* factors.

CONCLUSION

Chapter 9 was a relatively quiet corner of bankruptcy law until the wave of filings precipitated by the last recession gave it a national spotlight. Likewise, third-party relief in municipal bankruptcy has risen from a hypothetical to a highly desirable option due to widespread public employee indemnification. The first cases to address third-party relief raised the possibility that it will be generally available to municipal debtors as a means of discharging their employees' otherwise non-dischargeable debts. The lack of an objective measure of necessity or other limiting factors gives the "necessity" standard more bark than bite, ignoring third-party relief's role as a "dramatic measure." This incentivizes municipalities to leave the less-palatable solutions of adjusting

[304] Sovereign immunity extends to states and entities acting as "arms of the state." Northern Ins. Co., 547 U.S. at 193. However, a suit against an indemnified employee is not a suit against a state for purposes of sovereign immunity. V.W., 2013 U.S. Dist. LEXIS 109145, at *21.

their own future spending or indemnification obligations untouched, leading to results at odds with bankruptcy policy. The discharge of debts excepted under § 523(a) is also problematic because it is at odds with congressional policy as expressed in the Bankruptcy Code. Regularly approving third-party releases of these debts would carve out a wide exception to § 523(a) that Congress has shown no intention of creating.

An appropriate standard for chapter 9 should include substantive limitations on the availability of third-party relief. A categorical ban would accomplish this but would also narrow the scope of discharge beyond what the Code demands, denying some debtors a useful remedy. The seven *Dow Corning* factors, on the other hand, provide an appropriate balance and have the advantage of already being accepted by most jurisdictions in the chapter 11 context. The existing case law also provides precedent on releasing corporate officers and directors from liability that can guide analogous municipal plan provisions. Ideally, a standard for third-party relief would point bankruptcy courts to truly unusual circumstances for municipal debtors and encourage municipalities to explore every option for resolving their own obligations directly before turning to those of third parties.

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