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Great Debates

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Supreme Court Reverses Purdue: No Nondebtor, Third-Party, Nonconsensual Releases

> Justice Gorsuch for the majority bans third-party releases broader than a discharge for those who don't surrender all their assets to the court.

In a 5/4 decision, the Supreme Court reversed the Second Circuit's *Purdue* decision and declined an invitation to anoint chapter 11 as the remedy for deficiencies in the state and federal tort systems.

In his 20-page majority opinion June 27, Justice Neil M. Gorsuch defined the question before the Court as "whether a court in bankruptcy may effectively extend to nondebtors the benefits of a Chapter 11 discharge usually reserved for debtors." He held "that the bankruptcy code does not authorize a release and injunction that, as part of a plan of reorganization under Chapter 11, effectively seeks to discharge claims against a nondebtor without the consent of affected claimants."

Justice Gorsuch telegraphed the outcome when he said in the very first paragraph that the owners and executives of the opioid manufacturer were aiming for absolution from claims against them "without securing the consent of those affected or placing anything approaching their total assets on the table for their creditors."

The Profit by the Owners from Opioids

Justice Gorsuch recited the facts and procedural history, focusing on the profits that the owners and managers of the Purdue opioid manufacturer had realized in the years leading up to the filing of the company's chapter 11 case in 2019. In the years before the opioid crisis grabbed national attention, the owners and managers received some 15% of company revenue, compared to about 70% each year after 2007. Ultimately, they received distributions of about $11 billion.

In the original chapter 11 plan, the owners proposed to contribute $4.325 billion, spread over 10 years, in exchange for nonconsensual "releases" of all claims, present and future, that might be brought against them. Justice Gorsuch noted that "thousands" of "opioid victims" voted against the plan. The U.S. Trustee, eight states and others opposed confirmation of the plan.

The bankruptcy court confirmed the plan over objections by the U.S. Trustee, eight states and others. On appeal, the district court reversed and vacated the decision confirming the plan. *In re Purdue Pharma, L.P.*, 635 14 B.R. 26 (S.D.N.Y. 2021). To read ABI's report, **click here**.

After reversal in district court, the owners contributed another $1.675 billion to the plan to alleviate objections from states. Justice Gorsuch said that the owners' "proposed contribution still fell well short of the $11 billion they received from the company between 2008 and 2016."

On the debtor's appeal, the Second Circuit reversed and reinstated the plan over a dissent. *Purdue Pharma LP v. City of Grand Prairie (In re Purdue Pharma LP)*, 69 F.4th (2d Cir. May 30, 2023). To read ABI's report, **click here**.

The U.S. Trustee filed an application with the Supreme Court for a stay pending appeal. The Court treated the application as a petition for *certiorari* and granted the petition in August along with a stay. The Court heard argument on December 4.

The Merits and Section 1123(b)(6)

Before turning to Section 1123(b)(6) and the principal reason for reversing the Second Circuit, Justice Gorsuch noted that the owners "have not filed for bankruptcy and have not placed virtually all their assets on the table for distribution to creditors, yet they seek what essentially amounts to a discharge."

If there were any basis for a discharge in favor of nondebtors, Justice Gorsuch said it would be found in Section 1123(b)(6). It provides that a chapter 11 plan may include "any other appropriate provision not inconsistent with the applicable provisions of this title."

The plan proponents argued before the Court that the releases were permissible because they were nowhere prohibited in the Bankruptcy Code. As a so-called catchall subject to the *ejusdem generis* canon, Justice Gorsuch said that the subsection is "not necessarily" given the broadest possible construction but "must be interpreted in light of its surrounding context."

"Viewed with that much in mind," Justice Gorsuch said, "we do not think paragraph (6) affords a bankruptcy court the authority the plan proponents suppose." Rather, he said that "the catchall cannot be fairly read to endow a bankruptcy court with the 'radically different' power to discharge the debts of a nondebtor without the consent of affected nondebtor claimants." The other subsections in Section 1123(b), he said, authorize releases "without consent only to the extent such claims concern the debtor."

Justice Gorsuch said that "no one (save perhaps the dissent) thinks [that the catchall] provides a bankruptcy court with a roving commission to resolve all such problems that happen its way."

Other Grounds for Reversal

In the Bankruptcy Code, Justice Gorsuch found three other grounds for reversal. First, the Code reserves discharges for the debtor. Second, the Code requires the debtor to submit all of the debtor's assets to the court. Furthermore, he said, a discharge is not "unbounded," because some claims are exempted from discharge. The Purdue plan, he said, "transgresses all these limits too."

Third, Justice Gorsuch pointed to Section 524(g)(4)(A)(ii) and said that the Code authorizes nondebtor releases "but does so in only one context," namely, plans dealing with asbestos.

Saying that "word games cannot obscure the underlying reality," Justice Gorsuch rejected the idea that the plan just gave releases to the owners, not discharges.

Prior Law

"History" offers a "third" ground for dismissal, Justice Gorsuch said, observing that "pre-code practice may sometimes inform our interpretation of the code's more 'ambiguous' provisions." From 1800 to 1978, he said,

> No one has directed us to a statute or case suggesting American courts in the past enjoyed the power in bankruptcy to discharge claims brought by nondebtors against other nondebtors, all without the consent of those affected.

As far as policy is concerned, Justice Gorsuch noted arguments going both ways. If a policy decision were to be made, "it is for Congress to make," he said.

What the Opinion Does Not Decide

Justice Gorsuch devoted the last page of his decision to noting what the opinion does not decide. First, he said,

> Nothing in what we have said should be construed to call into question consensual third-party releases offered in connection with a bankruptcy reorganization plan; those sorts of releases pose different questions and may rest on different legal grounds than the nonconsensual release at issue here.

Likewise, he said that the decision does not say "what qualifies as a consensual release," nor does the decision "pass upon a plan that provides for the full satisfaction of claims against a third-party nondebtor." The statement appears to express no view on whether a consensual release must be "opt-in" rather than "opt-out."

Of significance with respect to plans already confirmed, Justice Gorsuch said, "because this case involves only a stayed reorganization plan, we do not address whether our reading of the bankruptcy code would justify unwinding reorganization plans that have already become effective and been substantially consummated." The statement is pertinent to the confirmed Boy

Scouts plan, where an appeal is pending in the Third Circuit. The statement is another way of saying that the opinion says nothing about the validity of the doctrine of equitable mootness.

Holding that "the bankruptcy code does not authorize a release and injunction that, as part of a plan of reorganization under Chapter 11, effectively seeks to discharge claims against a nondebtor without the consent of affected claimants," Justice Gorsuch reversed and remanded.

The Lengthy Dissent

Joined by Chief Justice John G. Roberts, Jr., Sonia Sotomayor and Elena Kagan, Justice Brett Kavanaugh "respectfully" dissented in a 54-page opinion. However, he was dissenting "respectfully but emphatically," which became evident with his choice of language, as the reader will see below.

Justice Kavanaugh said that the majority's decision was "wrong on the law and devastating for more than 100,000 opioid victims and their families." Chapter 11, he said, was designed to prevent a race to the courthouse by vesting "bankruptcy courts with broad discretion to approve 'appropriate' plan provisions. 11 U.S.C. § 1123(b)(6)."

In the case at hand, he said that "the Bankruptcy Court exercised that discretion appropriately — indeed, admirably." It was, he said, a "shining example of the bankruptcy system at work." In making a categorical preclusion of nondebtor releases for "no good reason," he said that the majority "now throws out . . . a critical tool for bankruptcy courts to manage mass-tort bankruptcies like this one."

Justice Kavanaugh said that mass torts "present the same collective-action problem that bankruptcy was designed to address," by preventing "victims from litigating outside of the bankruptcy plan's procedures." He found authority for the releases in Section 1123(b)(6), saying that the word "appropriate" was broad and all-encompassing authority that "empowers a bankruptcy court to exercise reasonable discretion." He said that the majority's decision "flatly contradicts the Bankruptcy Code" and that the Code "does not remotely support that categorical prohibition."

In terms of history, Justice Kavanaugh said that "courts have been approving such nondebtor releases almost as long as the current Bankruptcy Code has existed since its enactment in 1978." He lauded the Second Circuit for having "developed a non-exhaustive list of factors for determining whether a non-debtor release is appropriately employed and appropriately tailored in a given case."

Judge Kavanaugh said that the majority's use of the *ejusdem generis* canon was "dead wrong" for two reasons. "First," he said, "its common thread is factually wrong. And second, its purported common thread disregards the evident purpose of § 1123(b)."

The majority should not have relied on Section 524(g), Justice Kavanaugh said, because the "very text of § 524(g) expressly precludes the Court's inference." He quoted the statute as follows: "'Nothing in [§ 524(g)] shall be construed to modify, impair, or supersede any other authority the court has to issue injunctions in connection with an order confirming a plan of reorganization.' 108 Stat. 4117, note following 11 U.S.C. § 524."

