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WELLNESS INTERNATIONAL: U.S. SUPREME COURT RULES THAT BANKRUPTCY COURTS MAY ADJUDICATE "*STERN* CLAIMS" WITH LITIGANTS' CONSENT

Jane Rue Wittstein and Genna L. Ghaul

In *Wellness Int'l Network, Ltd. v. Sharif*, ___ U.S. ___, 135 S. Ct. 1932 (2015), a divided U.S. Supreme Court resolved the circuit split regarding whether a bankruptcy court may, with the consent of the litigants, adjudicate a claim that, though statutorily denominated as "core," is not otherwise constitutionally determinable by a bankruptcy judge. The majority held that so long as consent—whether express or implied—is "knowing and voluntary," Article III of the U.S. Constitution is not violated by a bankruptcy court's adjudication of such a claim. The ruling builds upon the Supreme Court's recent decisions in *Stern v. Marshall*, 564 U.S. ___, 131 S. Ct. 2594 (2011), and *Executive Benefits Insurance Agency v. Arkison*, ___ U.S. ___, 134 S. Ct. 2165 (2014). *Wellness* nonetheless leaves many significant jurisdictional and constitutional questions unanswered.

BANKRUPTCY JURISDICTION IN A POST-*STERN V. MARSHALL* WORLD

Article III, Section 1 of the U.S. Constitution provides that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." It further states that such judges "shall hold their Offices during good Behaviour, and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office."

Given these provisions, the exercise of the "judicial Power of the United States" is vested in so-called Article III judges. Bankruptcy judges, however, are not Article III judges. They do not have life tenure, and their salaries are subject to diminution. Instead, bankruptcy judges are technically authorized under Article I, which governs the legislative branch and authorizes the establishment of a uniform system of federal bankruptcy laws. Under principles of separation of powers, bankruptcy judges cannot exercise the judicial power reserved for Article III judges.

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Thirty-three years ago, in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the Supreme Court struck down certain provisions of the Bankruptcy Act of 1978 because it conferred Article III judicial power upon bankruptcy judges who lacked life tenure and protection against salary diminution. After more than two years of delay, Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984 to fix the statutory infirmity identified in *Marathon*. The jurisdictional scheme for bankruptcy courts continues in force today. Or nearly so.

Congress established the jurisdiction of the bankruptcy courts in the Federal Judicial Code, 28 U.S.C. §§ 1 *et seq.* ("title 28"). As amended in 1984, 28 U.S.C. § 1334 provides that the district courts shall have "original and exclusive jurisdiction of all cases under title 11" and "original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." Section 151 of title 28 provides that each bankruptcy court is "a unit of the district court" in the federal district where it is located. Each district court may—but need not—refer cases and matters within the scope of bankruptcy jurisdiction to the bankruptcy court in its district.

Section 157(b) of title 28 provides that "[b]ankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11." Thus, a bankruptcy court may enter a final order with respect to all bankruptcy cases before it and all matters within the scope of its "core" jurisdiction. Such a final order is subject to appellate review by the applicable district court or bankruptcy appellate panel (and, thereafter, by the applicable court of appeals). Section 157(b)(2) of title 28 provides a nonexclusive list of matters that purportedly fall within "core" jurisdiction.

A bankruptcy court may also hear a noncore proceeding that is "related to" a bankruptcy case, but absent consent of the litigants, a bankruptcy court cannot enter a final order when exercising related to jurisdiction. Instead, it may issue only a proposed order, which is reviewed *de novo* by the district court.

In 2011, the Supreme Court in *Stern* shook up the jurisdictional scheme established in title 28 and declared that a portion of title 28 addressing the bankruptcy courts' core jurisdiction was unconstitutional. According to *Stern*, the 1984 jurisdictional scheme did not adequately address the *Marathon* issue, at least not in all instances. In *Stern*, the Court held that, even though bankruptcy courts are statutorily authorized under 28 U.S.C. § 157(b)(2) to enter final judgments on various categories of bankruptcy-related claims, Article III prohibits bankruptcy courts from finally adjudicating certain of those claims. Specifically, the Court ruled that a bankruptcy court lacks constitutional authority under Article III to enter a final judgment on a state law counterclaim of the bankruptcy estate which is not resolved in the process of ruling on a creditor's proof of claim, even though 28 U.S.C. § 157(b)(2)(C) identifies such a counterclaim as a core proceeding.

While *Stern* itself purported to be a narrow decision, it has given rise to a great deal of litigation concerning whether or not a particular claim, though statutorily denominated as core, is in fact a claim that is finally determinable by a bankruptcy judge. Further, in the years since *Stern*, courts have also struggled with the following issues: (i) whether a bankruptcy court has jurisdiction to address, and how it should deal with, a claim that, while statutorily denominated as core, is not in fact constitutionally determinable by an Article III judge (a "*Stern* claim"); and (ii) the effect of a party's consent to adjudication of a *Stern* claim by a bankruptcy court.

In its 2014 ruling in *Arkison*, a unanimous Supreme Court decided the first of these two issues by explaining that when a bankruptcy court is confronted with a claim which is statutorily denominated as "core" but is not constitutionally determinable by a bankruptcy judge under Article III of the U.S. Constitution, the bankruptcy judge should treat such a claim as a noncore "related to" matter that the district court reviews *de novo*. The ruling eliminated any supposed statutory gap created by *Stern* and maintained, for the most part, the "division of labor" between bankruptcy courts and district courts.

Arkison did not reach the question of whether a party's consent to adjudication of a *Stern* claim can cure any constitutional deficiency, as the Court found that the district court's *de novo* review of the bankruptcy court's judgment was sufficient to cure any potential error in that case.

In *Wellness*, the Supreme Court addressed this issue head-on.

THE DISPUTE

Richard Sharif and Wellness International Network ("Wellness") entered into a contract under which Sharif would distribute

Wellness's health and nutrition products. The parties' relationship quickly deteriorated, and in 2005, Sharif commenced a lawsuit against Wellness in federal court, claiming Wellness was running a pyramid scheme. After Sharif's repeated failure to respond to discovery requests and other litigation obligations, the court entered a default judgment for Wellness and later sanctioned Sharif by awarding Wellness more than $650,000 in attorneys' fees.

In February 2009, and in the midst of Wellness's ongoing efforts to collect its attorneys' fees, Sharif filed a chapter 7 case in the Northern District of Illinois. Sharif's bankruptcy petition listed Wellness as a creditor. However, Sharif once again refused to comply with Wellness's repeated requests for information. Upon its own initiative, Wellness discovered a loan application Sharif had filed in 2002 that listed more than $5 million in assets. Sharif claimed he had lied on the loan application and that the listed assets were actually owned by a trust Sharif administered on behalf of his mother for the benefit of his sister (the "Trust"). Wellness rejected this explanation and filed an adversary proceeding complaint against Sharif which, in addition to objecting to Sharif's discharge, sought a declaratory judgment that the Trust was Sharif's alter ego and that the Trust's assets should therefore be treated as part of Sharif's bankruptcy estate.

In his (pre-*Stern*) answer to the complaint, Sharif admitted that the adversary proceeding was a "core proceeding" under title 28, meaning that the bankruptcy court could enter a final judgment subject to appeal, and he requested judgment in his favor on all counts. But again, Sharif was repeatedly delinquent in meeting his discovery obligations. As a consequence, the bankruptcy court denied Sharif's request to discharge his debts; entered a default judgment for Wellness in the adversary proceeding; and declared, as requested by Wellness's complaint, that the Trust's assets were the property of Sharif's bankruptcy estate.

Sharif appealed to the district court. Six weeks before Sharif filed his opening brief, *Stern* was handed down by the Supreme Court. In light of *Stern* and a later-issued Seventh Circuit decision interpreting *Stern*, and despite not having originally cited *Stern* in his opening brief, Sharif moved for supplemental briefing so that he could challenge the bankruptcy court's constitutional authority to enter a declaratory judgment regarding the Trust. The district court denied as untimely Sharif's motion for supplemental briefing and affirmed the bankruptcy court's decision.

Sharif again appealed, this time to the U.S. Court of Appeals for the Seventh Circuit. The Seventh Circuit agreed with the district court that Sharif's untimely *Stern* objection ordinarily would not be preserved. Even so, the Seventh Circuit ruled that a litigant cannot waive a *Stern* objection because such an objection concerns "the allocation of authority between bankruptcy courts and district courts" under Article III and thus "implicate[s] structural interests." On the merits, the Seventh Circuit affirmed the bankruptcy court's denial of Sharif's discharge but found that the declaratory judgment sought in Wellness's adversary complaint concerned a *Stern* claim regarding which the bankruptcy court lacked the constitutional authority to enter a final judgment.

The Supreme Court granted Sharif's petition for a writ of certiorari as to whether: (i) the presence of a subsidiary state property law issue in an action brought against a debtor to determine whether property in its possession is property of the bankruptcy estate under section 541 of the Bankruptcy Code means that the action does not "stem[] from the bankruptcy itself" (and thus is not a core proceeding) and, therefore, that a bankruptcy court does not have the constitutional authority to enter a final order deciding that action; and (ii) Article III permits the exercise of the judicial power of the United States by a bankruptcy court on the basis of litigant consent and, if so, whether implied consent based on a litigant's conduct is sufficient to satisfy Article III.

THE SUPREME COURT'S RULING

The Supreme Court affirmed in a split decision. The five-justice majority, however, declined to consider the question of whether the claims asserted by Wellness were, in fact, core and skipped directly to the question of consent.

Writing for the five-justice majority, Justice Sonia Sotomayor highlighted the practical considerations at stake if the Court were to hold that Article III is violated when parties consent to adjudication by a bankruptcy judge. Such a decision, she wrote, would severely diminish the "distinguished service" of 883 full-time magistrate judges and bankruptcy judges; this, in turn, would cause "the work of the federal court system [to] grind nearly to a halt." According to the majority, such a result would be completely at odds with *Stern*, in which the Court described its holding as a "narrow" one that did "not change all that much" about the division of labor between the district courts and bankruptcy courts. If *Stern* is truly a narrow decision, Justice

Sotomayor stated, it cannot "bar consensual adjudications by bankruptcy courts."

After setting this backdrop, Justice Sotomayor turned to the premise underlying the majority ruling—that "[a]djudication by consent is nothing new." She noted the Court's precedent in *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833 (1986), which involved the defendant's waiver of the right to have his claims heard before an Article III court after submitting those claims to the Commodity Futures Trading Commission. She also explained that, in *Gomez v. United States*, 490 U.S. 858 (1989), and *Peretz v. United States*, 501 U.S. 923 (1991), the Court emphasized the importance of consent in the context of allowing a magistrate judge to supervise the jury selection process. In her view, those cases stand for the common principle that "[t]he entitlement to an Article III adjudication is 'a personal right' and thus ordinarily 'subject to waiver.' " Justice Sotomayor noted that Article III also serves a "structural purpose" by barring legislative attempts to erode the power of the judicial branch in favor of Congress. She concluded that, so long as "Article III courts retain supervisory authority over" Article I adjudicators, there is no offense to the separation of powers.

In *Wellness*, the majority determined that permitting bankruptcy courts to consider *Stern* claims by consent would not " 'impermissibly threaten[] the institutional integrity of the Judicial Branch' " (quoting *Schor*). Again with "an eye to the practical effect" which the Court's decision would have on the federal judiciary, Justice Sotomayor considered that bankruptcy judges, like magistrate judges, are appointed and subject to removal by Article III judges. Further, she explained, bankruptcy courts hear matters solely on a district court's reference, which the district court may withdraw *sua sponte* or at a party's request. Justice Sotomayor likened this dynamic to the relationship between district courts and magistrate judges, where the district court decides whether or not to invoke the assistance of a magistrate judge. Finally, she emphasized that bankruptcy courts' ability to resolve claims typically heard by Article III courts is limited to "a narrow class of common law claims" and that the legislative grant of this ability was not intended to "aggrandize [Congress] or humble the judiciary." In sum, Justice Sotomayor concluded, "[S]o long as [bankruptcy judges] are subject to control by the Article III courts, their work poses no threat to the separation of powers."

