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Purdue Pharma LP - Restructuring

Bankruptcy Spotlight: Former bankruptcy judges sound off on S.D.N.Y. district court's reversal of Purdue Pharma plan confirmation based on presence of non-consensual third-party releases

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S.D.N.Y. District Judge Colleen McMahon's recent landmark decision and order vacating the **Purdue Pharma** debtors' twelfth amended chapter 11 plan confirmation order on the grounds that the bankruptcy court lacked statutory or other authority to impose non-consensual releases of claims against the Sackler shareholder parties and related entities and that the court, as an Article I court, was constitutionally prohibited from entering a final order imposing such releases has undeniably generated a considerable amount of buzz and debate among restructuring professionals and the general public alike over the past roughly one month since the ruling came down, and justifiably so given the importance of the legal issues to the chapter 11 process.

With an expedited appeal to the U.S. Court of Appeals for the Second Circuit already initiated by the Stamford, CT-based opioid maker, the Sacklers and other plan support parties, further guidance from a higher court on the polarizing issue of the propriety, or lack thereof, of involuntary third-party releases in a chapter 11 plan, which essentially release and extinguish non-debtor claims against other non-debtors and which have become standard provisions in chapter 11 plans in most of today's larger cases, may be soon forthcoming. It will also come as no surprise to see the U.S. Supreme Court grant certiorari on the issue sooner than later.

Despite the pending appeals and their uncertain outcome, the current state of play for the Purdue Pharma debtors and the Sacklers is that the third-party releases in exchange for which the Sacklers had agreed to pay in excess of $4.325 billion in cash consideration to the debtors' estates have been struck down, and the debtors' plan is in limbo, although a mediation is ongoing between the nine states and the District of Columbia that successfully appealed chapter 11 plan confirmation order, on the one hand, and the Sacklers, on the other, aimed at resolving the states' and D.C.'s objections to confirmation.

As a result of the divergence of judicial opinions on the matter in courts across the country, the issue of whether non-consensual third-party releases are in fact permissible in a chapter 11 plan will undoubtedly remain in the spotlight for the foreseeable future, at least until and if the Supreme Court addresses the issue – and the debate will continue to rage on long thereafter in the restructuring community and in the court of public opinion.

Whether the decision is upheld on appeal or not, Judge McMahon's ruling is likely to impact other courts' views on the matter (and in fact is already doing so with the E.D. Va. district court's reversal last week of the **Ascena Retail Group** debtors' plan confirmation order on nearly identical grounds, citing the Purdue district court decision), which in turn could begin to materially alter the architecture of release, exculpation and injunction provisions in future chapter 11 plans – as well as parties' willingness to participate in an in-court restructuring process if non-consensual third-party releases are no longer available.

LevFin Insights' head of bankruptcy coverage and analysis, Jason C. DiBattista, Esq., recently spoke with five retired U.S. Bankruptcy Court judges to gauge their reactions to Judge McMahon's decision to reverse U.S. Bankruptcy Judge Robert D. Drain's Purdue Pharma confirmation order and get their in-depth and detailed thoughts on whether the district court got it right, among other things. Their answers are eye-opening.

The Hon. Kevin Gross (Ret.)

Judge Gross (Ret.), who joined Wilmington, Del. law firm of Richards, Layton & Finger after serving a 14-year term as a judge on the U.S. Bankruptcy Court for the District of Del. beginning in 2006, including as chief judge from July 1, 2011 to June 30, 2014, had this to say:

"I am concerned about the District Court's ruling in which it reversed Judge Robert Drain's plan confirmation ruling, largely because the decision is an absolute rejection of third-party releases and absolutes are troubling. I believe that there is an important role for third-party releases under appropriate circumstances.

The Purdue case was one which was hotly contested but based upon what I know of it, the third-party releases were justifiable. I am also concerned because Judge Drain carefully and thoughtfully confirmed the plan and provided detailed and valid reasons for allowing the third-party releases and Judge Drain is an exceptionally fine and brilliant jurist.

I am further troubled by the District Court's reversal because third-party releases play a large part in allowing confirmation of what otherwise might be non-confirmable cases by providing often needed consideration, and finally because creditors and claimants voted overwhelmingly in favor of confirmation of the plan which included the third-party releases. If the District Court's holding with its outright rejection of third-party releases is affirmed, it will make many plans far more difficult to confirm and in such cases may also eliminate recoveries for claimants."

The Hon. Randall J. Newsome (Ret.)

