# Third-Party Nondebtor Releases for "Bankruptcy Grifters": A Response to Professor Simon

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## 1. Introduction

It is a great honor to participate in this celebration of the tenth anniversary of the Netherlands Association of Comparative and International Insolvency Law. Prof. Dr. Rolef de Weijs is to be congratulated for choosing such a timely and fascinating topic for this year's program: third-party (or nondebtor) releases.

I have been writing about third-party releases for the past 25 years, and I have been one of the most persistent and vocal critics of the practice. Nondebtor-release practice is receiving considerable renewed attention in the U.S. now because of a number of very high-profile mass-tort bankruptcies, such as the Boy Scouts of America, USA Gymnastics, and various Catholic diocese cases (all involving large-scale sexual abuse claims) and the Purdue Pharma and Mallinckrodt opioid cases. In each of those cases, various nondebtor parties have used or are using the bankruptcy filing of a corporate debtor to try to have their own liability, for their own alleged misconduct, discharged, by making whatever the bankruptcy court ultimately signs off on as a sufficiently "substantial" contribution to a settlement fund.

That practice is receiving very critical coverage in the popular press, and legislation has been introduced in the U.S. Congress that would prohibit nonconsensual nondebtor releases. In addition, there was a very dramatic and sensational development in December 2021 in the *Purdue Pharma* case. Purdue, which was owned and managed by the Sackler family, manufactured the opioid OxyContin. The bankruptcy court presiding over Purdue's reorganization proceedings confirmed a plan of reorganization in September 2021 that released the Sacklers from any personal liability to opioid claimants, in exchange for their multibillion-dollar contribution to a settlement fund.[1] On appeal, though, a federal district court in New York

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

vacated the confirmation order and, at least temporarily, blew that deal up, holding that the bankruptcy court had no authority to approve the liability releases for the Sacklers.[2] That decision has been further appealed to the Second Circuit Court of Appeals, which has heard oral argument, but has not yet issued a decision. Regardless of how the Second Circuit rules, though, many expect the case to go up to the U.S. Supreme Court, because there is a long-standing disagreement in the lower court as to whether nondebtor releases are permissible (outside of the kinds of asbestos cases in which the U.S. bankruptcy statute explicitly authorizes some kinds of nondebtor releases).

My article excerpted in the NACIIL meeting materials[3] is a response to Professor Lindsey Simon's "Bankruptcy Grifters" article in the *Yale Law Journal*.[4] There is no disagreement between Simon and me about whether bankruptcy grifting is a good or a bad development, in general. We both agree that it is a very significant systemic problem. Our only disagreement is what to do about it.

We also agree regarding the pivotal end-game relief that makes bankruptcy grifting possible, which is so-called nonconsensual third-party or nondebtor "releases" and channeling injunctions that give nondebtor defendants, who have not filed bankruptcy themselves, the equivalent of a discharge from all of their mass-tort liability. That nondebtor discharge is accomplished through the so-called "release" approved by the bankruptcy court, which parallels the debt discharge that a bankruptcy debtor receives through the bankruptcy process, complete with a permanent injunction prohibiting the mass-tort plaintiffs from thereafter suing the released nondebtors. That nondebtor discharge effectively forces the mass-tort plaintiffs to pursue their claims solely through the bankruptcy process, against a settlement pot comprised of the bankruptcy debtor's assets that go into the settlement pot, plus amounts paid by the released nondebtors into the settlement pot in exchange for their "releases."

Simon is of the view that nondebtor-release practice is so entrenched at this point that it is futile to try to prohibit it. In addition, she does not seem to be convinced that an outright prohibition on nonconsensual nondebtor releases is appropriate. Thus, she proposes helpful reforms to nondebtor-release practice.

