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The Way Is Shut: Nondebtor Release Legislation Proposes Mandatory Dismissal on Account of Pre-Bankruptcy Liability Management Transactions

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Third-party, or nondebtor, releases have continued to attract attention from both commentators and legislators in the wake of recent cases such as *Purdue Pharma LP, Boy Scouts of America* and *USA Gymnastics*. Most recently, Senators Elizabeth Warren (D-Mass.), Dick Durbin (D-Ill.) and Richard Blumenthal (D-Conn.), and Representatives Jerrold Nadler (D-N.Y.) and Carolyn B. Maloney (D-N.Y.), have introduced the **Nondebtor Release Prohibition Act of 2021** (the "NRPA") aimed at limiting, if not prohibiting entirely, the use of third-party releases in such cases.[1]

If enacted, however, the NRPA would go well beyond the "limited" scope suggested by its name. Instead, the NRPA will materially affect not only the availability (or not) of third-party releases in bankruptcy, but also substantially restrict access to the bankruptcy courts for corporate debtors. In particular, the NPRA proposes to:

- via Section 4, force the **dismissal** of any chapter 11 bankruptcy when the debtor engaged in a transaction that had the "***foreseeable effect*** of separating material assets from material liabilities . . . and assigning or allocating all or ***a substantial portion*** of those liabilities to the debtor" in the ***10 years prior to the bankruptcy filing***;

- severely curtail a bankruptcy court's ability to stay or enjoin litigation against a nondebtor even if that litigation impairs a corporate debtor's ability to reorganize; and

- of course, effectively ban all nondebtor releases in chapter 11 bankruptcies by requiring the express written consent of each and every releasing party.

At the risk of understatement, legislation that mandates dismissal for a 10-year lookback on account of any transaction that had the "foreseeable effect" (as opposed to even a "reasonably foreseeable effect") of separating assets from liabilities will fundamentally change corporate decision-making and bankruptcy practice. And, while the legislative process for the NRPA remains in its early stage, investors and practitioners should be keenly focused on the extent to which the NRPA proceeds through Congress in its present form.

Third-Party Releases

Generally, a plan of reorganization governs the distribution of the assets of the bankruptcy estate and discharge of claims against the debtor. A "debtor release," or the release of claims otherwise held by the debtor's estate against third parties, is often (but not always) included in such plans.[2] Less common and often challenged are "nondebtor" or "third party" releases, which, as the name suggests, are releases granted to persons or entities other than the debtor by third parties, including the debtor's creditors. These third-party releases can be an effective and, indeed, necessary tool to maximize value in complex chapter 11 cases. For example, such third-party releases can facilitate and incentivize substantial

[1] The full text of the NRPA, as introduced, is reproduced here.
[2] *See* 11 U.S.C. § 1123(b)(5)(A).

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contributions to the bankruptcy estate that benefit a debtor's creditors and drive valuable settlements without the cost or delay attendant to potentially catastrophic litigation.[3]

Third-party releases typically come in two varieties: (i) "consensual" third-party releases, when the third party grants the release in some form or fashion by consenting or being deemed to consent, and (ii) "nonconsensual" third-party releases, when the third party grants the release regardless of whether (or not) the third party actually consents or intends to release such claims, and even when such third party expressly objects to giving the release. Federal circuit courts are split on the propriety of nonconsensual third-party releases and a court's power to grant them,[4] and recently, nonconsensual third-party releases have attracted public attention for their use in the mass tort context where express consent is impossible or at least impractical.[5]

NRPA Section 2 seeks to resolve this controversy by adding a new Section 113 to the Bankruptcy Code that would provide for an outright prohibition of nonconsensual third-party releases. Proposed Section 113 provides that a court may not approve any provision in a plan of reorganization or otherwise, or issue an order for, the discharge, release, termination, or modification of any liability related to the claim of a third party against another third party unless the releasing third-party claimholder expressly consents[6] in a signed writing after being given clear and conspicuous notice.[7]

Third-Party Litigation and the "10-Year Lookback"

While commentary around the NRPA has focused almost exclusively on its proposed treatment of third-party releases, the most dramatic implications actually stem from Section 2's limitation on a bankruptcy court's ability to temporarily stay or enjoin third-party litigation and Section 4's mandatory dismissal of corporate debtors that are the product of divisional mergers.

In addition to banning nonconsensual third-party releases, Section 2 provides that any court order temporarily staying or enjoining any third-party action against another third party cannot last longer than 90 days unless an appeal of such order is dismissed or affirmed within such period regardless of the impact that litigation might have on the debtor's ability to reorganize or obtain value for stakeholders. A fundamental principle of bankruptcy policy is to provide debtors a "breathing spell" from the pressures precipitating a bankruptcy, such as related third-party litigation, which bankruptcy

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[3] *See, e.g.*, *In re Drexel Burnham Lambert Group, Inc.,* 960 F.2d 285, 292 (2d Cir. 1992) ("The Settlement Agreement [containing a third party injunction] is unquestionably an essential element of [the debtor's] ultimate reorganization.").

