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The 3rd-Party Bankruptcy Release Landscape After Purdue

By **Andrew Gallo and David Shim** (November 6, 2024, 4:38 PM EST)

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In Harrington v. Purdue Pharma LP, the U.S. Supreme Court held that Section 1123(b)(6) of the Bankruptcy Code, which permits a bankruptcy plan to include provisions not inconsistent with the code, generally prohibits third-party releases that discharge claims against nondebtors without the consent of affected claimants.[1]

The court's reasoning centered on Section 524(e), which specifies that a discharge protects only the debtor, without affecting the liability of other parties to nondebtors.

The Supreme Court did not specifically comment on what it would take to render a third-party release consensual, thus opening a post-Purdue debate on the permissibility of opt-out releases, where creditors are bound to third-party releases unless they actively decline, typically by checking a box in a bankruptcy ballot, as opposed to opt-in releases, which bind only those who explicitly agree.

Decisions After Purdue Concerning Nondebtor Releases

For example, in In re: BowFlex, U.S. Bankruptcy Judge for the District of New Jersey Andrew B. Altenburg Jr. found on Aug. 19 that an opt-out mechanism could indicate consent to nondebtor releases if the notice met due process standards and the opt-out process and consequences were clearly communicated.[2]

Similarly, in In re: Acorda Therapeutics, U.S. Bankruptcy Judge David S. Jones for the Southern District of New York ruled on Aug. 7 that the ballots clearly stated that a vote in favor of the plan would bind the party to nondebtor releases, thus constituting consent under relevant contract law.[3]

In Robertshaw US Holding Corp., on Aug. 16, U.S. Bankruptcy Judge Christopher M. Lopez for the Southern District of Texas reinforced the .US. Court of Appeals for the Fifth Circuit's prohibition on nonconsensual third-party releases in bankruptcy plans, noting that plans in the circuit typically include third-party releases with an opt-out option, and that Purdue Pharma aligns with this established precedent, leaving the use of opt-out mechanisms unaffected in that district.[4]

Conversely, in In re: Ebix, U.S. Bankruptcy Judge Scott W. Everett for the Northern District of Texas held on Aug. 2 that, under Texas contract law, inaction, such as failing to return an opt-out form, does not constitute consent, and nothing in the Bankruptcy Code authorizes nondebtor releases.[5]

In In re: 2U Inc., U.S. Bankruptcy Judge Michael E. Wiles for the Southern District of New York diverged from Acorda Therapeutics on Sept. 6, instructing debtors to substitute the opt-out mechanism with an opt-in structure and to exclude from the releases those who abstained from voting or rejected the plan.[6]

Similarly, in Red Lobster Management, U.S. Bankruptcy Judge Grace E. Robson for the Middle District of Florida found on Sept. 5 that Purdue and relevant contract law require an opt-in for third-party releases.[7]

In-Depth Analysis in Smallhold

Against this backdrop of varying interpretations, U.S. Bankruptcy Judge Craig T. Goldblatt for the District of Delaware recently provided an in-depth examination of the consent requirement for third-party releases in the bankruptcy case of In re: Smallhold Inc.[8]

In Smallhold, Judge Goldblatt analyzed diverging judicial approaches, concluding that only clear, affirmative consent meets the standard under Purdue. Although Smallhold offered a thorough analysis of third-party release requirements, bankruptcy courts continue to interpret these requirements differently post-Smallhold, leading to varied outcomes.

Case Background

Smallhold, a mushroom farming company, filed for Chapter 11 bankruptcy under Subchapter V of the Bankruptcy Code. Its main investor, who also provided its debtor-in-possession loan, supported the plan. The key issue in the case was whether the plan could include third-party releases using a modified opt-out mechanism.

The plan's release mechanism provided that impaired creditors who received a ballot and voted on the plan would be bound by the releases unless they affirmatively opted out by checking a box, regardless of whether they voted in favor or against the plan.

Impaired creditors who did not vote, i.e., those who did not return a ballot, would not be bound by the releases. Unimpaired creditors were deemed to accept the plan, did not receive ballots and were automatically bound by the release.

