By Matthew K. Stiles[1]

Bad Moon Rising?

Purdue *and the Future of Nonstatutory Bankruptcy Doctrines*

Matthew K. Stiles
U.S. Bankruptcy Court (D. Conn.); Hartford

Matthew Stiles is the career law clerk for Hon. James J. Tancredi of the U.S. Bankruptcy Court for the District of Connecticut and is based in Hartford.

In *Harrington v. Purdue Pharma LP*,[2] the U.S. Supreme Court 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."[3] In doing so, the 5-4 majority rejected the argument that nonconsensual third-party releases were authorized under § 1123(b)(6), which states that a chapter 11 plan may "include any other appropriate provision not inconsistent with the applicable provisions of this title,"[4] because that catch-all provision was cabined by the prior five subsections, which pertain to a debtor and its creditors.[5] The Court also determined that related Code provisions were of no help.[6]

The majority opinion then gave the history of nonconsensual third-party releases little weight.[7] Without discussing the doctrine's development over the years, the Court merely stated that "[e]very bankruptcy law the parties and their *amici* have pointed us to, from 1800 until 1978, generally reserved the benefits of discharge to the debtor who offered a 'fair and full surrender of [its] property.'"[8] As to various policy arguments, the Court simply stated that "we are the wrong audience for them."[9]

Much has already been said about *Purdue* — and I do not intend to dwell on the case itself — but this last point bears noting because it seemingly alludes to equitable considerations, which the majority did not discuss. Although the Supreme Court has long said that bankruptcy courts are courts of equity,[10] it has also stated that "the Bankruptcy Code does not authorize free-wheeling consideration of every conceivable equity."[11] It has restricted usage of § 105(a) of the Bankruptcy Code[12] such that it may not be used to "contravene express provisions" of the Code,[13] nor deviate from norms specified in the Code in a way that could benefit creditors.[14] In other words, recent case law suggests that whatever equitable powers bankruptcy courts possess might be limited to those enumerated in Code provisions — and even then, they might be suspect.

On the same day that the Supreme Court issued *Purdue*, it also issued *SEC v. Jarkesy*.[15] Despite pertaining to in-house adjudications at the Securities and Exchange Commission (SEC), it might augur how the Court feels about bankruptcy courts — essentially grouping them with Article I administrative agencies.

Don't believe me? *Jarkesy* essentially hung its hat on *Granfinanciera SA v. Nordberg*,[16] stating that it "effectively decides this case."[17] Article I tribunals — including bankruptcy courts — simply do not have the powers that Article III courts have, particularly where private rights are concerned.[18] This is a roundabout way of saying that, to today's Supreme Court, bankruptcy courts might look less like courts of equity than the limited-scope agency tribunals. With that comes a limitation on powers, particularly those lacking a statutory or historical basis.

Acknowledging that debtors' and lawyers' immediate concern is figuring out how to operate in a post-*Purdue* world,[19] we should not lose sight of the problem lurking in the interstices of *Purdue* (as framed by a *Jarkesy*-minded Court): What nonstatutory doctrines are now suspect? Three immediately come to mind: substantive consolidation, recharacterization and necessity of payment.[20]

Substantive Consolidation

One tool — used when faced with multiple debtors (and, sometimes, nondebtors) — is substantive consolidation, which "treats separate legal entities as if

