Severing Third-Party Releases: A Path Forward After Patterson

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In an opinion issued on January 13, 2022, Judge David Novak of the United States District Court for the Eastern District of Virginia struck down non-consensual third-party releases [2] from a plan confirmed by the bankruptcy court. [3] While appellate courts commonly consider the wholesale invalidation of releases and subsequent remand of confirmed plans of reorganization or liquidation ("plans"), [4] Judge Novak took the uncommon step in *Patterson* to sever these releases from the confirmed plan before remanding it on other grounds. After finding the releases lacked sufficient factual and legal support, Judge Novak concluded they should not only be invalidated but should be altogether severed from the plan.

Severance refers to excising releases from a plan without affecting any other plan provisions and, barring any other issues, allowing the court to otherwise affirm the plan's confirmation.

Courts only consider severance after they have ruled a release is invalid; in those instances, severance might affect only a subset of those invalid releases. To borrow from a popular geometry expression, in the same manner that all squares are rectangles but not all rectangles are squares, all severed releases are invalid but not all invalid releases should be severed.

For invalid releases that strike at the heart of the plan, appellate courts will simply remand the plan back to the bankruptcy court for reconsideration. Severance, therefore, is used when a release is merely an add-on, "merit badge" or "gold star" [5] while invalidation and remand is more appropriate when the release was essential to negotiating the plan.

The Patterson decision raises an unfamiliar quandary for practitioners: what can reorganization attorneys do to either seek or prevent severance of releases on appeal? [6]

I. Severability Generally

The severability doctrine is rarely discussed independently from release invalidation or equitable mootness as it incorporates elements of each topic, but the severability analysis, as *Patterson* demonstrates, is analytically distinct from both topics. This article provides a brief introduction of each before diving into the issue of severability.

A. Non-Consensual Third-Party Releases

An increasingly controversial topic, non-consensual third-party releases are used in plans to provide relief to non-debtor parties against one or more claimants who may have claims against both the debtor and certain non-debtor parties. While releases are intended to "be granted cautiously and infrequently," [7] their use has grown more prevalent. [8]

In ruling on the validity of releases in applicable circuits, [9] courts often consider:

(a) the third party's contribution of assets to the reorganization;

(b) whether the enjoined claims would indirectly impact the reorganization;

(c) whether the enjoined claims were channeled to a settlement fund rather than extinguished;

(d) whether the plan otherwise provided for the full payment of the enjoined claims; and

(e) whether the impacted class has overwhelmingly voted in favor of the plan. [10]

B. Equitable Mootness

Separately, equitable mootness is "a prudential doctrine that is invoked to avoid disturbing a reorganization plan once implemented." [11] "Within the context of a bankruptcy proceeding, a court may dismiss an appeal as equitably moot 'when it becomes impractical and imprudent to upset the plan of reorganization at this late date.'" [12] As a practical consideration rather than a constitutional limitation, courts have significant discretion in this matter. [13]

To decide whether an appeal is equitably moot, courts often analyze the following factors:

(a) whether the plan has been substantially consummated; [14]

(b) whether the appellant sought and obtained a stay;

(c) the extent to which the requested relief would affect the plan's success;

(d) the extent to which the requested relief would affect the interests of third parties; and

(e) the public policy of affording finality to bankruptcy court judgments. [15]

If a court finds the appeal equitably moot, it may decline to sever a release from the plan even if it holds that the bankruptcy court improperly granted the release.

II. Severing or Maintaining Releases

While severance is distinct from release validity and equitable mootness, it is interrelated to those doctrines because a release must be invalid and the appeal must not be equitably moot. Appellate courts generally analyze severability in the following order. First, the court evaluates the validity of the release. Second, if the court finds the release is invalid, it looks to whether the release is severable from the remainder of the plan. Third, the court determines whether the appeal is equitably moot. If the release's absence would not unravel the plan, the release is severed and the remainder of the confirmed plan may be affirmed. [16]

A. Severing Releases

Counsel seeking to sever a release from a plan must first keep in mind that any severance will also result in the surrender of any contribution from the released party, as any party offering such contribution will surely withdraw their offer upon the release's invalidation. [17]

