The Bankruptcy Cheat Code: How Bad Actors Are Escaping Liability Through the Bankruptcy Code

Britani Potter

The U.S. District Court for the Southern District of New York vacated Purdue Pharma's settlement plan that the Bankruptcy Court had approved because the plan included a release of liability in existing and potential future opioid related civil cases for individuals that are not parties to the bankruptcy proceeding. The court found that there is no existing statutory authority to allow bankruptcy courts to authorize such third-party releases for non-debtors. Allowing such releases provides for an escape of liability for knowingly bad acts—a purpose outside of what the bankruptcy system is intended to do.

I. INTRODUCTION

This is a story about a greedy family that, through its family business, amassed great wealth from the profits of its proprietary product at the great expense of countless individuals and society as a whole. Facing mounting legal troubles, the family proceeded to pull the majority of the profits out of the business and into family trusts. Now the family is hoping to use the bankruptcy system to escape personal liability and significantly limit business liability for the hundreds-of-thousands of lives ruined and lost at the hands of a product it knew to be dangerous and deadly.

The bankruptcy system is a congressionally enacted policy choice that exists because of the public and private benefits afforded to society by allowing a fresh start to those facing financial misfortune.[1] The Supreme Court has emphasized that providing relief to "the honest but unfortunate debtor" so they may "start afresh" is a central purpose of the Bankruptcy Act.[2] A current trend in Chapter 11 bankruptcy reorganization plans is the inclusion of nonconsensual third-party non-debtor releases.[3] The Purdue

1. Local Loan Co. v. Hunt, 292 U.S. 234, 244-45 (1934).
2. *Id.* at 244.
3. William Hallam, *Is the End Near for Third Party Releases in Chapter 11 Plans?*, JDSUPRA (Jan. 21, 2022) https://www.jdsupra.com/legalnews/is-the-end-near-for-third-party-6944004/ [https://perma.cc/6ZJ5-MRGW]. "Although they have not passed muster with all courts,

Pharma ("Purdue") bankruptcy highlights this "bankruptcy cheat code" that allows bad actors to escape personal civil liability by bankrupting their business and then demanding third-party releases be included as part of the approved bankruptcy reorganization plan.[4] The "bankruptcy cheat code"—nonconsensual third-party releases—undermines the purpose and integrity of the bankruptcy system. Bankruptcy reorganization plans that include such releases should not be approved by bankruptcy courts.[5]

II. BACKGROUND

A. Case Description

Purdue Pharma ("Purdue") is the prescription pharmaceutical company that manufactures the opioid pain medication OxyContin.[6] Purdue, a limited partnership, is one of many interrelated business entities owned and operated by members of the Sackler family.[7] Until 2019, members of the Sackler family were active participants in many of the day-to-day operations of the business and served on the board of directors for multiple entities within or closely related to the Purdue family business.[8]

By the 1990s, Purdue had developed and begun marketing OxyContin, a semisynthetic opioid pain reliever with a controlled-release feature.[9] The medication quickly became popular within the medical community, particularly for chronic pain sufferers.[10] Purdue marketed OxyContin as a virtually nonaddictive pain relief option for a variety of pain conditions.[11] Marketing efforts were multi-fold and aggressive with a focus on overcoming concerns about addiction and the use of opioid medications.[12]

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such so-called 'non-consensual third-party releases' have become common features of Chapter 11 plans in large, complex Chapter 11 cases." *Id.*

4. *See* In re Purdue Pharma, L.P., 635 B.R. 26, 57–59 (S.D.N.Y. 2021).

5. The statutorily authorized third-party releases for bankruptcy reorganization plans involving asbestos litigation are outside the scope of this Comment and therefore not included in this statement. Authorization for asbestos litigation-related third-party releases can be found at 11 U.S.C. § 524(g)(2)(B).

6. *Purdue Pharma*, 635 B.R. at 39.

7. *Id.* at 39–40.

8. *Id.* at 40.

9. *Id.* at 41–42.

10. *Id.* at 41–43.

11. *Id.* at 42–43.

