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Bankruptcy 2021: Views from the Bench

Great Debates

Norman N. Kinel, Moderator
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Resolved: The Bankruptcy Code impliedly repeals the Federal Arbitration Act with respect to disputes regarding the allowance of claims against a bankruptcy estate.

Pro: Hon. Ashely M. Chan
U.S. Bankruptcy Court (E.D. Pa.); Philadelphia

Con: Hon. Eric L. Frank
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DEBATE 1

The Bankruptcy Code Impliedly Repeals the Federal Arbitration Act with Respect to Disputes Regarding the Allowance of Claims Against a Bankruptcy Estate.

Pro: Judge Ashely Chan

Con: Judge Eric Frank

I. INTRODUCTION

The first debate topic—between the Honorable Ashely Chan and the Honorable Eric Frank—is whether title 11 of the United States Code (the "Bankruptcy Code") impliedly repeals the Federal Arbitration Act (the "FAA"), with respect to disputes regarding the allowance of claims against a bankruptcy estate.

As a threshold matter, in *Shearson/American Express, Inc. v. McMahon,* 482 U.S. 220 (1987), the Supreme Court established a three-part test to determine when the FAA can appropriately be found to have been impliedly repealed. The Supreme Court held that in order to make such a determination, courts must look to (1) the text of the statute that supposedly impliedly repeals the FAA, (2) its legislative history, and (3) whether its purpose leads to irreconcilable conflict with the FAA. *Id*., at 238-242 (1987).

The *McMahon* approach is deferential to the FAA, holding that once a court has concluded that a valid arbitration agreement exists, the FAA "mandates enforcement of agreements to arbitrate statutory claims" in the absence of implied repeal. *Id.* at 227. Further, the burden of proof is stacked in favor of arbitration, with the party opposing arbitration bearing the burden of demonstrating that "Congress intended to make an exception to the Arbitration Act for claims arising under" the relevant statute, such as the Bankruptcy Code. *Id.*

The following discussion summarizes the current state of the law regarding whether the Bankruptcy Code has impliedly repealed the FAA with respect to disputes regarding the allowance of claims against a bankruptcy estate.

II. DISCUSSION

The inquiry of whether the Bankruptcy Code has repealed the FAA has often been framed as whether arbitrating the dispute at issue would create an irreconcilable conflict with the Bankruptcy Code.

A. Core vs. Noncore Distinction

Several courts have concluded that bankruptcy courts must compel arbitration of non-core proceedings. *See In re Gandy*, 299 F.3d 489, 495 (5th Cir. 2002); *see also In re Crysen/Montenay Energy Co.*, 226 F.3d 160, 166 (2d Cir. 2000); *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1150 (3d Cir. 1989).

Similarly, other courts, including the Second Circuit in *MBNA Am. Bank, N.A. v. Hill,* 436 F.3d 104 (2d Cir. 2006), have adapted a framework involving the core/non-core distinction in assessing the court's discretion to compel arbitration:

> Bankruptcy courts are more likely to have discretion to refuse to compel arbitration of core bankruptcy matters, which implicate "more pressing bankruptcy concerns." *In re U.S. Lines,Inc.*, 197 F.3d at 640. However, even as to core proceedings, the bankruptcy court will not have discretion to override an arbitration agreement

> unless it finds that the proceedings are based on provisions of the Bankruptcy Code that "inherently conflict" with the Arbitration Act or that arbitration of the claim would "necessarily jeopardize" the objectives of the Bankruptcy Code. *Id*. This determination requires a particularized inquiry into the nature of the claim and the facts of the specific bankruptcy. The objectives of the Bankruptcy Code relevant to this inquiry include "the goal of centralized resolution of purely bankruptcy issues, the need to protect creditors and reorganizing debtors from piecemeal litigation, and the undisputed power of a bankruptcy court to enforce its own orders." *Ins. Co. of N. Am. v. NGC Settlement Trust & Asbestos Claims Mgmt. Corp. (In re Nat'l Gypsum Co.)*, 118 F.3d 1056, 1069 (5th Cir. 1997). If a severe conflict is found, then the court can properly conclude that, with respect to the particular Code provision involved, Congress intended to override the Arbitration Act's general policy favoring the enforcement of arbitration agreements.

MBNA Am. Bank, N.A. v. Hill, 436 F.3d 104, 108 (2d Cir. 2006). As summarized by the Second Circuit in *MBNA*, the determination of whether a dispute is a core or non-core proceeding is not dispositive as to whether a bankruptcy court will compel arbitration. Instead, the core/non-core distinction is used as an indication of matters that are more pressing to bankruptcy concerns.

Core proceedings are defined in the Bankruptcy Code, in part, as:

> (2) Core proceedings include, but are not limited to—
>
> > (A) matters concerning the administration of the estate;
> >
> > (B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for the purposes of confirming a plan under chapter 11, 12, or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11.

28 U.S.C. § 157(b)(2). Thus, the plain language of the Bankruptcy Code dictates that the "allowance or disallowance of claims against the estate" are core proceedings. Accordingly, courts have routinely found that a proceeding seeking the allowance or disallowance of a claim is a core proceeding. *See, e.g., Bavelis v. Doukas (In re Bavelis),* 773 F.3d 148 (6th Cir. 2014); *Cont'l Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.),* 671 F.3d 1011, 1021-22 (9th Cir. 2012) (relying on 28 U.S.C. § 157(b)(2)(A) - (B)); *In re Day,* 208 B.R. 358 (Bankr. E.D. Pa. 1997) (noting that the claims allowance process is one of the core processes in any bankruptcy contested matter and permitting the arbitration of such claims would likely result in several months' delay in a court ruling on the confirmation of the debtors' plan).

