NEW YORK CITY BAR

REPORT ON LEGISLATION BY THE BANKRUPTCY AND CORPORATE REORGANIZATION COMMITTEE[1]

H.R. 4777	**Rep. Nadler**
S.2497	**Sen. Warren**

A BILL to amend title 11, United States Code, to prohibit nonconsensual release of a nondebtor entity's liability to an entity other than the debtor, and for other purposes.

Nondebtor Release Prohibition Act of 2021

THIS BILL IS OPPOSED[2]

In July 2021, Representatives Nadler, Maloney, and Cicilline, along with Senators Warren, Durbin, and Blumenthal, introduced H.R. 4777 and S. 2497, the Nondebtor Release Prohibition Act of 2021 ("NRPA"). This bill aims to prohibit bankruptcy courts from approving nonconsensual releases of nondebtors under chapter 11 plans of reorganization or otherwise under the Bankruptcy Code.[3] While it is appropriate, and arguably vital, to enact legislation that establishes uniform treatment of nonconsensual nondebtor releases in all federal judicial courts,[4] we disagree with the inflexible approach proposed in the NRPA. Nondebtor releases can be an important tool for parties to a bankruptcy proceeding, including those with claims against a nondebtor, to fairly and efficiently resolve disputes. The NRPA's blanket prohibition on nonconsensual nondebtor releases would deprive courts, debtors, nondebtors and claimants of this important tool and weaken the bankruptcy courts' powers under the Code. Enactment of the NRPA could lead to undemocratic holdup by the minority of claimants, a narrower window for negotiation and smaller recoveries for claimants, each of which are contrary to the purpose of the Bankruptcy Code. Instead, as discussed below, we suggest that Congress consider enacting legislation that would allow bankruptcy courts to enter nondebtor injunctions, but only where appropriate standards

[1] The current members of the judiciary and employees of the US Trustee Program who are on the Committee have abstained from supporting the views set forth in this letter and do not express any views with respect to the NRPA.

[2] We note that our Committee's opposition is to the provisions of the bill regarding nondebtor releases, and we do not take any position regarding the provisions of the bill that concern divisional mergers.

[3] 11 U.S.C. §§ 101 *et seq.*

[4] There is currently significantly disparate treatment of nonconsensual nondebtor releases among the circuit courts, with the Second, Third, Fourth, Sixth, Seventh and Eleventh Circuits generally permitting them in appropriate circumstances and the Fifth, Ninth and Tenth Circuits generally prohibiting them.

specified by Congress have been met and only where the facts and circumstances warrant such relief.

We write on behalf of the Bankruptcy and Corporate Reorganization Committee of the New York City Bar Association (our "Committee") to register our support for a uniform law on nondebtor releases but our opposition to the passage of the NRPA in its current form.

Our Committee's members represent both debtors and creditors (including employees) in business bankruptcy cases and have been involved in chapter 11 cases of varying degrees of size and complexity across the country.

Our Committee's interest is in the well-being and efficient functioning of the bankruptcy system as a whole. Bankruptcy is intended to bring order to difficult situations in which there are insufficient assets to pay creditors in full. Particularly in bankruptcies with many individual claimants, such as mass tort bankruptcies, debtors, creditors and other parties in interest attempt to maximize funds available for compensation and distribute these funds in a just and timely manner. Bankruptcy judges look to the Bankruptcy Code to evaluate plans of reorganization, but their interpretations of the Code may differ.

We, like the sponsors of the NRPA, share the goal of holding parties accountable and providing fair and just compensation to claimants. We commend the sponsors of the NRPA for recognizing the need to codify and make uniform the manner in which courts treat nondebtor releases.

Courts have split on whether these releases are permitted under the Bankruptcy Code, and even those who *agree* that releases are appropriate in some circumstances *disagree* on the standards by which to evaluate them. The majority view is that bankruptcy courts may approve nonconsensual nondebtor releases pursuant to their powers under Section 105(a), which grants courts the ability to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title."[5] However, a minority of circuits interpret the language of Section 524(e), which provides that a "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of another entity for, such debt,"[6] as a complete bar to nonconsensual nondebtor releases. In a recent decision,[7] a District Court judge in the Southern District of New York observed that contradictory interpretations of the Bankruptcy Code across the courts leave debtors and creditors unsure about the statutory authority for nonconsensual nondebtor releases and is "a most unfortunate circumstance when dealing with a supposedly uniform and comprehensive nationwide scheme to adjust debtor-creditor relations."[8] An amendment to the Code that provides for a consistent and predictable application of this important mechanism of bankruptcy is necessary, and given the frequency with which nonconsensual

[5] 11 U.S.C. § 105(a).