My Response to Simon's proposed reforms pushes at both of the

[2] *In re Purdue Pharma, L.P.*, 635 B.R. 26 (S.D.N.Y. 2021).
[3] Ralph Brubaker, *Mandatory Aggregation of Mass Tort Litigation in Bankruptcy*, 131 Yale L.J.F. 960 (2022).
[4] Lindsey D. Simon, *Bankruptcy Grifters*, 131 Yale L.J. 960 (2022).

premises for those proposals, because I hold a more extreme view of nondebtor-release practice. As a normative policy matter, I believe there should be a flat prohibition on nonconsensual nondebtor releases, which is the view I articulated in a book-length law review article 25 years ago,[5] and I believe that subsequent developments have made the case for a flat prohibition even stronger. I have also not given up on the feasibility of a flat prohibition. On that score, and somewhat ironically, all of the renewed attention that nondebtor releases are receiving (which Simon's *Bankruptcy Grifters* article has actually helped fuel) may well increase the chances that the U.S. Supreme Court will finally take up the issue and decide whether nonconsensual nondebtor releases are permissible under existing law.[6]

I have discussed that legality question elsewhere and at length.[7] For the purposes of this discussion, then, I want to focus on the normative policy question and why I believe there should be a flat prohibition on nonconsensual nondebtor releases. First, though, I need to provide some contextual background, starting with a basic taxonomy of the various kinds of bankruptcy releases. A brief description of resolution of mass torts outside of bankruptcy is also in order, because it makes clear why nonconsensual nondebtor releases are so controversial and, in my opinion, normatively indefensible.

## 2. Uncontroversial Nondebtor Releases

To set the stage for my discussion of the most controversial kinds of releases (and injunctions that implement them), it is helpful to distinguish them from those releases and implementing injunctions that are not at all controversial.

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[5] Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. Ill. L. Rev. 959 (1997).

[6] Indeed, I think it is highly likely that all of the public furor over nondebtor releases contributed to the New York district court's ruling in the *Purdue Pharma* case, cited and discussed *supra* note 2 and accompanying text, in which the court took a fresh look at the nondebtor-release practice that has taken hold over the past 30 years, and ultimately came to the conclusion (which I believe is correct) that nondebtor-release practice is not only extremely troubling but also illegitimate and unlawful. That was a very shocking decision that few (if any) anticipated, not least because that same judge had said exactly the opposite in a different case only a few years earlier: that nonconsensual nondebtor releases are permissible. *See In re Kirwan Offices S.à.R.L.*, 592 B.R. 489, 511 (S.D.N.Y. 2018), *aff'd*, 792 F. App'x 99 (2d Cir. 2019).

[7] *See, e.g.*, Brubaker, *supra* note 3, at 966-986; Brubaker, *supra* note 5, at 1028-1080; Ralph Brubaker, *Nondebtor Releases and Injunctions in Chapter 11: Revisiting Jurisdictional Precepts and the Forgotten* Callaway v. Benton *Case*, 72 Am. Bankr. L.J. 1 (1998) [hereinafter Brubaker, *Nondebtor Release Jurisdiction*].

There is clearly authority for the bankruptcy estate's representative, be it a trustee or Chapter 11 debtor-in-possession, or even a creditors' committee if authorized to pursue claims on behalf of the estate, to compromise claims and causes of action belonging to the estate and give the defendants a release of those settled claims. The bankruptcy court can approve those settlements, and the U.S. bankruptcy statute expressly provides that the terms of such a settlement can be incorporated into a debtor's plan of reorganization.[8]

That kind of settlement and corresponding release of claims belonging to the bankruptcy estate includes causes of action that individual creditors or shareholders could pursue outside bankruptcy. For example, fraudulent conveyance claims are claims assertable by individual judgment creditors outside bankruptcy. When the debtor who allegedly made a fraudulent transfer files bankruptcy, however, the U.S. bankruptcy statute gives those state-law fraudulent transfer claims to the debtor's bankruptcy estate to pursue on behalf of all creditors.[9] A bankruptcy filing, therefore, preempts individual creditors' fraudulent conveyance claims, which are stayed once the debtor files bankruptcy, and the estate representative thereafter has exclusive authority to prosecute and (with bankruptcy-court approval) settle that cause of action.[10]

The same is true for corporate derivative suits that individual shareholders could prosecute outside bankruptcy, for example, against corporate officers and directors for breach of their fiduciary duties. Once the corporation files bankruptcy, though, that cause of action belongs to the estate; any nonbankruptcy suit on it is stayed; and the bankruptcy process determines the fate of that cause of action.[11]