However, "[t]he fact that the dispute . . . is a core proceeding is not in and itself determinative. The court must next consider whether enforcement of the arbitration provisions . . . inherently conflict with the underlying purposes of the Bankruptcy Code." *In re Patriot Solar Grp., LLC*, 569 B.R. 451, 459 (Bankr. W.D. Mich. 2017) (internal citations removed). In *Patriot Solar Grp,*

LLC, the Bankruptcy Court for the Western District of Michigan held that inherent conflict existed between arbitration and chapter 11, stating that one of the underlying purposes of bankruptcy is to provide the debtor with a breathing spell during which it can develop a strategy for its exit from bankruptcy. *Id*. at 461 (citing *NLRB v. Bildisco and Bildisco*, 465 U.S. 513 (1984); *Md. v. Port Admin. v. Premier Auto. Servs., Inc. (In re Premier Auto. Servs., Inc.)*, 492 F.3d 274, 284 (6th Cir. 2007)). The court held that "the Debtor should be given a reasonable period of time to propose a plan or market its assets for sale without simultaneously having to devote significant time and resources towards arbitration" regarding the allowance of claims. *Id*. The court further noted that permitting arbitration might result in piecemeal litigation. *Id*.

In another case, which involved assessing whether arbitration should be enforced with respect to allegations of fraud and abuse of the bankruptcy claims process, the Bankruptcy Court for the Eastern District of Kentucky held that arbitration would "directly conflict with the bankruptcy purpose of prompt and effectual administration and settlement of Debtor's estate because that claim arises from the bankruptcy claims allowance process." *Kiskaden v. LVNV Funding, LLC (In re Kiskaden)*, 571 B.R. 226, 238 (Bankr. E.D. Ky 2017). The court noted that the bankruptcy court is "uniquely qualified to evaluate violations of the bankruptcy process, and it has inherent authority to remedy such violations under the Bankruptcy Code and Rules." *Id*.

Thus, using the core/non-core framework, bankruptcy courts have found that the FAA has been repealed with respect to certain disputes regarding the allowance of claims against a bankruptcy estate. However, the fact that the claims allowance process is a core proceeding does not automatically mean that the FAA has been repealed. Instead, courts further analyze case-by-case whether arbitration of a particular issue would be in conflict with purposes of bankruptcy.

B. Rejection of Core/Non-Core Distinction

Other courts, such as the Third Circuit in *Mintze v. Am. Fin. Servs., Inc. (In re Mintze)*, 434 F.3d 222 (3d Cir. 2006), have rejected the core/noncore distinction as a determining factor for whether a bankruptcy court can decline to enforce an arbitration agreement:

> The core/non-core distinction does not [] affect whether a bankruptcy court has the discretion to deny enforcement of an arbitration agreement. *See Insurance Co. of N. Am. v. NGC Settlement Trust (In re National Gypsum Co.)*, 118 F.3d 1056, 1068 (5th Cir. 1997) (quoting *In re Statewide Realty Co.*, 159 B.R. 719, 722 (Bankr. D.N.J. 1993)). It merely determines whether the bankruptcy court has the jurisdiction to make a full adjudication. Because this distinction does not affect whether the Bankruptcy Court had the discretion to deny arbitration, we will accept the parties' stipulation that the proceeding was a "core" proceeding for the purposes of deciding whether the Bankruptcy Court had discretion.
>
> If a party opposing arbitration can demonstrate that "Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue," the FAA will not compel courts to enforce an otherwise applicable arbitration agreement. *McMahon*, 482 U.S. at 227. To overcome enforcement of arbitration, a party must establish congressional intent to create an exception to the FAA's mandate with respect to

> the party's statutory claims. Congressional intent can be discerned in one of three ways: (1) the statute's text, (2) the statute's legislative history, or (3) "an inherent conflict between arbitration and the statute's underlying purposes." *McMahon*, 482 U.S. at 227 (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628, 632-37, 105 S. Ct. 3346, 87 L. Ed. 2d 444 (1985)).

Id. at 229. Thus, courts rejecting the core/non-core framework instead look to the more general three-prong test established by the Supreme Court in *McMahon*.

II. Legislative and Policy Concerns

A. Jurisdiction Under 28 U.S.C. § 1334

Bankruptcy courts, through referral from the district courts, have original but not exclusive jurisdiction of proceedings arising under, or arising in or related to, cases under the Bankruptcy Code:

> Except as provided in subsection (e)(2), and *notwithstanding any Act of Congress* that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.

28 U.S.C. § 1334(b) (emphasis added).

The plain language of 28 U.S.C. § 1334(b) indicates Congressional intent that section 1334(b) will "repeal" acts of Congress conferring other courts with exclusive jurisdiction of proceedings arising under, or arising in or related to cases under the Bankruptcy Code. This does not create a presumption of repeal or preclusion of the FAA. John R. Hardison, *Express Preclusion of the Federal Arbitration Act for All Bankruptcy-related Matters*, 93 St. John's L. Rev. 627, 661 (Jan, 2019). Instead, it simply demonstrates that bankruptcy law permits concurrent litigation in other forums, but do not "imply that those provisions permit the bankruptcy courts to be deprived of their original jurisdiction." *Id.* at 666.

The Supreme Court in *Celotex Corp. v. Edwards* agreed with the views expressed by the Third Circuit in *Pacor, Inc. v. Higgins*, that "Congress intended to grant comprehensive jurisdiction to the bankruptcy courts so that they might deal efficiently and expeditiously with all matters connected with the bankruptcy estate" and that the "related to" language of § 1334(b) must be read to give district courts (and bankruptcy courts under § 157(a)) jurisdiction over more than simple proceedings involving the property of the debtor or the estate. *Celotex Corp. v. Edwards,* 514 U.S. 300, 308 (1995) (citing S. Rep. No. 95-989, 2nd Sess., pt.1 at 153-54, 1978; *Pacor, Inc. v. Higgins,* 743 F.2d 984, 994 (1984), overruled in part by *Things Remembered, Inc. v. Petrarca,* 516 U.S. 124, 135-36 (1995)).