Having dismissed all but *de minimis* structural concerns, the majority revisited *Stern*. The majority noted that *Stern* was premised on "non-consent to adjudication by the Bankruptcy Court" and therefore does not apply to the "question of whether litigants may validly consent to adjudication by a bankruptcy court." Justice Sotomayor again emphasized the narrow holding of *Stern* and the absence of any intention in the ruling to turn the division of labor between district courts and bankruptcy courts on its head.

Wellness is a welcome clarification of the effect of consent on bankruptcy courts' adjudication of *Stern* claims. However, the opinion does not offer any guidance on what constitutes "knowing and voluntary" consent or when such consent (express or implied) must be given in order to cure any constitutional deficiency. In addition, like *Arkison*, *Wellness* does nothing to help explain which claims, as a constitutional matter, can be finally determined by a bankruptcy judge.

Finally, the majority ruled that consent to adjudicate a *Stern* claim may be express or implied, so long as it is "knowing and voluntary." Because it was unclear "whether Sharif's actions

evinced the requisite knowing and voluntary consent, and also whether . . . Sharif forfeited his *Stern* argument below," the Court remanded the case to the Seventh Circuit to resolve those issues.

Justice Samuel Alito filed a concurring opinion in which he agreed with the majority opinion but stated that he would not have decided whether consent may be implied. In Justice Alito's view, it was unnecessary to reach this question because Sharif had forfeited his *Stern* objection by failing to timely present it to the district court.

Chief Justice John Roberts, Justice Antonin Scalia, and Justice Clarence Thomas dissented. The dissenters faulted the majority for, among other things: (i) failing to decide the case on the issue of whether the presence of a subsidiary state property law issue in an action brought against a debtor to determine whether property in its possession is property of the bankruptcy estate means that the action is noncore, leaving the bankruptcy court without constitutional authority to enter a final order deciding the dispute; (ii) yielding too fully to functionalism at the expense of the judiciary's constitutionally endowed power; and (iii) failing to inquire "whether bankruptcy courts act within the bounds of their constitutional authority when they adjudicate *Stern* claims with the consent of the parties."

OUTLOOK

Wellness is a welcome clarification of the effect of consent on bankruptcy courts' adjudication of *Stern* claims. However, the opinion does not offer any guidance on what constitutes "knowing and voluntary" consent or when such consent (express or implied) must be given in order to cure any constitutional deficiency. In addition, like *Arkison*, *Wellness* does nothing to help explain which claims, as a constitutional matter, can be finally determined by a bankruptcy judge. The majority passed on the opportunity to clarify the scope of *Stern* claims. Thus, disputes over whether a claim is a *Stern* claim are likely to continue.

The U.S. District Court for the Southern District of New York recently shed light on the question of whether a bankruptcy court has power to make a final decision on disputed ownership of property so long as there are not adverse claims by third parties—a question on which the majority in *Wellness* expressed "no view."

In *Ka Kin Wong v. HSBC Bank USA, N.A. (In re Lehman Bros. Holdings Inc.)*, 2015 BL 195866 (S.D.N.Y. June 15, 2015), the plaintiffs filed a motion to withdraw the reference to the bankruptcy court of an adversary proceeding that dealt with the contested ownership of property held by the debtor, over which the plaintiffs alleged a common law constructive trust. Because the plaintiffs claimed that property held by the estate was subject to a constructive trust, the dispute affected the "administration of the estate" and was arguably a core proceeding under 28 U.S.C. § 157(b)(2)(A).

The *Ka Kin Wong* court examined whether the Supreme Court's ruling in *Stern* affected the Second Circuit's ruling in *Orion Pictures Corp. v. Showtime Networks, Inc.*, 4 F.3d 1095 (2d Cir. 1993). In *Orion*, the Second Circuit instructed district courts, in deciding whether to withdraw the reference to a bankruptcy court, to "first evaluate whether the claim is core or non-core" and then "weigh questions of efficient use of judicial resources, delay and costs to the parties, uniformity of bankruptcy administration, the prevention of forum shopping and other related factors."

In *Ka Kin Wong*, the district court also analyzed "whether the bankruptcy court may constitutionally enter a final judgment" on the plaintiffs' claims. It concluded that, although the bankruptcy court's ability to do so "is not in and of itself determinative of whether the Court should grant a motion to withdraw the reference," there was a "strong argument that Plaintiff's claims here are core and constitutionally within the province of the bankruptcy court for final adjudication." Thus, the district court found with respect to this element of the *Orion* test that, where the property is in the debtor's possession and there is no adverse claim by third parties, the bankruptcy court may have power to make a final decision regarding ownership notwithstanding the involvement of common law (or, as in *Wellness*, state law) issues relating to the claims. However, examining the remaining *Orion* factors, the *Ka Kin Wong* court ruled that withdrawal of the reference was not warranted.

NEWSWORTHY

Jones Day represented NII Holdings, Inc. ("NII"), a Reston, Virginia-based telecommunications company that provides wireless services under the Nextel name in Brazil, Mexico, Argentina, and Chile, in connection with the confirmation on June 19, 2015, by the U.S. Bankruptcy Court for the Southern District of New York of a chapter 11 plan of reorganization and NII's subsequent emergence from bankruptcy. With $7.4 billion in assets and $8 billion in debt, NII filed the second-largest public-company chapter 11 case of 2014. The Jones Day team was led by ***Scott J. Greenberg (New York)***, ***David G. Heiman (Cleveland)***, and ***Carl E. Black (Cleveland)*** and included ***Lisa G. Laukitis (New York)***, ***Robert W. Hamilton (Columbus)***, ***Michael J. Cohen (New York)***, ***George R. Howard (New York)***, ***Bryan M. Kotliar (New York)***, ***Alex M. Sher (New York)***, and ***Genna L. Ghaul (New York)***.

Jones Day is representing Molycorp, Inc., in connection with its chapter 11 filing on June 25, 2015, in the U.S. Bankruptcy Court for the District of Delaware. The Colorado-based company owns the largest rare-earth deposits outside China, operates across 10 countries, and makes specialized products from 13 different rare earths and other metals. The Jones Day team was led by ***Paul D. Leake (New York)***, ***Lisa G. Laukitis (New York)***, and ***Ryan T. Routh (Cleveland)*** and includes ***I. Lewis H. Grimm (Banking & Finance; New York)***, ***Joseph M. Tiller (Chicago)***, ***Lauren M. Buonome (New York)***, and ***William M. Hildbold (New York)***.

Bruce Bennett (Los Angeles), ***Paul D. Leake (New York)***, and ***Corinne Ball (New York)*** were recommended in the field of "Finance—Corporate restructuring (including bankruptcy)" in *The Legal 500 United States 2015*.

An article written by ***Lori Sinanyan (Los Angeles)*** and ***Bennett L. Spiegel (Los Angeles)*** entitled "Does the 'Best Interests' Test Protect the Tardy?" was published in the July 2015 edition of *The Bankruptcy Strategist*.

An article written by ***Corinne Ball (New York)*** entitled "Risk Management in Exiting an Equity Investment: 'Tristar' " was published in the April 23, 2015, edition of the *New York Law Journal*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "Tender Offer Approved to Implement Classwide Debt Exchange Outside Plan of Reorganization" was posted on May 19, 2015, on the website of the Harvard Law School Bankruptcy Roundtable.

Bruce Bennett (Los Angeles) was recommended in the field of "Finance—Municipal bankruptcy" in *The Legal 500 United States 2015*.

Paul D. Leake (New York) was a panelist at the 31st Annual Bankruptcy & Restructuring Conference in Philadelphia on June 6, 2015, hosted by the Association of Insolvency & Restructuring Advisors. The panel discussion was entitled "Post-Sale Issues in Chapter 11: Sailing into Rough Seas."

Heather Lennox (New York and Cleveland) moderated a panel at the 2015 NASP Annual Pension and Financial Services Conference in Chicago on June 16, 2015. The topic discussed was "Municipal Bankruptcy Lessons Learned and What Lies Ahead."

Lawdragon has selected ***Heather Lennox (New York and Cleveland)*** as a member of the Lawdragon 500 Leading Lawyers in America for 2014–2015.

THIRD CIRCUIT APPROVES STRUCTURED DISMISSAL OF CHAPTER 11 CASE THAT INCLUDES SETTLEMENT DEVIATING FROM BANKRUPTCY CODE'S PRIORITY SCHEME

Charles M. Oellermann and Mark G. Douglas

A "structured dismissal" of a chapter 11 case following a sale of substantially all of the debtor's assets has become increasingly common as a way to minimize costs and maximize creditor recoveries. However, only a handful of rulings have been issued on the subject, perhaps because bankruptcy and appellate courts are unclear as to whether the Bankruptcy Code authorizes the remedy.

The U.S. Court of Appeals for the Third Circuit recently weighed in on this issue in *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 2015 BL 160363 (3d Cir. May 21, 2015). The court ruled that "absent a showing that a structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion processes, a bankruptcy court has discretion to order such a disposition." The court also held that "bankruptcy courts may approve settlements that deviate from the priority scheme of [the Bankruptcy Code]," but only if the court has "specific and credible grounds" to justify the deviation.

STRUCTURED DISMISSALS

In a typical successful chapter 11 case, a plan of reorganization or liquidation is proposed; the plan is confirmed by the bankruptcy court; the plan becomes effective; and, after the plan has been substantially consummated and the case has been fully administered, the court enters a final decree closing the case. Because chapter 11 cases can be prolonged and costly, prepackaged or prenegotiated plans and expedited asset sales under section 363(b) of the Bankruptcy Code have been increasingly used as methods to short-circuit the process, minimize expenses, and maximize creditor recoveries.

After a bankruptcy court approves the sale of substantially all of a chapter 11 debtor's assets under section 363(b), a number of options are available to deal with the debtor's vestigial property and claims against the bankruptcy estate and to wind up the bankruptcy case. Namely, the debtor can propose and seek confirmation of a liquidating chapter 11 plan, the case can be converted to a chapter 7 liquidation, or the case can be dismissed. The first two options commonly require significant time and administrative costs.

As a consequence, structured dismissals of chapter 11 cases following section 363(b) sales of substantially all of the debtors' assets have become a popular exit strategy. A "structured dismissal" is a dismissal conditioned upon certain elements agreed to in advance by stakeholders and then approved by the bankruptcy court, as distinguished from an unconditional dismissal of the chapter 11 case ordered by the court under section 1112(b) of the Bankruptcy Code. Structured dismissals have typically been granted in cases where: (i) the debtor has sold, with court authority, substantially all of its assets outside the plan context but is either administratively insolvent or lacks sufficient liquidity to fund the plan confirmation process; or (ii) after approval of a section 363(b) asset sale, the debtor has the wherewithal to confirm a liquidating chapter 11 plan, but costs associated with the confirmation process would likely eliminate or significantly reduce funds available for distribution to creditors.

Typical Terms

Among the common provisions included in bankruptcy court orders approving structured dismissals are the following:

- Expedited procedures to resolve claims objections.
- Provisions specifying the manner and amount of distributions to creditors.
- Releases and exculpation provisions that might ordinarily be approved as part of a confirmed chapter 11 plan.
- Senior creditor carve-outs and "gifting" provisions, whereby, as a quid pro quo for a consensual structured dismissal, a senior secured lender or creditor group agrees to carve out a portion of its collateral from the sale proceeds and then "gift" it to unsecured creditors.
- Provisions that, notwithstanding section 349 of the Bankruptcy Code (vacating certain bankruptcy court orders when a case is dismissed), prior bankruptcy court orders survive dismissal and the court retains jurisdiction to implement the structured dismissal order; to resolve certain disputes; and to adjudicate certain matters, such as professional fee applications.

Sources of Authority

The Bankruptcy Code does not expressly authorize or contemplate structured dismissals. Even so, sections 105(a), 305(a)(1), and 1112(b) are commonly cited as predicates for the remedy.

Section 1112(b)(1) directs a bankruptcy court, on request of a party in interest and after notice and a hearing, to convert a chapter 11 case to a chapter 7 liquidation or to dismiss a chapter 11 case, "whichever is in the best interests of creditors and the estate, for cause." "Cause" is defined in section 1112(b)(4) to include, among other things, "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation" and "inability to effectuate substantial consummation of a confirmed plan." Dismissal or conversion of a chapter 11 case under section 1112(b) is a two-step process. First, the court must determine whether "cause" exists for dismissal or conversion. Second, the court must determine whether dismissal or conversion of the case is in the best interests of the creditors and the estate. *See*, *e.g.*, *Rollex Corp. v. Associated Materials, Inc. (In re Superior Siding & Window, Inc.)*, 14 F.3d 240, 242 (4th Cir. 1994).

