Morally Bankrupt: Bankruptcy Law, Corporate Responsibility, and Sexual Misconduct

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The MeToo Movement has spurred a wave of sexual misconduct-related lawsuits against corporations, prompting many to file for bankruptcy. Recent examples include the Weinstein Company, Boy Scouts of America, and USA Gymnastics.

This Article is the first to analyze the long-term social effects of bankruptcy law and the ways in which it potentially perpetuates sexual misconduct by denying victims their day in court, limiting their recovery, and distorting monitoring incentives. Specifically, because current bankruptcy law protects secured creditors and often shields managers as well, these groups have little incentive to monitor sexual misconduct, as they are effectively insulated from damage claims through the absolute priority rule and the use of third-party releases.

To prevent that result, this Article offers several policy proposals to ensure that managers, lenders, and other financially healthy parties remain accountable and invest resources to fight sexual misconduct. Managers could, for example, monitor sexual misconduct directly, and lenders could modify their pricing and underwriting practices to encourage compliance. While these policy proposals are designed to address sexual misconduct, they have broad applicability to other ESG risks, such as human rights and environmental violations. This Article provides a novel discussion of the impact of bankruptcy law on corporate misbehavior and resource allocation in an era of corporate responsibility.

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INTRODUCTION

In 2018, the Weinstein Company, once a leading independent movie studio, filed for bankruptcy.[1] The company had been struggling after more than eighty women accused Harvey Weinstein, its chief executive, of sexual misconduct—including rape and sexual assault.[2] Although the company was sold after just several months in bankruptcy and although the purchase price was almost $290 million,[3] Weinstein's victims remained empty-handed for almost three years and ultimately had to settle for a share in a court-sanctioned compensation fund that capped the company's liability at a paltry $17 million.[4]

[1] Brooks Barnes, *Weinstein Company Files for Bankruptcy and Revokes Nondisclosure Agreements*, N.Y. TIMES (Mar. 19, 2018), https://www.nytimes.com/2018/ 03/19/business/weinstein-company-bankruptcy.html.

[2] Harvey Weinstein was finally sentenced to 23 years in prison in 2020 after being convicted in New York of rape and sexual assault. Jan Ransom, *Harvey Weinstein's Stunning Downfall: 23 Years in Prison*, N.Y. TIMES (Mar. 12, 2020), https://www.nytimes.com/2020/03/11/nyregion/harvey-weinstein-sentencing.html.

[3] Ryan Faughnder, *Weinstein Co. completes $289-million sale to private equity company*, L.A. TIMES (Jul. 16, 2018), https://www.latimes.com/ business/hollywood/la-fi-ct-weinstein-sale-close-20180716-story.html.

[4] By way of comparison, the professional fees and expenses in this bankruptcy exceeded $40 million. In addition, the insurance companies paid approximately $9.7 million to cover the defense costs for the company's directors and officers (other than Harvey Weinstein). *See* Post-confirmation Report, *In re* The Weinstein Company Holdings LLC, No. 18-10601 (Bank. D. Del. Apr. 19, 2023), ECF No. 3600. *See also* Order Confirming

Harvey Weinstein became a symbol of everything the MeToo Movement sought to combat, and his exposure no doubt encouraged other victims to come forward. Before then, sexual misconduct claims were often not raised, even in relatively egregious cases, which contributed to a significant lack of policing within companies. While this was partially due to a cultural taboo that discouraged victims from speaking up, it was also because sexual misconduct victims generally had limited avenues of legal recourse against the company under existing law.[5] Employees could sue for employment discrimination under Title VII of the Civil Rights Act of 1964 (Title VII).[6] Non-employee victims, however, were relegated to general tort law doctrines, such as vicarious liability and negligent supervision, if they wanted to impose liability on a company.[7]

In the wake of the Weinstein debacle and other MeToo scandals, a number of states began to broaden the legal frameworks available to victims and loosen the applicable statutes of limitation.[8] This expansion may help

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Plan Proponents' Fifth Amended Joint Chapter 11 Plan of Liquidation, *In re* The Weinstein Company Holdings LLC, No. 18-10601, at 26 (Bankr. D. Del. Jan. 26, 2021), ECF No. 3203, https://dm.epiq11.com/case/twc/documents. Megan O'Neill, *Harvey Weinstein Victims' Sexual Abuse Settlement Took Years To Create And Crumbled Within Minutes. What Comes Next?*, FORBES (Aug. 14, 2020), https://www.forbes.com/sites/legalentertainment/2020/08/14/harvey-weinstein-victims-sexual-abuse-settlement-took-years-to-create-and-crumbled-within-minutes-what-comes-next/?sh=5d16f02b407d; Jonathan Randles, *Bankruptcy Judge Approves $17 Million Fund for Harvey Weinstein Victims*, WSJ PRO BANKRUPTCY (Jan. 25, 2021), https://www.wsj.com/articles/bankruptcy-judge-approves-17-million-fund-for-harvey-weinstein-victims-11611625431; Tatiana Siegel, *Harvey's Cronies Are Making Bank Off of Weinstein Movies and Shows*, ROLLINGSTONE (Apr. 20, 2022), https://www.rollingstone.com/tv-movies/tv-movie-features/harvey-weinstein-company-insiders-bob-profit-hollywood-yellowstone-1289849/.

[5] *See* Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 COLUM. L. REV. 1583, 1603-1610 (2018) (explaining Title VII's shortcomings as a remedy for sexual misconduct victims, including capped damages and a 180-day limitation period).

[6] 42 U.S.C. § 2000e-2 (2012). Only 20 years after the enactment of Title VII, the Supreme Court recognized workplace harassment as an independent form of sex discrimination in Meritor Sav. Bank, FSB v. Vinson, 477 U.S. 57 (1986).

[7] *See* Deana Pollard Sacks, *Intentional Sex Torts*, 77 FORDHAM L. REV. 1051 (2008) (providing a historical review of sex torts in the United States); Alexandra Raso, *Abused in the Pursuit of a Dream: How USA Gymnastics Failed to Protect Its Gymnasts*, 37 HOFSTRA LAB. & EMP. L. J. 439, 458-462 (2020) (analyzing the potential liability of Michigan State University for the USA Gymnastics sex abuse scandal under the doctrines of respondeat superior and negligent supervision).

[8] Erik A. Christiansen, *How Are the Laws Sparked by #MeToo Affecting Workplace Harassment?*, The American Bar Association (May 8, 2020),

explain the growth in sexual misconduct claims and the attendant desire by corporations to use bankruptcy to limit liability. Under current law, corporate debtors can block and potentially dispose of such claims in bankruptcy. Unlike individual debtors, who are not permitted to discharge liability for sexual misconduct due to the "willful and malicious" exception to discharge,[9] corporations can take full advantage of the bankruptcy process to dispose of sexual misconduct claims.[10]

https://www.americanbar.org/groups/litigation/publications/litigation-news/featured-articles/2020/new-state-laws-expand-workplace-protections-sexual-harassment-victims/; Progress in Advancing Me Too Workplace Reforms in #20STATESBY2020, National Women's Law Center (July 2019), https://nwlc-ciw49tixgw5lbab.stackpathdns.com/wp-content/uploads/2019/07/final_2020States_ Report-9.4.19-v.pdf. The report's updates are available here: 2020 Progress Update: Me Too Workplace Reforms in The States, National Women's Law Center (September 2020), https://nwlc.org/wp-content/uploads/2020/09/v1_2020 _nwlc2020States_Report.pdf. (providing a comprehensive review of the legal changes in sexual harassment law following the MeToo revolution); *See also* Debtors' Informational Brief at 32-34, *In re* Boy Scouts of Am., No. 20-10343 (Bankr. D. Del. Feb. 18, 2020), ECF No. 4.

[9] 11 U.S.C. § 523(a)(6). While this exception mainly refers to liabilities arising from intentional torts, recent courts have interpreted it to include sexual harassment claims under Title VII and state law. *See* Gansi v. Townsend (*In re* Townsend), 550 B.R. 220 (Bankr. E.D.N.Y. 2016), *aff'd sub nom.* Townsend v. Ganci, 566 B.R. 129 (E.D.N.Y. 2017), *aff'd sub nom.* Townsend v. Gansi (*In re* Townsend), 726 F. App'x 91 (2d Cir. 2018); Basile v. Spangola (*In re* Spagnola), 473 B.R. 518, 523 (Bankr. S.D.N.Y. 2012) (holding a sexual harassment judgment under Title VII or the New York state law cannot be discharged in personal bankruptcy). In one early case, however, the bankruptcy court required another trial to determine intent, though the matter was never resolved since the victim refused to re-testify. *See* Sanger v. Busch (*In re* Busch), 311 B.R. 657, 669 (Bankr. N.D.N.Y. 2004) (holding that sexual harassment is not "willful" without showing intent and therefore can be discharged in bankruptcy). For criticism on this decision, *see* Andy Gaunce, *Rethinking* In re Busch*: Bankruptcy Discharge of Sexual Harassment Judgments under Section 523(A)(6)*, 56 S. CAR. L. REV. 645 (2005); David L. Adamson, *The Discharge of Sexual Harassment Judgments in Bankruptcy Court: An Attempt to Right a Grave Injustice*, 25 HOFSTRA LAB. & EMP. L. J. 283 (2007). Originally, the "willful and malicious" standard of intent was determined in a medical malpractice case. *See* Kawaauhau v. Geiger, 523 U.S. 57 (1998) (holding debts arising from recklessly or negligently inflicted injuries do not fall within § 523(a)(6)). This standard has not yet been considered by the Supreme Court in relation to sexual harassment cases.

[10] Historically, Section 17 of the Bankruptcy Act applied this exception to both individuals and corporations. *See* Bankruptcy Act of 1898, 30 Stat. 544, 550-51, § 17(a). However, the legislature narrowed it to include only individuals in the new Bankruptcy Code of 1978. An attempt to challenge the constitutionality of this distinction between

This Article examines the use of corporate bankruptcy proceedings to limit liability for sexual misconduct, a practice that has become increasingly prevalent. From a company's perspective, bankruptcy has at least three advantages. First, the automatic stay halts litigation and protects the corporation from most civil lawsuits, which must then be settled through the restructuring plan.[11] Victims who do not participate in the process are barred from taking legal action against the debtor while the bankruptcy proceedings are ongoing. Once a specified majority of creditors approves the plan, the corporation is free of its past debts.[12]

Second, a debtor's plan of reorganization can reduce and cap a company's liability for tort and other claims, since such claimants are usually treated as unsecured creditors. As such, they stand last in line when it comes to payment—far behind secured creditors (mainly banks)[13] and other statutorily preferred groups (e.g., unpaid employees, bankruptcy professionals, and the government).[14] By taking advantage of this priority or "waterfall" structure, a corporate debtor can effectively force tort victims to discount their claims in a bankruptcy proceeding.

individuals and corporations was unsuccessful. *See* Ackles v. A.H. Robins Co. (*In re* A.H. Robins Co., Inc.), 59 B.R. 99, 102-105 (Bankr. E.D. Va. 1986) (holding that distinction between corporations and individuals is promoting efficient bankruptcy and thus constitutional). In 2005, Congress considered broadening the scope of this discharge exception so it applies to both individuals and corporations, but later abandoned the idea. The distinction between corporations and individuals was not discussed in Congress or in court in the context of discharging sexual misconduct-based claims. *See In re* Exide Tech., 601 B.R. 271, 280-281 (Bankr. D. Del. 2019); Luke Sperduto, *Three and a Half Rules for Tort Claims in (and out of) Chapter 11*, 95 AM. BANKR. L.J. 127, 152, 162-166 (2021) (both describing the legislative history of Section 523). Eventually, only two discharge exceptions, debts owed to the government for fraud or for tax evasion, were applied to corporations.

[11] However, there are certain exceptions to the stay. *See infra* Section I.A.i.

[12] 11 U.S.C. § 1141(d)(1). For further discussion on the required majority, *see infra* note 85.

[13] 11 U.S.C. § 1129(b)(2). Under the absolute priority rule, secured lenders must be paid in full before other groups are paid.

[14] 11 U.S.C. § 507. The fees and costs of professionals retained in the bankruptcy proceedings get administrative priority. Unpaid wages and other benefits of corporate employees earned within 180 before the bankruptcy filing are also prioritized (subject to a cap). Additionally, certain government payments, mainly involving taxes and penalties, are prioritized under the law.

Last, a bankruptcy plan can sometimes release third parties, including managers, parent entities, and insurers from liability.[15] In recent cases, courts have granted these third parties a general release, even though such parties had not sought bankruptcy protection themselves (and even though the individuals would not have been entitled to releases due to the "willful and malicious" exception had they filed for personal bankruptcy).[16]

This Article suggests that, because bankruptcy law allows managers and certain capital providers to externalize the costs of workplace sexual misconduct, the system helps to perpetuate such misconduct. In other words, because managers and corporate boards are insulated from damage, they are less likely to invest resources to combat sexual misconduct. In addition, this Article suggests that the managers' ability to insulate themselves from liability, even when they are themselves the perpetrators of the sexual misconduct at issue and even when shareholders stand to suffer loss, may create agency costs: managers might be too eager to file for bankruptcy, even when it is not in their shareholders' best interests.[17]

Moreover, because the bankruptcy waterfall structure shields secured lenders from sexual misconduct costs, the risk of misconduct is not priced in debt markets. Indeed, while the MeToo movement sparked equity investors' interest in sexual misconduct risks and prompted changes in equity investment practices, the movement has had only a minimal effect on lenders.[18] Thus, sexual misconduct risks are priced in equity markets but not in debt markets, distorting the capital markets and allowing corporations with sexual misconduct issues to access debt markets at a low price—one that does not reflect the true costs of their behavior. Thus, they have not had to change their conduct to reduce their financing costs.

To avoid this result, this Article proposes that sexual misconduct costs be shifted back to managers and lenders by re-ordering the statutory waterfall to prioritize sexual misconduct-based claims and limiting third-party releases. Using empirical evidence drawn from the environmental

[15] *See infra* Section I.B.iii.

[16] *See supra* note 9.

[17] Since bankruptcy may erase the company's equity value, shareholders may also lose their rights to sue the managers and the company for breach of fiduciary duties and violations of securities regulation. *See infra* Section II.B.

[18] *See infra* Section II.A.

arena,[19] this Article posits that changes in bankruptcy priorities can change the way lenders perceive and address sexual misconduct risks. It suggests prioritizing sexual misconduct-based claims could encourage lender monitoring, promote efficient resource allocation that accurately prices social harms, and potentially reduce wrongful corporate and managerial behavior.

This Article makes several contributions to the literature. Traditionally, in discussing lender monitoring, scholars have focused on the borrower's financial results[20] and environmental risks.[21] This Article, however, reveals lenders' potential role in monitoring social risks, and provides another explanation why tort victims should come ahead of other lenders in the bankruptcy waterfall and joins many distinguished scholars who already support this position (albeit outside the sexual misconduct arena).[22] Indeed, uncovering lenders' potential role in monitoring sexual

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[19] *See* Michael Ohlrogge, *Bankruptcy Claim Dischargeability and Public Externalities: Evidence from a Natural Experiment* 1 (May 24, 2022) (unpublished manuscript), https://ssrn.com/abstract=3273486 [http://dx.doi.org/10.2139/ssrn.3273486] (showing how a legal change in bankruptcy law, disallowing some environmental claims discharge, has induced lenders to monitor environmental risks, thus forcing borrowers to reduce their polluting behavior); Jonathan Remy Nash, *Environmental Superliens and the Problem of Mortgage-Backed Securitization*, 59 WASH. & LEE L. REV. 127, 163-166 (2002) (discussing how the adoption of environmental super liens in some states caused lenders to monitor environmental risks).

[20] *See* Michael C. Jensen and William H. Meckling, *Theory of the Firm, Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 334-337 (1976) (introducing the agency costs of debt); Stewart Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977) (explaining how firms can attract capital despite their agency costs using debt covenants); Clifford Smith and Jerold Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979) (examining how contracts control the stockholder-bondholder conflict); Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 136 (1989) (discussing how borrowers enable lenders to have monitoring mechanisms in exchange for a discount in credit costs).

[21] *See* Ohlrogge and Nash, *supra* note 19.

[22] *See, e.g.,* David W. Leebron, *Limited Liability, Tort Victims, and Creditors,* 91 COLUM. L. REV. 1565, 1643-50 (1991) (recognizing that corporations can externalize tort risk through limited liability and calling for a superpriority solution); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy,* 45 STAN. L. REV. 311, 340 (1993) ("Ideally, nonconsensual claimants would have highest priority in any sort of firm."); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1891, 1913 (1994) ("The tort-first regime that I propose is grounded in the premise that whoever

misconduct risks has broad implications for other environmental, social and governance (ESG) matters. To be clear, this Article does not seek to expand corporate purpose or lender responsibility to include social obligations. Instead, it reveals how the current design of bankruptcy law allows lenders and other stakeholders to ignore (or discount) social risks as business risks and, consequently, reduces their motivation to price and monitor for such risks.

This Article also extends the literature about the impact of bankruptcy on inequality.[23] Many scholars have already recognized that because bankruptcy discharge exceptions (such as the one for "willful and malicious injury") are strictly enforced against individuals from vulnerable communities, those debtors are deprived of a fresh start. Corporations, on the other hand, enjoy broader discharge rules, allowing them to use

supplies the capital that enables a business to operate should be legally responsible for its torts, at least to the extent of the supplier's investment."); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) (challenging the absolute priority rule and showing how priority over non-adjusting creditors creates distorted investment decisions); Hanoch Dagan, *Restitution in Bankruptcy: Why All Involuntary Creditors Should Be Preferred*, 78 AM. BANKR. L.J. 247, 277 (2004) (suggesting all involuntary claimants, including restitution claimants and tort victims, should be considered preferred classes); Barry E. Adler & Vedran Capkun, *Debt-Equity Conflict and the Incidence of Secured Credit*, 62 J.L. & ECON. 551 (2019) (suggesting that issuing secured debt creates an overinvestment incentive while tort victims suffer externalization); Sperduto, *supra* note 10, at 180-206 (advocating for superpriority to tort victims in bankruptcy, reviewing current theories, and evaluating the efficiency of potential reforms); Vincent S. J. Buccola & Joshua C. Macey, *Claim Durability and Bankruptcy's Tort Problem*, 38 YALE J. ON REG. 766, 815-16 (2021) (calling judges to preserve successor liability in bankruptcy as an alternative for superpriority to tort victims).