Furthermore, comments in the House Report indicated Congressional concern that "the extra expense entailed by the estate in litigating outside the bankruptcy court," or costs incurred in litigating "over whether the bankruptcy court has jurisdiction," could tax the estate or give unfair

"bargaining leverage against" the trustee to parties who owe the estate money. H.R. REP. No. 95-595, xv, at 45-46 (1978). Thus, much like existing case law, legislative history demonstrates an emphasis on preserving the bankruptcy purpose of prompt and effectual administration and settlement of a debtor's estate.

B. Policy

Whereas the FAA's purpose is to render arbitration agreements as enforceable as other contractual provisions, the Bankruptcy Code is rooted in modifying contractual rights. 93 St. John's L. Rev. at 670 (citing *Phillips v. Congelton, L.L.C. (In re White Mountain Mining Co., L.L.C.),* 403 F.3d 164, 169 (4th Cir. 2005) (explaining that the "very purpose of bankruptcy is to modify the rights of debtors and creditors"). The modification of contractual rights both ensures that honest debtors can receive a fresh start and creditors are protected from the "machinations between the debtor and particular creditors or other third parties." 93 St. John's L. Rev. at 670.

Through the enactment of the Bankruptcy Code and related legislation, Congress has ensured that a creditor will receive notice and opportunity to participate in proceedings affecting the estate before the creditor's contract is terminated and property rights against the debtor are extinguished. *Id.* at 630-32; *see* 11 U.S.C. §502(b); Fed. R. Bankr. P. 3007. Arguably, a creditor's due process rights could be threatened if an arbitration agreement with one creditor, to which another creditor was not a party, is enforced. 93 St. John's L. Rev. at 632, 671 ("For example, an insolvent debtor in a liquidating bankruptcy case may care very little about objecting to claims against the estate, since the resolution affects only the distribution between creditors as to assets the debtor is not permitted to retain. Allowing the debtor and the counterparty to arbitrate a dispute outside of the purview of the bankruptcy court may therefore jeopardize creditors' indirect interest in the resolution of the issue.").

III. *Henry Schein Inc. v. Archer & White Sales Inc.* and its Implications on Bankruptcy

On January 8, 2019, Justice Brett Kavanaugh authored the opinion for the Supreme Court's unanimous decision in *Henry Schein Inc. v. Archer & White Sales Inc.*, 139 S. Ct. 524 (2019). In *Schein*, the Supreme Court held that under the FAA, a court may not decide whether an arbitration agreement applies to the particular dispute if the parties clearly and unmistakably delegated the question to an arbitrator, even if the court believes that the argument for arbitrability is "wholly groundless." *Id*. at 531.

Although the case did not involve or implicate any bankruptcy proceedings, the *Schein* decision nevertheless raises concerns for bankruptcy professionals. If the decision is applied rigorously in bankruptcy courts, bankruptcy judges may not be able to bar creditors from initiating arbitrations over 'core' issues such as allowance of claims, objections to dischargeability of debts, and even adequate protection." Bill Rochelle, *Supreme Court Decision on Arbitration Has Ominous Implications for Bankruptcy*, ABI, Jan. 14, 2019, available at: https://www.abi.org/newsroom/daily-wire/supreme-court-decision-on-arbitration-has-ominous-implications-for-bankruptcy.

A. The *Schein* Case

In 2012, Archer and White (the "Plaintiff"), a small business that distributed dental equipment, filed a lawsuit against Henry Schein, Inc. and its parent company (collectively, the "Defendant"), alleging violations of federal and state antitrust law. Invoking the FAA, the Defendant asked the district judge to refer the case to arbitration. Relying on Fifth Circuit precedent, the district court denied the Defendant's motion to compel arbitration, finding the request for arbitration "wholly groundless." 139 S. Ct. at 528. The Fifth Circuit affirmed the district court's decision, and the Supreme Court granted certiorari in light of the circuit split over the "wholly groundless" exception to the FAA.

In *Schein*, Justice Kavanaugh relied on *Rent-A-Center West Inc. v. Jackson*, 561 U. S. 63 (2010) to conclude that "the 'wholly groundless' exception is inconsistent with the text of the Act and with our precedent." 139 S. Ct. at 529. Citing *Rent-A-Center*, Justice Kavanaugh noted that "parties may agree to have an arbitrator decide not only the merits of a particular dispute but also gateway questions of arbitrability, such as whether the parties have agreed to arbitrate or whether their agreement covers a particular controversy." *Id*. (internal quotation marks removed).

The Supreme Court held, in no uncertain terms, that:

> When the parties' contract delegates the arbitrability question to an arbitrator, a court may not override the contract. In those circumstances, ***a court possesses no power to decide the arbitrability issue***. That is true even if the court thinks that the argument that the arbitration agreement applies to a particular dispute is wholly groundless.

Id. (emphasis added). Furthermore, in another case favoring the FAA, the Supreme Court held that the party arguing that the FAA has been repealed "must show a 'clear and manifest' congressional intention," noting that there is a strong presumption that disfavors repeals by implication. *Epic Sys. Corp. v. Lewis*, 138 S. Ct. 1612, 1617 (2018).

B. Application to Bankruptcy Cases

If *Schein* and *Epic* were applied strictly in a case involving a pre-bankruptcy agreement between a debtor and a creditor to arbitrate all disputes—including any proceedings arising or related to bankruptcy and the arbitrability issue—the bankruptcy court would have no power to deny a request for arbitration. Even if the dispute was a core proceeding and presented an inherent conflict with the underlying purposes of the Bankruptcy Code, because the Bankruptcy Code does not show a "clear and manifest" intent to repeal the FAA, the bankruptcy judge may be bound by the *Schein* rule that "a court possesses no power to decide the arbitrability issue."

Taken at face value, the *Schein* and *Epic* opinions appear to divest bankruptcy judges of their original jurisdiction over disputes arising under, or arising in or related to, cases under the Bankruptcy Code that are subject to pre-bankruptcy arbitration agreements. The Supreme Court has not yet opined on whether disputes under bankruptcy proceedings are bound by the strict rules

under *Schein* and *Epic*, or whether bankruptcy represents an exception to the enforceability of arbitration agreements.

