

Second Circuit Affirms Permissibility of Nonconsensual Third-Party Releases in *Purdue Pharma* Bankruptcy Case

In a long-awaited decision, on May 30, 2023, the U.S. Court of Appeals for the Second Circuit rendered its opinion in the *Purdue Pharma* bankruptcy case and affirmed the permissibility of nonconsensual third-party releases in bankruptcy plans under appropriate circumstances. In doing so, the Second Circuit reversed Judge Colleen McMahon of the U.S. District Court for the Southern District of New York, who vacated the bankruptcy court's earlier order approving nonconsensual third-party releases in Purdue Pharma's bankruptcy plan.

This decision is important not only for allowing the Purdue Pharma debtors to confirm their bankruptcy plan and claimants to receive payments thereunder, but also for reestablishing bankruptcy courts within the Second Circuit (including the Southern District of New York) as potential venues for future mass tort bankruptcy filings. Judge McMahon's now-reversed ruling that nonconsensual releases of third-party claims against nondebtors are not permitted by the Bankruptcy Code came as a surprise to market participants and bankruptcy practitioners, as it departed from what most thought was well-settled Second Circuit case law. The Second Circuit's opinion in the *Purdue Pharma* bankruptcy case clears the way for parties to once again choose the Southern District of New York as a venue for bankruptcy cases where it is expected that nonconsensual third-party releases will be necessary to confirm a chapter 11 plan.

This decision comes on the heels of a ruling by District Judge Richard J. Andrews of the U.S. District Court for the District of Delaware, who affirmed the power of bankruptcy courts to approve nonconsensual third-party releases under appropriate circumstances in the *Boy Scouts of America* bankruptcy case.

However, there remains a significant circuit split as to the permissibility of nonconsensual third-party releases, as the Fifth, Ninth and Tenth Circuits have

all ruled that bankruptcy courts lack the power to grant nonconsensual third-party releases. That position is based primarily on a reading of section 524(e) of the Bankruptcy Code, which provides that the discharge of the debt of a debtor in bankruptcy does not affect the liability of any other person for such debt (such as a guarantor). The Fifth, Ninth and Tenth Circuits have found that this provision of the Bankruptcy Code precludes bankruptcy courts from fashioning relief in the form of nonconsensual third-party releases.¹

Nonconsensual third-party releases can be controversial for a host of reasons and under certain circumstances may create the potential for abuse, but we believe that bankruptcy judges can and do exercise their discretion to approve such releases, in appropriate cases, in a manner that benefits the body of claimants as a whole. Indeed, under certain circumstances, nonconsensual third-party releases may be the only way claimants can obtain a recovery against a limited pool of resources that would otherwise be dissipated through piecemeal litigation. For example, in the *Weinstein Company* bankruptcy (where we represented the debtor), it would have been impossible to establish a survivors' fund without providing the funding insurers with the benefit of nonconsensual third-party releases. That was true in the *Boy Scouts of America* case as well.

Importantly, one of the factors that bankruptcy courts look to (and a factor that the Second Circuit emphasized in its opinion) is that the claimants themselves must vote to accept a bankruptcy plan containing nonconsensual third-party releases for such releases to be approved. Courts typically expect such approval to be overwhelming or close to it. That approach is consistent with the overall bankruptcy framework that allows class voting in bankruptcy: namely, that the majority can bind the minority. Bankruptcy is a collective process, not an individual one, and without the ability to bind holdouts it would often (if not always) be impossible to confirm bankruptcy plans. Similarly, nonconsensual third-party releases permit a majority of creditors to accept a compromise with a third party that would not be achievable if individual creditors were able to opt out.

Although the Second Circuit reversed Judge McMahon's primary holding that nonconsensual third-party releases are not permitted by the Bankruptcy Code, it agreed with her ruling that that any plan containing nonconsensual third-party releases must be finally approved by the district court (not just the bankruptcy court). This clarification provides an additional guardrail against potential abuse of nonconsensual third-party releases and is consistent with the special bankruptcy provisions dealing with asbestos liability.

Finally, we are pleased that the Second Circuit largely adopted the standard that we proposed in the amicus brief we filed on behalf of our client, The Association of the Bar of the City of New York (Committee on Bankruptcy and Corporate Reorganization). The Court articulated seven factors to guide future courts in evaluating the propriety of granting nonconsensual third-party releases:

1. Whether there is an identity of interest between the debtor and the released parties;

2. Whether there is factual and legal overlap between claims against the debtor and the settled third-party claims;
3. Whether the releases are essential to the reorganization;
4. Whether the releases are proper in scope;
5. Whether the released party made a substantial contribution to the reorganization;
6. Whether the plan containing the releases was overwhelmingly approved by creditors; and
7. Whether the payment in respect of enjoined claims is fair.

The fact that the Second Circuit has approved the permissibility of nonconsensual third-party releases does not mean that they are appropriate in every case. Judge Wiles of the U.S. Bankruptcy Court for the Southern District of New York recently made that point in the *Aegean Marine Petroleum Network* case, where he stated that "third-party releases are not a merit badge that somebody gets in return for making a positive contribution for a restructuring," nor are they a "participation trophy" or a "gold star for doing a good job." While approving the releases in *Purdue Pharma*, the Second Circuit endorsed, and quoted, Judge Wiles's observation.

In bankruptcy, a resolution that is satisfactory to a majority of the claimants is far preferable to endless litigation, even if the outcome isn't perfect. As the Second Circuit aptly puts it in the opening line of its opinion: "Bankruptcy is inherently a creature of competing interests, compromises and less-than-perfect outcomes." Grants of nonconsensual third-party releases will still require a careful balancing of the equities and specific findings from the bankruptcy court, but the fact that the Second Circuit has confirmed that this important tool is available in appropriate cases is a positive development in bankruptcy law.

¹ Notwithstanding this case law, the Fifth Circuit's decision in *In re Pacific Lumber Co.* suggested in dicta that third party releases may be appropriate in the context of a mass tort bankruptcy.

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