August 2, 2021

CONGRESSIONAL COMMITTEES PROPOSE CHANGES TO BANKRUPTCY CODE PROHIBITING NON-CONSENSUAL RELEASES OF THIRD PARTIES AND LIMITING OTHER IMPORTANT BANKRUPTCY TOOLS

To Our Clients and Friends:

On July 28, 2021, certain Democratic members of Congress, primarily in response to the $4.325 billion contribution made by the Sackler family to fund the settlement underpinning Purdue Pharma's chapter 11 plan, introduced the *Nondebtor Release Prohibition Act of 2021* (the "NRPA"), which proposes to amend the Bankruptcy Code to (i) prohibit the use of non-consensual third party releases in chapter 11 plans, (ii) limit so-called "Section 105" injunctions to stay lawsuits against third parties to a period no greater than 90 days after the commencement of a bankruptcy case, and (iii) provide a ground for dismissing a bankruptcy case commenced by a debtor that was formed within 10 years prior to such case via a divisional merger that separated material assets from liabilities.

The proposed elimination of the important bankruptcy tools of non-consensual third party releases and Section 105 injunctions – each of which is extraordinary in nature and only permitted in the rarest of circumstances – is a blunt force measure that threatens to vitiate the longstanding bankruptcy policy of favoring settlements over interminable value-destructive litigation. Moreover, the loss of these tools may cause inequitable disruption in currently pending cases and stymie the implementation of critical creditor-supported strategies to resolve the most difficult cases going forward. Additionally, while the disincentive against divisional mergers would affect a far more limited set of cases, it appears that the harm raised by some divisional mergers that are followed by bankruptcy may be adequately addressed through clarifying the applicability of fraudulent transfer law to challenge these transactions.

I. Bankruptcy Tools Impacted by the Proposed Legislation

At the heart of corporate chapter 11 bankruptcies are an array of tools that serve to preserve the value of a debtor's estate for the benefit of all stakeholders. Certain tools promote the "breathing spell" necessary for a debtor to formulate and propose a plan, while others, such as the power to reject executory contracts, allow debtors to restructure their operations to emerge from bankruptcy stronger and with greater prospects to succeed than when it filed for bankruptcy.

a. Non-Consensual Third Party Releases

Non-consensual releases of third parties are not common and typically arise as a provision in a chapter 11 plan in which the release of the applicable third party in question is essential to a reorganization in light of, among other considerations, the identity of interest of such third party and the debtor and the substantial economic contribution made to the chapter 11 plan by such third party.

Section 105 of the Bankruptcy Code is often cited as a statutory basis for such releases. Section 105 permits a bankruptcy court to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code.

These releases are distinct from voluntary releases that are commonly featured in corporate chapter 11 plans, whereby creditors are given an opportunity to "opt out" of such releases. A key contextual distinction between these two types of releases is that in the rarer instances in which non-consensual third party releases are sought, the economic contribution of the released third party is so substantial and vital to a chapter 11 plan as to require as a condition to such contribution that all claims against such third party be released, without regard to whether a subset of holdout creditors desire not to provide the release.

Currently, there is a federal circuit split among the courts that have ruled on the permissibility of non-consensual third party releases in connection with a chapter 11 plan. Notably, the Ninth and Tenth Circuits prohibit such releases, while the Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits permit such releases, with the Fifth Circuit taking a more restrictive approach short of a flat prohibition.

In the circuits where non-consensual third party releases are permitted, a debtor must satisfy a high evidentiary bar to obtain approval of such releases. The factors a bankruptcy court must consider in such circuits include (i) the identity of interests between the debtor and the third party, such that a suit against the non-debtor is akin to a suit against the debtor due to, for example, an indemnity obligation that may deplete the debtor's assets; (ii) whether the non-debtor has contributed substantial assets to the reorganization; (iii) whether the release is essential to reorganization; (iv) whether the impacted classes of claims have overwhelmingly accepted the plan in question; and (v) whether the bankruptcy court has made a record of specific factual findings to support such releases.

The application of this standard typically requires the released third party to make a substantial financial contribution to a chapter 11 plan, which, in turn, has received extensive creditor support. In essence, these releases serve as an integrated component of a comprehensive economic settlement of claims accepted widely by the creditor body and without which a debtor likely could not reorganize.

Notably, the American Bankruptcy Institute's exhaustive 2014 report and recommendations on bankruptcy reform recommended the use of non-consensual third party releases based on a consideration of the above-referenced fact-intensive standard and discouraged the imposition of a blanket prohibition against such releases.

b. Injunctions Against Third-Party Lawsuits

Similar to non-consensual third party releases, bankruptcy courts have used their authority under Section 105 of the Bankruptcy Code to preliminarily stay lawsuits against third parties in furtherance of the debtor's reorganizational efforts. These injunctions constitute extraordinary relief and thus are not routine in corporate chapter 11 cases.

