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TWO RECENT BANKRUPTCY COURT DECISIONS ON THIRD-PARTY RELEASES HIGHLIGHT DIVERGENT APPROACHES TO THE "OPERATIVE PROCEEDING" ANALYSIS

To Our Clients and Friends:

I. Introduction

Non-consensual third-party non-debtor releases are often included in chapter 11 plans. While the language and scope of these provisions vary, they all seek to prevent one or more non-debtor parties from pursuing claims against certain other non-debtor parties. Often, these releases are sought by prepetition lenders or equity owners of the debtors as part of a consensual restructuring deal in which the released parties obtain a release in exchange for a financial contribution of value which supports the debtor's reorganization.

Courts are divided on whether granting such releases on a non-consensual basis—i.e., over the objection (or without the affirmative consent) of the parties barred from bringing certain claims against the releasees—is permissible under any circumstances.[1] Before a bankruptcy court can examine the issue of whether this type of release is permissible, however, it must first determine whether it has both statutory subject matter jurisdiction[2] and constitutional authority[3] to enter the proposed confirmation order authorizing such releases.

Two recent (and conflicting) opinions[4] suggest that that this determination depends on the bankruptcy court's view as to what "operative proceeding" governs the matter. Is the "operative proceeding" (i) a core proceeding before the bankruptcy court (e.g., a confirmation hearing in which the debtor seeks entry of a proposed order confirming a plan that includes third-party releases), or (ii) a separate proceeding (whether actual or hypothetical) in which a non-debtor third party has asserted or could assert the claims to be released under the plan? *Millennium Lab* holds that plan releases are considered in the context of a confirmation hearing, and thus the court has jurisdiction to authorize a claim release, notwithstanding the existence (or potential existence) of a litigation in another forum brought to adjudicate one of the claims subject to release. *Midway Gold* holds that non-debtor claim releases should be viewed separately from the confirmation hearing, and that a bankruptcy court has no jurisdiction to "adjudicate" (by approving a release of) claims or potential claims between non-debtors that are not related to the bankruptcy case.

II. *In re Millennium Lab Holdings II, LLC*

In *Millennium Lab*, the debtors sought to confirm a chapter 11 plan containing non-consensual third-party release provisions. These releases would prevent creditors and other releasing parties from

asserting claims based on actions or events occurring prior to the plan effective date and relating to the debtors, the pre-petition credit agreement, or the restructuring (among other things) against certain equity holders of the debtors. At the confirmation hearing, a group of lenders led by Voya (collectively, "Voya") objected that the third-party releases were inappropriate, arguing (among other things) that the court did not have jurisdiction to grant them, and, therefore, did not have authority to confirm a plan that included the releases.

To crystalize claims against the non-debtor releasees, on the eve of the confirmation hearing Voya filed a complaint asserting RICO and common law fraud claims against those releasees in the United States District Court for the District of Delaware (the "RICO Lawsuit"). On December 11, 2015, the court issued a bench ruling confirming the debtors' plan of reorganization over Voya's objection, concluding that the court had jurisdiction to confirm the plan and approve its release provisions.[5] On appeal, the District Court for the District of Delaware agreed with the bankruptcy court's conclusion that it had subject matter jurisdiction, but reversed and remanded asking the bankruptcy court to consider the separate issue of whether the court "had constitutional adjudicatory authority to approve the nonconsensual release of [Voya's] direct non-bankruptcy common law fraud and RICO claims against the Non-Debtor Equity Holders."[6]

On remand, the court found that it had both subject matter jurisdiction and constitutional adjudicatory authority to enter the confirmation order.[7] The decisive issue for the court was whether the "operative proceeding" to adjudicate the release of third-party claims was the confirmation hearing or the RICO Lawsuit. Voya argued that the RICO Lawsuit was the "operative proceeding," urging that because the claims asserted therein were non-bankruptcy claims similar to those at issue in *Stern*, the bankruptcy court lacked the constitutional authority to enter a final order that would effectively adjudicate the claims by enjoining their future prosecution.[8] The court rejected this argument, holding that "the operative proceeding for purposes of a constitutional analysis is confirmation of a plan."[9] Because the releases were considered in the context of confirmation of a plan, the court found that it had the jurisdiction and constitutional authority to release those claims.

