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Purdue Pharma Ruling by U.S. Court of Appeals for the Second Circuit: Not the Last Word

By Michael L. Cook*

In this article, the author provides perspective for a recent controversial decision by the U.S. Court of Appeals for the Second Circuit regarding the nonconsensual releases of direct claims against third-party non-debtors in a Chapter 11 reorganization plan.

The U.S. Court of Appeals for the Second Circuit, in *In re Purdue Pharma L.P.* (Purdue III),[1] recently affirmed a bankruptcy court's confirmation of a reorganization plan with nonconsensual releases of direct claims against third-party non-debtors, the debtor's controlling owners (the Sacklers).

Reversing the forceful opinion of the district court in *In re Purdue Pharma L.P.* (Purdue II),[2] the Second Circuit held that releases of direct claims are permitted under both Bankruptcy Code (Code) Sections 105 (a) and 1123(b)(6) and under "this Court's case law."

One judge on the three-judge panel, though, "reluctantly" concurred with the majority's holding only because of "binding" Second Circuit precedent, citing *In re Drexel Burnham Lambert Group, Inc.* (Drexel).[3]

KEY QUESTIONS

The Second Circuit addressed "two key questions":

(1) Does the Code "permit nonconsensual third-party releases of direct claims against non-debtors," and

(2) Were such releases "proper here in light of all equitable considerations and the facts of this case"?

The court answered "both in the affirmative."

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1 In re Purdue Pharma L.P., Nos. 22-110-bk (L), 22-113-bk, 22-115-bk, 22-116-bk, 22-117-bk, 22-119-bk, 11 22-121-bk, 22-299-bk, 22-203-bk (2d Cir. May 30, 2023).

2 In re Purdue Pharma, L.P., 635 B.R. 26 (S.D.N.Y. 2021).

3 In re Drexel Burnham Lambert Grp., Inc., 960 F.2d 285, 293 (2d Cir. 1992) (bankruptcy courts have power to release third-party direct claims against non-debtors without the third parties' consent).

"PRIMARY LEGAL ISSUE ON APPEAL": RELEASE OF THIRD-PARTY DIRECT CLAIMS AGAINST NON-DEBTORS

As the Second Circuit explained, the third-party "direct claims" here arose "under state law," are against non-debtors, and the claimants "have not sought to recover on those claims in bankruptcy, or otherwise consented to a bankruptcy court's adjudication of those claims." Thus, the "direct claims are causes of action brought to redress a direct harm to a plaintiff caused by a non-debtor third party."

"By contrast, derivative claims . . . 'arise from harm done to the [debtor's] estate and that seek relief against [the] third party that pushed the debtor into bankruptcy.'"[4] Derivative claims (e.g., fraudulent transfers) which belong to the debtor's estate could be released, but the parties never challenged those releases here.

This article will not dwell on the Second Circuit's detailed exposition of the facts and "equitable considerations" justifying its holding. Nor will this article discuss the Second Circuit's "guide" to "future courts evaluating" the primary issue on appeal. As the concurring judge noted, "the parties have sacrificed a forest on the matter."[5]

Instead, this article summarizes below the court's legal analysis and the opposing analysis of the concurring opinion, other circuits and the district court in Purdue II. This summary shows that the Second Circuit's holding will bind courts in this circuit and may influence other courts. The battle may be over in the Second Circuit, but the war continues elsewhere.

Second Circuit Majority	Other Courts and Concurrence
1. Code Sections 105(a) ("any order . . . necessary or appropriate" to implement Code "provisions") and 1123(b)(6) (plan may include any "provision not inconsistent with Code") permit releases of creditors' direct claims against third-party non-debtors.	1. No Code provision supports *Drexel* decision cited by majority; Code adjusts debtor-creditor relationship, but independent third-party liability not covered.[6]

[4] Purdue III, quoting In re Bernard L. Madoff Inv. Secs., LLC, 740 F.3d 81, 89 n.9 (2d Cir. 2014).

[5] See also Patrick Radden Keefe, Empire of Pain: The Secret History of the Sackler Dynasty (Doubleday 2021) (441 pages).

[6] In re Metromedia Fiber Network, Inc., 416 F.3d 136, 142 (2d Cir. 2005) ("[S]ection 105(a) does not allow . . . bankruptcy court 'to create substantive rights . . . otherwise unavailable under applicable law.'").