When such injunctions are requested, a debtor must satisfy a multi-factor standard that in most jurisdictions requires consideration of the likelihood of a successful reorganization, the balance of harms,

and the public interest in the injunction. These injunctions are typically limited to 60 to 90 days, but have been of longer duration in certain limited cases. For example, the Section 105 injunction in the Purdue Pharma case enjoining litigation against the Sacklers has persisted for a longer period given the central role such injunction has played in fostering the global multi-billion dollar settlement that was ultimately reached.

II. Commentary

While the NRPA may be the product of valid frustrations some parties may have experienced in certain contentious and emotionally charged bankruptcy cases, its passage will likely do more harm than good.

Implicit in the testimony supporting passage of the NRPA is the premise that litigation against third parties should be preserved in all cases despite substantial creditor support that may otherwise exist for the settlement of such claims and the resulting emergence of the debtor from chapter 11. Eliminating the judicial discretion available in certain jurisdictions to implement this tool and elevating the rights of holdout creditors in its stead could lead to value-destructive liquidation outcomes in difficult cases that could otherwise be salvaged through settlements supported by a supermajority of the creditor body that include non-consensual releases of contributing third parties.

The NRPA's policy preference for preserving litigation claims against third parties who may play a role in plan formulation means that, in cases where a financial contribution is no longer viable due to such mandatory preservation of litigation claims, tort claimants may receive less of a recovery than they would have under the current state of the law and possibly no recovery at all in many cases.

When viewed against the backdrop of current complex chapter 11 practice, this proposed legislation is misguided and elevates the interests of a minority of creditors in contravention of the vaunted bankruptcy principle of binding intransigent holdout creditors through supermajority support for a chapter 11 plan.

Moreover, the bankruptcy tool of preliminary "Section 105" injunctions similarly must satisfy a high evidentiary bar, and bankruptcy courts in practice do not grant these injunctions lightly. These injunctions, which stay suits against individuals and entities that are vital to ongoing reorganization efforts, serve a valuable function in providing the debtor with a limited temporal window within which to negotiate comprehensive settlements with protected parties and, thereby, maximize the chances of a successful reorganization. These injunctions are usually relatively short in duration and subject to dissolution in the event the ultimate reorganization purpose underpinning them is no longer being served.

The NRPA's disincentivizing of divisional mergers, such as are available under Texas law, is a creative attempt at curbing a perceived abuse in a limited subset of cases. Contrary to the rhetoric of the bill's supporters, such divisional mergers, which are actually more akin to reverse mergers, are not exclusively followed by bankruptcy and have independent purposes under state law, which include providing a measure of successor liability protection to entities implementing such mergers.

Notably, a divisional merger is not the only means of corporate separation. Companies frequently separate assets and liabilities in corporate "spinoffs" and "splitoffs." Indeed, when these types of separation transactions are followed by bankruptcy, they have frequently come under vigorous attack. In

such cases, fraudulent transfer law has played a vital role in preserving the claims related to such transactions, either as a means of fostering settlement (e.g, Peabody Energy's spinoff of Patriot Coal) or through post-confirmation litigation (e.g., Kerr-McGee's spinoff of Tronox, which resulted in fraudulent transfer litigation that led to a multi-billion dollar damages award). In order to neuter any argument that a divisional merger is immune from fraudulent transfer law, clarifying language to the Bankruptcy Code to that effect may be a more direct solution than permitting dismissal of any case filed by a debtor within 10 years of its formation via divisional merger.

Procedurally, the NRPA still needs to move through the Congressional committee process and, based on the current composition of the Senate, will ultimately require some measure of Republican support in order to become law.

Gibson Dunn lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Business Restructuring and Reorganization practice group, or the following authors:

Michael J. Cohen – New York (+1 212-351-5299, mcohen@gibsondunn.com)
Michael A. Rosenthal – New York (+1 212-351-3969, mrosenthal@gibsondunn.com)
Matthew J. Williams – New York (+1 212-351-2322, mjwilliams@gibsondunn.com)

Please also feel free to contact the following practice leaders:

Business Restructuring and Reorganization Group:
David M. Feldman – New York (+1 212-351-2366, dfeldman@gibsondunn.com)
Scott J. Greenberg – New York (+1 212-351-5298, sgreenberg@gibsondunn.com)
Robert A. Klyman – Los Angeles (+1 213-229-7562, rklyman@gibsondunn.com)

© 2021 Gibson, Dunn & Crutcher LLP

Attorney Advertising: The enclosed materials have been prepared for general informational purposes only and are not intended as legal advice.