Third-Party Releases in Chapter 11 (An Update)

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The ability of a chapter 11 debtor to confirm a plan containing nondebtor, third-party releases continues to be at the forefront of discussion among bankruptcy practitioners. This paper provides a brief update to Judge Jessup and Judge Henderson's 2022 seminar paper regarding third party releases (accessible at https://perma.cc/TKL9-XJP2). Specifically, this paper examines recent developments in the widely watched *Purdue Pharma* case, the status of legislation proposed to address third-party releases, and annotations of recent (selected) third-party release cases.

I. AN UPDATE ON THE *PURDUE PHARMA* CASE

The Second Circuit Court of Appeals heard oral argument in *In re Purdue Pharma, L.P.*, case number 22-00110-bk *et al.* on April 29, 2022. During oral arguments, a three-judge panel examined whether the Bankruptcy Code contemplates releases of claims against nondebtor, third-parties (specifically, potential claims that could be brought against individual members of the Sackler family, who are not themselves parties to the Purdue Pharma bankruptcy proceeding).[2]

The Purdue Pharma attorneys argued that the circuit court should reverse District Judge McMahon's December 2021 opinion, which vacated the bankruptcy court's order confirming the debtor's chapter 11 plan on the ground that the third-party releases contained therein were unsupportable.[3] The Office of the United States Trustee, represented by the United States Department of Justice, argued that the releases in the Purdue Pharma plan were "the equivalent of a discharge—only attainable by a debtor that files for bankruptcy—which the Sacklers and other released parties have not done."[4] Citing *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451 (2017), the Department of Justice further posited that "[i]f Congress wanted to allow these kinds of releases . . . they would have expressly provided for them in the code and not just limited it to asbestos cases under Section 524(g)."[5] The panel of Second Circuit judges appeared to distinguish the Purdue Pharma releases from those in prior cases, noting that the proposed releases appeared broader than those approved in prior precedent.[6]

Before the conclusion of briefing on the appeal, the appellees had reached a new deal with the Sacklers, who increased their contribution to the plan trusts to at least $5.5 billion, and later to $6 billion.[7] The Second Circuit took the matter under advisement, but as yet, no further opinion

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[2] *See* Dietrich Knauth, *Purdue Urges Skeptical Appeals Court to Revive Sackler Opioid Lawsuit Shield,* Reuters (Apr. 29, 2022), https://www.reuters.com/legal/litigation/purdue-urges-skeptical-appeals-court-revive-sackler-shield-opioid-lawsuits-2022-04-29/.

[3] *See* Vince Sullivan, *Purdue Tells 2nd Circ. 30 Years of Precedent Back Ch. 11 Plan,* Law360 (Apr. 29, 2022), https://www.law360.com/articles/1488639/purdue-tells-2nd-circ-30-years-of-precedent-back-ch-11-plan.

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.; see also* Evan Ochsner, *Opioid Victims Wait as Second Circuit Mulls Purdue Pharma Deal,* Bloomberg Bankruptcy Law (Apr. 4, 2023), https://www.bloomberglaw.com/bloomberglawnews/bankruptcy-law/X1C9FHFC000000?bna_news_filter=bankruptcy-law#jcite.

or order has issued.[8] It is widely anticipated that Purdue Pharma will appeal the Second Circuit's decision to the Supreme Court if adverse.[9]

In the bankruptcy court, Judge Robert D. Drain retired in June 2022, and Judge Sean H. Lane took over the case in July 2022.[10] Meanwhile, the proposed $6 billion settlement cannot be distributed to claimants, as it still requires bankruptcy court approval, pending the Second Circuit's forthcoming decision.[11] Potential claimants have argued that the bankruptcy court should lift the automatic stay to permit them to pursue their claims in state court.[12] Thus far, that argument has been unsuccessful.[13]

II. THE STATUS OF PROPOSED LEGISLATION

The Nondebtor Release Prohibition Act of 2021 (the "Act") was introduced in both the House and Senate in July 2021. The bill proposed to amend the Bankruptcy Code to prohibit the nonconsensual release of a non-debtor's liability to an entity other than the debtor, except where expressly consented to by the third-party.