2. Shareholder release limited: only claims based on Purdue's "conduct" – "legally relevant," "overlapping claims"; not a discharge of all claims; no "umbrella protection"	2. But no carve-out in release for non-dischargeable fraud claims.[7] Wrong to enjoin claims based solely on third party's financial contribution; majority's "legally relevant" claims analysis ignores lack of subject matter jurisdiction over direct third party claims, and ignores Manville III precedent; also risky – could cover truly independent claims; potentially wide range of claims covered, giving Sacklers "blanket immunity." Purdue III concurrence.
3. Court had "residual authority" as court of equity; Supreme Court approved plan "designating tax payments as either trust fund or non-trust fund" despite lack of express authorization from Code; Section 1126(b)(6) limited only by what Code expressly forbids.[8]	3. *Energy Resources* does not create power to "extinguish" direct claims "without . . . consent, and without providing . . . any value in return. . . . [S]ays nothing about a nondebtor's obligations" under Code; case dealt only with creditor-debtor relationship.[9]
4. Code Section 524(e) (discharge "does not affect" third-party liability) not a bar to third-party releases.[10]	4. Discharge of debt limited under Code Section 524(e); co-obligor remains liable despite debtor's discharge.[11]
5. Third-party release okay if injunction "an important part in . . . reorganization plan."[12]	5. Broad release here goes too far; Purdue Pharma distribution available only on claims against debtors but disallows value based on claims against non-debtors.[13]
6. MacArthur Co. v. Johns-Manville Corp. (Manville I)[14] and Metromedia: Third-party releases "are [not] discharges" and are not limited to "asbestos cases."	6. Release here "enjoins a broader swath of claims than debtor . . . could seek to discharge under . . . Code," with no compensation to claimants and no opt-out for objectors.[15]

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[7] Archer v. Warner, 558 U.S. 314, 321 (2003) (Code ensures "that all debts arising out of fraud are excepted from discharge no matter their form."). See also In re Johns-Manville Corp., 517 F.3d 52, 63-65 (2d Cir. 2008) (Manville III) (no bankruptcy jurisdiction to enjoin direct claims against third party).

[8] United States v. Energy Resources Co., Inc., 495 U.S. 545, 549 (1990); In re Airadigm Commc'ns, Inc., 519 F.3d 640, 657 (7th. Cir. 2008) (Section 1123(b)(6) gives court equitable power to release third parties); In re Dow Corning Corp., 280 F.3d 648, 656-58 (6th Cir. 2002).

[9] Purdue III concurrence.

[10] In re Airadigm, 519 F.3d 640 (7th Cir.) ("does" in statutory text different from "shall" or "will").

[11] In re Pac-Lumber Co. 584 F.3d 229, 251-53 (5th Cir. 2009); In re Lowenschuss, 67 F.3d 1394, 1401-02 (9th Cir. 1995); In re W. Real Estate Fund, Inc., 922 F.2d 592, 600-02 (10th Cir. 1990).

[12] Drexel, 960 F.2d 285, 293 (2d Cir. 1992).

[13] Purdue III concurrence.

[14] MacArthur Co. v. Johns-Manville Corp. 837 F.2d 89 (2d Cir. 1988).

[15] Purdue III concurrence; Metromedia (release "may operate as a . . . discharge . . . without a filing and . . . the safeguards of the Code.").

COMMENTS

"[T]he main challenge to this appeal," said the Second Circuit, "is not by creditors, but by the [U.S.] Trustee – a government entity without a financial stake in the litigation." Those entities with a financial stake, of course, support the Purdue plan, regardless of the applicable law. According to the concurring opinion, the primary issue on appeal – "extinguishing direct . . . claims against nondebtors without compensating the claimholder" – "has divided the courts of appeals for decades," and "would benefit from nationwide resolution by the Supreme Court." Unless the Second Circuit overturns Purdue III with an en banc decision, the U.S. Trustee will likely seek Supreme Court review because of the acknowledged circuit split and other policy concerns (e.g., an expansive reading of generic Code provisions to grant extraordinary relief).

The majority opinion in Purdue III, like the bankruptcy court, "sought to achieve one-stop relief" for the Sacklers "that could be seen as well deserved" due to their $6 billion contribution to the Purdue reorganization plan.[16] But "there is not one but many courthouses where the legitimacy" of the Sacklers' conduct could be tested.[17] Still, from a pragmatic perspective, reasoned the Second Circuit, creditors accepted the Sacklers' huge $6 billion settlement fund because of the expense, litigation delay, and the weakness of creditor remedies under existing law (e.g., the Sacklers' spreading of their assets among domestic and international trusts; illiquid holdings).

Debtors have not yet rushed to seek Chapter 11 relief in the Second Circuit after Purdue III. That would be wrong, explained the concurrence: "Forum-dependent results are anathema to the establishment of 'uniform laws on the subject of Bankruptcies throughout the United States.'"[18] The circuit split provides more reason for the Supreme Court to resolve the issue.

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[16] Manville III, at 68.

[17] Id.

[18] Purdue III, quoting U.S. Const. art. I, § 8, cl. 4.