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Memorandum

Supreme Court Rules That Bankruptcy Code Does Not Authorize Non-Consensual Third Party Releases in Non-Asbestos Cases

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Key Takeaways

- *Bankruptcy no longer has a mechanism for 100% resolution of current and future mass tort claims for equity holders and other non-debtor affiliates.*
- *Debtors can still resolve most claims by settling derivative claims and using consensual releases.*
- *Sponsors and parent companies in commercial chapter 11 cases will not be severely impacted, as the vast majority of claims in bankruptcy of portfolio company or subsidiary are derivative claims, and important commercial creditors are typically engaged and can provide a consensual release.*

On June 27, 2024, the Supreme Court issued a decision in *Purdue Pharma*, reversing court approval of the Purdue Pharma bankruptcy plan and significantly altering mass tort bankruptcy practice. The Court held that the Bankruptcy Code does not authorize non-consensual third party releases of direct claims as part of a Chapter 11 plan, other than in asbestos cases. The Court specifically noted that consensual releases, as well as releases of derivative claims "owned" by the debtor's estate, are authorized by the Bankruptcy Code. The Court also expressly noted that it was not addressing whether previously confirmed Chapter 11 plans that contained non-consensual third party releases and had already gone effective would need to be unwound.

The Court's opinion represents a sea change in mass tort bankruptcy cases. Bankruptcy no longer provides a mechanism for debtors to resolve 100% of all current and future mass tort claims against their equity holders and other non-debtor affiliates. However, mass tort debtors can still use a variety of authorized mechanisms to stay litigation and garner consensual releases of mass tort liabilities that can covers most of their non-debtor affiliates' mass tort liability.

In commercial Chapter 11 cases, the effect of the Court's decision will have limited effect. The vast majority of claims against third parties in a commercial chapter 11 case are derivative claims for alleged harm to the bankrupt company itself. Those claims can still be settled and released by the debtor with binding effect on third parties. Further, commercial creditors are generally engaged in the process and finite in number, and can provide a

consensual release as part of a Chapter 11 plan. On the margins however, the Court's decision increases the bargaining power of diffuse creditor groups such as employees or shareholders, particularly in prepackaged bankruptcy cases.

As a result of this decision, courts in mass tort and commercial Chapter 11 cases will face numerous issues raised by companies and their counsel seeking the broadest possible release within the permissible bounds of the Bankruptcy Code.

Mass Tort Bankruptcy Cases and Non-Consensual Third Party Releases

Since the Bankruptcy Code was enacted over 45 years ago, companies have increasingly turned to bankruptcy courts to seek a global resolution of their and their affiliates' mass tort liabilities. The first wave of mass tort bankruptcy cases included many asbestos manufacturers during the 1980s, 1990s, and early 2000s, while more recent mass tort bankruptcy cases have involved a diverse array of harms ranging from talcum powder and opioids to forever chemicals and sexual abuse. In each case, the bankruptcy court has served as a forum for collective negotiation and can lead to a successful resolution of the mass tort liabilities.

Bankruptcy resolutions of mass tort liabilities have historically been modeled after the *Johns-Manville* case. Johns-Manville, which was the largest asbestos processor and asbestos-cement manufacturer in the world, filed for chapter 11 in 1982 as a result of a flood of asbestos litigation. To equitably resolve current and future asbestos claims, Johns-Manville channeled those liabilities to a trust that would pay current and future claims. The trust was funded by a percentage of Johns-Manville's earnings, and Johns-Manville's insurers and other third parties could contribute funds to the trust (for the benefit of claimants) and, in return, be released by both the debtor and all creditors, both consenting and non-consenting, from all asbestos-related claims.

Following the *Johns-Manville* case, Congress enacted a specific provision of the Bankruptcy Code, section 524(g), which codified the Johns-Manville trust construct as a viable solution for asbestos liabilities in bankruptcy. However, companies also sought to use bankruptcy to resolve their liabilities for *non*-asbestos mass tort liabilities, where Congress had not provided explicit statutory authorization for a trust construct in which third parties contribute to the trust and receive a third-party release in exchange. Practitioners and courts relied on two other Bankruptcy Code provisions for the bankruptcy court's authority to approve such a trust in non-asbestos cases: Section 1123(b)(6) and—to a lesser extent—Section 105(a).

Section 1123(b)(6) provides that a chapter 11 plan can "include any other appropriate provision not inconsistent with the applicable provisions of this title." Section 105(a) authorizes the bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." Courts have interpreted these provisions as providing authority for third parties who contribute to a Johns-Manville-like trust to receive a broad non-consensual release from related mass tort liabilities, subject to certain conditions and limitations. This interpretation has enabled mass tort debtors, along with their equity holders and insurers, to achieve a global resolution of their mass tort liabilities through a bankruptcy proceeding. Courts have differed

with respect to the permissibility of this non-asbestos trust construct. The Fifth and Ninth Circuits have prohibited non-consensual third party releases in non-asbestos cases, while the Second, Third, Sixth, and Seventh Circuits have approved such releases based on Sections 1123(b)(6) and 105(a).

Purdue Pharma Bankruptcy and Supreme Court Opinion

Purdue Pharma filed for chapter 11 in September of 2019 after the opioid epidemic precipitated public and private litigation involving trillions of dollars in actual and potential liabilities. Purdue reached an agreement with its creditors to channel its liabilities to a trust largely funded by the Sackler family, who owned and operated Purdue Pharma. Members of the Sackler family agreed to contribute $4.325 billion (which increased to approximately $6 billion during the appeal) in exchange for a global, non-consensual release of all opioid-related claims (including claims for fraud and willful misconduct). The agreement, set forth in Purdue's chapter 11 plan, was confirmed by the Bankruptcy Court, reversed by the District Court, then re-affirmed by the Second Circuit.