12. *Id.* One element of Purdue's marketing strategy included targeting prescribers they believed to be more open and willing to prescribe opioids. *See e.g.*, *The Role of Purdue Pharma and the Sackler Family in the Opioid Epidemic: Hearing Before the H. Comm. on Oversight & Reform*, 116th Cong. 3 (2020), https://www.congress.gov/116/chrg/CHRG-116hhrg43010/CHRG-116hhrg43010.pdf [https://perma.cc/L78L-LWQK] [hereinafter *Hearing*]. "Purdue Pharma created false advertising documents to provide doctors and patients illustrating that time-released OxyContin was less addictive than other immediate-release alternatives. Furthermore, they sought out doctors who were more likely to prescribe opioids and encourage them to prescribe OxyContin because it was safe." *Id.* at 3–4.

Many of the statements made by Purdue and its employees were unsubstantiated or just plain false.[13]

On September 15, 2019, several Purdue entities based in the United States filed for bankruptcy after facing legal battles with states, the federal government, and individuals for nearly twenty years.[14] Members of the Sackler family strategized with its legal and financial experts for years following a 2007 settlement and plea agreement with twenty-six states and D.C., and quickly began taking steps to insulate themselves and the company from further liability over the fraudulent marketing of OxyContin.[15] One of the steps taken was increasing monetary distributions "to and for the benefit of the Sacklers" from Purdue.[16] The distributions starting in 2008 and continuing over the next decade totaled approximately $10.4 billion with approximately $4.6 billion being used to pay taxes.[17] By the end of 2019, all members of the Sackler family had resigned from Purdue's board and left Purdue with drained coffers and mounting legal liability.[18]

Prior to the actual filing of the Chapter 11 bankruptcy petition, the Sackler family was working on a settlement framework with the goal of obtaining releases as part of the bankruptcy settlement, in exchange for a contribution to Purdue's estate.[19] However, members of the Sackler family were not debtors, or even parties, to the bankruptcy case.[20] Shortly after the September 2019 bankruptcy filing, all related litigation was halted under a preliminary injunction to allow for facilitation of "a global settlement in a single forum."[21] After two years of negotiations and several amendments to the settlement plan, the Bankruptcy Court approved the plan, and on September 17, 2021, written confirmation was filed by the court.[22] The approved plan at issue in this case included the desired third-party releases for the non-debtor Sackler family members in exchange for approximately

13. *Purdue Pharma*, 635 B.R. at 42–43. Purdue's early promotional strategy for OxyContin focused on promoting the potency of the drug without giving prescribers and patients reasons to be concerned that it might be dangerous. *E.g.*, Shraddha Chakradhar & Casey Ross, *The History of OxyContin, Told Through Unsealed Purdue Documents*, STAT (Dec. 3, 2019), https://www.statnews.com/2019/12/03/oxycontin-history-told-through-purdue-pharma-documents/ [https://perma.cc/X8JC-E8H7]. Purdue also focused heavily on publicly representing the risk of addiction from OxyContin as being negligible. *E.g.*, Art Van Zee, *The Promotion and Marketing of OxyContin: Commercial Triumph, Public Health Tragedy*, 99 AM. J. PUB. HEALTH 221, 221–27 (Feb. 2009), https://www.ncbi.nlm.nih.gov/pmc/articles/PMC2622774/ [https://perma.cc/GA27-H6G9].

14. *Purdue Pharma*, 635 B.R. at 44–60.

15. *Id.* at 55–58.

16. *Id.* at 56.

17. *Id.* at 56–57.

18. *Id.* at 40, 58.

19. *Id.* at 58–59.

20. *Id.* at 59–60.

21. *Id.* at 60.

22. *Id.* at 65–66.

