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Does Stern v. Marshall Prohibit Non-Consensual Third Party Releases of Non-Bankruptcy Claims in Plans of Reorganization?

Client Advisories

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November 15, 2017 - An increasingly common aspect of Chapter 11 plans is non-consensual third party releases, which are often a vital tool required to obtain global peace among competing constituencies whose support is often needed for a debtor to obtain confirmation of a Chapter 11 plan. However, the parameters of a bankruptcy court's Constitutional authority to approve such non-consensual releases has, to date, been unclear. Clarity, however, has been provided by the recent decision by the United States Bankruptcy Court for the District of Delaware *In re Millennium Lab Holdings II, LLC*,[1] where the Court concluded that it had constitutional authority to confirm a restructuring plan that released third parties from liability to certain creditors, even though those creditors had not consented to the releases. The Bankruptcy Court's ruling will be of interest to potential debtors and other potential releasees who may seek to employ or benefit from non-consensual third party releases as well as to lenders and other creditors who may find themselves bound by non-consensual release contained in a Chapter 11 plan.

Debtor Millennium Lab Holdings II, LLC and certain affiliates commenced their Chapter 11 Cases in 2015 following a settlement with the United States federal government and certain states relating to alleged violations of the Anti-Kickback Statute, the False Claims Act, and the Stark Act (which relates to physician referrals for Medicare and Medicaid services). In December 2015, the Bankruptcy Court confirmed a Plan of Reorganization which contained settlements with certain equity holders (the "Non-Debtor Equity Holders"), who contributed $325 million to the estate and received third party releases. Immediately prior to the confirmation hearing, certain dissenting creditors (the "Opt-Out Lenders") commenced a lawsuit asserting common law fraud and RICO claims against the Non-Debtor Equity Holders. The Opt-Out Lenders also filed an objection to the non-consensual third party releases in the proposed Plan. The Opt-Out Lenders argued that the Plan's non-consensual releases went beyond the scope of the Bankruptcy Court's authority.[2]

The Bankruptcy Court overruled the Opt-Out Lenders' arguments and confirmed the Plan in a bench ruling on December 11, 2015. Thereafter, in a January 12, 2016 written opinion, the Bankruptcy Court certified an appeal directly to the Third Circuit on the following question: "Do Bankruptcy Courts have the authority to release a non-debtor's direct claims against other non-debtors for fraud and other willful misconduct without the consent of the releasing non-debtor?"[3] The Third Circuit denied the petition for permission to appeal, and the appeal was docketed with the Delaware District Court.[4]

In the District Court, the Opt-Out Lenders principally pursued an argument based on the Supreme Court's decision in *Stern v. Marshall*.[5] According to the Opt-Out Lenders, the Bankruptcy Court lacked constitutional authority to enter a final order releasing direct, non-bankruptcy claims against non-debtors. The District Court remanded the case to the Bankruptcy Court to decide that issue. In doing so, however, the District Court provided its own view of the merits and voiced agreement with the Opt-Out Lenders' *Stern* argument. The District Court stated that it was "persuaded by [the Opt-Out Lenders'] argument that the Plan's release, which permanently extinguished [the Opt-Out Lenders'] claims, is tantamount to resolution of those claims on the merits" and that it believed that "[i]f Article III prevents the Bankruptcy Court from entering a final order disposing of a non-bankruptcy claim against a nondebtor outside of the proof of claim process, it follows that this prohibition should be applied regardless of the proceeding (*i.e.,* adversary proceeding, contested matter, plan confirmation)."[6]

On remand, the Bankruptcy Court concluded that it did have the authority to grant the release of the Opt-Out Lenders' claims via confirmation of the Plan. In its analysis, the Bankruptcy Court laid out a continuum of interpretations of *Stern*. On one end of the continuum, the narrow interpretation reads *Stern* only as prohibiting a bankruptcy court from entering a "final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim."[7] Next, a relatively broad interpretation of *Stern* would prohibit a bankruptcy court from entering a final judgment on "all state law claims, all common law causes of action or all causes of action under state law."[8] Finally, the broadest view of *Stern* holds "that bankruptcy judges should examine their ability to enter final orders in all enumerated or unenumerated core proceedings."[9]