[6] 11 U.S.C. § 524(e).

[7] *In re* Purdue Pharma, No. 7:21-cv-07585, ECF No. 148 (S.D.N.Y. Dec. 16, 2021), https://restructuring.primeclerk.com/purduepharma/Home-DownloadPDF?id1=MTMxMzAwMg==&id2=-1 (last visited Feb. 1, 2022).

[8] *Id.* at *117, *136-37.

nondebtor releases have recently been proposed in plans of reorganization, in the words of that same District Court Judge: "the time to resolve the question for once and for all is now."[9]

We appreciate the concern that in certain instances, particularly when nondebtors have sufficient assets to make greater contributions or may have caused significant harm to claimants, releases of such parties may be inappropriate. However, we disagree with the blanket prohibition proposed by the sponsors of the NRPA, as there are more nuanced solutions available to address this concern.

CONCERNS WITH THE NRPA

More specifically, we oppose the NRPA for the following reasons:

1. **The NRPA may render claimants worse off in many cases**.

Nondebtor releases incentivize nondebtors to come to the negotiating table and make meaningful contributions to a settlement or a plan of reorganization to avoid costly litigation. However, if nondebtors cannot be confident that they will not be pursued again by claimants in the future for the same alleged misconduct, nondebtors have little incentive to contribute to reorganization plans. Such contributions are often critical to a successful reorganization and, in some cases, absent a global settlement incorporated in the plan of reorganization, claimants would receive no economic recovery at all.

2. **In many instances, the nondebtors to be released from liability are distinct from the "bad actors" targeted by the NRPA**.

Nondebtor releases are often used to protect insurers and other necessary sources of funding for plans, not the type of bad actors targeted by the proposed legislation. It would be inappropriate to flatly prohibit the release of such nondebtors and detrimental to the bankruptcy process given such funding may be necessary for a successful plan of reorganization.

3. **Under the NRPA, a small minority of claimants could hold out and prevent the majority of claimants from receiving compensation.**

While "nonconsensual" may be construed to mean there is little or no agreement between claimants and nondebtors, these plans are, in fact, largely *consensual*. Approval of any plan by a class of creditors (such as tort victims) requires the approval of the holders of at least 66 ⅔% in amount and more than one-half in number of the allowed claims in such class.[10] It is neither fair nor equitable to allow a minority to derail a democratic process that provides compensation acceptable to and approved by the majority of claimants. Ultimately, it is the claimants themselves who are empowered to determine, by supermajority vote, whether to accept the proposed compensation. Dissenters have an equal vote to reject the proposed plan (and to express their objections to it), and bankruptcy courts provide a check to ensure a fair process and outcome.

[9] *Id.* at *136.

[10] Because tort claims are unliquidated, they are often estimated at $1 each solely for plan voting purposes.

4. Bankruptcy judges are well equipped to determine when nondebtor releases are appropriate.

Rather than imposing a blanket ban on nondebtor releases, legislators should empower courts to weigh the particular circumstances within guidelines provided by Congress. Bankruptcy courts are uniquely qualified to determine case and fact-specific approaches, as they have successfully done in the majority of circuits when evaluating nondebtor releases and in a myriad other contexts.

5. The alternative to nondebtor releases may be more costly and less efficient.

If nondebtor releases are absolutely prohibited in bankruptcy, Article III federal courts and state courts would become the only forum for resolving individual claims. Litigation in such courts is often costly and drawn-out, with multiple levels of appeals and procedural hurdles. These costs could consume the estate's limited resources, leaving fewer, if any, funds available to compensate claimants. Claimants also have varying resources available to pursue litigation, and forcing claimants to pursue recovery through non-bankruptcy litigation alone will likely lead to inequality among claimants (both as a result of the "race to the courthouse" and unequal resources among claimants to pursue litigation). Bankruptcy provides a single central forum and has equal treatment rules that protect all claimants.[11]

PROPOSAL FOR UNIFORM STANDARDS

To address these issues, we propose alternate legislation to provide uniform standards for bankruptcy courts that *regulate*, rather than *prohibit*, nonconsensual nondebtor releases and that ensure that such injunctions are entered only in carefully circumscribed circumstances warranting such relief. The proposed standards outlined below would require courts to carefully scrutinize reorganization plans and approve nonconsensual nondebtor releases only when necessary for the reorganization and fair to the class of claimants. This proposal would, where appropriate, incentivize nondebtors to participate in reorganization plans and provide claimants with greater access to sources of funds outside the debtor's estate.