The U.S. trustee objected to the release mechanism, arguing that after Purdue, third-party releases can only be valid if a creditor affirmatively expresses its consent to be bound by the release.

Ruling

On Sept. 25, Judge Goldblatt held that creditors cannot be presumed to consent to third-party releases without clear, affirmative action. He explained that, prior to Purdue, he approved the opt-out mechanism by analogizing it to cases where a nonresponse could lead to a default judgment, but this analogy no longer holds after Purdue.

Because unimpaired creditors in the proposed Smallhold plan were not given a chance to vote or opt out, they could not be considered to have consented to the releases. On the other hand, impaired creditors who filled out and submitted a ballot but did not check the opt-out box could be viewed as having affirmatively consented, even if they voted against the plan.

The ballot clearly indicated that failure to check the box would result in being bound by the release, regardless of how the creditor voted, and the court found that submitting such a ballot, without checking the box, was sufficient affirmative action to bind voting creditors to the release.

The court rejected the reasoning from post-Purdue cases like BowFlex, which suggested that a true opt-out mechanism — where a creditor who fails to act at all could be bound to a release — could be considered consensual. Instead, the court endorsed the Ebix approach, holding that under contract law, silence or inaction does not typically equate to consent.

Creditors, Judge Goldblatt reasoned, must take affirmative steps, such as opting in or, as in Smallhold, submitting a ballot that contains clear instructions about the consequences of not checking the opt-out box. This "limiting principle," the court emphasized, should apply in bankruptcy cases to align with Purdue, especially when it involves releasing claims against third parties.

Judge Goldblatt also distinguished third-party releases from settlements in class actions, which can bind class members who do not affirmatively opt out, on the basis that class certification requires a court determination that the named representative sufficiently represents the class, whereas in the traditional bankruptcy plan context, no such representative exists to bind other creditors.

Post-Smallhold

In the wake of the Smallhold decision, debtors in the Delaware bankruptcy cases of Basic Fun and SunPower Corp. have modified the third-party release mechanisms in their plans, shifting to a pure opt-in mechanism.[9] However, in other cases — such as FTX and Wheel Pros — pure opt-out and hybrid release mechanisms have been approved.[10]

In In re: FTX Trading Ltd., on Oct. 7, U.S. Chief Bankruptcy Judge John T. Dorsey for the District of Delaware approved a hybrid approach, combining both opt-in and opt-out mechanics. Creditors or interest holders who voted on the plan had to check a box to opt out of the release. Regardless of how a creditor voted, they would be deemed to have granted the releases if they cast a vote and did not affirmatively opt out by checking the box.

Furthermore, creditors who received a ballot and did nothing would also be deemed to have granted the release. Unimpaired creditors deemed to have accepted the plan without voting were automatically treated as agreeing to the releases. However, those creditors that were not asked to vote because they were deemed to have rejected the plan would be bound by the releases only if they actively chose to opt in.

Judge Dorsey approved a similar release mechanism in In re: Wheel Pros on Oct. 15. In that case, parties voting to accept the plan were automatically deemed to have granted the third-party releases. Parties voting against the plan were given the option to opt out of the releases, but if they did not affirmatively do so, they would also be deemed to have granted the releases. Creditors who received a ballot and did not return it were also bound to the release.

Like FTX, creditors deemed to have rejected the plan and who were not entitled to vote would not be bound by the release, but, unlike FTX, nonvoting, rejecting creditors had no ability to opt in to the release.

With overwhelming creditor support for the plan and proper notice of the confirmation hearing, including publication notice, the court found that using an opt-out mechanism, similar to the one in FTX, was justified under the circumstances.

In both cases, Judge Dorsey relied upon the parallel between the opt-out mechanism and class action settlements, although Judge Goldblatt in Smallhold viewed this analogy as less applicable in the traditional bankruptcy context.

In In re: Fisker, similar to Wheel Pros, U.S. Bankruptcy Judge Thomas M. Horan for the District of Delaware approved a pure opt-out approach on Oct. 11, finding that an opt-out mechanism for nondebtor releases is permissible post-Purdue.[11] However, Judge Horan specified that a nonvoting, rejecting party receiving no distribution, such as an equity holder, cannot be assumed to consent to a release merely by failing to opt out.

