CLIENT ALERT

Delaware Bankruptcy Court Rules It Has Constitutional Authority To Approve Nonconsensual Third Party Releases

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Bankruptcy Judge Laurie Selber Silverstein issues opinion confirming that she has the constitutional authority to approve nonconsensual third party releases in a plan of reorganization, rejecting a broader reading of the Supreme Court's opinion in Stern v. Marshall *that would have required separate approval of the releases by the district court.*

On October 3, 2017, the Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") issued an opinion in *In re Millennium Lab Holdings II, LLC*[1] (the "Decision"), ruling that the Bankruptcy Court has the constitutional authority to enter a confirmation order approving a plan of reorganization that includes nonconsensual third party releases, despite certain restrictions on a bankruptcy court's constitutional authority as set forth in the U.S. Supreme Court's decision in *Stern v. Marshall*.[2] The Decision rejected an expansive reading of these constitutional limitations on a bankruptcy court's authority.[3]

Background

Bankruptcy Court Confirms the Plan, Including Nonconsensual Third Party Releases

The debtors, Millennium Lab Holdings II, LLC, Millennium Health, LLC, and RxAnte, LLC (collectively, the "Debtors" or "Millennium"), filed for chapter 11 bankruptcy on November 10, 2015. Millennium, founded in 2007, provided laboratory-based diagnostic testing, primarily for clinical medication monitoring and drug abuse compliance. In 2012, the U.S. Department of Justice investigated Millennium for allegations of fraudulent billing practices, and revoked Millennium's Medicare billing privileges. In September 2015, Millennium settled with the Department of Justice, agreeing to pay

$256 million to the federal government and enter into a restructuring support agreement with Millennium's equity holders and prepetition lenders in exchange for regaining Millennium's Medicare billing privileges. In November, Millennium filed chapter 11 petitions and the proposed plan, which included third party releases. According to the Debtors, the releases were essential to induce their equity holders to contribute $325 million to the Debtors.[4]

Third party releases are provisions in a plan of reorganization that release the liability of non-debtor parties on claims related to the debtor (typically, released parties include the debtor's directors, officers, shareholders, lenders, and/or guarantors). If a party votes in favor of a plan, it consents to the third party releases, but debtors often seek to have the bankruptcy court approve the releases as to nonconsenting parties as well. The legality of nonconsensual releases is controversial because the Bankruptcy Code does not explicitly prohibit or authorize them, and courts have ruled that they are only appropriate in rare circumstances.

A group of Millennium's lenders that were managed by Voya Investment Management Co. LLC and Voya Alternative Asset Management LLC (collectively, "Voya") objected to the plan, arguing that the Bankruptcy Court did not have subject matter jurisdiction to approve the nonconsensual third party releases contained in the plan. Voya also argued that the plan could not be confirmed unless it permitted creditors to opt out of the third party releases, and that the releases were otherwise impermissible. Prior to the hearing on the plan, Voya filed a complaint against the Debtors' prepetition equity holders alleging common law fraud and violations of RICO. The third party releases would have prevented Voya from pursuing those claims against the Debtors' equity holders. In a bench opinion, Judge Silverstein overruled Voya's objections, finding that the Bankruptcy Court had subject matter jurisdiction, and that the releases were fair and necessary to the reorganization, which satisfied the standard for approving nonconsensual third party releases. Voya appealed the Bankruptcy Court's decision to confirm the Debtors' plan.

District Court Opinion Remanding Case to Bankruptcy Court

Article III of the United States Constitution prevents bankruptcy courts from entering final judgments on certain state law claims without the consent of the affected parties. In *Stern v. Marshall*, the Supreme Court ruled that a bankruptcy court lacks the constitutional authority to enter a final judgment on a debtor's state law counterclaim that is unrelated to the creditor's claim against the debtor. The *Stern* decision is often cited by bankruptcy courts as they determine whether they have the constitutional authority to enter certain orders.

On appeal, Voya argued that pursuant to *Stern*, the Bankruptcy Court did not have the constitutional authority to enter the confirmation order that approved the nonconsensual releases, asserting that the confirmation order amounted to a final judgment against Voya on its state law claims against the Debtors' equity holders.

On March 17, 2017, Judge Leonard Stark of the District Court of the District of Delaware (the "District Court") issued an opinion that suggested that *Stern* may prevent the Bankruptcy Court from approving the third party releases, explaining that "[Voya] appear[s] to be entitled to Article III adjudication of these claims" and that the District Court was "further

persuaded by [Voya's] argument that the Plan's release, which permanently extinguished [Voya's] claims, is tantamount to resolution of those claims on the merits against [Voya]."[5] Nevertheless, the District Court found that the Bankruptcy Court did not have the opportunity to consider Voya's *Stern* argument, and remanded the case to the Bankruptcy Court to consider whether it had the constitutional authority to approve the nonconsensual release of Voya's common law fraud and RICO claims against the Debtors' equity holders.

The Bankruptcy Court's Decision on Remand

Following the District Court's remand of the case to the Bankruptcy Court, the Debtors and Voya briefed and argued the *Stern* issue before the Bankruptcy Court, and on October 3, 2017, the Bankruptcy Court issued the Decision. The Decision holds that (i) the Bankruptcy Court had the constitutional authority to approve the nonconsensual third party releases in the plan, and (ii) even if the Bankruptcy Court is incorrect about its constitutional authority, Voya waived and forfeited its *Stern* argument by failing to raise the issue at the confirmation hearing.

