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Unpacking *Purdue*: The Second Circuit's Recent Opinion on the Allowability of Nonconsensual Third-Party Releases

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On May 30, 2023, the Second Circuit released the latest opinion on nonconsensual third-party releases, reversing the District Court's vacatur of the Bankruptcy Court's confirmation of a plan that approved such releases.[2] *Purdue Pharma, L.P. v. City of Grande Prairie (In re Pharma L.P.)*, Case No. 22-110-bk (L), 2023 U.S. App. LEXIS 13236 (2d Cir. May 30, 2023) (the "**Second Circuit Opinion**").[3] This alert provides: (i) an overview of the Second Circuit Opinion and the history of the Purdue Pharma cases leading to the appeal; (ii) key takeaways from the Second Circuit Opinion, and (iii) the current state of the Circuit Court split on this issue.

Procedural History of the Releases in Purdue

On September 15, 2019, Purdue Pharma L.P. and certain affiliates ("**Purdue**") voluntarily sought bankruptcy protection by filing chapter 11 cases (the "**Purdue Bankruptcy Case**") under chapter 11 of the Bankruptcy Code. Owned and operated by the Sackler Family, Purdue produced the opioid OxyContin. Through the Purdue Bankruptcy Case, Purdue sought to address a "veritable tsunami" of tort suits related to its production of opioids. *In re Purdue Pharma, L.P.*, 635 B.R. 26, 34 (S.D.N.Y. 2021) (history omitted) ("**District Court Opinion**"). To do so, Purdue constructed a plan to fund creditor and abatement trusts to resolve the tort claims, in exchange for nonconsensual third-party releases of liability against non-debtors, including the Sackler Family (herein, the "**Third-Party Releases**").

The Bankruptcy Court Confirms the Purdue Plan, Which Includes the Nonconsensual Third-Party Releases. On September 1, 2021, the Bankruptcy Court confirmed Purdue's proposed plan (the "**Purdue Plan**"). The Purdue Plan implemented a settlement among Purdue, the Sackler Family, and other stakeholders and opioid tort victims, pursuant to which the Sackler Family agreed to fund $4.325 billion into nine creditor and abatement trusts for the purpose of abating the national opioid crisis and settling qualifying tort claims. It also included the Third-Party Releases of opioid tort liability for the benefit of the Sackler Family. Notably, the Bankruptcy Court modified the original proposed Third-Party Release "to ensure that [Purdue's] conduct must be a legal cause or a legally relevant factor of any released cause of action against the Sacklers." Second Circuit Opinion, 2023 U.S. App. LEXIS at *19–*20.

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[2] Second Circuit refers to the Second Circuit Court of Appeals. District Court refers to the United States District Court for the Southern District of New York. Bankruptcy Court refers to the United States Bankruptcy Court for the Southern District of New York.

[3] Capitalized terms used but not defined have the meanings given in the Second Circuit Opinion.

The District Court Vacates the Bankruptcy Court's Confirmation Order. On appeal, on December 16, 2021, the District Court vacated the Bankruptcy Court's order confirming the Purdue Plan because the confirmation order approved the Third-Party Releases. The District Court reasoned that the Bankruptcy Code does not "confer on any court the power to approve the release of non-derivative third-party claims against non-debtors, including specifically the [Releases] … under attack on . . . appeal." District Court Opinion, 635 B.R. at 90.

Moreover, as discussed in detail below, the District Court also found that the Bankruptcy Court lacked constitutional authority to enter a final order approving the releases and could not "manufacture constitutional authority to resolve a non-core claim by the artifice of including a release of that claim in a plan of reorganization." District Court Opinion, 635 B.R. at 81.

The Second Circuit Reverses the District Court. Purdue and the Sackler Family, among others, appealed the District Court's ruling to the Second Circuit. At the time of the appeal, the appellee group consisted of only the U.S. Trustee, some Canadian municipalities and indigenous nations, and *pro se* plaintiffs. Many of the appellees withdrew their objections to the Purdue Plan because pursuant to additional negotiations, the Sackler Family increased their "contribution to make the settlement equal to approximately $5.5–6.0 billion" from $4.325 billion. Second Circuit Opinion, 2023 U.S. App. LEXIS at *69.