$4.27 billion in contributions to the Purdue bankruptcy estate.[23] Although the reorganization plan was approved by a legally sufficient amount of votes cast by members from each class of creditors, many dissenting creditors filed formal objections and appealed the confirmation of the plan.[24] Appellants cite the broad releases provided to the Sacklers as the reason for their opposition.[25]

B. Legal Background

Bankruptcy law in the United States is congressionally created through legislation and found in Title 11 of the United States Code.[26] Within the Code, there are provisions that allow businesses to reorganize by restructuring to avoid total liquidation.[27] Many of the provisions relevant to a bankruptcy reorganization are found in Chapter 11 of the Bankruptcy Code.[28] Chapter 11 provides a framework that allows the parties to negotiate an agreeable plan for the distribution of assets held in an estate on behalf of the debtor and managed by a fiduciary responsible for the creditors' interests.[29] There are three possible outcomes in a Chapter 11 bankruptcy: (1) a plan confirmed by the bankruptcy court that helps creditors while allowing the business to continue operating; (2) a distribution of assets to creditors by converting to Chapter 7 and liquidating the business; or (3) a dismissal of the case resulting in what amounts to a return to the prepetition state.[30]

Generally, U.S. district courts hold jurisdiction over Title 11 cases with the authority to refer such proceedings to the bankruptcy courts of their district.[31] Bankruptcy courts are courts of limited jurisdiction as they are not Article III courts.[32] The authority of a bankruptcy court judge to render a final judgment is dependent on the type of proceeding necessary to resolve the specific matter at issue.[33] Congress outlines and defines the three types of bankruptcy proceedings in 28 U.S.C. § 157.[34] The three types of proceedings further divide into core bankruptcy proceedings and non-core bankruptcy proceedings.[35] Matters that "arise under" or "arise in" Title 11

23. *Id.* at 67.
24. *Id.* at 35–36.
25. *Id.* at 36.
26. 1 COLLIER ON BANKRUPTCY P 1.01 (Richard Levin & Henry J. Sommer eds., 16th ed. 2021).
27. *Id.*
28. *See* 11 U.S.C. § 1101.
29. Czyzewski v. Jevic Holding Corp., 580 U.S. 451, 454 (2017).
30. *Id.* at 456.
31. Stern v. Marshall, 564 U.S. 462, 473 (2011).
32. *Id.* at 469.
33. *Id.* at 473–74.
34. *Id.* at 473; *see also* 28 U.S.C. § 157.
35. *Purdue Pharma*, 635 B.R. at 79.

cases are deemed core bankruptcy proceedings, while matters "related to" Title 11 cases are deemed non-core bankruptcy proceedings.[36] The authority of a bankruptcy court to dispose of a matter turns on whether the matter is deemed core or non-core.[37] The critical question is whether the specific matter at issue "stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process."[38] A bankruptcy court does not acquire authority to dispose of non-core matters—authority constitutionally conferred to Article III courts—merely because resolution of the matter substantially impacts the debtor-creditor relationship, as is the case with nonconsensual third-party releases for non-debtor parties.[39]

Third-party releases are a mechanism to release non-debtor third-parties from liability for conduct outside of the bankruptcy action.[40] Approval of a reorganization plan that includes such a release effectively extinguishes any legal claims between non-debtor parties that are covered by the release.[41] Third-party releases can be consensual which are akin to a contractual agreement between those being released from liability and the consenting creditors.[42] Alternatively, bankruptcy courts in some jurisdictions will also approve third-party releases that are nonconsensual, meaning some or all of the creditors are not in agreement with releasing the non-debtor party from liability.[43] Nonconsensual third-party releases may be used as a bargaining tool to incentivize the non-debtor party to monetarily contribute to the bankruptcy estate in exchange for the release from liability.[44] Currently, the Bankruptcy Code only expressly permits the approval of nonconsensual third-party releases in bankruptcy proceedings involving asbestos litigation.[45]

