Benchnotes

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Bankruptcy Courts Lack Authority to Approve Third-Party Releases

In *In re Millennium Lab Holdings II LLC*,[1] the U.S. District Court for the District of Delaware held that a bankruptcy court does not have constitutional authority under *Stern* and its progeny to approve nonconsensual third-party releases in chapter 11 plans. The debtor provided laboratory and diagnostic services, and was reimbursed by Medicaid. While being investigated by the government for fraudulent billing, the debtor obtained a $1.825 billion senior secured credit facility and used $1.3 billion of the proceeds to pay a special dividend to its shareholders. One year later, the debtor agreed to settle the Medicaid fraud claims with the government by paying $256 million.

The debtor commenced a prepackaged chapter 11 in order to effectuate the settlement. The debtor's plan contemplated that the nondebtor equityholders would contribute $325 million. Of that amount, $256 million would fund the government settlement. In exchange for their contribution, the nondebtor equityholders were provided with full releases and discharges of any and all claims against them, including fraud and Racketeer Influenced and Corrupt Organizations Act (RICO) claims related to the special dividend.

A group of lenders filed an objection to the plan, arguing, among other things, that the releases were inappropriate and, in any event, the bankruptcy court did not have subject-matter jurisdiction to approve such releases. The objectors only briefly alluded to a *Stern* objection. The debtor responded, noting that courts have rejected *Stern* challenges with respect to the approval of nonconsensual third-party releases in a plan because adjudication of a plan is "not an adjudication of the various disputes it touches upon."[2] The bankruptcy court ultimately confirmed the plan, concluding that the third-party releases were fair and necessary to the reorganization. The lenders appealed.

On appeal, the district court summarized the state of the law regarding a bankruptcy court's constitutional authority based on *Stern* and its progeny, noting, "It is clear from these recent Supreme Court cases that parties have a constitutional right to have their common law claims adjudicated by an Article III court."[3] It is equally clear, the court explained, that regardless of whether the bankruptcy court has subject-matter jurisdiction, it cannot enter a final order releasing third-party claims unless it has constitutional authority to do so as well. The court concluded that the bankruptcy court had not had the opportunity to rule on the constitutional authority issue and therefore remanded the case for further consideration.

The court did not stop there, though; rather, it stated that it was not persuaded by the debtor's arguments that the claims released under the plan involve matters of "public rights" that can be assigned to a non-Article III court. To the contrary, these are claims between two private parties based on state common laws or statutes that are not closely intertwined with a federal regulatory program. As such, the court stated, the lenders "appear to be entitled to Article III adjudication of these claims,"[4] and absent consent, the confirmation order could not be entered on a final basis by the bankruptcy court.

The court rejected the debtor's contention that a plan confirmation does not implicate *Stern* because it is not an "adjudication" of the third-party claims. "If Article III prevents the Bankruptcy Court from entering a final order disposing of a nonbankruptcy claim against a nondebtor," the court reasoned, "it follows that this prohibition should be applied regardless of the proceeding (*i.e.*, adversary proceeding, contested matter, plan confirmation)."[5]

On remand, the bankruptcy court was directed to clarify whether it has constitutional authority to approve the nonconsensual third-party releases. If it concluded that it does not, then the court was directed to submit proposed findings of fact and conclusions of law for approval by the district court; alternatively, the parties could simply strike the releases from the plan.

Completed Pre-Petition Assignment of Rents Results in Rents Being Excluded from Bankruptcy Estate

In *In re Town Center Flats LLC*,[6] the Sixth Circuit Court of Appeals held that a perfected assignment of rents that is enforced by a lender pre-petition constitutes a transfer of ownership of the rents under Michigan law such that they do not become property of the bankruptcy estate. The debtor, a single-asset real estate debtor, owned a 53-unit residential complex in Michigan. The debtor financed the building's construction with a $5.3 million loan, which had been secured with a mortgage and an agreement to assign rents to the lender in the event of a default.

Post-default, the lender sent a notice of the default and a request for payment of rents to all

1 *Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, 2017 WL 1032992 (D. Del. March 20, 2017).
2 *Id.* at *6.
3 *Id.* at *2.
4 *Id.* at *13.
5 *Id.*
6 *Town Center Flats LLC v. ECP Commercial II LLC (In re Town Center Flats LLC)*, 855 F.3d 721 (6th Cir. 2017).

known tenants. The notice complied with the terms of the parties' agreement and the applicable state statute, which allows creditors to collect rents directly from tenants post-default. Consistent with the statutory requirements, the lender recorded the notice documents in the real property records, thereby completing the last step under Michigan law to make the assignment binding against both the debtor and the tenants. Seeking to stop the lender from cutting off its sole source of revenue, the debtor commenced a chapter 11 case.

Noting a split in authority, the U.S. Bankruptcy Court for the Eastern District of Michigan held that the assigned rents were property of the estate and were thus usable by the debtor, subject to the constraints set forth in the Bankruptcy Code on the use of cash collateral. After reviewing the assignment agreement and the statute, the bankruptcy court found that the parties intended the assignment-of-rents provision merely to provide additional security to the lender, as opposed to an absolute transfer of such rents upon a default.