The Second Circuit reversed the District Court's ruling, affirmed the Bankruptcy Court's order confirming the Purdue Plan, and remanded to the District Court for further necessary proceedings. In so holding, the Second Circuit relied on sections 1123(b)(6) and 105(a) of the Bankruptcy Code to support the Bankruptcy Court's statutory basis to approve a plan with nonconsensual third-party releases. The Second Circuit also promulgated a new seven (7) factor test for evaluating the propriety of nonconsensual third-party releases and provided insight on related issues that debtors may face when pursuing such releases in and out of the Second Circuit.

Key Takeaways

Factor Test. The Second Circuit identified a seven factor test for bankruptcy courts to "look to . . . before imposing nonconsensual third-party releases." *Id.* at *61. The Second Circuit imported some of the factors from *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005), a case in which one of the authors of this client alert, Richard Kanowitz, served as counsel to the debtors and drafted third-party releases to protect insiders and the parent company from a securities class action into the plan that was ultimately confirmed and upheld on appeal.

The Second Circuit ordered that the bankruptcy courts consider each factor with specific and detailed findings while cautioning that satisfaction of each factor may not be sufficient depending on the circumstances of each case. The Second Circuit instructed bankruptcy courts to balance all the factors "against a backdrop of equity" and "exercise particular care when evaluating these types of releases." *Id.* at *63–64.

The seven factors include:

(1) Whether there is an identity of interests between the debtors and released third parties, including indemnification relationships.

(2) Whether the claims against the debtor and non-debtor are factually and legally intertwined, including whether the debtors and the released parties share common defenses, insurance coverage, or levels of culpability.

(3) Whether the scope of the releases is appropriate, in that the breadth of the release is necessary to the plan.

(4) Whether there is a likelihood of plan success without the releases.

(5) Whether the non-debtor receiving the release contributed substantial assets to the debtor's reorganization.

(6) Whether the impacted class of creditors overwhelmingly supports the plan with the releases.

(7) Whether the contributed sum permits the fair resolution (as opposed to full payment) of the enjoined claims.

Jurisdictional Issues. The Second Circuit agreed with the District Court that the Bankruptcy Court "lacked constitutional authority to finally approve of the releases." *Id.* at *38. Following Supreme Court precedent, the Second Circuit found that the released claims "do not stem from the bankruptcy itself," and instead, are "direct claims, arising under state law, against non-debtors held by third parties who have not sought to recover those claims in bankruptcy." *Id.* (citing *Stern v. Marshall*, 564 U.S. 462, 499 (2011)).

The practical implications of this holding were largely irrelevant for the Second Circuit Opinion because the evaluation required de novo review in any event. But, this holding could impact the procedure for obtaining confirmation of a plan that contains nonconsensual third-party releases. Indeed, Rochelle's Daily Wire has already criticized this piece of the ruling stating that "in similar circumstances, a chapter 11 plan may not be confirmed and consummated until the equivalent of an appeal has been completed in district court."

It is undisputed that if the bankruptcy court lacks constitutional authority to enter final orders on a matter, the bankruptcy court may issue findings of fact and conclusions of law for referral to the district court. 28 U.S.C. § 157(c)(1). In the context of confirmation, this issue may present hurdles for debtors, including for example, unexpected delays which could risk financial commitments that are tied to confirmation.

One solution to this problem is the path taken in *In re ASARCO LLC*, 420 B.R. 314 (S.D. Tex. 2009). There, the parties sought to utilize the channeling injunction of section 524(g) of the Bankruptcy Code, which can only be approved through a final order from the district court. *See* 11 U.S.C. 524(g)(3)(A). In that case, to resolve the jurisdictional hurdle, the parties agreed to have the bankruptcy judge and district court judge jointly preside over the confirmation hearing. This procedure had the benefit of allowing the

bankruptcy judge to decide the bankruptcy issues based on such court's extensive knowledge of the case and having the district court available to enter the final and necessary orders.

Indemnification Obligations. In its evaluation of bankruptcy court subject matter jurisdiction and the factors, the Second Circuit considered the indemnification obligations that existed between the Purdue Debtors and the Sackler Family. In 2004, Purdue's board approved an indemnity agreement of all directors and officers against claims made in connection with their service to the company, including the payment of all costs and expenses related thereto. The indemnity agreement had no time limits and included a bad faith carveout.