Among the unresolved issues post-Purdue are (1) whether a nonconsensual third-party release may be imposed in a paid-in-full plan, and (2) whether U.S. courts can recognize such releases under Chapter 15 as part of foreign insolvency plans with nondebtor releases approved abroad.

The Supreme Court offered limited guidance on when a nonconsensual release might be valid in a paid-in-full plan.

In the Chapter 15 context, on Sept. 25, the U.S. trustee objected to recognizing Yuzhou Group's Hong Kong scheme in the U.S. District Court for the Southern District of New York, arguing that Section 1521(a) (permitting "appropriate relief" to protect foreign debtor assets) and Section 1507 (allowing "additional assistance" to foreign representatives) do not support binding U.S. creditors to Yuzhou's nonconsensual releases sanctioned in Hong Kong.[12]

The U.S. trustee contends that this approach is inconsistent with Purdue and argues that the U.S. court need not recognize these releases, as they could instead be raised as affirmative defenses in future disputes. Yuzhou's recognition hearing is postponed to a date to be determined.

Key Takeaways

The fate of opt-out releases post-Purdue continues to evolve, with courts applying varied standards and outcomes.

Until binding guidance is provided by a higher court, bankruptcy judges may approach opt-out releases differently, with some rejecting them outright, others endorsing hybrid mechanisms requiring affirmative creditor action, and some allowing pure opt-out structures where creditors are bound if they take no action, especially in cases where there is substantial creditor support and adequate notice.

As courts focus on case-specific factors like proper notice, the consideration offered to releasors in exchange for the releases, and the contract law applicable in each jurisdiction, practitioners should closely monitor decisions for evolving standards.

Additionally, the recognition of foreign insolvency plans that provide nonconsensual releases under Chapter 15 raises further questions.

Courts in the U.S. may grapple with recognizing such releases under Chapter 15 when approved abroad,

balancing the deference typically afforded to foreign judgments with the Supreme Court's principles set forth in Purdue.

These unresolved issues add complexity, signaling a need for careful cross-border planning and close attention to judicial trends.

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Disclosure: The firm represents various stakeholders in FTX, Wheel Pros, Basic Fun, SunPower Corp. and Fisker.

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[1] Harrington v. Purdue Pharma L.P., 603 U.S. — — — — , 144 S. Ct. 2071, 219 L. Ed. 2d 721 (2024).

[2] In re BowFlex, Inc., Case No. 24-12364 (ABA) (Bankr. D.N.J.).

[3] In re Acorda Therapeutics, Inc., Case No. 24-22284 (DSJ) (Bankr. S.D.N.Y).

[4] In re Range WD 1 LLC, Case No. 24-90052 (CML) (Bankr. S.D. Tex.), Memorandum Decision on Plan Confirmation (Aug. 16, 2024), D.I. 959.

[5] In re Ebix, Inc., Case No. 23-80004 (SWE) (Bankr. N.D. Tex.).

[6] In re 2U, Inc., Case No. 24-11279 (MEW) (Bankr. S.D.N.Y.).

[7] In re Red Lobster Mgmt. LLC, Case No. 6:24-bk-02486 (GER) (Bankr. M.D. Fla.).

[8] In re Smallhold, Inc., Case No. 24-10267 (CTG) (Bankr. Del.), Memorandum Opinion (Sept. 25, 2024), D.I. 288.

[9] In re Basic Fun, Inc., Case No. 24-11432 (CTG) (Bankr. Del.); In re SunPower Corp., Case No. 24-11649 (CTG) (Bankr. Del.).

[10] In re FTX Trading Ltd., Case No. 22-11068 (JTD) (Bankr. Del.); In re Wheel Pros, LLC, Case No. 24-11939 (JTD) (Bankr. Del.).

[11] In re Fisker Inc., Case No. 24-11390 (TMH) (Bankr. Del.).

[12] In re Yuzhou Grp. Holdings Co. Ltd., Case No. 24-11441 (LGB) (Bankr. S.D.N.Y.).