ALERTS

Validity of Non-Consensual Third-Party Releases Called into Question in Purdue Bankruptcy — But for How Long?

December 22, 2021

On Dec. 16, 2021, U.S. District Court Judge Colleen McMahon in the Southern District of New York vacated Purdue Pharma's confirmed plan of reorganization after finding that the Bankruptcy Court below did not have statutory authority to issue a confirmation order granting non-consensual third-party releases — namely for the benefit of the Sackler family who owns Purdue. *In re Purdue Pharma, L.P.*, Case No. 7:21-cv-08566 (S.D.N.Y. Dec. 16, 2021).

Unlike the discharge of debts in chapter 11, a third-party release extinguishes claims between *non-debtor* entities to prevent post-confirmation claims from being asserted against the released party. Although third-party releases can be granted upon the consent of the releasing party, the propriety of non-consensual third-party releases has long been controversial and resulted in diverging precedent in various jurisdictions.

While the Fifth, Ninth and Tenth Circuits have ruled that such releases are impermissible, they are often permitted in other Circuits including in the Southern District of New York and the District of Delaware. Even in those districts, however, bankruptcy judges have questioned the propriety and breadth of non-consensual third-party releases at times.

In this case, the District Court's decision departs from many rulings in Bankruptcy Courts in the Southern District of New York, which have held that the Second Circuit generally permits non-consensual third-party

releases upon the consideration of several factors. As discussed further below, Judge McMahon's decision will not likely be the last word on the subject and may serve as the impetus for the Supreme Court to resolve the issue definitively.

Purdue Bankruptcy and Sackler Family Releases

Purdue is a privately held Delaware limited partnership that operates a branded prescription pharmaceutical business known for exacerbating the opioid crisis by falsely marketing OxyContin as non-addictive. In the aftermath of the crises, Purdue faced a litany of litigation that culminated in its chapter 11 bankruptcy. Purdue's owners, some members of the Sackler family, also faced potential exposure to personal liability over OxyContin's marketing. Between 2008 and 2017, some members of the Sackler family were alleged to have upstreamed approximately $10.4 billion from Purdue into spendthrift trusts and offshore companies to protect their personal finances.

As part of Purdue's bankruptcy discussions, some members of the Sackler family agreed to contribute toward Purdue's bankruptcy estate if each member received blanket releases discharging them of liability for all fraudulent transfer and other civil claims.

After a lengthy confirmation hearing, U.S. Bankruptcy Judge Drain confirmed Purdue's proposed plan, which included a provision releasing, discharging and enjoining all claims against, among others, Sackler family members that are "based on or related to the Debtors, their estates, or chapter 11 cases" and where the "conduct, omission or liability of any Debtor or any Estate is the legal cause or is otherwise a legally relevant factor" with respect to such claims. In exchange for these releases, some members of the Sackler family agreed to contribute $4.325 billion to resolve public and private claims against Purdue and to fund civil and criminal settlements with the federal government. *In re Purdue Pharma L.P.*, 2021 WL 4240974, at *25.

Summary

The U.S. Trustee, attorneys general from several states and other parties appealed and attacked the legality of the plan's non-consensual release of third-party claims against non-debtors by arguing on appeal to the

District Court that the Bankruptcy Court lacks subject matter jurisdiction and statutory authority to approve such releases.

As an initial matter, the District Court Judge Colleen McMahon held that the Bankruptcy Court had subject matter jurisdiction to approve the release. The District Court found that the release of claims against members of the Sackler family clearly affects Purdue's estate because such a release may alter the distribution of estate assets, may alter estate liabilities, is interconnected with lawsuits against Purdue, and could deplete estate assets if Purdue is required to indemnify Sackler family members.

The District Court then turned to the permissibility of the release of direct third-party claims. Judge McMahon began this discussion with a caveat, distinguishing between "derivative" claims – those that "would render the Sacklers liable because of Purdues' actions [as the Debtor]," because they seek to recover from the estate indirectly on the basis of the Debtor's conduct – and direct claims, like the ones at issue on appeal – that "are not derivative of Purdue's liability, but are based on the Sacklers' own, individual liability, predicated on their own alleged misconduct and the breach of duties owed to claimants other than Purdue." The District Court limited its discussion to the permissibility of non-consensual release of "direct" third-party claims arising out of the Sacklers' own conduct.

After determining that the Bankruptcy Court had subject matter jurisdiction, the District Court held that nothing in the Bankruptcy Code allows bankruptcy courts to approve non-consensual releases of third-party claims against non-debtors.