Justice Kavanaugh disagreed with the majority's belief that a release was the same as a discharge. He pointed out that the release only pertains to claims related to Purdue.

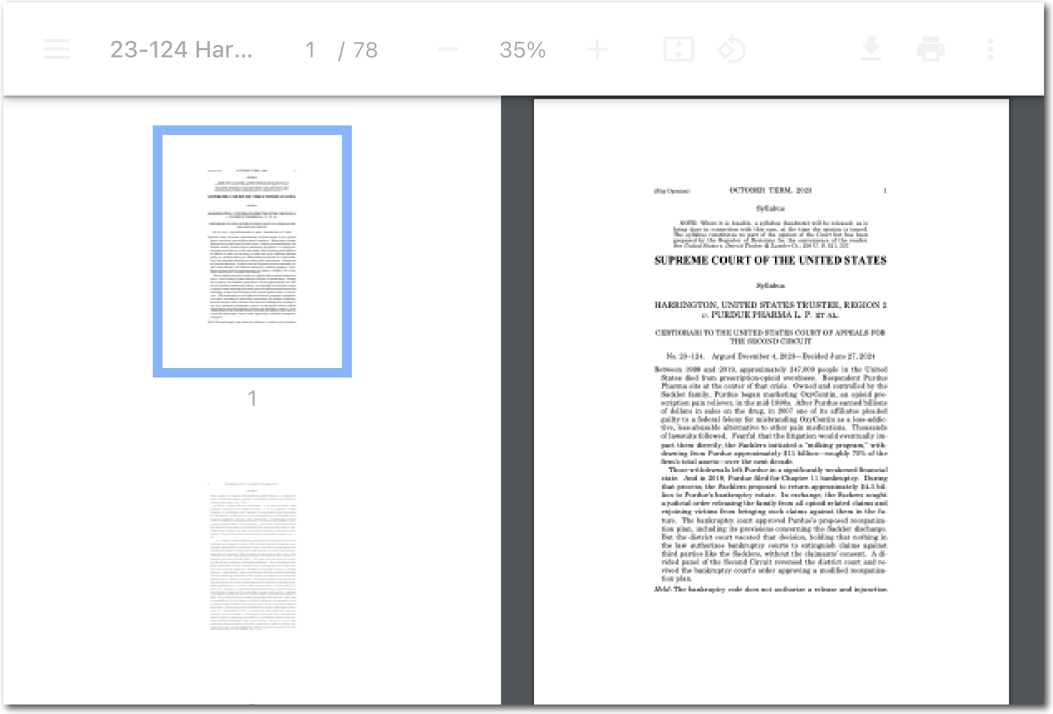
Concluding his dissent, Justice Kavanaugh said that the majority's opinion "makes little sense legally, practically, or economically." Pointing to Boy Scouts, the Catholic Church cases, breast implants, Dalkon Shield and others, he said that nondebtor releases "have been indispensable to solving that problem and ensuring fair and equitable victim recovery."

Justice Kavanaugh said that the "Court's decision will lead to too much harm for too many people for Congress to sit by idly without at least carefully studying the issue." If the majority believed that $5.5 billion to $6 billion from the owners was not enough, he said that the Court "at most" should have remanded for the lower courts to decide “whether the releases were ‘appropriate’ under 11 U.S.C. § 1123(b)(6) (if anyone had raised that argument here, which they have not).”

Note: Justice Kavanaugh said that the U.S. Trustee opposed the plan “for reasons that remain mystifying.”

Opinion Link

PREVIEW



https://www.supremecourt.gov/opinions/23pdf/23-124_8nk0.pdf

Case Details

Case Citation	Harrington v. Purdue Pharma L.P., 23-124 (Sup. Ct. June 27, 2024.)

Case Name	Harrington v. Purdue Pharma L.P.
Case Type	Business
Court	Supreme Court
Bankruptcy Tags	Claims Bankruptcy Litigation Court Administration Plan Confirmation Business Reorganization Govt. Claims/Sovereign Immunity

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Litigator's Perspective

By Marshall S. Huebner and Kate Somers

Opting Into Opting Out: Due Process and Opt-Out Releases

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Mass tort bankruptcies often involve complex and interrelated settlements where the primary payors — including insurers, former owners or co-tortfeasors — are not the debtors themselves. Finality and the resolution of litigation, including releases from third parties and the debtors, are often the only ways to achieve a value-maximizing (and invariably largely consensual) outcome for creditors.

Now that the U.S. Supreme Court has issued its ruling barring nonconsensual releases, there will — absent legislative change — be an even greater focus on (and need for) other types of releases with respect to third parties, including both opt-out and opt-in releases. Provided that factors are satisfied, opt-out releases (a mechanic on a ballot or notice of nonvoting status that allows claimants to check a box to opt out of nondebtor releases in a reorganization plan) will likely be the best available pathway for effectuating the will of — and providing the best available recovery to — creditors and victims.

For good reason, the overwhelming majority of courts that have considered the issue have held that opt-out releases are permissible in appropriate circumstances. These decisions focus on a small number of appropriate factors to ensure fairness and that due process has been satisfied.[1] Virtually all of the cases declining to approve opt-out releases did so because these same factors were not satisfied on the facts before them.

This also comports with Federal Rule of Civil Procedure 23(b)(3) class actions, where courts have agreed that "it seems fair for the silent to be considered as part of the class."[2] Appellate courts around the nation have expressed serious reservations regarding whether Civil Rule 23 permits certification of an *opt-in* class, and have recognized the benefit of opt-out settlements in class actions, in part because requiring "individuals affirmatively to request inclusion in the lawsuit would result in freezing out the claims of people — especially small claims held by small people — who for one reason or another ... will simply not take the affirmative step."[3]

Simply stated, due process (as well as care and concern for victims) weighs strongly in favor of opt-out over opt-in procedures. Creditors' rights are far better preserved by an opt-out mechanism that allows them to participate in the deal unless they expressly decline where (1) reorganization plans negotiated by multiple fiduciaries and creditor representatives provide enhanced recoveries to claimants in exchange for consenting to third-party releases; (2) the consideration provided in exchange for the release is substantial; (3) settlements result from fair, arm's-length negotiations; and (4) there is appropriate notice of the right to opt out. This is especially true for less sophisticated or not separately represented claimants: The notion that they were unable to timely opt out (a one-page form), but desire to prosecute a lawsuit in lieu of accepting their plan recovery, is illogical and unsupportable.

Factors in Support of Opt-Out Releases in Appropriate Circumstances

Bankruptcy courts have focused on the following entirely sensible factors in deciding whether opt-out releases are appropriate on the facts before them:

1. adequate or meaningful recoveries for creditors;[4]
2. volume of opt-out elections actually received;[5]
3. adequate consideration provided in exchange for release;
4. clear and prominent notice of the release and the opportunity to opt out;[6]
5. highly publicized nature of the case and the third-party releases, including in cases "of great notoriety" where creditors "knew about the existence of the bankruptcy case [and] knew they would have to act";[7]
6. active creditor participation;[8]

1 Both Second Circuit opinions in *Purdue* suggest that opt-out releases are consensual. *See In re Purdue Pharma LP*, No. 22-110, at 83 (2d Cir. May 30, 2023) (ECF No. 978-1) ("[T]he Trustee also questions whether such a release, without an ability to opt out, can comply with due process because it effectively denies claimants their day in court."); *see also id.* at 87-88 (concurrence) ("Finally, the Release is nonconsensual; *it binds consenting and objecting parties, without providing an opt-out option to those who object.*") (emphasis added).

2 *Kern v. Siemens Corp.*, 393 F.3d 120, 124 (2d Cir. 2004) (citing Benjamin Kaplan, "Continuing Work of the Civil Committee: 1966 Amendments of the Federal Rules of Civil Procedure (I)," 81 *Harv. L. Rev.* 356, 397-98 (1967)); *see also Philipps Petroleum Co. v. Shutts*, 472 U.S. 797 at 813, n.4 (1985).

3 *Id.*

4 *In re LATAM Airlines Grp. SA*, No. 20-11254 (JLG), 2022 Bankr. LEXIS 1725, at 144 n.88 (Bankr. S.D.N.Y. June 18, 2022).

5 *Id.*

6 *Id.* at 144.

7 Hr'g Tr. at 110: 10-17, *In re Insys Therapeutics Inc.*, No. 19-11292 (KG) (Bankr. D. Del. Jan. 17, 2020) (ECF No. 1121).

8 Hr'g Tr. at 158:19-22, I*n re Cumulus Media Inc.*, No. 17-13381 (Bankr. S.D.N.Y. May 1, 2018) (ECF No. 749).

7. whether creditors had adequate representation, including by official committees;[9] and
8. the unique nature of mass tort bankruptcies and/or integrated settlements that confer broad benefit to all stakeholders.