IV. Conclusion

"The various tests are so vague and malleable that they give courts license to do almost anything they want. Anecdotal evidence suggests that bankruptcy judges routinely enforce arbitration agreements, for both noncore and core claims, as a way to clear matters off the docket." Paul F. Kirgis, *Arbitration, Bankruptcy, and Public Policy: A Contractarian Analysis*, 17 Am. Bankr. Inst. L. Rev. 503, 520 (2009). Even if in theory the Bankruptcy Code does impliedly repeal the FAA as applied in certain limited instances involving the core purpose of the Code, for practical purposes, the question remains open.

DEBATE 2

A Chapter 11 Plan of Reorganization May Lawfully Release the Liability of a Third Party for its Own Tortious Conduct Without the Consent of the Creditor Whose Claim is Being Released.

Pro: Judge Janet Bostwick

Con: Judge Frank Bailey

I. INTRODUCTION

The question raised in the second debate—between the Honorable Janet E. Bostwick and the Honorable Frank J. Bailey—is whether a chapter 11 plan of reorganization may lawfully release the liability of a third party for its own tortious conduct without the consent of the creditor whose claim is being released. The issue has not been addressed by courts, except within the unique context of asbestos-related bankruptcy cases. The following discussion will first address the general debate surrounding nonconsensual third-party releases and then turn to the specific issue of whether the release of liability of a third party for its own tortious conduct is permissible within the asbestos context and beyond.

The Bankruptcy Code does not expressly sanction or prohibit the issuance of non-debtor releases. Accordingly, the bankruptcy courts that have faced the question have taken varying approaches to the permissibility of non-debtor releases. Furthermore, circuit courts of appeals are split over whether a bankruptcy court has the authority to confirm chapter 11 plans of reorganization that provide nonconsensual third-party releases.

The majority view—adapted by the Second, Fourth, Sixth, Seventh, and Eleventh Circuits—holds that nonconsensual third-party releases and injunctions are permissible under certain narrow circumstances. *See*, *e.g.*, *In re Drexel Burnham Lambert Grp., Inc.*, 960 F.2d 285 (2d Cir. 1992); *In re A.H. Robins Co., Inc.*, 880 F.2d 694 (4th Cir. 1989); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640 (7th Cir. 2008); *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015). Courts allowing such releases argue that there are no explicit prohibitions on such releases in the Bankruptcy Code. *See* Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolves the Debate over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 Emory Bankr. Dev. J. 13, 17 (2006). Further, courts note that sections 105(a) and 1123(b)(6) of the Bankruptcy Code encourage the court's exercise of broad equitable relief to effectuate the purpose of a chapter 11 reorganization plan. *Id.* In other words, third-party releases are acceptable under the bankruptcy courts' equitable powers if such releases make reorganization plans feasible. *Id.*

On the other hand, the minority view—held by the Fifth, Ninth, and Tenth Circuits—prohibits such nonconsensual third-party releases. *See, e.g., Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995); *In re W. Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990). These courts emphasize that a statute's general power to take certain actions must yield to specific prohibitions found elsewhere. *See*, *e.g.*, *Law v. Siegel*, 571 U.S. 415, 419 (2014). The equitable powers of bankruptcy courts can only be exercised within the confines of the Bankruptcy Code. *Id*. (stating that "it is it is quite impossible to ["carry out" the provisions of the Code under section 105(a)] by taking action that the Code prohibits"). Section 524(e) of the Bankruptcy Code, which provides that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt," presents such a prohibition. 11 U.S.C. § 524(e).

In turn, section 524(g) establishes a narrow exception to the general rule found in section 524(e)—that the liability of other parties is not affected by the debtor's discharge—in the narrow

circumstances involving asbestos-related injuries. *See* 11 U.S.C. § 524(g) (providing for the creation of trusts for tort actions arising from alleged exposure to asbestos or asbestos-containing products).

II. GENERAL DISCUSSION REGARDING THIRD-PARTY RELEASES

A. Equitable Powers Under Section 105(a)

Section 105(a) authorizes bankruptcy courts to take actions "necessary or appropriate" to carry out the provisions of Title 11 of the United States Code. *See* 11 U.S.C. § 105(a); *In re Continental Airlines*, 203 F.3d 203, 211 (3rd Cir. 2000). However, section 105(a) is not limitless. *In re Continental Airlines*, 203 F.3d at 211. Section 105(a) does not "create substantive rights that would otherwise be unavailable under the Bankruptcy Code." *Id.* The court's equitable powers can only be exercised within the confines of the Bankruptcy Code. *Id*. A bankruptcy court's jurisdiction is also limited, and section 105 is not an independent source of jurisdiction. *See* 11 U.S.C. § 105(c) (stating that authority shall be determined by reference to the provisions relating to such judge, officer, or employee set forth in title 28). Further, "[i]t is hornbook law that §105(a) does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code." *Law v. Siegel*, 571 U.S. 415, 421 (2014) (citing 2 Collier on Bankruptcy ¶105.01[2], p. 105-6 (16th ed. 2013))

In *In re Continental Airlines*, the Third Circuit articulated the significance of the jurisdictional issue:

> Although bankruptcy subject matter jurisdiction can extend to matters between non-debtor third parties affecting the debtor or the bankruptcy case . . . a court cannot simply presume it has jurisdiction in a bankruptcy case to ['release' and] permanently enjoin third-party . . . actions against non-debtors. We must remain mindful that bankruptcy jurisdiction is limited, as is the explicit grant of authority to bankruptcy courts.