1 The views expressed in this article are the author's alone and not necessarily those of the U.S. Bankruptcy Court for the District of Connecticut.
2 144 S. Ct. 2071 (2024).
3 *Id.* at 2088.
4 11 U.S.C. § 1123(b)(6).
5 *Purdue*, 144 S. Ct. at 2082-84.
6 *Id.* at 2084-86.
7 *Id.* at 2086.
8 *Id.*
9 *Id.* at 2087.
10 *Pepper v. Litton*, 308 U.S. 295, 304 (1939); *Young v. United States*, 535 U.S. 43, 50 (2002).
11 *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 527 (1984).
12 11 U.S.C. § 105(a) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").
13 *Law v. Siegel*, 571 U.S. 415, 427-28 (2014).
14 *Czyzewski v. Jevic Holding Corp.*, 580 U.S. 451, 471 (2017).
15 144 S. Ct. 2117 (2024). The *Jarkesy* Court held that the Seventh Amendment requires that certain fraud claims brought by the SEC must be adjudicated in a jury trial rather than before an administrative agency.
16 492 U.S. 33 (1989). In *Granfinanciera*, the Court held that one who has not submitted a claim has a Seventh Amendment right to jury trial when sued by a bankruptcy trustee to recover a fraudulent transfer. *Id.* at 36.
17 *Jarkesy*, 144 S. Ct. at 2135.
18 *See id.* at 2132 ("If a suit is in the nature of an action at common law, then the matter presumptively concerns private rights, and adjudication by an Article III court is mandatory." (citing *Stern v. Marshall*, 564 U.S. 462, 484 (2011))). *Jarkesy* also cites *N. Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), for those playing Supreme Court bankruptcy bingo at home.
19 The majority opinion was clear that it had not decided anything regarding consensual releases, full satisfaction of claims against third parties, or what to do with substantially consummated effective plans that include nonconsensual third-party releases.
20 This food-for-thought list is not exhaustive. In addition, no definitive statement about the propriety of any doctrine discussed here is intended.

they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased)."[21] The effect is that claims against the various debtors become claims against the survivor,[22] as the sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors.[23] In the Second Circuit, substantive consolidation considers whether (1) "creditors dealt with the entities as a single economic unit" and (2) "the affairs of the debtors are so entangled that consolidation will benefit all creditors."[24]

However, "[s]ubstantive consolidation has no express statutory basis [and] is the product of a judicial gloss."[25] Some courts have cited § 105(a) as a basis for bankruptcy courts' authority to invoke it.[26] It is in essence an outgrowth of alter-ego and veil-piercing remedies,[27] with the Third Circuit stating that "the Supreme Court ... approved (at least indirectly and perhaps inadvertently) what became known as substantive consolidation."[28] It then took courts of appeals a while to stamp their imprimatur on its usage, along with the admonition that it be used "sparingly."[29]

Despite fairly robust case law, it is questionable whether today's Court would approve of *Owens Corning*'s statement that the Court somehow approved substantive consolidation in a case concerning the turnover of fraudulently transferred assets.[30] With a thin historical basis (at best) and no apparent statutory support (apart from § 105(a)), substantive consolidation may become a future target for scrutiny.[31]

Recharacterization

Another tool, recharacterization, involves a finding by a court that a pre-petition advance is a contribution of equity as opposed to debt — regardless of any label.[32] Similar to equitable subordination, it is "grounded in bankruptcy courts' equitable authority to ensure 'that substance will not give way to form, that technical considerations will not prevent substantial justice from being done.'"[33] Many courts use the 11-factor test laid out in *In re AutoStyle Plastics Inc*.[34] when determining whether an advance is debt or equity.[35]

Unlike equitable subordination,[36] recharacterization has not been codified.[37] In *Purdue*, the Supreme Court noted that Congress authorized asbestos-related bankruptcies to issue injunctions barring actions against third parties under certain circumstances, and that it had done so in that one context "ma[de] it all the more unlikely that § 1123(b)(6) is best read to afford courts the same authority in *every* context."[38]

Thus, although recharacterization has a much older pedigree than nonconsensual third-party releases, this apparent omission from codification — where a similar doctrine that largely emanates from the same case *was* codified — could be read to suggest that Congress meant to exclude recharacterization from the Code.[39] Given that the Court appears loath to recognize any power bankruptcy courts may have unless such is directly expressed in the Code (and not subject to constitutional concerns), the Court might be disinclined to recognize any power to recharacterize.

Necessity of Payment

The final tool, doctrine of necessity, involves courts approving the payment of pre-petition claims for certain key creditors that might otherwise refuse to continue supplying the debtor absent immediate payment.[40] This often manifests itself in a critical-vendor motion, usually filed (and decided) near the beginning of a chapter 11 case. Thus, before many creditors have even had the chance to get their bearings, other creditors may have had their pre-petition claims paid in full.

