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Business Reorganization

Third Circuit Holds that Bankruptcy Courts Have Constitutional Power to Approve Compelled Third-Party Releases Only When Releases Are "Integral to the Restructuring"

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In an opinion issued in December 2019, the Third Circuit found that the bankruptcy court below had constitutional authority to confirm a plan containing compelled third-party releases because — on the "specific, exceptional facts of [the *Millennium Lab*] case" — those releases were "integral to the restructuring of the debtor/creditor relationship." [1] But given that a finding that the third-party releases are "*necessary*" to the reorganization is already a factor for their approval *on the merits* in the Third Circuit, this decision may have little practical import.

The "Specific, Extraordinary Facts" and Lower Court Proceedings

During pre-petition negotiations, pre-petition lenders raised the prospect of claims against equityholders. [2] The resulting restructuring agreement contemplated, *inter alia*, that the equityholders would contribute $325 million in exchange for comprehensive releases (including third-party releases, should the restructuring be effected in chapter 11). [3] The bankruptcy court's "careful fact finding" reflected that "the deal to avoid corporate destruction would not have been possible without the third-party releases." [4]

The parties attempted to implement the agreement out of court, but certain pre-petition lenders held out (the appellants in this case, the "Opt-Out Lenders"). Millennium Lab pivoted to the in-court option, filing a chapter 11 petition with a prepackaged plan that included the nonconsensual release of, *inter alia*, the Opt-Out Lenders' claims against the equityholders. [5] The Opt-Out Lenders objected, arguing *inter alia* that the bankruptcy court lacked subject-matter jurisdiction to grant the compelled third-party releases. [6] The bankruptcy court found that it had subject-matter jurisdiction to consider the releases in the context of plan confirmation, disagreed that such releases contravened the Bankruptcy Code, and confirmed the plan. [7] The Opt-Out Lenders appealed.

At the district court, the debtors moved to dismiss the appeal on the basis that it was equitably moot, and the appellants countered that the bankruptcy court had lacked constitutional authority to enter a confirmation order containing third-party releases (raising that argument for the first time, at least comprehensively). [8] Determining that it could not consider the motion to dismiss without first analyzing the constitutional issue, the district court remanded on that issue. [9]

On remand, the bankruptcy court found that it had constitutional authority to grant the releases ("*Millennium III*"). [10] As a threshold matter, the bankruptcy court ruled that no interpretation of *Stern* — which applied only in the context of "a state law cause of action filed by a trustee" — affected a bankruptcy court's ability to confirm a plan, which is a quintessential feature unique to federal bankruptcy law. [11] As such, *Stern's* so-called "Disjunctive Test" — "whether the action at issue stems from the bankruptcy itself *or* would necessarily be resolved in the claims allowance process" — need not even be applied. [12] The bankruptcy court rejected the Opt-Out Lenders' view that the confirmation context was irrelevant, and that the bankruptcy court should instead analyze whether it had constitutional authority to adjudicate the merits of the underlying claims being affected by confirmation. [13] Rather, consideration of the third-party releases on the merits "d[id] not ask the

bankruptcy judge to examine or make rulings with respect to the many claims that may be released by virtue of the third-party releases. An order confirming a plan with releases, therefore, does not rule on the merits of the state law claims being released." [14]

The bankruptcy court went on to find that even if *Stern* governed its analysis, the "action at issue" under the Disjunctive Test was confirmation of a plan, not the claims articulated in the district court complaint. [15] Rather, the court found that "[t]aking the position that third-party releases in a plan are equivalent to an impermissible adjudication of the litigation being released is, at best, a substantive argument against third-party releases, not an argument that confirmation orders containing releases must be entered by a district court." [16]

The Opt-Out Lenders appealed, arguing that "the relevant inquiry is not whether plan confirmation is core, but whether the other proceedings ... affected by plan confirmation are core." [17] The district court affirmed, determining that *Stern* did not require application of the Disjunctive Test in the confirmation context. [18] The district court went on to affirm the bankruptcy court's ruling that the confirmation order approving the release of state law claims was *not* an adjudication of the released claims on the merits, favoring the distinction drawn between approval of a *settlement* of claims — which involved application of a federal bankruptcy standard — and a ruling on the merits. [19] The district court agreed that the *impact* of that "settlement" (the release of claims) went to whether the settlement satisfied the federal standard for approval; *i.e.*, the objectors' contention was an argument as to why the release was *inappropriate*, not a challenge to the bankruptcy court's constitutional authority to approve it in the first place. [20] The Opt-Out Lenders appealed to the Third Circuit.

The Third Circuit's Decision and Implications

The Third Circuit began by analyzing *Stern*, highlighting several points relevant to the dispute before it:

> "[A] bankruptcy court is within constitutional bounds when it resolves a matter that is integral to the restructuring of the debtor/creditor relationship." [21]
>
> As demonstrated by the availability of the second prong of the Disjunctive Test, for a bankruptcy court to have constitutional authority, "a matter need not stem from the bankruptcy itself." [22]
>
> The constitutional analysis should focus not on the *category* of the "proceeding" (*i.e.*, is it a counterclaim?), bu context (*i.e.*, is resolution of that counterclaim necessary for the claims-allowance process?). [23]

