Corporate bankruptcy reformation in the US

David H. Conaway reports on the proposed legislation to address controversial practices in chapter 11

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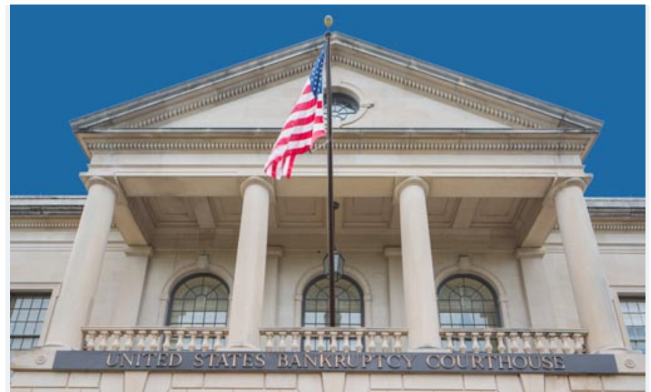
Chapter 11 debtors have routinely filed their cases essentially wherever they choose

As a result of recent high profile Chapter 11 cases, such as *Purdue Pharma* and *Johnson & Johnson*, there has been great Congressional and media attention to controversial Chapter 11 practices. These include debtors' forum- and judge-shopping, nonconsensual third party releases of non-debtors in the Plan of Reorganization and the use of divisional mergers to isolate liabilities into special purpose entities.

In 2021, to address these concerns, two bills were introduced in the US Senate and House of Representatives:

- Bankruptcy Venue Reform Act of 2021 ("Venue Bill"); and
- Nondebtor Release Prohibition Act of 2021 ("Release Bill").



Venue Bill

Currently, a corporate debtor can file a Chapter 11 case where it has its domicile (usually state of incorporation), principal place of business (usually corporate headquarters) or location of principal assets for at least 180 days. **Or, where there is pending a Chapter 11 case of an affiliate.** Chapter 11 debtors have routinely filed their cases essentially wherever they choose. According to testimony in a 28 July 2021 House Judiciary Subcommittee on Confronting Abuses of the Chapter 11 System, certain US Bankruptcy Courts are eager to attract large complex Chapter 11 cases to their districts. In fact, it was noted that 3 out of 375 U.S. bankruptcy judges presided over 57% of large public company cases in 2020. Furthermore, the suggestion is that certain courts may be more likely to rule in favour of Chapter 11 debtors on key issues, such as third party releases, incentive compensation packages and fast-track sales of assets or pre-packaged plans. In *Purdue Pharma*, the Bankruptcy Court for the Southern District of New York (SDNY) (White Plains division) approved a Plan of Reorganization that included releases of all claims against the Sackler family (officers, directors or shareholders), including the claims of opioid victims.

In addition, certain Bankruptcy Courts have case assignment procedures that direct cases to certain judges. In the SDNY, all White Plains cases were assigned to Judge Robert Drain, who presided over the *Purdue Pharma* case. In the Southern District of Texas, all complex cases are assigned to Judges David Jones or Marvin Isgur. Delaware's case assignment procedures are random. In the wake of media attention and judicial challenges to third party releases, the SDNY changed the case assignment procedures so that White Plains cases are now randomly assigned. The same change has occurred in the Eastern District of Virginia.

Under the Venue Bill, businesses would only be able to file their Chapter 11 cases where they have their principal place of business or where their principal assets are located. The Venue Bill would eliminate affiliate-based filings unless the affiliate were the debtor's controlling shareholder.

The Venue Bill would certainly end debtors' forum- and judge-shopping, which presumably would reduce alleged debtor bias by certain Bankruptcy Courts. On the other hand, certain Bankruptcy Courts, including Delaware, the SDNY and the Southern District of Texas, have developed a high level of expertise in handling complex Chapter 11 cases efficiently. In considering the Venue Bill, these conflicting policy issues should be considered.

Non-debtor third-party releases

The Release Bill would generally prohibit bankruptcy courts

approving nonconsensual third-party releases of claims against non-debtors, such as the Sacklers in *Purdue Pharma*. In addition, the Release Bill would prohibit bankruptcy courts from applying the section 362 automatic stay (injunction of all actions) to non-debtors for more than 90 days. Finally, the Release Bill would require the dismissal of Chapter 11 cases where the debtor was created by a "divisional merger", effectively ending the so-called "Texas 2-Step" cases, such as in *Johnson & Johnson*.

To date, US Bankruptcy Courts have issued conflicting rulings on third-party releases. The most notable ruling was in the *Purdue Pharma* case, where, on 16 December 2021, the SDNY vacated the order confirming the Chapter 11 Plan of Reorganization and the releases in favour of the Sackler family. The District Court found there was no statutory authority in the Bankruptcy Code for third party releases, except in cases involving asbestos claims (where channelling injunctions are permitted). However, in another opioid case, *Mallinckrodt PLC*, the Delaware Bankruptcy Court ruled that nonconsensual third-party releases were permissible.

The Release Bill would simply prohibit nonconsensual third-party releases of non-debtors, applicable to all US bankruptcy courts. Moreover, the Release Bill would require consent to a proposed release only by a written consent signed by the releasing party (example, opioid claimants). This would eliminate consent by voting for a plan, failing to reject or object to a proposed plan or failing to opt out of or object to the releases, all of which are common tactics utilized by debtors.

The controversial third party release cases have generally been associated with mass tort claims, such as the opioid claims in *Purdue Pharma* and *Mallinckrodt* or asbestos claims. However, third party releases are very broadly drafted and have released perhaps unintended claims. We were involved in a Delaware case where our client had significant executory contracts, specifically a USD 3.5 billion supply agreement and related consignment and security agreements. Negotiations regarding the assumption of these contracts were complex and sometimes contentious.

Ultimately, our client was able to achieve a favourable resolution, requiring the debtor to honour 100% of its obligations post-confirmation of the Plan on a fully secured basis. However, the Plan contained broad releases of all claims with respect to any creditor that would include obligations owed to our client that were negotiated and approved by the Bankruptcy Court. Thus, we were required to file an objection to the Plan's third party releases to preserve the performance and other obligations by the debtor and its lenders with respect to our client's executory contracts. ■

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