The practice predates the Code (and the Bankruptcy Act), having been endorsed by the Supreme Court in *Miltenberger v. Logansport, Crawfordsville & Southwestern Railway Co*.[41] In this railway reorganization case, the Court noted that "[m]any circumstances may exist [that] may make it necessary and indispensable to the business of the road and the preservation of the property for the receiver to pay pre-existing debts of certain classes out of the earnings of the receivership, or even the corpus of the property, under the order of the court, with a priority of lien," including, for example, "where a stoppage of the continuance of [indispensable] business relations would be a probable result."[42]

Although § 105(a) is often cited as authority for a critical-vendor order,[43] courts have also cited § 363(b) of the Bankruptcy Code,[44] which gives a court the power to authorize the use of estate funds outside of the ordinary course of

21 *In re Owens Corning*, 419 F.3d 195, 205 (3d Cir. 2005).
22 *Id.*
23 *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988).
24 *Id.* For example, in *Augie/Restivo*, the Second Circuit reversed the substantive consolidation of the debtor baking companies because a bank had extended credit to one before that debtor had any relationship with the other, and the consolidation also unfairly benefited later creditors that were aware of the debtors' separate corporate status. *Id.* at 516.
25 *Id.* at 518.
26 *See* Richard Levin & Henry A. Sommer, 2 *Collier on Bankruptcy* ¶ 105.09[1][b], n.8 (16th ed. 2024) (collecting cases).
27 *Owens Corning*, 419 F.3d at 205-06.
28 *Id.* (citing *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941)).
29 *Id.* at 206-09 (quoting *Augie/Restivo*).
30 In *Sampsell*, 313 U.S. at 215-16, a debtor transferred assets to a corporation owned by himself, his wife and his son pre-petition, despite owing a creditor approximately $104,000. Imperial Paper then extended credit to the corporation. *Id.* at 216. Once in bankruptcy, the referee ordered that the corporation's assets be marshalled for the benefit of the debtor's estate because of the fraudulent transfers. *Id.* at 216-17. Imperial Paper thought that it should get a priority, but the referee — and ultimately the Supreme Court — disagreed. *Id.* at 217-18. The fact that Imperial Paper was allowed to assert a claim against the debtor, which was left untouched by the Supreme Court decision, is hardly a full-throated endorsement of substantive consolidation.
31 The Supreme Court missed a chance to (at least tacitly) endorse substantive consolidation early in the Bankruptcy Code era. In *Central Trust Co., Rochester, N.Y. v. Official Creditors' Comm. of Geiger Enterprises*, 454 U.S. 354, 355 (1982), the debtors sought to dismiss their cases under the Bankruptcy Act so that they could proceed under the Code and substantively consolidate their cases. However, the Court held that such was prohibited by the Code's enacting legislation. *Id.* at 357. Thus, the debtors could not escape application of the Bankruptcy Act, and the Court had no occasion to pass on the propriety of substantive consolidation.
32 Levin & Sommer, 4 *Collier on Bankruptcy* ¶ 510.02[3].
33 *In re SubMicron Sys. Corp.*, 432 F.3d 448, 454 (3d Cir. 2006) (quoting *Pepper*, 308 U.S. at 305) (footnote omitted). The omitted footnote cites § 105(a) as the source of bankruptcy courts' equitable powers. *Id.*
34 *Bayer Corp. v. MascoTech Inc. (In re AutoStyle Plastics Inc.)*, 269 F.3d 726 (6th Cir. 2001).
35 *Id.* at 749-50. The 11-factor test was lifted from a tax court case. *See Roth Steel Tub Co. v. CIR*, 800 F.2d 625, 630 (6th Cir. 1986). For a detailed example applying, among other things, the *AutoStyle* factors and rejecting a recharacterization claim, *see Official Comm. of Unsecured Creditors of HH Liquidation LLC v. Comvest Grp. Holdings LLC (In re HH Liquidation LLC)*, 590 B.R. 211, 289–98 (Bankr. D. Del. 2018) (determining that grocery store operators and real estate holding company intended loan to be secured debt instead of equity infusion).
36 *See* 11 U.S.C. § 510(c).
37 Some courts have relied on § 502 of the Bankruptcy Code and state law for authority for recharacterization. *See* Levin & Sommer, 4 *Collier on Bankruptcy* ¶ 510.02[3] (collecting cases).
38 *Purdue*, 144 S. Ct. at 2085.
39 Without saying as much, the Supreme Court effectively applied the canon *expressio unius est exclusio alterius* (Latin phrase meaning "to express or include one thing implies the exclusion of the other, or of the alternative").
40 Levin & Sommer, 4 *Collier on Bankruptcy* ¶ 105.02[4][a].
41 *Miltenberger v. Logansport, Crawfordsville & Sw. Ry. Co.*. 106 U.S. 286 (1882).
42 *Id.* at 311-12.
43 *See, e.g., In re Ionosphere Clubs Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989).
44 11 U.S.C. § 363(b).