Another uncontroversial category of releases, which is very similar to the one just discussed, are those releases that prevent individual creditors from pursuing or interfering with the estate's property rights, for example, the estate's insurance policies that provide proceeds to cover claims against the debtor. There are various and sundry nonbankruptcy state laws that permit individual claimants whose claims are covered by insurance to bypass the insured and seek to collect insurance proceeds directly from the insurer. Liability insurance policies and their proceeds, however, are property of the estate when the insured files bankruptcy, so individual creditors' suits and

[8] 11 U.S.C. § 1123(b)(3)(A); *see Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414 (1968).
[9] 11 U.S.C. § 544(b)(1).
[10] *See* Charles Jordan Tabb, Law of Bankruptcy § 3.6, at 259 (5th ed. 2020).
[11] *See* Ralph Brubaker, *The Fundamental (and Limiting) Status Quo Function of Bankruptcy's Automatic Stay*, 41 Bankr. L. Letter No. 2, at 1, 9 (February 2021).

other actions that attempt to recover policy proceeds from the insurer are stayed.

Moreover, to fund a plan of reorganization, a Chapter 11 debtor-in-possession may strike a deal with the insurance company to simply pay out the policy limits to the estate. And, of course, the estate's corresponding commitment in that settlement is to fully release the insurer from any further claims under the policy, which is property of the estate. Indeed, that was the court's rationale in the seminal 1988 decision approving the insurance injunction in the Johns-Manville massive asbestos-liability bankruptcy.[12] Such insurance injunctions are clearly permissible and should not be at all controversial.

There is a very similar *in rem* property-of-the-estate rationale for injunctions protecting purchasers in a bankruptcy sale of the debtor's business from creditors' claims for successor liability and for injunctions protecting individual partners from creditor claims of personal liability for partnership debts in the bankruptcy proceedings of the partnership.[13] Also relatively uncontroversial are injunctions protecting defendants who settle with the estate against later claims for indemnity or contribution by nonsettling codefendants.[14]

The *only* nondebtor, third-party claims for which releases are controversial are *direct* claims by individual creditors or shareholders against a nondebtor third party for that nondebtor's own conduct that gives rise to a cause of action belonging to those individual creditors or shareholders. A common example of such a direct claim by an individual creditor or shareholder is an allegation that certain individuals within the debtor corporation or in other entities (such as affiliates, insurers, or other creditors) personally participated in fraud or other tortious misconduct that injured the creditor or shareholder and that gives that creditor or shareholder a cause of action directly against that tortfeasor for their own tortious conduct.

That tort cause of action does not belong to the debtor's bankruptcy estate; it belongs to the individual creditor or shareholder personally. Consequently, the debtor's estate and its fiduciary representatives have no authority whatsoever to prosecute that cause of action belonging to the

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[12] *See In re Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988); *see generally* Ralph Brubaker, *Supreme Court Validates "Clarified"* Manville *Insurance Injunction: Channeling ... and So Much More!*, 29 Bankr. L. Letter No. 8, at 1 (August 2009).

[13] *See* Brubaker, *supra* note 5, at 962 n.3.

[14] *See, e.g., In re Munford, Inc.*, 97 F.3d 449 (11th Cir. 1996); *see generally* Ralph Brubaker, *An Incipient Backlash Against Nondebtor Releases? (Part I): The "Necessary to Reorganization" Fallacy*, 42 Bankr. L. Letter No. 2, at 1 (February 2022).

individual creditor or shareholder (rather than the estate).[15] Ergo, the debtor's estate and its fiduciary representatives also have no authority to compromise that claim belonging to the individual creditor or shareholder.