Many courts have found opt-out releases to be appropriate in the mass tort context.[10] Even the U.S. Trustee's Office has started coming around of late.[11]

Where these factors are satisfied, it defies reason to assume that creditor silence should be deemed a rejection, rather than an acceptance, of a negotiated settlement. Moreover, as the *Mallinckrodt* court explained, the notion of deemed consent by failure to act "is utilized throughout the judicial system."[12] The court continued, "in bankruptcy ... [d]ebtors send out bar date notices, and if claimants fail to file a proof of claim by a certain time, they lose the right to assert a claim," concluding that it would be reasonable to apply this principle "in the same manner to properly noticed releases within a plan of reorganization."[13] Several dozen bankruptcy courts around the nation have applied similar reasoning in approving opt-out releases.

Hon. **Mary F. Walrath** of the U.S. Bankruptcy Court for the District of Delaware, one of the only judges to have held opt-out releases to be categorically impermissible other than for creditors voting in favor of the plan (in 2011's *Washington Mutual* case),[14] recently has approved them at least twice. In *Clarus Therapeutics*, she approved opt-out releases for voting creditors "given [the] sufficient opportunity to opt out of any releases," finding that "the releases as to them are fair and consensual."[15] In *EYP Group*, Judge Walrath found releases consensual as to claimants that (1) voted to accept; (2) were deemed to accept and did not object to the releases; or (3) voted to reject and did not opt out.[16]

The two other cases (out of dozens that take the opposite view) most frequently cited as categorically opposing opt-out releases may well not be, for while the *Ascena* court so states, the majority of the decision examined the very aforementioned factors, suggesting that opt-out releases may have been denied for case-specific reasons.[17] In particular, the notice of the *Ascena* opt-out release provision was found to be wholly inadequate,[18] the releasing parties received "nothing more than illusory consideration" in exchange for providing the release,[19] the releasing parties lacked adequate representation, and negotiation of the release settlement was not done at arm's length.[20]

We do not believe that there are any other categorical rejection decisions. For example, *Chassix*, often mis-cited as one, expressly acknowledged that "[c]ircumstances may justify a different approach in different cases."[21] Hon. **Michael E. Wiles** of the U.S. Bankruptcy Court for the Southern District of New York noted that on the facts before him, "relatively small recoveries ... could easily have prompted an even higher-than-usual degree of inattentiveness or inaction."[22] More recent decisions have distinguished *Chassix* on this basis, noting that "projected meager recoveries" in that case made it "likely that unsecured creditors did not focus on the fact that the plan called for them to take action not to grant the nondebtor releases."[23]

Civil Rule 23(b)(3)

In *Chassix*, Judge Wiles opined that while "in the class-action context there is a public policy that favors the consolidation of similar cases" and "justifies the imposition of a rule that binds class members who have not affirmatively opted out," no such policy exists "in favor of making third-party releases applicable to as many creditors as possible."[24] As an initial matter, his position seems inapposite to mass tort cases, which have tens of thousands of victims with similar claims. In these cases, opt-in procedures might not be feasible.

In *Mallinckrodt*, Hon. **John T. Dorsey** of the U.S. Bankruptcy Court for the District of Delaware distinguished cases that did not "involve mass tort bankruptcies like this one."[25] As he explained, "the sheer volume and complexity of the issues presented in cases like these require creative solutions which often build upon each other or depend on the success of each other in a way that unraveling one will cause all to fall apart."[26]

Justice Sonia Sotomayor's reasoning during oral arguments in *Purdue* further supports this position. Contemplating "thousands, if not hundreds of thousands, maybe millions of personal injury claims" in *Purdue*, she asked the U.S. Trustee what consent would look like "in a case like this."[27] Addressing the suggestion that an opt-in election evidencing affirmative consent should always be required, Justice Sotomayor replied, "So, basically, you're [saying] that there really is no way to do this in bankruptcy right now, because I don't know how an opt-in process ... would actually work."[28]

In *Ascena*, the court concluded that none of the protections of Civil Rule 23 existed in chapter 11, opining, *inter alia*, that "the absent releasing party does not enjoy counsel that will represent his best interests in his stead."[29] This is not so: Creditors in bankruptcy cases benefit from

9 Hr'g Tr. at 13:21-25; 14:1-7, *In re Clovis Oncology Inc.*, No. 22-11292 (JKS) (Bankr. D. Del. June 9, 2023) (ECF No. 875).
10 *In re Mallinckrodt PLC*, 639 B.R. 837 (Bankr. D. Del. 2022); *In re Boy Scouts of Am. and Delaware BSA LLC*, 642 B.R. 504 (Bankr. D. Del. 2022).
11 U.S. Trustee Objection, *In re Amyris Inc.*, No. 23-11131 (Bankr. D. Del Jan. 18, 2024) (ECF No. 1154) (acknowledging *Mallinckrodt* and *Boy Scouts* and that "not all decisions from this District have required affirmative consent for third-party releases").
12 *Mallinckrodt*, 639 B.R. at 879.
13 *Id.*
14 *In re Wash. Mut. Inc.*, 442 B.R. 314, 355 (Bankr. D. Del. 2011).
15 Hr'g Tr. at 8:17-20, *In re Clarus Therapeutics Holdings Inc.*, No. 22-10845 (Bankr. D. Del. Feb. 8, 2023) (ECF No. 322).
16 Confirmation Order ¶ T, *In re EYP Grp. Holdings Inc.*, No. 22-10367 (Bankr. D. Del. Nov. 1, 2022) (ECF No. 568); *see also* Plan ¶¶ 1.1.122, 6.5.
17 *Patterson v. Mahwah Bergen Retail Grp. Inc.*, 636 B.R. 641 (E.D. Va. 2022) ("*Ascena*").
18 *Id.* at 659 (noting that bankruptcy court "did not order that any notice or opt-out forms be sent to all of the Releasing Parties" and ordered publication of "general notice of the confirmation hearing in *USA Today* and *The New York Times*" for one single day).
19 *Id.* at 687.
20 *Id.* at 686 (noting that bankruptcy court "expressly rejected the ability of certain absent releasing parties to have a party and counsel represent their best interests").
21 *In re Chassix Holdings Inc.*, 533 B.R. 64, 79 (Bankr. S.D.N.Y. 2015).
22 *Id.* at 80.
23 *In re LATAM Airlines Grp. SA*, No. 20-11254 (JLG), 2022 Bankr. LEXIS 1725, at *144 n.88 (Bankr. S.D.N.Y. June 18, 2022) (noting that in *LATAM*, releasing parties were "receiving exponentially greater recovery" than in *Chassix*).
24 *In re Chassix Holdings Inc.*, 533 B.R. at 78.
25 *Mallinckrodt*, 639 B.R. at 881.
26 *Id.*
27 Hr'g Tr. at 15:6-14, *William K. Harrington, U.S. Trustee v. Purdue Pharma LP*, No. 23-124 (U.S. Dec. 4, 2023).
28 *Id.* at 16:2-9, 12-13.
29 *Ascena*, 636 B.R. at 686-87.

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Litigator's Perspective: Due Process and Opt-Out Releases

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a multitude of protections that collectively ensure that due process is satisfied, including representation by two statutory fiduciaries and other organized creditor groups, statutorily mandated notice under § 1125 of the Bankruptcy Code, opportunities to participate and be heard throughout a case, and the myriad protections of § 1129, including that the plan be in the best interests of *all* creditors, and that they receive more than they would in a liquidation.

Provided that the factors supporting opt-out releases are satisfied, opt-outs are far more protective of creditor interests than a mandatory opt-in. This is particularly true where creditors stand to receive increased recoveries in exchange for granting third-party releases. For example, the *Endo* plan featured different release mechanics for different classes: "sophisticated" creditors (including secured creditors and tribes) would be granted third-party releases if they declined to opt out, whereas general unsecured creditors and personal-injury victims would only be granted releases if they voted in favor of the plan or opted in.[30] Certain of these creditors received a four-times-the-recovery multiplier for granting the third-party release, either by opting in or declining to opt out, as applicable.[31]

Ironically, the U.S. Trustee in *Endo* did not object to opt-outs for "sophisticated" creditors and was seemingly a central participant in negotiating the releases.[32] However, barring the opt-out for smaller creditors was tragically detrimental to them. Counsel to the official committee of *Endo* opioid claimants explained:

> [T]he U.S. Trustee's position regarding the release provisions has the result of penalizing personal-injury victims who do not either vote in favor of the Plan or affirmatively "opt in" to the third-party releases by depriving them of a significant portion of their recovery (while not doing the same for political subdivisions or any other non-individual Opioid Claimants). The U.S. Trustee presumably took this position because it did not want to allow personal-injury victims to unwittingly grant third-party releases ... notwithstanding the outsized importance of Plan recoveries to such claimants relative to the potentially released claims against third-party defendants — claims [that] personal-injury victims likely would not bring if they did possess them in light of the costs of litigation relative to the speculative recoveries on such claims in this particular case.... The U.S. Trustee must believe that its position in this case (and others) is actually helping personal-injury victims; the [official committee of unsecured creditors] disagrees.[33]

As in Civil Rule 23(b)(3) class actions — which require opt-outs and likely bar opt-ins — the *Endo* victims would have been far better served with an opt-out provision, which would have quintupled their plan recoveries unless they opted out. Instead, because they had to opt in to get the multiplier, many victims inadvertently lost out on 80 percent of their plan recoveries — for nothing. This grievous harm is as avoidable as it is incomprehensible.