[23] *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) (using public choice theory to explain the inefficiencies of bankruptcy law and suggesting an alternative model); Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47 (1997) (analyzing the legislative history of the Bankruptcy Reform Act of 1978 and describing the influence of interest groups on the final statute); Abbye Atkinson, *Consumer Bankruptcy, Nondischargeability, and Penal Debt*, 70 VAND. L. REV. 917 (2017) (criticizing the categories of nondischargeable debt, focusing on penal debt and its negative implications for economically and socially disfranchised communities); *see also* Sperduto, *supra* note 10, at 156-180 (analyzing the legislative history of discharge exceptions under the US bankruptcy law from a political economy prism).

loopholes in the bankruptcy system opportunistically. This Article sheds light on this disparity in treatment and shows how high-level executives can manipulate the bankruptcy system to be released from such liabilities, even in the absence of an individual bankruptcy filing.

Finally, this Article's most significant contribution is that it illustrates how bankruptcy law inadvertently perpetuates sexual misconduct as it often denies victims' access to courts, limits their compensation, and distorts monitoring incentives by insulating managers and secured lenders from liability. This analysis contributes to the broader discussion of corporate abuse of the bankruptcy system (especially in mass tort cases) by exploring the long-term social effects it potentially creates.[24]

This Article proceeds as follows: Part I explains how sexual misconduct-based claims are treated in bankruptcy. This Part analyzes recent corporate bankruptcies triggered by sexual misconduct scandals and shows how corporations use bankruptcy to avoid liability for sexual misconduct. Part II explains why corporations historically placed less emphasis on policing sexual misconduct and how bankruptcy law contributes to this problem. This Part shows how the law distorts incentives for managers and capital providers to invest resources in fighting sexual misconduct. Part III provides policy suggestions and argues sexual misconduct-based claims should be preferred or nondischargeable in bankruptcy. Part III also advocates restricting third-party releases in sexual misconduct-driven bankruptcies. Finally, the last section analyzes the economic consequences of the proposed policy, focusing on its effects on monitoring and credit pricing.

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[24] *See, e.g.,* Melissa B. Jacoby, *Shocking Business Bankruptcy Law*, 131 YALE L.J.F. 409 (2021) (showing how opportunistic parties use the bankruptcy system for purposes beyond addressing unmanageable debt burdens); Adam J. Levitin, *Purdue's Poison Pill: The Breakdown of Chapter 11's Checks and Balances,* 100 TEX. L. REV. 1079 (2022) (revealing the potential for unfair restructuring transactions in mass tort bankruptcies due to aggressive restructuring techniques, lack of appellate review, and judge selection); Lindsey D. Simon, *Bankruptcy Grifters*, 131 YALE L. J. 1154 (2022) (examining the abuse of nonconsensual non-debtor releases in mass tort bankruptcies).

I. Escaping Liability for Sexual Misconduct: Bankruptcy as a Loophole

This Part explains how corporations take advantage of bankruptcy law to avoid liability for sexual misconduct. Section I.A.i. provides an overview of Chapter 11 bankruptcy proceedings. Section I.A.ii. sheds light on how mass torts are generally resolved in bankruptcy. Section I.B. explains how companies and managers can use Chapter 11 to escape liability for sexual misconduct and analyzes several bankruptcies triggered by sexual misconduct scandals, pointing out the merits and pitfalls of bankruptcy law as it pertains to sexual misconduct claims.

A. The Fundamentals of Chapter 11 Bankruptcy

i. General Overview

The Bankruptcy Code has two main policy goals—providing a fresh start to the debtor (i.e., free and clear of its past debts) and enhancing recovery to creditors. One of the primary tools available to a debtor in bankruptcy is the automatic stay. The stay shields the filer from new lawsuits and pauses existing litigation proceedings.[25] Following a Chapter 11 restructuring (as opposed to a Chapter 7 liquidation proceeding), a corporate debtor continues as an ongoing business, discharged from its past debts.

[25] However, there are some exceptions to the stay. For instance, governmental units are still free to pursue legal actions against the debtor under the police and regulatory power exception. *See* 11 U.S.C. § 362(b)(4). This exception was extensively discussed in the context of environmental law. *See* Solis v. SCA Rest. Corp., 463 B.R. 248 (E.D.N.Y. 2011). Also, certain creditors can ask the court to lift the stay. For example, secured creditors can file such a motion if their interests are not adequately protected. *See* 11 U.S.C. § 362. Additionally, in some cases, bankruptcy courts allowed tort victims to continue litigation in state courts. *See In re* Roman Catholic Archbishop of Portland in Oregon, 338 B.R. 414, 422 (Bankr. D. Or. 2006) (granting a relief from the stay to the abuse claimants. The relief was limited to liquidating the claims for distribution purposes). However, generally, an estimate of total award in tort claims does not require mini-trials of all claims. *See In re* Roman Catholic Archbishop of Portland in Oregon, 339 B.R. 215, 223 (Bankr. D. Or. 2006).

In a Chapter 11 bankruptcy, the debtor's assets are distributed according to a reorganization plan which must be approved by a special majority of creditors.[26] Then, the debtor is discharged from its past debts, which are paid from the debtor's assets under the plan's terms. Upon approval, the creditors receive new, usually discounted, rights for payment under the plan.

Bankruptcy law's distribution schemes, however, are subject to the absolute priority rule.[27] Under this rule, secured creditors (generally banks who receive collateral under their loan agreements) are paid in full first, followed by special groups such as employees and bankruptcy professionals who receive priority under the law.[28] The residual value is distributed to unsecured creditors on a pro rata basis, and those creditors (such as suppliers, customers, and bondholders) often recover only a few cents on the dollar. Tort victims are treated as unsecured creditors in a bankruptcy proceeding and thus are among the last creditors in line to receive payments in bankruptcy.

Typically, corporations file for bankruptcy when they are struggling financially. But a company does not have to be insolvent to benefit from Chapter 11 protection. Indeed, some debtors use it for a tactical advantage, such as preventing foreclosure, terminating agreements, or blocking litigation. Although courts have the power to dismiss a bankruptcy case filed in bad faith,[29] they are often reluctant to do so. Thus, even in cases involving egregious sexual misconduct (such as the Catholic dioceses' bankruptcies)

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[26] Generally, the creditors are divided to classes and a majority of creditors holding 75% of the dollar amounts in each class must approve the plan. *See* 11 U.S.C. § 1126. Nevertheless, a plan can potentially be approved even without the support of all classes. *See* 11 U.S.C. § 1129(b).

[27] 11 U.S.C. § 1129(b)(2).

[28] 11 U.S.C. § 507. *See also supra* note 14.

[29] Chapter 11 bankruptcy petitions are subject to dismissal under 11 U.S.C. § 1112(b). Any "party in interest" can file a motion to dismiss. Section 1112(b) provides a laundry list of causes for dismissal. While bad faith is not listed, some courts have considered it an implicit requirement; *see also* 11 U.S.C. § 305. Section 305(a)(1) allows permissive abstention. Under this section, a bankruptcy court may dismiss or suspend all proceedings in a bankruptcy case, if "the interests of creditors and the debtor would be better served by such dismissal or suspension." *See, e.g., In re* SGL Carbon Corp., 200 F.3d 154, 165 (3d Cir. 1999) and more recently *In re* Nat'l Rifle Ass'n of Am., 628 B.R. 262, 280-81 (Bankr. N.D. Tex. 2021).

the courts did not dismiss the filings.[30] Nevertheless, several recent cases (though none involved sexual misconduct) suggest the courts' patience with such tactical filings may be wearing thin.[31]

To recover their debt in bankruptcy, all creditors must submit proof of their claims against the debtor company by a specific deadline (which the court sets after the initial bankruptcy filing). Thus, a bankruptcy filing effectively accelerates the statute of limitations for claimants—the relevant date for pursuing legal action against the debtor becomes the bar date for submitting their proof of claims in bankruptcy. If potential claimants miss the bar date for submitting their proof of claims, they cannot be paid in bankruptcy and are barred from pursuing their rights against the debtor after bankruptcy ends.

In cases where a potential creditor has not yet filed a lawsuit or was mid-litigation at the time of filing the bankruptcy court must first determine how much the company owes her.[32] To do that, the court can opt to allow the litigation to continue outside the bankruptcy proceeding. If, however, such litigation would "unduly delay" the process, the bankruptcy court has the power to estimate her claims.[33] Bankruptcy courts need not conduct mini-trials; they have discretion to determine how to estimate a claim amount, and they use different mechanisms to do so, often relying on expert

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[30] *See* Allison Walsh Smith, *Chapter 11 Bankruptcy: A New Battleground in the Ongoing Conflict between Catholic Dioceses and Sex-Abuse Claimants*, 84 N.C. L. REV. 282, 304-315 (2005) (examining the motion to dismiss as a tool for sex-abuse claimants in bankruptcy).

[31] *In re* LTL Mgmt., LLC, 58 F.4th 738 (3d Cir. 2023) (dismissing the Chapter 11 case of the Johnson & Johnson entity holding talc-related tort liabilities and determining that the company was not in financial distress); *See also In re* LTL Mgmt., LLC, 23-12825 (MBK), 2023 WL 4851759 (Bankr. D.N.J. July 28, 2023), ECF No.1127 (dismissing a second Chapter 11 petition by the same Johnson & Johnson entity); *In re* Aearo Techs. LLC, No. 22-02890-JJG-11, 2023 WL 3938436 (Bankr. S.D. Ind. June 9, 2023) (dismissing Aearo Technologies' Chapter 11 petition which aimed to settle Combat Arms Earplugs multidistrict litigation, and determining that the company was not in financial distress); *In re* Nat'l Rifle Ass'n of Am., 628 B.R. 262, 280-81 (Bankr. N.D. Tex. 2021) (dismissing the National Rifle Association's Chapter 11 petition attempting to block governmental enforcement action).

[32] 11 U.S.C. § 101(5)(A). A claim is broadly defined under the Code to include unliquidated claims.

[33] 11 U.S.C. § 502(c).

opinions. In mass tort cases (where many victims do not hold final judgment), for example, courts often use an aggregate estimation to value victims' claims. Then, a court-appointed examiner decides on the specific amount each victim receives.[34]

While filing a bankruptcy petition is relatively easy, it does not come without costs. In addition to reputational harm, corporations which file for bankruptcy are subject to stringent discovery rules, tight court supervision, and monitoring by creditors' committees and the United States Trustee. They are also limited in their ability to pursue certain actions not in the ordinary course of their business. Thus, bankruptcy is not always the best solution for corporations dealing with financial distress. Nevertheless, as described below, bankruptcy can be an attractive avenue for corporations facing a large number of lawsuits.

ii. Mass Torts in Bankruptcy

Corporations are increasingly using bankruptcy to resolve a variety of mass tort cases, ranging from those addressing asbestos exposure[35] to the opioid crisis.[36] In fact, more than thirty bankruptcy petitions involving mass tort litigation were filed since December 2018.[37] Most of the tools

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[34] Estimating claims could be required for different bankruptcy purposes like evaluating a creditor's voting power to approve a bankruptcy plan or determining a creditor's share in the debtor's assets for distribution. When it comes to personal injury claims, the district court presiding over the bankruptcy court is usually the one in charge of estimating claims. However, bankruptcy courts may also estimate claims themselves when the estimation is related to core issues of the bankruptcy proceeding. 28 U.S.C. § 157(b)(2),(5); *In re* Roman Catholic Archbishop of Portland in Oregon, 339 B.R. 215, 220-24 (Bankr. D. Or. 2006); *See also* Douglas G. Smith, *Resolution of Mass Tort Claims in the Bankruptcy System,* 41 UC DAVIS L. REV. 1613 (2008) (describing how tort claims are adjudicated in bankruptcy).

[35] *See, e.g., infra* note 38 and more recently *In re* HONX, Inc., No. 22-90035 (Bankr. S. D. Tex. Apr. 28, 2022).

[36] *See, e.g., infra* note 61 and more recently *In re* Endo Int'l, No. 22-22549 (Bankr. S.D.N.Y. Apr. 21, 2023).

[37] *See* 'Bankruptcy: Mass Tort Tracker' (2022) <Practical Law> accessed 26 April 2023, https://1.next.westlaw.com/Document/I5f9aa177561d11e9adfea82903531a62/View/FullText.html?transitionType=Default&contextData=(sc.Default). More than a third of those cases involved sexual abuse. This number is expected to grow as more states expand the legal remedies available for sexual misconduct victims. Further, companies with significant tort liabilities would be more likely to file for Chapter

bankruptcy courts are deploying today to deal with those cases were first introduced in the bankruptcy of the Johns-Manville Corporation ("Johns-Manville") and others involved in the asbestos industry.[38] Facing thousands of personal injury claims, those companies used bankruptcy to consolidate lawsuits and limit future liability, which was especially important because of the time lag between exposure to asbestos and the onset of illness. Indeed, people exposed to asbestos usually develop cancer only decades after exposure. Thus, at the time of bankruptcy, no one knew how many future victims there would be.[39]

Under normal circumstances, the Bankruptcy Code only allows a debtor to discharge claims that existed prior to the date of the petition. But the *Johns-Manville* court recognized that this presented a unique problem for debtors: as many of the victims would not get sick until after the bankruptcy case was resolved, the debtors would be precluded from discharging those claims, and hence, could not achieve the much-desired clean slate. Moreover, from the victims' perspective, there was a risk there would be nothing left to compensate them with by the time they developed symptoms.

As a result, the *Johns-Manville* court had to develop innovative mechanisms to include all tort victims (i.e., both current and future) in the process. The answer the court arrived at was to establish special trusts to compensate future claimants and appoint a representative to vote for them in bankruptcy. The Johns-Manville court used "channeling injunctions" to override traditional discharge rules and direct all victims' current and future claims to the compensation fund. Consequently, victims no longer had claims against the debtor and could sue only the fund for damages.[40] The

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11 if they were permitted to segregate their tort obligations from their other obligations (in a separate entity with little or no assets). For further discussion, *see infra* note 56.

[38] *In re* Johns-Manville Corp., 68 B.R. 618, 624-26 (Bankr. S.D.N.Y. 1986), *aff'd sub nom.*, Kane v. Johns-Manville Corp., 843 F.2d 636 (2d Cir. 1988) (first introducing the idea of appointing a future claims representative and establishing trusts to compensate victims in the asbestos context).

[39] *In re* Johns-Manville Corp., 36 B.R. 743, 745-746, 749, 758-759 (Bankr. S.D.N.Y. 1984).

[40] *Id.* The channeling injunction funnels claimants into a trust system, meaning that after the bankruptcy, all victims can recover only from a designated trust and not from the debtor. Although courts lack the express authority to issue those injunctions, they used

court then appointed a special claims examiner to decide claim amounts and distribute the fund among victims.[41] Notably, the court also approved third-party releases, allowing other parties (such as insurance carriers) to be released from asbestos-related liability even though such entities had not filed bankruptcy petitions of their own.[42]

After the Johns-Manville's bankruptcy, many asbestos manufacturers followed a similar path.[43] In fact, in 1994, Congress officially approved the practice of appointing a representative for future claimants, compensating them through special trusts, and releasing third parties, by adopting section 524(g) of the Bankruptcy Code (often referred to as the "Manville Amendments").[44] These amendments, however, apply only to asbestos-related bankruptcies. Nevertheless, bankruptcy courts have used their general authority[45] to adopt a similar strategy in other mass torts cases where the pool of future victims is unknown, including in cases involving liability related to opioid and defective products such as breast implants and airbags.[46]

Scholars have mixed views about this practice.[47] On the one hand, the case for an innovative approach is clear; if future claims are not discharged in bankruptcy, they create a lingering or "debt overhang" problem for the debtor and the debtor may not obtain a clean slate. Additionally, excluding future claims from bankruptcy could unfairly

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their general powers under 11 U.S.C. § 105 (a). They also relied on 11 U.S.C. § 363(f) and (h). For further discussion, *see* Simon, *supra* note 24, at 1166-1171.

[41] *In re* Johns-Manville Corp., 801 F.2d 60, 63 (2d Cir. 1986).

[42] MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89 (2d Cir. 1988). This decision was later overturned in *In re* Johns-Manville Corp., 517 F.3d 52 (2d Cir. 2008) and reversed and remanded in *Travelers Indemnity Co. v. Bailey*, 557 U.S. 137 (2009).

[43] *See* Alan N. Resnick, *Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. PA. L. REV. 2045, *supra* note 29, at 2046 (2000); *see also* Joshua M. Silverstein, *Overlooking Tort Claimants' Best Interests: Non-Debtor Releases in Asbestos Bankruptcies*, 78 UMKC L. REV. 1, 2 (2009).

[44] 11 U.S.C. § 524(g).

[45] 11 U.S.C. § 105(a).

[46] *See* Simon, *supra* note 24, at 1183-1205 (describing different case Studies in which companies used bankruptcy to resolve mass torts).

[47] Mark J. Roe, *Bankruptcy and Mass Tort*, 84 COLUM. L. REV. 846 (1984); Yair Listokin & Kenneth Ayotte, *Protecting Future Claimants in Mass Tort Bankruptcies*, 98 NW. U. L. REV. 1435 (2004) (both criticizing the use of trusts to compensate future victims and explaining how they lead to unfair distribution among victims, harming later-arriving claimants, when the amount and size of claims exceeds expectations).

discriminate among victims, since the ability of victims to recover could turn on the date a victim filed a lawsuit or the date the injury first appeared.