The United States Supreme Court granted certiorari. Writing for the majority, Justice Gorsuch held that the Bankruptcy Code does not permit non-consensual third party releases of direct claims in non-asbestos cases. The Court reasoned that Section 1123(b)(6) and 105(a) only provided bankruptcy courts with authority to alter the debtor-creditor relationship, not the relationship between creditors and parties who had not filed for bankruptcy. In essence, the Court construed the Bankruptcy Code as providing a fundamental bargain: if a debtor files for bankruptcy, puts all of its assets on the table for creditors, and subjects itself to the scrutiny of a bankruptcy process, then it can receive a discharge and be released from claims. Those who do not file for bankruptcy cannot receive the benefits of a bankruptcy.

The dissent, written by Justice Kavanaugh, disputed the Court's reasoning and noted the overwhelming creditor support for the Purdue settlement and suggested the decision would harm opioid crisis victims and their families.

Importantly, the Court did not call into question the authority for several other categories of releases. Bankruptcy courts still have authority to approve and enter *consensual* releases of third parties, as well as non-consensual releases of third parties if the releasing creditors' claims are being paid in full under the chapter 11 plan. Debtors can also continue to settle and release *derivative* claims that are "owned" by the estate (*e.g.*, fraudulent conveyance, alter ego, veil piercing, successor liability, breach of fiduciary duty, and insurance coverage claims). Finally, in *asbestos* cases, Section 524(g) continues to provide explicit statutory authority for non-consensual third party releases.

Additionally, the Court did not address other sources of releases in the Bankruptcy Code, namely Section 363(f) and the ability to buy back insurance policies "free and clear" of liabilities. Courts have used Section 363(f) as an independent source of statutory authority for releases in connection with insurance policy buybacks, even without resorting to Section 105(a) or 1123(b)(6)—the provisions discussed by the Court. Accordingly, the Court's decision does not undermine the specific statutory authority for those releases.

Implications

The Court's decision may have broad implications for bankruptcy practice, but its impact will be most strongly felt in mass tort non-asbestos bankruptcy cases. As in class actions, current personal injury claimants will now be able to opt out of bankruptcy third-party releases, and future personal injury claimants can no longer be bound by third-party releases. Mass tort non-asbestos debtors with solvent equity holders can no longer use bankruptcy to provide 100% finality with respect to the mass tort exposure of the entire corporate family, and the releases that they are able to achieve will come at a greater financial cost and take more time.

Nonetheless, bankruptcy continues to provide many benefits for mass tort debtors and their equity holders and remains a viable option for managing those liabilities. Bankruptcy courts may stay claims against non-debtor affiliates during a bankruptcy case to provide the parties with breathing room to negotiate a consensual resolution. Moreover, companies and their counsel will use and enhance the tools that the Court *did* permit in order to maximize claim resolutions in a bankruptcy, for example:

- Securing court approval of opt-out procedures, coupled with broad noticing program, to maximize the scope of consensual releases
- Conditioning settlement payments on low opt-out thresholds or high consensual claimant participation
- Settling derivative claims "owned" by the estate against equity holders and others and fully releasing those parties from derivative claims (which may be the bulk of their exposure, especially if the debtor designed, manufactured, and sold the product at issue), coupled with a gatekeeper injunction requiring the bankruptcy court to confirm that to-be-asserted claims are not released derivative claims
- Seeking court determination that Chapter 11 plan pays claimants in full, thus enabling non-consensual third party releases to ensure that claimants do not receive a double recovery
- Equity holders can contribute money to a sub-trust that enhances claimant recovery in exchange for consensual releases, or in the alternative, that funds continued litigation against holdout creditors
- Debtors can channel lingering post-confirmation litigation to a centralized forum and organized process

Each of these strategies will undoubtedly lead to litigation defining the contours of consensual releases, derivative claims, and payment in full. Courts already disagree as to whether, and in what contexts, a debtor can use opt-out structure to bind claimants to consensual releases. The U.S. Trustee and SEC will invoke the Court's ruling to advocate for an opt-in regime in which only claimants who affirmatively consent to the releases are bound. There will also be increased attention as to what claims are classified as derivative (an area of law that is not particularly well-developed), as well as questions about what evidence and expert testimony the bankruptcy court will need to use to decide that a claimant has been paid in full by a Chapter 11 plan. Finally, bankruptcy courts in Chapter 15 proceedings will consider whether to give effect to non-consensual third party releases entered in foreign cases.

The impact of the Court's decision is much more limited in commercial non-mass tort cases for several reasons. First, the counterparties in commercial cases are finite in number and can be directly engaged in negotiations, so debtors are more readily able to obtain consensual releases as part of a deal. Second, claims against equity holders, sponsors, directors, and officers in commercial cases are overwhelmingly derivative claims "owned" by the estate, which can unquestionably be settled and fully released by the debtor (although the bankruptcy court will consider creditor support in deciding whether to approve the settlement). Third, lender liability claims and direct claims against equity holders are still rare and plaintiffs usually lose on the merits. Fourth, future claims are not typically a feature of commercial Chapter 11 cases. Finally, claims in commercial cases do not have the same emotional baggage as mass tort claims, making consensual settlement and release easier to achieve.

The Court's decision will nonetheless affect certain issues in commercial cases. Sponsors will be unable to secure full non-consensual third party releases of direct claims in a portfolio company bankruptcy. Equity holders and plan sponsors will no longer be able to guarantee releases from broad, diffuse constituencies such as employees, unions, vendors, and shareholders without soliciting each party's consent. These concerns are accentuated in a prepackaged case where speed and certainty are the key to success.

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