Statement of Douglas G. Baird*

on behalf of the

NATIONAL BANKRUPTCY CONFERENCE

at the Hearing on

Oversight of the Bankruptcy Code

Part 1: Confronting Abuses of the Chapter 11 System

Before the

Subcommittee on Antitrust, Commercial and Administrative Law

of the Committee on the Judiciary

U.S. House of Representatives

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The National Bankruptcy Conference is grateful for the opportunity to participate in this hearing. The Conference was established in the 1930s, and it is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors, and judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and proposed changes to those laws. A Fact Sheet describing the Conference and listing its Members is attached to this Statement.

For over four decades, Chapter 11 has allowed financially distressed corporations to continue as going concerns and preserve jobs. Vast sectors of the economy from retailing to air transportation to automobile manufacturing would look altogether different—and worse—if Chapter 11 had not been in place. Precisely because of the power that Chapter 11 brings, however, ongoing vigilance against abuse is essential. Nowhere is vigilance more important than when the rights affected are those of tort victims. In contrast to ordinary consensual creditors, tort victims do not choose to become exposed to their debtor. They are seeking redress of wrongs imposed on them against their will and are considered involuntary creditors.

Third-party releases (e.g., where creditors release their personal claims against an entity other than the debtor as part of a Chapter 11 plan) raise important challenges. The Bankruptcy Code offers no explicit guidance, and this may not be an arena in which it is prudent to entrust the matter to unbridled judicial discretion. Potential for abuse is ever-present. Tort victims and other creditors are entitled to due process, and wrong-doers who are not themselves in bankruptcy should not get to exploit the bankruptcy process for their own benefit. Third-party releases, if they are allowed at all, should be an exceptional remedy put in place only after the most zealous attention to the rights of the nonconsenting parties.

An outright prohibition against third-party releases is not straightforward, however. For decades, courts have approved third-party releases and limited the rights of tort victims to recovering from an identified fund in a number of mass-tort cases. See, e.g. In re A.H. Robins Co., 880 F.2d 694 (4th Cir. 1989). Rarely are third-party releases in mass-tort cases approved unless a large majority of the tort victims themselves support them. See In re Dow-Corning Corp., 280 F.3d 648, 656-58 (6th Cir. 2002).

If bankruptcy judges had been unable to issue releases and so-called "channeling injunctions" in such cases, the survival of these

firms might have been threatened and even the tort victims themselves might have received less compensation in the end. A third-party release may allow a reorganization to succeed and at the same time fairly compensate tort victims for the rights that they are losing. Such a release can work with and enhance the other flexible restructuring tools contained in the Bankruptcy Code. The hard question is whether the potential benefit outweighs the substantial risks.

The following hypothetical illustrates how third-party releases (and the channeling injunctions that often accompany them) can promote well-established and legitimate objectives of bankruptcy law.

ABC Corp. is a privately held firm owned by the descendants of its founders. Many of these shareholders are entirely passive, but some have sat on its board and have served as officers. An employer of many thousands, ABC Corp. is a major supplier of a variety of building materials. Many of ABC Corp.'s materials are critical to large-scale construction projects, and they are hard to source from elsewhere.

Some decades ago, however, ABC Corp. began using a chemical compound in some of its materials that has since been shown to cause cancer. Some of those at ABC Corp. were aware of its dangers before the public at large. ABC Corp. eventually ceased using the compound. Before then, it put warnings on products it sold with this component. But ABC Corp. was generally slow to add these warnings and then to suspend its use of the compound.

Many cancer victims began to sue ABC Corp. in state court. Issues such as the adequacy of ABC Corp.'s warnings were litigated. ABC Corp. won some cases and settled others. In recent years, ABC Corp. has faced a growing tide of tort suits and settlements have grown ever larger. At the same time this litigation was happening, ABC Corp. issued hundreds of millions of dollars in dividends to its shareholders. The size of the dividends grew over time.

