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PERSPECTIVES

RECENT DEVELOPMENTS AT THE CROSSROADS OF BANKRUPTCY AND MASS TORTS

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In many mass tort mega-cases, the liability of the primary tortfeasor greatly exceeds its assets, setting up a 'race to the courthouse' among private and governmental plaintiffs. The US Bankruptcy Code provides a unique set of tools for resolving these cases.

Among other things, Chapter 11 centralises claims against the company in a single forum, thereby avoiding the immense destruction of value associated with thousands of lawsuits in scores of courts. It also facilitates coordinated representation of claimants not amenable to class treatment such as personal injury claimants.

The Bankruptcy Code requires fairness across classes of similarly situated plaintiffs and provides for 'creditor democracy', balancing the power of larger creditors (i.e., governments) with that of large groups of smaller ones (i.e., personal injury victims).

Bankruptcy also offers a unique tool to address the potential liability of third parties: third-party releases – i.e., the settlement of non-debtors' claims against *non-debtor* tortfeasors. While these non-debtors may bear or share liability, they have little incentive to contribute to settlements absent a comprehensive resolution.

Plaintiffs, likewise, have little incentive to settle unless hold outs – who could jump the queue or

render defendants insolvent – can be barred from separately pursuing co-tortfeasors. Third-party releases can address these problems and enable victims to resolve claims against all co-tortfeasors in value-maximising global settlements.

In *In re Purdue Pharma L.P.,* 69 F.4th 45 (2d Cir. 2023), the Second Circuit recently reaffirmed the majority rule regarding the availability of third-party releases, setting forth a new, stringent, seven-factor test expressly designed to address and mitigate concerns of abuse by tortfeasors looking to evade liability.

In another notable development, two recent decisions – including the Third Circuit's decision in *LTL Management* – have dismissed putative mass tort bankruptcies where debtors could not demonstrate bona fide 'financial distress' despite facing thousands of mass tort claims. These decisions underscore the role that Chapter 11 can (and cannot) play to maximise the recovery of, and ensure fairness among, mass tort victims.

The Second Circuit affirms the availability of third-party releases

Third-party releases have long been the cornerstone of victim-centric, value-maximising settlements of mass tort litigation. Such cases include asbestos (*Johns-Manville*), Dalkon Shield (*A.H. Robins*), silicone breast implants (*Dow Corning*), opioids (*Mallinckrodt, Purdue Pharma*) and sexual abuse (*Boy Scouts of America*). In each, courts concluded, on a developed factual record, that value-maximising settlements and reorganisation plans were viable only by providing settling parties paying into the estate third-party releases of appropriate scope. The alternative to these broadly supported settlements was years of uncoordinated litigation resulting in no or greatly diminished victim recoveries.

Purdue Pharma is a prime example. In 2019, facing thousands of lawsuits, Purdue filed for Chapter 11. Over $40 trillion in claims were asserted – the largest bankruptcy claims pool in US history, and thousands of times Purdue's value. Many lawsuits against Purdue also named as defendants members of the Sackler family (Purdue's former owners), asserting substantially similar – and often identical – claims.

After two years of mediation, negotiation and litigation, the debtors and their creditors developed a plan of reorganisation. The overwhelmingly supported plan includes unprecedented commitments by Purdue's non-federal governmental creditors to dedicate all of their recoveries to abate the opioid crisis. The plan also embodies mediated settlements of civil claims against the Sacklers.

Pursuant to these settlements, the Sacklers will pay between $5.5bn and $6bn to fund opioid abatement efforts and individual victim recoveries – representing over 97 percent of the non-tax cash distributions they withdrew from Purdue in the nearly 12 years prior to its bankruptcy. The plan channels all civil claims related to Purdue's opioids, including against the Sacklers, to the creditor trusts, and releases the debtors, the Sacklers and certain related parties from such claims.

In September 2021, following a lengthy trial with 41 witnesses, the bankruptcy court confirmed the plan, finding that individual victims would recover materially less on their claims against Purdue and the Sacklers absent the settlements. The district court reversed, finding that third-party releases were not authorised by the bankruptcy code. But the Second Circuit reversed the district court and ultimately affirmed the plan in *Purdue Pharma L.P.* It first confirmed that 11 USC section 105(a) and section 1123(b)(6) authorise nonconsensual third-party releases. The court then outlined a new seven factor test for third-party releases, expressly informed by the risk of potential abuse.

Factors 2, 3 and 4, for example, require claims "against the debtors and non-debtors [to be] factually and legally intertwined", the "scope of the

releases [to be] appropriate", and the releases to be "essential" to the reorganisation. These factors cannot be satisfied unless there is a nexus between the claims released and the restructuring. The court found these factors satisfied because a suit against the Sacklers is, in essence, a suit against Purdue, and those suits "will deplete the assets of the estate" through indemnity, contribution, or otherwise.