Conclusion

Much is lost when silent creditors are denied plan recoveries in exchange for illusory rights to retain direct claims they will almost surely never bring. The irrational assumption that silence can constitute rejection but not acceptance of a fair deal harms creditors and victims. Due process, and justice itself, is far better served where — in appropriate cases — statutory fiduciaries overseen by courts can opt in to opt-outs, and opt out of using opt-ins. abi

30 Confirmation Brief, *In re Endo Int'l plc*, No. 22-22549 (JLG), at 120 (Bankr. S.D.N.Y. March 7, 2024) (ECF No. 3787).

31 Fourth Amended Joint Chapter 11 Plan, *Endo Int'l* (Bankr. S.D.N.Y. March 18, 2024) (ECF No. 3849), at Art. IV.

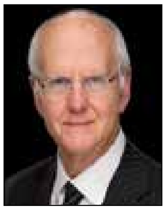
32 Confirmation Brief, *Endo Int'l* at 120 (Bankr. S.D.N.Y. March 7, 2024) (ECF No. 3787).

33 Statement of the Official Comm. of Opioid Claimants in Support of Confirmation, *Endo Int'l* ¶ 8, n.10 (Bankr. S.D.N.Y. March 7, 2024) (ECF No. 3785).

Feature

By David R. Kuney[1]

The Aftermath of *Purdue Pharma*: The Myth of the Full-Pay Plan



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The U.S. Supreme Court ruled on June 27, 2024, that nonconsensual third-party releases in a bankruptcy reorganization plan are not permitted under the Bankruptcy Code other than in 11 U.S.C. § 524.[2] "[A] bankruptcy court's powers are not limitless, and do not endow it with the power to extinguish without their consent claims held by nondebtors ... against other nondebtors."[3] Further, the Bankruptcy Code "does not authorize a release and injunction that, as part of a plan of reorganization under Chapter 11, effectively seeks to discharge claims against a nondebtor without the consent of affected claimants."[4] The scope of the ruling has already generated debate as to the meaning of the final paragraph in the majority decision, authored by Justice Neil Gorsuch, which reads as follows:

> Nor do we have occasion today to express a view on what qualifies as a consensual release or pass upon a plan that provides for the full satisfaction of claims against a third-party non-debtor ... [and] we do not address whether our reading of the [B]ankruptcy [C]ode would justify unwinding reorganization plans that have already become effective and have been substantially consummated.[5]

The Boy Scouts of America have a pending appeal before the Third Circuit Court of Appeals that likewise involves the validity of a nonconsensual third-party release.[6] The Boy Scouts have already pounced on this last paragraph in the hopes of convincing the Third Circuit that the nonconsensual releases in its plan are valid, notwithstanding the ruling in *Purdue*. In the Boy Scout's post-*Purdue* letter to the Third Circuit dated June 28, 2024 (just one day after *Purdue* was decided), it argued that their chapter 11 plan is "materially different from the plan at issue in *Purdue* in multiple respects," including that their plan supposedly "provide[s] for payment in full."[7] In the Boy Scouts' *amicus* brief in *Purdue*, it expressly asks the Court to reserve on the issue of "full satisfaction."[8]

Justice Brett Kavanaugh's dissent is fairly read as closing the door on the "full pay" argument as a matter of law.[9] "The Court decides today to reject the plan by holding that nondebtor releases are *categorically impermissible* as a matter of law."[10] Again, "the Court categorically decides that nondebtor releases are *never* allowed as a matter of law."[11] However, "the Court today says that a plan can *never* release victims' and creditors' claims *against nondebtor officers and directors of the company*."[12] "Categorical" and "never" are not words lacking in force.

Justice Kavanaugh said that he believed "full satisfaction" releases should be permitted.[13] However, he acknowledged that under the majority's opinion, "full satisfaction releases *might* be permissible," but only if one "eviscerated" the majority's analysis under the rule of construction of *ejusdem generis*.[14] If the majority's decision is to be regarded now as the legally correct and binding view, then third-party releases are not permitted — even if the plan provides for the "full satisfaction" of claims. He also stated that it was possible that "full satisfaction releases are actually impermissible" under the majority's view of § 1123(b)(6) — a view that he held was "extreme."[15] In short, permitting full-pay plans as a justification for nonconsensual third-party releases eviscerates the majority's holding in *Purdue*.

If the Supreme Court truly did not "express" a view on the legitimacy of full-pay plans, it was mostly because the issue was not before it. *Purdue* was not a full-pay plan, so the Court had no need to address the issue. Nevertheless, the underlying logic and rationale of the majority decision is entirely consistent with the view that even full-pay plans would fall outside of what Congress intended to permit.

The appellants in the *Boy Scouts* case, the D&V claimants, argued that there were serious deficiencies with the expert testimony and

1 Mr. Kuney has authored two *amicus* briefs in the *Boy Scouts of America* case in support of a group of sexual abuse claimants (herein referred to as the "D&V claimants"). This article represents solely the author's own views and not those of Georgetown University Law Center.
2 *Harrington, United States Trustee, Region 2 v. Purdue Pharma LP, et al., slip op.* 23-124 (June 27, 2024).
3 *Id.* at 13.
4 *Id.* at 19.
5 *Id.*
6 *Dumas & Vaughn, Claimants v. Boy Scouts of Am., et al. (In re Boy Scouts of Am. and Delaware BSA LLC)*, App. Case No. 23-1666 (3d Cir.) (hereinafter, *In re Boy Scouts of Am.*).
7 *Id.* at ECF Dkt. 191-1.
8 Brief for the Boy Scouts of America as *Amicus Curiae* in Support of Respondent, at 18, n.2.
9 Justice Kavanagh's dissent was joined by Chief Justice John Roberts and Justices Sonia Sotomayor and Elena Kagan.
10 *Purdue Pharma, slip op.* at 31 (Kavanaugh, J., dissenting) (emphasis added).
11 *Id.* at 32.
12 *Id.* at 2.
13 *Id.* at 39.
14 *Id.* at 39-40 (emphasis added).
15 *Id.* at 40.

the determination of the aggregate value of the tort claims (which effectively caps liability) this being an issue that leading scholars have identified as one of the core defects with assertions of "full pay." This is further explained in the discussion below concerning Profs. **Ralph Brubaker** of the University of Illinois College of Law and **Melissa B. Jacoby** of the University of North Carolina School of Law. In short, the aftermath of *Purdue* is that the use of full-pay releases should not be seen as a legitimate road map for future cases to impose nonconsensual third-party releases, nor should it prevail in the existing appeal in the *Boy Scouts* case now pending before the Third Circuit.

The Structural and Legal Defects with the Full-Pay Argument

At its core, the majority's decision is a legal determination that Congress did not intend to permit nonconsensual releases, other than in one narrow area under § 524(g). No Bankruptcy Code provision permits them, various Code provisions are inconsistent with such releases, and there is neither a public policy nor historical precedent to justify them. This is likely why Justice Kavanaugh stated that the majority opinion categorically held releases to be impermissible.

"Full pay" is nothing more than one of the many factors sometimes used to justify permitting nonconsensual third-party releases. The notion that a list of "factors" can be developed and deployed by the bankruptcy court to sanction the use of nonconsensual third-party releases has been sharply criticized by Prof. Brubaker.