In re Continental Airlines, 203 F.3d at 214 n.12. As discussed above, circuit courts of appeals are split on whether section 105 provides bankruptcy courts with the authority to grant nonconsensual nondebtor releases. Despite the seemingly broad reach of the "necessary and appropriate" clause, some courts are wary that the statute's general power to take certain actions must yield to specific prohibitions found elsewhere. *Law v. Siegel*, 571 U.S. at 419 (2014).

B. Limitations Under Section 524(e)

One such prohibition is section 524(e) of the Bankruptcy Code. Significantly, the plain language of section 524(e) reads as a *per se* rule against non-debtor releases. Section 524(e) provides that "[e]xcept as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e).

The history of section 524(e) further indicates a disapproval of non-debtor releases. Section 524(e) of the 1978 Bankruptcy Reform Act was a reenactment of section 16 of the 1898 Reform Act, which provided that "[t]he liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankrupt." *In re American Hardwoods, Inc*., 885 F.2d 621, 625 (9th Cir. 1989). Thus, although the Bankruptcy Code is relatively silent on nondebtor releases, under section 524(e), bankruptcy courts have interpreted their powers to be able only to affect the relationships of debtors and creditors. *See R.I.D.C. Indus. Development Fund v. Snyder*, 539 F.2d 487, 490 n.3 (5th Cir. 1976). On the other hand, other courts have rejected this interpretation and have held that section 524(e) does not categorically prohibit non-consensual third-party releases. *See e.g*., *Blixseth v. Credit Suisse*, 961 F.3d 1074 (9th Cir. 2020).

C. Extraordinary Circumstances

Courts agree that if non-consensual third-party releases are to be granted, such equitable power should be exercised with restraint and only in extraordinary circumstances. *See In re Grove Instruments, Inc.,* 573 B.R. 307, 314 (Bankr. D. Mass. 2017).

In *In re Master Mortgage Investment Fund, Inc.*, 168 B.R. 930 (Bankr. W.D. M0. 1994), the Bankruptcy Court for the Western District of Missouri established five factors to determine when third-party releases are appropriate: (1) there is identity of interest between the debtor and the third party; (2) the third party has contributed substantial assets to debtor's reorganization; (3) the injunction is essential to debtor's reorganization; (4) a substantial majority of creditors, and especially affected classes, agree to the release and have overwhelmingly voted to accept proposed plan treatment; and (5) the plan provides a mechanism for payment of all, or substantially all, claims of class or classes affected by the injunction. *Id.* at 935.

In conclusion, because section 524(e) operates as a limitation on the equitable powers provided under section 105(a), courts are split on their authority to grant non-consensual third-party releases. As discussed below, however, Congress has recently begun to address this split beyond the narrow circumstances involving asbestos-related cases.

III. W.R. GRACE—A CASE STUDY

In 2019, the Honorable Ashely Chan of the United States Bankruptcy Court for the District of Delaware thoroughly addressed the question of third-party releases and channeling injunctions in *In re W.R. Grace & Co.*, 607 B.R. 419 (Bankr. D. Del. 2019). Although *Grace* involved asbestos-related claims and thus was governed by section 524(g)(2), the case nevertheless presents a helpful framework for understanding the issue of the appropriateness of nonconsensual, non-derivative (*i.e.*, liability of a third party for its own tortious conduct) third-party releases in chapter 11 plans of reorganization.

A. History of Section 524(g).

Section 524(g)(2) of the Bankruptcy Code—the provision establishing the creation of trusts for tort actions arising from alleged exposure to asbestos or asbestos-containing products—was

modeled on the injunction issued in the *Johns-Manville* bankruptcy case. *Id*. at 422. In *Johns-Manville*, in order to provide a fair resolution for all current and potential claimants injured by the debtor's asbestos, the bankruptcy court constructed an injunction that "channeled" current and future claims into a trust. *Id*. The trust—funded by the debtor, its insurers, and its affiliates—became the sole source of recovery for the claimants. *Id*. In order to incentivize the parties to fund the trust, the bankruptcy court entered an injunction which enjoined certain types of third-party claims. *Id.*

The injunction enjoined only derivative litigation (*i.e.*, claims seeking recovery from the debtor's insurance policies), but not non-derivative litigation (*i.e.*, third-party tort claims filed against the debtor's insurers which were not part of the debtor's bankruptcy estate and over which the bankruptcy court had no jurisdiction). *Id*. Accordingly, the Second Circuit developed a derivative liability inquiry, which was used to determine whether a claim was derivative and would be channeled to the bankruptcy trust. *Id.* The Second Circuit further confirmed that the bankruptcy court only has *in rem* jurisdiction over the third-party released party and does not have *in personam* jurisdiction. *Id*. at 423.

B. Analysis

The derivative liability requirement under section 524(g)(4)(A)(ii) requires a determination as to whether a claim is based upon rights derivative of, or derived from, the debtor's rights:

> In the bankruptcy context, if a plaintiff's claim against a third party is based upon: (1) the plaintiff's claim against a debtor (the debtor's liability); and (2) the debtor's claim against the third party (the third party's liability to the debtor), then the plaintiff's claim is derivative. On the other hand, if a plaintiff's claim against a third party is not based upon the debtor's liability and the third party's liability to the debtor but, rather, an entirely independent claim held by the plaintiff directly against the third party, then the plaintiff's claim is nonderivative.