The House bill (H.R. 4777) was referred to the House Committee on the Judiciary, which held a consideration and mark-up session. The Committee voted to recommend that the Act be considered by the full House of Representatives in November 2021. A full House vote has not yet been scheduled, and no further activity has been reported on the Act.

The Senate version of the bill (S. 2497) is still under consideration by the Senate Judiciary Committee. No further action has been reported.

III. RECENT CASES ADDRESSING THE THIRD-PARTY RELEASE ISSUE

A. *Nat'l Union Fire Ins. Co. of Pittsburgh v. Boy Scouts of Am. and Del. BSA, LLC (In re Boy Scouts of Am. and Del. BSA, LLC)*, No. 20-10343-LSS (jointly administered), 2023 WL 2662992 (D. Del. Mar. 28, 2023) (Andrews, J.), *appeal filed*, No. 23-1668 (3d Cir. Apr. 11, 2023):

A group of insurance companies and two sets of abuse claimants appealed from the bankruptcy court's confirmation of the plan of reorganization put forth by the Boy Scouts of America. The plan contemplated a series of settlements, involving a multitude of overlapping

[8] *See In re Purdue Pharma*, Nos. 22-00110 *et seq*. (2nd Cir. 2023); *see also* Leslie A. Pappas, *Purdue Warns Tribe's NY Lawsuit Could 'Blow Up' Ch. 11 Plan,* Law360 (Jan. 24, 2023), https://www.law360.com/articles/1568682/purdue-warns-tribe-s-ny-lawsuit-could-blow-up-ch-11-plan.
[9] *See* Ochsner, *supra* n.7.
[10] *See* Pappas, *supra* n.8.
[11] *See* Ochsner*, supra* n.7.
[12] *See, e.g.*, Pappas, *supra* n.8.
[13] *Id*.

liabilities and insurance rights and which would establish "the largest sexual abuse compensation fund in the history of the United States," totaling at least $2.46 billion in cash and property and unliquidated assets, including insurance rights worth up to another "$4 billion plus." *Id.* at *1. To aid the case's administration, the plan envisioned a channeling injunction and releases under a set of procedures designed to ensure an equitable process for the payment of survivors' claims.

The plan was supported by "every estate fiduciary and nearly every organized creditor group," and was the product of three years of chapter 11 proceedings necessitated by the sprawling organization of the debtor and the sheer number of potential claimants. *Id.* at *2. The appellants, non-settling insurance companies and two sets of abuse claimants, appealed the bankruptcy court's confirmation order on the ground that the plan did not meet the Bankruptcy Code's requirements for confirmation.

Of interest for purposes of this paper, certain claimants challenged the bankruptcy court's jurisdiction and authority to enjoin/release certain third-party claims.

Ruling: The district court found that the appellants did not put forth sufficient evidence to demonstrate the bankruptcy court's clear error in its findings of fact, nor did the bankruptcy court err in its legal conclusions. *Id.* at *2. Accordingly, the district court affirmed the confirmation order and permitted the proposed third-party releases, setting the stage for a potential circuit split between the Second and Third Circuits on the issue of non-consensual third-party releases. *Id.* The court reasoned:

- Regardless of whether confirmation of a chapter plan is an exercise of the bankruptcy court's "arising in" or "arising under" jurisdiction, "a separate analysis is required with respect to a Plan's release of claims and/or suits between third parties." *Id.* at *17. In the Third Circuit, the bankruptcy court may "exercise 'related to' jurisdiction over third-party claims where the debtor is the real party defendant or where the claims implicate indemnification obligations owed by, or insurance policies shared with, the debtor." *Id.* at *18.