First, the court found that it had statutory jurisdictional authority to enter final judgment confirming the plan because confirmation of a plan is an enumerated core proceeding.[10] The court then concluded that under any of the various interpretations of *Stern* adopted by courts, it also had constitutional authority to enter the confirmation order.[11] The court found that plan confirmation was a "proceeding at the core of bankruptcy law" and a "quintessential core proceeding," noting that "in confirming a plan, even one with releases, the judge is applying a federal standard."[12] In the court's view, the issue before it was whether the proposed releases are legally permissible under the applicable federal standard—i.e., the plan confirmation standard under section 1129 of the Bankruptcy Code—which does not require the judge to make rulings with respect to the many claims that may be released by virtue of third-party release provisions in a plan.[13]

The court rejected Voya's argument that because it filed the RICO Lawsuit before confirmation, the appropriate *Stern* analysis in connection with confirmation should focus on that lawsuit rather than on the confirmation proceeding. Noting that Voya could not identify anything in *Stern* or cases interpreting *Stern* suggesting that the "action at issue" should be any proceeding other than the "operative proceeding"

before the bankruptcy judge, the court distinguished *Stern*, where the bankruptcy court had entered a summary judgment order rejecting a state law counterclaim on the merits in the context of an adversary proceeding.[14]

Citing two recent Third Circuit decisions (among other circuit court decisions), the court further held that a bankruptcy court's entering an order that may preclude a third-party lawsuit does not violate *Stern*, because the relief being sought by the debtors in the operative proceeding before the court was "quintessentially federal in nature."[15] In *In re Lazy Days' RV Center Inc.*, the Third Circuit upheld the bankruptcy court's constitutional exercise of jurisdiction to confirm that a landlord could not refuse to honor a purchase option provision in its lease with the reorganized debtors because anti-assignment provisions are unenforceable under section 365(f) of the Bankruptcy Code.[16] In *In re Linear Elec. Co.*, the Third Circuit held that *Stern* did not bar a bankruptcy judge from entering a final order enforcing the automatic stay and discharging construction liens filed by a non-debtor supplier against real property owned by a non-debtor, finding that the debtor's claims—asserted through a motion to enforce of the automatic stay—are claims arising under the federal bankruptcy laws and are therefore outside the scope of *Stern*.[17] In both cases, the Third Circuit focused on the actual "operative proceeding" before the bankruptcy court and relief sought therein under the Bankruptcy Code, rather than on the underlying state law claims or rights asserted by the non-debtor entities. Accordingly, the *Millennium Lab* court found that "[t]here is no question . . . that, if the proper standard is met, a bankruptcy judge may enter a final order in a core matter that impacts or even precludes a state law action between two non-debtors."[18]

Finally, the court noted that adopting Voya's interpretation of *Stern* would dramatically change the division of labor between the bankruptcy and district courts.[19] Specifically, if all final orders affecting asserted or potential state law claims with *Stern* implications could only be entered by district courts, bankruptcy courts would no longer be able to enter final orders approving section 363 sales that release purchasers from successor liability, substantively consolidating estates, or recharacterizing or subordinating claims, among other matters.[20] Because Justice Roberts stated in *Stern* that his majority decision did not "change all that much," the court pointed to the sweeping practical implications of adopting Voya's readings as support for its finding of constitutional authority.[21]

III. *In re Midway Gold US, Inc.*

In *Midway Gold*, the United States Trustee objected to plan confirmation based in part on the notion that the bankruptcy court lacked the jurisdiction to rule on issues relating to the plan's third-party release and exculpation provisions.[22] Though the court's decision did not reference *Stern* and never used the words "operative proceeding," its jurisdictional analysis reflects an approach to the operative proceeding issue that is almost diametrically opposed to that of the *Millennium Lab* court.