With respect to those kinds of direct third-party nondebtor claims, the bankruptcy court clearly has some injunctive powers. For example, the U.S. Supreme Court has held that a bankruptcy court has the power to temporarily stay the prosecution of third-party nondebtor claims in order to facilitate an orderly and expeditious reorganization for the debtor.[16] In addition, all courts seem to agree that if an individual creditor or shareholder consents to a release or compromise of its third-party nondebtor claim, then the bankruptcy court can approve that consensual release.[17]

## 3. Nonconsensual Nondebtor Releases

The *only* controversial "releases," then, are nonconsensual nondebtor releases of creditors' and shareholders' *direct* third-party nondebtor claims that bind all creditors and shareholders, whether they have consented or not, and even over their express objections, the same way the debtor's bankruptcy discharge binds all creditors and shareholders with respect to their claims against and interests in the debtor. Why are those releases so controversial? And why do I think a flat prohibition on nonconsensual nondebtor releases is the better response to the bankruptcy grifter problem from a normative policy perspective?

In thinking about those questions, it is important to recognize that the distribution and discharge scheme for nondebtors that is effectuated via nonconsensual nondebtor releases departs from bankruptcy norms for distribution and discharge in all sorts of ways, like allowing released individuals to discharge debts for fraud or intentional torts and punitive damages that they could not discharge if they were to actually file bankruptcy. And remedying some of the most significant departures from bankruptcy norms seems to be the principal objective of Simon's proposed reforms.

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[15] *See Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972).

[16] *See Celotex Corp. v. Edwards*, 514 U.S. 300 (1995); *see generally* Brubaker, *Nondebtor Release Jurisdiction*, *supra* note 7, at 22-47, 59.

[17] The only bone of contention is what action (or inaction) by a creditor or shareholder is a sufficient indication of consent to the release. For example, is doing nothing to affirmatively opt out of a proposed release properly considered consent to that release? If the necessary consent is given, though, binding a creditor or shareholder to a settlement and release to which the creditor or shareholder has freely consented is also not at all controversial. *See, e.g.*, *In re Specialty Equip. Cos.*, 3 F.3d 1043, 1045-1047 (7th Cir. 1993).

Even more importantly, though, given that released nondebtors have *not* filed bankruptcy and that many (if not most or even all) of them could not or would never even consider actually filing bankruptcy, not least because many are eminently solvent notwithstanding their mass-tort exposure, nonconsensual nondebtor releases also violate fundamental, immutable *nonbankruptcy* norms for effectuating aggregate settlements of mass-tort liability.

Consider, for example, plaintiffs' mass-tort claims against a solvent nondebtor, such as a codefendant with the debtor who is an alleged joint tortfeasor, or even a *principal* tortfeasor on torts for which the corporate debtor, as employer/principal, is only *vicariously* liable for the tortious conduct of the corporation's employees/agents. What nonconsensual nondebtor releases allow such a released nondebtor to do is impose a mandatory no-opt-outs settlement of the nondebtor's mass-tort liability on all plaintiffs, whether they all agree to the settlement or not.

Note in particular, then, that the mandatory settlement that nondebtor releases impose on nonconsenting plaintiffs is, necessarily, a settlement negotiated and agreed to by someone else – that is, someone other than the claimants on whom the settlement is imposed. Thus, it is a kind of representational settlement, like a class action, and those kinds of representative litigation and settlement processes have the potential to violate individual claimants' most fundamental substantive and procedural rights, in all sorts of ways. Those rights are preserved and protected in the United States via the due process guarantees enshrined in the U.S. Constitution. And the U.S. Supreme Court has an extensive jurisprudence on the constitutional due process rights of individual claimants, in order for such a representational settlement process to be valid. Most significantly, there is a long line of decisions regarding the right of individual claimants to "opt out" of the representative process (at least for the kinds of damages claims that are settled via nonconsensual nondebtor release) and pursue their individual claims on their own.[18]

The normative policy question that poses is this: given that there is no permissible nonbankruptcy process for a solvent defendant[19] to impose a mandatory no-opt-outs settlement of its mass-tort liability on claimants, why should there be such a process only when a codefendant has filed bankruptcy? There must be something about *the debtor's* bankruptcy filing that justifies having a mandatory no-opt-outs settlement process for these claims (against

[18] *See* Ralph Brubaker, *Assessing the Legitimacy of the "Texas Two-Step" Mass-Tort Bankruptcy*, 42 Bankr. L. Letter No. 8, at 1, 8-9 (August 2022).
[19] And perhaps even for an insolvent defendant. *See id.*

*a nondebtor*) that does not and cannot exist in the absence of the debtor's bankruptcy filing.