Applying those principles to the third-party releases, the Third Circuit framed the issue as "whether, looking to the content of the plan [and focusing on the release provisions], the Bankruptcy Court was resolving a matter integral to the restructuring of the debtor/creditor relationship." [24] In answering the question in the affirmative, the Third Circuit adopted the reasoning of the bankruptcy court, which had found the release provisions necessary to induce the equityholders' capital infusion, which in turn had been necessary to satisfy the debtor's obligations under a DOJ settlement, which in turn was necessary to continue operations. [25]

The Third Circuit was nevertheless sympathetic to the concern that permitting bankruptcy courts to approve compelled third-party releases upon a finding that those releases were integral to the restructuring would empower release recipients to simply demand releases during negotiations. [26] It stated that "we are not broadly sanctioning the permissibility of nonconsensual third-party releases in bankruptcy reorganization plans," and reinforced its prior decisions articulating "exacting standards" that must be satisfied when determining the appropriateness of releases on the *merits*. [27] Those "exacting standards" are whether the release "is both necessary to the reorganization and fair." [28] But the "necessity to the reorganization" factor seems virtually indistinguishable from the "integral to the reorganization" constitutional determination. The Third Circuit's ruling may simply mean, then, that once constitutional authority has been established, the only remaining consideration on the merits is whether the release is "fair."

In any event, the Third Circuit's opinion emphatically reaffirms bankruptcy courts' constitutional authority to enter final orders confirming plans containing compelled third-party releases (though because the Third Circuit had already weighed in on the permissibility of compelled third-party releases, it may not impact the weight of authority on either side of the issue). [29] Stay tuned for whether the Supremes grant the petition for *certiorari* filed by the Opt-Out Lenders on March 18, 2020 [No. 19-1152]. [30]

[1] *See In re Millennium Lab Holdings II LLC,* 945 F.3d 126, (3d Cir. 2019) ("Third Cir. Op.") (citing *Stern v. Marshall*, 564 U.S. 462, 131 S. Ct. 2594, 2614 (2011)).

[2] Third Cir. Op. at 130.

[3] *Id.* at 130-31.

[4] *Id.* at 132.

[5] *See In re Millennium Lab Holdings II LLC*, No. 15-12284 (Bankr. D. Del. Dec. 14, 2015), D.E. 195.

[6] *See In re Millennium Lab Holdings II LLC*, No. 15-12284 (Bankr. D. Del. Dec. 4, 2015), D.E. 122 at 17-26; No. 15-12284 (Bankr. D. Del. Dec. 9, 2015), D.E. 174 at 4-10. Although the Opt-Out Lenders did include a "reservation of rights" in their initial objection indicating that they did not consent to the bankruptcy court's entry of a final order, they described the issue as one of *jurisdiction* and not constitutional power, and failed to press that objection in their more detailed Supplemental Objection. *See* ¶ 75; *see also Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, 242 F. Supp. 3d 322, 331 (D. Del. 2017) ("*Millennium II*").

[7] *In re Millennium Lab Holdings II LLC*, No. 15-12284 (Bankr. D. Del. Dec. 11, 2015), D.E. 206 at 12, 16-30 ("*Millennium I*").

[8] *See Millennium II* at 325, 330-31, 339.

[9] *Millennium II* at 325-26 (quoting *Wellness Int'l Network Ltd. v. Sharif*, 135 S. Ct. 1932, 1938-39 (2015)), 338-39.

[10] *In re Millennium Lab Holdings II LLC*, 575 B.R. 252 (Bankr. D. Del. 2017).

[11] *Millennium III* at 271-72, 274.

[12] *Cf. Millennium III* at 274, 275 (quoting *Stern*, 131 S. Ct. at 2618 (emphasis added)).

[13] *Millennium III* at 273-74.

[14] *Millennium III* at 272-73 (internal citations omitted).

[15] *Millennium III* at 274, 275-76 (citing *In re Lazy Days' RV Center Inc.*, 724 F.3d 418 (3d Cir. 2013) ("*Stern* does not preclude a bankruptcy judge from entering final orders in statutorily core proceedings *notwithstanding the orders' collateral impact on state law claims*.") (emphasis added; other internal citations omitted).

[16] *Millennium III* at 283.

[17] *See Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, No. 17-1461-LPS, 2018 WL 4521941, at *11 (D. Del. Sept. 21, 2018) ("*Millennium IV*") (summarizing objectors' view).

[18] *See Millennium IV* at 12.

[19] *See id.* at 14.

[20] *Id.* at 13-14.

[21] Third Cir. Op. at 135.

[22] *Id.* at 136.

[23] *Id.*

[24] *Id.* at 137.

[25] *Id.*

[26] *Id.* at 139.

[27] *Id.* (citing *In re Global Indus. Techs. Inc.*, 645 F.3d 201, 206 (3d Cir. 2011) (*en banc*); *In re Continental Airlines Inc.*, 203 F.3d 203, 214 (3d Cir. 2000).

[28] *See Global Indus.*, 645 F.3d at 206; *see also Lower Bucks Hospital*, 571 Fed. Appx at 144 (quoting *Continental*, 203 F.3d at 214, n.11, as leaving "open the possibility that some small subset of non-consensual third-party releases might be confirmable where the release is 'both necessary [to the plan of confirmation] and given in exchange for fair consideration'").

[29] The Third Circuit went on to affirm the district court's finding that the remainder of the appeal was equitably moot.

[30] Millennium Lab Holdings II LLC and certain other parties filed waivers of their right to respond to the petition.

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