Next, counsel should not be dissuaded by a plan's non-severability provision as this, standing alone, cannot support a finding of non-severability or equitable mootness. [18] Furthermore, to support a finding that releases should be severed from the plan, counsel should emphasize to the court:

(a) the released parties contributed few, if any, assets to the plan;

(b) the plan can seamlessly continue without the releases;

(c) the releases did not induce the releasing parties to settle;

(d) the releasing parties did not have an opportunity to negotiate the releases;

(e) the released parties sought a stay or expedited appeal of the confirmed plan; and/or

(f) only the released and releasing parties would be affected by severance.

Likely the most important factor for counsel to demonstrate is that a released party contributed little to no assets to a plan. As the existence and value of a contribution weigh heavily on the inherent validity of the release, showing that a party has not given anything to the releasing parties will help prove the release was always improper. Additionally, without contributions to return to the released party, the releases can likely be severed without affecting the remainder of the plan or third parties and will not impact public reliance on the finality of bankruptcy court judgments.

In *Patterson*, the released parties made no financial contribution to the reorganization, **[19]** the releasing parties did not have an opportunity to negotiate the releases and the debtor's counsel put forth no evidence that the releases were required for the debtor's reorganization to succeed or that they induced the releasing parties to settle. Simply put, the releases in *Patterson* were merely add-ons to a viable plan and their severance could not impact the debtor's reorganization. The appeal, therefore, could not be equitably moot because the releases did not send the parties back to the negotiating table or otherwise disrupt the plan.

In contrast, the *In re Texaco* court noted several facts demonstrating that severing the releases would "strike at the very heart of the compromise" and "undermine the entire reorganization." **[20]** *In Texaco*, the debtor distributed $2.3 billion to creditors, reinstated $7 billion in long-term debt and guaranty obligations, and satisfied a $3 billion settlement. **[21]** Additionally, the appellants never sought a stay pending appeal and likely thousands of the debtor's shares had been traded since the effective date of the plan. **[22]** These actions were all taken in reliance on the release approval, and to undo them would be difficult if not impossible. The appeal, therefore, was moot and the releases could not be severed from the plan.

B. Maintaining Releases

Counsel seeking to maintain a release undoubtedly have more avenues to prevent severance. Counsel can prove the validity of the release, argue that severance is improper, or show that the appeal is equitably moot. Nevertheless, it is incumbent on counsel seeking to prevent severance to put forth evidence in the bankruptcy court to succeed on these arguments. Counsel should then argue to the district court or Bankruptcy Appellate Panel that the releases are integral to the plan, were properly granted and would, if removed, pull a string causing the entire reorganization to unravel.

To that end, counsel should use the inverse of many arguments for severance, including demonstrating that:

(a) any and all contributions from the released parties have value to pay the releasing parties' claims;

(b) severance would impact the entire plan;

(c) severance would significantly impact other third parties;

(d) appellants did not seek a stay or expedited appeal after confirmation;

(e) the plan has been substantially consummated;

(f) affected classes have overwhelmingly voted to accept the plan; and/or

(g) a series of complex or particularly numerous transactions have taken place since confirmation. **[23]**

Those seeking to maintain releases should be aware that opposing counsel may allege the bankruptcy process was manipulated to render any appeal equitably moot. **[24]** This may represent one of the many crossroads in which counsel must balance the need to practice in good faith while also providing zealous representation of the client. Accordingly, counsel must be deliberate in presenting legitimate reasons to the court that the releases were integral to the reorganization and that to sever them would compromise the entire plan. As in *In re Delta Air Lines*, counsel should present good faith reasons to structure the timing and provisions of the reorganization to avoid the court finding that equitable mootness resulted from bad faith positioning.

Whether seeking to sever or maintain releases in a chapter 11 confirmation appeal, counsel can incorporate the lessons of *Patterson* to achieve their client's desired outcome.

[1] Jon Schlotterback is the term law clerk for the Hon. Paul M. Black, Chief Judge of the United States Bankruptcy Court for the Western District of Virginia. The views expressed herein are those of the author and not of the United States Bankruptcy Court for the Western District of Virginia.