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36. *Id.*
37. *Id.* at 80.
38. *Stern*, 564 U.S. at 499.
39. *Purdue Pharma*, 635 B.R. at 81.
40. *See Third-Party Releases: A New Normal in Chapter 11 Plans?*, HIRSCHLER (May 4, 2021), https://www.hirschlerlaw.com/newsroom-publications-chapter-11-third-party-releases [https://perma.cc/DQ7G-E662] [hereinafter *Third-Party Releases*]; *see also* Elizabeth Brusa, *Nonconsensual Third-Party Releases: What They Are and Why You Should Care*, JDSUPRA (Mar. 15, 2022), https://www.jdsupra.com/legalnews/nonconsensual-third-party-releases-what-7042215/ [https://perma.cc/ZN9B-SPXW].
41. *Third-Party Releases*, *supra* note 40. In the case of the Sackler family, the third-party release included in the Purdue reorganization plan "extends to every Sackler presently alive, to their unborn progeny, and to various trusts, partnerships, corporations, and enterprises with which they are affiliated or that have been formed for their benefit." *Purdue Pharma*, 635 B.R. at 90 n.57.
42. *Third-Party Releases*, *supra* note 40.
43. Brusa, *supra* note 40.
44. *Third-Party Releases*, *supra* note 40; *see also Purdue Pharma*, 635 B.R. at 58–59.
45. *See* 11 U.S.C. § 524(g).

III. COURT'S DECISION

On appeal from the Bankruptcy Court, the U.S. District Court for the Southern District of New York found that no statutory authority exists within the Bankruptcy Code to authorize courts to approve nonconsensual third-party releases of non-debtor parties.[46] Although the practice is not uncommon in bankruptcy proceedings, the court found no support for such authority within the language of the Bankruptcy Code or existing Supreme Court precedent.[47] In fact, the Supreme Court has yet to consider the issue of nonconsensual third-party releases of non-debtor parties.[48] A review of federal circuit court holdings returned mixed results, with the majority of circuits either rejecting the existence of such authority, or allowing the releases to stand and failing to provide insight into where the authority originates.[49]

In reversing the Bankruptcy Court-approved settlement plan, Judge McMahon issued a thorough and lengthy opinion including outlining the history of Purdue and the Sackler family's involvement in the company's opioid-related activities.[50] The opinion summarizes the numerous legal battles involving Purdue and members of the Sackler family and details the development of the underlying bankruptcy action.[51] Judge McMahon then proceeds to articulate her comprehensive analysis of statutes and case law relevant to the issues on appeal.[52]

In the Court's opinion, Judge McMahon differentiated between derivative claims—claims against the Sacklers that are derived from Purdue's conduct—and direct claims—claims that stem directly from the conduct of individual members of the Sackler family.[53] This distinction is important because derivative claims relate directly to the debtor-creditor relationship, and therefore fall within the authority of the bankruptcy court, whereas direct claims arise independent of the business entity; however, the conduct of the business is still a legally relevant factor.[54] Although there may be significant factual overlap between the derivative claims and the direct claims, the legal distinction exists to provide a method of accountability by imposing liability and penalties on individuals independent of the business entity.[55] Judge McMahon's analysis of whether

46. *Purdue Pharma*, 635 B.R. at 90.
47. *Id.* at 89–96.
48. *Id.* at 94.
49. *Id.* at 96–105.
50. *Id.* at 38–44.
51. *Id.* at 44–78.
52. *Id.* at 77–118.
53. *Id.* at 90.
54. *Id.* at 90–91.
55. *See id.*

authority exists for courts to grant nonconsensual third-party releases proceeded under a narrow scope framed by this important distinction.[56]

Ultimately, Judge McMahon's review of the Bankruptcy Code's text and relevant legislative history found the only expressly granted authority for the approval of nonconsensual third-party releases is narrowly limited to asbestos liability cases.[57] She then surveyed Supreme Court and circuit court opinions finding that (1) no Supreme Court decisions specifically address the issue; (2) the only binding circuit court decisions—decisions of the Second Circuit—are unsettled because the decisions not involving asbestos were decided on non-statutory grounds; and (3) other circuit court decisions either directly conflict with Second Circuit law or fail to adequately address where statutory authority is found.[58]

IV. COMMENTARY

Nonconsensual third-party releases for non-debtors should not be available in bankruptcy reorganization plans. Bankruptcy should not be a get-out-of-jail-free card for bad actors seeking escape from liability for harms they knowingly caused. Overturning the district court's ruling vacating Purdue's bankruptcy plan would establish a dangerous precedent that could easily be abused by bad actors moving forward.[59] Allowing the Sackler family to evade liability for its tortious activity would effectively provide a green light to decision makers for businesses all over the country to siphon as much money as possible out of the business, and then turn to the bankruptcy courts requesting release of liability for themselves as non-debtors, in exchange for some contribution to the bankruptcy settlement. Essentially, the bankruptcy system would become a tool allowing those individuals to have their cake and eat it too.