On the other hand, the compromise the bankruptcy courts developed in the asbestos cases presents its own issues. For example, allowing unknown people with as-yet unproved and unquantified claims to participate in the bankruptcy proceeding may provide them with outsized voting power in approving a plan. Indeed, in some cases, future claimants may constitute the largest creditor group in a bankruptcy proceeding, giving their representative significant voting power compared to other creditors. Additionally, the appointment of a legal representative for future claimants may raise due process concerns because such future claimants are not able to choose their representative, and, as part of the bankruptcy plan, lose their rights to sue without prior notice (although some victims may benefit from the ability to receive payment from a trust without litigating their claims and having to testify in court).

Bankruptcy has also become a valuable tool for corporations dealing with mass torts, even when future claims are not an issue, as it allows the debtor to consolidate all lawsuits against the corporation into a single proceeding (de facto substituting a class action).[48] By comparison, case-by-case litigation can be a lengthy and costly process and produce inconsistent results. Notably, even from the victims' point of view, such case-by-case adjudication may be problematic. Early plaintiffs may, for example, drain the defendant's resources, before all victims recover.[49]

Unlike class actions, however, a bankruptcy resolution includes coercive elements that could harm victims. Victims are often deprived of their rights to a jury trial and to seek punitive damages without their consent,[50] cannot opt-out,[51] and may only recover from a limited pool of

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[48] Class actions are often unavailable for tort victims suffering personal injuries. *See* Lund, *supra* note 5, at 1609-1610.

[49] *See* Smith, *supra* note 34, at 1627-1632 (describing the failure of traditional litigation strategies in dealing with mass tort situations).

[50] A special majority approval is sufficient to approve a bankruptcy plan releasing the debtor from its liabilities. *See* 11 U.S.C. § 1121. In mass tort cases involving a channeling injunction, tort victims are often considered as a separate class for voting purposes and 75% of them must approve the plan. *See infra* note 85.

[51] *See* Simon, *supra* note 24, at 1204 (providing a summary table of different mass tort bankruptcies, showing that some of them included an opt-out option while others did not).

assets remaining once other creditors are paid.[52] Once a channeling injunction is approved, all victims (including those who objected, were absent, or could not vote on the plan)[53] must accept a speculative (and potentially highly discounted) amount to release their claims. This injunction funnels victims' claims to a newly founded compensation trust, which becomes their only source of recovery after bankruptcy (they can no longer sue the debtor directly). These claims are then adjudicated by an appointed claims examiner in what may be termed a shadow dispute-resolution system. This system has its own procedural and evidentiary standards and operates out of the public eye. It often lacks procedural safeguards victims would otherwise get in an Article III review if they filed a class action. For example, victims may have limited access to appeal, or the appeal may be handled by the same arbiter.[54]

Corporations involved in mass torts often use bankruptcy specifically for these litigation advantages—even when they are financially healthy and capable of paying full damages. Johnson & Johnson, for example, recently attempted to use bankruptcy to limit compensation to talcum powder tort victims. In fact, Johnson & Johnson went a step further and pursued a divisive merger (essentially a spin-off) in an effort to isolate its tort liability in a separate entity. That entity then filed for bankruptcy, leaving the balance of Johnson & Johnson's assets out of the tort victims' reach.[55] This move was perceived by scholars as particularly outrageous as Johnson & Johnson had a net worth of approximately $440 billion and would have, in all likelihood, been able to fully compensate victims without risking insolvency or other financial distress. Indeed, it was for this exact reason the Third Circuit concluded the petition was not filed in good faith and

[52] 11 U.S.C. § 1129(b)(2).

[53] For example, the Olympic gold medalist McKayla Maroney was forced to waive her sexual abuse-related claims, even though she could not vote on USA Gymnastics bankruptcy plan because she dismissed her lawsuit against it in 2018. *See* Simon, *supra* note 24, at 1157.

[54] *Id.* (showing how recent mass tort bankruptcies differ in the procedural protections they provide, including appeal rights and standards of claim review).

[55] *See* TEX. BUS. ORGS. CODE ANN. § 1.002(55)(A) (West 2023). Under the Texas Code, the definition of merger includes dividing a single corporation into two entities and reallocating its original assets and liabilities between them. *See also* Samir D. Parikh, *Mass Exploitation*, 170 U. PA. L. REV. ONLINE 53 (2022) (describing the Johnson & Johnson maneuver allowing the company to isolate its tort liabilities before filing for bankruptcy).

dismissed the case.[56] Other financially healthy defendants, however, including Walmart (formerly Wal-Mart) and Honda, have successfully used bankruptcy to discharge mass tort liability. In those cases, however, the discharges were obtained as an ancillary benefit to a third party's bankruptcy filing. In other words, neither Walmart nor Honda filed for bankruptcy on its own (or through an affiliated entity), but instead were granted relief via the operation of third-party releases in another tort defendant's bankruptcy plan.[57]

Generally, bankruptcy law is designed to release only the debtor from its past debts. When third-party releases are approved as part of the bankruptcy plan, other entities and individuals—who did not file for bankruptcy—also get to enjoy the benefit of discharge. These releases are often required to induce third parties to contribute money to the settlement funds or to buy their cooperation if they are essential to the business continuation (e.g., managers with special knowledge who keep running the company after bankruptcy). In mass tort cases, these releases often have a role in preventing erosion of the company's insurance funds (e.g., in cases in which the company and its managers share the same insurance policy).[58]

While third-party releases are often necessary to make more funds available to compensate victims, they are controversial. Courts have long debated whether these releases are appropriate and whether they have the authority to approve them. The Bankruptcy Code explicitly allows the use

[56] *In re* LTL Mgmt., LLC, 58 F.4th 738 (3d Cir. 2023) (dismissing the Chapter 11 case of the Johnson & Johnson entity that held its talc-related tort liabilities and determining the company was not in financial distress). The Third Circuit's conclusion that the entity was not in financial distress was largely based on the fact that the company had a generous funding agreement with Johnson & Johnson to cover its talc liabilities and bankruptcy costs. Despite the court's decision, the entity filed for Chapter 11 again, offering better compensation to tort victims this time. This case, however, was quickly dismissed. *See In re* LTL Mgmt., LLC, 23-12825 (MBK), 2023 WL 4851759 (Bankr. D.N.J. July 28, 2023), ECF No.1127 (dismissing a second attempt by the same Johnson & Johnson entity to file for Chapter 11).

[57] Simon, *supra* note 24, at 1158 ("Savvy defendants like the Sacklers, Honda, Wal-Mart, and USOPC have found a way to get this relief without filing Chapter 11, offering money to claimants and threatening to implode settlements unless they receive injunctions and releases in bankruptcy court.").

[58] *In re* A.H. Robins Co., 880 F.2d 694, 701-02 (4th Cir.1989).

of third-party releases only in asbestos-related cases.[59] Some courts have interpreted the law to prohibit them in other cases.[60]

Recently, the Purdue Pharma bankruptcy case shed light on the complex and controversial issue surrounding the authority of bankruptcy courts to approve third-party releases. While the district court initially rejected such releases outside of asbestos cases,[61] the appellate challenge and subsequent reversal underscore the divergent perspectives within the judiciary.[62] The case is currently pending before the Supreme Court.[63]

Courts approving third-party releases have used their general authority to allow them.[64] Although Congress has proposed to ban third-party releases in bankruptcy,[65] the issue remains largely unsettled, subject to varying interpretations across jurisdictions. Even courts that approved third-party releases have done so only in limited circumstances, generally allowing it where the third parties contributed funds, their contribution was vital, and nearly all plaintiffs who lost their right to sue consented.[66]

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[59] 11 U.S.C. § 524(g)(4).

[60] 11 U.S.C. § 524(e) states that only the debtor is discharged in bankruptcy. Some courts have suggested it bans third party releases in bankruptcy. Three of the eleven Circuits (the Fifth, Ninth, and Tenth) hold this approach. *See* Bank of N.Y. Tr. Co. v. Off. Unsecured Creditors' Comm. (*In re* Pacific Lumber Co.), 584 F.3d 229, 252 (5th Cir. 2009); *In re* Lowenschuss, 67 F.3d 1394, 1401-02 (9th Cir. 1995); Landsing Diversified Props.-II v. First Nat'l Bank and Trust Co. of Tulsa (*In re* W. Real Estate Fund), 922 F.2d 592, 600–02 (10th Cir. 1990); *In re* Am. Hardwoods, Inc., 885 F.2d 621, 626 (9th Cir. 1989).

[61] *In re* Purdue Pharma, L.P., 635 B.R. 26 (S.D.N.Y. 2021), *certificate of appealability granted*, No. 21 CV 7532 (CM), 2022 WL 121393 (S.D.N.Y. Jan. 7, 2022), and *rev'd and remanded sub nom. In re* Purdue Pharma L.P., 69 F.4th 45 (2d Cir. 2023), *cert. granted sub nom.* Harrington v. Purdue Pharma, L.P., No. 23-124, 2023 WL 5116031 (U.S. Aug. 10, 2023).

[62] *In* re Purdue Pharma L.P., 69 F.4th 45 (2d Cir. 2023), *cert. granted sub nom.* Harrington v. Purdue Pharma, L.P., No. 23-124, 2023 WL 5116031 (U.S. Aug. 10, 2023).

[63] Harrington v. Purdue Pharma, L.P., No. 23-124, 2023 WL 5116031 (U.S. Aug. 10, 2023).

[64] *See supra* note 61-62. Judges used a combination of the following provisions to justify those releases: 11 U.S.C. §§ 1129(a)(1), 1123(a)(5) & (b)(6), and 105(a).

[65] Nondebtor Release Prohibition Act of 2021, H.R.4777, 117th Congress (2021).

[66] Courts have also inquired as to how those plaintiffs are compensated and whether there is an opt-out option for dissenters to litigate their claims. Finally, they looked at the third parties' identities and whether their interests conflict with the debtor. MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89, 93 (2d Cir. 1988); *In re* Cont'l Airlines, 203 F.3d 203, 214 (3d Cir. 2000); *In re* A.H. Robins Co., 880 F.2d 694, 701-02 (4th Cir.1989).

B. How Corporations Use Bankruptcy to Avoid Liability for Sexual Misconduct

As we have seen, the Bankruptcy Code allows corporations to stop litigation and deal with mass torts through establishing special compensation funds. In this section, we will focus on how corporations use the Bankruptcy Code to escape liability for sexual misconduct. Bankruptcy courts have used their general authority[67] to adopt comparable solutions in cases involving sexual misconduct scandals. For example, courts used compensation funds to pay damages to sexual abuse victims in the various Roman Catholic dioceses' bankruptcies.[68] The first to emerge from bankruptcy and set up such a fund was the Archdiocese of Portland. Its bankruptcy plan granted a total of $75 million to abuse victims. Since then, at least thirty dioceses around the United States have followed suit.[69] More recently, the Weinstein Co., USA Gymnastics, and Boy Scouts of America have chosen bankruptcy to deal with sexual misconduct scandals.

It is true that some victims could benefit from resolving their sexual misconduct claims in bankruptcy, thereby avoiding the need to testify in court and adhere to traditional evidentiary standards. Litigation is costly, testifying may cause a secondary trauma, and gathering evidence may be challenging when it comes to sexual misconduct. Additionally, other tools such as class actions—which might spread the cost among a larger pool of claimants—are usually not available for these types of cases.[70] However, as shown below, the coercive elements of bankruptcy make this pro-victim argument less convincing.

[67] 11 U.S.C. § 105(a).

[68] *See, e.g.*, Third Amended and Restated Joint Plan of Reorganization, *In re Roman Catholic Archbishop of Portland in Oregon*, No. 04-37154-elp11 (Bankr. D. Or. 2007), ECF No. 5005. The plan is available at: https://elibrary.law.psu.edu/bankruptcy/; *See also* https://www.bishop-accountability.org/bankruptcy.htm (providing information on all U.S. Catholic dioceses and religious orders that have filed for bankruptcy protection during the ongoing sexual abuse crisis in the Catholic church).

[69] As of November 2021, thirty-one Catholic religious organizations have sought bankruptcy protection in chapter 11. *See* *h*ttps://elibrary.law.psu.edu/bankruptcy/index.html.

[70] *See* Lund, *supra* note 5, at 1609-1610.

This section shows how bankruptcy poses problems for sexual misconduct victims and why it is a particularly powerful tool for companies involved in sexual misconduct scandals. It suggests corporations benefit from bankruptcy as it shortens the statute of limitations for victims, prevents further investigation of wrongful acts, precludes victims from having jury trials, lumps victims with different injuries (and sometimes different perpetrators) to vote the plan together, pushes them to a shadow dispute-resolution system, and limits the asset pool victims can recover from. By doing so, bankruptcy essentially allows corporations to take a step backward and undo some of the MeToo revolution's achievements (such as providing victims more time to sue and discouraging mandatory arbitration).[71] Finally, bankruptcy often discharges managers and other financially healthy third parties from liability—including even the direct perpetrator—and deprives the opportunity to have an official adjudication of wrongdoing.

i. Restricting Victims' Access to Court

Because the automatic stay immediately halts any existing litigation, it effectively prevents sexual misconduct victims from further investigating wrongful acts and obtaining evidence via the discovery process. Thus, a bankruptcy filing may harm a victim's ability to gather evidence against the debtor—as well as other non-bankrupt parties (which often enjoy the protection of the automatic stay as well). For instance, when USA Gymnastics filed for bankruptcy in 2018, the automatic stay halted the more than one hundred lawsuits that had already been filed and blocked claimants from taking depositions and requesting further discovery.[72]

Moreover, a bankruptcy filing allows corporations to bypass new state laws that would otherwise have expanded the statute of limitations for sexual misconduct victims.[73] By creating a deadline for filing claims, bankruptcy accelerates the statute of limitations; it gives victims only a limited time frame to act if they want their claims to be recognized in bankruptcy, otherwise they will be discharged with no compensation (or a

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[71] *See supra* note 8.

[72] Juan Martinez, *Sexual Abuse and Bankruptcy: How Organizations Abuse Chapter 11 to Avoid Victims' Demands for Answers*, 37 EMORY BANKR. DEV. J. 213, 232-233 (2020) (suggesting that the automatic stay prevents victims' access to information because they cannot proceed with discovery).

[73] *Id.* at 233-236.

relatively small amount designated for future victims).[74] This result is troubling in sexual misconduct cases where it may difficult for victims to come forward.[75]

Even victims who timely file their claims stand to lose their due process rights. Sexual misconduct victims are often forced to recover from a fund and are stripped from most of their procedural safeguards. For example, they are denied a jury trial, and thus the possibility of a higher award and punitive damages.[76] This result is especially egregious given the history of corporate stonewalling and secrecy. Indeed, it is now well known that many corporations prevented victims' access to court through mandatory arbitration proceedings and silenced them with nondisclosure agreements.[77]

Early bankruptcy courts, however, have recognized the injustice of denying jury trials to sexual misconduct victims. In the past, mass tort settlements allowed victims to liquidate their claims against the fund in court or to opt-out of the fund system. This way, courts protected the victims' Seventh Amendment right to a jury trial.[78]

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[74] They have to file their claim before the bar date, even if they have a longer statute of limitations period under the relevant law.

[75] *See* Lund, *supra* note 5, at 1609-1610; Erin M. Morrissey, *#MeToo Spells Trouble for Them Too: Sexual Harassment Scandals and the Corporate Board*, 93 TULANE L. REV. 177, 194-199 (2018) (both describing how corporations used contractual tools such as non-disclosure agreements and mandatory arbitrations to silence victims of sexual harassment). For further discussion on why victims may not come forward or delay reporting, *see infra* note 107.

[76] Punitive damages, which may constitute a significant part of the damages in sexual misconduct cases, are generally not allowed in bankruptcy. Thus, victims may not be compensated for punitive damages at all. *See* Novak v. Callahan (*In re* GAC Corp.), 681 F.2d 1295 (11th Cir. 1982); *In re* A.G. Fin. Serv. Ctr., Inc., 395 F.3d 410 (7th Cir. 2005).

[77] *See* Lund, *supra* note 5 and Morrissey, *supra* note 75.

[78] *See, e.g., In re* Roman Catholic Archbishop of Portland in Oregon, 338 B.R. 414, 422 (Bankr. D. Or. 2006) (granting a relief from the stay to the abuse claimants. The relief was limited to liquidating the claims for distribution purposes). Some settlements required victims to opt out early if they want to continue litigating in court and others required victims to recover from the fund before they move on to litigate their claims in the court system. For example, in John-Manville's case, the victims could return to the tort system to litigate their claims 120 days after they filed a claim against the trust. *See In re* Joint E. & S. Dist. Asbestos Litig., 129 B.R. 710, 754-55 (E.D.N.Y. 1991), *judgment vacated*, 982 F.2d 721 (2d Cir. 1992), *judgment modified on reh'g*, 993 F.2d 7 (1993). Other bankruptcy settlements allowing victims to go back to state or federal court, include Takta's settlement and mass tort bankruptcies related to the opioid crisis. Purdue Pharma's plan,

Nevertheless, in more recent cases, victims of sexual misconduct were deprived of their day in court.[79] In the USA Gymnastics bankruptcy and the New Ulm diocese bankruptcy, for example, victims were denied the right to litigate their claims in court (and thus, had no opportunity for a jury trial or for punitive or exemplary damages) and were not permitted to opt-out. Moreover, they had only a narrow timeframe to appeal the examiner's decision—only 14 days in the USA Gymnastics bankruptcy[80] and 21 days in the New Ulm diocese bankruptcy.[81] To make matters worse, even if they managed to appeal, their claims were reexamined by the same arbiter who made the first decision, and they had to bear the adjudication costs. Additionally, the evaluation standards are often vague and different from traditional law.[82]

Forcing victims to resolve their claims in the bankruptcy may present additional issues as well. For instance, bankruptcy courts often group victims in a single class, even though their claims may differ in severity, time, and identity of the direct perpetrator. The Boy Scouts of America bankruptcy illustrates how far this grouping practice could go. In this case, more than 80,000 known sexual misconduct victims were grouped to vote a collective settlement together—they were harmed by thousands of different abusers in separate instances occurring throughout the organization's history around the United States.[83]

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however, required victims to opt out early, before their claims are reviewed by an examiner. *See* Simon, *supra* note 24, at 1176-1191. The Second Circuit approved the plan in May 2023, *see supra* note 62.

