COMMENTARY

Second Circuit Approves Third-Party Bankruptcy Releases, Then Tries (Unsucc to Limit Them

Second Circuit ruling in the Purdue Pharmacy bankruptcy appeal raises the basic question of whether such releases are permitted at a account the court's conclusion that some limits are essential, although not found anywhere in the Bankruptcy Code.

June 05, 2023 at 11:49 AM

Commentary

By Alan B. Morrison | June 05, 2023 at 11:49 AM

The Second Circuit had a tough call to make in the Purdue Pharmacy bankruptcy appeal: what to do about the release given to the Sackler families who had agreed to contribute $5.5 to $6 billion to Purdue's reorganization plan but were not themselves in bankruptcy. By the time that the Second Circuit heard the appeal from the district court's rejection of the release, all of the objections had been withdrawn, except those of the U.S. trustee, a Justice Department official who does not represent any creditors, and some Canadian municipalities. The release issue was all that was holding up the distribution of billions of dollars to the claimants that include municipalities, hospitals and individuals and families who suffered serious harms from Purdue's over promotion of OxyContin, which many claimants believe was due to the unlawful acts of the Sackers, who took out $11 billion from the company and are now living outside the United States.

The legality of third-party releases is an important issue that has divided the courts of appeals, with the Second Circuit having approved some in contexts different from this case. There is much to debate about whether the very detailed Bankruptcy Code allows releases of the kind that the Sacklers insist that they be given as a condition of making their contribution, but I will pass on that question now and instead focus on the Second Circuit's obvious concern that releases not be given as a matter of course. To set up that guardrail, the court announced a seven-factor test that must be applied to determine whether a release is authorized.

Before I examine that test to assess how much, if at all, it limits nondebtor releases, two points should be noted. First, none of the seven factors has any statutory basis in the Bankruptcy Code; they are all equitable considerations taken from other cases. By contrast, 11 U.S.C. §524(g), which specifically provides for the kind of relief that the Sacklers sought, has seven subsections, most of which contain multiple subparts. Second, there is no ranking among the factors or any rule on what to do when they do not all point in one direction. After that review, I will return to the basic question of whether such releases are permitted at all, taking into account the court's conclusion that some limits are essential, although not found anywhere in the code.

First, if the released party would have a claim of indemnity or contribution from the debtor, such that pursuing that party would deplete the debtor's estate, then the release would not harm creditors and should be permitted. If, as in Purdue, the released parties were corporate officers or directors, they are likely to have indemnity claims—and will surely seek them going forward—so that this condition will not preclude most releases like those for the Sacklers.

Second, are the claims against the released party factually intertwined with the claims against the debtor? If they are, then a failure to release may result in the debtor continuing to be embroiled in the litigation that bankruptcy was designed to end. Again, as Purdue shows, this factor is not likely to be much of a barrier to granting releases in most cases because the overlap is extensive. The *third* factor seeks to assure that the release is no broader than necessary but assumes that there will be a release, and for that reason will not limit the cases where a release is allowed.

"*Fourth*, courts should consider whether the releases are *essential* to the reorganization, in that the debtor needs the claims to be settled in order for the *res* to be allocated … [and that] the release be *important* to the plan." (at 65, emphasis added). It is hard to see how this highly subjective factor will have any role in slowing down the use of releases especially because, before the release issue is decided, the creditors must have approved the plan by a statutory super-majority, leaving very little room for a judge to decide that the release is not "essential" or "important."

The *fifth* consideration is whether the nondebtor has "contributed substantial assets to the reorganization." This too is unlikely to preclude many releases, given the subjectivity of "substantial." Thus, in Purdue, the bankruptcy judge approved both the first plan, for which the Sacklers offered at least $4.275, and the second plan when their offer was increased by between $1.175 and $1.675 billion. Was the first offer not "substantial," and wouldn't an offer of $1 billion also be substantial? Is this factor to be assessed by dollars alone, or must a court also consider issues of liability and collectability, and if how is this to be done when the non-debtor is not subject to the same scrutiny as the debtor?

"*Sixth*, courts should consider whether the impacted class of creditors 'overwhelmingly' voted in support of the plan with the releases" (67). The Code already requires a two-thirds approval of the dollar amount of all creditors in a non-consensual plan (11 U.S.C. § 1126(c)), but the Second Circuit decided that this was not enough. Instead, it surprisingly pointed to 11 U.S.C. § 524(g)(2)(B)(ii)(IV)(bb), which requires approval by a minimum of 75% of voting creditors in favor of the plan. That provision is found in the asbestos release authorization and includes seven subsections, most with many subparts that condition its use. That is the same provision which the court, earlier in its opinion, found to be irrelevant when deciding that releases were proper in cases not involving asbestos.

The *seventh* factor looks at whether the creditors are receiving fair payment, while also mentioning full payment. The latter almost never occurs, and if it did, the third party would not need a release because no creditor would have a claim to assert. As for fair payment, the court appears to be concerned about allocation, which is always an issue whether there is a released party or not.

Although initially touting the seven factors, the court then added two cautionary notes: while "consideration of each factor is required, it is not necessarily sufficient—there may even be cases in which all factors are present, but the inclusion of third-party releases in a plan of reorganization should not be approved," but it does not provide an example.

Then in the next paragraph, it adds a further qualifier: “a provision imposing releases of claims like that at issue here must be imposed against a backdrop of equity.” All in all, there is not very there to slow down potential third-party releases.

Beyond the limited impact of these factors in holding down releases, this portion of the Pharma opinion should shock those concerned about judicial overreaching because of the willingness of the court to create limitations when the statute included none of them. Imagine the reaction of the Supreme Court if a federal agency were authorized to issue permits, with no conditions required, and the agency on its own decided that exceptions were needed when certain factors were present. Or suppose that Congress gave that agency the permitting power and also said, “make whatever exceptions you think are appropriate, to assure that permits are not abused.” Yet if one substitutes bankruptcy court for agency, that is in essence what the Second Circuit concluded Congress has given the federal courts permission to do: make up exceptions if you think that third-party releases are being overused. And, the Second Circuit has given this power to federal judges with lifetime appointments, whose rulings will stand unless Congress is able to muster the votes to disagree.

If, as the Second Circuit implicitly held, third-party releases must be reined in or they will do serious damage to the basic concept that debtors are the primary beneficiaries of Chapter 11 proceedings, the absence of such protections in the code also calls into question the basic premise that such releases are ever permitted. Put another way, if the court had to create limits to assure that nondebtor releases do not destroy the system, that strongly suggests that the court’s conclusion that the code currently allows these releases in the first place is mistaken. Moreover, the multiple limits that Congress did include in the 1994 statute that expressly authorizes third-party releases in asbestos cases—but no others—casts further doubt on the ruling that the Purdue releases are authorized by the code. It is much more logical that the omission of an authorization for third-party releases outside of asbestos cases was not an oversight, but that they were not included because Congress was not willing to allow them without some checks and limits and was surely not willing to let federal judges create those limits when Congress had not.

Alan B. Morrison *is an associate dean at George Washington University Law School, where he teaches civil procedure and constitutional law. Many years ago, he unsuccessfully challenged a third-party release given in the A.H. Robins bankruptcy.*