Using 3rd-Party Releases In Chapter 11 After Court Pushback

By **Adam Harris, Douglas Mintz and Abbey Walsh** (February 7, 2022, 2:20 PM EST)

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For the second time in four weeks, a U.S. district court questioned the authority of bankruptcy courts to issue nonconsensual third-party releases as part of a plan of reorganization.

On Jan. 13, the U.S. District Court for the Eastern District of Virginia vacated the confirmation order in the Mahwah Bergen Retail Group Inc., formerly known as Ascena Retail Group Inc., Chapter 11 cases on the grounds that the plan contained impermissible nonconsensual third-party releases.[1] The court attributed its ruling, in part, to the fact that the "ubiquity of third-party releases in the Richmond Division demands even greater scrutiny of the propriety of such releases."

The Mahwah Bergen holding follows the December decision of U.S. District Judge Colleen McMahon of the U.S. District Court for the Southern District of New York to reverse confirmation of Purdue Pharma LP's reorganization plan due to its inclusion of nonconsensual third-party releases.[2]

The Purdue Pharma holding found that third-party releases are not permissible under the Bankruptcy Code at all. Mahwah Bergen, in line with applicable precedent from the U.S. Court of Appeals for the Fourth Circuit, does not ban third-party releases, but it imposes stringent limitations on their availability.

The decision holds that third-party releases should be granted only "cautiously and infrequently" and sets up an onerous process for their consideration and approval, which may make many third-party releases practically unavailable, particularly if a plan seeks to release noncore claims.

Summary

Ascena Retail Group was a publicly held retailer of apparel for women and girls that filed for bankruptcy in 2020. Ascena owned brands such as Ann Taylor, Ann Taylor Loft, Lane Bryant and Lou & Grey. The debtors liquidated their assets through a series of sales. The debtors then proposed a plan that provided for the distribution of the remaining cash in the estate and the bankruptcy court confirmed the plan.

The plan included broad third-party releases, covering any type of claim that existed or could have been brought against anyone associated with the debtors as of the effective date of the plan, including a securities fraud class action that was pending against certain prepetition executives of Ascena. The releases bound anyone that did not affirmatively opt out of such releases.

Due to the ability of parties to opt out of the third-party releases, the U.S. Bankruptcy Court

for the Eastern District of Virginia treated the releases as consensual and conducted little to no analysis of:

- Whether it had the constitutional power to grant the releases nonconsensually;
- The nature of the claims being released and whether the claims were core or noncore;
- Whether notice of the right to opt out was actually received by the releasing parties — of which the district court estimated there may have been thousands; and
- Whether the releases were permissible under the standard set forth in Behrmann v. National Heritage Foundation, the Fourth Circuit's binding precedent on third-party releases.[3]

The U.S. trustee appealed the confirmation of the plan and challenged the legality of the plan's third-party releases and exculpation provisions, arguing that the bankruptcy court erred in the manner it conducted the plan's approval process and in approving the releases.

The district court agreed with the U.S. trustee and vacated the confirmation order, remanding the case to a bankruptcy judge outside of the Richmond Division.

The district court ordered the new court to redraft the exculpation provisions and then confirm the plan without the third-party releases, which the district court found to be severable from the remainder of the plan.

The district court's holding creates a two-pronged process for review of third-party releases.

First, the content of any proposed third-party releases must be analyzed to determine whether they have any relationship with or effect on the bankruptcy proceeding. As per the U.S. Supreme Court's 2011 ruling in Stern v. Marshall, if they do not, then they are noncore issues over which the bankruptcy court lacks the constitutional authority to issue a final order, unless the parties involved consent to the jurisdiction of the bankruptcy court over such claims.[4]

The district court held that a party's failure to opt out of a third-party release does not constitute knowing and voluntary consent to the bankruptcy court's jurisdiction over a noncore claim — or to the release of the claim itself.

As such, without consent by action — as opposed to by inaction — a bankruptcy court will not have jurisdiction over noncore claims. Noncore releases approved by the bankruptcy court over which the bankruptcy court does not have jurisdiction will be treated as an advisory opinion subject to de novo review by a district court.