[79] This deterioration of procedural safeguards, however, is part of larger trend in mass tort bankruptcies in recent years. *See generally* Simon, *supra* note 24, at 1202-1205.

[80] Modified Third Amended Joint Chapter 11 Plan of Reorganization Proposed by USA Gymnastics and the Additional Tort Claimants Committee of Sexual Abuse Survivors, at 6, *In re* USA Gymnastics, No. 18-09108-RLM-11 (Dec. 13, 2021), ECF No. 1761.

[81] Second Amended Joint Chapter 11 Plan of Reorganization at 26, *In re* The Diocese of New Ulm, No. 17-30601 (Bankr. D. Minn. Mar. 6, 2020), ECF No. 360.

[82] *See* Simon, *supra* note 24, at 1194-1202. For example, the USA Gymnastics' evaluation method was based on victims' personal statements and the award was affected by the victim's level of performance as a gymnast among other things.

[83] Soma Biswas, *Boy Scouts Fall Short of Desired Vote on $2.7 Billion Abuse Settlement*, WSJ PRO BANKRUPTCY (Jan. 5, 2022), https://www.wsj.com/articles/boy-scouts-fall-short-of-desired-vote-on-2-7-billion-abuse-settlement-11641364299. *See also infra* note 91.

Being a single class—the victims vote together to reject or approve a plan and each of them has an equal voice to form a majority. As a 75 percent majority is often sufficient to approve a plan, it can be approved despite some victims' objections. Those who object are coerced to accept the settlement and waive their claims against the debtor, which is problematic, as there may be significant conflicts of interest among the victims. Such conflicts are based on the severity of their injuries, the strength of their evidence, the stage of their litigation, and their willingness to sue.[84] Victims who prefer to have their day in court might be forced to waive their rights to sue simply because they are outnumbered by victims who—because of the amount of the claim or lack of evidence—prefer to settle.[85]

ii. Capping Compensation

Besides restricting victims' access to court, limiting the victims' recovery to a court-approved fund presents another, purely financial, problem: unless the fund calls for future deposits, the fund may not be large enough to fully compensate all victims as it was sized before exploring the

[84] Conflicts like this are especially troubling given the involvement of personal injury lawyers who work with professional claims aggregators and may gain substantial voting power. *See* Randall Chase, *Judge Upholds Boy Scouts' $2.4 Billion Bankruptcy Reorganization Plan*, PBS (Mar. 28, 2023), https://www.pbs.org/newshour/nation/judge-upholds-boy-scouts-2-4-billion-bankruptcy-reorganization-plan ("The huge number of claims filed in the bankruptcy was the result of a nationwide marketing effort by personal injury lawyers working with for-profit claims aggregators to drum up clients, according to plan opponents.").

[85] Generally, the creditors are divided to classes and a majority of creditors holding 75% of the dollar amounts in each class must approve the bankruptcy plan. *See* 11 U.S.C. § 1126. In mass tort cases involving a channeling injunction, tort victims are often considered as a separate class for voting purposes and 75% of them must approve the plan. This threshold is specifically adopted in the Bankruptcy Code for asbestos bankruptcies. *See* 11 U.S.C. § 524(g)(2)(B)(ii)(IV)(bb). Sexual misconduct victims are usually grouped together in the same class for voting on the plan. For further discussion on conflicts between victims, *see* Martinez, *supra* note 72, at 227-228, 241-242 (discussing the conflicts of interests between victims who were grouped together in the USA Gymnastics' case). Victims who objected the bankruptcy plan and even some victims who did not have the right to vote on it are forced to waive their rights. For example, the Olympic gold medalist McKayla Maroney was forced to waive her sexual abuse-related claims, even though she could not vote on USA Gymnastics bankruptcy plan because she dismissed her lawsuit against it in 2018. *See* Simon, *supra* note 24, at 1157.

entire value of the claims.[86] And the victims will be unable to reach any other assets the debtor acquires after bankruptcy ends because, following bankruptcy, the debtor is fully discharged from those claims.

One might argue that discounted compensation is an inevitable result when the company is in financial distress. Nevertheless, sexual misconduct-driven bankruptcies often involve financially healthy parties.[87] Additionally, if the company continues to operate following bankruptcy, there may be additional resources for the victims in the future. For these reasons, some courts have required solvent parties to make future deposits to the fund, to fully compensate the victims.[88] Finally, the victims' low recovery derives not only from the fact that there is little to distribute but also from the fact that bankruptcy prefers other groups of creditors at their expense and debtors can deploy opportunistic tactics to keep assets out the creditors' reach.

In fact, there is some evidence debtors are strategically shielding certain assets from the victims, thereby deliberately undersizing their compensation funds. For instance, in some diocesan bankruptcies, churches were accused of transferring and reclassifying assets before bankruptcy, thereby shrinking the pot of money available to sexual abuse victims. Most of the dioceses' assets were not included in the bankruptcy estate because they were held at the parish level and the parishes never filed for bankruptcy.[89] Another example is Boy Scouts of America, which did not include its local councils' property in its bankruptcy filing.[90] The local

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[86] Notably, in some cases involving non-bankrupt defendants, courts required them to make future payments to the fund. This way, the fund amount was growing and there was no cap on the victims' compensation. However, recent cases involving sexual misconduct do not include such a mechanism, even though many non-bankrupt parties are released through the plan. *See infra* Section III.B.

[87] *See infra* Section II.B.iii.

[88] *See infra* notes 187-188, and accompanying text.

[89] *See* Walsh Smith, *supra* note 30, at 315-318 (discussing disputes concerning the scope of property in the bankruptcy estate between Catholic Dioceses and sexual abuse claimants).

[90] Michael Flannery, *Boy Scouts Protects Assets From Legal Troubles*, AbuseLawsuit.com (Feb. 1, 2021), https://www.abuselawsuit.com/news/boy-scouts-protect-assets-from-legal-troubles/.

councils, however, benefited from the bankruptcy, since they got broad third-party releases protecting them from sexual abuse claims.[91]

Additionally, the fund may be undercapitalized in the first place, given that personal injury victims are among the last in line to be paid from the debtor's assets (after secured creditors and other groups are paid in full). As a result, victims often receive only a fraction of their damages. For instance, although Weinstein Co.'s assets were sold in bankruptcy for $289 million, the bulk of those proceeds went to secured creditors. Harvey Weinstein's victims were allocated a paltry $17 million.[92]

Over the years, and even after the bankruptcy is over and the fund is sized, the victims' compensation amount may be eroded with administrative expenses, including bankruptcy professionals' fees. As these expenses are prioritized in bankruptcy,[93] the higher they are, the less is left for the victims. Weinstein Co.'s bankruptcy provides an unfortunate example of this risk: the amount offered to the victims has significantly shrunk, declining from $25.7 to $17 million over the years, due in part to mounting legal fees.[94] Although a bankruptcy plan was already approved in the Weinstein case and the money was transferred to a victims' compensation fund, legal expenses still continue to erode it until all claims are examined and the distribution process is over.[95] Thus, Weinstein's victims might eventually recover even less than $17 million.

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[91] In fact, approximately 100,000 non-debtor parties took advantage of third party releases under the plan, including 251 local councils. *In re* Boy Scouts of Am., No. 20-10343, 2023 WL 2662992 (D. Del. Mar. 28, 2023), ECF No. 11057, https://cases.omniagentsolutions.com/home?clientId=3552

[92] Jonathan Randles, *Bankruptcy Judge Approves $17 Million Fund for Harvey Weinstein Victims*, WSJ PRO BANKRUPTCY (Jan. 25, 2021), https://www.wsj.com/articles/bankruptcy-judge-approves-17-million-fund-for-harvey-weinstein-victims-11611625431

[93] 11 U.S.C. § 507.

[94] *See supra* note 92.

[95] In the Weinstein bankruptcy, the Sexual Misconduct Claims Fund was used to pay administrative expenses related to its operation. See Order Confirming Plan Proponents' Fifth Amended Joint Chapter 11 Plan Of Liquidation, *In re* The Weinstein Company Holdings LLC, No. 18-10601, at 17 (Bankr. D. Del. Jan. 26, 2021), ECF No. 3203, https://dm.epiq11.com/case/twc/documents

iii. Protecting Third Parties

Sexual misconduct victims may also be effectively forced into waiving their right to sue third parties who did not file for bankruptcy. These releases are approved as a part of the bankruptcy plan, without unanimous consent from those victims whose claims are released. Indeed, courts have approved non-consensual third-party releases in corporate bankruptcies involving sexual misconduct—even releasing the abuser from liability. In Weinstein Co.'s bankruptcy, for example, the court approved a plan that released Harvey Weinstein (the direct perpetrator) and other managers from liability. Any victim unwilling to release their claims against him were forced to discount their claims by 75 percent. Ironically, Harvey Weinstein could not have obtained such relief had he filed for bankruptcy on his own because of the "willful and malicious" exception to discharge.[96]

There are, however, a number of recognized problems with granting such releases. First, because such third parties are not debtors themselves, they are not required to disclose their assets, thereby potentially shielding them from victims. Thus, such releases allow them to enjoy the benefit of discharge, without the price of filing for bankruptcy. Second, third-party releases are often extremely broad and include financially healthy parties that could easily pay the full amount of damages. For example, the USA Gymnastics' bankruptcy plan included broad releases to the Olympic Committee and the insurers.[97] The most outrageous of all, however, is the recent Boy Scouts of America's bankruptcy plan releasing about 100,000 non-debtor parties from liability—including the local councils and chartered

[96] The plan, including the claim release, was not approved unanimously but only by a majority of sexual abuse victims. The plan also stated a financial penalty for victims unwilling to release their claims against the abuser, Harvey Weinstein. Only victims who waive their claims against him will be entitled to receive the full value of their claims. If they decide to pursue litigation against Weinstein, they will receive only twenty-five percent of the value assigned to their claim by a special claim examiner. See *supra* note 4.

[97] Louise Radnofsky and Jonathan Randles, *Nassar Victims Reach $380 Million Settlement With USA Gymnastics and U.S. Olympic and Paralympic Committee*, WALL ST. J. (Dec. 13, 2021), https://www.wsj.com/articles/nassar-victims-reach-380-million-settlement-with-usa-gymnastics-and-u-s-olympic-and-paralympic-committee-11639406377.

organizations (e.g., schools and churches),[98] allowing them to escape liability with no trial.[99]

Some courts, however, have been reluctant to approve third-party claim releases. In the Archdiocese of Saint Paul's bankruptcy,[100] for example, the court dismissed a plan that would have released several third parties from liability, including insurance companies and affiliate parishes, even though they were scheduled to contribute funds to compensate sexual abuse victims. The court based its denial on the fact there had been a lack of "significant acceptance" by the class of victims the release would harm. As mentioned earlier, several courts have even interpreted the law to prohibit such releases outright.[101]

If there is any consensus among the courts, it's that such releases should only be granted in limited circumstances.[102] The factors courts consider include: whether the third parties contributed funds, whether the third party's contribution was vital, and whether all (or nearly all) of the claimants who lost their right to sue consented.[103] Courts have also inquired as to how those plaintiffs are compensated and whether there is an opt-out option for dissenters to litigate their claims. Finally, they looked at the third

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[98] According to the BSA website, a chartered organization is "a community-based group whose objectives, mission and methodologies are compatible with those of the BSA. It agrees to use the Scouting program to further its mission to serve young people." For example, several churches have started Scouts BSA troops as a complement to their youth ministry or to reach out to new families. *See* Scouting FAQ: Chartered Organizations, Scouting Magazine, https://scoutingmagazine.org/2021/04/scouting-faq-chartered-organizations/

[99] *See supra* note 91.

[100] Order Denying Confirmation of Debtor's Plan, *In re* Archdiocese of St. Paul, No. 15-30125 (Bankr. D. Minn. Dec. 28, 2017), ECF No. 1170.

[101] 11 U.S.C. § 524(e) states that only the debtor is discharged in bankruptcy. Some courts suggested it bans third party releases in bankruptcy. See *In re* Am. Hardwoods, Inc., 885 F.2d 621, 626 (9th Cir. 1989); Landsing Diversified Props.-II v. First Nat'l Bank and Trust Co. of Tulsa (*In re* W. Real Estate Fund), Inc., 922 F.2d 592, 600–02 (10th Cir. 1990).

[102] Courts that permit third-party releases usually rely on 11 U.S.C. §105(a). This section grants bankruptcy courts the power to issue any order "that is necessary or appropriate to carry out the provisions of this title." For further analysis, *see infra* note 143.

[103] MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89, 93 (2d Cir. 1988); *In re* Cont'l Airlines, 203 F.3d 203, 214 (3d Cir. 2000); Menard-Sanford v. Mabey (I*n re* A.H. Robins Co.), 880 F.2d 694, 701-02 (4th Cir.1989).

parties' identities and whether their interests conflicted with the debtor. Although Congress recently proposed banning third-party releases in bankruptcy, the issue remains under dispute.[104]

Additionally, some courts have expanded the automatic stay to protect third parties during the bankruptcy proceedings, thereby stopping victims from suing them and continue their existing lawsuits.[105] Thus, the victims' rights against third parties are often harmed even before a bankruptcy plan is approved. For instance, in Boys Scouts of America's bankruptcy, litigation was halted against the local councils and sponsoring organizations even though they did not file for bankruptcy.[106]

II. How Discharging Sexual Misconduct-Based Claims Distorts Investments

Over the years, corporations had little incentive to invest resources against sexual misconduct and actively monitor it, as they bore almost none of its costs. Additionally, given how difficult it is for victims to come forward, recent studies suggest most incidents go unreported.[107] Even when victims find the courage to speak, corporations manage to silence them through mandatory arbitration and nondisclosure agreements, allowing predators to continue their behavior. Arbitration provisions block victims' access to court and nondisclosure agreements prevent them from discussing the allegations publicly. These conditions appear both in employment contracts (as a condition to employment) and in settlement agreements made with the victims after the fact. For example, in the 21st Century Fox case, Gretchen Carlson had to sue her perpetrator, CEO Roger Ailes,

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[104] Nondebtor Release Prohibition Act of 2021, H.R.4777, 117th Congress (2021).

[105] The bankruptcy court may use its general authority under § 105(a) to extend the scope of the automatic stay to protect third parties. Such extension was found justified in cases where both the debtor and its officers were insured by the same policy. Therefore, if litigation against the officers proceeded, it could have harmed the insurance policy funds available to the debtor. *See In re A.H. Robins Co.*, 880 F.2d at 701-02 (holding an extension of the automatic stay might apply only if a claim against a non-debtor would adversely affect the debtor's estate).

[106] Randall Chase, *Boy Scouts Seek to Extend Halt to Lawsuits Vs. Local Groups*, U.S. NEWS (Feb. 23. 2021), https://www.usnews.com/news/us/articles/ 2021-02-23/boy-scouts-seek-to-extend-halt-to-lawsuits-vs-local-groups

[107] *See supra* note 107.

individually (as opposed to suing their employer) in order to avoid a mandatory arbitration clause.[108] Unfortunately, this allows perpetrators to continue their sexual misconduct against new victims. Although federal and state legislators have made some efforts to fight these harmful practices,[109] they remain relatively common.[110]

In addition, corporations are unlikely to be held fully responsible for sexual misconduct even when victims are not contractually prohibited from suing them in court. The primary legal tool available to victims is to sue for

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[108] Katie Reilly, *Attorneys for Gretchen Carlson Seek Public Trial for Sexual Harassment Suit Against Fox CEO Roger Ailes*, TIME (Jul. 16, 2016), https://time.com/4409289/fox-news-roger-ailes-gretchen-carlson-arbitration-public-trial/.

[109] The Obama administration had adopted an executive order preventing federal contractors from using mandatory arbitration in the context of sexual harassment, it was later revoked and no longer valid. See Exec. Order No. 13673, Fair Pay and Safe Workplaces. 79 FR 45309 (July 31, 2014); Mary Emily O'Hara, *Trump Pulls Back Obama-Era Protections For Women Workers*, NBC NEWS (Apr. 3, 2017), https://www.nbcnews.com/news/us-news/trump-pulls-back-obama-era-protections-women-workers-n741041. In 2017, Congress banned corporations from deducting business expenses deriving from sexual harassment settlements (including settlement payments and attorney fees) from their taxable income, if an NDA was a part of the agreement. This reform aimed at making NDAs more costly and less desirable for companies. Pub. L. No. 115-97, § 13307, 131 Stat. at 2129. For a detailed analysis see Shane Rader, *The Weinstein Tax: Congress' Attempt to Curb Non-Disclosure Agreements in Sexual Harassment Settlements*, 3 BUS. ENTREPRENEURSHIP & TAX L. REV. 329 (2019). Since 2017, sixteen states have restricted the use of NDAs in cases of sexual harassment through state law. *See* Progress in Advancing Me Too Workplace Reforms in #20STATESBY2020, National Women's Law Center (July 2019), https://nwlc-ciw49tixgw5lbab.stackpathdns.com/wp-content/uploads/2019/07/final_2020States_Report-9.4.19-v.pdf. The report's updates are available here: 2020 Progress Update: Me Too Workplace Reforms In The States, National Women's Law Center (September 2020), https://nwlc.org/wp-content/uploads/2020/09/v1_2020_nwlc2020States _Report.pdf.