Section 305(a)(1) of the Bankruptcy Code provides that a bankruptcy court may dismiss or suspend all proceedings in a bankruptcy case under any chapter if "the interests of creditors and the debtor would be better served by such dismissal or suspension." Section 305(a)(1) has traditionally been used to dismiss involuntary cases where recalcitrant creditors involved in an out-of-court restructuring file an involuntary bankruptcy petition to extract more favorable treatment from the debtor. However, the provision has also been applied to dismiss voluntary cases, albeit on a more limited basis. Because an order dismissing a case under section 305(a) may be reviewed on appeal only by a district court or a bankruptcy appellate panel, rather than by a court of appeals or the U.S. Supreme Court (*see* 11 U.S.C. § 305(c)), section 305(a) dismissal is an "extraordinary remedy." *See In re Kennedy*, 504 B.R. 815, 828 (Bankr. S.D. Miss. 2014); *see also Gelb v. United States (In re Gelb)*, 2013 BL 166941, *6 n.13 (B.A.P. 9th Cir. Mar. 29, 2013) (dismissal or suspension order under section 305(a) reviewable by bankruptcy appellate panel).

Section 105(a) of the Bankruptcy Code provides that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. However, section 105(a) " 'does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.' " *Law v. Siegel*, 134 S. Ct. 1188, 1194 (2014) (quoting 2 COLLIER ON BANKRUPTCY ¶ 105.01[2], pp. 105–06 (16th ed. 2013)).

Most structured dismissals are consensual. The few reported and unreported decisions on the issue reflect that some courts have been willing to order structured dismissals due to the consent of stakeholders and because a structured dismissal is a more expeditious, cost-effective, and beneficial means of closing a chapter 11 case. *See*, *e.g.*, *In re Naartjie Custom Kids, Inc.*, 2015 BL 223160 (Bankr. D. Utah July 13, 2015) (structured dismissal authorized as "an extraordinary remedy" under sections 305(c) and 349(b) of the Bankruptcy Code (the latter specifies the effects of dismissal, unless the court orders otherwise "for cause"); *In re Buffet Partners, L.P.*, 2014 BL 207602,*4 (Bankr. N.D. Tex. July 28, 2014) (ruling that sections 105(a) and 1112(b) of the Bankruptcy Code provide authority for structured dismissals and approving structured dismissal, "emphasiz[ing] that not one party with an economic stake in the case has objected to the dismissal in this manner"); *In re Felda Plantation, LLC*, 2012 WL 1965964 (Bankr. N.D. Fla. May 29, 2012) (granting chapter 11 debtor's motion for structured dismissal in order, provided that, notwithstanding dismissal, all orders entered in bankruptcy survived dismissal, court retained jurisdiction to rule on fee applications, and debtor was obligated to pay U.S. Trustee and professional fees, as well as creditors, as specified); *Omaha Standing Bear Pointe, L.L.C. v. Rew Materials (In re Omaha Standing Bear Pointe, L.L.C.)*, 2011 BL 69859 (Bankr. D. Neb. Mar. 17, 2011) (noting that chapter 11 debtor's motion for structured dismissal was granted after real property was sold free and clear and proceeds were distributed to secured creditor); *see also In re Fleurantin*, 420 Fed. Appx. 194, 2011 BL 80633 (3d Cir. Mar. 28, 2011) (ruling that bankruptcy court did not abuse its discretion in approving structured dismissal of individual chapter 7 case, which trustee argued "was in the best interests of the parties, particularly in light of the estate's continued expenditure of legal fees in response to [debtor's] motions and other efforts to obstruct its administration"). *But see In re Biolitec,* 2014 BL 355529 (Bankr. D.N.J. Dec. 16, 2014) (rejecting proposed structured dismissal as invalid under Bankruptcy Code)*; In re Strategic Labor, Inc.*, 467 B.R. 11, 11 and n.10 (Bankr. D. Mass. 2012) (stating that "[t]his matter offers an object lesson in how not to run a Chapter 11 case"; denying debtor's post-asset sale motion for approval of a structured dismissal, where, among other things, debtor intentionally mischaracterized secured claim of Internal Revenue Service and used cash collateral without authority; and instead granting U.S. Trustee's motion to convert to chapter 7).

Regardless of stakeholder consent, the Office of the U.S. Trustee, the division of the U.S. Department of Justice entrusted with overseeing the administration of bankruptcy cases, frequently objects to structured dismissals. The U.S. Trustee has argued, among other things, that structured dismissals: (i) distribute assets without adhering to statutory priorities; (ii) include improper and overbroad releases and exculpation clauses; (iii) violate the express requirements of section 349(b); (iv) may constitute "*sub rosa*" chapter 11 plans that seek to circumvent plan confirmation requirements and creditor protections; (v) improperly provide for retention of the bankruptcy court's jurisdiction; and (vi) fail to reinstate the remedies of creditors under applicable nonbankruptcy law. *See* Nan Roberts Eitel, T. Patrick Tinker & Lisa L. Lambert, *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, 30 AM. BANKR. INST. J. 20 (Mar. 2011).

THE BANKRUPTCY CODE'S PRIORITY SCHEME

Secured claims enjoy the highest priority under the Bankruptcy Code. A claim is secured only to the extent that the value of the underlying collateral is equal to or greater than the face amount of the indebtedness. If this is not the case, the creditor will hold a secured claim in the amount of the collateral value, along with an unsecured claim for the deficiency. Applicable nonbankruptcy law and any agreements between and among the debtor and its secured creditors generally determine the relative priority of secured claims. However, the Bankruptcy Code provides for the creation of priming liens superior even to pre-existing liens under certain circumstances, in connection with financing extended to a debtor during a bankruptcy case.

The order of priority of unsecured claims is specified in section 507(a) of the Bankruptcy Code. Priorities are afforded to a wide variety of unsecured claims, including, among others, specified categories and (in some cases) amounts of domestic support obligations, administrative expenses, employee wages, taxes, and certain wrongful death damages awards.

In a chapter 7 case, the order of priority of the distribution of unencumbered estate assets is determined by section 726 of the Bankruptcy Code. The order of distribution ranges from payments on claims in the order of priority specified in section 507(a), which have the highest priority, to payment of any residual assets to the debtor, which has the lowest priority. Distributions are to be made pro rata to claimants of equal priority within each of the six categories of claims specified in section 726. If claimants in a higher category of distribution do not receive full payment of their claims, no distributions can be made to lower category claimants.

In a chapter 11 case, the chapter 11 plan determines the treatment of secured and unsecured claims (as well as equity interests) in accordance with the provisions of the Bankruptcy Code. If a creditor does not agree to "impairment" of its claim under a plan—such as by agreeing to receive less than payment in full—and votes to reject the plan, the plan can be confirmed only under certain specified conditions. Among these are: (i) the creditor must receive at least as much under the plan as it would receive in a chapter 7 case (section 1129(a)(7)), a requirement that incorporates the priority and distribution schemes delineated in sections 507(a) and 726; and (ii) the plan must be "fair and equitable." Section 1129(b)(2) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, if no creditor or equity holder of lesser priority receives any distribution under the plan. This requirement is sometimes referred to as the "absolute priority rule."

In *Jevic Holding*, the Third Circuit addressed the validity of a settlement deviating from the Bankruptcy Code's priority scheme as part of a structured dismissal.

JEVIC HOLDING

Jevic Transportation, Inc. ("Jevic") was a New Jersey-based trucking company. In 2006, the financially troubled company was acquired in a leveraged buyout by a subsidiary of private-equity firm Sun Capital Partners, Inc. ("Sun Capital"). The transaction was financed by a group of lenders led by CIT Group Business Credit Inc. ("CIT").

Jevic's financial situation continued to deteriorate. On May 19, 2008, Jevic ceased operating and notified its employees that they were being terminated, effective immediately. Jevic filed for chapter 11 protection in the District of Delaware on May 20, 2008. As of the petition date, Jevic owed approximately $53 million to its first-priority secured lenders (CIT and Sun Capital) and more than $20 million to taxing authorities and general unsecured creditors.

A group of Jevic's terminated truck driver employees (the "Drivers") commenced a class action adversary proceeding against Jevic and Sun Capital, alleging that they had been given

insufficient notice of termination under federal and state Worker Adjustment and Retraining Notification ("WARN") Acts. In a separate action, the official unsecured creditors' committee (the "Committee") sued Sun Capital and CIT on behalf of the estate, claiming, among other things, that the transfers made and obligations incurred during the leveraged buyout were avoidable as preferences and fraudulent transfers.

After the court granted and denied in part the defendants' motions to dismiss the Committee's complaint, the parties convened in March 2012 to negotiate a settlement of the dispute. By that time, substantially all of Jevic's assets had been liquidated to repay the lender group led by CIT. The only remaining assets consisted of $1.7 million in cash (encumbered by Sun Capital's lien) and the avoidance claims against CIT and Sun Capital.

The Committee, Jevic, CIT, and Sun Capital reached a settlement whereby, among other things: (i) CIT would pay $2 million into an account earmarked for the payment of legal fees and other administrative expenses; (ii) Sun Capital would release its lien on the remaining $1.7 million in cash, which would be distributed under a trust to tax and administrative creditors, with any remaining cash to be distributed to general unsecured creditors on a pro rata basis; (iii) the parties would exchange releases, and the avoidance action would be dismissed; and (iv) Jevic's chapter 11 case would then be dismissed. The parties jointly sought bankruptcy court approval of the settlement and the structured dismissal.

The Drivers, whose WARN Act claims were not covered by the settlement, and the U.S. Trustee objected. Although the Drivers' claims had not been liquidated, the Drivers estimated that their claims amounted to approximately $12.4 million, of which $8.3 million was entitled to priority as a wage claim under section 507(a)(4) of the Bankruptcy Code. According to the Drivers and the U.S. Trustee, the proposed settlement and structured dismissal should not be approved because: (i) the settlement would distribute property of the estate to creditors of lower priority than the Drivers without paying their more senior priority claims; and (ii) the Bankruptcy Code does not authorize structured dismissals.

The bankruptcy court acknowledged that the Bankruptcy Code does not expressly authorize the distributions and dismissal contemplated by the settlement motion. Even so, noting that other courts have granted similar relief, the court concluded that "the dire circumstances that are present in this case warrant the relief requested here." Specifically, the court found that: (a) absent approval of the settlement, there was "no realistic prospect" of a meaningful distribution to anyone other than secured creditors; (b) there was "no prospect" of a confirmable chapter 11 plan (of either reorganization or liquidation); and (c) conversion to a chapter 7 liquidation would have been unavailing because a chapter 7 trustee would not have sufficient funds "to operate, investigate or litigate."

The bankruptcy court also rejected the argument that the settlement should not be approved because it distributed estate assets in violation of the absolute priority rule. Although chapter 11 plans must comply with the Bankruptcy Code's priority scheme, the court noted, settlements need not do so.

Instead, the bankruptcy court applied the multifactor test articulated in *In re Martin*, 91 F.3d 389, 393 (3d Cir. 1996), to assess the propriety of the settlement under Rule 9019 of the Federal Rules of Bankruptcy Procedure. Under this test, the court considers: (i) the probability of success in the litigation; (ii) the likely difficulties in collecting on a judgment; (iii) the complexity of the litigation, as well as the cost, inconvenience, and delay associated with it; and (iv) the paramount interests of creditors.

The bankruptcy court found, among other things, that the Committee's likelihood of success in the avoidance action was "uncertain at best," given the legal impediments to recovery, the substantial resources of the defendants, and the scarcity of estate funds. Confronted, in its view, with either "a meaningful recovery or zero," the bankruptcy court ruled that "[t]he paramount interest of the creditors mandates approval of the settlement" and nothing in the Bankruptcy Code dictates otherwise. It accordingly approved the settlement and the structured dismissal of Jevic's chapter 11 case.