Id. at 424. The *Grace* court reviewed the Second Circuit's decisions in *Tronox Inc. v. Kerr-McGee Corp. (In re Tronox)*, 855 F.3d 84 (2d Cir. 2017) and *In re Quigley Co., Inc.*, 676 F.3d 45 (2d Cir. 2012) in its analysis of derivative liability in the context of bankruptcy cases, as discussed below.

i. Derivative Liability Analysis in Tronox

Merely alleging that a third party engaged in wrongdoing does not render such claim non-derivative. *In re W.R. Grace & Co.*, 607 B.R. at 430. Citing *In re Tronox*, 855 F.3d at 100 (2d Cir. 2017), the *Grace* court emphasized that courts should not focus on the nature of the injuries, but the nature of the legal claims asserted. *In re W.R. Grace & Co.*, 607 B.R. at 430. Further, the court noted that contrary to nonderivative claims which are personal to the individual creditor and can only be brought by such creditor, if a claim can be brought by *any* of the debtor's creditors, such claim belongs to the estate and are properly brought by the trustee:

> [O]ften there are claims against third parties that wrongfully deplete the debtor's assets. Individual creditors may wish to bring claims against those third parties to

> seek compensation for harms done to them by the debtor *and secondary harms done to them by the third parties in wrongfully diverting assets of the debtor that would be used to pay the claims of the individual creditor*. The fact that an individual creditor may seek to do so does not make those secondary claims particular to the creditor, for it overlooks the obvious: *Every creditor has a similar claim for the diversion of assets of the debtor's estate*. Those claims are general—they are not tied to the harm done to the creditor by the debtor, but rather are based on an injury to the debtor's estate that creates a secondary harm to all creditors regardless of the nature of their underlying claim against the debtor.

Id. (quoting *In re Tronox*, 855 F.3d at 103-04). In summary, the Grace court held as follows:

> A derivative claim [] is a general claim which can be brought by the debtor (or a trustee on behalf of all the debtor's creditors). Accordingly, any recovery on account of a derivative claim goes directly to the debtor's estate to benefit all creditors. A derivative claim, therefore, constitutes property of the debtor's estate and the debtor (or trustee) is the only party who has standing to pursue such a claim.
>
> In contrast, a nonderivative claim cannot be brought by the debtor or trustee, because it is not based upon a right held by the debtor. Any recovery on account of a nonderivative claim goes directly to the claimant and has no impact on the debtor's bankruptcy estate. As a result, a nonderivative claim does not constitute property of the estate and, therefore, bankruptcy courts typically do not have jurisdiction over such claims.

Id. at 432.

ii. Derivative Liability Analysis in Quigley

In *In re Quigley Co., Inc.*, 676 F.3d 45 (2d Cir. 2012), the Second Circuit again addressed the issue of derivative liability in the context of bankruptcy cases. The Second Circuit clarified that the derivative liability inquiry is merely a tool to assist the court in determining whether the bankruptcy court had jurisdiction over a third-party litigation. *In re W.R. Grace & Co.*, 607 B.R at 444 (citing *In re Quigley Co., Inc.*, 676 F.3d at 55). The Second Circuit concluded that:

> the underlying framework for determining whether jurisdiction exists (*i.e.*, whether a claim could have a conceivable effect on the estate) is separate from and broader than the derivate liability inquiry *(i.e.*, whether a claim will affect the *res* of the bankruptcy estate), although the two issues can be "intertwined." As a result, the court held that bankruptcy jurisdiction may exist over nonderivative claims against third parties in certain limited instances.

Id. at 445 (citing *In re Quigley Co., Inc.*, 676 F.3d at 57-58) (citations omitted).

iii. Derivative Liability Analysis in Grace

The *Grace* court analyzed whether certain claims fell within the scope of the channeling injunction under section 524(g)(4)(A)(ii) against the backdrop of *Tronox* and *Quigley*. In *Grace*, third-parties Continental Casualty Company and Transportation Insurance Company (collectively, "CNA") asserted that certain negligence claims based on asbestos-related injuries (the "Montana Claims") were derivative because the alleged harms and their need for protection were both dependent on the debtor's wrongdoing. However, the court noted that the fact that the underlying asbestos-related injuries were caused by the debtor and arose out of the debtor's relationship with CNA "is of little significance to the legal determination that this court must make, and is insufficient to render the Montana Claims derivative." *In re W.R. Grace & Co.*, 607 B.R. at 447. The court instead took into consideration the fact that under Montana law, CNA's duty to the Montana plaintiffs in connection with the negligence claim was completely independent of its contractual duty to the debtor, as it was based upon allegations of CNA's own misconduct—not the debtor's misconduct.

Further, the *Grace* court noted that permitting the litigation to go forward on the Montana Claims will have no effect on the *res* of the debtor's bankruptcy estate. *Id*. at 448. Should the plaintiffs prevail on the Montana Claims, the judgment will only be against CNA, not the debtor or the debtor's estate. *Id*. Accordingly, the Court ultimately concluded as follows:

> [T]he Montana Plaintiffs hold the following types of claims: (1) direct claims against Grace for asbestos injuries caused by Grace's wrongdoing; (2) derivative claims against CNA arising under CNA's Policies which are based upon Grace's rights to sue CNA under the CNA Policies; and (3) nonderivative claims against CNA based upon CNA's alleged negligence in providing industrial hygiene services to Grace and/or alleged breach of its duty to warn the Montana Plaintiffs about certain hazards. The first two types of claims fall within the scope of the Channeling Injunction under § 524(g)(4)(A)(ii) and, therefore, may be enjoined. The last group of claims, however, is not within the scope of the Channeling Injunction under § 524(g)(4)(A)(ii) and may proceed in Montana state court.

In re W.R. Grace & Co., 607 B.R. at 448.

C. Application to Non-Asbestos Bankruptcy Cases

As mentioned above, *Grace* is guided and bound by section 524(g)(4)(A)(ii) of the Bankruptcy Code. However, asbestos-related cases are not the only instances in which debtors may seek releases of third parties for their own tortious conduct. Notably, *In re Purdue Pharma L.P.*, Case No. 19-23639 (RDD) and *In re Boy Scouts of America and Delaware BSA, LLC*, Case No. 20-10343 (LSS), are two recent bankruptcy cases in which the debate over third-party releases has been hotly contested.