Beginning a year ago, financial creditors have become worried by the course of the tort litigation. They threaten to terminate their loans, and they insist that ABC Corp. take drastic steps. Restructuring professionals are brought in. The old managers are appropriately displaced, and new independent managers are installed who have no past affiliation of any kind with the company. When these new managers take stock, they decide that the best course for ABC Corp. is to reorganize under Chapter 11.

The filing of Chapter 11 under these facts is completely appropriate and serves the public policy goals underlying the Bankruptcy Code. Chapter 11 is a suitable vehicle to resolve ABC

Corp.'s problems. ABC Corp. is a viable firm, employing numerous hard-working employees. Keeping it intact as a going concern provides the best chance of ensuring maximum recoveries for all the creditors, including the tort victims, while preserving the jobs and other value ABC Corp. adds to society. Moreover, Chapter 11 is particularly well-equipped to confront the question of whether it is possible to recapture the dividends made to the shareholders as the threat posed by state litigation grew larger.

It has long been the law that such dividends can be pulled back into the bankruptcy estate if they were made with "intent to hinder, delay, or defraud" creditors (including the tort victims) or if they were made when ABC Corp. was insolvent. Proving either insolvency or "intent to hinder, delay, or defraud," however, is fact-intensive and hard. The costs and the time consumed by a full-blown trial on the merits and subsequent appeals put everyone at risk. The cost and the delay can threaten the survival of the business as a going concern, something that is essential to ensure that the victims enjoy substantial recoveries. The parties can attempt to settle, but the doubts about the merits and the complexity of the issues to be litigated give the shareholders some bargaining leverage.

Under these facts, the best course for the debtor (and the tort victims) is a global settlement in which the shareholders return some, but not all, of the dividends they received. It is the special obligation of the bankruptcy judge to ensure any such settlement is reached on terms that are fair and equitable. See In re Iridium Operating LLC, 478 F.3d 452, 461–62 (2d Cir. 2007).

In a case such as ABC Corp., however, the tort victims' ability to bring an independent action against some of the shareholders may present a serious obstacle. Shareholders of a corporation are generally not liable for its torts, but it is possible under these facts that the shareholders who were active in running the affairs of the corporation independently engaged in conduct that itself was tortious. Those shareholders who served as officers of ABC Corp. might have approved the label on a particular product with enough knowledge of the hazards of the compound that they are themselves personally liable as a matter of nonbankruptcy law.

Showing personal liability on the part of a particular officer is significantly harder and less likely to succeed than a fraudulent transfer action. Nonbankruptcy law might, as a policy matter, inappropriately put too many obstacles in the way of recovery, but this is not a question of bankruptcy policy, as it takes nonbankruptcy law as it finds it. See Butner v. United States, 440 U.S. 48 (1979). As a

result, the settlement value of these actions might be small relative to the value of the fraudulent transfer actions.

Nevertheless, the existence of these potential third-party causes of action might prevent a successful resolution of the Chapter 11 case. The shareholders may take the view that they would rather refuse all settlements and take their chances. The shareholders as a group may insist on global peace as a condition of settling the much larger fraudulent transfer action.

The representative of the bankruptcy estate lacks the ability to bring “direct” actions against third parties like those brought by the tort victims. See Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972). Yet, the bankruptcy estate has its own fraudulent transfer claims against the same third parties, which may have substantial merit and, if successful, even deplete the resources of the target defendants. In such situations, the ability to negotiate and implement a global compromise that includes both the estate claims and the direct actions of tort victims can bring about a resolution that would not otherwise be possible. The settlement itself should reflect the value of both the fraudulent transfer actions of the bankruptcy estate and the independent actions that could be asserted by the tort victims. Moreover, the settlement should be constructed to allow the tort victims to receive a fair share of the additional consideration resulting from the release of their potential claims.

There is, of course, a risk that those negotiating on behalf of the debtor (the trustee, the debtor in possession, or the creditors’ committee) will settle with the shareholders on unfavorable terms. But this should not be the case when the bankruptcy judge is attentive and vigilant. Indeed, bankruptcy law has required for more than a century that rigid scrutiny be applied by bankruptcy judges to settlements and other transactions that could benefit “insiders” of a corporate debtor. See Sawyer v. Hoag, 84 U.S. (17 Wall.) 610, 623 (1873).