The legal defect, which is broad, is that the power to determine the scope of the bankruptcy discharge is constitutionally vested solely within Congress's bankruptcy power. Under basic principles of separation of powers, bankruptcy courts are not constitutionally free to infringe on this legislative power by judicially adding "factors" that create substantive discharge rights. Prof. Brubaker noted that "federal courts are illicitly creating substantive federal common law through their jurisprudence authorizing nondebtor releases. Indeed, this is apparent from the list of criteria — exclusively the product of judicial imagination — that supposedly trigger bankruptcy courts' power to grant discharge relief for nondebtors."[16]

What makes the use of such factors as "full pay" illicit is that it allows the courts to usurp the congressional power to determine the scope of the discharge. However, "nondebtor release practice — including the requirement that a discharged nondebtor 'has contributed substantial assets to the reorganization — presumes to lodge plenary authority for such determination in the courts,'" thus violating basic principles of separation of powers of Congress and the courts.[17]

The further legal defect with engrafting "full pay" onto the discharge/release power is its "pernicious" unfairness and the almost certain likelihood that the promise of full pay will prove illusive. Prof. Brubaker points out that the structural defect with full-pay plans is that the actual aggregate liability to all mass tort claimants is not yet fully determined; instead, the court uses an estimate to put a "hard cap" on the liability, which is then used to fund a settlement trust. As such, the "prejudice to mass tort claimants from such a cap is obvious, given that [the] estimated amount ultimately may prove incorrect."[18] Prof. Brubaker emphasized how characterizing mass tort plans as "full payment" is perniciously disingenuous when the plan caps the debtor's aggregate liability and discharges its liability for anything more (which the plan invariably does):[19]

> It is, of course, impossible to know, at the time of confirmation of the plan of reorganization, what amount is ultimately going to be necessary to pay all of the mass tort claimants in full. That amount cannot be known until all the claims are fully liquidated, which can take years or even decades.... All references to "full payment" mass tort bankruptcy plans, therefore, describe plans that do *not actually promise to pay all claimants in full*.
>
> The most pernicious (and vastly misunderstood, underappreciated, or strategically de-emphasized) aspect of so-called "full payment" plans is that the inevitable errors in estimating the debtor/defendants, aggregate mass tort liability systematically go in only one direction. *Estimate errors systematically prejudice the tort claimants* by underestimating the debtor/defendant's aggregate tort liability.[20]

Another serious problem with the notion of "full pay" is that historically, many such promises of full pay turned out to be wrong. As Prof. Jacoby outlined in her new book, *Unjust Debts*, "a promise is a promise and money is money, but a promise to pay is not money."[21] Prof. Brubaker likewise noted the high failure rate in plans that promise full pay.[22] What is meant, of course, is that "history has shown that other mass tort cases have failed dramatically to live up to the bold expectations of [their] sponsors."[23]

When looking at cases from *Manville* to *Mallinckrodt*, what one sees is overly optimistic assertions of full pay that resulted instead in plan failure and disappointment.[24] Further, even if the plan fails to pay the claims, the releases remain in place: "[T]he company's admission that it cannot honor its promises to fund the trust to compensate opioid claim-

16 Ralph Brubaker, "Mandatory Aggregation of Mass Tort Litigation in Bankruptcy," 131 *Yale L.J.*, 976 (Feb. 28, 2022).

17 *Id.* at 978 (internal citation omitted).

18 Ralph Brubaker, "Assessing the Legitimacy of the 'Texas Two-Step' Mass-Tort Bankruptcy," 42 *Bankr. L. Letter* No. 4, at 13 (August 2022).

19 Ralph Brubaker, "Mass Torts, the Bankruptcy Power, and Constitutional Limits on Mandatory No-Opt-Outs Settlements," 23 *FSU Bus. Rev.* __ (forthcoming 2024), at 10-11.

20 *Id.* at p. 10.

21 Melissa B. Jacoby, *Unjust Debts: How Our Bankruptcy System Makes America More Unequal*, 203 (2024).

22 Ralph Brubaker, "Non-Debtor Releases in Bankruptcy," 1997 *Univ. Ill. L.R.* __, 987-88, n.102 (stating that promises of full pay "tend to ring hollow" and pointing out an "empirical study of large Chapter 11 cases, finding that in 32 percent of cases where the entity survived confirmation of a plan, the emerging entity subsequently filed another Chapter 11 case").

23 Lloyd Dixon, Geoffrey McGovern & Amy Coombe, "Asbestos Bankruptcy Trusts: An Overview of Trust Structure and Activity with Detailed Reports on the Largest Trusts," RAND Inst. for Civil Justice, *available at* rand.org/content/dam/rand/pubs/technical_reports/2010/RAND_TR872.sum.pdf ("Unfortunately, bankruptcy has a rocky track record in delivering its hoped-for financial benefits. While *Manville* lived on, the trust created by its bankruptcy swiftly ran out of money and slashed recoveries to even the most severely ill claimants. And asbestos cases continue to generate underfunding and inconsistent payouts. People have received vastly different recoveries depending on when they got sick. Concerns that asbestos trusts shortchanged people with severe injuries while potentially overcompensating others fueled several (ultimately unsuccessful) congressional efforts to move asbestos claims out of court systems altogether.") (unless otherwise specified, all links in this article were last visited on July 8, 2024).

24 Jacoby, *supra* n.21 at 201-02 (describing Mallinckrodt's inability to fund claims under its first bankruptcy case and requiring second bankruptcy case).

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The Aftermath of Purdue Pharma*: The Myth of the Full-Pay Plan*

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ants does not make claimants' legal rights spring back to life unless a plan expressly provides such a remedy."[25]

Promises of Full Pay in *Boy Scouts* Case

The pernicious effects of systematic underestimation of aggregate liability is at the very heart of the defect with the assertion of full pay in the *Boy Scouts* case. The related problem with the use of "full pay" as a factor in future cases is illustrated by the dispute in the *Boy Scouts* case — a dispute that highlights the problem with using estimates and speculation to determine when and if victims will be paid.

The D&V claimants, who have appealed from the confirmation of the Boy Scouts' reorganization plan, have challenged the notion that their claims for sexual abuse will be paid in full.[26] The Boy Scouts' expert, Dr. Charles Bates, estimated that the direct-abuse claims had an aggregate value of $2.4 billion to $7.1 billion, although he later claimed that the likely range was $2.4 billion to $3.6 billion.[27] The D&V claimants have argued that "[T]he only findings about actual, existing funds provided for payment [of claims] is the finding that the plan calls for $2,484,200 in 'noncontingent funding.'"[28]

Further, the D&V claimants state that with estimated administrative expenses of 10 percent, there will be only $2,235,780 in the settlement trust.[29] The D&V claimants contend that even at Bates' lowest estimate of aggregate tort liability, the claimants would receive approximately 93 percent payment; at the higher end of his expected range, $3.6 billion, claims would only receive 62 percent, and at the upper end of Bates' possible range, only 31.5 percent.[30]

A key part of the bankruptcy court's ruling confirming the plan was that there was an additional $4 billion in "unallocated" excess insurance coverage, which referred to policy proceeds that were not triggered by the filed abuse claims.[31] The D&V claimants' briefing argued that the plan only gives the settlement trustee the ability to negotiate with the nonsettling insurers to contribute such funds: "For now, these funds do not exist. Their availability is speculative and without evidence or findings concerning the merits of the coverage litigation, defenses or claims."[32]

The D&V claimants' arguments find support in statements made by the settlement trust trustee.[33] In addition, Prof. Jacoby's book shows that the assertions of full pay are often highly unreliable and of doubtful validity.[34] As she observed, "The Boy Scouts of America predicted full compensation for survivors of child sex abuse when it sought approval of its Chapter 11 plan. *Yet it was later made clear that survivors almost certainly will not recover at that level*."[35] Prof. Jacoby outlined the negotiation history and the key change in the expert's testimony:

> Lengthy negotiations and financial contributions from third parties notwithstanding, the Boy Scouts of America initially were unable to attract sufficient numbers of survivors to support its plan. The official committee of survivors ... had recommended that claimants reject the plan. The committee warned that survivors might recover less than 10 percent of their claims.[36]

Conclusion

Prof. Brubaker's analysis of why assertions of "full pay" are inadequate to cure the legal infirmities with nonconsensual third-party releases is set forth in his *amicus* brief filed in the *Purdue* case.[37] If courts do view the final paragraph of the *Purdue* opinion as an opportunity to revisit the issue of engrafting factors onto the law of discharge, then Prof. Brubaker's articles and *amicus* brief — along with Prof. Jacoby's empirical study — should be a strong cautionary note that such engrafting raises serious constitutional issues of federalism and separation of powers. In the final analysis, the question of who is entitled to a discharge is a matter solely for Congress, and tinkering with the entitlement should not be a matter of judicial imagination. In short, the use of full pay as a factor is regressive and would turn back the clock to the state of the law before the Supreme Court announced its decision in *Purdue*. abi

Editor's Note: *ABI held a webinar shortly after the Supreme Court issued its decision, of which the author was a participant. To listen to the abiLIVE recording, please visit abi.org/newsroom/videos. The author also is the editor of ABI's digital book* The Purdue Papers, *a compilation of 3,300+ pages of* amicus *briefs, petitions and other related background material that includes the Supreme Court's decision, an analysis, and a transcript of the abiLIVE webinar. To order your downloadable copy, visit store.abi.org.*

25 *Id.* at 205.
26 Opening Brief of the *Dumas & Vaughn Claimants (In re Boy Scouts of Am.)*, *supra* n.6, ECF Dkt. 61, at 13 (also noting that the releases bar claims for fraud and punitive damages).
27 *Id.* at 60.
28 *Id.* at 62.
29 *Id.* at 9.
30 *Id.* at 65.
31 *In re Boy Scouts of Am. and Delaware BSA LLC*, 642 B.R. 504, 560-561 & n.277 (Bankr. D. Del. 2022).
32 *D&V* Opening Brief at 64.
33 *See* Dumas & Vaughn Claimants Response to Appellees' Motions to Dismiss, *In re Boy Scouts of Am.*, *supra* n.6, ECF Dkt. 153 (quoting settlement trustee: "[Y]ou may not receive payment of the full value that the Trustee assigns to your Abuse Claim.... [T]he percentage of each Allowed Abuse Claim that will be paid depends on the amount of the available funds in the Trust and the aggregate amount of all Allowed Abuse Claims") (internal citation omitted); *see also* Jacoby, *supra* n.21 at p. 209 ("In virtual town hall meetings, the retired judge overseeing the Boy Scouts of America trust as its trustee was candid with survivors: there was no guarantee they would receive full payment.").
34 *See* Jacoby, *supra* n.21.
35 Melissa Jacoby, "The Moral Limits of Bankruptcy Law," *New York Times* (June 4, 2024) (emphasis added), *available at* nytimes.com/2024/06/04/opinion/purdue-sackler-supreme-court.html (subscription required to view article).
36 Jacoby at 195. The article also noted that to get to an agreement with the claimants, "its expert witness revised downward his estimate of the value of the abuse claims." *Id.* at 197-98.
37 Brief for *Amici Curiae* Bankruptcy Law Profs. Ralph Brubaker, Bruce A. Markell and Jonathan M. Seymour in Support of Petitioner (Sept. 27, 2023).

