To Release or Not to Release?

COURTS REMAIN SPLIT ON RELEASE PROVISIONS

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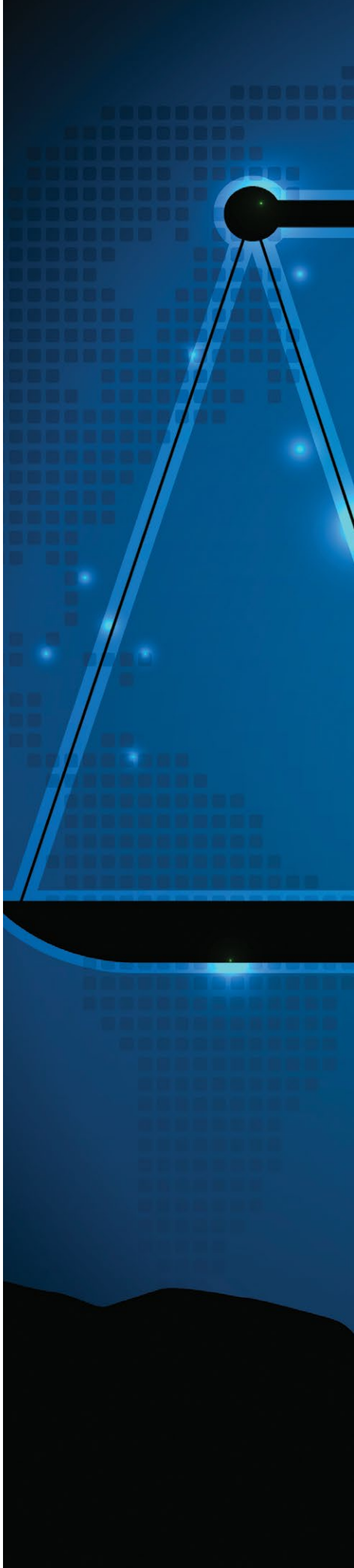

Release provisions are a common feature of almost every Chapter 11 plan in large bankruptcy cases. Three categories of release provisions typically are included: (i) releases by the debtors of claims they may hold against a list of "released parties;" (ii) consensual releases by and among the non-debtor third parties involved in the bankruptcy case; and (iii) in extraordinary circumstances, non-consensual releases of claims held by non-debtor third parties against other non-debtor third parties.

There has long been a split among Bankruptcy Courts and Circuit Courts of Appeal on the scope and permissibility of third-party releases. With the recent wave of large, high-profile Chapter 11 cases filed to address mass tort liabilities, a number of prominent courts have recently weighed in on these issues. In addition to the new precedent, pending appeals and proposed legislation could impact the ability of parties in complex Chapter 11 cases to use third-party releases as a tool in a plan of reorganization. These issues are likely to continue to generate significant litigation in Chapter 11 cases in the near term so long as the circuit splits and lack of clarity remain.

The law surrounding debtor releases, and the evidentiary burden the debtor is required to meet if seeking to release claims, are not controversial. Therefore, this article focuses on the recent case law on consensual third-party releases and non-consensual third-party releases, as well as the proposed legislation that, if passed, would impact the permissibility of such releases.

Consensual Third-Party Releases

The permissibility of consensual third-party release provisions is not seriously questioned. Rather, litigation on consensual third-party releases generally revolves around what constitutes a sufficient manifestation of consent to the release. On one end of the spectrum are courts that require an affirmative manifestation of consent, usually through the return of a ballot and/or a separate release form whereby a party expressly confirms consent to granting the release. Parties who object or remain silent are not bound by such release provisions in the Chapter 11 plan. These so-called opt-in releases often are advocated by the U.S. Trustee. Recently, at least one court has suggested that only opt-in releases can be binding.[1]

On the other end of the spectrum are releases where consent is manifested by notice and an opportunity to object. In this situation, unless a party files a

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formal objection to plan confirmation, they will be bound by the release provisions. A less extreme variation involves providing parties who will be bound by the release with a form they can return to opt out of granting the releases. These opt-out releases come in different variations with respect to who is entitled to receive an opt-out form, or whether they are part of, or separate from, the ballot for voting on the Chapter 11 plan. What is generally consistent in the opt-out release context is that (i) notice of the releases and their import must be sufficiently prominent and clear and (ii) parties must have ample opportunity to opt out or object to the releases.