The dispute in *Midway Gold* focused on whether the bankruptcy court had jurisdiction to approve the plan's third-party non-debtor releases—specifically, to the extent such releases covered claims among non-debtors that had a tenuous connection (if any) to the debtors, the property of the debtors' estates, or the administration of the debtors' chapter 11 cases.[23] The releases provided, among other things, that all creditors that accept the plan, are deemed to accept the plan, or reject the plan but fail to affirmatively

opt out of plan releases are deemed to have released all claims and causes of action existing as of the plan effective date that are in any way related to the debtors, the chapter 11 cases, or the debtors' plan.[24] Having concluded that the Tenth Circuit did not categorically bar third-party releases in all cases,[25] the court stated that "[w]hether the Court may consider approval of releases of or injunctions against such claims hinges on whether the Court has jurisdiction over those peripheral claims in the first place."[26]

In his jurisdictional analysis, the court focused on the claims and disputes that *could be* brought between third-party non-debtors, noting that these claims would neither "arise in" nor "arise under" the Bankruptcy Code. Critically, the court held that the court could not find "arising in" jurisdiction over the proceedings simply because the releases are included within a proposed chapter 11 plan.[27] While recognizing that the court had subject matter jurisdiction over the chapter 11 cases and that confirmations of plans are expressly recognized as core proceedings under the bankruptcy jurisdiction statute, the court held that "[t]here must be some independent statutory basis for the Court to exercise jurisdiction over the third-parties' disputes before the Court may adjudicate them."[28] This holding reflects a concern that third-party non-debtors would otherwise be able to "bootstrap" their disputes into a bankruptcy case, and that without a requirement of independent jurisdiction over the disputes, the court could acquire "infinite jurisdiction."[29]

On this basis, the court found that it lacked jurisdiction over the causes of action and claims that would be released, because they included claims that were not "related to" the debtors, the property of the debtors' estates, or the administration of the chapter 11 cases.[30] The court stated that even if the success of the plan of reorganization depended on non-debtor third-party releases being given in exchange for contributions and settlements entered into by the released parties, this would not provide a sufficient basis for the bankruptcy court to exercise jurisdiction over the claims, because "[o]therwise, 'a debtor could create subject matter jurisdiction over any non-debtor third-party by structuring a plan in such a way that it depended on third-party contributions.'"[31] Thus, the court held that it would only have jurisdiction to approve releases under which "the disputes subject to releases or injunctions would have an effect, for example through indemnification or some other form of post-confirmation liability, on the debtor's property or the administration of the estate."[32] In light of this analysis, the court found that it lacked subject matter jurisdiction to enjoin or release the non-debtor claims covered by the plan provision and denied confirmation of the plan.

In short, though discussing statutory jurisdiction rather than *Stern* issues of constitutional authority, the *Midway Gold* court adopted an "operative proceeding" analysis with a far narrower view of bankruptcy courts' authority than that of the *Millennium Lab* court. Where the *Millennium Lab* court focused on the nature of the proceeding before it (i.e., a confirmation hearing in which the debtors sought confirmation of a plan that granted third-party non-debtor releases), the *Midway Gold* court set aside the confirmation context and focused on whether it would *independently* have jurisdiction over hypothetical, not-yet-asserted claims between non-debtors that would be covered by the plan releases. Put another way, the *Millennium Lab* court concluded that it was not adjudicating the underlying claims even though the effect of entry of the confirmation order would be to preclude those claims from being asserted or prosecuted. By contrast, the *Midway Gold* court's jurisdictional analysis assumed that confirmation of the plan would require him "to enjoin or adjudicate the [claims]".[33]

IV. Practical Implications

The two bankruptcy courts' approaches reflect countervailing concerns. The *Millennium Lab* court found no *Stern* issue with a bankruptcy court issuing a final order on a core issue—namely, confirming a plan—despite that order's likely preclusive effect on claims similar to the counterclaims in *Stern*. This conclusion was partly driven by a concern that to hold otherwise would fundamentally change the division of labor between bankruptcy and district courts, as any bankruptcy proceeding impacting third-party rights—for instance, an asset sale under section 363 of the Bankruptcy Code—would need to be finally adjudicated by a district court. Conversely, the *Midway Gold* court feared that finding jurisdiction over the third-party releases in the plan would sanction "bootstrapping" an infinite jurisdictional scope, such that any proceedings over which a bankruptcy court has no independent jurisdiction could be placed within the court's jurisdiction by simply including their release in a proposed plan. With its explicit and more comprehensive operative proceeding analysis, the *Millennium Lab* decision appears to be the better view, although the decision is under appeal. It remains unclear whether the *Midway Gold* decision will be appealed.