After the U.S. District Court for the District of Delaware affirmed on appeal, the Drivers appealed to the Third Circuit.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit affirmed in a split decision. At the outset, writing for the majority, circuit judge Thomas M. Hardiman noted that "[t]his appeal raises a novel question of bankruptcy law: may a case arising under Chapter 11 ever be resolved in a 'structured dismissal' that deviates from the

Bankruptcy Code's priority system?" He concluded that "in a rare case, it may."

Structured Dismissal May Be Authorized

Judge Hardiman agreed with the Drivers that, although structured dismissals have been approved with increasing frequency, the Bankruptcy Code does not expressly authorize such dismissals. He also acknowledged that Congress "would have spoken more clearly if it had intended to leave open an end run around the procedures that govern plan confirmation and conversion to Chapter 7." Even so, the judge rejected as overbroad the Drivers' argument that the position staked out by the settlement proponents overestimated the breadth of a bankruptcy court's settlement-approval power under Rule 9019, " 'render[ing] plan confirmation superfluous' and paving the way for illegitimate *sub rosa* plans engineered by creditors with overwhelming bargaining power."

According to Judge Hardiman, those concerns are relevant only if a structured dismissal is used to circumvent the plan confirmation process or conversion to chapter 7. In Jevic's case, Judge Hardiman stated, the evidence showed that there was no prospect of a confirmable plan for Jevic and that conversion to chapter 7 "was a bridge to nowhere." Accordingly, the majority ruled that "absent a showing that a structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion processes, a bankruptcy court has discretion to order such a disposition."

Settlement That Deviates From the Code's Priority Scheme Permitted

Next, Judge Hardiman considered whether a settlement in the context of a structured dismissal "may ever skip a class of objecting creditors in favor of more junior creditors." For guidance, he looked to the rulings of two sister circuits that had previously grappled with this question. In *Matter of AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984), the Fifth Circuit rejected a settlement that would have transferred litigation proceeds to an unsecured creditor without paying senior creditors in full. The Fifth Circuit held that chapter 11's "fair and equitable" standard, which requires compliance with the priority scheme, applies to settlements.

The Second Circuit adopted a more flexible approach in *In re Iridium Operating LLC*, 478 F.3d 452, 463–64 (2d Cir. 2007). There, the court rejected the Fifth Circuit's approach as "too rigid," ruling that the absolute priority rule "is not necessarily implicated" when "a settlement is presented for court approval apart from a reorganization plan." Instead, the Second Circuit held that:

> whether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is "fair and equitable" under Rule 9019, [but a noncompliant settlement can be approved when] the remaining factors weigh heavily in favor of approving a settlement.

Id. at 464.

In *Jevic*, the majority agreed with the Second Circuit's approach in *Iridium*. Given the " 'dynamic status of some pre-plan bankruptcy settlements,' " Judge Hardiman wrote, "it would make sense for the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure to leave bankruptcy courts more flexibility in approving settlements than in confirming plans of reorganization" (quoting *Iridium*, 478 F.3d at 464). However, echoing a concern expressed by the Second Circuit in *Iridium*, he cautioned that compliance with the Bankruptcy Code's priorities will ordinarily be dispositive of whether a proposed settlement is fair and equitable. "Settlements that skip objecting creditors in distributing estate assets," Judge Hardiman wrote, "raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals."

Judge Hardiman acknowledged that the propriety of the settlement among Jevic, Sun Capital, CIT, and the Committee was "a close call." Even so, he concluded that the bankruptcy court had sufficient reason to approve the settlement and the structured dismissal of Jevic's chapter 11 case. According to Judge Hardiman, "This disposition, unsatisfying as it was, remained the least bad alternative since there was 'no prospect' of a plan being confirmed and conversion to Chapter 7 would have resulted in the secured creditors taking all that remained of the estate in 'short order.' "

DISSENT

Judge Anthony J. Scirica filed a dissenting opinion. According to him, the settlement should not have been approved because it is "at odds with the goals of the Bankruptcy Code." He explained that, had the settlement's departure from the statute's priority scheme been necessary to maximize the estate's overall value,

he would have had no objection. However, Judge Scirica wrote that:

> the settlement deviates from the Code's priority scheme so as to maximize the recovery that certain creditors receive, some of whom (the unsecured creditors) would not have been entitled to recover anything in advance of the WARN Plaintiffs had the estate property been liquidated and distributed in Chapter 7 proceedings or under a Chapter 11 "cramdown."

As such, he concluded that the settlement and structured dismissal raise the same concern as transactions invalidated under the *sub rosa* plan doctrine. In short, he wrote, the settlement "appears to constitute an impermissible end-run around the carefully designed routes by which a debtor may emerge from Chapter 11 proceedings."

Judge Scirica acknowledged that, if the settlement were vacated, Jevic's chapter 11 case would likely be converted to a chapter 7 liquidation in which secured creditors would be the only creditors to recover anything. As a consequence, the judge noted that he "would not unwind the settlement entirely." Instead, he would: (i) permit the secured creditors to retain their releases; (ii) allow administrative creditors to keep their distributions; but (iii) force unsecured creditors to disgorge their distributions, which should then be distributed pro rata to pay the priority wage claims of the Drivers, with any surplus to be distributed to other creditors in accordance with the Bankruptcy Code's priority scheme.

OUTLOOK

Jevic Holdings is undoubtedly a positive development for proponents of structured dismissals as a means of maximizing creditor recoveries and keeping down costs. The approach sanctioned by the Third Circuit gives bankruptcy judges the flexibility, by means of a structured dismissal, to salvage some measure of recovery for parties other than secured creditors in a case where no chapter 11 plan could be confirmed and conversion to chapter 7 would only add another layer of administrative costs.

The final report issued on December 8, 2014, by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 recommended that rules governing section 363(b) sales be amended to build some of the features commonly included in structured dismissal orders into orders authorizing the sale of all or substantially all of a debtor's assets. If this proposal were adopted, the Commission stated, structured dismissals should be unnecessary, and courts could comply strictly with the Bankruptcy Code in connection with orders ending chapter 11 cases. It remains to be seen whether Congress will adopt this view in any future amendments to the Bankruptcy Code.

Pending congressional consideration of any such amendments, any concern about the Third Circuit's approval of the *Jevic Holdings* settlement, which deviated from the Bankruptcy Code's priority scheme by depriving an entire class of priority unsecured creditors of any recovery whatsoever, may be overblown. In its opinion, the majority noted that the Drivers were late in coming to the negotiating table and, more significantly, that Sun Capital, which was a defendant in the WARN Act litigation, was not eager to allow its cash collateral to be used to fund litigation against itself.

The perceived injustice of this "class skipping" in the settlement was apparently the principal provocation for Judge Scirica's dissent, as it clearly motivated his argument that the settlement should be modified to rectify the deviation. However, the funds earmarked in the settlement for paying unsecured creditors were subject to Sun Capital's liens. Thus, the settlement can be viewed as a senior-class "gift," a practice that has been sanctioned by some courts in approving a settlement or chapter 11 plan despite the absence of strict compliance with the Bankruptcy Code's priority scheme. *See*, *e.g.*, *In re Journal Register Co.*, 407 B.R. 520 (Bankr. S.D.N.Y. 2009); *In re World Health Alternatives, Inc.*, 344 B.R. 291 (Bankr. D. Del. 2006). *But see DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79 (2d Cir. 2011); *In re Armstrong World Indus.*, 432 F.3d 507 (3d Cir. 2005).

On July 6, 2015, the Drivers petitioned for a rehearing en banc of the Third Circuit's ruling. The Drivers argued in their petition, among other things, that the decision clashes with *AWECO* and *Iridium*. "Review by the full court is warranted," the Drivers contended, "to ensure the uniformity of federal law on a question of considerable and increasing importance to bankruptcy law."

LARGEST PUBLIC-COMPANY BANKRUPTCY FILINGS SINCE 1980

Company	Filing Date	Industry	Assets
Lehman Brothers Holdings Inc.	09/15/2008	Investment Banking	$691 billion
Washington Mutual, Inc.	09/26/2008	Banking	$328 billion
WorldCom, Inc.	07/21/2002	Telecommunications	$104 billion
General Motors Corporation	06/01/2009	Automobiles	$91 billion
CIT Group Inc.	11/01/2009	Banking and Leasing	$80 billion
Enron Corp.	12/02/2001	Energy Trading	$66 billion
Conseco, Inc.	12/17/2002	Financial Services	$61 billion
Energy Future Holding Corp.	04/29/2014	Utilities	$41 billion
MF Global Holdings Ltd.	10/31/2011	Commodities	$40.5 billion
Chrysler LLC	04/30/2009	Automobiles	$39 billion
Thornburg Mortgage, Inc.	05/01/2009	Mortgage Lending	$36.5 billion
Pacific Gas and Electric Company	04/06/2001	Utilities	$36 billion
Texaco, Inc.	04/12/1987	Oil and Gas	$35 billion
Financial Corp. of America	09/09/1988	Financial Services	$33.8 billion
Refco Inc.	10/17/2005	Brokerage	$33.3 billion
IndyMac Bancorp, Inc.	07/31/2008	Banking	$32.7 billion
Global Crossing, Ltd.	01/28/2002	Telecommunications	$30.1 billion
Bank of New England Corp.	01/07/1991	Banking	$29.7 billion
General Growth Properties, Inc.	04/16/2009	Real Estate	$29.6 billion
Lyondell Chemical Company	01/06/2009	Chemicals	$27.4 billion
Calpine Corporation	12/20/2005	Utilities	$27.2 billion
New Century Financial Corp.	04/02/2007	Financial Services	$26.1 billion
Colonial BancGroup, Inc.	08/25/2009	Banking	$25.8 billion
UAL Corporation	12/09/2002	Aviation	$25.2 billion
AMR Corporation	11/29/2011	Aviation	$25 billion
Delta Air Lines, Inc.	09/14/2005	Aviation	$21.9 billion
Adelphia Communications Corp.	06/25/2002	Cable Television	$21.5 billion
Capmark Financial Group, Inc.	10/25/2009	Financial Services	$20.6 billion
MCorp	03/31/1989	Banking	$20.2 billion
Mirant Corporation	07/14/2003	Energy	$19.4 billion
Ambac Financial Group, Inc.	11/08/2010	Financial Insurance	$18.9 billion

TEXAS DISTRICT COURT AFFIRMS BANKRUPTCY COURT'S USE OF CLAIM ESTIMATION PROCESS

Bryan M. Kotliar

Many companies that file for bankruptcy protection have liabilities that cannot be definitively quantified as of the bankruptcy petition date. Such "unmatured," "contingent," "unliquidated," or "disputed" debts could arise from, among other things: (i) causes of action that are being litigated at the time of a bankruptcy filing but have not resulted in a judgment; or (ii) claims against the company that exist prior to a bankruptcy filing but have not been asserted against the company in litigation or otherwise, let alone liquidated, as of the petition date.

All of these claims must be dealt with in administering a bankruptcy estate for the benefit of stakeholders as part of a chapter 7 liquidation or a chapter 11 case (whether a liquidation or a reorganization). However, litigating such claims to conclusion can be time-consuming and expensive, particularly if the litigation has not yet been commenced or must proceed in many different forums.

To aid in this difficult process, section 502(c) of the Bankruptcy Code provides bankruptcy courts with a mechanism to estimate contingent and unliquidated claims for purposes of allowance (and, in some cases, distribution) in the bankruptcy case. A ruling recently handed down by the U.S. District Court for the Southern District of Texas illustrates the dynamics of the claim estimation process. In *Mud King Prods., Inc. v. Nat'l Oilwell Varco, L.P. (In re Mud King Prods., Inc.)*, 2015 BL 52638 (S.D. Tex. Feb. 27, 2015), the district court upheld a bankruptcy court order estimating a chapter 11 debtor's liabilities in pre-bankruptcy litigation involving claims asserted by a competitor of the debtor.

CLAIM ESTIMATION IN BANKRUPTCY

One of the most important aspects of a bankruptcy case is the resolution—by allowance or disallowance—of "claims" asserted by creditors against a debtor. Section 101(5) of the Bankruptcy Code defines the term "claim" broadly to mean, among other things, a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." Accordingly, proofs of claim filed by creditors or claims scheduled by debtors may include contingent, unliquidated, disputed, or otherwise undetermined debts.