The fact the Sackler Family could seek indemnification from the Purdue Debtors provided a sufficient basis to implicate "related to" subject matter jurisdiction for the bankruptcy court. Moreover, the indemnity obligations also weighed in favor of the Purdue Debtors under the factor analysis because litigating the indemnity would deplete the estate, regardless of the outcome of the third-party claims. Second Circuit Opinion, 2023 U.S. App. LEXIS at *66. The Second Circuit also found persuasive that the indemnity agreements were entered into "well before the contemplation of bankruptcy" (*id.* at *67) and cautioned that indemnity agreements would be far less persuasive if the indemnity agreements were entered into in contemplation of obtaining a third-party release in bankruptcy.

Opt outs. The U.S. Trustee objected to the Third-Party Releases, in part, because "without an ability to opt-out, [the Third-Party Release] effectively denies claimants their day in court." Second Circuit Opinion, 2023 U.S. App. LEXIS at *73–74. The Second Circuit disagreed that an opt-out was required because due process was satisfied through "adequacy of notice and a meaningful opportunity to be heard." *Id.* at *74. As stated above, the Second Circuit relied, in part, on section 1123(b)(6), which serves as a general catch-all and does not include specific requirements.

By contrast, bankruptcy courts in the Southern District of Texas routinely use an opt-out procedure for the approval of third-party releases in approving agreed plans under section 1123(b)(3)(A) of the Bankruptcy Code. *In re CJ Holding Co.*, 597 B.R. 597, 608 (S.D. Tex. 2019). Recognizing the limitations of section 524(e) (as discussed more below), bankruptcy courts in the Southern District of Texas premise approval of third-party releases under section 1123(b)(3)(A) of the Bankruptcy Code. *In re Bigler LP*, 442 B.R. 537, 543 (Bankr. S.D. Tex. 2010). Under this section, courts hold that third-party releases "must satisfy the requirements of a valid settlement of claims under the Code," including "consent and consideration by each participant in the agreement." *Id.* at 543–44. In relevant part, courts find that the consent prong is satisfied when parties can affirmatively opt-out or object to releases.[4]

[4] Typically, the opt-out is provided in the solicitation materials distributed with the plan ballots.

Thus, while an opt-out may not be required to meet due process requirements relied on by the Second Circuit under section 1123(b)(6), to the extent a debtor is seeking confirmation based on section 1123(b)(3)(A)—at least in the Fifth Circuit—the opt-out procedure is required.

Is the Second Circuit Opinion Limited to Mass Tort Bankruptcies? The Second Circuit Opinion highlights a procedural gap absent in the Bankruptcy Code. At present, there is no explicit provision that deals with mass tort litigation in a bankruptcy case, unless such litigation arises from asbestos exposure (*see* 11 U.S.C. § 524(g)). Rather, debtors facing these liabilities generally model relief after what is acceptable under section 524(g)—*i.e.*, creation of a sizeable trust to fairly treat victims in exchange for broad releases of parties that contribute to the trust. Indeed, the Second Circuit appears aware of this limitation, relies on the contours of section 524(g) (*e.g.*, p. 66), and endeavors that its opinion will "guide the analysis as to when to allow similar releases in reorganization plans." *Id.* at *11.

As such, the Second Circuit Opinion does not broadly open the door to nonconsensual third-party releases outside of the mass tort space. Rather, the Court repeatedly states that its analysis is limited to the facts and circumstances applicable to Purdue and that any subsequent analysis using the factors will be extremely fact dependent. *See, e.g.*, Second Circuit Opinion, 2023 U.S. App. LEXIS at *63 ("[T]here may even be cases in which all factors are present, but the . . . third-party releases . . . should not be approved."); *id.* at *10 ("We . . . hold that the bankruptcy court's inclusion of the releases . . . is equitable and appropriate under the specific factual circumstances of this case."). Thus, for debtors facing mass tort liabilities, the Second Circuit Opinion will be helpful (and in some cases binding authority) to fairly addressing such liabilities, and persuasive for other circumstances.