- "The Bankruptcy Court found that the third-party claims subject to the Channeling Injunction and Releases have a 'conceivable effect' on [the debtor's] estates" and so, "related to jurisdiction" existed with respect to the abuse claims for several reasons, namely a "clear identity of interest based on interconnectedness" among the released parties, shared insurance coverage among the debtor and the released parties, which "if depleted, would reduce the property of the [bankruptcy] estate that would otherwise be available for distribution to creditors," contractual indemnification obligations among the debtor and released parties, which also stood to deplete the bankruptcy estate, and the debtor's residual interest in the released parties' property. *Id.* at *19.

- Sections 105(a), 1123(a)(5), and 1123(b)(6) "confer what the Supreme Court has described as a bankruptcy court's 'residual authority' to formulate plans that enable

successful and value-maximizing reorganizations, including relief not specifically authorized elsewhere in the Bankruptcy Code," including the issuance of non-consensual third-party releases "under appropriate circumstances." *Id.* at *26-27.

- With respect to the plain language of section 524(g), the district court construed the statute to mean that nothing in that sub-section "shall be construed to modify, impair, or supersede any other authority the court has to issue injunctions in connection with an order confirming a plan of reorganization" and could not be used as a basis to "prohibit relief otherwise allowed by the Bankruptcy Code." *Id.* at *28.

- The district court reasoned that the channeling injunction and releases were necessary for the debtor's reorganization because the plan's success depended upon the debtor's "future membership revenue, which, in turn, depend[ed] upon the Local Councils and Chartered Organizations resolving their abuse liabilities and continuing to deliver the Scouting program." *Id.* at *29. Similarly, the district court concluded that the releases were fair to holders of the abuse claims because the plan provided a mechanism for payment of "all or substantially all" of the direct abuse claims and this provision constituted fair treatment for the releases they were granting. *Id.* at *31. Importantly, no party presented evidence at trial to challenge these findings. *Id.* at *30-33.

B. *In re Arsenal Intermediate Holdings, LLC*, No. 23-10097 (CTG), 2023 WL 2655592 (Bankr. D. Del. Mar. 27, 2023) (Goldblatt, J.):

In a jointly administered subchapter V case, three debtors operated captive insurance and alternative risk management companies. The debtors sought bankruptcy protection after the parent entity allegedly discovered "that the debtors' prior owners had committed fraud in connection with the sale of the business," specifically that various health plans administered by one of the debtors were underfunded in contrast to representations made in connection with the sale. *Id.* at *2.

The debtors proposed to sell their assets as part of the plan of reorganization, filing a liquidating plan whereby the sale proceeds would be distributed to creditors. The plan also contained "a consensual third-party release under which creditors release[d] claims against [the parent company] and its 'Related Parties,' which include[d] its directors and officers." *Id.*

The court noted that, typically in chapter 11 cases before the court, creditors' consent (or not) to a third-party release is to be determined in connection with voting on a plan. Because the debtors did not intend to solicit votes on their plan, they asked the court to approve a provision deeming creditors to have consented to the third-party releases unless they affirmatively opted out. The United States Trustee opposed the relief requested by the debtors, arguing that the court should (under the circumstances of the case) require an opt in procedure instead.

Ruling: In a traditional (3rd Circuit) chapter 11 case, third-party releases that permit affected creditors to opt out may be deemed consensual releases by the creditors who

do not exercise their right to opt out. *Id.* at *3-8. In this case, however, the bankruptcy court was concerned about a prior court order that was meant to protect certain creditors from adverse collection activity but might instead prevent those creditors from learning of their claims before the opt out deadline expired. *Id.* at *9-10. Accordingly, the bankruptcy court ruled that it would not authorize the form of notice proposed by the debtors but would authorize a notice that either (a) relies on an opt-in mechanism for third party-releasors or (b) provides for an opt out procedure but extends the date to opt out to the extended claims bar date in the case. *Id.* at *10-11. The court reasoned:

- The court expressly stated that its opinion did not speak to the bankruptcy court's authority to grant non-consensual third-party releases, a question that is the matter "of ongoing controversy." *Id.* at *3. The bankruptcy court also noted that on that topic, it had "meaningful guidance from the Third Circuit" that non-consensual releases "may be permissible where the key 'hallmarks' of an appropriate release—'fairness, necessity to the reorganization, and specific factual findings to support these conclusions' are present." *Id.* (internal citations omitted).

