The Evolving Status of Nondebtor Releases in Bankruptcy Plans

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By: Kelly Curtin, Rachel Parisi, Dean Oswald

Historically, courts have varied in their determination as to whether, and how, a Chapter 11 plan may provide non-consensual third party releases to nondebtors, such as the bankrupt debtor's owners, officers, directors, or employees. In the face of recent judicial scrutiny and regulatory attention, the standards for nondebtor releases are being reexamined.

The Third Circuit's Standard

Presently, in the Third Circuit, non-consensual third-party releases must be (i) fair, (ii) necessary to the reorganization, (iii) supported by specific factual findings, and (iv) given in exchange for fair value. In re Continental Airlines, 203 F.3d 203, 214 (3d Cir. 2000). Additional considerations include whether there is (i) an identity of interest between the debtor and the third-party, (ii) substantial contribution by the nondebtor of assets to the reorganization, (iii) little likelihood of success of the reorganization without the injunction, (iv) an agreement by a substantial majority of creditors to support the injunction, and (v) provision in the plan for payment of substantially all of the class or classes affected by the injunction. In re Zenith Electrics Corporation, 241 B.R. 92, 110 (Bankr. D. Del. 1999) (citations omitted).

The Nondebtor Release Prohibition Act

On July 28, 2021, Congress introduced the Nondebtor Release Prohibition Act (the "NRPA"). Of the NPRA's six sections, the second and fourth sections have received the most attention. The second section prohibits non-consensual third-party releases and injunctions by a bankruptcy court, but permits consensual third-party releases if there is signed, written consent after clear and conspicuous notice of the release. This section further clarifies that such signed, written consent cannot be given by accepting, failing to accept or reject, or failing to object to, a proposed plan, or any other silence or inaction, and that treatment of such entity under a plan cannot be more or less favorable by reason of such entity's consent or failure to consent. This section also limits temporary injunctions against a nondebtor to 90 days.

Section four takes aim at divisional mergers. This section provides that the court shall dismiss a Chapter 11 reorganization bankruptcy case, on request of an interested party after notice and a hearing, if the debtor was involved in certain restructuring activity within the 10-year period prior to the filing of the bankruptcy petition that had the intent or foreseeable effect of (a) separating an entity's material assets from material liabilities, and (b) assigning a substantial portion of such liabilities to the debtor.

On November 3, 2021, the NRPA received the House Judiciary Committee's vote (23-17) that it be considered by the full House, but such vote has not yet been scheduled. Although the Senate version of the NRPA is still being considered by the Senate Judiciary Committee, recent case developments signal a shifting tide.

Highlights of Recent Case Developments

Dominating legal news and garnering national attention, the Chapter 11 plan in Purdue Pharma L.P., et al. ("Purdue") included a settlement with the Sackler family (the founders of the OxyContin manufacturer), in which the Sacklers would contribute $4.325 billion to the bankruptcy estate in exchange for certain releases. On December 16, 2021, confirmation of Purdue's Chapter 11 plan was overturned in a 142-page opinion by Judge McMahon of the U.S. District Court for Southern District of New York, which concluded that "the Bankruptcy Code does not authorize such non-consensual nondebtor releases: not in its express text (which is conceded); not in its silence (which is disputed); and not in any section or sections

of the Bankruptcy Code that, read singly or together, purport to confer generalized or 'residual' powers on a court sitting in bankruptcy." In re Purdue Pharma, L.P., 21 cv 7532 (CM), 2021 WL 5979108, at *4 (S.D.N.Y. Dec. 16, 2021). Purdue has appealed Judge McMahon's decision to the Second Circuit, where it presently sits.

Purdue is just one example of what appears to be a shifting of tides with respect to third-party releases. On January 13, 2022, Judge Novak of the U.S. District Court for the Eastern District of Virginia, overturned confirmation of a Chapter 11 plan containing nondebtor releases, stating that "[t]he sheer breadth of the releases can only be described as shocking[,] … releas[ing] the claims of at least hundreds of thousands of potential plaintiffs not involved in the bankruptcy, shielding an incalculable number of individuals associated with Debtors in some form, from every conceivable claim – both federal and state claims – for an unspecified time period stretching back to time immemorial. In doing so, the releases close the courthouse doors to an immeasurable number of potential plaintiffs, while protecting corporate insiders who had no role in the reorganization of the company." See Patterson, et al., v. Mahwah Bergen Retail Group, Inc., Civil No. 3:21cv167 (DJN), ECF No. 79 (E.D. Va. 2022) (citations omitted). Judge Novak concluded that in extinguishing these claims without analysis, "the Bankruptcy Court exceeded the constitutional limits of its authority as delineated by the Supreme Court in Stern v. Marshall, 564 U.S. 462 (2011), ignored the mandates of the Fourth Circuit in Behrmann [which stated that third-party releases are disfavored, and should be "granted cautiously and infrequently"], and offended the most fundamental precepts of due process." Id. (citations omitted)

Key Takeaway

Although it remains to be seen whether Congress will ever enact the NPRA, it is clear that Courts are taking a closer look at nondebtor and third-party release and injunction provisions in Chapter 11 plans. Debtors, creditors and restructuring professionals should keep apprised of case developments as these issues continue to evolve.