In response to earlier iterations of the proposed plan of reorganization (the "Plan") and the disclosure statement in *Boy Scouts* providing for the release of the local councils of Boy Scouts of America (the "Local Councils") and the chartered organizations (the "Chartered Organizations"),

the tort claimants' committee (the "TCC") filed an objection to the Plan, arguing that the Plan "releases the Boy Scouts' affiliates, Local Councils, and Contributing Chartering Organizations for a small sum relative to the enormous liabilities attributable to 84,000 childhood sexual abuse survivors." Specifically, the TCC argued that although the Third Circuit permits third party releases, the bankruptcy courts in Delaware have allowed non-consensual, non-debtor releases only if certain factors are satisfied, citing the factors identified in the seminal case of *In re Master Mortgage Inv. Fund, Inc.*, 168 B.R. 930, 934 (W.D. Mo. 1994). TCC went on to say:

> [W]ithout (a) overwhelming support from the Survivors (in the 90% range) (b) a demonstrated substantial financial contribution to the Settlement Trust by the applicable Local Councils and Contributing Chartered Organizations (as the proposed beneficiaries of the channeling injunction) based on pending childhood sexual abuse claims and the assets available to pay such Claims, and (c) a Plan that pays substantially all of the estimated value of the Survivors' claims, the Local Councils and Contributing Chartered Organizations cannot obtain non-consensual releases from Survivors or the benefits of the channeling injunction. Based on the publicly stated positions of the Tort Claimants' Committee and the Coalition, more than 90% of the Survivors will vote to reject the Plan. The Tort Claimants' Committee cannot fathom that the Boy Scouts could confirm the Plan over the opposition of the Survivors' fiduciary representative and the near unanimous opposition of the Survivor constituency.

See In re Boy Scouts of America and Delaware BSA, LLC, Case No. 20-10343 [ECF No. 3526].[1]

Although the derivative/non-derivative liability framework has not been adjudicated in these cases, *Grace* and other asbestos bankruptcy cases may be instructive to bankruptcy professionals in formulating chapter 11 reorganization plans in bankruptcies involving mass tort litigation. The derivative/non-derivative distinction (and by extension the distinction between whether a claim does or does not constitute property of the estate) may present a way to both promote the purposes of the Bankruptcy Code (*i.e.*, by encouraging the feasibility of a plan) and to ensure that creditors are not unduly denied their right to pursue their claims against third parties.

IV. PROPOSED LEGISLATION

At a hearing of the House Judiciary Committee on July 28, 2021, Congressman Jerrold Nadler announced the introduction of the *Nondebtor Release Prohibition Act of 2021* (the "NPRA"),[2] which proposes to amend the Bankruptcy Code to restrict non-consensual third-party releases in chapter 11 cases. The NPRA is sponsored by United States Senators Elizabeth Warren (D-Mass.),

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[1] Boy Scouts of America and Delaware BSA, LLC have since filed the *Fourth Amended Chapter 11 Plan of Reorganization for Boy Scouts of America and Delaware BSA, LLC* [ECF No. 5485] (the "Fourth Amended Plan"), which incorporates the support of the TCC. Among other tings, the Fourth Amended Plan provides for increased contributions from the debtors and the Local Councils.

[2] Nondebtor Release Prohibition Act, 117th Cong. (2021), available at: https://www.warren.senate.gov/imo/media/doc/DUN21578.pdf.

Dick Durbin (D-Ill.), and Richard Blumenthal (D-Conn.), and United States Representatives Jerrold Nadler (D-N.Y.) and Carolyn B. Maloney (D-N.Y.).

The proposed legislation is primarily in response to the proposed third-party release of the Sackler family in the reorganization plan in *In re Purdue Pharma L.P.*, Case No. 19-23639 (RDD). The hearing also discussed the nondebtor releases in *In re Boy Scouts of America and Delaware BSA, LLC*, Case No. 20-10343 (LSS) and *USA Gymnastics*, Case No. 18-09108 (RLM).

According to Congressman Nadler, the NPRA "will ban non-consensual non-debtor releases in most circumstances, impose strict safeguards for consensual non-debtor releases, and address the use of divisional mergers to shield a company's assets from bankruptcy."[3] Further, the bill expressly provides that consent to non-debtor releases must be given in a "signed writing" and such consent cannot be implied through accepting a proposed plan, failing to accept or reject a proposed plan, failing to object to a proposed plan, or any other silence or inaction.[4]

[3] Press Releases, *Chairman Nadler Statement for Subcommittee Hearing on "Oversight of the Bankruptcy Code, Part 1: Confronting Abuses of the Chapter 11 System,"* July 28, 2021, available at: https://nadler.house.gov/news/documentsingle.aspx?DocumentID=394711

[4] NPRA, § 2(a).

Faculty

Hon. Frank J. Bailey was appointed as a U.S. Bankruptcy Judge for the District of Massachusetts in Boston on Jan. 30, 2009, and served as Chief Judge from December 2010 until December 2015. He also serves on the First Circuit Bankruptcy Appellate Panel. Previously, Judge Bailey clerked for Hon. Herbert P. Wilkins of the Massachusetts Supreme Judicial Court from 1980-81 and was an associate at the Boston office of Sullivan & Worcester LLP until 1987, where he practiced in its litigation and bankruptcy departments. He spent the next 22 years as a partner at Sherin and Lodgen LLP, where he chaired its litigation department and was a member of its management committee. His practice focused on complex business litigation and creditors' rights, and he often represented clients in medical device, pharmaceutical and high-technology businesses. Judge Bailey served as the consul for the Republic of Bulgaria in Boston before his appointment to the bench, and he has participated in many international judicial programs. In 2013, he taught at the Astrakhan State University School of Law in south central Russia, and he has also taught courses in Sofia, Bulgaria and Tashkent, Uzbekistan. In addition, he taught legal writing and research at Boston University School of Law from 1981-93 and currently teaches business reorganizations at Suffolk University Law School in Boston. Judge Bailey was appointed by the First Circuit to oversee the financial restructuring of the City of Central Falls, R.I. He has served on the Board of Governors of the National Conference of Bankruptcy Judges and was its Education Committee Chair in 2017. He is currently president of the National Conference of Bankruptcy Judges. In addition, he is past chair of the National Conference of Federal Trial Judges of the American Bar Association, for which he currently serves as the Judicial Member at Large on the ABA Board of Governors and a member of the House of Delegates, and recently served as the chair of the Committee on the Profession, Public Service and Diversity. Judge Bailey received his B.S.F.S. from Georgetown University's School of Foreign Service and his J.D. from Suffolk University School of Law.