Judge Randall J. Newsome (Ret.), who served as a U.S. Bankruptcy Judge from Oct. 1982 until Dec. 31, 2010 in both the S.D. Ohio in Cincinnati and the N.D. Cal. in Oakland, and is currently a national restructuring mediator, said:

"From a broader perspective, the decision is unfortunate for everyone involved. As a former bankruptcy judge, my heart goes out especially to Judge Drain, who is as fine a jurist as anyone could ever ask for on any court in this country. With the Supreme Court all but foreclosing the possibility of class actions in cases such as Purdue, and with the Supreme Court's pleas to Congress for a legislative solution going largely unanswered, the conundrum posed by mass tort cases such as Purdue has been left to the bankruptcy system to sort out. But that system was never designed to deal with these kinds of problems. This case proves the point.

As for the specific bankruptcy issue involved in the case, Judge McMahon's decision shouldn't have been a shock to anyone. At least three circuit courts previously reached the same conclusion, and the Second Circuit has not squarely ruled on the issue. As her decision correctly notes, everyone has been tip-toeing around the validity of non-consensual releases of third-party claims against non-debtors for at least three decades. From the *Johns Manville* case forward, bankruptcy lawyers have been attempting to find workarounds to the prohibition in Bankruptcy Code section 524(g) against awarding a discharge to anyone but the debtor. None of the statutes or doctrines invoked to justify such a workaround (particularly section 105), was ever really up to the challenge. Undoubtedly, that was no secret to those of us (myself included) who begrudgingly signed off on such releases in chapter 11 plans. We signed off because it was necessary to make the plan work. But in Purdue, the doctrine of necessity ran headlong into the clear meaning of a statute, and was forced to give way.

What her decision further notes is that the Sacklers got more under the Purdue plan than they would have gotten had they filed their own chapter 11 cases. Granted, they were required to pay over $4 billion to get the releases. But they never had to file bankruptcy petitions, with all of the attendant financial consequences of doing so. They never had to subject their assets and liabilities to full scrutiny. They never had to face the real threat of a chapter 11 trustee being appointed. They never had to propose a plan that met all of the requirements of chapter 11. The liquidation test in section 1129(a)(7) would be particularly daunting. It's difficult to see how paying creditors only $4 billion out of their reported worth of $14 billion would meet that test. Most importantly, given the allegations of fraud and fraudulent transfers made against some of the family members, it's not at all clear that the Sacklers could withstand objections to their discharges under section 727 and challenges to the dischargeablity of their debts under section 523 of the Bankruptcy Code. Arguably, the Purdue plan didn't just give them the equivalent of a discharge, it gave them a super discharge that they could never have gotten otherwise."

The Hon. Judith K. Fitzgerald (Ret.)

Judge Fitzgerald, who presided over bankruptcy matters in the W.D. Pa. (where she was chief judge for five years) as well as in the District of Del. (20 years), the E.D. Pa. (8 years) and the U.S.V.I. (9 years), and is now in private practice as a Shareholder at Pittsburgh, PA-based law firm Tucker Arensberg, commented as follows:

"Third-party releases have been a part of confirmed plans for over three decades, even though the various Courts of Appeals have not ruled uniformly on when a non-consensual third-party release can be authorized against non-debtor parties as part of plan confirmation. Despite the lack of uniformity in detailing the standards that apply in permitting non-consensual third-party releases, the prevailing principles generally follow the types of releases authorized by Congress in asbestos cases pursuant to 11 U.S.C. § 524(g). Primary in this context is the requirement that any released claim has a derivative nexus with claims against the debtor. Direct claims against the third party, i.e., those based on the third party's own conduct or breach of duty owed to an entity other than the debtor, are not able to be released in the asbestos context. Appellate courts generally rule that non-consensual third-party releases should be narrowly tailored, reserved for extraordinary circumstances, and fair to all parties. Additionally, the third party must make a substantial contribution to the debtor's reorganization.

Currently, in reviewing confirmation orders, district courts are questioning not only the power of Article I bankruptcy courts to enter final orders that permit non-consensual third-party releases over the objection of non-debtor parties but also whether bankruptcy courts are moving beyond the precept that a third-party release should be the exception and not the rule. The appellate courts are demanding findings of fact and conclusions of law based on evidence as to how each party to be released is liable for the claims against the debtor and how the released claims are integrally related to the debtor's restructuring. These are valid inquiries because only a debtor in bankruptcy is entitled to a discharge. And an overly broad release is the functional equivalent of a discharge in that it prevents actions against the third-party for any released claim, thereby precluding a creditor whose claim allegedly lies against only the third party from an opportunity to prove the claim and recover on a judgment against the non-debtor third-party even though the confirmed plan will not return full payment to the creditor.