1. Approval by a "super-supermajority" of claimants.

Similar to the voting requirement under Section 524(g) of the Bankruptcy Code,[12] nondebtor releases should require the affirmative vote of a "super-supermajority" of the class of claimants in addition to the regular class votes required to approve the corresponding reorganization plan. We recommend requiring at least 75% approval (which is the same as the current requirement for asbestos cases under Section 524(g)). Requiring a "super-supermajority"

[11] 11 U.S.C. § 1123(a)(4).

[12] 11 U.S.C. § 524(g).

vote will ensure that a sufficient portion of claimants in a given circumstance supports the proposed nondebtor release as the mechanism for recovery.[13]

2. Specific finding by the court that the nondebtor release is necessary to the reorganization.

The court in *In re Continental Airlines* set forth this standard, calling "fairness, necessity to the reorganization, and specific factual findings to support these conclusions" the "hallmarks of permissible non-consensual releases."[14] We propose codifying this standard, under which the court must make specific findings that the nondebtor to be released has conditioned contributing funding on the protection of release from future liability, and that this funding is necessary for the debtor to propose a feasible plan and successfully emerge from bankruptcy. This standard would ensure that the funding amount is critical to the reorganization and that nondebtors who are granted release from future liability would only have chosen to provide funding in exchange for the protection of such release.

3. Financial disclosure by nondebtors seeking release.

Discharges in bankruptcy occur only after debtors open their books to creditors and make detailed disclosures. We understand the criticism that nondebtors can be granted releases, which are similar to discharges, without similarly presenting evidence of their assets, liabilities, and ability to compensate claimants. We propose requiring nondebtors to provide sworn financial disclosures appropriate under the circumstances of the case in order to benefit from releases. This should facilitate negotiations over the size of the contribution for the nondebtor release and minimize the perception that the parties receiving the release are not appropriately subjecting themselves and their assets to the bankruptcy process.

To be clear, we are not proposing that the nondebtors would be required to file for bankruptcy themselves, nor are we proposing that nondebtors would be required to make the same level of financial disclosure that a debtor would make. Rather, the type and level of the disclosures would be tailored to the purposes and circumstances of the case. And because the disclosures would need to be sworn to (*i.e.*, provided under penalty of perjury), the court and the parties to the negotiation would feel comfortable relying upon them.

4. Finding by the court of overall fairness.

Courts should be required to evaluate the fairness of nonconsensual nondebtor releases and issue a finding that the class of claimants would be better off overall under the proposed reorganization plan than they would be pursing their claims in other venues. Courts should consider factors such as those outlined in *In re Master Mortgage Investment Fund, Inc.*,[15] including the relationship between the debtor and the nondebtor, whether the nondebtor has contributed

[13] In addition, the provisions relating to "opt out" rights and the consequences of opting out could still be negotiated and included in plans and approved by the Bankruptcy Court as part of the overall plan approval process.

[14] 203 F.3d 203, 214 (3d. Cir. 2000).

[15] 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994).

substantially to the reorganization, and whether in the aggregate, the reorganization plan with the releases better serves the majority of claimants than a plan (if one is possible) without the releases. When evaluating whether claimants are better off under the plan, courts should also consider the likelihood of success, time to recovery and prospects for (and the challenges of) collection if claimants instead pursued their claims independently in state or federal courts (or in foreign jurisdictions).

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In sum, nondebtor releases should be preserved as a tool in circumstances where the vast majority of claimants consent to the release and bankruptcy courts deem it fair to the claimants overall and necessary to the plan of reorganization after sufficient financial disclosure by the relevant nondebtor. Although existing law is not satisfactorily consistent or predictable on this issue across jurisdictions around the country, the proposed NRPA is too blunt a response to this nuanced issue and would eliminate an important tool used by bankruptcy courts. The NRPA runs counter to one of the most fundamental purposes of the Bankruptcy Code: to maximize recoveries to claimants and other creditors and to ensure equal treatment among similarly situated creditors. To achieve this purpose, we recommend amending the Bankruptcy Code to provide clear standards that bankruptcy courts can apply in assessing the appropriateness of nondebtor releases. Bankruptcy courts are best positioned to strike a just balance between holding nondebtors accountable and cutting through expensive litigation to deliver timely compensation to worthy claimants.

We would welcome the opportunity to discuss these matters further.

Bankruptcy and Corporate Reorganization Committee
Ana Maria Alfonso, Chair
aalfonso@willkie.com
212-728-8244

February 2022

Contact
Maria Cilenti, Senior Policy Counsel | 212.382.6655 | mcilenti@nycbar.org
Elizabeth Kocienda, Director of Advocacy | 212.382.4788 | ekocienda@nycbar.org