Hon. Janet E. Bostwick is a U.S. Bankruptcy Judge for the District of Massachusetts in Boston, appointed on Sept. 27, 2019. Prior to her appointment, she practiced as a bankruptcy attorney with more than 30 years of experience with financially troubled companies, dealing with chapter 11 business reorganizations, liquidations and wind-downs, loan workouts and creditor negotiations. From 2001-19, Judge Bostwick practiced at her own firm, Janet E. Bostwick, PC, which focused on business bankruptcy and restructuring. Before launching her firm, she practiced at the Boston firms of Goldstein & Manello, PC and Sherin and Lodgen, LLP. During her career, Judge Bostwick has been active in professional and bar associations and is a member of the Boston Bar Association, the American Bar Association and ABI. In 2007, she became a Fellow of the American College of Bankruptcy. She serves as a director of the American College of Bankruptcy Foundation and chairs its Pro Bono Committee. Judge Bostwick is actively involved in other professional organizations and frequently lectures on bankruptcy topics. She is a member of the American Bar Association, for which she serves as co-chair of the Administration and Courts Subcommittee of the its Business Bankruptcy Committee. She also is a member of the National Conference of Bankruptcy Judges, for which she serves on its Membership and Next Generation Committees. Judge Bostwick is a longstanding member of the International Women's Insolvency & Restructuring Confederation (IWIRC) and she served its IWIRC Chair (2002-04) and as a director. She also is the founding chair of the IWIRC-New England Network. Judge Bostwick received her B.A. in economics and mathematics from the State University of New York at Albany and her J.D. from Cornell Law School.

Hon. Ashely M. Chan is a U.S. Bankruptcy Judge for the Eastern District of Pennsylvania in Philadelphia. Prior to taking the bench, she was a shareholder at Hangley Aronchick Segal Pudlin & Schiller and concentrated her practice in the areas of bankruptcy and corporate restructuring. From 1996-97, Judge Chan clerked for Hon. Gloria M. Burns of the U.S. Bankruptcy Court for the District of New Jersey. Before joining HASPS, she was an associate at Morgan, Lewis & Bockius LLP in its business and finance section, where she focused on bankruptcy, corporate restructuring and corporate finance. Judge Chan has received numerous recognitions, including being selected as a Leader in Bankruptcy/Restructuring by *Chambers USA*, being listed in *The Best Lawyers in America* for Bankruptcy and Creditor-Debtor Rights, and being listed as a Pennsylvania Lawyer on the Fast Track by *The Legal Intelligencer* and *Pennsylvania Law Weekly*. She also served as chair of the Eastern District of Pennsylvania Bankruptcy Conference and president-elect and board member of the Homeless Advocacy Project. Judge Chan received her J.D. in 1996 from Rutgers School of Law – Camden, where she received Tax Honors with Distinction and the Rutgers Pro Bono Publico Award.

Hon. Eric L. Frank is a U.S. Bankruptcy Judge for the Eastern District of Pennsylvania in Philadelphia, initially appointed in February 2006 and appointed Chief Judge from March 2013 to February 2018. Prior to taking the bench, he was a shareholder in DiDonato and Winterhalter, P.C., a partner in Miller, Frank & Miller and a supervising attorney at Community Legal Services, Inc. in Philadelphia. From 1998 to 2005, Judge Frank served as a member of the federal Judicial Conference Advisory Committee on the Federal Rules of Bankruptcy Procedure, where he served as chair of the subcommittee with primary responsibility for drafting numerous rules and forms amendments required by the enactment of BAPCPA in 2005. He is a past chair of the Steering Committee of the Eastern District of Pennsylvania Bankruptcy Conference and a past president of the board of directors of the Consumer Bankruptcy Assistance Project in Philadelphia, which provides referrals and representation in chapter 7 bankruptcy cases to low-income individuals on a *pro bono* basis. Since 1998, Judge Frank has been a contributing author to *Collier on Bankruptcy*. He received his B.A. from the State University of New York at Binghamton in 1973 and his J.D. from the University of Pensylvania Law School in 1976, where he served on its law review. Following law school, he clerked for the late Justice Samuel J. Roberts of the Pennsylvania Supreme Court and for U.S. Bankruptcy Judge Bruce I. Fox.

Norman N. Kinel is a partner in Squire Patton Boggs' Restructuring & Insolvency Practice group in New York and is national chair of the firm's Creditors' Committee Practice. With more than 30 years of experience as a bankruptcy practitioner, he has successfully represented and litigated on behalf of clients in some of the nation's largest and most intricate bankruptcy cases, involving numerous industries. Mr. Kinel regularly represents debtors, creditors, bondholders, trustees and committees of creditors, equityholders and retirees. He also often advises clients in out-of-court default, workout and restructuring matters. Mr. Kinel has experience in bankruptcy asset sales and mergers and acquisitions, as well as cross-border insolvency proceedings. His practice includes complex bankruptcy litigation and appeals involving contested confirmations of plans, DIP financing, cash collateral and adequate protection, relief from the automatic stay, assumption and rejection of executory contracts and leases, exclusivity and substantive consolidation. He also has litigation expertise in connection with director and officer liability, breach of fiduciary duty, fraudulent conveyance and preferential transfer actions. Mr. Kinel is listed on the Register of Mediators of the U.S. Bankruptcy Courts for the Southern and Eastern Districts of New York and the District of Delaware, and was a court-approved mediator in the *Lehman Brothers* cases. He received his undergraduate degree in 1980 from Yeshiva University and his J.D. in 1983 from American University Washington College of Law.