[4] *Compare, e.g.*, *In re Millennium Lab Holdings II, LLC,* 945 F.3d 126, 140 (3d Cir. 2019) (holding that "the bankruptcy court was constitutionally authorized to confirm the plan in which [nonconsensual third party release] provisions appeared") *with In re Lowenschuss*, 67 F.3d 1394, 1401 (9th Cir. 1995) ("[The Ninth Circuit] has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors.") (citations omitted).

[5] *See* Jan Hoffman, *Purdue Pharma Is Dissolved and Sacklers Pay $4.5 Billion to Settle Opioid Claims*, THE NEW YORK TIMES (Sept. 1, 2021), https://www.nytimes.com/2021/09/01/health/purdue-sacklers-opioids-settlement.html; Jonathan Randles, *Purdue Pharma Bankruptcy Plan Approved, Freeing Sacklers From Lawsuits*, THE WALL STREET JOURNAL (Sept. 1, 2021), https://www.wsj.com/articles/purdue-pharma-bankruptcy-plan-approved-freeing-owners-from-lawsuits-11630528636; Tom Hals & Mike Spector, *Judge will approve Purdue Pharma bankruptcy plan that shields Sacklers*, REUTERS (Sept. 1, 2021), https://www.reuters.com/business/healthcare-pharmaceuticals/judge-rule-purdue-pharma-bankruptcy-plan-that-shields-sacklers-2021-09-01/.

[6] The NRPA provides that consent may not be given by accepting a proposed plan, failing to reject a proposed plan, or any other silence or inaction, or giving treatment more or less favorable to a nondebtor claimholder for consenting or failing to consent.

[7] Proposed exceptions to the NRPA's prohibition of nondebtor releases include a court's power to: (i) authorize a sale of assets free and clear of claims or interest; (ii) prevent a nondebtor from exercising control over the property of the estate; (iii) bar a claim for indemnity or reimbursement when the nondebtor claimholder may also be liable; (iv) hear and decide claims under 28 U.S.C. §§ 157(a) or 1334(b); and (v) enjoin actions against court-appointed or employed entities for acts or omissions related to such appointment or employment.

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courts have temporarily stayed on occasion in the interest of facilitating a debtor's reorganization efforts.[8] By fixing a 90-day limit, Section 2 has the potential to severely undercut any meaningful restructuring efforts in such cases before they even take place.

NRPA Section 4 is even more sweeping in effect. Section 4, in its current form, would amend Section 1112 of the Bankruptcy Code by forcing a court to dismiss any chapter 11 case when the debtor or its predecessor was "***the subject of***, or was formed or organized in connection with a divisional merger or equivalent transaction" that had the "intent or ***foreseeable effect***" of separating material assets and liabilities and then allocating "all or ***a substantial portion*** of those liabilities to the debtor." And, as noted above, the relevant timeframe applicable to this lookback is the ***10 years prior to the bankruptcy filing***.

Section 4 is simply breathtaking in scope. By its terms, it applies to any transaction that had the "foreseeable effect" of assigning a "substantial portion" of liability to a debtor—*i.e.*, a transaction need not have been intended to allocate liabilities to the debtor; the debtor need only have been the "subject of" such a transaction. And with the 20/20 lens typically applied in hindsight, practically any transaction may presumably be characterized as "foreseeable." Nor does a bankruptcy court have any discretion under Section 4. Dismissal is mandatory when its elements have been met. At core, then, it would seem that any debtor that was the "subject of" any internal restructuring, reorganization, division, separation, merger, combination, spinoff, or carve-out will be at risk for the mandatory dismissal of its bankruptcy case on account of practically any such transaction that occurred in the decade before its bankruptcy filing.

At the risk of understatement, the wide-ranging reach of this provision seems to fundamentally contradict the public policy favoring ready access to the bankruptcy courts[9] by, in its present form, proposing to radically limit such access. It remains to be seen how Section 4, in particular, and the NRPA, in general, will proceed in the legislative process.

Ropes & Gray will continue to monitor developments around the NRPA, and we encourage you to contact your Ropes & Gray team to discuss these important matters more fully.

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[8] *See, e.g.*, *Queenie, Ltd. v. Nygard Intern.*, 321 F.3d 282, 287–88 (2d Cir. 2003) ("The automatic stay can apply to non-debtors . . . when a claim against a non-debtor will have an immediate adverse economic consequence for the debtor's estate.") (citing *McCartney v. Integra National Bank North,* 106 F.3d 506, 510–11 (3d Cir. 1997); *Johns–Manville Corp. v. Asbestos Litigation Group (In re Johns–Manville Corp.),* 26 B.R. 420, 435–36 (Bankr. S.D.N.Y. 1983); *A.H. Robins Co. v. Piccinin,* 788 F.2d 994, 999 (4th Cir. 1986)).

[9] *See, e.g.*, *In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 265 (Bankr. D. Del. 2016) (holding that "a provision in a limited liability governance document obtained by contract . . . [that] eviscerate[d] the right of [an] entity to seek federal bankruptcy relief . . . is void as against public policy"); *In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899, 914 (Bankr. N.D. Ill. 2016) ("[C]onsent required in order for Debtor to petition for bankruptcy relief is [] unenforceable [] as a matter of . . . bankruptcy law.").

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