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Purdue Pharma: Is Protection of Third Parties by the Automatic Stay an Oxymoron?

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The automatic stay provided under section 362 of the Bankruptcy Code is an injunction, arising when a bankruptcy case is filed, which prevents all proceedings or actions against the debtor or the property of the estate without court permission - the so-called "lifting of the stay".[1]

Once the bankruptcy action has been commenced, this prohibition extends to all jurisdictions in the US, including those beyond where the case is filed. The purpose of this provision is to ensure the removal of all such disputes to the bankruptcy court so they may be adjudicated under the provisions of the bankruptcy code. We have addressed interesting cases under 11 U.S.C. § 362 in prior client alerts.[2]

Typically, the automatic stay does not extend to non-debtor parties.[3] For example, the stay does not prevent the commencement or pursuit of actions against guarantors, owners of a debtor company, corporate affiliates, partners in debtor partnerships or codefendants in pending actions.[4]

However, as with any rule, there are exceptions. "Specifically, where a particular action against the non-debtor party threatens to adversely affect the debtor's reorganization efforts, courts are willing to extend § 362(a)'s coverage accordingly."[5] Additionally, the courts have extended the protection of section 362 where "there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment against the debtor." [6] However, the courts have cautioned that these exceptions are rare and have repeatedly held that the extension of the automatic stay provision to non-debtor parties is "reserved for special circumstances and typically [applies] to those lawsuits which threaten serious risk to a reorganization in the form of immediate adverse economic consequences for the debtor's estate."[7]

Recently, the issue of extending the automatic stay protections to members of a family which owns a corporate debtor has been a hot topic. Members of the Sackler family, who own Purdue Pharma – the maker of OxyContin – have been seeking immunity from future opioid lawsuits in exchange for their voluntary forfeiture of control of

the bankrupt drug company. Judge Robert Drain, who is presiding over the case in the Southern District of New York[8], has suggested that a deal of that nature may be achievable as part of a negotiated settlement which could avoid years of litigation. However, the many opponents of this potential "deal" argue that this would set a terrible precedent and strongly contend that the protections afforded a debtor in bankruptcy – specifically, the automatic stay protections of section 362 - should only be extended to the Sacklers (or any similarly situated party) upon the filing of their own individual bankruptcy proceedings.

We will continue to monitor the Purdue Pharma matter as well as all important developments regarding the application of § 362.

Our financial institution and other creditor clients are cautioned to be very careful about proceeding against debtors once a case is filed in the bankruptcy court. Violation of the automatic stay can create serious consequences. However, beyond that, we are prepared to assist our creditor clients with preventing actions against related parties in appropriate circumstances.

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Michael Traison at 312.860.4230

Footnotes

[1] 11 U.S.C. § 362; Citizens Bank of Maryland v. Strumf, 516 U.S. 16, 21 (1995)

[2] Relevant Prior Cullen and Dykman LLP Legal Alerts: The Automatic Stay: Even Pre-Petition Seizures May Be Covered, July 1, 2019; Bank Freezes and the Automatic Stay, July 8, 2019; Yet Another Court Addresses Violation of the Automatic Stay, September 4, 2019; Automatic Stay Violators and Prepetition Seizures, November 15, 2019; Supreme Court to Decide Whether Creditor's Inaction Violates the Automatic Stay, December 31, 2019; Beware of the Automatic Stay! Bankruptcy Court Sanctions Law Firm and Client for "Willful" Violation of the Automatic Stay, February 19, 2020; Automatic Stay Violators and Prepetition Seizures, January 20, 2021.

[3] See Gucci, America, Inc. v Duty Free Apparel, Ltd., 328 F.Supp.2d 439 (Bankr. S.D.N.Y. 2004); citing Teachers Ins. & Annuity Ass'n v. Butler, 803 F.2d 61, 65 (2d Cir. 1986)

[4] See In re: Mohr, 538 B.R. 882, 888 (Bankr. S.D. Ga. 2015) ["Although the automatic stay is extremely broad in scope … it does not extend to separate legal entities such as corporate affiliates, partners in debtor partnerships or to codefendants in pending litigation." (internal citations and quotations omitted); In re: Lengacher, 485 B.R. 380, 383 (Bankr. N.D. Ill. 2012) ("[The automatic stay provision] does not prevent actions against non-debtor co-obligors, debtor's sureties or guarantors."); Gray v. Hirsch, 230 B.R. 239, 242 (Bankr. S.D.N.Y. 1999) (citing consistent Second Circuit refusal to shelter non-debtor principals as evidence that control of a bankrupt entity does not automatically establish § 362(1) protection.).

[5] Gucci, supra., citing In re: United Health Care Org., 210 B.R. 228, 232 (Bankr. S.D.N.Y 1997); see also In re: North Star Contr. Corp., 125 B.R. 368, 370-71 (Bankr. S.D.N.Y. 1991) (extending the automatic stay protections to debtor's

president, where reorganization efforts would be harmed by a state lawsuit against debtors President, given his active role in the reorganization planning process.)

[6] In re: United Health Care Org., supra.

[7] Gucci, supra.; In re: United Health Care Org., supra.; In re: North Star, supra.

[8] In re: Purdue Pharma L.P. Bankr. S.D.N.Y., Case No. 19-23649 (RDD)

Practices

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