However, although such claims are not quantified when a debtor files for bankruptcy, an essential part of administering a bankruptcy estate involves assigning a monetary amount (or a range of monetary amounts) to every claim. The Bankruptcy Code provides a mechanism to estimate contingent and/or unliquidated claims. Specifically, section 502(c) of the Bankruptcy Code provides that "[t]here shall be estimated for purpose of allowance under this section . . . any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case."

The purpose of section 502(c) is to facilitate administration of a bankruptcy case: estimating a claim avoids the need to delay the case while liability and damages issues in other forums are resolved. Furthermore, claim estimation promotes a fair distribution to creditors through a realistic assessment of uncertain or undetermined claims. In addition, claim estimation can assist parties with formulating chapter 11 plans by quickly establishing the amount of liability for potentially large, undetermined claims.

Section 502(c) expressly states that estimation is "for purpose of allowance under this section." As such, "an estimation under section 502(c) generally should result in an allowed claim for all purposes in the bankruptcy case." COLLIER ON BANKRUPTCY ¶ 502.04[3] (16th ed. 2015). It follows that, unless stated otherwise and subject to certain exceptions, an order estimating a claim is final and subject to principles of judicial finality, including res judicata and collateral estoppel. *Id.*

In this regard, contingent or unliquidated personal injury tort or wrongful death claims can be estimated on a final basis by a bankruptcy court for purposes of allowance, but not for purposes of distribution in a bankruptcy case. Twenty-eight U.S.C. § 157(b)(2)(B) provides that "core proceedings" include "estimation of claims or interests for the purposes of confirming a plan under chapter 11, 12, or 13 . . . but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under [the Bankruptcy Code]." In addition, 28 U.S.C. § 157(b)(5) mandates that personal injury tort and wrongful death claims must be tried in a federal district court. Thus, although a bankruptcy court may estimate such claims for purposes of confirming a chapter 11

plan, the final amount of any such claim for purposes of distribution under the plan must be determined by a district court. *See* COLLIER ON BANKRUPTCY ¶ 3.06[1] (16th ed. 2015).

ESTIMATION METHODOLOGIES

The Bankruptcy Code does not dictate the method to be used to estimate a contingent or unliquidated claim. Bankruptcy courts generally employ whatever method is best suited to the circumstances. Various methods used by courts to estimate claims include summary trials, evidentiary hearings, and simple review of the pleadings and oral argument. *See In re Cantu*, 2009 BL 106556 (Bankr. S.D. Tex. May 15, 2009) (citing *In re Windsor Plumbing Supply Co.*, 170 B.R. 503 (Bankr. E.D.N.Y. 1994)). Some courts have used an "ultimate merits" approach in which the value of the claim is estimated according to its merits. *Id.* at *2–3 (citing cases). Other courts have focused on a probabilistic methodology in which the estimated value of the claim is "the amount of the claim diminished by the probability that it may be sustainable only in part or not at all." *Id.*

On appeal, a bankruptcy court's decision regarding the method used to estimate a claim is reviewed under a narrow "abuse of discretion" standard. *See Mud King Products*, 2015 BL 52638, *3. Appellate courts will generally defer to the congressional intent to accord "wide latitude" to the bankruptcy court's decision. *Id.* (citing *Bittner v. Borne Chem. Co.*, 691 F.2d 134, 136 (3d Cir. 1982)). In *Mud King Products*, the district court reviewed the claim estimation process employed by a bankruptcy court to establish the debtor's liability for claims asserted in litigation that had been pending as of the petition date for more than two years.

MUD KING PRODUCTS

Mud King Products, Inc. ("Mud King") is a small, Houston-based oilfield services company that sells primarily replacement "aftermarket" pump parts used in oil rigs. Mud King and similar companies create aftermarket replacement parts by reverse engineering a pump part manufactured by another company and then selling the replica version as compatible with the original manufacturer's product. One such original manufacturer is National Oilwell Varco, L.P. ("NOV"), a multinational manufacturer and distributor of equipment and parts used in the oil and gas industry.

In 2011, NOV discovered that one of its employees was selling blueprints for its original product designs to her brother-in-law, a Mud King manager. NOV sued Mud King in Texas state court on a variety of common law and statutory causes of action, including misappropriation of trade secrets under federal law, conversion, liability under the Texas Theft Liability Act ("TTLA"), civil conspiracy, and unjust enrichment. NOV sought and obtained a temporary restraining order from the state court prohibiting Mud King from selling any pump parts related to blueprints that were alleged to have been stolen from NOV. As damages, NOV sought disgorgement of Mud King's alleged profits of $284,000, associated development costs of more than $4 million, and punitive damages in the amount of approximately $2.5 million, plus attorneys' fees, costs, and prejudgment interest.

Mud King filed for chapter 11 protection in April 2013 in the Southern District of Texas, citing, among other things, escalating legal costs in defending against the NOV action, which had been removed to federal court prior to the bankruptcy filing. Mud King listed NOV's claim on its schedules as disputed, unliquidated, and contingent. NOV filed a proof of claim indicating that the amount it was owed in respect of the claims asserted in the state court action was "unknown."

Mud King later filed a motion to estimate NOV's claim under section 502(c). In the motion, Mud King asserted that, of the allegedly hundreds of NOV drawings in its possession, Mud King used only 23 such drawings to make 81 parts, for which it realized only approximately $131,000 in gross profits. Mud King requested that the bankruptcy court estimate NOV's claim at zero dollars or, alternatively, that the court enter an injunction similar to the temporary restraining order entered by the state and federal courts which would adequately protect NOV's interests. Mud King also argued that, at the estimation hearing, each side should be permitted no more than two hours to put on its case regarding both liability and the measure of damages.

NOV responded by moving to dismiss Mud King's chapter 11 case as having been filed in bad faith. According to NOV, Mud King was solvent at the time of the filing and was allegedly using bankruptcy as a litigation tactic to delay the pending nonbankruptcy litigation. NOV also objected to the estimation motion. It argued that estimation of its claim was improper due to Mud King's bad faith and its efforts to use estimation as a way to short-circuit the customary discovery and litigation procedures available to parties in federal litigation. Moreover, NOV asserted that its claim should not be estimated because the claim could be litigated to conclusion in the federal court

without undue delay, provided that NOV was granted relief from the automatic stay.

Mud King Products illustrates how section 502(c) of the Bankruptcy Code can be used to expedite and compress traditional litigation into a streamlined process that quickly establishes the amount of a creditor's contingent or unliquidated claim in a bankruptcy case. The availability of the claim estimation process (or the prospect thereof) can also facilitate meaningful plan negotiations by providing a mechanism to assign a monetary amount to contingent and unliquidated claims.

The bankruptcy court held an eight-day evidentiary estimation hearing. After meticulously examining each of the causes of action asserted by NOV in its complaint, the bankruptcy court ruled that NOV had established a claim for misappropriation of trade secrets, with damages in the amount of $74,434.95, plus possible prejudgment interest and attorneys' fees in the amount of $320,893, and a claim for statutory damages under the TTLA in the amount of $1,000. The bankruptcy court held that Mud King was not liable on any of the other causes of action. The court later denied NOV's motion to dismiss Mud King's chapter 11 case. NOV appealed the estimation ruling.

THE DISTRICT COURT'S RULING

The district court affirmed both the bankruptcy court's decision to estimate NOV's claim and the court's findings of fact and conclusions of law regarding the amount of the claim.

Initially, the district court explained that a bankruptcy court's decision regarding the methodology to estimate claims pursuant to section 502(c) may be reversed only if the bankruptcy court abused its discretion. Given this standard of review, the district court examined the bankruptcy court's estimation process. The bankruptcy court treated Mud King's estimation motion as if it were an objection to a claim under section 502(b) of the Bankruptcy Code. Because NOV's claim was disputed, the bankruptcy court determined that NOV had the burden of proving the amount of its claim by a preponderance of the evidence.

The district court held that it was not an abuse of discretion for the bankruptcy court to conduct a lengthy evidentiary hearing and to estimate NOV's claim in accordance with the procedures and rules governing the resolution of claims under section 502(b). In so ruling, the district court rejected NOV's argument that the bankruptcy court disregarded "overwhelming evidence" that Mud King filed for bankruptcy in bad faith in order to gain an unfair litigation advantage.

The district court also affirmed the bankruptcy court's conclusions with respect to Mud King's liability and its measure of damages on all counts.

CONCLUSION

Less than two months after the district court affirmed the estimation ruling, the bankruptcy court confirmed a chapter 11 plan of reorganization for Mud King under which NOV's estimated claim was paid in full. Absent estimation of NOV's claim, it might have taken months or even years to liquidate the claim, perhaps jeopardizing Mud King's prospects for reorganization and eventual emergence from bankruptcy.

Mud King Products illustrates how section 502(c) of the Bankruptcy Code can be used to expedite and compress traditional litigation into a streamlined process that quickly establishes the amount of a creditor's contingent or unliquidated claim in a bankruptcy case. The availability of the claim estimation process (or the prospect thereof) can also facilitate meaningful plan negotiations by providing a mechanism to assign a monetary amount to contingent and unliquidated claims.

IN RE SEASIDE ENGINEERING: ELEVENTH CIRCUIT HOLDS FAST ON LEGITIMACY OF NONCONSENSUAL THIRD PARTY PLAN RELEASES

Genna L. Ghaul

In a recent decision, the United States Court of Appeals for the Eleventh Circuit reaffirmed its position sanctioning, under appropriate circumstances, nonconsensual third party release provisions in chapter 11 plans. In *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc.(In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015), the Eleventh Circuit affirmed bankruptcy and district court decisions approving a debtor's chapter 11 plan that released the debtor's former principals over the objection of a noninsider equity holder. In so ruling, the Eleventh Circuit maintained its alignment with the majority position on the third party release issue, along with the Second, Third, Fourth, Sixth, and Seventh Circuits.

VALIDITY OF NONCONSENSUAL THIRD PARTY RELEASES IN A CHAPTER 11 PLAN

The federal circuit courts of appeal are split as to whether a bankruptcy court has the authority to approve chapter 11 plan provisions that, over the objection of creditors or other stakeholders, release specified nondebtors from liability and/or enjoin dissenting stakeholders from asserting claims against such nondebtors. The minority view, held by the Fifth, Ninth, and Tenth Circuits, bans such nonconsensual releases on the basis that section 524(e) of the Bankruptcy Code, which provides generally that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt," prohibits them. *See Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995); *In re W. Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990).

On the other hand, the majority of circuits to consider the issue—the Second, Third, Fourth, Sixth, and Seventh Circuits—have found such releases and injunctions permissible, under certain circumstances. *See In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285 (2d Cir. 1992); *In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000); *In re A.H. Robins Co., Inc.*, 880 F.2d 694 (4th Cir. 1989); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Airadigm Communications, Inc.*, 519 F.3d 640 (7th Cir. 2008). For authority, these courts generally rely on section 105(a) of the Bankruptcy Code, which authorizes courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." Moreover, as the Seventh Circuit held in *Airadigm*, the majority view is that section 524(e) does not limit a bankruptcy court's authority to grant such a release. The First and D.C. Circuits have indicated that they agree with the "pro-release" majority, as did the Eleventh Circuit in a decision that had long predated *Seaside Engineering*. *See In re Monarch Life Ins. Co.*, 65 F.3d 973 (1st Cir. 1995); *In re Munford, Inc.*, 97 F.3d 449 (11th Cir. 1996); *In re AOV Industries*, 792 F.2d 1140 (D.C. Cir. 1986).

In *Dow Corning*, the Sixth Circuit identified seven factors that bankruptcy courts should consider when evaluating the propriety of a nonconsensual release of claims against a nondebtor third party in a chapter 11 plan:

(1) An identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the estate;

(2) Substantial contribution by the nondebtor of assets to the reorganization;

(3) The essential nature of the injunction to the reorganization, namely, the fact that the reorganization hinges on the debtor's being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;

(4) Overwhelming acceptance of the plan by the impacted class or classes;

(5) Provision in the plan for payment of all or substantially all of the claims of the class or classes affected by the injunction;

(6) Provision in the plan for an opportunity for claimants who chose not to settle to recover in full; and

(7) A record of specific factual findings by the bankruptcy court that supports its conclusions.

The list is nonexclusive, and not all of the factors need to be satisfied. Courts have the discretion and flexibility to determine which of the factors will be relevant in each case.