A majority of courts, including courts in Delaware, the Southern District of New York, and the Northern and Southern Districts of Texas, have approved consensual third-party releases via an opt-out mechanism, though individual judges within those jurisdictions continue to have specific preferences as to the form of the relevant notice and precise opt-out mechanism that must be taken into account.[2]

Non-Consensual Third-Party Releases

Within the last nine months, four decisions from three different circuits have addressed the propriety of non-consensual third-party releases. The District Court for the Southern District of New York invalidated non-consensual third-party releases on grounds that Bankruptcy Courts lack statutory authority to approve them. The District Court for the Eastern District of Virginia invalidated certain non-consensual third-party releases that it determined were not justified by the facts and circumstances of the case before it.

On the other hand, two bankruptcy judges in the District of Delaware have considered and approved non-consensual third-party releases. In addition, although not discussed here because the ruling dealt with exculpation, the 5th U.S. Circuit Court of Appeals has recently reiterated its position that non-consensual third-party releases are not permitted under the Bankruptcy Code.[3] The major elements of each of the non-consensual third-party release decisions are discussed below.

Purdue Pharma. On September 17, 2021, the Bankruptcy Court for the Southern District of New York (Judge Robert D. Drain) confirmed a plan of reorganization for Purdue Pharma L.P. and its debtor affiliates which contained controversial non-debtor third-party releases of claims against the Sackler family (the owners of Purdue) and certain Sackler-related entities, including claims premised on their fraud, misrepresentation, and willful misconduct under various state consumer protection statutes.[4] In exchange for the releases under the Chapter 11 plan, the Sacklers and related entities agreed to fund more than $4 billion into a settlement trust for claimants who allege injury and death relating to Purdue's marketing and sale of OxyContin.

On December 16, 2021, the District Court for the Southern District of New York (Judge Colleen McMahon) vacated the Bankruptcy Court's confirmation order on appeal, ruling that the Bankruptcy Code does not authorize a Bankruptcy Court to order the non-consensual release of third-party claims against non-debtors that are not derivative of claims belonging to the debtors' estate in connection with confirmation of a Chapter 11 plan.[5] Specifically, the District Court found no (1) express authority, (2) implied authority, or (3) residual authority in the Bankruptcy Code to approve the releases.

As to express authority, the District Court found that no provision in the Bankruptcy Code confers substantive authority on the Bankruptcy Court to grant such releases. As to implied authority, the District Court concluded that inferring authority to grant such

releases from silence in the Bankruptcy Code would be inconsistent with the comprehensive federal bankruptcy scheme and, furthermore, that Congress has, in fact, spoken on the subject of non-debtor third-party releases where it wanted to do so in Section 524(g), which applies only in asbestos-related bankruptcy cases. As to residual authority, the District Court considered Bankruptcy Code Section 105 and concluded that since there is no underlying provision in the Bankruptcy Code that would authorize such releases, Section 105 cannot be used to authorize them.

The debtors and certain creditor constituencies appealed the District Court's ruling to the 2nd Circuit Court of Appeals.

After the District Court vacated the confirmation order, on March 3, 2022, a deal was reached in mediation, pursuant to which certain objectors to the third-party releases agreed to be bound by them in exchange for an additional contribution of $1.175 billion to the settlement trust by the Sacklers. Judge Drain approved the settlement term sheet on March 10, 2022, but the settlement is conditioned on one or more orders from the District Court or the 2nd Circuit Court of Appeals permitting consummation of the plan.

Despite the settlement, the U.S. Trustee and certain non-settling creditors have continued to take the position that third-party releases are improper in the appeal before the 2nd Circuit, which heard oral argument on April 29, 2022. As of October 3, 2022, the 2nd Circuit ruling remained pending.