First, the Bankruptcy Court explained that courts have interpreted *Stern* in several different ways. The "Narrow Interpretation" is that *Stern* only applies to the narrow facts before the Court: "[a] bankruptcy judge lack[s] the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim."[6] The "Broad Interpretation" is that *Stern* prevents a bankruptcy judge from "enter[ing] a final judgment on all state law claims, all common law causes of action or all causes of action under state law."[7] The "Broadest Interpretation" is that *Stern* requires bankruptcy judges to "examine their ability to enter final orders in all enumerated or unenumerated core proceedings."[8]

The Bankruptcy Court explained that other judges in Delaware have consistently adopted the Narrow Interpretation of *Stern,*[9] but the court ruled that under any interpretation of *Stern*, a bankruptcy court has the constitutional authority to approve a nonconsensual third party release contained in a plan of reorganization. The principal reason is that the operative proceeding before the Bankruptcy Court is the confirmation of the plan, which is governed by a federal standard under the Bankruptcy Code. The bankruptcy judge is not considering the merits of the state law claim (here, the RICO and fraud claims). Accordingly, a ruling on the plan and the third party releases is not a ruling on the state law claim, meaning that *Stern* is not implicated. The Bankruptcy Court explained that entering a confirmation order that might have collateral effects on a state court lawsuit does not violate *Stern*, and ruled that a bankruptcy judge may enter a final order that "impacts or even precludes a state law action between two non-debtors."[10] Although Voya had filed a separate lawsuit in the District Court alleging fraud and RICO violations, the Bankruptcy Court's *Stern* analysis still focused on the plan confirmation, not on Voya's separate lawsuit.[11]

The Bankruptcy Court then explained that adopting Voya's argument that *Stern* prevents bankruptcy courts from entering confirmation orders that include third party nonconsensual releases would "dramatically change the division of labor between the bankruptcy and district courts" by requiring district courts to hear and enter final orders on a variety of issues,

including (i) asset sales pursuant to section 363 where there will be no successor liability, (ii) stay violation motions where state law lien rights against non-debtors are adjudicated, (iii) interpretation of previous court orders where state law contractual rights are adjudicated, (iv) substantive consolidation where rights against non-debtor entities "are rearranged," and (v) recharacterization and subordination where state law debts are transformed. The Bankruptcy Court rejected Voya's argument that parties may decide to consent to a bankruptcy court entering an order on these matters, explaining that "there is ample room for gamesmanship" and that "consent would be withheld to leverage a party's position."[12]

Implications

The Decision will certainly be appealed to the District Court, and Judge Stark will consider the issue of the Bankruptcy Court's constitutional authority to enter the confirmation order that included third party releases. In the order remanding the case to the Bankruptcy Court, Judge Stark's initial view appeared to be that Stern may prevent bankruptcy courts from entering orders that include nonconsensual third party releases, so Judge Stark may have a different view of this issue on appeal.

The Decision is another court opinion that interprets Stern narrowly and allows a bankruptcy court to issue a final order without the need for a district court to independently review the matter and issue a final order. If Voya's argument were accepted, several months would likely be added to every confirmation process that included nonconsensual third party releases because a district court's approval would be necessary for the releases. Additionally, Voya's argument (if successful) would likely be extended to other matters routinely handled by bankruptcy courts, such as section 363 asset sales where there will be no successor liability, and substantive consolidation involving rights against non-debtors, among other matters. A district court's review of these matters would be required before a final order could be entered.

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1 Case No. 15-12284 (LSS) (Bankr. D. Del. Oct. 3, 2017).

2 *Stern v. Marshall*, 564 U.S. 462 (2011).

3 The Bankruptcy Court also ruled in the alternative that even if the Decision was incorrect and the Bankruptcy Court did not have the constitutional authority to enter the confirmation order, the objecting party waived and forfeited its objection because such party did not sufficiently raise this argument before the Bankruptcy Court at the confirmation hearing.

4 The $325 million contribution was used to pay the settlement amount to the Department of Justice, pay fees to certain lenders and provide working capital for the reorganized Debtors.

5 *Opt-Out Lenders v. Millennium Lab Holdings II, LLC,* Case No. 16-110 (LPS) (D. Del. Mar. 17, 2017).

6 Decision, at p. 20.

7 Decision, at p. 23.

8 Decision, at p. 25.

9 Decision, at pp. 24–25 (citing the following decisions where Delaware bankruptcy judges have adopted the Narrow Interpretation of *Stern*: *In re USDigital, Inc.*, 461 B.R. 276 (Bankr. D. Del. 2011) (Sontchi, J.); *Burtch v. Seaport Capital, LLC (In re Direct Response Media, Inc.)*, 466 B.R. 626 (Bankr. D. Del. 2012) (Gross, J.); *Zazzali v. 1031 Exch. Grp. (In re DESI)*, 467 B.R. 767 (Bankr. D. Del. 2012) (Walsh, J.); and *In re WCI Cmtys., Inc.*, No. 09-52250, 2012 WL 1981713 (Bankr. D. Del. June 1, 2012) (Carey, J.)).

10 Decision, at p. 39.

11 Decision, at p. 31.

12 Decision, at pp. 50–51, 50 n.155.