In *In re Master Mortgage Invest. Fund, Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994), the bankruptcy court articulated a similar five-factor test that considers: (i) the identity of interests between the debtor and the third party, including any indemnity relationship; (ii) any value (monetary or otherwise) contributed by the third party to the chapter 11 case or plan; (iii) the need for the proposed release in terms of facilitating the plan or the debtor's reorganization efforts; (iv) the level of creditor support for the plan; and (v) the payments and protections otherwise available to creditors affected by the release. Like the *Dow Corning* factors, the *Master Mortgage* test has been cited with approval by many other courts. *See, e.g.*, *In re Charles St. African Methodist Episcopal Church of Bos.*, 499 B.R. 66 (Bankr. D. Mass. 2013); *In re Riverbend Leasing, LLC*, 458 B.R. 520 (Bankr. S.D. Iowa 2011); *In re Wash. Mut., Inc.*, 442 B.R. 314 (Bankr. D. Del. 2011); *In re Zenith Elecs. Corp.*, 241 B.R. 92 (Bankr. D. Del. 1999).

The Eleventh Circuit revisited the third party release issue in *Seaside Engineering*.

BACKGROUND

Seaside Engineering & Surveying, Inc. ("Seaside") was a closely held civil engineering and surveying firm that conducted hydrographic surveying and navigational mapping. Seaside's five principal shareholders were also its officers, directors, and key operating personnel.

Seaside's principal shareholders also formed two wholly separate real estate companies. These companies borrowed money from Vision-Park Properties, LLC, and an affiliate (collectively, "Vision"). Seaside's shareholders personally guaranteed the loans, but Seaside was neither a borrower nor a guarantor.

The real estate ventures ultimately defaulted on the loans, triggering a $4.5 million obligation under the personal guarantees. Three of Seaside's principal shareholders then filed chapter 7 cases. The chapter 7 trustee in one of the cases auctioned the debtor's Seaside shares, which Vision acquired for $100,000.

Seaside filed for chapter 11 protection in the Northern District of Florida on October 7, 2011 (after Vision acquired the Seaside shares). Seaside filed a chapter 11 plan (the "Plan") under which Seaside proposed to reorganize and continue operating under a new name—Gulf Atlantic, LLC ("Gulf"). Gulf would be owned by irrevocable family trusts settled for Seaside's principal shareholders, who would also manage the reorganized company. Under the Plan, nonmanager equity holders, including Vision, were to receive promissory notes with interest accruing at the rate of 4.25 percent annually in exchange for their interests in Seaside and would not receive an ownership interest in Gulf.

The Plan also included provisions releasing Seaside's officers, directors, and members; Gulf; Gulf's officers, directors, and members; and the representatives of each of these nondebtor entities. The releases covered liability for acts, omissions, transactions, and other occurrences related to Seaside's chapter 11 case, except actions amounting to fraud, gross negligence, or willful misconduct.

Vision objected to various aspects of the Plan, including the releases. According to Vision, the releases were "inappropriate, unjust and unnecessary" and improperly sought to frustrate Vision's efforts to collect from the principal shareholders and their respective bankruptcy estates.

The bankruptcy court approved the releases after Seaside amended the Plan provisions to remove subsidiaries and affiliates from the list of released parties and agreed to terminate litigation against Vision seeking sanctions. In doing so, the court applied the multifactor *Dow Corning* test.

The bankruptcy court confirmed the amended Plan over Vision's objections. Vision appealed to the U.S. District Court for the Northern District of Florida, which affirmed the confirmation order. Vision then appealed to the Eleventh Circuit.

THE ELEVENTH CIRCUIT'S RULING

A three-judge panel of the Eleventh Circuit affirmed.

At the outset of its ruling, the Eleventh Circuit noted that, in *Munford*, the court previously held that section 105(a) of the Bankruptcy Code provides bankruptcy courts with authority to approve nonconsensual third party releases. The court approved the release in *Munford* because: (i) it was "integral to settlement in an adversary proceeding," and (ii) the released party was a settling defendant that would not have agreed to the settlement without the release. Despite the factual dissimilarities between the two cases, the Eleventh Circuit in *Seaside Engineering* wrote that "*Munford* is the controlling case here" and held that the Eleventh Circuit follows the "majority view" that

nonconsensual third party releases are permissible under certain circumstances.

The Eleventh Circuit rejected the argument endorsed by the "minority circuits" that such releases are prohibited by section 524(e) of the Bankruptcy Code. In doing so, the court agreed with the Seventh Circuit's rationale in *Airadigm*, where the court stated that "[t]he natural reading of this provision does not foreclose a third-party release from a creditor's claims." Moreover, the Eleventh Circuit explained, if Congress had intended to limit the power of bankruptcy courts in this respect, it would have done so unequivocally.

Seaside Engineering confirms that the Eleventh Circuit is still firmly in the majority camp concerning the propriety of nonconsensual third party releases in a chapter 11 plan, depending on the circumstances. This can be viewed as a positive development for proponents of such releases as a tool for overcoming confirmation obstacles in complex, contested chapter 11 cases.

With this groundwork, the Eleventh Circuit ruled that the bankruptcy court's application of *Dow Corning* was consistent with existing Eleventh Circuit precedent. In commending those factors to bankruptcy courts within the circuit, the Eleventh Circuit emphasized that bankruptcy courts have discretion to determine which of the factors will be relevant in each case and that the factors should be considered a nonexclusive list of considerations. Moreover, the Eleventh Circuit noted, the *Dow Corning* factors should be applied flexibly, always keeping in mind that such releases should be used "cautiously and infrequently" and only where essential, fair, and equitable.

The Eleventh Circuit determined that the bankruptcy court did not abuse its discretion in finding that, overall, application of the *Dow Corning* factors demonstrated that the Plan releases were appropriate. However, the Eleventh Circuit explained that, in accordance with *Munford*, bankruptcy courts should also consider whether a proposed release is "fair and equitable." Although the bankruptcy court did not explicitly make such a finding in the case before it, the Eleventh Circuit was satisfied that the bankruptcy court, in discussing considerations relevant to such a finding and requiring Seaside to cease litigation against Vision, properly considered whether the releases had satisfied this requirement. Among other things, the Eleventh Circuit, noting that the bankruptcy court had described the chapter 11 case as a "death struggle," stated that "the nondebtor releases are a valid tool to halt that fight."

IMPACT OF *SEASIDE ENGINEERING*

Seaside Engineering confirms that the Eleventh Circuit is still firmly in the majority camp concerning the propriety of nonconsensual third party releases in a chapter 11 plan, depending on the circumstances. This can be viewed as a positive development for proponents of such releases as a tool for overcoming confirmation obstacles in complex, contested chapter 11 cases.

The final report issued on December 8, 2014, by the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 highlights the circuit split on this controversial issue. Although the Commission endorsed the majority view in favor of plan releases under appropriate circumstances, it also examined which text better determines whether such circumstances exist: the *Dow Corning* test or the *Master Mortgage* test.

The two tests overlap significantly. However, unlike the *Dow Corning* factors, the *Master Mortgage* factors do not consider whether "[t]he bankruptcy court made a record of specific factual findings that supports its conclusions." The Commission ultimately recommended that courts adopt a standard based on the factors articulated in *Master Mortgage* rather than those in *Dow Corning*. The Commission declined "to incorporate separate identification of unique or unusual circumstances," stating that "the *Master Mortgage* factors adequately capture[] the careful review required in these cases."

FROM THE TOP IN BRIEF

FEES ON FEES

On June 15, 2015, the U.S. Supreme Court handed down its ruling in *Baker Botts LLP et al. v. ASARCO LLC*, No. 14-103, 2015 BL 187887 (June 15, 2015), in which it considered whether a bankruptcy court has the power to award fees to a law firm for defending its fee application for services performed on behalf of a chapter 11 debtor.

The dispute concerned a $124 million base fee award for a law firm's work on mining giant ASARCO LLC's bankruptcy. The firm also received a $4 million merit enhancement for "rare and extraordinary" work. The Fifth Circuit upheld the enhancement bonuses but reversed the $5.2 million in fees awarded for defending the "core" fee, ruling that the Bankruptcy Code "does not authorize compensation for the costs counsel or professionals bear to defend their fee applications." *See ASARCO LLC v. Jordan Hyden Womble Culbreth & Holzer, P.C. (In re ASARCO LLC)*, 751 F.3d 291 (5th Cir. 2014), *cert. granted sub nom. Baker Botts LLP v. ASARCO LLC*, 135 S. Ct. 44 (2014). The Eleventh Circuit and a handful of lower courts have also disallowed "fees on fees," whereas the Ninth Circuit and a number of lower courts have permitted recovery of such professional fees. *See In re Smith,* 317 F.3d 918 (9th Cir. 2002); *Grant v. George Schumann Tire & Batt. Co.*, 908 F.2d 874 (11th Cir. 1990); *see generally* COLLIER ON BANKRUPTCY ¶ 330.03[16][a][ii] (16th ed. 2016).

The Supreme Court affirmed the Fifth Circuit's ruling in a 6-3 decision. Writing for the majority, Justice Clarence Thomas explained that, in accordance with the "American Rule," each litigant pays its own attorneys' fees, win or lose, unless a statute or contract provides otherwise.

Justice Thomas further explained that section 327(a) of the Bankruptcy Code authorizes the employment of professionals by a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP"), and section 330(a)(1), in turn, authorizes payment to such professionals of "reasonable compensation for actual, necessary services rendered" to the trustee or DIP.

According to Justice Thomas, the text of section 330(a)(1) "cannot displace the American Rule with respect to fee-defense litigation." The phrase "reasonable compensation for actual, necessary services rendered," he wrote, "neither specifically nor explicitly authorizes courts to shift the costs of adversarial litigation from one side to the other—in this case, from the attorneys seeking fees to the administrator of the estate."

Justice Thomas rejected the argument that fee-defense litigation is part of the "services" rendered to the estate administrator under section 330(a)(1). Reading "services" in this manner, he wrote, "could end up compensating attorneys for the *unsuccessful* defense of a fee application," which would be both an "unnatural interpretation" of the term and a "particularly unusual deviation from the American Rule."

Justice Thomas also rejected the argument that compensation for defending fees should be viewed as part of the compensation for the underlying services in the bankruptcy case. According to Justice Thomas, this interpretation simply cannot be reconciled with the text of section 330(a)(1) and rests on a "flawed and irrelevant policy argument . . . that awarding fees for fee-defense litigation is a 'judicial exception' necessary to the proper functioning of the Bankruptcy Code."

Justice Breyer, joined by Justice Ginsburg and Justice Kagan, dissented.

According to Justice Breyer, "[W]hen a bankruptcy court determines 'reasonable compensation,' it must take into account the expenses that a professional has incurred in defending his or her fee application." A contrary interpretation of the term, he explained, "would undercut a basic objective" of the Bankruptcy Code in ensuring that high-quality professionals are available to assist trustees in administering bankruptcy estates. Justice Breyer emphasized that additional fees, such as compensation for fee defense, may be necessary "in order to maintain comparability of compensation."

Justice Breyer concluded that, given these considerations, section 330(a) should be read to authorize compensation for defending fees as part of a professional's "reasonable compensation" and, accordingly, that the provision displaces the American Rule.

LIEN STRIPPING

On June 1, 2015, the U.S. Supreme Court handed down its ruling in a pair of related bankruptcy cases, *Bank of Am., N.A. v. Caulkett*, No. 13-421, 2015 BL 171240 (June 1, 2015), and *Bank of*

Am., N.A. v. Toledo-Cardona, No. 14-163, 2015 BL 171240 (June 1, 2015), where it considered whether, under section 506(d) of the Bankruptcy Code, a chapter 7 debtor may "strip off" a junior mortgage lien in its entirety when the outstanding debt owed to a senior lienholder exceeds the current value of the collateral.

"Claim" is generally defined in section 101(5) of the Bankruptcy Code as a "right to payment" from the debtor. Under section 506(a) of the Bankruptcy Code, a claim is secured only to the extent of the value of the collateral securing the debt. Any deficiency is deemed to be an unsecured claim.

Subject to certain exceptions, a claim filed by a creditor is deemed "allowed" under section 502(a) of the Bankruptcy Code if no interested party objects to the claim or, in the case of an objection, if the bankruptcy court determines that the claim should be allowed under section 502(b).