In jurisdictions that permit nonconsensual third-party releases, the judges often approve such settlements only if a number of conditions are satisfied. Judges are rarely willing to approve third-party releases unless a majority of the tort victims themselves support the plan. In addition, the bankruptcy judge ensures that due process has been meticulously observed. The bankruptcy judge also insists that the tort victims receive an amount for their independent tort actions that fairly reflects the actions’ value. What the victims receive under the plan should include value they could expect to receive if they pursued the shareholders outside of bankruptcy. Finally, the bankruptcy judge approves releases only when the reorganization could not go forward without them.

Judges are inclined to approve a third-party release only when the nondebtors' action against the third party is a small part of the picture. In the case of *ABC Corp*., recovery of the dividends, something that is unequivocally the province of bankruptcy, swamps the value of the actions being released. Even though the expected value of the third-party actions that are released is small, resolving them (on terms fair to the tort victims) may be essential to a speedy resolution of the entire bankruptcy case. And unanimity may not be possible. Even when there is widespread acceptance of a Chapter 11 plan, there may be hold-outs. Overcoming such holdout problems is a standard function of bankruptcy law. Third-party releases are not objectionable merely because some vote against a plan.

In some cases, bankruptcy may enable tort victims to capture value that would otherwise be beyond their reach. Class actions are hard to bring in an environment in which each victim has a cause of action based on somewhat different facts and must make a different showing in order to recover. Some victims might be able to recover with a class action, but many others might not, and often a large portion of the recovery for any given victim will be consumed by attorneys' fees.

These facts illustrate how third-party releases and channeling injunctions can promote the traditional bankruptcy goals and respect the rights of victims. Other types of situations involving mass torts can arise in which third-party releases bring similar benefits. For example, an insurance company may be willing to settle its liability on a policy to a debtor arising from a mass tort only if it is released from any and all claims that the victims might be able to assert against it. A third-party release can be essential to providing any victim with any substantial recovery. See, e.g., Travelers Indemnity Co. v. Bailey, 557 U.S. 137 (2009) (decided on res judicata grounds).

It should be emphasized that the justification of third-party releases has nothing to do with solicitude for the parties who receive the release. They are alleged tortfeasors who drive a hard bargain in settlement negotiations. They have no right to enjoy any of the protections of the Bankruptcy Code. Any benefits they receive should not be part of the calculus.

Showing that nonconsensual releases bring benefits in cases like that of *ABC Corp*. falls short of proving that reform of the Bankruptcy Code is unnecessary. The Bankruptcy Code offers no explicit guidance outside of cases involving asbestos. Some courts of appeals insist that third-party releases can be approved only under extraordinary circumstances. See, e.g., In re Metromedia Fiber Network, Inc., 416 F.3d 136, 141 (2d Cir. 2005) (third-party releases "proper only in rare

cases"). But there is a risk that permitting such releases gives the bankruptcy judge too much discretion.

Without statutory guidance, third-party releases may become too routine. The multi-factored tests for third-party releases that permeate the caselaw are a recipe for mischief and the inconsistent decisions of circuit courts of appeals create uncertainty and asymmetry in what should be a nationally uniform law. Once empowered to approve third-party releases, some bankruptcy judges may do it too readily. They may be too inclined to agree that the case before them is one where such extraordinary relief should be granted, even when this is not the case.

Outside the mass tort context, third-party releases and exculpations, especially for the benefit of corporate insiders, have become all too common. See, e.g., In re Astria Health, 623 B.R. 793, 801 n.25 (Bankr. E.D. Wash. 2021) (noting that they have become a routine part of nearly every Chapter 11 case and are an example of "the Lake Wobegon effect whereby many ordinary and average things are postured as extraordinary, causing the very concept of extraordinariness to lose meaning"). If judges are insufficiently vigilant, third-party releases in mass tort cases may become a vehicle that allows tortfeasors to escape too cheaply from their wrong-doing.