The Bankruptcy Court held that it possessed constitutional authority to confirm the Plan under both the narrow and broad views of *Stern* because confirmation of a plan is neither a state law counterclaim nor a state law claim of any kind.[10] Furthermore, even under the broadest interpretation of *Stern*, the Bankruptcy Court maintained constitutional authority to confirm the plan because (1) confirmation is at the core of a bankruptcy judge's power, (2) confirmation applies a "federal standard," and (3) the confirmation of the Plan met the Third Circuit's "standard of fairness and necessity to the reorganization."[11]

The Bankruptcy Court also rejected the Opt-Out Lenders' interpretation of *Stern*. The Opt-Out Lenders argued that confirmation would violate *Stern*'s statement that "the question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process." The Bankruptcy Court questioned whether that disjunctive test was the appropriate measure of the constitutionality of a restructuring plan, and further held that confirmation of the Plan was constitutional because the Plan stemmed from the Chapter 11 Cases and "the releases were integral to confirmation and thus integral to the restructuring of the debtor-creditor relationship."[12]

The Bankruptcy Court also dismissed the Opt-Out Lenders' functionalist argument that, because confirmation had the effect of extinguishing their RICO lawsuit, the confirmation constituted an "impermissible adjudication of the litigation being released." Relying on pre-*Stern* Third Circuit precedent,[13] the Bankruptcy Court concluded that a confirmation order can permissibly impact and even extinguish lawsuits in non-core proceedings. The Bankruptcy Court went on to note that, if taken to its logical conclusion, the Opt-Out Lenders' interpretation of *Stern* would apply to an eye-popping range of core bankruptcy matters, including substantive consolidation, recharacterization and subordination of debts, and practically every section 363 sale.

In short, the Bankruptcy Court held that, regardless of *Stern*, bankruptcy courts have constitutional authority to confirm restructuring plans that include non-consensual releases of claims against third parties. Furthermore, *Stern* does not extend to core proceedings concerning federal law that implicate state law rights.

Although *Stern* is now nearly eight years old, its meaning remains a source of controversy and litigation in bankruptcy courts. The range of possible interpretations of *Stern* described by the Bankruptcy Court—as well as the differing view offered by the District Court—show that courts have not yet settled how *Stern* affects even routine and fundamental bankruptcy court business. Perhaps not surprisingly in light of the long history of the dispute and the District Court's decision, the Opt-Out Lenders have filed a notice of appeal of the Bankruptcy Court's decision.

* James Henseler assisted with the preparation of this post.

Footnotes

[1]. *In re Millennium Lab Holdings II, LLC*, No. 15-12284, 2017 WL 4417562 (Bankr. D. Del. October 3, 2017).

[2]. According to the Bankruptcy Court, the Opt-Out Lenders raised four objections to the releases: (i) the court lacked subject matter jurisdiction to grant nonconsensual third party releases, (ii) the releases were impermissible, (iii) the Plan impermissibly did not allow parties to opt-out of the releases, and (iv) the releases were inconsistent with the Third Circuit's holding in *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203 (3d Cir. 2000).

[3]. *In re Millennium Lab Holdings II, LLC*, 543 B.R. 703, 711 (Bankr. D. Del. 2016).

[4]. *In re Millennium Lab Holdings II, LLC*, 242 F. Supp. 3d 322, 335 (D. Del. 2017).

[5]. *Stern v. Marshall*, 564 U.S. 462 (2011).

[6]. *In re Millennium Lab Holdings II, LLC*, 242 F. Supp. 3d 322, 339 (D. Del. 2017).

[7]. 2017 WL 4417562, at *12 (quoting Stern, 564 U.S. at 503).

[8]. *Id.*

[9]. *Id.* at *13 (emphasis removed).

[10]. *Id.* at *14 (internal quotation marks omitted).

[11]. *Id.* at *15 (citing *In re Cont'l Airlines*, 203 F.3d 203, 214 (3d Cir. 2000)).

[12]. 2017 WL 4417562, at *18.

[13]. *CoreStates Bank, N.A. v. Huls Am., Inc.*, 176 F.3d 187 (3d Cir. 1999).

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