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United States: Who Gets Released In Chapter 11?

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In Chapter 11, a business or individual seeks to confirm a plan of reorganization that – upon compliance – will release it from liability for certain claims and obligations.

But what about parties other than the debtor? Can officers, directors, members, managers, co-debtors, guarantors, and affiliated or related entities also enjoy a release of their potential liability (without having to file bankruptcy themselves)? A recent decision in the Purdue Pharma bankruptcy casts doubt on the validity of certain non-debtor releases.

Purdue Pharma manufactured and sold OxyContin, an opioid-based pain medication that contributed to the opioid crisis in the United States. Historically, the Sackler family owned and controlled Purdue. In 2007, Purdue Pharma pled guilty to one felony count of misbranding OxyContin and agreed to pay the United States and 49 individual states over \$600 million to settle claims asserted against it and its directors and officers. Purdue Pharma was not out of the woods. A tsunami of litigation began in the 2010s, leading Purdue Pharma to file Chapter 11 in 2019.

During bankruptcy, Purdue Pharma and the Sacklers negotiated a proposed plan that provided that members of the Sackler family would contribute \$4.325 billion to fund various trusts for victims. In exchange, the Sacklers and non-debtor entities they controlled would receive releases from all civil liability for direct claims filed against them as individuals. In September 2021, the bankruptcy court confirmed the plan over the objections of the U.S. Trustee, eight states, and others. The objecting parties appealed the bankruptcy court order to the United States District Court.

Just before Christmas, a United States District Court in New York vacated the confirmed Chapter 11 plan of Purdue Pharma L.P. The District Court held it was improper for the plan to contain non-consensual releases of direct claims held by third parties against non-debtors. Specifically, the District Court disapproved of the releases provided to members of the Sackler family. Historically, the Sacklers owned and controlled Purdue, but they had not filed for personal bankruptcy protection. The district court held there is no statutory authority to approve non-consensual releases of direct third-party claims against third parties like the Sackler family.

The District Court focused its decision on the non-consensual release of direct claims of third parties against non-debtors. For example, some states contended they held direct claims against the Sackler family based on their individual fraud, misrepresentation, and willful misconduct, and under state consumer protection and unfair and deceptive practices laws. The District Court held that, except for asbestos cases, there is no statutory basis for a bankruptcy court to approve a release of such claims and vacated Purdue's plan confirmation order.

The District Court distinguished releases of claims derivative of claims held by a debtor's estate or asserted against a debtor's estate, which the Bankruptcy Code allows. All other things being equal, a release of a claim that would render the Sacklers liable because of Purdue's actions could be upheld. Query whether, in a credit context, a principal's guaranty of the debtor's obligations is a direct or derivative claim.

The District Court decision is not the final word on this issue. Purdue Pharma intends to appeal the ruling to the Second Circuit Court of Appeals. As it stands, different courts have reached different conclusions on the authority of non-consensual releases of third-party direct claims against non-debtors. The Fourth Circuit, which includes federal courts in North Carolina, permits non-consensual, non-debtor releases under certain circumstances. The Fourth Circuit requires the bankruptcy court to consider these factors:

1. Is there an identity of interests between the debtor and the third party?
2. Has the non-debtor contributed substantial assets to the reorganization?
3. Is the release essential to reorganization?
4. Have the impacted classes overwhelmingly voted to accept the plan?
5. Does the plan provide a mechanism to pay the classes affected by the release?
6. Does the plan provide an opportunity for claimants who choose not to settle to recover in full?

The Fourth Circuit is in the minority and, ultimately, the United States Supreme Court may resolve the issue. Until then, parties in Chapter 11 can expect uncertainty and litigation and should consult with counsel when the issue arises.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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