The sixth factor requires that there be truly "overwhelming" support of each class of creditors subject to a release. In *Purdue*, over 95 percent of the personal injury and governmental classes voted to accept the plan.

Factor 7 requires courts to consider whether the plan provides for the "fair payment" of claims. This provides yet an additional check. As the court noted, "the determinative question is not whether there is full payment, but rather whether the contributed sum permits the fair resolution of the enjoined claims". This reflects the reality of most mass tort bankruptcies, such as Purdue, in which the assets are insufficient to pay all claims in full. As the Second Circuit noted, "[w]ithout the Plan,… many victims of the opioid crisis would go without any assistance and face an uphill battle of litigation".

Finally, the new test provides the flexibility to reject third-party releases even if every factor is met, if the court otherwise finds that there is abuse. "[A]s with any term in a bankruptcy plan", the court noted, this analysis "must be imposed against a backdrop of equity; [g]iven the potential for abuse, courts should exercise particular care when evaluating these types of releases".

Chapter 11 dismissals in LTL Management and Aearo Technologies

In re LTL Management LLC 64 F.4th 84 (3d Cir. 2023) and *In re Aearo Technologies LLC*, No.22-02890-JJG-11, 2023 WL 3938436 (Bankr. S.D. Ind. June 9, 2023) are also important legal developments.

In both cases, the debtors faced thousands of personal injury lawsuits. In *LTL*, J&J Consumer (a subsidiary of Johnson & Johnson) faced claims that its talc products, including baby powder, contained asbestos and caused cancer. In *Aearo*, Aearo Technologies (a subsidiary of 3M) faced claims for injuries in connection with 3M's military-grade ear plugs as well as allegedly faulty respirators. Both companies had managed this liability for years. For example, although J&J Consumer had paid billions for verdicts and settlements, it was still a highly valuable enterprise even accounting for future talc liabilities.

Both enterprises sought Chapter 11 relief to resolve claims against them. J&J Consumer, for example, consummated a divisional merger under Texas law that created two new entities: one (New Consumer) with J&J Consumer's assets and the other (LTL Management) with its liabilities, including talc. Critically, LTL Management had a contractual payment right against its parent for talc-related costs

up to the value of New Consumer. LTL Management filed for Chapter 11 relief (colloquially referred to as the 'Texas two-step'). Aearo Technologies likewise had secured a funding agreement from 3M to fund the costs of any liability related to claims against *Aearo.*

Ultimately, courts in both cases dismissed the petitions because neither debtor had demonstrated the bona fide "financial distress" that must underlie a Chapter 11 petition.

In *LTL*, a group of talc claimants filed a motion to dismiss the bankruptcy petition alleging a "bad faith" filing. The bankruptcy court denied the motion (based on the substantial threat of future talc liability). The Third Circuit reversed, holding that a debtor that was not in "financial distress" could not demonstrate the "good faith" necessary to maintain its Chapter 11 petition.

The court, however, stopped short of articulating a bright-line rule for determining what "degree" of "financial distress" is sufficient. It opined that a company does not necessarily need to be insolvent to be considered in financial distress, but "good faith" requires measuring not just the "scope of liabilities the debtor faces, but also the capacity it has to meet them".

The court found that, because of LTL's payment right from its parent to fund talc liabilities and bankruptcy costs, it was not in financial distress.

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Approximately two hours after the case was dismissed, LTL commenced a second bankruptcy case, in the wake of an $8.9bn settlement trust agreement with plaintiffs' firms representing nearly 60,000 talc claimants. Applying the Third Circuit's ruling – which set a "more exacting gateway requirement" – the bankruptcy court dismissed the second case because LTL still could not demonstrate financial distress under the Third Circuit's standard.

Similarly, in *Aearo*, the bankruptcy court dismissed the petition because it found that even with significant debts and limited assets, Aearo was financially healthy. Among other things, the court found that Aearo's sales had been increasing, it

had not faced execution on any judgment or any operational disruptions, and it had a right to payment from 3M, which, in the court's view, was an "obvious and significant factor" in concluding that Aearo was not sufficiently distressed.

Both of these recent decisions illustrate another important check inherent in the Bankruptcy Code for policing which mass tort debtors can gain access to bankruptcy's powerful tools. And even when they do, not all of those tools may be appropriate in every case. The Second Circuit's new seven-factor test confirms that narrowly-tailored third-party releases – a critical tool for ensuing meaningful recoveries for individual victims – are available only in rare cases. In August, the US Supreme Court granted certiorari, so more chapters will soon be written. CD

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