- "The obvious implication of the Third Circuit's suggestion that non-consensual releases may be authorized in exceptional cases is that *consensual* third-party releases ought to be noncontroversial." *Id.* (emphasis in original). "At one end of this spectrum, some cases view the model for finding a third-party release to be consensual as being based in principles of contract law, in which some affirmative expression of consent is required before one would find that an offer has been accepted and a binding contract thus formed." *Id.* at *4. "At the other end of the spectrum, there are cases—particularly in a jurisdiction like this one in which even non-consensual third-party releases may be appropriate based on the facts and circumstances of the case—that view a third-party release just like any other plan provision." *Id.*

C. *In re Highland Cap. Mgmt., L.P.*, No. 19-34054-SGJ11, 2023 WL 2250145 (Bankr. N.D. Tex. Feb. 27, 2023) (Jernigan, J.):

The debtor filed for chapter 11 protection in 2019, and the bankruptcy court entered a confirmation order in February 2021. The confirmation order was appealed to the Fifth Circuit, which found the plan provision that exculpated certain non-debtors violated 11 U.S.C. § 524(e), remanding the case to the bankruptcy court to "strike those few parties from the plan's exculpation" while affirming the confirmation order on the remaining grounds. *Id.* The Fifth Circuit held that the only properties properly entitled to plan exculpations were the debtor, the unsecured creditors committee, and a board of independent directors selected by the committee to serve a quasi-trustee function in the case. *Id.*

Briefly explained, the plan's exculpation provision purported to shield "a specified list of parties from any negligence liability for post-petition conduct in connection with the" chapter 11 case and acted as "an absolution of liability" for the exculpated parties. *Id.* at *4 (emphasis

omitted). The plan's injunction provision acted as a "belt[] and suspenders[] to the Plan discharge and was essentially a policing mechanism to deter actions in violation of the discharge or otherwise inconsistent with the plan." *Id.* at *5 (emphasis omitted). The gatekeeper provision "was somewhat of a tool to deal with any future, potential lawsuits that might be deemed to run afoul of the Injunctions," but "did not effectuate a release or an absolution of any liability" and only required a plaintiff to ask the gatekeeper before pursuing a claim against "Protected Parties." *Id.* at *6. The debtor filed a motion in the bankruptcy court to determine whether the term "Protected Parties" in the gatekeeper provision was coterminous with the defined term "Exculpated Parties," which needed to be narrowed on remand, per the Fifth Circuit's amended opinion. *Id.* at *9.

Ruling: The court ordered that the definition of "Exculpated Parties" in the plan be modified as proposed in the motion for rehearing and consistent with the Fifth Circuit's remand order. *Id.* at *10. The bankruptcy court relied on language in the Fifth Circuit's amended opinion that the "injunction and gatekeeping provisions are sound" to refrain from tailoring the definition of "Protected Parties" to match the revised definition of "Exculpated Parties." *Id.* The court reasoned:

- The bankruptcy court stated that it was "awkward for this court to attempt to be a mind-reader regarding editorial or wordsmithing decisions undertaken by the Fifth Circuit." *Id.* at *9. Relying on the Fifth Circuit's decision to decline the request for a rehearing, the bankruptcy court also declined to further tailor the contested provisions "in any manner." *Id.* at *10.

- The bankruptcy court also stated that an unintended consequence of modifying the term "Protected Parties" to match "Exculpated Parties" would be to render the gatekeeper provision meaningless, as it "would have no effect on any conduct that occurs after the Plan Effective Date," and had largely been intended as a "forward-looking [provision], to prevent interference with post-Effective-Date management as they consummate the Plan, wind down the assets, and administer the [relevant trusts]." *Id.* at *9.