[110] Erin Mulvaney, *Mandatory Arbitration at Work Surges Despite Efforts to Curb It*, BLOOMBERG LAW (Oct. 28, 2021), https://news.bloomberglaw.com/ daily-labor-report/mandatory-arbitration-at-work-surges-despite-efforts-to-curb-it ("The number of employment disputes resolved in arbitration climbed by roughly 66% between 2018 and 2020, according to new data, despite pressure from the #MeToo movement and efforts by Fortune 500 companies and lawmakers to curb agreements that keep claims out of court."). *See also* Forced Arbitration in a Pandemic: Corporations Double Down, American Association for Justice (October 2021), https://www.justice.org/resources/research/forced-arbitration-in-a-pandemic.

employment discrimination under Title VII, which has a short statute of limitations and allows only capped damages, thus creating minimal exposure for corporations.[111] Additionally, courts require a high burden of proof to win a Title VII claim involving sexual harassment.[112] Thus, many victims find they do not have an actionable claim under federal law. Moreover, there is a safe harbor for corporations under Title VII, provided they are able to show that they put in place preventive measures (such as an internal reporting system), but the victims failed to use them.[113] Proving these measures existed was enough to deny a remedy to victims who failed to come forward immediately.[114] Thus, employers could escape liability by merely adopting paper policies and procedures, whether they had any practical value in preventing sexual misconduct. Corporations could continue to ignore core problems, such as toxic corporate culture and low gender diversity, which are linked to workplace sexual harassment.[115]

In recent years, state legislators have tried to adopt new laws to expand the protections for sexual misconduct victims. Since 2017, fifteen states and municipalities have adopted some form of law protecting against sexual harassment in the workplace, extending the statute of limitations, loosening the standard of proof, and removing compensation caps.[116]

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[111] *See* Lund, *supra* note 5, at 1603-1610 (explaining Title VII's shortcomings as a remedy for sexual misconduct victims including capped damages and 180-day limitation period).

[112] Plaintiff in a Title VII case must show the harassment was "sufficiently severe or pervasive" to alter their work conditions or terms, objectively and subjectively. *See* Harris v. Forklift Sys., 510 U.S. 17, 21–22 (1993). Victims were protected only if the harassment was repeated, severe, and unwelcome. *See also* Wilson v. N.Y. City DOT, 2005 U.S. Dist. LEXIS 21620, *64 (S.D.N.Y. Sept. 28, 2005); Terry v. Ashcroft, 336 F.3d 128, 148 (2d Cir. 2003).

[113] *See* Faragher v. City of Boca Raton, 524 U.S. 775, 805 (1998); Burlington Indus., Inc. v. Ellerth, 524 U.S. 742, 765 (1998) (holding that an employer can avoid Title VII liability if it had measures to prevent or address the harassment, but the plaintiff failed to use them).

[114] *See* Lund, *supra* note 5, at 1605. In one case, even a reporting delay of seven days was considered unreasonable. *See* Marsicano v. Am. Soc'y of Safety Eng'rs, No. 97-C7819, 1998 WL 603128, at *7. (N.D. Ill. Sept. 4, 1998).

[115] Anne Lawton, *Operating in an Empirical Vacuum: The Ellerth and Faragher Affirmative Defense*, 13 COLUM. J. GENDER & L. 197, 198, 210-242 (2004) (suggesting that the Faragher-Ellerth defense encouraged employers to focus on anti-harassment policies instead of addressing corporate culture and gender diversity).

[116] *See supra* note 8.

Nevertheless, as described earlier, corporations can use bankruptcy to avoid such liability, blocking victims' access to jury trials and limiting their recovery.

As a result, bankruptcy law has the potential to perpetuate sexual misconduct since it allows some parties to escape liability, thereby creating a gap between shareholders, managers, and lenders in the way they perceive sexual misconduct. For that reason, bankruptcy can distort managers' and capital providers' behavior and their resource allocation, making them less likely to monitor and combat sexual misconduct.

A. Capital Providers

Shareholders and lenders face different risks when the company they invest in is involved in sexual misconduct. On one hand, shareholders will bear some of the consequences of sexual misconduct if the company goes bankrupt; they stand to potentially lose the full value of their investment.[117] On the other hand, secured lenders are generally insulated from the costs of sexual misconduct: they must be fully paid before the victims can recover any value. As a result, secured lenders do not bear sexual misconduct costs and are unlikely to price it into their loans. In other words, they will probably offer similar loan terms to all borrowers—violating and non-violating,[118] regardless of their sexual misconduct risk. Secured lenders have little incentive to inquire on issues related to sexual misconduct in their due diligence process and to monitor the risk of sexual misconduct using their debt covenants. Once again, however, it is worth noting that this Article does not seek to impose social responsibilities upon lenders. Instead, the

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[117] Their potential loss, however, is capped at the value of their shares because of their limited liability. In fact, limited liability creates a situation in which shareholders are not fully responsible for the potential social costs they create. This situation may also trigger distorted investment decisions. For further discussion, *see* Vincent S. J. Buccola & Joshua C. Macey, *Claim Durability and Bankruptcy's Tort Problem*, 38 YALE J. ON REG. 766, 776 (2021). For this reason, some scholars advocate unlimited liability for corporate torts, *see* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

[118] The terms "violating" and "non-violating" in this Article refer to the corporate policy against sexual misconduct. Violating corporations are more prone to sexual misconduct. They underinvest in preventing it, may have a history of sexual misconduct, weak anti-harassment policies, and other factors predicting a higher risk.

purpose of this analysis is to reveal and highlight the disparity in the way shareholders and lenders capture social risks as business risks. The different reactions to the MeToo movement demonstrate the effects of the different incentives operating on equity and debt investors.

Regarding equity investments, institutional investors have begun paying attention to corporate culture and gender equality, including workplace sexual harassment—part of the "social" prong of ESG investing. Major institutional investors, such as CalPERS and BlackRock, have updated their investment strategies accordingly. For example, CalPERS's voting and engagement policy now supports the establishment of provisions providing for compensation clawbacks against managers involved in sexual harassment.[119] ISS and Glass Lewis, the two major proxy advisory firms, have also updated their voting recommendation policies to account for gender diversity and human capital management and are tracking allegations of sexual harassment in public corporations.[120] In addition, activist investors have begun filing shareholder proposals relating to workplace sexual harassment, gender diversity, and the gender pay gap, urging boards to enhance their oversight and disclosure of these issues.[121] Shareholders have also pushed boards to remove unethical executives or senior employees who faced sexual harassment allegations.[122]

[119] David A. Katz and Laura A. McIntosh, *Corporate Governance Update: Shareholder Activism Is the Next Phase of #MeToo*, Harvard Law School Forum on Corporate Governance (Sep. 28, 2018), https://corpgov.law.harvard.edu/2018/09/28/corporate-governance-update-shareholder-activism-is-the-next-phase-of-metoo/. For a detailed analysis and more examples of how institutional investors are referring to issues of sexual harassment, *see* Amelia Miazad, *Sex, Power, and Corporate Governance*, 54 UC DAVIS L. REV. 1913, 1936-1950 (2021).

[120] Miazad, *supra* note 119, at 1943-1944.

[121] Katz and McIntosh, *supra* note 119.

[122] Recent examples include Roger Ailes (Fox News Chairman), Harvey Weinstein (CEO of Weinstein Co.), Steve Wynn (CEO of Wynn Resorts), Roy Price (Head of Amazon Studios), and Travis Kalanick (CEO of Uber). *See* Tom Huddleston, *Roger Ailes Resigns: A Timeline of His Downfall*, FORTUNE (Jul. 21, 2016), https://fortune.com/2016/07/21/roger-ailes-resigned-scandal-timeline/. Brooks Barnes, *Harvey Weinstein, Fired on Oct. 8, Resigns From Company's Board*, N.Y. TIMES (Oct 17, 2017), https://www.nytimes.com/2017/10/17/business/media/harvey-weinstein-sexual-harassment.html; Maggie Astor and Julie Creswell, *Steve Wynn Resigns From Company Amid Sexual Misconduct Allegations*, N.Y. TIMES (Feb. 6, 2018), https://www.nytimes.com/2018/02/06/business/steve-wynn-resigns.html; John Koblin, *Roy Price Quits Amazon Studios After Sexual Harassment Claim*, N.Y. TIMES (Oct. 17,

The issue has also assumed prominence in the mergers and acquisitions ("M&A") and venture capital arenas. Buyers in M&A transactions, as well as the venture capital industry, increasingly demand their counterparties disclose issues related to sexual misconduct and conduct what is usually referred to as social due diligence. Indeed, "Weinstein Clauses" now appear in many agreements, requiring corporations to disclose sexual misconduct allegations against senior employees.[123] The venture capital industry has adopted its own version of these clauses in fundraising agreements (known as "candor clauses"), requiring investors to disclose whether their executives have been involved in sexual misconduct.[124] Companies also increasingly require investors to sign "morality clauses" allowing them to remove directors involved in sexual misconduct.[125]

On the other hand, these changes, so dramatic in the equity investing arena, have not filtered through into credit markets in a significant way. While industry professionals, including lenders and credit rating agencies, capture ESG risks as credit risks, they generally limit themselves to environmental violations and climate change risks. Thus, for example, to

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2017), https://www.nytimes.com/2017/10/17/business/media/roy-price-amazon-studios.html; Greg Bensinger, *Uber CEO Travis Kalanick Quits as Investors Revolt*, WALL ST. J (Jun. 21, 2017), https://www.wsj.com/articles/uber-ceo-travis-kalanick-resigns-1498023559.

[123] Nabila Ahmed, *Wall Street Is Adding a New 'Weinstein Clause' Before Making Deals*, BLOOMBERG (Aug. 1, 2018), https://www.bloomberg.com/news/articles/2018-08-01/-weinstein-clause-creeps-into-deals-as-wary-buyers-seek-cover#:~:text=On%20Wall%20Street%2C%20it's%20known,behavior%20of%20a%20company's%20leadership; Javon Johnson, *An Epidemic of Workplace Sexual Misconduct: The Birth of the Weinstein Clause in Merger and Acquisition Agreements*, 52 TEX. TECH L. REV. 377 (2020) (describing "Weinstein Clauses" and how they are incorporated into M&A deals).

[124] *Investor's Naked Selfies Ignite #MeToo Moment: Female Founder Fights Back*, NPR (Jan. 6, 2020), https://www.npr.org/2020/01/06/793134459 /investors-nakedselfie-ignites-metoo-moment-female-founder-fights- back.

[125] *Alice's Morality Clause*, ALICE BLOG (Jan. 12, 2020), https://blog.helloalice.com/ alices-morality-clause/; Anne Stych & Brian Rinker, Serena Ventures, *Bumble fund tech company with MeToo 'morality clause'*, BIZWOMEN (Dec. 13, 2019), https://www.bizjournals.com/bizwomen/ news/latestnews/2019/12/serena-ventures-bumble-fund-tech-company-with.html?page=all; Melinda Gates, *What #MeToo Meant For Venture Capitalists*, REFINERY29 (Nov. 14, 2018), https://www.refinery29.com/en-us/melinda-gates-vc-venture-capitalmetoo.

address environmental factors, lenders and borrowers have developed specific credit devices such as "green bonds" and "sustainability-linked bonds." But the effect of "social" and "governance" issues on credit pricing and underwriting is still negligible,[126] although there are early signs of change. Recently, BlackRock entered into a credit facility with several commercial banks and incorporated diversity goals into the loan documents.[127] Although BlackRock did not target sexual misconduct specifically, it was the first time social causes were included in a commercial loan agreement. However, this is still a marginal phenomenon in credit markets compared to equity markets; this one example may be an artifact of the fact that BlackRock is a prominent operator in the equity space.[128]

What can explain this lack of interest in the credit space when compared to the equity space? The answer may depend on the type of creditor. Secured lenders appear to be irresponsive to sexual misconduct risks because they are insulated from damages—they have collateral to protect them. Other groups of creditors, like bondholders, are less likely to monitor those risks due to a collective action problem—in other words, it is inefficient for individual holders to invest resources in monitoring. In fact,

[126] *See* Joshua A. Feltman and Emily D. Johnson, *ESG Performance and the Credit Markets,* Harvard Law School Forum on Corporate Governance (Mar. 1, 2020), https://corpgov.law.harvard.edu/2020/03/01/esg-performance-and-the-credit-markets/. For example, the ESG guidance published by the European Leveraged Finance Association is almost entirely focused on environmental risks. *See* Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions, ELFA & LMA (Jan 19, 2021), available at: https://www.lma.eu.com/application/files/8816/1105/1620/Guide_for_Company_Advisers_to_ESG_Disclosure_in_Leveraged_Finance_Transactions.pdf; However, some suggest social risks are likely to have a more significant effect on credit pricing in the future with the release of the EU's draft Social Taxonomy over 2022. Nevertheless, they mainly refer to sustainability-related credit products marketed as such. *See* ESG Credit Trends 2022 Special Report, Fitch Ratings (Dec. 17, 2021), https://www.fitchsolutions.com/products/fitch-ratings-esg-relevance-scores-data. In addition, the American LSTA ESG Questionnaire also briefly refers to social risks, *see* https://www.lsta.org/content/esg-diligence-questionnaire-borrower/.

[127] BlackRock borrowed money from commercial banks with a diversity-linked revolving loan. The loan agreement included a provision discounting the credit price if BlackRock improves diversity. *See* Matt Levine, *BlackRock Borrows Against Diversity*, BLOOMBERG (Apr. 17, 2021), https://www.bloomberg.com /opinion/articles/2021-04-07/blackrock-borrows-against-diversity.

[128] Indeed, many institutional investors hold both equity and debt in large companies. As such, they probably care more about ESG risks in both hats.

such holders usually rely on piggybacking on the monitoring efforts of other stakeholders, such as banks.[129]

This gap in the way lenders and shareholders view sexual misconduct risks might limit the MeToo revolution's effect on US corporations, as investors' involvement in monitoring ESG risks generally and sexual misconduct specifically is a major factor in whether corporations change their behavior. The more these risks affect capital costs, the more likely corporations will invest resources to reduce them. Currently, however, it appears sexual misconduct risks affect only certain types of financing tools.

Given this monitoring gap between debt and equity markets, high risk corporations may prefer the private debt market (where information on sexual misconduct is not required to be revealed, and hence, not priced), instead of the public equity market which might entail damaging disclosure or a change to their behavior. The due diligence associated with raising equity in public markets can reveal issues of sexual misconduct. Thus, one could see how if managers know about sexual misconduct, they will choose private debt to avoid due diligence.

Were such a migration from public equity markets to private debt markets to occur, a "lemons problem" could result.[130] In other words, all privately held corporations will be "high risk" when it comes to sexual misconduct (and thus, "lemons"). To avoid this situation, this Article argues legislators should change bankruptcy law so lenders will price sexual misconduct risks and extend different terms to "high risk" and "low risk" corporations. This way, privately held corporations will also have an incentive to monitor sexual misconduct risks—because "good" behavior will be rewarded.

[129] *See* Yakov Amihud, Kenneth Garbade, and Marcel Kahan, *A New Governance Structure for Corporate Bonds*, STAN. L. REV. 447, 448-468 (1999) (describing how creditors use debt covenants to monitor borrowers and pointing out the collective action problem as the main failure preventing bondholders from monitoring); *see also* George G. Triantis; Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1114 (1995) (explaining the interactive relationship between different creditors when there is one efficient monitoring party the others are relaying on to prevent duplicative monitoring efforts).

[130] A lemons problem occurs when there is an information gap between buyers and sellers in a particular market; thus, only the seller knows the product's true value. Then, products' quality may deteriorate since "good" and "bad" products are priced equally.

But how can legislators encourage such differential pricing? One way would be to make sexual misconduct-based claims nondischargeable in bankruptcy. Another solution would be to allow victims of sexual misconduct to receive priority over secured debt in a bankruptcy.[131] Both solutions would expose senior lenders to the consequences of workplace sexual misconduct and provide an incentive to price that risk in their loan agreements.

Pricing sexual misconduct risks could be done directly through higher interest rates or indirectly through debt covenants. In the former case, borrowers with bad sexual misconduct histories who have not done much to fix it or those unwilling to provide disclosures will be charged higher rates. In the latter case, lenders can require borrowers to disclose all past sexual misconduct allegations against senior employees and all related settlements. Sexual misconduct-related issues may appear not only in the representations and warranties part but also as part of the indemnification and insurance arrangements. Lenders can also indirectly mitigate sexual misconduct risks by requiring their borrowers increase board gender diversity, include compensation clawbacks in employment agreements, and adopt zero-tolerance termination policies for abusing managers.

While some might question the effects of bankruptcy law on corporate behavior, research shows that changes in bankruptcy law can facilitate lenders' behavior regarding other ESG risks, particularly environmental risks. For example, after the Seventh Circuit held that certain environmental liabilities regarding the cleanup of toxic chemicals could not be discharged in bankruptcy, lenders began to tighten their credit terms for impacted firms. As a result, those firms changed their behavior and reduced the volume of toxic chemicals they released.[132] Indeed, lenders can be efficient monitors for ESG risks just as they are for other credit risks. By

[131] By no means does this Article suggest sexual misconduct victims should be considered superior to all other involuntary creditors. It supports the general academic view that better treatment of tort victims in bankruptcy is needed and highlights how such policies could affect sexual misconduct victims. *See supra* note 22.

[132] One paper shows that impacted firms (that are likely to file for bankruptcy in the Seventh Circuit) responded by reducing the volume of toxic chemicals they release on-site by approximately 15% and switching to more environmental friendly practices. The paper also provides evidence that lenders tightened their credit terms to impacted firms, suggesting a possible creditor influence triggered the change. *See* Ohlrogge, *supra* note 19, at 6.

demanding access to information through debt covenants and due diligence, lenders can have a market-wide reach and create a signaling effect. If a corporation is getting credit on good terms, e.g., agrees to covenants that mitigate sexual misconduct risks in exchange for a discount, it signals to the market that this is a low risk corporation. And that, in turn, allows other stakeholders with less access to information to incorporate sexual misconduct risks into their pricing.

B. Managers

Shareholders and managers have divergent interests in dealing with workplace sexual misconduct, potentially creating agency costs—and bankruptcy law only makes matters worse. Managers are largely insulated from sexual misconduct costs—they are usually insured and entitled for indemnification and it is costly to fire them.

Executive employment agreements often defend managers against termination in case of sexual misconduct. Executives are usually protected against "at will" termination and can only be terminated for "cause." The definition of such "cause" might not cover most instances of sexual misconduct (especially if there is no final judgment). Thus, managers who are fired for sexual misconduct may be entitled to hefty severance payment upon termination.[133]

Indeed, many managers who were fired or forced to resign for sexual misconduct allegations still received their golden parachutes, sometimes receiving millions of dollars in severance pay. Recent examples include

[133] For example, Bill O'Reilly's employment contract with Fox News allowed termination for harassment only if it was "expressly limited to a final, non-appealable judgment by a court of law finding that Performer sexually harassed an employee of Fox." *See* Emily Steel & Michael S. Schmidt, *Bill O'Reilly Thrives at Fox News, Even as Harassment Settlements Add Up*, N.Y. TIMES (Apr. 1, 2017), https://www.nytimes.com/2017/04/01/business/media/bill-oreilly-sexual-harassment-fox-news.html.