[2] All mentions of "releases" and "third-party releases" in this article refer to non-consensual third-party releases.

[3] *Patterson v.Mahwah Bergen Retail Grp.,Inc.* , No. 3:21cv167, 2022 WL 135398, at*43 (E.D. Va. Jan. 13, 2022). Although Judge Novak also determined the releases were severable under the plan language itself, this article focuses on the substantive issues surrounding severability generally.

[4] *See, e.g., In re Purdue Pharma,L.P.* , No. 21cv7532, 2021 WL 5979108 (S.D.N.Y. Dec. 16, 2021). Third-party releases have recently drawn increased scrutiny from both courts and Congress. In November 2021, the House Judiciary Committee favorably reported the Nondebtor Release Prohibition Act of 2021, H.R. 4777, by a vote of 23-17. At the time of this writing, the House has not voted on the bill, and the Senate has not voted on its counterpart, S. 2497.

[5] *In reAegean Marine Petroleum Network,Inc.* , 599 B.R. 717, 726–27 (Bankr.S.D.N.Y. 2019).

[6] Because severability of non-consensual third-party releases on appeal involves the prior approval of such releases, this article will necessarily be focused on circuits permitting releases. Currently, only the Fifth, Ninth and Tenth Circuits expressly prohibit the use of non-consensual third-party releases.

[7] *In re Behrmann v.Nat'l Heritage Found.,Inc.* , 663 F.3d 704, 712 (4th Cir. 2011).

[8] *Patterson* , 2022 WL 135398, at *43 n.16 (directing the Chief Judge of the Bankruptcy Court for the Eastern District of Virginia to reassign the case outside of the Richmond division "due to the practice of issuing third-party releases in the Richmond Division in contravention of the Fourth Circuit's admonitions in *Behrmann* ").

[9] *See supra* note 6.

[10] *See generally Behrmann*, 663 F.3d 704 (adopting factors from *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002)); *Deutsche Bank AG v. Metromedia Fiber Network, Inc.* (*In re Metromedia Fiber Network, Inc.*), 416 F.3d 136 (2d Cir. 2005).

[11] *Metromedia*, 416 F.3d at 144.

[12] *Retired Pilots Ass'n of US Airways, Inc. v. US Airways Grp., Inc.* (*In re US Airways Grp., Inc.*), 369 F.3d 806, 809 (4th Cir. 2004) (citing *Mac Panel Co. v. Virginia Panel Corp.*, 283 F.3d 622, 625 (4th Cir. 2002)).

[13] *See Patterson*, 2022 WL 135398, at *38 (citing *Behrmann*, 663 F.3d at 714).

[14] *See* 11 U.S.C. § 1101(2) (defining "substantial consummation").

[15] *See generally Behrmann*, 663 F.3d 704; *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203 (3d Cir. 2000).

[16] *See Patterson*, 2022 WL 135398, at *33 ("Consequently, the Third-Party Releases must be voided and rendered unenforceable. The Court will now turn to the impact on the Plan of the voiding of the Third-Party Releases and whether the voided releases may be severed from the Plan.").

[17] *See Trans World Airlines, Inc. v. Texaco, Inc. (In re Texaco Inc.)*, 92 B.R. 38, 51 (S.D.N.Y. 1988).

[18] *See Patterson*, 2022 WL 135398, at *35 (citing *In re Charter Commc'ns, Inc.*, 691 F.3d 476, 485 (2d Cir. 2012)).

[19] *Id.* at *32.

[20] *Texaco,* 92 B.R. at 50.

[21] *Id.* at 46.

[22] *Id.*

[23] For publicly traded companies, demonstrating the number of shares traded since confirmation and arguing that these investors have relied on the finality of the bankruptcy court's ruling may serve counsel well.

[24] See Kenton Cnty. Bondholders Comm. v. Delta Air Lines, Inc. (In re Delta Air Lines, Inc.), 374 B.R. 516, 525 (S.D.N.Y. 2007).