The Sackler family and the ongoing Purdue saga highlight the great potential for grave injustice to occur through the use of third-party releases granted in bankruptcy proceedings. Members of the Sackler family held positions of power and authority that provided them the opportunity to dictate the marketing of OxyContin from the beginning.[60] The same positions of power and authority gave them the ability to take corrective action at numerous points in time over the last twenty years, yet they

56. *Id.* at 91.
57. *Id.*; *see also* 11 U.S.C. § 524(g).
58. *Purdue Pharma*, 635 B.R. at 89–106.
59. *See* In re Purdue Pharma, L.P., No. 21 CV 7532 (CM), 2022 WL 121393 (S.D.N.Y. Jan. 7, 2022 (certificate of appealability granted)).
60. *Purdue Pharma*, 635 B.R. at 40–43; *see also* Chakradhar, *supra* note 13.

deliberately chose not to.[61] Instead, the decision was made to deplete the company coffers by taking unprecedented levels of distributions from the company and stashing the funds away in protected family trusts to prepare to file for bankruptcy.[62] With the family fortune safely stored away, the Sacklers come to the bankruptcy negotiation table with an egregious ultimatum, hoping to use the bankruptcy system as a get-out-of-jail-free card.[63]

Bankruptcy is not intended to protect bad actors from liabilities they knowingly created through their own bad actions. Allowing for an escape from liability under these circumstances is an abuse of the Bankruptcy Code and an affront to justice. Bankruptcy exists to provide a financial fresh start to individuals and business entities that find themselves in a financial situation where the debts owed to others are too large to overcome without court involvement.[64] Purdue and the Sackler family spent years knowingly creating both the financial situation where debts owed became too large to overcome—deliberately taking money out of the company in the wake of mounting legal trouble—and the civil liability situation—marketing a dangerous and addictive product that was known to cause injury and death to users of the product.[65] If there exists a situation where authorizing nonconsensual third-party releases may be appropriate, this surely is not such a situation.

V. CONCLUSION

Allowing non-debtors in a bankruptcy proceeding to reap the benefit of being released from potential current and future civil liability provides

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61. *Purdue Pharma*, 635 B.R. at 49–51; *see also Hearing*, *supra* note 12 ("In 2007, these lies resulted in Purdue Pharma pleading guilty to felony charges of misbranding OxyContin and paying more than $600 million in criminal penalties. However, this did not stop Purdue's marketing campaign. It just sent it underground. Purdue spent the next decade misleading the DEA, defrauding the United States, paying kickbacks to companies that would steer patients on to OxyContin, and exacerbating the opioid epidemic. All the while, the Sackler family profited immensely from the deaths of millions of Americans.").

62. *Purdue Pharma*, 635 B.R. at 55–58.

63. *Id.* at 58–59.

> Purdue's bankruptcy was thus a critical part of a strategy to secure for the Sacklers a release from any liability for past and even future opioid-related litigation without having to pursue personal bankruptcy. David Sackler acknowledged as much in his testimony, "I don't know of another forum that would allow this kind of global solution, this kind of equitable solution for all parties."

Id. at 59 (quoting Confr. Hr'g Tr., Aug. 17, 2021, at 35:4–6).

64. *See Local Loan*, 292 U.S. at 244–45; *see also* Williams v. U.S. Fid. & Guar. Co., 236 U.S. 549, 554–55 (1915) ("It is the purpose of the Bankrupt Act to convert the assets of the bankrupt into cash for distribution among creditors and then to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.").

65. *Purdue Pharma*, 635 B.R. at 39–43.

an appealing avenue for bad actors to escape personal liability for tortious actions. The bankruptcy landscape for mass tort claims and business restructuring efforts will be forever altered, and not for the better, if the Sackler family—or others like them—are ultimately granted the third-party releases they are seeking through the Purdue bankruptcy plan.