Section 506(d) provides that, with certain exceptions, "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void." Prior to 1992, some courts reasoned that section 506(d) permits a chapter 7 debtor to either: (i) "strip down" a partially secured claim to the value of the collateral, with the remaining debt treated as an unsecured claim; or (ii) "strip off" a junior mortgage lien entirely, in both cases because the claim in question is "not an allowed secured claim" by operation of section 506(a).

In *Dewsnup v. Timm*, 502 U.S. 410 (1992), the Supreme Court ruled that a chapter 7 debtor could not *strip down* a partially secured lien under section 506(d). Prior to the Court's recent rulings, several courts determined that *Dewsnup* should be read to preclude a chapter 7 debtor from *stripping off* a wholly unsecured junior lien. *See*, *e.g.*, *Ryan v. Homecomings Fin. Network*, 253 F.3d 778 (4th Cir. 2001); *Talbert v. City Mortg. Serv.*, 344 F.3d 555 (6th Cir. 2003). The Eleventh Circuit ruled to the contrary both prior to and after *Dewsnup* (*see Folendore v. United States Small Bus. Admin.*, 862 F.2d 1537 (11th Cir. 1989), and *McNeal v. GMAC Mortg., LLC (In re McNeal)*, 735 F.3d 1263 (11th Cir. 2012)), stating in *McNeal* that it rejected this extrapolation of *Dewsnup* to apply in a context which is factually and legally distinguishable.

The Eleventh Circuit reiterated this position in *Bank of Am., N.A. v. Caulkett (In re Caulkett)*, 566 Fed. App'x 879 (11th Cir. 2014), and in *Bank of Am., N.A. v. Toledo-Cardona*, 556 Fed. App'x 911 (11th Cir. 2014). The Supreme Court granted certiorari on November 17, 2014.

The Supreme Court reversed the rulings below. Writing for the unanimous court (with three justices declining to join in the opinion's footnote noting that *Dewsnup* has been the target of criticism since its inception), Justice Clarence Thomas explained that in *Dewsnup*, the Court defined the term "secured claim" in section 506(d) to mean "a claim supported by a security interest in property, regardless of whether the value of that property would be sufficient to cover the claim." Under this definition, he wrote, "§506(d)'s function is reduced to 'voiding a lien whenever a claim secured by the lien itself has not been allowed.' "

Because the lender's claims in the *Bank of America* cases were secured by liens *and* allowed under section 502, Justice Thomas ruled, they cannot be voided in accordance with *Dewsnup*'s definition of the term "allowed secured claim." The Court rejected the argument that *Dewsnup* should be limited to partially—as distinguished from wholly—underwater liens. "Given the constantly shifting value of real property," Justice Thomas wrote, "this reading could lead to arbitrary results."

On June 8 and June 22, 2015, the Court vacated the judgments in 13 Eleventh Circuit bankruptcy cases addressing the same issue as *Caulkett* and *Toledo-Cardona* and remanded each case to the Eleventh Circuit for further consideration in light of the rulings.

IN BRIEF: DELAWARE CHANCERY COURT RULES THAT CREDITOR DOES NOT FORFEIT STANDING TO BRING DERIVATIVE SUIT IF CORPORATION BECOMES SOLVENT

In a matter of first impression, the Delaware Court of Chancery held in *Quadrant Structured Products Co. Ltd. v. Vertin*, No. 6990-VCL, 2015 BL 128889 (Del. Ch. May 4, 2015), that a creditor suing derivatively on behalf of an insolvent corporation does not lose standing to prosecute the derivative claims if the corporation becomes solvent while the lawsuit is pending. In so ruling, the court expressly rejected a "continuous insolvency" or an "irretrievable insolvency" requirement for standing purposes.

Quadrant Structured Products Co. Ltd. ("Quadrant"), a creditor of Athilon Capital Corp. ("Athilon"), commenced a derivative suit in 2011 against Athilon's directors for alleged breaches of fiduciary duties. Although Athilon was insolvent on a balance sheet basis at the time Quadrant filed its complaint, Athilon achieved balance sheet solvency during the pendency of the lawsuit. The defendants moved for summary judgment, arguing that Athilon's return to solvency eliminated Quadrant's standing to maintain the derivative action. Alternatively, the defendants contended that they were entitled to summary judgment because Quadrant could not prove that Athilon was "irretrievably insolvent," with no reasonable prospect of returning to solvency.

The court rejected both arguments as a matter of law. It ruled that, to bring a derivative action, a creditor-plaintiff must plead and later prove insolvency under the traditional balance sheet test and that insolvency is measured at the time the suit is commenced.

The court's opinion is a primer on the evolution of creditor derivative suits asserting breach of fiduciary duty claims against directors of Delaware corporations. The court explained that, prior to the Delaware Supreme Court's decision in *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007), some courts and commentators had expressed the view that: (i) the directors of a Delaware corporation owed fiduciary duties to creditors once the corporation entered the "vicinity" or "zone" of insolvency; and (ii) the creditors could assert direct or derivative claims on behalf of the corporation, because the directors were obligated to "manage the corporation conservatively as a trust fund for the creditors' benefit."

Before *Gheewalla*, concerns were also raised that directors' decisions could be subjected to scrutiny under the more exacting "entire fairness" standard (as distinguished from the deferential "business judgment" standard) due to the inherent conflict of interest resulting from owing fiduciary duties to both creditors and stockholders. Directors also risked incurring liability to creditors for continuing to operate an insolvent corporation under a theory of "deepening insolvency."

Gheewalla, the Delaware Chancery Court explained in *Vertin*, rejected the concept of a "vicinity" or "zone" of insolvency and clarified that Delaware law imposes upon directors fiduciary duties to creditors only after the corporation is actually insolvent. In addition, creditors may commence only derivative (as distinguished from direct) actions for breach of fiduciary duty. Moreover, *Gheewalla* established that directors do not owe any particular duties to creditors. Instead, the fiduciary obligations of directors run "to the corporation for the benefit of all of its residual claimants," including creditors. Finally, in the aftermath of *Gheewalla*, it is clear that the directors of an insolvent corporation are entitled to the protection of the business judgment rule, even if the company's financial condition deteriorates (or deteriorates further) as a consequence of their decisions, provided that the directors were disinterested, were reasonably prudent, and acted in good faith.

Having established the groundwork, the Chancery Court in *Vertin* ruled that a creditor need establish insolvency only at the time it files a derivative action and that it is not stripped of standing to sue if the corporation becomes solvent during the pendency of the litigation. Continuous insolvency is not required, nor must the corporation be irretrievably insolvent in this context. The court acknowledged that its view on this issue might not be shared by the Delaware Supreme Court. It also noted that this approach might create the possibility of dual standing in some cases (i.e., both creditors and shareholders having standing to bring claims derivatively on behalf of a corporation which achieves solvency after derivative litigation has been commenced by a creditor against directors).

SOVEREIGN DEBT UPDATE

GREECE

On July 16, 2015, the finance ministers of the 19 eurozone countries agreed to "grant in principle" a third bailout package for Greece that could total €86 billion ($94.5 billion). Those ministers were joined by their counterparts from the remainder of the 28-nation European Union (the "EU") in agreeing to give Greece short-term loans of as much as €7 billion to meet its immediate needs. In addition, the European Central Bank (the "ECB") expanded an emergency line of credit for Greece's banks by €900 million, to total nearly €90 billion. Greek banks, which had been closed on June 29, finally reopened on July 20.

As of the end of July, it was far from clear that Greece would actually receive its third bailout package in five years and remain a member of the eurozone. The answer to those questions depends in part on whether the Greek government can get Greeks to stomach yet another round of wildly unpopular austerity measures and tax increases.

How did Greece find itself on the brink of a sovereign debt default?

Greece joined the EU in 1981 and became part of the eurozone currency union in 2001. Prior to the introduction of the euro, currency devaluation helped to finance the Greek government's borrowing. After Greece adopted the euro, devaluation was no longer an option. Still, during the next eight years, Greece was able to continue its high level of borrowing because of low interest rates borne by euro-denominated government bonds.

The Greek debt crisis started in late 2009. Among its catalysts were the turmoil of the global recession, structural weaknesses in the Greek economy, and a sudden crisis in confidence among lenders. Late in 2009, revelations that the Greek government had misreported data on debt levels and deficits triggered both anger that Greece had misrepresented its way into the eurozone and widespread apprehension that Greece was incapable of meeting its debt obligations.

In February 2010, the new government of George Papandreou (elected in October 2009) acknowledged that past governments had misreported statistics. The government then revised Greece's 2009 deficit from a previously estimated 6 to 8 percent of GDP to an alarming 12.7 percent. The deficit was later revised upward yet again to 15.7 percent, the highest for any EU nation in 2009. Estimated government debt at the end of 2009 was also increased, from €269.3 billion (113 percent of GDP) to €299.7 billion (130 percent of GDP).

Despite the crisis, Greece's €13 billion bond auctions in 2010 were oversubscribed. High yields on the debt worsened the Greek deficit, however, leading rating agencies to downgrade Greece's credit rating to junk status in late April 2010.

On May 2, 2010, the European Commission, the ECB, and the International Monetary Fund (the "IMF") (collectively referred to as the "Troika") launched a €110 billion bailout loan to rescue Greece from sovereign default and to cover the nation's financial needs for the next three years. However, the bailout was conditioned upon the implementation of austerity measures, structural reforms, and privatization of government assets.

Greece needed a second bailout in 2011. This package (including a bank recapitalization package worth €48 billion) brought the total Greek bailout outstanding to €240 billion. A worsening recession and delays in implementing the conditions of the bailout program spurred the Troika to approve another round of debt relief measures in December 2012.

An improved outlook for the Greek economy during 2013 and 2014 (with a government surplus in both years, a decline in the unemployment rate, positive economic growth, and a brief return to the private lending market) abruptly ended in the fourth quarter of 2014, when the country once again slipped into recession.

At the end of 2014, adding fuel to the fire, the Greek parliament called a premature parliamentary election for January 2015. Syriza, the party that emerged victorious, had campaigned on a promise to disavow Greece's current bailout agreement, including continued austerity measures. Due to rising political uncertainty, the Troika suspended the remaining aid to Greece scheduled under the existing bailout program until the newly elected government, led by Prime Minister Alexis Tsipras, either ratified the previously negotiated terms of the bailout or reached a new agreement with different terms. A Greek liquidity crisis ensued, resulting in plummeting stock prices at the Athens Stock Exchange, while a spike in interest rates effectively excluded Greece once again from the private lending market as an alternative funding source.

After the election, the Troika granted an additional four-month extension of its bailout program pending the completion of negotiations. Confronted with the threat of a sovereign default, the Tsipras government continued to negotiate throughout most of June 2015 but formally broke off negotiations with the Troika on June 26. The following day, Prime Minister Tsipras announced that, in lieu of continued negotiations, a referendum would be held on July 5, 2015, to either approve or reject the terms negotiated thus far.

On July 5, 2015, Greek voters overwhelmingly (61 percent to 39 percent) rejected the proposed terms of the bailout agreement. The result sent world markets into turmoil as the prospect of Greece's exit—"Grexit"—from the 19-nation eurozone loomed ever larger.

On July 8, 2015, Greece formally requested a three-year loan from the eurozone's bailout fund, seeking a "light at the end of the tunnel" as time expires for the country to reach a deal with the Troika. Newly appointed Greek Finance Minister Euclid Tsakalotos submitted the request in advance of a proposal due July 9, pledging that Greece would implement tax- and pension-related reforms in exchange for the much-needed relief.

On July 16, in connection with the bailout package agreed to "in principle" by eurozone finance ministers, Greece's parliament approved painful new austerity measures—ironically, with the support of Prime Minister Tsipras, who announced that the measures were necessary to reach a deal which would avert a humanitarian and fiscal disaster.

On July 20, Greece made a critical €4.2 billion bond payment to the ECB and repaid the IMF €2 billion in loan arrears. The money for those payments came from a €7 billion bridge loan that the EU approved on July 17.

As of the end of July, the Greek sovereign debt crisis remained very much in flux.

ARGENTINA

The long-running dispute over the payment of Argentina's sovereign debt, on which the South American nation defaulted for the second time in July 2014, continues.