Ascena Retail Group. On February 25, 2021, the Bankruptcy Court for the Eastern District of Virginia (Judge Kevin R. Huennekens) confirmed a plan of liquidation for Ascena Retail Group, Inc. (which owned various women's and girls' clothing brands, including Ann Taylor, LOFT, and others), overruling certain objections to the third-party releases in the plan. On appeal, the District Court (Judge David J. Novak) rejected arguments that Bankruptcy Courts are categorically barred from approving non-consensual third-party releases and instead applied the 6th Circuit's multifactor test from *In re Dow Corning Corp.*

The District Court found that the Bankruptcy Court failed to consider the relevant factors and concluded, using its own analysis, that none of the factors were satisfied. Further, it determined that it could sever the non-debtor third-party releases from the plan because they did not form an "integral" part of the plan. Ascena's plan was reconfirmed on March 3, 2022 (Judge Frank J. Santoro) without the voided third-party releases and with certain other changes.[6]

Mallinckrodt. On February 8, 2022, the Bankruptcy Court for the District of Delaware (Judge John T. Dorsey) confirmed a plan of reorganization for Mallinckrodt and its debtor affiliates, which operate a global specialty biopharmaceutical company that produces and sells a variety of pharmaceutical products, including opioids.[7] The plan included non-consensual third-party releases for the benefit of non-debtor affiliates and their related entities and persons, which the court found to be fair and necessary to the reorganization under the standard articulated by the 3rd Circuit in *In re Continental Airlines.*

Specifically, the Bankruptcy Court found the releases to be necessary as an integral part of settlements implemented by the plan, which were the debtors' "only way out," and found the releases to be fair because they had been negotiated at arm's-length among sophisticated parties, substantial consideration had been given in exchange for the releases, and it was unlikely material claims against the non-debtor released parties existed. The Bankruptcy Court bolstered its opinion by also noting the extraordinary nature and the sensitivity of the case, the overwhelming support of the releases by the creditor body, and the fact that the only alternative to the plan would be protracted and expensive litigation.

Boy Scouts. In the Boy Scouts' Chapter 11 case, which was filed in part due to existing and future litigation by plaintiffs alleging sexual abuse, the Bankruptcy Court for the District of Delaware (Judge Laurie

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Selber Silverstein) confirmed the debtors' plan of reorganization that included non-consensual third-party releases for certain settling parties (including non-debtor local councils, chartered organizations, settling insurance companies, and their respective representatives (each as defined in the Bankruptcy Court's opinion)) as to claims relating to scouting-related abuse.

In an opinion supporting confirmation, which examined whether releases in the plan could be approved, the Bankruptcy Court found, under the extraordinary circumstances of the case, statutory authority for exercising its inherent equitable power to approve non-consensual third-party releases consistent with Bankruptcy Code Sections 105(a), 1123(a)(5), and 1123(b)(6).[8]

The Bankruptcy Court further found that the non-consensual third-party releases satisfied the standard from *In re Continental* because the releases were both fair and necessary to the reorganization where, among other things, (i) the plan was a 100% payment plan to holders of abuse claims, (ii) the releases were consistent with how holders of abuse claims had historically sued and settled their claims against the debtors and the released non-debtor third parties, (iii) releasing claim holders overwhelmingly accepted the plan (by over 85%), and (iv) without the plan and releases, there would either be a race to the courthouse by litigants or a plan resulting in pennies-on-the-dollar recoveries for abuse claimants.

The Bankruptcy Court also found the releases were necessary to the reorganization where they helped ensure the scouting program could continue into the future and were the cornerstone of the funding of the settlement trust, including the contribution of more than $4 billion of accessible insurance assets.

From September 21 to 23, 2022, certain non-settling insurers and other claimants filed notices of appeal of the confirmation order. That appeal remained pending as of October 3, 2022.[9]

Pending Legislation

In 2021, legislation was proposed in both the U.S. House of Representatives and the Senate that, if passed, would aim to provide uniformity with respect to Bankruptcy Court approvals of non-debtor third-party releases.