Harvey Weinstein ($40 million),[134] Roger Ailes ($47 million),[135] Bill O'Reilly ($25 million),[136] and Andy Rubin ($90 million).[137] There is a significant and obvious injustice when the perpetrators leave with substantial payouts while victims and the shareholders are left behind.

Additionally, managers are usually insured and entitled to indemnification that could protect them against personal lawsuits filed against them in cases of sexual misconduct.[138] Moreover, it is often the case that the company and its managers share the same insurance policy. Thus, managers might erode the policy funds early, leaving the company and its shareholders unguarded. The risk of draining out the insurance fund adds to the inherent conflict between the managers and shareholders.

Exacerbating the problem, there is a growing trend of releasing managers from liability in mass torts bankruptcies. Recent examples include

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[134] Jill Filipovic, *Harvey Weinstein and What Happens Next*, TIME (Oct. 12, 2017), https://time.com/4979258/harvey-weinstein-what-happens-next/. Harvey Weinstein also borrowed $1 million from his company in the months before public revelations of his alleged sexual misconduct plunged the movie studio into bankruptcy. He took home nearly $3 million during his last half year at the company. *See* Peg Brickley and Jonathan Randles, *As Weinstein Scandal Brewed, Studio Executives Cashed In*, WSJ PRO BANKRUPTCY (Apr. 24, 2018), https://www.wsj.com/articles/as-weinstein-scandal-brewed-studio-executives-cashed-in-1524599965.

[135] Chris Isidore, *21st Century Fox Gets Nearly $90 Million from Insurers to Cover Harassment Claims*, CNN MONEY (Nov. 21, 2017), http://money.cnn.com/2017/11/21/media/fox-harassment-discrimination-settlement/index.html.

[136] Erik Ortiz, *Bill O'Reilly Severance: Fox News Host to Get $25 Million*, NBC NEWS (Apr. 20, 2017), https://www.nbcnews.com/news/us-news/bill-o-reilly-severance-fox-news-host-expected-get-25-n748916.

[137] Daisuke Wakabayashi and Katie Benner, *How Google Protected Andy Rubin, the 'Father of Android'*, N.Y. TIMES (Oct. 25, 2018), https://www.nytimes.com/2018/10/25/technology/google-sexual-harassment-andy-rubin.html.

[138] Three types of corporate insurance are relevant in this context: Employment Practices Liability Insurance (EPL insurance), Directors & Officers Liability Insurance (D&O insurance), and General Liability Insurance. The first covers claims for damages by employees related to harassment, discrimination, unlawful dismissal and other employment issues, the second covers shareholder claims against the senior management, and the third covers negligence claims.

USA Gymnastics,[139] the Weinstein Co.,[140] and the Boy Scouts of America cases.[141] These cases suggest managers are increasingly using a *corporate* bankruptcy proceeding to evade personal liability for workplace sexual misconduct—even if they were the perpetrators of the misconduct and even in the most egregious cases. In other words, current bankruptcy law expands the inherent agency costs. From a particular point in time, the marginal costs of additional sexual misconduct instances will be zero. Even if a sexual misconduct scandal is uncovered, abusers can use corporate bankruptcy to be discharged from liability or mitigate it.

Ironically, this trend of granting third-party releases in corporate bankruptcies allows the direct perpetrators to gain benefits they would not otherwise have been eligible for—even if they had filed for bankruptcy on their own. Thanks to the "willful and malicious" exception to discharge discussed above.[142] Although some courts (for example, the district court rejecting Purdue Pharma's plan) have recently criticized the practice of releasing third parties in bankruptcy,[143] there is still a split between jurisdictions that can lead to forum shopping.

Without the threat of personal liability, it makes sense that managers will be less likely to invest resources to prevent sexual misconduct (because they do not bear its costs). And this is true even if shareholders will suffer the cost of sexual misconduct in the form of a drop in stock price. Moreover, stockholders stand to lose even more if the corporation files for bankruptcy, because even reorganization has the potential to reduce or erase equity. And

[139] Third Amended Chapter 11 Plan, *In re* USA Gymnastics, No. 18-09108-RLM-11 (Bankr. S.D. Ind. Oct. 25, 2021), ECF. No. 1776, https://cases.omniagentsolutions.com/?clientId=2459. Louise Radnofsky and Jonathan Randles, *Nassar Victims Reach $380 Million Settlement With USA Gymnastics and U.S. Olympic and Paralympic Committee*, WALL ST. J (Dec. 13, 2021), https://www.wsj.com/articles/nassar-victims-reach-380-million-settlement-with-usa-gymnastics-and-u-s-olympic-and-paralympic-committee-11639406377.

[140] Jonathan Randles, *Bankruptcy Judge Approves $17 Million Fund for Harvey Weinstein Victims*, WSJ PRO BANKRUPTCY (Jan. 25, 2021), https://www.wsj.com/articles/bankruptcy-judge-approves-17-million-fund-for-harvey-weinstein-victims-11611625431.

[141] *See supra* note 91.

[142] 11 U.S.C. § 523(a)(6). For further discussion on how this exception applies to sexual misconduct claims *see* supra note 9.

[143] *See supra* note 61.

to compound the damage, shareholders might also lose their right to sue for a breach of fiduciary duties[144] and securities regulation,[145] as their claims against the corporation and its managers will be discharged.[146]

In some cases, managers might even push for a quick bankruptcy filing to avoid facing the consequences of personal liability and reputational damage associated with litigating sexual misconduct-based claims (even against the shareholders' interest).[147] Managers and senior employees could potentially keep their jobs under the new ownership after the corporation is sold in bankruptcy, especially if they were not directly involved in the misconduct.[148]

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[144] *See* Lund, *supra* note 5; Morrissey, *supra* note 75 (both examining the role of corporate and securities law in regulating workplace sexual harassment). Directors and officers who fail to monitor sexual misconduct at their firms may be liable in certain circumstances under a *Caremark* theory. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) (establishing the duty of oversight for directors to implement and maintain a monitoring system to prevent and detect illegal activities within the corporation). Indeed, the Delaware Court of Chancery recently recognized the possibility of suing directors and officers for failing to monitor sexual misconduct. *In re* McDonald's Corp. Stockholder Derivative Litig., C.A. No. 2021-0324-JTL, 2023 WL 387292, at *2 (Del. Ch. Jan. 26, 2023) (recognizing officer liability for ignoring red flags of sexual misconduct).

[145] *Id.* Shareholders sued public companies for making misleading and materially false statements to conceal harassment patterns.

[146] However, some practitioners suggested the bankruptcy estate could potentially pursue certain claims against the management for failing to address sexual misconduct. *See* Kenneth H. Brown, *The Estate's Potential Claims Against Management for Failure to Prevent Sexual Misconduct*, 356 American Bankruptcy Trustee Journal 30 (No. 3 Summer 2019), September 2019, https://www.pszjlaw.com/newsroom-publications-133.html. Nonetheless, in practice, claims against officers and directors will often be discharged through third party releases in the bankruptcy plan.

[147] Such tension between the managers and the shareholders seems to exist in other cases involving massive tort liability as well. For example, in the PG&E bankruptcy (triggered by wildfire liability), major shareholders criticized the decision to file for bankruptcy, arguing the company was solvent and, thus, the board had breached its fiduciary duties by pushing for bankruptcy. Interestingly, the shareholders' equity value was not wiped out in bankruptcy, implying that the company might have been solvent from the beginning. *See* Anthony J. Casey & Joshua C. Macey, *The Hertz Maneuver (and the Limits of Bankruptcy Law)*, 2020 U. CHI. L. REV. ONLINE 1, 12-13 (2020).

[148] For example, many senior employees in the Weinstein Co., including two former board members, were employed by the new buyer after the company was sold in bankruptcy (several years before the bankruptcy proceeding was over and any amount was distributed to the victims). *See infra* note 160.

III. Policy Proposals

Having explored the ways corporations use bankruptcy to avoid liability for sexual misconduct and how the current system preserves underinvestment in preventing sexual misconduct, this Part offers several policy proposals. Section III.A. proposes that sexual misconduct-based claims be prioritized in bankruptcy. Section III.B. calls for limiting the availability of non-consensual third-party releases in bankruptcy. Section III.C. examines how these proposals would potentially affect monitoring incentives and credit costs.

A. Priority v. Exception to Discharge

As discussed above, due to the fact that sexual misconduct victims hold unsecured claims, they are among the last in line to receive payment. In fact, they usually receive nothing until senior creditors are paid in full. Only limited categories of liabilities arising out of intentional wrongdoing, such as tax evasions and some environmental violations, are prioritized or excluded from discharge in corporate bankruptcy[149]—and sexual misconduct is not among them.[150]

Scholars have suggested the choice to treat only certain types of liabilities arising out of misconduct as prioritized or nondischargeable is arbitrary, politically motivated, and has discriminatory consequences for vulnerable communities.[151] For example, some have argued the inability to discharge criminal and civil fines and penalties in personal bankruptcy

[149] *See* Nash, *supra* note 19, at 145-6 (providing an overview of state legislation on environmental liens). In addition to environmental liens that exist in some states, environmental liabilities can receive priority as administrative expenses if they are necessary to preserve the value of the collateral. *See* 11 U.S.C. §506(c). They can also pass-through bankruptcy if they are categorized as injunctive obligations. *See In re* Combustion Engineering, 391 F.3d 190, 217 (3d Cir. 2004) (demonstrating the use of an injunctive relief to keep environmental liabilities out of bankruptcy). Tax evasions are recognized as non-dischargeable in corporate bankruptcy, as well as fraud against a governmental entity. *See* 11 U.S.C. § 1141(d)(6).

[150] *See, supra* note 10.

[151] *See* Atkinson, *supra* note 23, at 8; *See also* Sperduto, *supra* note 10, at 156-180 (analyzing the legislative history of discharge exceptions under the US bankruptcy law from a political economy prism).

disproportionally affects individuals in over-policed and economically disfranchised communities. With no path to recovery, they are then forced to deal with an additional—and never-ending—debt burden.[152] This seems especially wrong given that corporations and their high-level executives are often able to exit bankruptcy with a relatively clean slate even if they pursue wrongful acts.

One method of making lenders accountable for sexual misconduct costs is changing that waterfall by prioritizing victims so they get paid before other creditors, including secured creditors. The idea of prioritizing general tort claims in bankruptcy, either on a par with or above those of secured creditors, is not a new idea. Indeed, many scholars have advocated for that change, though there has not been agreement on the level of priority.[153] Regardless of the exact terms of the priority, those who support prioritizing tort victims in bankruptcy focus on their nature as involuntary creditors, as well as the fact that tort victims are further subordinated every time the debtor takes on secured debt. To these scholars it creates an inefficient and unfair system because tort victims (unlike lenders and other voluntary creditors) cannot react to additional risks by adjusting their deal terms.

Another policy alternative is to disallow the discharge of sexual misconduct-based claims in corporate bankruptcy, thereby keeping victims out of the process entirely. Such a rule already exists in personal bankruptcies, falling under the "willful and malicious" exception to discharge.[154] If there is a no-discharge rule, victims could continue to pursue their claims against the debtor outside of bankruptcy courts (during the bankruptcy process and after it ends). As a result, they might avoid the steep discount typically associated with bankruptcy filings—assuming the company survives after bankruptcy and has enough resources to pay. Even if the company survives, allowing claimants to continue to pursue damages against the debtor might well lead to the liquidation of the company, which could leave the victims with no recovery at all.

Although both policy suggestions (i.e., prioritizing victims and exempting them from discharge) would put sexual misconduct victims ahead of other creditors, there are significant differences in their practical

[152] *Id.*

[153] *See, e.g., supra* note 22.

[154] 11 U.S.C. § 523(a)(6). For further discussion on how this exception applies to sexual misconduct claims *see supra* note 9.

implications. For example, changing the priority rules would still require victims to participate in the bankruptcy. Thus, they would be barred from pursuing litigation on an individual basis, having a jury trial, and receiving punitive damages. Exempting victims' claims from discharge, on the other hand, would fully protect their due process rights, allowing them to have their day in court.

Notably, protecting due process rights may be especially appropriate in the sexual misconduct arena because corporations have historically deprived victims' access to court through the imposition of mandatory arbitration provisions and shielded predators by forcing victims to sign nondisclosure agreements. Moreover, there is another benefit to making sexual misconduct-based claims nondischargeable: it would likely have a more robust effect on lenders' behavior than merely prioritizing them. Such policy makes the victims' claims superior to any current and future lender or buyer, including potential DIP lenders. This is because the victims' claims would survive bankruptcy at their full value. Changing priority rules, however, would make the victims superior only to pre-petition lenders, as they would still be discharged in bankruptcy. There is empirical evidence showing that exempting certain environmental claims from discharge improved lender monitoring of environmental risks.[155] There is no such evidence, however, regarding changes in priority rules. Nevertheless, some indications suggest the enactment of environmental liens also triggered enhanced practices of environmental due diligence among lenders.[156]

On balance, however, prioritizing victims may be the better solution. First, as noted earlier, exempting sexual misconduct victims from discharge might harm their recovery, as there might be no assets left after bankruptcy. A victim's ability to recover would depend on whether the business entity

[155] Ohlrogge, *supra* note 19.

[156] *See* Nash, *supra* note 19 (describing how lenders began conducting environmental due diligence to estimate their exposure to the possible entry of a superlien). Although a similar body of evidence does not exist regarding sexual misconduct, it is reasonable to predict that lenders will adopt similar practices to shareholders to monitor sexual misconduct if they are exposed to the same risks. For further discussion, *see infra* Section III.C. Generally, however, as investors' practices against sexual misconduct are relatively new and sexual misconduct is often not reported, it is extremely difficult to produce evidence regarding their effects and prevalence.

survives and whether there are any assets left after bankruptcy. If the business survives and continues to make profits, the victims would benefit from their exemption. In contrast, if the company ends up in liquidation and all of its assets are distributed, the victims could be left empty-handed.

Indeed, this failure risk may become even more significant because expanding discharge exceptions can negatively impact the chances of saving the business given the "cloud of uncertainty" that the claims create over a firm, making it harder for the debtor to recover and move forward as an ongoing business. Potential investors and DIP lenders might, for example, be deterred from providing financing. Similarly, the overhanging obligations might make it more difficult to estimate the expected enterprise value following the reorganization, and thus, the company may fall below its liquidation value. If the estimated going concern value of the business is too low, saving it might not be worthwhile. Moreover, victims' claims would survive bankruptcy, so new lenders would be subordinated to them. As a result, a debtor would be unable to offer a super-priority lien to DIP lenders in bankruptcy, as is typically done. Without the ability to finance the firm's operations, it might end up liquidating.

In fact, exempting sexual misconduct-based claims from discharge could potentially prevent corporations from using Chapter 11 bankruptcy proceedings to resolve mass torts involving sexual misconduct. And the absence of an alternative path for a collective resolution might eventually push these corporations to liquidation. Everyone, including the victims, would likely lose in such a scenario.

Because prioritizing sexual misconduct-based claims in bankruptcy does not present the same set of risks, it is probably the better alternative. Prioritizing sexual misconduct-based claims will not prevent corporations from using bankruptcy to resolve mass torts involving sexual misconduct. Thus, this solution will still allow the debtor to have a fresh start. At the same time, this proposal will probably make more funds available to the victims as they will be paid before secured lenders, and thus, will not have to settle for the residual value. Prioritizing victims may also expedite their compensation as senior lenders may push for a quick settlement so they can recover quickly as well.

Prioritizing sexual misconduct-based claims in bankruptcy also presents fewer challenges for DIP financing or a sale of the company since the new system would operate the same way current liens do. In other words, companies could still offer DIP lenders super-priority liens above all existing debt (including the victim's claims). A priority model still allows DIP lenders to obtain super-priority for their "new loans" and roll-ups for their "old loans" (with court approval). In fact, the only way for secured lenders to protect their claims from subordination would be to provide DIP finance. Thus, a change in priority rules is unlikely to prevent DIP lenders from financing reorganization—even when they are pre-existing lenders (as is often the case). If anything, such change would further incentivize them to support restructuring, as they might not recover in full otherwise (potentially becoming under-secured as they are forced to share their collateral). Thus, a successful reorganization may benefit them as it would generate more money. Essentially, providing DIP finance might be their only chance to be paid as a whole.

Although prioritizing sexual misconduct-based claims would benefit victims, it could negatively affect other creditors from a distributional perspective—at least in the short run. They would be subordinated to sexual misconduct victims and would therefore recover less. This result is inevitable given there is a limited pot of money to distribute and thus any preference of a certain group would come at the expense of the other. Yet most voluntary creditors, like banks and bondholders, could account for this additional risk in their loan agreements. Furthermore, despite being officially classified as unsecured, some of them already benefit from preferential treatment in the bankruptcy plan (e.g., through payment of critical vendors[157] and debt roll-ups),[158] as their support is critical to rehabilitating the business.[159] As opposed to the victims, they can add new investments,

[157] *See, e.g., In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004).

[158] Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. ON REGUL. 651, 668-72, 695-702 (2020).