Second, whether a third-party release relates to a core or noncore claim, if the release is nonconsensual, then its permissibility must be determined using the seven-factor analysis set forth in the Fourth Circuit's Behrmann ruling, which requires consideration of factors such as whether there is an identity of interests between the debtor and the released third parties, whether the released third parties are making a substantial contribution to the reorganization, whether the releases are essential to the reorganization, whether the class or classes of claims or interests affected by the releases have voted in favor of the plan and will be substantially paid under the plan.

In applying this test to the facts in Mahwah Bergen, the district court rejected the debtors' argument that constitutional authority to grant the third-party releases stemmed from the inclusion of the releases in the plan.

The district court held that "jurisdiction over confirmation proceedings [does not cure] any jurisdictional defects within those proceedings ... Article III simply does not allow third-party non-debtors to bootstrap any and all of their disputes into a bankruptcy case to obtain relief."[5]

The district court further rejected the bankruptcy court's holding that the releases were consensual because parties had the ability to opt out of them. As such, the district court treated the third-party releases as noncore and nonconsensual, thereby depriving the bankruptcy court of the authority to grant them.

Accordingly, the district court reviewed the confirmation order de novo as a report and recommendation with proposed findings of fact and conclusions of law. In conducting its review, the district court noted that the bankruptcy court did not conduct the Behrmann analysis, but that if it had, there was ample evidence to support the rejection of the third-party releases.

In response to the district court's decision, the debtors announced that, although they disagreed with portions of the district court's opinion, they would seek reconfirmation of the plan without the third-party releases in accordance with the decision. As a result, we do not expect the Mahwah Bergen opinion to be appealed.

Practical Considerations

In recent months, courts have asserted clear pushback on third-party releases, after years of uncertainty. This case represents another potential blow against the long-used bankruptcy tool. At least within the Eastern District of Virginia, there are several takeaways from this decision for debtors, creditors and other estate constituents to note.

While this case does not outright eliminate third-party releases, it imposes a significant barrier to their implementation. The need for a bankruptcy court to determine whether every claim released by third-party releases is a core or noncore claim will require that a debtor specifically identify each claim to be released and provide an explanation of how the claim relates to the bankruptcy case.

And, the bankruptcy court will be required to conduct a full Behrmann analysis for nonconsensual third-party releases — and consent cannot be obtained by a failure to opt out. In the face of these evidentiary burdens, debtors may well be forced to more narrowly tailor any third-party releases contained in a plan.

Narrowly tailored and specifically articulated release provisions will also allow a bankruptcy court to parse the requested releases and approve those that are permissible under Behrmann.

In Mahwah Bergen, the debtors drafted the releases in a vague and general manner such that the bankruptcy court could neither identify nor analyze each of the claims to be released. As a result, the district court summarily rejected all the third-party releases, including any that may have been permissible had they been specifically identified and subjected to the analysis set forth above.

Parties seeking to obtain permissible third-party releases in a plan should ensure that the released claims are specifically identified in the plan so that they can be considered individually, rather than having the bankruptcy court approve or reject the releases as a whole.

Parties seeking an expeditious confirmation process should note that the inclusion of third-party releases of nonconsensual, noncore claims in a plan will mean that the plan cannot be confirmed until after a district court review of the bankruptcy court's order.

This will extend the amount of time needed to confirm a plan. Parties could require that the plan not include any releases of nonconsensual, noncore claims to avoid the risk of undue delay in the confirmation process. However, this could reduce the post-confirmation protection for those parties.

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[1] Patterson v. Mahwah Bergen Retail Grp., Inc., No. 3:21cv167(DJN), 2022 U.S. Dist. LEXIS 7431 (E.D. Va. Jan. 13, 2022).

[2] In re Purdue Pharma LP, Case No. 7:21-cv-08566 (S.D.N.Y. Dec. 16, 2021). Our alert on that decision can be found here.

[3] Behrmann v. National Heritage Foundation, 663 F.3d 704, 712 (4th Cir. 2011).

[4] Stern v. Marshall, 546 U.S. 462 (2011).

[5] Mahwah Bergen, supra, at 53.