For these reasons, it is possible to argue that nonconsensual third-party releases should be prohibited categorically. Such a prohibition may lead to the liquidation of firms like ABC Corp., but this may be a price worth paying if the alternative undermines the rights of tort victims. Moreover, once the possibility of a third-party release is taken off the table, the dynamics of the negotiations change. The tortfeasors may still be willing to settle even though it exposes them to further litigation. Sometimes everyone benefits when the judge's hands are tied.

The matter, however, is not clear-cut. Third-party releases in the hands of able professionals and a fair judge can bring about resolutions of hard cases relatively swiftly and on terms that, while they do not leave anyone happy, are vastly better than what could be achieved in bankruptcy or anywhere else. There are many able bankruptcy judges who wield firm hands and refuse to approve third-party releases when the facts do not justify them. See, e.g., In re Aegean Marine Petroleum Network Inc., 599 B.R. 717 (Bankr. S.D.N.Y. 2019). From this vantage point, the third-party release is a powerful tool that, while subject to abuse, is sufficiently useful that it should be preserved.

As the provisions in the Bankruptcy Code that cover asbestos cases show, there are a range of possible reforms to the law. Third-party

releases might be explicitly authorized, but only if particular procedural and substantive hurdles are met. Something between maintaining the largely direction-less status quo and outright prohibition may be more sensible.

Again, the challenges presented by third-party releases, like others facing the bankruptcy system, resist simple solutions and easy answers. As you pursue the hard challenges you face here, the National Bankruptcy Conference stands ready to provide its assistance.

National Bankruptcy Conference

A non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

History. The National Bankruptcy Conference (NBC) was formed from a nucleus of the nation's leading bankruptcy scholars and practitioners, who gathered informally in the 1930's at the request of Congress to assist in the drafting of major Depression-era bankruptcy law amendments, ultimately resulting in the Chandler Act of 1938. The NBC was formalized in the 1940's and has been a resource to Congress on every significant piece of bankruptcy legislation since that time. Members of the NBC formed the core of the Commission on the Bankruptcy Laws of the United States, which in 1973 proposed the overhaul of our bankruptcy laws that led to enactment of the Bankruptcy Code in 1978, and were heavily involved in the work of the National Bankruptcy Review Commission (NBRC), whose 1997 report initiated the process that led to significant amendments to the Bankruptcy Code in 2005. Most recently, the Conference played a leading role in developing the Small Business Reorganization Act of 2019, Pub. L. 116-54.

Current Members. Membership in the NBC is by invitation only. Among the NBC's 60 active members are leading bankruptcy scholars at major law schools, as well as current and former judges from eleven different judicial districts and practitioners from leading law firms throughout the country who have been involved in most of the major corporate reorganization cases of the last three decades. The NBC includes leading consumer bankruptcy experts and experts on commercial, employment, pension, mass tort, and tax-related bankruptcy issues. It also includes former members of the congressional staff who participated in drafting the Bankruptcy Code as originally passed in 1978 and former members and staff of the NBRC. The current members of the NBC and their affiliations are set forth on the second page of this fact sheet.

Policy Positions. The Conference regularly takes substantive positions on issues implicating bankruptcy law and policy. It does not, however, take positions on behalf of any organization or interest group. Instead, the NBC seeks to reach a consensus of its members - who represent a broad spectrum of political and economic perspectives - based on their knowledge and experience as practitioners, judges, and scholars. The Conference's positions are considered in light of the stated goals of our bankruptcy system: debtor rehabilitation, equal treatment of similarly situated creditors, preservation of jobs, prevention of fraud and abuse, and economical insolvency administration. Conferees are always mindful of their mutual pledge to "leave their clients at the door" when they participate in the deliberations of the Conference.

Technical and Advisory Services to Congress. To facilitate the work of Congress, the NBC offers members of Congress, Congressional Committees and their staffs the services of its Conferees as non-partisan technical advisors. These services are offered without regard to any substantive positions the NBC may take on matters of bankruptcy law and policy.

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