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[1] Courts in a majority of circuits, including the Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits, have held that non-consensual third-party releases are permitted under certain limited circumstances, *see In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 143 (2d Cir. 2005); *In re Washington Mut., Inc.*, 442 B.R. 314, 352 (D. Del. 2011); *Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 351 (4th Cir. 2014); *In re Dow Corning Corp.*, 280 F.3d 648, 657-58 (6th Cir. 2002); *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 656 (7th Cir. 2008); *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070, 1078 (11th Cir. 2015), while courts in the Fifth and Ninth Circuits have adopted a strict prohibition against such releases, *see In re Pac. Lumber Co.*, 584 F.3d 229, 253 (5th Cir. 2009); *In re Lowenschuss*, 67 F.3d 1394, 1402 (9th Cir. 1995).

[2] *See* 28 U.S.C. §§ 157, 1334.

[3] *See Stern v. Marshall*, 131 S. Ct. 2594 (2011). In *Stern*, the Supreme Court held that notwithstanding Congress's statutory grant of subject matter jurisdiction over counterclaims brought by the estate against persons filing claims against the estate, bankruptcy courts lacked the constitutional authority to enter a final order on a state law counterclaim against a creditor unless the claim is necessarily resolved in the process of ruling on the creditor's proof of claim. Thus, the Supreme Court vacated a grant of summary judgment denying a tortious interference counterclaim filed in an adversary proceeding before the bankruptcy court in which the complaint brought defamation claims against the counterclaimant.

[4] *In re Millennium Lab Holdings II, LLC*, No. 15-12284 (LSS), 2017 WL 4417562 (Bankr. D. Del. Oct. 3, 2017) ("*Millennium Lab*"); *In re Midway Gold US, Inc.*, No. 15-16835 (MER), 2017 WL 4480818 (Bankr. D. Colo. Oct. 6, 2017) ("*Midway Gold*").

[5] No. 15-12284 (LSS) (Bankr. D. Del. Dec. 15, 2015) (Dkt. 206).

[6] *Opt-Out Lenders v. Millennium Lab Holdings II, LLC (In re Millennium Lab Holdings II, LLC)*, 242 F. Supp. 3d 322, 338, 340 (D. Del. 2017).

[7] *Millennium Lab* at *1-2.

[8] *Id.* at *5 and *23.

[9] *Id.* at *14; *see also id.* at *6-7.

[10] *Id.*; *see* 28 U.S.C. § 157(b)(2)(L).

[11] *Id.* at *14-17.

[12] *Id.* at *15.

[13] *Id.* at *16.

[14] *Id.* at *17.

[15] *Id.* at *19-20.

[16] 724 F.3d 418, 423-24 (3d Cir. 2013).

[17] 852 F.3d 313, 320 (3d Cir. 2017).

[18] *Millennium Lab* at *20.

[19] *Id.* at *25-26.

[20] *Id.* at *25.

[21] *Id.* at *26.

[22] 2017 WL 4480818 at *13.

[23] *Id.* at *31

[24] *Id.* at *10.

[25] Notably, the court's view conflicts with other courts' views on the matter. These courts have taken the position that the Tenth Circuit does categorically prohibit non-consensual non-debtor releases. *Id.* at *16 (noting that *In re Western Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990), is frequently cited for the proposition that non-debtor releases of any type are prohibited in the Tenth Circuit (citing *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141 (2d Cir. 2005))).

[26] 2017 WL 4480818 at *30-31.

[27] *Id.* at *32.

[28] *Id.*

[29] *Id.* at *32 (quoting *In re Digital Impact, Inc.*, 223 B.R. 1, 10 (Bankr. N.D. Okla. 1998)).

[30] *Id.* at *33.

[31] *Id.* (quoting *In re Combustion Eng'g, Inc.*, 391 F.3d 225, 228 (3d Cir. 2004)).

[32] *Id.* at *34.

[33] *Id.* at *34.

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Business Restructuring and Reorganization practice group, or the following authors:

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