[159] For this reason, scholars suggest that bankruptcy law is biased against those who cannot make new investments in the business, the most prominent group of which are the tort victims. Other ways to provide preferential treatment include commitment payments for select Restructuring Support Agreement signatories, favored rights offerings for preferred investors, and inflated backstop fees. *See* David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366, 384-88 (2020); Edward J. Janger & Adam J. Levitin, *The Proceduralist Inversion -A Response to Skeel*, 130 YALE L.J. 335, 341-49 (2020); Marti P. Murray, *Assessing the Reasonableness of Rights Offerings: Raising Exit Financing in a Chapter 11 Proceeding*, 32 AIRAJ 35, 36 (2019); Oscar Couwenberg & Stephen J. Lubben, *Private Benefits Without Control? Modern Chapter 11 and the Market for Corporate Control*, 13 BROOK. J. CORP. FIN. & COM. L. 145, 154-56 (2018).

labor, supplies, and services to the business. Additionally, unlike the victims, most other creditors (like employees and suppliers) potentially have more to gain from a successful bankruptcy than recovering the full amount of their debt. In other words, their subordination is less disturbing because they may be compensated in other ways. For instance, about a half of Weinstein Co.'s workforce was rehired by the new private equity owner who bought the company's assets a few months after it filed for bankruptcy.[160]

In the long run, however, prioritizing victims may not even harm other creditors' recovery—these creditors may gain from enhanced lender monitoring, potentially decreasing aggregate sexual misconduct costs and thus making more assets available for distribution. Furthermore, some of the unsecured creditors (like shareholders, bondholders, and insurance companies) can also mitigate sexual misconduct costs by monitoring for them in their own contracts.[161] Thus, subordinating them to the victims may be beneficial. If they fully bear those costs, they are more likely to monitor against sexual misconduct risks, add corresponding provisions to their contracts, and account for it in pricing. Shareholders and bondholders may price it in their financing terms, and insurance companies may account for it in underwriting their policies and determining their costs. Thus, their subordination is less concerning. Moreover, if monitoring is improved, employees would particularly benefit as they get enjoy from a better and safer work environment and corporate culture.

Assuming sexual misconduct-based claims should be prioritized in bankruptcy, there are still two open questions left: how and to which extent these claims be prioritized? Academics discuss different priority models for tort victims—above, on par with, and below secured creditors (all above the unsecured ones). Some support keeping tort victims below secured creditors as it preserves these creditors' priority value. As long as priority is valuable, they suggest, lenders will be willing to make concessions in exchange for it.

Additionally, reorganized firms often assume prepetition debts to preserve relationship with a counterparty or to avoid labor conflicts. *See* Mark J. Roe & Joo-Hee Chung, *How the Chrysler Reorganization Differed from Prior Practice*, 5 J. LEGAL ANALYSIS 399, 416-26 (2013).

[160] Shawn Tully, *Meet the man who brought back the Weinstein movie empire—sans Weinsteins*, FORTUNE (Jul. 15, 2021), https://fortune.com/ 2021/07/15/spyglass-media-andy-mitchell-lionsgate-harvey-weinstein-film-compan y-movies/

[161] For additional discussion on how such monitoring can be done see *infra* Section III.C.

Thus, this model encourages creditors to settle with the firm in the pre-bankruptcy period.[162] This model, however, would probably not result in the monitoring effects discussed below.

To preserve secured lenders' incentive to monitor the borrower's sexual misconduct risk, this Article argues that they must bear at least some costs associated with it. Putting sexual misconduct victims on par with or above secured lenders would serve this purpose. In addition, if lenders are subordinated or forced to share their priority position, they are more likely to become under-secured and thus may be more likely to support restructuring efforts as they could benefit from any economic surplus (unlike fully secured creditors who recover in full in any event).[163]

Moreover, putting sexual misconduct victims on par with secured lenders could generally benefit restructuring efforts. First, it would reduce the victims' typical objections to a restructuring plan, as they would no longer have to settle for leftovers. Second, if both groups—the victims and the secured lenders—share the collateral value, they would be less likely to favor liquidation. Both groups would have a similar incentive to vote in favor of restructuring as it could increase their potential recovery, reducing the risk of hold-outs and other opportunistic tactics. Finally, if both groups share the collateral on a pro rata basis, the victims are less likely to wipe out the lenders' security interest (as they are not subordinated). Ensuring lenders retain value in the collateral is essential to preserve their interest in the debtor and willingness to aid restructuring.

Ideally, prioritizing sexual misconduct-based claims would be established via legislation. The current political stalemate in Congress, however, probably necessitates alternative approaches, such as judicial intervention. In fact, a number of commentators discussed two potential

[162] Jason R. Donaldson, Edward R. Morrison, Giorgia Piacentino & Xiaobo Yu, *Restructuring vs. Bankruptcy*, COLUMBIA LAW & ECONOMICS WORKING PAPER NO. 630 (2020), https://scholarship.law.columbia.edu/faculty_scholarship/2706 (suggesting that when priority is valuable, creditors are willing to make significant concessions in exchange for it, allowing successful restructuring; thus, tort claims should not harm the priority of secured debt but make it more valuable).

[163] Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 514-515 (2009) (explaining the difference between under-secured and over-secured lenders and why the latter often prefer liquidation); Sperduto, *supra* note 10, at 194 (suggesting that prioritizing victims is unlikely to prevent DIP finance more than current liens do).

judicial tools: bad faith dismissal[164] and claim durability.[165] The first allows judges to dismiss cases filed for inappropriate reasons, while the second lets them impose successor liability on prospective buyers in bankruptcy. Yet, implementing these tools would have economic implications similar to excluding sexual misconduct-based claims from discharge, leaving debtors and victims vulnerable.

Therefore, equitable subordination appears to be a more promising theory for addressing sexual misconduct-based claims. Section 510(c)(1) of the Bankruptcy Code empowers courts to reorder a creditor's debt in response to unfair conduct.[166] This provision enables courts to subordinate a creditor's claim based on its inequitable conduct. Although primarily used for punishing corporate insiders for fraud, undercapitalization, or a fiduciary breach, recent cases suggest a broader application is possible.[167] For

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[164] *See supra* notes 29-31.

[165] Bankruptcy courts have adopted claim durability as a method of ensuring fairness for disfavored creditors. This approach was first introduced in the railroad equity receiverships. There were only a few instances when courts applied claim durability, however. Scholars suggest that a judge can require the buyer to assume certain liabilities as a condition of approving a sale of the debtor's assets. While this solution may seem appealing as there is no legislation needed, it may be difficult to implement in the sexual misconduct context since these claims do not directly relate to a debtor's assets (unlike environmental claims that are often asset-specific). Vincent S. J. Buccola & Joshua C. Macey, *Claim Durability and Bankruptcy's Tort Problem*, 38 YALE J. ON REG. 766 (2021) (calling bankruptcy courts to adopt a durability norm in which tort claims follow a debtor's assets out of Chapter 11).

[166] 11 U.S.C. § 510(c)(1). Although early courts have considered "inequitable conduct" as a precondition for equitable subordination, a close reading of Section 510(c) reveals that it does not require misconduct on the part of the subordinated creditor. The Supreme Court has yet to decide if inequitable conduct is necessary under the Bankruptcy Code. *See* United States. v. Noland, 517 U.S. 535, 543 (1996) ("…this Court need not decide whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated."). Nonetheless, bankruptcy courts cannot use equitable subordination to equitably subordinate claims "on a categorical basis in derogation of Congress's priorities scheme." *Id.* Scholars criticize the judicial development of the "no-fault" equitable subordination as a potential threat to legal certainty and predictability. *See* Steven L. Schwarcz, *The Inequities of Equitable Subordination*, 96 AM. BANKR. L.J. 29 (2022).

[167] *Id. See, e.g., In re* AutoStyle Plastics, Inc., 269 F.3d 726, 744 (6th Cir. 2001); *In re* Mid-Am. Waste Sys., Inc., 284 B.R. 53, 70 (D. Del. 2002). Some courts suggested that subordination of the claim of a non-insider creditor, however, requires a showing of "gross misconduct tantamount to fraud, misrepresentation, overreaching or spoliation." Bank of N.Y. v. Epic Resorts-Palm Springs Marquis Villas, LLC (*In re* Epic Cap. Corp.), 307 B.R.

instance, courts have used equitable subordination to subordinate pre-petition tax penalty claims,[168] claims originating from stock redemption,[169] and non-tendering shareholders' claims[170]—without any wrongful conduct on the subordinated creditor's part. In courts that required misconduct, misconduct was often interpreted broadly to include predatory or reckless lending[171] as well as terminating a debtor's post-petition credit line.[172]

In the context of sexual misconduct, courts could potentially use equitable subordination to subordinate creditors involved in the misconduct (e.g., the abuser, corporate managers, and other co-defendants) to the victims. Such subordination, for example, may prevent a situation in which managers are being reimbursed for their defense expenses before victims are compensated or fully recover.[173] Although a more general application of equitable subordination may be theoretically possible, such an approach could grant judges unlimited power to reorder priorities, thereby jeopardizing legal certainty and predictability, as well as undermining good faith lender reliance.[174] Consequently, equitable subordination cannot be regarded as a perfect substitute for legislative action. While a comprehensive

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767, 772 (D. Del. 2004).

[168] *In re* Virtual Network Servs. Corp., 98 B.R. 343, 353 (N.D. Ill. 1989), *aff'd*, 902 F.2d 1246 (7th Cir.1990) (finding that permitting the government to recover a penalty before other creditors are paid would be unfair). Schwarcz, *supra* note 166, at 46, 38-42.

[169] *In re* SPM Mfg. Corp., 163 B.R. 411, 416 (Bankr. D. Mass 1994). Schwarcz, *supra* note 166, at 38-42.

[170] Envirodyne Indus. v. Am. Express (*In re* Envirodyne Indus.), 176 B.R. 825 835 (Bankr. N.D. Ill. 1995), *aff'd*, 79 F.3d 579 (7th Cir. 1996). Schwarcz, *supra* note 166, at 38-42.

[171] Credit Suisse v. Off. Comm. of Unsecured Creditors (*In re* Yellowstone Mountain Club, LLC), No. 08-61570, 2009 WL 3094930, at *8 (Bankr. D. Mont. May 12, 2009), *vacated as resolved by plan confirmation*, *In re* Yellowstone Mountain Club, LLC, No. 08-61570, 2009 WL 10624435 (Bankr. D. Mont. June 29, 2009). Schwarcz, *supra* note 166, at 38-42.

[172] First Bank of Whiting v. Kham & Nate's Shoes, No. 2, Inc.,1, 104 B.R. 909, 912 (N.D. III. 1989), *vacated*, 908 F.2d 1351 (7th Cir. 1990). Schwarcz, *supra* note 166, at 38-42.

[173] Which is exactly what happened in the Weinstein case, where the victims received only $17 million in total, while the company's directors and officers received $9.7 million to cover their defense costs. *See supra* note 4.

[174] Schwarcz, *supra* note 166, at 42-44, 46-51.

examination of equitable subordination's effectiveness in addressing mass tort issues is warranted, it falls outside the scope of this paper.

B. Limiting Non-Consensual Third-Party Releases

As discussed above, victims of sexual misconduct (including those who objected to the plan and who may not have had the right to vote on it) are sometimes forced to release non-bankrupt third parties through the operation of the bankruptcy plan. These third parties often include corporate affiliates, managers, and insurance companies.

As a legal matter, third-party releases obtained without unanimous consent in a bankruptcy proceeding ("non-consensual releases") are highly controversial. There is a split among federal courts regarding whether bankruptcy courts even have the power to approve such waivers, and, if so, under what conditions.[175] Some courts have strictly prohibited the use of non-consensual third-party releases in bankruptcy in all cases (except asbestos cases, where the law explicitly allows it).[176] Other courts, however, have permitted it.[177] There is proposed legislation[178] that would prohibit bankruptcy courts from providing third-party releases and limit their discretion to extend the automatic stay to protect third parties. In the meantime, however, the issue remains unsettled.

Scholars also have different opinions on non-consensual releases in bankruptcy. Early scholars questioned their legitimacy,[179] while more recent

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[175] The Fifth, Ninth and Tenth Circuits prohibit such releases, while the Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits permit them.

[176] *See supra* note 60.

[177] SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (*In re* Seaside Eng'g & Surveying, Inc.), 780 F.3d 1070, 1076, 1081 (11th Cir. 2015); Class Five Nev. Claimants v. Dow Corning Corp. (*In re* Dow Corning Corp.), 280 F.3d 648, 656 (6th Cir. 2002); Gillman v. Cont'l Airlines (*In re* Cont'l Airlines), 203 F.3d 203, 211 (3d Cir. 2000); *In re* Specialty Equip. Cos., 3 F.3d 1043, 1047 (7th Cir. 1993) (consensual releases only); Menard-Sanford v. Mabey (*In re* A.H. Robins Co.), 880 F.2d 694, 702 (4th Cir. 1989); MacArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89, 93 (2d Cir. 1988).

[178] Nondebtor Release Prohibition Act of 2021, H.R.4777, 117th Congress (2021). Additionally, it stops debtors from using "divisional mergers" and other strategies to isolate their tort liabilities before filing by allowing courts to dismiss such cases.

[179] Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 961 (1997).

ones have accepted the validity of such releases and instead focus on their specific terms.[180] Even these recent scholars, however, agree non-consensual releases should be granted only rarely and some have advocated for heightened disclosure requirements.[181] The proposals in this section are premised on the view that courts should closely scrutinize such releases and grant them only rarely, as they harm the victims' due process rights by, among other things, denying them their day in court. Thus, the analysis below will focus on the specific conditions under which such releases should be allowed.

Courts that have allowed third-party releases in bankruptcy generally refer to the following five factors to determine whether a release will be approved: (a) the identity of interest between the debtor and the released parties; (b) whether the released parties make a substantial contribution to the settlement funds; (c) whether the release is essential for the reorganization; (d) whether the affected parties whose rights are waived have overwhelmingly consented; and (e) whether the plan pays substantially all of the affected parties' claims.[182] In mass tort cases, courts have also looked at whether there is an opt-out option for dissenters.[183] While this multi-factor test provides some guidance to courts, it seems relatively vague and leads to inconsistent results.[184]

To avoid this problem, this Article suggests bankruptcy courts should allow third-party releases in sexual misconduct cases in only two scenarios: (a) when there is unanimous consent; or (b) when the third party

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[180] Simon, *supra* note 24, at 1205-1215.

[181] *Id.* This solution might seem appealing, especially as it could deter debtors from transferring assets to affiliates in the pre-bankruptcy period. Nevertheless, imposing mandatory disclosure requirements may deter many parties from participating in bankruptcy settlements. Additionally, it could make negotiations more lengthy and costly.

[182] *In re* Cont'l Airlines, 203 F.3d 203, 213-215 (3d Cir. 2000); *In re* Master Mortgage Investment Fund, Inc., 168 B.R. 930, 935-37 (Bankr. W.D. Mo. 1994).

[183] Some settlements required victims to opt out early if they want to continue litigating in court and others required victims to recover from the fund before they move on to litigate their claims in the court system. For example, in John-Manville's case, the victims could return to the tort system to litigate their claims 120 days after they filed a claim against the trust. *See In re* Joint E. & S. Dist. Asbestos Litig., 129 B.R. 710, 754-55 (E.D.N.Y. 1991), *vacated*, 982 F.2d 721 (2d Cir. 1992), *opinion modified*, 993 F.2d 7 (2d Cir. 1993).

[184] *See* Simon, *supra* note 51.

is not directly involved in the sexual misconduct (i.e., not the abuser) and agrees to make an ongoing contribution to the settlement fund until the victims claims are fully satisfied. The contribution can be non-financial when it comes to managers who are vital to the post-bankruptcy future of the business.

What exactly would constitute a "direct involvement" that should preclude managers from being released is an open question. It should at least mirror the law in personal bankruptcy—that is, any individual who engages in "willful and malicious" conduct should not be released from liability. However, given that some courts interpreted the "willful" prong of this definition to include only "intentional" behavior, perhaps a more expansive definition should be used (as intent is hard to prove and often not required in cases of sexual harassment).[185] For example, precluding release from individuals who engage in "known and malicious" conduct.

Among other things, the proposed solution is designed to prevent the legal arbitrage that might otherwise occur, whereby abusers cannot achieve discharge from sexual misconduct claims in personal bankruptcy (given the "willful and malicious" exception to discharge) but can achieve it through a corporate filing—as Harvey Weinstein did in Weinstein Co.'s liquidation plan.[186] Additionally, it would deter managers from pursuing wrongful acts and make them accountable for the consequences of their actions.

Requiring released third parties to make ongoing future payments to compensate victims would mirror the existing policy of requiring debtors to make future payments in a situation where a fund proves insufficient. In fact, the original asbestos settlements included a mechanism by which the debtor was required to fund the trust with future profits, bonds, and equity holdings. This mechanism was later adopted in the Bankruptcy Code as the

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[185] *See supra* note 9.

[186] David v. Weinstein Co. Holdings, LLC, No. CV 21-171 (MN), 2021 WL 979603 (D. Del. Mar. 16, 2021), *appeal dismissed sub nom. In re* Weinstein Co. Holdings LLC, No. 21-1598, 2021 WL 4429044 (3d Cir. Apr. 27, 2021); Silvia Stockman, *Nonconsensual Third-Party Releases Not Limited to Plans of Reorganization*, HERRICK RESTRUCTURING REVIEW (March 29, 2021), https://www.herrickrestructuringreview.com/2021/03/nonconsensual-third-party-releases-not-limited-to-plans-of-reorganization/.

"gold standard" for asbestos settlements.[187] Additionally, the Archbishop of Portland's plan, which was the first to resolve sexual misconduct liability in bankruptcy, includes a replenishment requirement if the fund falls below a certain amount during the distribution process.[188]

There are three potential benefits to this solution. First, disallowing solvent third parties (like managers and insurers) to escape liability in bankruptcy could improve deterrence and monitoring incentives, as described in the next section. For example, insurance companies could revise their underwriting process to include due diligence on sexual misconduct-related issues and refuse to cover managers that engage in sexual misconduct. Second, the estimation of victims' claims may become less crucial as there would be no cap, making plan negotiations potentially less intense and faster and victims could theoretically benefit from faster distribution. When there is no cap on the victims' compensation, funds can be distributed on an ongoing basis without resolving all claims first to accommodate a pro rata distribution. And third, a future deposits requirement for solvent parties would make it more difficult for the debtor to use intercompany transfers and third party releases to shield assets from the victims.