The standard justification that is given is that the nondebtor-release settlement is "necessary" or "essential" to successful reorganization of the debtor. And, of course, one of the distinctive and prominent policy justifications for having a Chapter 11 corporate reorganization process is an overt policy and preference in favor of reorganizing operating businesses, rather than shutting them down and liquidating them. Not only may reorganization bring more aggregate value to the debtor's creditors, but it can also produce various collateral benefits, for example, to the employees of the business who keep their jobs, for the communities in which the business operates, etc. *If* a mandatory nondebtor-release settlement were, in fact, necessary to keep a debtor's business operating, then that could supply a compelling normative justification for a mandatory no-opt-outs settlement of a nondebtor's mass-tort liability to claimants. Indeed, the most critical stated requisite, as formulated by the courts, is that a nonconsensual nondebtor release can be approved only to the extent it is necessary or essential to the debtor's successful reorganization.

As applied by the courts, though, that "necessity" standard (that I have elsewhere dubbed the "necessity" fiction[20]) does *not* mean that if nonconsensual nondebtor releases were prohibited and simply unavailable, the debtor would have to shut down its business and liquidate. As applied, it merely means the nonconsensual nondebtor release is necessary or essential to the complex series of compromises embedded in the proposed plan of reorganization. In other words, the "necessity" case is (always): "Your honor, the nonconsensual nondebtor release is necessary to do this particular deal, and if you do not approve the release, this deal will fall apart."

But *all* Chapter 11 reorganizations involve a series of compromises over any number of things. That is what Chapter 11 is – a structured negotiation framework. Consequently, if nonconsensual nondebtor release deals are permissible, and if the necessary to "reorganization" standard for approval is nothing more than necessary to "do the deal," then that is a nonstandard. It is simply a negotiating script for nondebtors. The predictable negotiating position of nondebtors who have something to contribute that the debtor's bankruptcy estate and its representatives want, like a large contribution to a settlement fund for payment of mass-tort claimants, will be: "Look, a nonconsensual nondebtor release is an absolute deal-breaker condition for me to contribute anything. The only way we can do a deal is if

[20] *See* Brubaker, *supra* note 3, at 986-992.

I get a nonconsensual release of all my mass-tort exposure."

"Necessary to reorganization," then, because it means nothing more than necessary to do this deal, does not supply any unique bankruptcy justification at all for allowing nondebtors to impose a mandatory no-opt-outs settlement on nonconsenting claimants. It is just a negotiating position that says nothing about the ability to successfully reorganize the debtor if nonconsensual nondebtor releases were prohibited and unavailable. It supplies no legitimate justification for permitting a mandatory no-opt-outs settlement of a nondebtor's mass-tort liability *only* when a codefendant has filed bankruptcy.

## 4. Conclusion

If mandatory no-opt-outs settlement of solvent defendants' mass-tort liability is a good idea, then it should be available as a matter of nonbankruptcy law. And that reasoning, of course, is a classic "creditors' bargain" approach to this problem. Indeed, the bankruptcy grifter phenomenon that Simon documents is a vindication of at least one aspect of creditors' bargain theory, which predicts that if we dramatically change parties' substantive rights in bankruptcy, the inevitable result will be forum shopping, whereby parties opt for the bankruptcy forum *solely* to take advantage of the rule change in bankruptcy and *not* because there is a good bankruptcy reason for sorting out the parties' rights in bankruptcy.[21] And that kind of forum shopping into bankruptcy seems to be precisely what we are now witnessing with mass-tort litigation and the bankruptcy grifter phenomenon – a migration of mass-tort litigation against nondebtor codefendants out of the tort system and into the bankruptcy system, because the bankruptcy system is the only place where those codefendants can impose a mandatory no-opt-outs settlement of their mass-tort liability on nonconsenting plaintiffs.

[21] *See* Thomas H. Jackson, The Logic and Limits of Bankruptcy, Harvard Univ. Press, Cambridge, Mass, 21-27, 33, 45-46, 193-201 (1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 100-101, 103-104 (1984).