Subchapter V

Subchapter V Small Business Reorganizations

The Small Business Reorganization Act of 2019 (SBRA) was enacted on August 23, 2019, with an effective date of February 19, 2020. Pub. L. No. 116-54 (2019). Upon enactment, small business debtors with less than about $2.75 million in debts (to be adjusted at 3-year intervals per 11 U.S.C. § 104) could voluntarily elect to proceed under a new subchapter V of chapter 11 of the Bankruptcy Code if they met certain eligibility criteria. Shortly thereafter, the CARES Act increased this debt limit to $7.5 million, for cases pending, commenced on, or commenced after March 27, 2020, which increase was then further extended by two additional acts until June 21, 2024. *See* Pub. L. No. 116-136 (2020), *as amended by* Pub. L. No. 117-5 (2021), *as further amended by* Pub. L. No. 115-151 (2002). The extension that increased the debt limit applicable to subchapter V cases to $7.5 million expired on June 21, 2024. Accordingly, for subchapter V cases commenced on or after June 21, 2024, the applicable debt limit is the original limit enacted in the SBRA, as adjusted per 11 U.S.C. § 104, or $3,024,725.

Subchapter V imposes shorter deadlines for filing reorganization plans, allows for greater flexibility in negotiating restructuring plans with creditors, and does not require the payment of United States Trustee quarterly fees. Unlike in other chapter 11 cases, the United States Trustee Program appoints a trustee in each subchapter V case. The trustee works with the small business debtor and the creditors to facilitate the development of a consensual plan of reorganization, which may include evaluating the viability of the debtor's business and investigating the debtor's financial condition and conduct if directed by the court.

The USTP publishes a summary of statistical results from subchapter V cases.

Updated June 24, 2024

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Small Business Bankruptcy Rules Get Tighter After U.S. Law Expiration

A popular program that expanded eligibility for small business bankruptcies in the U.S. expired on Friday, limiting small and mid-sized businesses' ability to access a more streamlined and less-costly alternative to a traditional chapter 11 filing, Reuters reported. Congress passed the Small Business Reorganization Act in 2019, adding subchapter V to the U.S. Bankruptcy Code as a way for small businesses to shed debts without losing ownership of their companies, and without some of the procedural oversight mechanisms that can add cost and delay in a typical chapter 11 case. Subchapter V quickly became a popular tool for distressed small businesses, but Congress's failure to renew a part of the law closes the door to businesses with between $2.7 million and $7.5 million in debt. Senator Dick Durbin of Illinois had introduced a bipartisan bill to keep the $7.5 million limit in place for two more years, but Senator Rand Paul (R-Ky.) placed a hold on the bill and blocked it from swiftly advancing by unanimous consent in the Senate. Durbin said on Friday that he was "disappointed that one Senator has stood in the way" of his bill, and he would continue to try to restore the $7.5 million debt limit for small business bankruptcies. Subchapter V accounted for about 30% of all chapter 11 bankruptcy filings in the U.S. between February 19, 2020, and September 30, 2023, according to a **recent report** by the American Bankruptcy Institute. More than one-quarter of those small business debtors would not have qualified for Subchapter V under the lower $2.7 million debt threshold, according to ABI, which recommended that the debt threshold be permanently raised to $7.5 million.

Monday, June 24, 2024

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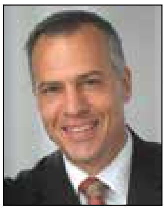
Legislative Update

By Frank W. DiCastri and Sara C. McNamara

Testing Subchapter V's Limits: A Creditor's Perspective



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Editor's Note: *ABI's Subchapter V Task Force released its Final Report and recommendations to Congress in April, and its findings support maintaining the eligibility limit of $7.5 million in aggregate noncontingent, liquidated debt for small businesses looking to reorganize under subchapter V. For more information, please visit subvtaskforce.abi.org.*

Subchapter V cases were billed as more efficient than other chapter 11s in terms of timing, resources and plan confirmability. The stated congressional goal was to process small business debtors more quickly and easily, simultaneously relieving debtors of the expenses associated with disclosure statements, creditors' committees and quarterly U.S. Trustee fees, while imposing easier confirmation burdens and expedited timelines.[1] Initially, only a small subset of debtors were eligible for relief under subchapter V due to relatively small debt limits, but during the COVID-19 pandemic, the doors were opened wider, and many walked through. When the expanded eligibility expired in March 2022, Congress quickly reinstated and extended it to June 2024.

Much has already been written about the perceived successes or failures of subchapter V, and the statistics are telling. For example, recent data from the U.S. Trustee Program show that during fiscal years 2020-22, subchapter V plans were confirmed in 55 percent of the cases, compared with 23 percent of traditional small business chapter 11s.[2] Subchapter Vs also saw half of the case conversions and more than 20 percent fewer dismissals,[3] but like anything else, the data does not tell the whole story. As will be detailed herein, *In re Sunlight River Crossing LLC* is one example of a case that did not fit the description of the congressionally ideal subchapter V case.

In re Sunlight River Crossing LLC

The debtor, Sunlight River Crossing LLC,[4] was a single-member limited liability company (LLC) whose owner initially intended to start a yoga business. The entity was formed to purchase a property in the Yavapai County, Ariz., countryside, complete with a river running through the backyard, a pasture for horses, space for entertainment, and — of all things — a treehouse complex that overlooked the river (herein referred to as the "property"). The lender was an LLC, controlled by the trustee of a family trust, that owned the property until the lender financed its acquisition by the debtor a couple of years before the COVID-19 pandemic.

Not long after the sale and the accompanying financing, the debtor began using the property as a vacation rental, the debtor's sole member transferred all of the debtor's equity to her then-boyfriend, and the zen-like calm at the property was shattered by a payment default. A forbearance agreement followed, then a foreclosure case and, eventually, a subchapter V case.

The debtor admitted that it had commingled funds with the personal funds of the single-member boyfriend prior to the petition date. In fact, it appeared that the corporate form had never truly been honored by the debtor's new owner. This, and other developments in the case, allowed dismissal of the case to be sought, or conversion or "removal" of the debtor-in-possession (DIP) as alternatives, the last of these pursuant to subchapter V's § 1185, the details of which will be discussed later in this article.

Following a short trial, the bankruptcy court granted the lender's motion in part (as discussed in the previous paragraph), taking the rare step[5] of removing the DIP for a variety[6] of pre- and post-petition conduct amounting to "gross mismanagement." Unlike § 1112 of the Bankruptcy Code, which generally focuses on the DIP's post-petition conduct, § 1185 of the Bankruptcy Code expressly contemplates consideration of gross mismanagement "either before or after the date of commencement of the case."

As explained in the previous paragraph, the bankruptcy court concluded that the "[d]ebtor was grossly mismanaged pre-petition and has continued to be grossly mismanaged post-peti-

1 *See, e.g.*, H.R. Rep. No. 116-171, at 1 (2019) (noting that Small Business Reorganization Act of 2019 "would streamline the bankruptcy process by which small businesses debtors reorganize and rehabilitate their financial affairs"); at 4 (noting that legislation allows small business debtors "to file [for] bankruptcy in a timely, cost-effective manner, and hopefully allows them to remain in business") (quoting Rep. Ben Cline (R-Va.)).

2 Chapter 11 Subchapter V Statistical Summary through Jan. 31, 2024, U.S. Trustee Program, *available at* justice.gov/media/1221551/dl?inline (unless otherwise specified, all links in this article were last visited on May 23, 2024).

3 *Id.*

4 Case No. 21-4364 (Bankr. D. Ariz.).

5 In the authors' experience, it is rare that a court removes the DIP.

6 The intent is not to focus on each of the findings of gross mismanagement, although commingling and failure to follow the corporate form were mentioned in the prior paragraph.

tion."[7] Unfortunately for the litigants, by the time the bankruptcy court had ruled on the lender's motion, more than 14 months had passed since the filing of the case and significant fees had been incurred by all involved. The authors are observing that a significant amount of time had already passed by the time the motion was decided. The relevance and implications are further explained herein.