On May 11, 2015, holdout bondholders from Argentina's 2005 and 2010 debt restructurings filed a motion with the U.S. District Court for the Southern District of New York to amend their complaint against Argentina to include $5.3 billion in BONAR 2024 bonds issued by the republic in April 2015. The amendment would bring this latest bond offering into the ongoing battle before district judge Thomas Griesa that concerned the validity of the *pari passu*, or "equal treatment," clause which, according to a 2012 ruling by Judge Griesa, prevents Argentina from making payments on restructured bonds without making corresponding payments to holdout bondholders. Argentina's Minister of Economy, Axel Kicillof, later responded to the action taken by holdout bondholders, asserting that the BONAR 2024 bonds constitute domestic debt denominated in foreign currency and thus do not fall within the jurisdiction of Judge Griesa. Kicillof also accused the holdouts of seeking to generate "uncertainty in the market to harm the Republic and the bondholders" or creditors with exposure to exchanged debt.

On May 18, 2015, one of Argentina's federal administrative courts enjoined the Argentine branch of Citibank, N.A. ("Citibank") to "refrain from any act" intended to fulfill a March 20, 2015, court-approved agreement between the New York-based bank and holdout bondholders whereby Citibank's Argentine branch was authorized to make interest payments on Argentine-law bonds and to exit its custody business in Argentina. According to the Argentine court, Citibank failed to satisfy the requirements of Argentina's *Código Procesal* for validating the agreement approved by Judge Griesa.

On June 5, 2015, Judge Griesa granted partial summary judgment to a group of 526 "me too" plaintiffs in 36 separate lawsuits. Consistent with his previous ruling in litigation commenced by a group of holdout bondholders led by NML Capital Ltd., Judge Griesa ruled that Argentina violated the equal treatment clause in bonds issued to the "me too" bondholders under a Fiscal Agency Agreement beginning in 1994 by refusing to make payments on their bonds at the same time it paid holders of debt restructured in 2005 and 2010. *See Guibelalde v. The Republic of Argentina*, 2015 BL 179208 (S.D.N.Y. June 5, 2015). The decision obligates Argentina to pay the plaintiffs $5.4 billion before it can make payments on restructured debt.

PUERTO RICO

Although Puerto Rico is an unincorporated territory of the United States rather than a sovereign, the financial troubles of the beleaguered Caribbean commonwealth, which has more than $72 billion in debt, have received a great deal of attention lately.

Due to its status as an unincorporated territory of the U.S., Puerto Rico is barred from seeking either protection under the Bankruptcy Code or international financial assistance. In an effort to remedy this problem in part, Puerto Rican governor Alejandro García Padilla gave his imprimatur to Puerto Rican legislation on June 28, 2014, that created a judicial debt relief process modeled on chapters 9 and 11 of the U.S. Bankruptcy Code for certain public corporations, including the Puerto Rico Electric Power Authority ("PREPA"), which has $9 billion in bond debt. The Puerto Rico Public Corporations Debt Enforcement and Recovery Act (the "Recovery Act") was intended to ring-fence Puerto Rico from potential liabilities arising from defaults by its public corporations and to give the corporations a framework for restructuring their obligations.

The new law's obvious similarities to chapter 9 and chapter 11 of the Bankruptcy Code, as well as the fact that the legislation was not enacted in accordance with Article I, Section 8 of the U.S. Constitution, immediately provoked attacks on its constitutionality. Bond funds affiliated with Franklin Resources Inc. and Oppenheimer Rochester Funds, which collectively hold approximately $1.7 billion in Puerto Rican debt, filed a lawsuit alleging that the legislation is unconstitutional, even though no debtor has actually attempted to restructure its debt under the law.

The Recovery Act was dealt a severe blow on February 6, 2015, when a federal district court judge struck down the law as unconstitutional. In *BlueMountain Capital Management, LLC v. García-Padilla*, No. 14-01569 (D.P.R. Feb. 6, 2015), the court ruled, among other things, that "[b]ecause the Recovery Act is preempted by the federal Bankruptcy Code, it is void pursuant to the Supremacy Clause of the United States Constitution." The ruling, which was appealed by Puerto Rico to the U.S. Court of Appeals for the First Circuit, was a setback not only for PREPA and other public corporations attempting to restructure their bond debt (e.g., the Puerto Rico Aqueduct and Sewer Authority and the Puerto Rico Highways and Transportation Authority), but also for Puerto Rico itself.

On February 11, 2015, Resident Commissioner Pedro Pierluisi, the Commonwealth of Puerto Rico's representative in Congress, reintroduced a bill, the Puerto Rico Chapter 9 Uniformity Act of 2015 (H.R. 870), to allow Puerto Rico's public agencies to be debtors under chapter 9. The bill is nearly identical to one Pierluisi introduced in 2014. The House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law held a hearing on H.R. 870 but has taken no action since then on the bill. U.S. Senators Chuck Schumer of New York and Richard Blumenthal of Connecticut introduced companion legislation in the U.S. Senate on July 15, 2015.

On June 28, 2015, Governor Padilla announced that the island cannot pay back its $72 billion in debt, which he characterized as a "death spiral." The announcement set the stage for an unprecedented financial crisis that could shake the municipal bond market and lead to higher borrowing costs for governments across the U.S. However, Puerto Rico avoided defaulting on July 1, 2015, when it paid back $645 million of general obligation bonds as well as a short-term bank loan of about $245 million. In addition, PREPA made a $415 million bond payment.

More bad news for Puerto Rico came on July 6, 2015, when the First Circuit affirmed the district court's ruling that the Recovery Act is unconstitutional. In *Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico*, 2015 BL 215414 (1st Cir. July 6, 2015), the court of appeals ruled that the district court had not erred in striking down Puerto Rico's own municipal bankruptcy laws because such laws are preempted by section 903(l) of the Bankruptcy Code. In its opinion, the First Circuit wrote:

> In denying Puerto Rico the power to choose federal Chapter 9 relief, Congress has retained for itself the authority to decide which solution best navigates the gauntlet in Puerto Rico's case. The 1984 amendment ensures Congress's ability to do so by preventing Puerto Rico from strategically employing federal Chapter 9 relief under § 109(c), and from strategically enacting its own version under § 903(1), to avoid such options as Congress may choose. . . . We must respect Congress's decision to retain this authority.

In a concurring opinion, circuit judge Juan Torruella stated that the 1984 amendments to the Bankruptcy Code, which for the first time prohibited Puerto Rico's instrumentalities from seeking

bankruptcy protection, appear to lack a rational basis and may be constitutionally invalid. According to Judge Torruella:

> Not only do [the 1984 amendments] attempt to establish bankruptcy legislation that is not uniform with regards to the rest of the United States, thus violating the uniformity requirement of the Bankruptcy Clause of the Constitution, . . . but they also contravene both the Supreme Court's and this circuit's jurisprudence in that there exists no rational basis or clear policy reasons for their enactment.

On July 8, 2015, Judge Francisco A. Besosa of the U.S. District Court for the District of Puerto Rico, in light of the First Circuit's ruling that the Recovery Act is unconstitutional, permanently enjoined government authorities from attempting to enforce the restructuring law. *See BlueMountain Capital Management LLC v. García-Padilla*, No. 14-01569 (D.P.R. July 8, 2015), and *Franklin California Tax-Free Trust et al. v. Commonwealth of Puerto Rico*, No. 14-1518 (D.P.R. July 8, 2015).

The government of Puerto Rico announced on July 9, 2015, that it would seek to appeal the First Circuit's ruling to the U.S. Supreme Court. In a written statement, Justice Secretary César Miranda explained that "[w]e are turning to the Supreme Court because we believe that the First Circuit Court of Appeals decision was wrong in that it validates an irrational action by Congress to exclude Puerto Rico from the application of Chapter 9 of the U.S. Bankruptcy Code." Miranda further noted that "[t]his action—without any basis in legislative precedent—continues to seriously hurt Puerto Rico's interests."

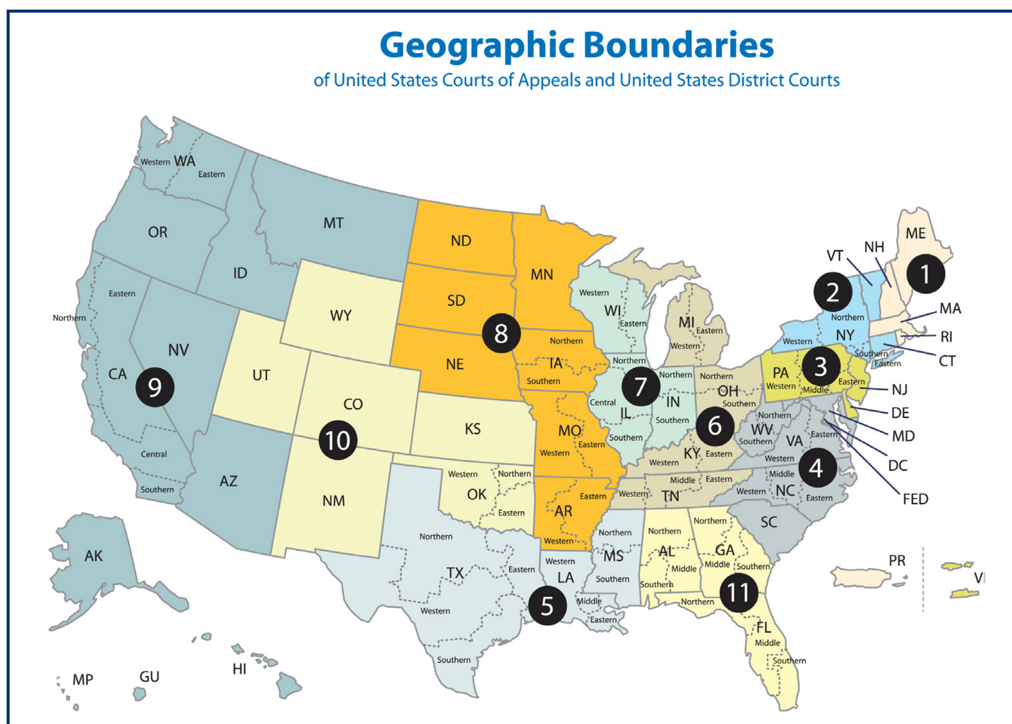
THE U.S. FEDERAL JUDICIARY

U.S. federal courts have frequently been referred to as the "guardians of the Constitution." Under Article III of the Constitution, federal judges are appointed for life by the U.S. president with the approval of the Senate. They can be removed from office only through impeachment and conviction by Congress. The first bill considered by the U.S. Senate—the Judiciary Act of 1789—divided the U.S. into what eventually became 12 judicial "circuits." In addition, the court system is divided geographically into 94 "districts" throughout the U.S. Within each district is a single court of appeals, regional district courts, bankruptcy appellate panels (in some districts), and bankruptcy courts.

As stipulated by Article III of the Constitution, the chief justice and the eight associate justices of the Supreme Court hear and decide cases involving important questions regarding the interpretation and fair application of the Constitution and federal law. A U.S. court of appeals sits in each of the 12 regional circuits. These circuit courts hear appeals of decisions of the district courts located within their respective circuits and appeals of decisions of federal regulatory agencies. Located in the District of Columbia, the Court of Appeals for the Federal Circuit has nationwide jurisdiction and hears specialized cases such as patent and international trade cases. The 94 district courts, located within the 12 regional circuits, hear nearly all cases involving federal civil and criminal laws. Decisions of the district courts are most commonly appealed to the district's court of appeals.

Bankruptcy courts are units of the federal district courts. Unlike that of other federal judges, the power of bankruptcy judges is derived principally from Article I of the Constitution, although bankruptcy judges serve as judicial officers of the district courts established under Article III. Bankruptcy judges are appointed for a term of 14 years (subject to extension or reappointment) by the federal circuit courts after considering the recommendations of the Judicial Conference of the United States. Appeals from bankruptcy court rulings are most commonly lodged either with the district court of which the bankruptcy court is a unit or with bankruptcy appellate panels, which presently exist in five circuits. Under certain circumstances, appeals from bankruptcy rulings may be made directly to the court of appeals.

Two special courts—the U.S. Court of International Trade and the U.S. Court of Federal Claims—have nationwide jurisdiction over special types of cases. Other special federal courts include the U.S. Court of Appeals for Veterans Claims and the U.S. Court of Appeals for the Armed Forces.



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