Assessing the Shifting Landscape after the Second Circuit's Purdue Opinion

Following the Second Circuit Opinion, the Circuit split on the allowability of nonconsensual third-party releases is as follows:

Permitted	**Not Permitted**	**Unclear**
Second Circuit	Fifth Circuit	First Circuit
Third Circuit	Tenth Circuit	Eighth Circuit
Fourth Circuit		Ninth Circuit
Sixth Circuit		D.C. Circuit
Seventh Circuit		
Eleventh Circuit		

Given the popularity of filing complex chapter 11 cases in the Southern District of New York (Second Circuit) and Delaware (Third Circuit), on one hand, and the Southern District of Texas (Fifth Circuit), on the other hand, the majority/minority split is noteworthy.

The Fifth Circuit's position is based primarily on the primacy of section 524(e) of the Bankruptcy Code. This provision states that "discharge of a debt of the debtor *does not affect* the liability of *any other entity* on . . . such debt." 11 U.S.C. § 524(e) (emphasis added). The Fifth Circuit has held, in a variety of contexts, that as such, section 524(e) limits releases (*i.e.*, discharges) to the debtor and therefore, cannot

include releases for third parties.[5] In what some may consider a workaround to the Fifth Circuit's categorical prohibition of non-consensual third-party releases, the Fifth Circuit affirmed a bankruptcy court's approval of a "gatekeeping" provision, which required prospective litigants to seek approval from the bankruptcy court before proceeding with a lawsuit against a non-debtor third party, in a plan confirmed in the Highland Capital case. *See Matter of Highland Capital Mgmt., L.P.*, 48 F.4th 419, 438–39 (5th Cir. 2022). The Fifth Circuit reasoned that longstanding Supreme Court precedent leaves the determination of whether a bankruptcy court has jurisdictional authority over non-core claims *to the bankruptcy court itself* in the first instance. *See id.* at 439 (citing *Barton v. Barbour*, 104 U.S. 126 (1881)) ("Courts have long recognized bankruptcy courts can perform a gatekeeping function. . . . Relevant here, we left to the bankruptcy court, faced with pre-approval of a claim, to determine whether it had subject matter jurisdiction over that claim in the first instance.").

The Second and Third Circuits, however, do not find limits on such releases in section 524(e). Indeed, in the Second Circuit Opinion, the Second Circuit now squarely holds that "§ 524(e) does not purport to limit the bankruptcy court's powers to release a non-debtor from a creditor's claims." Second Circuit Opinion, 2023 U.S. App. LEXIS at *51 (quoting *Airadigm Commc'ns, Inc. v. FCC (In re Airadigm Commc'ns, Inc.)*, 519 F.3d 640, 656 (7th Cir. 2008)). The Third Circuit, without addressing section 524(e), affirmed confirmation of a plan under which equity holders contributed $325 million in exchange for nonconsensual third-party releases. *In re Millennium Lab Holdings II, LLC.*, 945 F.3d 126, 144 (3d Cir. 2019). In doing so, the Third Circuit agreed with the bankruptcy court's finding that it had constitutional authority to enter the confirmation order approving the releases under *Stern* precedent because the releases were "integral to the restructuring" and the facts of the case otherwise met the "exacting standards" set forth in the Third Circuit's precedents regarding nonconsensual third-party releases. *See id.* at 139–40.

Conclusion

Though the Second Circuit Opinion added even more nuance to an already complex and often controversial legal question, importantly, one thing remained the same: the permissibility of nonconsensual third-party releases always depends on the facts and circumstances of each case and the binding precedent of the Circuit where the bankruptcy case is pending, at least until the Supreme Court (or Congress) resolves the split. For these reasons, the value that experienced counsel can contribute to a case involving nonconsensual third-party releases is higher than ever. Haynes and Boone's deep bench of Restructuring professionals have extensive experience with nonconsensual third-party releases and regularly practice in bankruptcy courts where these issues are most commonly litigated.

[5] *In re Vitro S.A.B. de C.V.*, 701 F.3d 1031, 1059 (5th Cir. 2012) (holding that "non-consensual, non-debtor release through a bankruptcy proceeding" are "explicitly prohibited" based on the prohibited discharge of third-party liabilities in section 524(e) of the Bankruptcy Code); *In re Pac. Lumber Co.*, 584 F.3d 229, 252 (5th Cir. 2009) (collecting cases); *but see id.* ("[T]he Bankruptcy Code now permits bankruptcy courts to enjoin third-party asbestos claims under certain circumstances, 11 U.S.C. § 524(g), which suggests non-debtor releases are most appropriate as a method to channel mass claims toward a specific pool of assets.").