Removal of the DIP was not a panacea by any means. It left the subchapter V trustee in charge of a business with which he was not intimately familiar, balancing the demands of his private practice and other, unrelated subchapter V cases.[8] What is more, the trustee was compelled to rely on the debtor's sole member[9] to manage the day-to-day business affairs, even though the bankruptcy court had just declared that the debtor's business practices amounted to "gross mismanagement." The trustee's supervision proved important, but because the Code allows only the debtor to file a plan in a subchapter V case, the trustee's options for advancing the case were limited. The trustee replaced the DIP, but the trustee continued to employ the debtor's principal.

In the first 18 months of the case, the debtor filed — or offered — three different reorganization plans, but never got around to presenting one for confirmation. Every time the debtor filed or presented a plan, the debtor modified it or otherwise postponed the confirmation process. Subchapter V may command a debtor to *file* a plan within 90 days after the order for relief, but it says nothing about when a debtor has to *confirm* a plan.[10]

Despite the delays and the repeated failures to prosecute the case to confirmation, dismissal was not a great option, because counsel anticipated that the debtor would continue to tie up the lender in state court litigation for many more months. Conversion was possible, but there was already a subchapter V trustee-in-possession, so he was persuaded to file a motion to sell the property.

Although only the debtor can file a plan in a subchapter V case, nothing in the Bankruptcy Code prevents a subchapter V trustee-in-possession from pursuing a § 363 sale. The debtor vigorously objected to the sale, sensing that it might lose the plan-confirmation opportunity it had thus far squandered, but the bankruptcy court allowed the sale process to move forward simultaneously with the plan process. Significantly, the court felt that it was appropriate to hear confirmation before the proposed sale, and the subchapter V trustee-in-possession did not press the issue.[11]

All told, some 23 months had passed by the time the debtor presented its second amended reorganization plan for confirmation. After a three-day trial and another half-day of oral argument, the bankruptcy court entered an order denying confirmation of the debtor's plan on virtually every ground considered: (1) the proposed cramdown interest rate was 5.5 percent too low; (2) the plan was not feasible for a variety of reasons; (3) retention of the debtor's management was not in the best interests of creditors; and (4) the plan contemplated a business that violated Arizona zoning laws.

A time limit on the exclusive right to file a plan — even a lenient one — would appear to reasonably balance both debtor and creditor rights.

By this time, the debtor was on its third bankruptcy lawyer, 26 months had passed since the filing of the case, and several hundred thousand dollars of accrued administrative expenses — debtor's counsel and subchapter V trustee fees included — were left unpaid. To be sure, however, the delays were not all bad for the lender.[12]

The prime interest rate when the debtor filed its first plan was 3.25 percent. By the time the bankruptcy court ruled on confirmation, the prime interest rate had risen to 8.5 percent. (The bankruptcy court found that a cramdown interest rate of 11.5 percent was appropriate.) During that time, various issues with the property persisted or worsened, the debtor continued to suffer from some of the same management and performance ills that had triggered the DIP's removal in the first instance, and the delays allowed counsel to the lender to compare the debtor's earliest plan projections with the actual results that followed. (The debtor consistently failed to meet its projections.)

Making matters worse for the debtor, at confirmation the debtor made the strategic decision to effectively stipulate to the lender's lower valuation of the property after more than two years of asserting a significantly higher value. This only added to the bankruptcy court's concerns, noting that it might have dismissed the case earlier had it known there was agreement on the lower value, which was a factor in the court's denial of confirmation.

Having denied confirmation, the bankruptcy court directed the subchapter V trustee-in-possession to proceed with the sale. Twenty-eight months after the debtor filed its bankruptcy case — and 42 months after the first default — the subchapter V trustee-in-possession sold the property to the highest and best bidder, and paid the net sale proceeds to the lender.

Predictably, this did not end the litigation. The debtor sought to appeal the order denying confirmation of its plan, arguing that the bankruptcy court effectively mandated a sale. The Bankruptcy Appellate Panel (BAP) for the Ninth Circuit ultimately dismissed the appeal on the grounds that the order denying confirmation was not a final order, and

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7 Minute Entry/Order, Case No. 21-4364 (Bankr. D. Ariz.), Dkt. No. 234, at 10 (Aug. 11, 2022).

8 This article provides commentary on the authors' experience with subchapter V. The challenges presented by replacing a DIP with a trustee unfamiliar with the business at issue, and lacking the resources to fully invest himself in the operations of the business, are directly relevant to the article and the points the authors make herein.

9 The DIP was removed entirely, but as explained herein, the trustee chose to continue employing the principal of the debtor, who was more familiar with the business and had the time and incentive to continue operating it.

10 Emphasizing the importance of speed in subchapter V cases — at least, the need for speed in filing a plan — Congress clarified that the 90-day deadline can only be extended "if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable." 11 U.S.C. § 1189(b). Adding to the confusion and delays, the debtor was represented by three different lawyers during the case, with each counsel-swap creating significant impediments and expense. In all, some seven different lawyers were utilized by the debtor from the time of its first default under the loan documents until the end of the bankruptcy case.

11 No additional information was provided by the court. The court essentially gave the debtor the benefit of the doubt by allowing confirmation to proceed before the sale.

12 Subchapter V can be every bit as time-consuming and expensive as a traditional chapter 11 case.

Legislative Update: Testing Subchapter V's Limits: A Creditor's Perspective

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because the debtor had not met the standards for an interlocutory appeal.

The debtor also sought stays pending appeal from both the bankruptcy court and BAP, both of which were denied. Bitter to the end, the debtor objected to its third bankruptcy lawyer's fee application, resulting in a prompt attorney withdrawal and a subsequent dismissal of the case. At the finish line, three lawyers for the debtor and the subchapter V trustee-in-possession were left with six-figure claims in the aggregate (despite a stipulated carveout for the subchapter V trustee-in-possession), and unsecured creditors got nothing.

Post-Mortem

This may have been a unique subchapter V experience[13] — one characterized by delays, persistent litigation and repeated failures to achieve compromise — but rare or not, it is safe to say that subchapter V can be just as litigious and cumbersome as a traditional chapter 11.[14] The structural changes to the Bankruptcy Code that may, on paper, streamline the process and aid both the debtor and the court can be negated in practice by a debtor that abuses the process, fails to negotiate in good faith or simply refuses to accept the inevitable.

Resting the exclusive power to file a plan in the hands of such a debtor can make things worse, as it did in this case. In the end, counsel worked around this limitation by having the subchapter V trustee-in-possession pursue a sale, but this was a time-consuming and expensive alternative, and one that may be more difficult in a case that does not involve a single asset like the property. A time limit on the exclusive right to file a plan — even a lenient one — would appear to reasonably balance both debtor and creditor rights.

On the other hand, by expanding the grounds for dismissal, conversion or removal to include pre-petition misconduct, subchapter V helped the lender establish a pattern of bad behavior that tainted the beginning, middle and end of the debtor's case. However, these, too, are time- and money-gobbling options for a creditor. Congress would do well to recognize the inherent limitations of these remedies and consider a hard stop for confirmation of the debtor's plan in a subchapter V case by a defined period of exclusivity or otherwise — even more so if lawmakers decide to extend the current criteria for subchapter V eligibility beyond June 2024. abi

13 Nearly two-and-a-half years had passed by the time the case was resolved, which is unique in the authors' experience for subchapter V cases.

14 *See, e.g.*, "Chapter 11 Subchapter V Statistical Summary Through April 30, 2024," U.S. Trustee Program, *available at* justice.gov/ust/page/file/1499276/dl?inline (noting that median time to confirmation in subchapter V cases, from fiscal years 2020-23, was 6.5 months).

MEDIATBANKRY

On Bankruptcy and Mediation

Subchapter V’s $7.5 Million Debt Limit Expired: A Return To Congress’s Bias Against Formerly-Successful Entrepreneurs?

Expired (Photo by Marilyn Swanson)

By: Donald L Swanson

The continuing effort in Congress to extend Subchapter V's $7.5 million debt limit recently hit a snag. The result: the $7.5 million debt limit for Subchapter V eligibility expired on June 21, 2024, and the Subchapter V debt limit is now reduced to an inflation-adjusted $3,024,725.[i]

The snag exists, I'm told, despite near-unanimity within both houses of Congress that the $7.5 million debt limit should be extended. Rumor has it that the snag comes from a single U.S. Senator and is for reasons that are unknown or uncertain.

How can this happen? Here are four different answers that combine to create the snag.

One Answer—No Political Constituency

One answer is this: bankruptcy has no political constituency. There is, for example, no lobbying organization called, (i) National Association of Bankruptcy Debtors, or (ii) Future Bankruptcy Debtors of America.