continued on page 62

from page 35

business.[45] However, not every court has seen it this way. In *In re Kmart Corp.*,[46] the Seventh Circuit thought using § 363(b) "to rearrange priorities among creditors" was a step too far, particularly where the record was lacking.[47] Despite the Seventh Circuit's opinion in *Kmart* to the contrary, critical-vendor orders have a stronger historical and statutory basis than nonconsensual third-party releases, suggesting that the Court might be OK with the doctrine of necessity — especially where the record is better developed than *Kmart*'s apparently was.[48]

Trouble May Be a Ways Off

For those worried that your favorite chapter 11 tool is on its way out the door soon, there are several potential obstacles in the way of their wholesale repudiation. First, for doctrines that are well established under circuit precedent, it is difficult, if not impossible, for a bankruptcy court to suddenly state that such a doctrine is outlawed by *Purdue*. For example, in the Second Circuit, substantive consolidation is recognized by *Augie/Restivo*. The Second Circuit has also stated that lower courts "must follow controlling precedent — even precedent the [court] believes may eventually be overturned — rather than pre-emptively declaring that our case law has been abrogated."[49] Thus, absent a clear indication to the contrary from the circuit courts after *Purdue*, many courts are likely to continue to follow established precedent for these various doctrines.

Second, even if a party objects to the usage of one of these doctrines, it will likely take a trip to the circuit court to get relief, at which point the appeal may be equitably moot.[50] *Purdue* managed to progress through the appellate system, in part because the district court acted quickly to stay effectiveness of the plan.[51] Another's mileage might vary.

Third, state law rights and remedies might exist that provide relief like those doctrines being questioned such that courts can dodge the question.

Finally, even if a question concerning these doctrinal tools goes all the way to the Supreme Court, the Court might rule differently than it did in *Purdue*, particularly where there is a stronger basis in text and history for the doctrine in question. If — and when — the Supreme Court strikes next, "[h]ope you got your things together."[52] abi

Editor's Note: *ABI held a webinar shortly after the Supreme Court issued its decision in this case. To listen to the abiLIVE recording, please visit abi.org/newsroom/videos. ABI also published a digital book,* The Purdue Papers*, a compilation of 3,500+ pages of amicus briefs, petitions and other related background material. To order your downloadable copy, visit store.abi.org.*

45 *See, e.g., Ionosphere Clubs*, 98 B.R. at 175.

46 *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004). Kmart had been allowed to pay some 2,330 suppliers about $300 million shortly after filing, but another 2,000 or so were not. *Id.* at 869. The 2,330 were paid in full but the 2,000 (plus 43,000 other unsecured creditors) were later paid about 10 cents on the dollar. *Id.*

47 *Id.* at 872, 874 ("Even if § [363](b)(1) allows critical-vendor orders in principle, preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors.").

48 The Court could also decide that *Jevic* would require a *Kmart*-esque decision.

49 *Packer, ex rel. 1-800-Flowers.com Inc. v. Raging Capital Mgmt. LLC*, 105 F.4th 46, 50 (2d Cir. 2024). The Second Circuit also noted a rare case exception where "an intervening Supreme Court decision has so clearly undermined our precedent that it will almost invariably be overruled." *Id.* at 54, n.36.

50 Another nonstatutory bankruptcy tool that already has volumes of literature dedicated to it.

51 *See In re Purdue Pharma LP*, No. 21-cv-07532 (CM) (S.D.N.Y. Oct. 10, 2021) (temporary restraining order) ("I have no intention of allowing the critically important issues on appeal to be 'equitably mooted.'").

52 Creedence Clearwater Revival, "Bad Moon Rising," on *Green River* (Fantasy Records 1969). John Fogerty apparently has said that the song was inspired by the movie *The Devil and Daniel Webster*, which includes the famed lawyer-cum-statesman Daniel Webster defending a man who was motivated by his financial distress to sell his soul to the devil.