The court also articulated a policy rationale for its decision, noting that a ruling in the lender's favor would effectively preclude many single-asset real estate debtors from attempting to reorganize in chapter 11. The district court reversed, and the debtor appealed to the Sixth Circuit Court of Appeals.

The Sixth Circuit affirmed. The court began its analysis by acknowledging that property rights are determined under the law of the state in which the real property is located. Because the highest court in Michigan had not spoken directly on the issue, it was required to guess as to how that court would rule. The court looked at the applicable state statute and case law, and predicted that the Michigan Supreme Court would treat a completed assignment of rents as a transfer of ownership of such rents.

The court rejected the debtor's arguments that the state statute contemplated that only a security interest, as opposed to an ownership interest, is assigned. Moreover, the court found that the parties' agreement made clear that the debtor "irrevocably, absolutely and unconditionally" transferred its rights in the rents to the lender upon a default. The debtor did not retain any sort of a secondary or residual interest in the rents after a default. Finally, while acknowledging that the goal of chapter 11 is to encourage reorganizations for a broad range of debtors and their property, the court refused to decide the case based on policy rationales. The court stated:

> Excluding the assigned rents from the estate would effectively foreclose Chapter 11 relief for companies like [the debtor] that own a single property and receive their sole stream of revenue from rents of the property. We recognize the concern of [the debtor] — and the bankruptcy court — that single-asset real estate entities may have limited options under Chapter 11 in this situation. Michigan law, however, is clear on the matter and governs despite other policy concerns.[7]

Accordingly, the court held that since all requisite action had been taken by the lender pre-petition to effectuate its assignment following a default, the rents were not included in the debtor's bankruptcy estate.

7 *Id.* at 728.

Miscellaneous

• *Farmer v. Navient Sols. LLC (In re Farmer)*, --- B.R. ---, 2017 WL 1743517 (Bankr. W.D. Wash. 2017) (bankruptcy court declined to enforce arbitration clause in student loan note concerning dischargeability of student loan; Hon. **Christopher M. Alston** held that dischargeability of student loan is "core" matter in bankruptcy, and bankruptcy courts have discretion to refuse to compel arbitration of such matters);

• *In re Harpole*, --- B.R. ---, 2017 WL 1501384 (Bankr. D.N.M. 2017) (bankruptcy court disallowed portion of fees by counsel for official committee of unsecured creditors because counsel failed to carry its burden in showing that his hourly rates were in line with those in prevailing community; counsel applied for approval of his fees at rate of $325 per hour, but evidence reflected that same counsel routinely billed $280 per hour in other bankruptcy matters before court; court reduced counsel's fees accordingly);

• *Brown v. Ellmann*, 851 F.3d 619 (6th Cir. 2017) (noting split in authority with respect to statutory mootness under § 363(m) and rejecting *per se* rule adopted by most circuits pursuant to which non-stayed sale orders are automatically moot, Sixth Circuit held that party alleging statutory mootness "must prove that the reviewing court is unable to grant effective relief without affecting the validity of the sale" in order for § 363(m) to be applicable);

• *In re Billings*, --- Fed. App'x ---, 2017 WL 1488657 (3d Cir. 2017) (Third Circuit ruled that automatic stay does not apply to motions for continuance in pending state court proceedings; in case at hand, county/tax lienholder filed series of motions to extend tax sale date of subject property after bankruptcy was filed; debtors argued that such filings were in violation of automatic stay because, among other reasons, county incurred attorneys' fees and costs in filing motions that will ultimately be borne by debtors; Third Circuit rejected debtors' argument and ruled that "preserving the status quo is not always a cost-free proposition, and applicable fee shifting provisions may ultimately require a debtor to pay some or all of those costs");

• *Chapman v. Chlad (In re Chlad)*, 2017 WL 1102894 (Bankr. N.D. Ill. March 23, 2017) (court held that initial schedules filed by debtors in their bankruptcy case were not binding "judicial admission" in subsequently commenced adversary proceeding because adversary proceedings are separate and distinct proceedings from underlying case; nevertheless, bankruptcy schedules might be treated as evidentiary admissions under Federal Rule of Evidence 801(d)(2));

• *Cripps v. Foley (In re Cripps)*, 566 B.R. 172 (2017) (district court affirmed bankruptcy court ruling that counsel for chapter 13 debtors who filed application for allowance of post-confirmation professional fees just as debtors completed their plan payments had valid claim, but one that could not be paid as administrative expense and that was discharged pursuant to §§ 524 and 1328(a)); and

• *Hillen v. City of Many Trees LLC (In re CVAH Inc.)*, 2017 WL 1684119 (Bankr. D. Id. May 2, 2017) (noting split in authority, bankruptcy court held that bankruptcy trustee can utilize rights of Internal Revenue Service to sue for recovery of fraudulent transfers going back as far as 10 years pursuant to § 544(b)(1) of Bankruptcy Code where IRS is creditor). abi