There are, however, contrary interests with substantial lobbying capacity and effectiveness. Such interests are often against any proposed legislation containing the word "bankruptcy"—even when that bankruptcy legislation is good for everyone.

Subchapter V is one of those good-for-everyone laws. That's because the reorganization of a struggling business allows employees to keep their jobs, allows vendors to continue supplying the debtor with goods and services, allows customers to continue buying debtor's goods and services, allows taxing authorities at all levels to continue collecting taxes from debtor, allows creditors to get more than they would receive in debtor's liquidation, etc.

But without a political constituency, even the best-possible bills can languish and die.

Second Answer—No Financial Catastrophe

A result of no political constituency is this: Congress enacts meaningful bankruptcy laws only amid a national financial catastrophe. That's because, during a financial catastrophe, everyone is a potential bankruptcy debtor. And that puts pressure on Congress to act.

For the $7.5 million debt limit, there is no financial catastrophe in existence right now.

The $7.5 million debt limit for Subchapter V eligibility is, in itself, a prime example of the during-a-catastrophe phenomenon: (i) Subchapter V was enacted by Congress on August 23, 2019, with a $2.75 million debt limit for eligibility, (ii) Subchapter V became effective on February 19, 2020;[ii] (iii) the Covid Pandemic hit the public consciousness hard in January and

February of 2020, and (iv) Congress increased the debt limit for Subchapter V to $7.5 million on March 27, 2020.[iii] The increased debt limit to $7.5 million has been a much-needed lifeline for many family businesses.

Here is a historical chronology that also illustrates the during-a-catastrophe point.

1788—the U.S. Constitution is ratified, providing "The Congress shall have Power . . . To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[iv]

1800—Congress enacts its first bankruptcy law to get prominent citizens out of debtors' prisons, such as Robert Morris (one of the primary financiers of the American Revolution and a good friend of George Washington).[v] This law was scheduled to sunset in five years, but it only lasts three.[vi]

1841—Congress enacts its second bankruptcy law, due to the financial Panic of 1839. But Congress repeals the new law in 1843. Both the enactment and the repeal of this bankruptcy law reflect differences between Northern and Southern interests, which differences ultimately result in the Civil War.[vii]

1867—Following the financial Panic of 1857 and due to financial distresses upon Northern merchants caused by the Civil War, Congress enacts its third bankruptcy law, the Bankruptcy Act of 1867—but Congress repeals it in 1878.[viii]

1986—Congress enacts Chapter 12 so family farms could reorganize. This law is a direct result of the 1980s Farm Crisis and the failure of other Bankruptcy Code provisions to provide meaningful reorganization relief for farmers.

Without an existing financial catastrophe, there is no pressure on Congress to act.

Third Answer—Bias Against Formerly-Successful Entrepreneurs

Politicians of all types and stripes love to talk about small businesses being important to our economy and about doing everything possible to help small businesses. They really do.

But when the element of financial failure is introduced into the mix, politicians change their views. And the reality is this: they don't like formerly-successful entrepreneurs.

As an attorney practicing bankruptcy law longer than I care to admit, I've been saying the following for decades (pre-Subchapter V) about formerly-successful entrepreneurs:

- "You'd think a prosperous nation thriving on a market economy would make generous provision for those who risk everything but are then judged harshly by the market. But we don't. What we do, instead, is treat them harshly . . . with disrespect . . . and punishment. Our bankruptcy laws pile on and kick them while they're down. Seriously! That's what our bankruptcy laws do."[ix]

- "Our bankruptcy laws may provide well for, (i) large businesses with lots of passive owners, and (ii) consumers. But our bankruptcy laws are particularly disdainful of failed family businesses and their owners—and especially those who were once successful."[x]

Such comments arise from decades of advising family businesses to avoid filing Chapter 11—as if such a filing were a plague. That's because pre-Subchapter V bankruptcy laws are, largely, unworkable for struggling family businesses and their owners. Such bankruptcy laws tended to be, for many such businesses, nothing more than hospice care, with the added disadvantage of potential liabilities for insider preferences and constructively-fraudulent transfers and from dischargeability litigation.

Subchapter V changed all that. It gave failing family businesses and their owners at least a fighting chance of staying in business.

Congress allowing the $7.5 million debt limit to sunset, and returning Subchapter V to a $3 million debt limit, feels like a return to the old Congressional bias against formerly-successful entrepreneurs. And the continuing delay in extending that $7.5 million debt limit feels like a confirmation of that bias's return.

Fourth Answer—Nobody Likes Bankruptcy

Let's acknowledge a basic reality: nobody likes bankruptcy.

Bankruptcy is like oncology . . . but with a big difference.

Nobody likes cancer. And nobody likes to see an oncologist. But when a person faces a cancer diagnosis, that person needs to schedules an appointment with an oncologist, follow through with the appointment, and do what the oncologist advises. Moreover, that person is glad for such a thing as the science and practice of oncology medicine and for oncology experts available to help.

In the same fashion, nobody likes a financial crisis. And nobody likes to see a bankruptcy attorney. But when a person faces a financial crisis, that person needs to schedule an appointment with a bankruptcy attorney, follow through with the appointment, and do what the bankruptcy attorney advises. Moreover, that person is glad for such a thing as the law and practice of bankruptcy and for bankruptcy experts available to help.

Almost no one sees cancer, and the need for an oncologist, as a moral failing. That's the difference between cancer and a personal financial crisis. A person's failure to pay all debts when due is commonly viewed as a blotch on that person's character, regardless of what the circumstances might be. After all, promissory notes contain the words, "I promise to pay," and a failure to do what is promised is commonly viewed as the very essence of a moral shortfall. As King Solomon wrote in the Book of Ecclesiastes, "It is better not to promise anything than to promise something and not do it."[xi]

And so it is that people in our society, generally, have a negative view of the very idea of bankruptcy. And it is from such a view that our politicians start with a general hesitance about providing any type of bankruptcy relief—let alone, effective bankruptcy relief. Many years ago, I tried to talk with a politician about a pending bankruptcy bill. Despite my many calls and emails to the politician's office over many months about the bankruptcy subject, no one from the politician's staff would even respond (beyond acknowledging on one occasion that my email had been received).

On the other hand, this nobody-likes-it reality does have a corresponding benefit: bankruptcy issues in Congress tend to be nonpartisan and apolitical. It's hard, for example, for political partisans to get worked up over such issues as adequate protection, relief from the automatic stay or absolute priority rule. That's why the initial enactment of Subchapter V and the increase of its debt limit to $7.5 million and the temporary extensions thereof could all occur during a time of intense political partisanship—and with nearly-unanimous approving votes in both houses. And that's why Subchapter V's initial enactment and subsequent extensions of its $7.5 million debt limit could be signed by two different presidents from two different political parties.

Conclusion

Congress created a new law for family businesses (Subchapter V) and set the debt limit for Subchapter V eligibility at $2.75 million.

The Covid Pandemic came along, and Congress immediately decided that the $2.75 million limit might not be sufficient to meet the needs of family businesses. And so Congress increased that debt limit to $7.5 million. But Congress had unease about that increase and decided to make the increase temporary.

Congress extended that debt limit increase on a couple occasions. But on this last go-around, Congress failed to act. And so, the Subchapter V debt limit is now at an inflation-adjusted $3,024,725.

Congress's failure to increase the debt limit is striking because there is broad agreement among the bankruptcy community that Subchapter V is working well and that the $7.5 million debt limit is an essential component of that law for family businesses in our market economy.

In fact, Congress's failure to extend the $7.5 million debt limit and allowing that limit to revert back to $3 million is shocking. And there is a sense that Congress may be reverting to its long-standing bias against formerly-successful entrepreneurs.

[i] Subchapter V Small Business Reorganizations, U.S. Trustee Program, U.S. Department of Justice.

[ii] *Id.*

[iii] *Id.*

[iv] This provision of the United States Constitution is in Article I, Section 8, Clause 4.

[v] *See, e.g.*, "Robert Morris, Financier of the American Revolution," at 490-530 (Simon & Schuster, 2010).

[vi] Bradley Hansen, Bankruptcy Law in the United States, Economic History Association.

[vii] *Id.*

[viii] *Id.*

[ix] Donald L. Swanson, "Congress Needs to Help Family Businesses in Financial Stress—Not Punish Them!" Published April 25, 2019.

[x] *Id.*

[xi] Ecclesiastes 5:5 (NCV).

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My name is Donald L. Swanson (please call me "Don"). I'm an attorney in Omaha, Nebraska, and am a shareholder in the law firm of Koley Jessen P.C., L.L.O. I've been practicing business bankruptcy law for more than three decades and represent all types of bankruptcy constituencies, including debtors, creditors, committees, trustees, and § 363 purchasers. I have extensive mediation experience in both bankruptcy and non-bankruptcy courts. Moreover, I have a decades-long background in resolving multi-party disputes while representing committees and trustees. View all posts by mediatbankry

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