Judge McMahon disagreed with Judge Drain's reasoning that Bankruptcy Code sections 105(a), 1123(a)(5), 1123(b)(6) and 1129, together with residual authority under the Bankruptcy Code, give him the statutory authority to approve non-consensual third-party releases when necessary and appropriate to carry out the provisions of the Bankruptcy Code. Judge McMahon held that none of these sections create a substantive right to grant non-consensual third-party releases nor do they create a residual authority that authorizes a bankruptcy court to take such action.

Bankruptcy Code sections 1123(a) and (b) dictate what a plan of reorganization must and may contain. Section 1123(a)(5) provides that a plan must "provide adequate means for [its] implementation." Judge McMahon noted that, while section 1123(a)(5) contains a laundry list of

things that a plan can include to make sure resources are available for its implementation, "[i]njunctions against the prosecution of third-party claims against non-debtors, and the release of such claims, are nowhere to be found on that list." Section 1123(b)(6) provides that a plan may "include any other appropriate provision not inconsistent with the applicable provisions of this title."

However, Judge McMahon found that the non-consensual third-party releases contained in Purdue's plan were inconsistent with the Bankruptcy Code because they "discharge[] a non-debtor from debts that Congress specifically said could not be discharged by a debtor in bankruptcy," namely claims for fraud, willful and/or malicious conduct. Thus, section 1123 did not grant the Bankruptcy Court authority to approve such releases. For the same reason, Judge McMahon found that section 1129(a)(1) did not provide any substantive authority for approving the releases under section 105(a) because it provides that a bankruptcy court "shall confirm a plan *only if . . . the plan complies with the applicable provisions of this title*."

Consistent with this analysis, Judge McMahon also dismissed Purdue's argument that non-consensual third-party releases are permissible so long as no provision of the Bankruptcy Code expressly prohibits them because the Court should not deem congressional silence as consent to expand what is allowable under the Bankruptcy Code.

It is important to note that, in her ruling, Judge McMahon finally noted that non-consensual third-party releases may be granted under "rare" circumstances; but that is not the case in practice because such releases are imbedded within almost all chapter 11 plans.

Takeaways and Implications

- In the immediate future, this decision will likely create uncertainty for all financial institutions and other regular bankruptcy participants that often rely on securing a release of third-party claims in exchange for their cooperation and/or funding of a debtor's bankruptcy case. The ruling may also impact prospective debtors because, without the global finality that releases represent, there may be little reason for equity sponsors and lenders to contribute funds towards a settlement or other resolution of a bankruptcy.

- The District Court's criticism, and ultimate rejection, of similar releases embedded in Purdue's opioid settlement calls into question whether such relief is permissible in the Southern District of New York and potentially other jurisdictions that do not have controlling Circuit-level precedent. Accordingly, companies that are negotiating the structure of a bankruptcy with their existing creditors may (if venue is appropriate) seek to commence a chapter 11 case in a jurisdiction with greater certainty.

- Judge McMahon all but openly invited the Second Circuit and even the Supreme Court to weigh in by highlighting the long-standing conflict among the Circuits that have ruled on the permissibility of non-consensual third-party releases, a matter that Judge McMahon states "ought to be uniform throughout the country." Judge McMahon dedicated a substantial portion of her 142-page ruling to assessing the text of the Bankruptcy Code, legislative history and conflicting case law from the Circuit courts in an attempt to synthesize some definitive guidance on this issue. While Judge McMahon concluded that no provision of the Bankruptcy Code expressly authorizes courts to grant non-consensual third-party releases, the decision also recognized that "the lower courts desperately need a clear answer" on this issue.

- Bankruptcy practitioners should keep a close eye on the progression of this appeal. *Deutsche Bank A.G. v. Metromedia Fiber Network, Inc., (In re Metromedia Fiber Network, Inc.),* 416 F. 3d 136, 141 (2d Cir. 2005) ("*Metromedia*") is often cited to justify a bankruptcy court's authority to approve non-consensual third-party releases. However, the District Court observed that the Second Circuit failed to approve any third-party releases in *Metromedia*, and did not resolve the question of whether these releases are consistent with or authorized by the Bankruptcy Code.

- The release provision in Purdue's plan did not contain a carve-out provision to preserve causes of action against members of the Sackler family for fraud or willfully malicious conduct, claims from which a debtor cannot be discharged in its own bankruptcy. The District Court could have ended the decision by requiring the addition of such a carve-out, which is standard practice. However, Judge McMahon took her decision one step further, deciding to address the propriety of non-consensual third-party releases generally.

Authored by Douglas S. Mintz, Kristine Manoukian, Peter J. Amend and Kelly (Bucky) Knight.

Related People

Douglas Mintz

Partner

Washington, DC

Kristine Manoukian

Partner

New York

Peter Amend

Special Counsel

New York

Kelly (Bucky) Knight

Associate

New York

Practices

BUSINESS REORGANIZATION

Attachments

Download Alert