The Stop Shielding Assets from Corporate Known Liability by Eliminating Non-Debtor Releases (SACKLER) Act has been proposed in House and Senate bills (H.R.2096 and S.2472) to prevent third parties from using the bankruptcy process to obtain a release from governmental claims. The SACKLER Act would amend Section 105(b) of the Bankruptcy Code to prohibit a court from enjoining or releasing a claim against a non-debtor held by a state, municipality, federally recognized tribe, or the United States (except as provided by Bankruptcy Code Section 524(g)).

The Nondebtor Release Prohibition Act of 2021 was introduced in House

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and Senate bills (H.R.4777 and S.2497) to prevent third parties from using the bankruptcy process to obtain releases from non-debtors without their express consent. The Nondebtor Release Prohibition Act of 2021 would amend the Bankruptcy Code to generally prohibit the discharge, release, termination, or modification of a liability of a non-debtor for claims held by third parties. However, it would permit the release of a non-debtor third-party claim through an opt-in process while prohibiting opt-out releases. In addition, it would require that the treatment of such entity and any of their claims under a plan not be more or less favorable due to consent or failure to consent to the third-party releases.

While passage of either would end certain differences among Bankruptcy Courts on the permissibility of consensual third-party releases and non-consensual third-party releases, no action has been taken on either piece of legislation since 2021.

Key Takeaways

For the time being, when parties seek to establish a fresh start as part of a debtor's restructuring efforts, consensual third-party releases may be obtained in most jurisdictions via an opt-out mechanism. However, parties must remain mindful of the particular preferences of individual judges in terms of the required notice and type of opt-out procedure that is likely to be permitted.

Debtors and their constituencies often use and rely on non-consensual third-party releases as a tool to reach case resolutions that maximize value to the estate and enhance creditor recoveries when mass tort liabilities are at issue. However, until the U.S. Supreme Court or Congress ultimately resolves the present split among courts and addresses the important issue of whether and under what circumstances such releases are permissible, significant time and money will continue to be spent litigating the subject, and parties will continue to face uncertainty in bankruptcy deal-making.

[1] See *Patterson v. Mahwah Bergen Retail Grp., Inc.*, 636 B.R. 641 (E.D. Va. 2022) (declining to approve third-party releases obtained through opt-out mechanism because consent did not constitute the "knowing and voluntary" consent required to adjudicate a non-core claim (citations omitted)).

[2] See *In re Fieldwood Energy LLC*, 2021 WL 2853151 (Bankr. S.D. Tex. June 25, 2021); *In re Mallinckrodt PLC*, 639 B.R. 837 (Bankr. D. Del. 2022); *In re Stoneway Cap. Ltd., et al.*, Case No. 1:21-bk-10646 (Bankr. S.D.N.Y. May 11, 2022); *In re Rockall Energy Holdings, LLC et al.*, Case No. 22-90000(MXM) (Bankr. N.D. Tex. June 6, 2022).

[3] See *In re Highland Cap. Mgmt.*, 2022 WL 4093167 (5th Cir. Sept. 7, 2022).

[4] *In re Purdue Pharma L.P.*, 633 B.R. 53 (Bankr. S.D.N.Y. 2021).

[5] See *In re Purdue Pharma L.P.*, 635 B.R. 26 (S.D.N.Y. 2021).

[6] See *Patterson v. Mahwah Bergen Retail Grp., Inc.*, 636 B.R. 641 (E.D. Va. 2022).

[7] See *In re Mallinckrodt PLC*, 639 B.R. 837 (Bankr. D. Del. 2022).

[8] See *In re Boy Scouts of Am. and Del. BSA, LLC*, 2022 WL 3030138 (Bankr. D. Del. July 29, 2022).

[9] For more information on the *Boy Scouts* ruling and third-party releases in general, and the "opt-in" versus "opt-out" debate, see "Another Bankruptcy Court Approves Third-Party Releases and Opt-Out Mechanisms Amidst Disagreements with Other Circuits," VELaw.com (Aug. 26, 2022) (also published in Law360 Expert Analysis, Sept. 15, 2022), velaw.com/insights/another-delaware-bankruptcy-court-approves-third-party-releases-and-opt-out-mechanisms-amidst-disagreements-with-other-circuits/