The scrutiny by appellate courts is not surprising. Efforts by apparently solvent third parties to use the bankruptcy system to achieve relief from alleged liabilities without first subjecting themselves and their assets to bankruptcy court jurisdiction is a frequent source of news, which is largely unfavorable. One commentator, David Skeel, in his recent piece entitled *The Populist Backlash in Chapter 11*, identifies rising public outrage from a perception that the bankruptcy system is manipulated by and tilted in favor of insiders (the "haves") to the detriment of outsiders (the "have-nots"). If that perception is perpetuated, the bankruptcy system is at substantial risk of a legislative overhaul that may be overkill and ultimately not in the best interests of debtors and creditors. Indeed, legislators are watching. Pending in Congress is the Nondebtor Release Prohibition Act of 2021 which essentially prohibits a non-consensual release of a non-debtor's liability to anyone other than the debtor. This bill may have a slim chance of passage but nonetheless illustrates interest in the subject by authorities who have the capability of imposing change.

Recent opinions have articulated what district courts will require before a non-consensual third-party release will survive plan confirmation. Bankruptcy judges are the gate keepers of the plan confirmation process and are eminently capable of addressing the concerns of both Article

III judges and the public. In these cases, precaution by the judiciary may be wiser than a solution crammed down by Congress."

The Hon. Joan N. Feeney (Ret.)

Judge Feeney, who served for almost 27 years as a U.S. Bankruptcy Court for the District of Mass. judge and 23 years as a member of the U.S. Bankruptcy Appellate Panel for the First Circuit, commented as follows:

"I agree with Judge McMahon's decision because under current law, the Bankruptcy Code, neither expressly nor implicitly, confers on bankruptcy judges the ability to grant non-consensual third- party releases in favor of non-debtors with respect to claims not derivative of a debtor's liability. Existing law (except in asbestos cases) does not permit the discharge of debt unless a person or entity is a debtor in a bankruptcy case and has disclosed all assets and submitted their value to repayment of creditors. Third-party releases as granted in Purdue denied creditors of the third parties their due process rights.

Unfortunately, affirmance of the District Court and reversal of the Bankruptcy Court may negatively impact and delay any compensation to be paid to Purdue's creditors, in particular opioid victims/survivors, unless a consensual plan can be agreed to in the mediation that has now resumed and is in progress. I hope that the litigation will end with an omnibus, consensual settlement for the sake of the victims/survivors and impacted communities with a significantly larger contribution from the release beneficiaries, but this would require 100% agreement.

The decision is likely to have and indeed already is having repercussions in appeals of other third-party release cases. Last week another intermediate appellate court, the E.D. Va. district court reversed orders confirming plans with non-consensual third-party releases in the *Mahwah Bergen Retail* cases (also known as *Ascena Retail Group*). The district judge in that case properly recognized the jurisdictional and authority flaws in bankruptcy courts granting third-party releases and, on remand, directed the reassignment of the case to another judge due to concerns about forum shopping and divisional venue shopping.

There are also bills pending in Congress which if passed into law would bar third-party releases. Restrictions on third-party releases by Congress will prevent abuse by wrongdoers who should not be allowed to discharge debts without avoidance of fraudulent transfers and payment of the value of their assets to creditors. However, an outright prohibition on third-party releases is not the best solution in my opinion and further hearings in Congress should be held with expert testimony on the issues of a legislative fix and how to prevent abuse. Congress could craft a solution to make third-party releases available on a limited basis where the contributors and joint tortfeasors benefitting from releases contribute what they would have to in their own bankruptcies without the delay and costs necessitated by separate bankruptcy filings.

The elimination of restrictions on third-party releases, whether under case law or legislation, may affect capital infusions to reorganizing companies and DIP loans to debtors. However, generally, lenders and other parties will participate in restructurings as long as they know the rules and adjust their terms accordingly."

The Hon. Catherine E. Bauer (Ret.)

Judge Bauer, who served as a U.S. Bankruptcy Court for the C.D. Cal. judge for more than a decade and is now a nationally-recognized mediator and arbitrator, added:

"In my opinion, the District Court got it right. It's always bothered me that third parties seek to use the bankruptcy cases of others to resolve their own legal issues. Due process lies at the heart of my concerns. Our bankruptcy system is generally very fair and gives creditors, employees and other interested parties plenty of opportunities to participate and be heard with regard to a debtor's affairs. If third parties want a discharge of their potential liabilities, they should file their own bankruptcies and be scrutinized personally in accordance with bankruptcy law and procedures. That, to me, seems only fair.

The recent District Court decision out of Virginia by Judge Novak (*Mahwah Bergen Retail*, i.e., *Ascena Retail Group*) mirrors the frustrations I felt as a judge when presented with broad third-party releases. If these releases are allowed at all, the bankruptcy process needs to safeguard the interests of those impacted. I understand that there are concerns that reorganizations may fail for lack of plan funding, but I don't think those concerns outweigh due process."

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