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"Take-Four": Another Court Sacks Third-Party Releases

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There has been much discussion concerning the recent district court appellate decision in *Purdue Pharma*. *See In re Purdue Pharma*, Case No. 21 cv 7532 (Master Case), 2021 WL 5979108 (S.D.N.Y. Dec. 16, 2021). We have been tracking developments relating to *Purdue Pharma* and issues concerning third-party releases: Purdue Pharma: Is Protection of Third Parties by the Automatic Stay an Oxymoron? - Cullen and Dykman LLP (cullenllp.com); Purdue Pharma Restructuring Plan Effectively Blocked...For Now - Cullen and Dykman LLP (cullenllp.com); Will the Third Party Releases be Sacked?: Leave to Appeal Granted in Perdue Case - Cullen and Dykman LLP (cullenllp.com).

Many have questioned what District Court Judge McMahon's decision in *Purdue Pharma* could mean for other bankruptcy cases where third-party releases are necessary to confirm a plan of reorganization. Now, Judge David J. Novak of the Eastern District of Virginia seems to have agreed with Judge McMahon in yet another case. He rejected confirmation of a chapter 11 plan which also included third-party releases. *Patterson v. Mahwan Bergen Retail Grp., Inc.*, Civil No. 3:21cv167 (DJN), 2022 WL 135398 (E.D. Va. Jan. 13, 2022).

In that case, the *Patterson* debtors operated household-name retail stores which struggled through the COVID-19 pandemic amassing $1.6 billion in secured debt and up to $800 million in unsecured claims. The *Patterson* debtors liquidated their businesses before filing a joint chapter 11 plan of reorganization. That plan provided for payments to be disbursed to both secured and unsecured creditors and contained third-party releases to resolve pending lawsuits through the bankruptcy process, including releasing defendants involved in a pending securities fraud class action.[1]

In his 87-page decision reviewing the bankruptcy court's confirmation of the plan, Judge Novak criticized third-party releases as a "device that lends itself to abuse" and emphasized that those at issue in *Patterson* (which are similar to many of the third-party releases that appear in chapter 11 plans of large entities facing insurmountable pre-petition lawsuits) "represent the worst of this all-too-common practice, as they have no bounds." *Patterson*, 2022 WL 135398, at **2, 3.

Judge Novak considered the constitutional implications of such releases, including the core vs. non-core classification set forth in *Stern v. Marshall*. [2] *Id.*, at **11-14. He determined that approval of third-party releases amounted to an adjudication of claims for purposes of *Stern* and found it to be improper for a bankruptcy court to "fully extinguish these claims based solely on their inclusion in the Plan." *Id.*, at *16. He further explained that these third-party claims were not the type that belong to the estate or property of the estate, and even more, lacked any relation to the bankruptcy case. *Id.*, at **16-17. On those bases, Judge Novak held that the bankruptcy court exceeded its authority. *Id.*

The *Patterson* debtors argued that the bankruptcy court had the authority to issue the releases because the ability to opt out of the releases was tantamount to consent. *Id.*, at *17. Judge Novak disagreed with the bankruptcy court's finding that failing to opt out meant consent and held that "implied consent" will not suffice. [3] *Id.*, at **27-28.

Ultimately, Judge Novak vacated the order of the bankruptcy court confirming the plan, voided the third-party releases, severed these "unenforceable releases" from the plan, and remanded the case to the bankruptcy court to proceed with confirmation without the third-party releases.

The future of third-party releases is unclear. District Court decisions questioning it will be appealed. In *Purdue*, the Second Circuit has been asked to expedite consideration of this issue.

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Michael Traison at 312.860.4230, Jocelyn Lupetin at 516.296.9109, and/or Amanda Tersigni at 516.357.3738.

Footnotes:

[1] Judge Novak opined that such "releases close the courthouse doors to an immeasurable number of potential plaintiffs, while protecting corporate insiders who had no role in the reorganization of the company." 2022 WL 135398, at *3.

[2] "*Stern* teaches that courts should focus on the content of the proceeding rather than the category of the proceeding when determining whether a bankruptcy court has acted within its constitutional authority .... Given *Stern*'s focus on the content of the claim over its categorization, courts cannot bypass the constitutional limitations simply by categorizing a widely varying swath of claims as 'core' and then assuming jurisdiction over them." *Id.*, at *14; *see also Stern v. Marshall*, 564 U.S. 462 (2011).

[3] "Failure to opt out, without more, cannot form the basis of consent to the release of a claim. Whether the Court labels these 'nonconsensual' or based on 'implied consent' matters not, because in either case there is a lack of sufficient affirmation of consent." *Id.*, at *31.

Practices

- Bankruptcy and Creditors' Rights

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