Theoretically, bankruptcy law is designed to prevent transfers that deny creditors the full benefit of a debtor's property. Indeed, the Bankruptcy

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[187] The reorganized Manville had to pay up to 20% of the company's post-confirmation profits if the trust funds were insufficient. See *In re* Johns-Manville Corp., 68 B.R. 618, 621 (Bankr. S.D.N.Y. 1986), *aff'd*, 843 F.2d 636 (2d Cir. 1988). One of the requirements for an asbestos fund under the Bankruptcy Code is "to be funded in whole or in part by the securities of 1 or more debtors involved in such plan and by the obligation of such debtor or debtors to make future payments, including dividends." *See* 11 U.S.C. § 524(g)(2)(B)(i)(II)-(III).

[188] "As Allowed Claims are paid and the amount of the Future Claims Deposit is reduced below one million dollars ($1,000,000), the Reorganized Debtor will, from time to time, replenish the Future Claims Deposit to the lesser of (a) two million dollars ($2,000,000), or (b) the outstanding balance of the Future Claims Note." *See* Third Amended And Restated Joint Plan of Reorganization, at 33, *In re* Roman Catholic Archbishop of Portland in Oregon, 339 B.R. 215 (Bankr. D. Or., Apr. 9, 2007), ECF No. 5005. A recent paper describes a more complex mechanism of future deposits that involves multiple parties in Takata's bankruptcy. *See* Simon, *supra* note 24, at 1176-1183. *See also* Fifth Amended Joint Chapter 11 Plan of Reorganization of TK Holdings Inc. and Its Affiliated Debtors at 8, 19, 21, *In re* TK Holdings, Inc., No. 17-11375 (Bankr. D. Del. Feb. 20, 2018) ECF No. 2116.

Code already includes some tools, such as the provisions regarding fraudulent and preferential transfers, that limit the debtor's ability to transfer assets free and clear of the bankruptcy court's reach. But the existing provisions do not provide a complete solution to prevent debtors from separating their assets and tort liabilities. [189] For example, in Johnson & Johnson's case, the parent company pursued a divisive merger—before bankruptcy—to transfer assets and liabilities in two new entities. Then, only the "liabilities entity" filed for bankruptcy and the other entity asked for third-party releases in an effort to shield its assets.[190] Preventing solvent entities from capping their liabilities using third-party releases would make this tactic less efficient.

Even when there is no financial contribution (or a limited one), a third-party release could still help the reorganization—but only if the release is essential to the business. This would prevent the result in Weinstein Co.'s liquidation plan, where managers were released even though there were no prospects of continuing the business activity.[191]

Some may argue that third-party releases are necessary in mass tort bankruptcies since absent such releases, third parties would not be willing to contribute to the settlement fund, potentially leaving victims with insufficient funds from which to recover. While this may be true, it is also true that under the current legal regime these solvent third parties are probably contributing too little. Indeed, victims' compensation in sexual misconduct-driven bankruptcies is often extremely low compared to that awarded outside of bankruptcy (i.e., in jury trials).[192]

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[189] Corporations can isolate their tort liability in a separate undercapitalized entity before filing for bankruptcy; thereby leaving little or no assets available to compensate victims (other than insurance, perhaps). *See* Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147, 147 (1998) (explaining how corporations create judgment-proof entities to isolate tort liabilities). *See also* Parikh, *supra* note 55.

[190] *See* supra notes 55-56.

[191] The company's assets were sold early in the process. *See* David v. Weinstein Co. Holdings, LLC, No. CV 21-171 (MN), 2021 WL 979603 (D. Del. Mar. 16, 2021), *appeal dismissed sub nom.* In re Weinstein Co. Holdings LLC, No. 21-1598, 2021 WL 4429044 (3d Cir. Apr. 27, 2021); Stockman, *supra* note 186.

[192] *See* Simon, *supra* note 51 (providing a comparison table of different mass tort bankruptcies and referring to whether the dollar value awarded in those cases reflect values awarded outside of bankruptcy). This does not mean courts are not concerned with whether victims are fully compensated. However, they often use historical settlements to estimate victims' claims rather than jury verdicts to estimate their claims. This estimation

It is also possible that managerial releases often increase the bankruptcy estate given the structure of managerial insurance and indemnities. For example, a manager who is entitled to indemnification from the corporation (e.g., for their legal expenses) may be willing to waive it if they are fully discharged, thereby reducing the debtor's liabilities. Additionally, if the manager is covered by the same insurance policy as the corporation, a waiver will put a stop to the litigation and thereby stop the erosion of insurance funds, potentially increasing the pool of assets for all creditors.[193]

Nevertheless, forcing victims to waive their rights to sue is not trivial. Other creditor groups, like those with set-off rights against the company or a mechanic's lien, are not required to do so. It is unclear why tort victims should be treated differently, especially in sexual misconduct cases where their due process rights were historically deprived. Moreover, managerial insurance and indemnities may be less of a concern in future cases of sexual misconduct as insurance carriers are changing their underwriting practices and corporations are changing their executive compensation agreements to reduce protections for managers who are involved in sexual misconduct.[194] This trend will likely grow if abusing managers are denied third-party releases in bankruptcy. In fact, the impact on future policies and monitoring could be significant, as discussed in the next section.

C. *Monitoring Effects and Credit Costs*

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results in low monetary awards for victims compared to what they would be entitled to outside of bankruptcy. For example, in the Boy Scouts of America (BSA) case, the court relied on an expert estimation based on BSA's historical settlements with abuse claimants (which probably does not reflect how much they would receive in a jury trial). *See supra* note 91, at 24. The expert found a benchmark value of about $200,000 for once-identified abusers and $975,000 for repeat abusers. By way of comparison, a New York jury recently awarded $25 million in a BSA sexual abuse case. Andrew Denney, *Upstate NY Jury Awards $25M Verdict in Child Victims Act Suit*, N. Y. LAW JOURNAL (March 31, 2022), https://www.law.com/newyorklawjournal/2022/03/31/upstate-ny-jury-awards-25m-verdict-in-child-victims-act-suit/.

193 Menard-Sanford v. Mabey (*In re* A.H. Robins Co.), 880 F.2d 694, 701-02 (4th Cir.1989).

194 Miazad, *supra* note 119, at 1936-1950, 1955-1957.

Economic theory suggests we should allocate risks to those best able to reduce them. In the case of sexual misconduct, secured lenders (mainly banks) are among those in the best position to monitor debtors, given their expertise and economic interest, yet they suffer none of the consequences as current law protects them. And absurdly, it imposes sexual misconduct costs on victims, the most vulnerable of all parties involved and the least able to mitigate the risk. If the system is changed, however, so that lenders are exposed to sexual misconduct costs upon default, they may be more likely to consider them when they price loans, screen borrowers, and set their terms.[195] Managers and insurance companies are also in a better position to mitigate risk. The former are the primary decision-makers who allocate resources to protect against sexual misconduct in an organization; the latter may account for it in their insurance policy terms. My proposal would shift risk to those groups–secured lenders, managers, and insurance companies–as they are in the best position to mitigate it.

It is true, hypothetically speaking, that other unsecured creditors will be negatively impacted by my proposals as they will be further subordinated. Yet there is an upside for them as well: the monitoring by secured lenders should benefit all creditors by reducing overall sexual misconduct risk. Moreover, in making their own credit decisions, some of the creditors (such as bondholders) may catch a free ride on the secured creditor's monitoring efforts,[196] so they may be in a position to mitigate risk as well.

Indeed, empirical evidence suggests that changes in bankruptcy law can trigger lender monitoring and eventually mitigate debtor misbehavior. For example, after certain courts interpreted bankruptcy law to make certain environmental claims nondischargeable,[197] lenders tightened their credit

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[195] Typically, secured lenders screen borrowers before extending credit and monitor them throughout the loan using debt covenants. *See supra* note 20.

[196] Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L. J. 49, 49 (1982) ("An individual seeking to reduce his own monitoring costs may attempt to rely on the efforts of others."); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 670 n. 61 (1992) (articulating the monitoring benefits of secured debt and how other creditors rely on them).

[197] United States v. Apex Oil Co. Inc., 579 F.3d 734, 736-37 (7th Cir. 2009) (holding that the cleanup injunctions are not dischargeable in bankruptcy since they do not qualify as monetary claims, even if the debtor has to pay a third party to comply with them).

terms to polluting firms, and polluting behavior was reduced.[198] There is also evidence that lenders took similar steps to minimize their exposure to environmental risks after several states adopted legislation regarding environmental liens.[199] It is easy to see how a similar result could follow if sexual misconduct-based claims are given preferential treatment in bankruptcy. Although a company does not control sexual misconduct directly the way it does on pollution levels, managers could take significant steps to reduce the risk of sexual misconduct and improve compliance, as described below.

And the incentives for creditors to monitor sexual misconduct compliance are likely to be even stronger than in the environmental arena given that there is only a downside (and no upside) to noncompliance. In other words, there is no counterincentive to monitoring sexual misconduct behavior. Indeed, unlike environmental violations, workplace sexual misconduct would be unlikely to boost profits or benefit the corporation.

Similarly, there should be no difficulty crafting covenants or monitoring tools as sexual misconduct-based claims are generally similar across industries. Unlike in the product liability arena, for example, lenders will not need to develop specific monitoring tools for each company or industry. They can simply require companies to disclose allegations, settlements, and legal disputes regarding sexual misconduct. They can also inquire about the company's anti-harassment policies, as well as related insurance and indemnification arrangements. Additionally, they can request information on managerial employment contracts, gender diversity goals, and compensation clawbacks for managers involved in sexual misconduct. Lenders can use this information to efficiently screen borrowers, evaluate their default risk, and price loans accordingly. They can charge higher interest rates from riskier borrowers (including those that refuse to provide information or sign corresponding representations), demand additional collateral, and perhaps even deny access to credit to some. Finally, lenders can effectively force a managerial turnover, urging companies to remove unethical managers or senior employees involved in sexual misconduct. Indeed, as discussed in Part II, other market participants like shareholders,

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[198] *See* Ohlrogge, *supra* note 19. For a broader analysis of monitoring effects that suggests the prioritization of tort claims *see generally* Sperduto, *supra* note 10, at 187-195.

[199] *See* Nash, *supra* note 19 (describing how lenders began conducting environmental due diligence to estimate their exposure to the possible entry of a super lien).

venture capitalists, and insurance companies have already developed strategies to monitor and price sexual misconduct risks.

Moreover, although the volume of claims might be problematic, the size of individual sexual misconduct-based claims is usually too small to provide a counterincentive to monitoring. In other words, while sexual misconduct-based claims may harm a company's value, they are unlikely to wipe out the lender's security interest. Even high-profile cases involve relatively small dollar amounts compared to the company's secured debt.[200] Thus, secured creditors would have no disincentive to monitor sexual misconduct claims. And even if sexual misconduct claims are too small for lenders to worry about from a collateral priority point of view, the volume of claims and the reputational damage would still be of concern, especially as more states provide more paths to relief for victims.[201]

Indeed, the volume of sexual misconduct-based claims may increase even more if the victims are prioritized in bankruptcy. Victims will have further incentive to pursue their rights in court as their potential recovery in bankruptcy grows. With that in mind, one might suggest that the aggregate claim amount could potentially remove the secured lenders' interest in the collateral. Nevertheless, this risk seems relatively remote given that victims continue to face many obstacles even if they come forward (e.g., a high burden of proof, mandatory arbitration clauses, and

[200] For example, in the Fox Corporation sexual harassment scandal, the abuser, Roger Ailes, settled Gretchen Carlson's lawsuit for $20 million. *See* Michael M. Grynbaum and John Koblin, *Fox Settles With Gretchen Carlson Over Roger Ailes Sex Harassment Claims*, N.Y. TIMES (Sep. 6, 2016), https://tinyurl.com/bdh634ec. While Fox Corporation has no secured debt, its total public debt exceeded $7 billion in 2020. See Fox Corporation, Annual Report (Form 10-K) (Aug. 10, 2020), https://investor.foxcorporation.com/reports/sec-filings; In the Weinstein case, the company's total secured debt was about $375 million, while victims were paid only $17 million in the aggregate in the bankruptcy. See Jonathan Randles, *Bankruptcy Judge Approves $17 Million Fund for Harvey Weinstein Victims*, WSJ PRO BANKRUPTCY (Jan. 25, 2021), https://www.wsj.com/articles/bankruptcy-judge-approves-17-million-fund-for-harvey-weinstein-victims-11611625431 In the USA Gymnastics' bankruptcy plan, abuse victims has received a total of $380 million. See Alex Wolf, *USA Gymnastics' $380 Million Bankruptcy Plan Gets Approval*, BLOOMBERG LAW (Dec. 13, 2021), https://news.bloomberglaw.com/bankruptcy-law/usa-gymnastics-380-million-bankruptcy-plan-set-for-approval.

[201] Until recently many states limited claimants to the $300,000 cap imposed under Title VII. See 42 U.S.C. § 1981a (b)(3). For further discussion on state legislation, *see supra* note 8; *see also* Miazad, *supra* note 119, at 1951-1955.

nondisclosure agreements).[202] Thus, many victims might still be silent about their injuries (as most do even when bankruptcy does not prevent them from getting full damages).[203]

Although prioritizing sexual misconduct-based claims is likely to induce lenders to monitor the risk, it might also increase credit costs. For example, lenders are likely to raise interest rates, demand stricter terms, or require additional collateral to compensate for the additional risk and monitoring costs.[204] Alternatively, they may protect their collateral through complex and often costly financial structures, such as bankruptcy-remote entities, to shield themselves from the risk (e.g., asset securitization).[205] And in a world with little information on the borrowers' quality, lenders will raise the cost of credit for everyone. It is reasonable to assume, however, that with better information, those who behave wrongfully will bear higher credit costs than non-violating corporations.

Lenders are expected to tighten their credit terms for violating corporations. Thus, such an increase in credit costs is not a disadvantage, but rather a tool to reduce bad behavior. Eventually, borrowers will be interested in changing their behavior and signaling they are non-violating firms to have access to cheaper financing. Thus, not only will corporations be incentivized to reduce sexual misconduct risks—they may voluntarily disclose information about it. Although it is unclear whether credit costs will increase in the aggregate or just be distributed differently between

[202] *See supra* Part II.

[203] *See supra* note 107.

[204] Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 136 (1989) (discussing how borrowers enable lenders to have monitoring mechanisms in exchange for a discount in credit costs).

[205] Such entities enable lenders to isolate and protect their collateral from other creditors. For an additional discussion of judgment-proof financial structures see Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147, 147 (1998); Sperduto, *supra* note 10, at 150-151. Shielding assets from sexual misconduct liability using separate entities can be done ex-ante or ex-post. The recent case of the Johnson & Johnson bankruptcy provides an example of how debtors use separate entities to protect their assets from tort victims before filing for bankruptcy. *See also* Parikh, *supra* note 55. It is true that transferring assets to a special purpose entity makes them unavailable to the victims, among others. This way, lenders will not be forced to share their collateral with sexual misconduct victims. Bankruptcy courts, however, have various tools to prevent it by applying theories of fraudulent transfer, substantive consolidation, and successor liability. This discussion, however, is beyond the scope of this Article.

borrowers, the additional risk premium some borrowers would have to pay might well be balanced by a discount to those who signal good behavior.

Ultimately, if secured lenders are exposed to sexual misconduct costs, they are likely to monitor it and price their loans accordingly. Indeed, as cases regarding environmental violations suggest, lenders will offer stricter loan terms to riskier borrowers who are more prone to sexual misconduct. And, unlike bad behavior that potentially benefits the bottom line, lenders are unlikely to be conflicted as to whether to ignore this misbehavior. It is also unlikely to erase the lenders' security interest in the collateral, so lenders would still have some value to preserve. Lender monitoring is likely to trigger a behavioral change as borrowers wish to decrease their credit costs, and such a change would eventually lead borrowers to reduce sexual misconduct costs.

CONCLUSION

Faced with a wave of sexual misconduct litigation following the MeToo Movement, companies have increasingly turned to bankruptcy. Although bankruptcy may be a rational response by companies, and might be the only way to resolve victims' claims collectively in such cases, its coercive nature undermines the rights of victims in a number of important respects. First, a bankruptcy proceeding compromises due process by precluding victims from having their day in court and forcing them into what this Article has characterized as a shadow dispute-resolution system. Second, it limits the asset pool from which victims could otherwise recover. And third, many court-approved bankruptcy plans contain broad releases that shield perpetrators and other potential co-defendants from liability, thus foreclosing the possibility of recovering directly from responsible parties.

Not only does resolving sexual misconduct claims in bankruptcy as it currently operates harm existing victims directly, it has larger social implications in that it perpetuates the problem by insulating secured lenders, managers, and others from future liability thanks to the absolute priority rule and availability of third-party releases. Because those parties generally remain minimally affected even in the most severe cases of abuse, they currently have little incentive to monitor sexual misconduct or invest resources against it.

To address these issues, this Article has advocated two specific policy changes: prioritizing payments to sexual misconduct victims in bankruptcy, so secured lenders would bear at least some of the costs, and limiting the availability of third-party releases. These proposed solutions would shift the costs of sexual misconduct back to those in the best position to mitigate them—managers, secured lenders, and insurers. If these parties are exposed to the costs of sexual misconduct, they would have a greater incentive to monitor compliance, price it into loans and insurance and account for it in covenants and policy terms. These policy changes would also close the current gap between how equity holders and these other groups perceive sexual misconduct risks.

Aside from the immediate applicability to the issue in question, this argument has broader implications for thinking about how bankruptcy law interacts with other aspects of ESG and corporate responsibility. Current bankruptcy priorities reflect a preference for some values at the expense of others. While these rules may seem technical, they affect firms' decision-making and resource allocation. On a nationwide scale, the effect of bankruptcy law can be broad and significant. Reconsidering bankruptcy law to reflect contemporary social values may help make corporations accountable for ESG risks. The ESG revolution needs capital providers to price ESG risk in their financing terms, both in debt and equity markets. Thus, in addition to addressing the problem of sexual misconduct, this Article opens the door to a new way of approaching the intersection of bankruptcy law, corporate responsibility, and ESG risks.