Hot Topics and the Latest and Greatest: Supreme Court and Lower Court Case Law Update

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U.S. Bankruptcy Court (W.D. Tenn.); Memphis

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HOT TOPICS & THE LATEST & GREATEST: SUPREME COURT CASE LAW UPDATE

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The following is a summary of the bankruptcy cases that were argued in front of the United States Supreme Court during the October, 2014 term:

I. *Wellness International Network, Ltd. v. Sharif* – Supreme Court to Revisit *Stern v. Marshall.*

Wellness International Network, Ltd. v. Sharif [No. 13-935] is the second opportunity for the Supreme Court to revisit its much-discussed opinion in *Stern v. Marshall,*[1] and presents an opportunity for it to address the consent issue that it elected not to address last year in *Executive Benefits Insurance Agency v. Arkinson (In re Bellingham).*[2] On January 14, 2015 (exactly one year after it heard oral argument in *Bellingham*), the Supreme Court heard oral argument in *Wellness International* regarding two issues:

i. Whether the presence of a subsidiary state property law issue in a section 541 action brought against a debtor to determine whether property in the debtor's possession is property of the bankruptcy estate means that such action does not "stem from the bankruptcy itself" and, therefore, that a bankruptcy court does not have the constitutional authority to enter a final order deciding that actions, and

ii. Whether Article III permits the exercise of the judicial power of the United States by the bankruptcy courts on the basis of litigant consent, and if so, whether implied consent based on a litigant's conduct is sufficient to satisfy Article III.

Article III of the United States Constitution vests the "judicial Power of the United States" in a judiciary with judges who enjoy life tenure (subject to removal only by impeachment) and whose salaries may not be diminished. As the Supreme Court explained in *Stern*, "Article III is an inseparable element of the constitution system of checks and balances that both defines the power and protects the independence of the Judicial Branch." As a general

[1] *Stern v. Marshall,* 131 S. Ct. 2594 (2011).
[2] *Executive Benefits Insurance Agency v. Arkinson (In re Bellingham),* 134 S. Ct. 2165 (2014).

rule, Congress may not "withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty."[3]

In *Stern,* the court addressed the interplay between Article III and 28 U.S.C. § 157(b), which authorizes bankruptcy judges (Article I judges who do not enjoy Article III's protections) to enter final judgments in certain "core" bankruptcy proceedings. Specifically, the Court addressed whether a bankruptcy judge may constitutionally enter a final judgment resolving a state law counterclaim asserted in defense to a proof of claim (a matter statutorily designated as "core" in 28 U.S.C. § 157(b)) where the creditor objected to the judge's exercise of jurisdiction. The Court compared the bankruptcy system's "public rights" function with the "private rights" function of common law, describing public rights as those that flow solely from action of the executive or legislative branches. Ultimately, the Court held that the state law counterclaim involved private rights and, thus, the bankruptcy court lacked the constitutional authority to enter a final judgment on the counterclaim. Rather, separation of powers mandates that such matters be finally determined by an Article III court, such as a federal district court.

By now, the facts of *Stern* are well known by most bankruptcy practitioners. Litigation arose in the bankruptcy case of Vickie Lynn Marshall. At issue was the bankruptcy court's ability to enter a final judgment on account of a counterclaim by the debtor, which is a core proceeding under 28 U.S.C. §157(b)(2)(C). Pierce Marshall, the son of Vickie's late husband, filed a proof of claim against her bankruptcy estate. He claimed that Vickie had defamed him, and requested damages from the bankruptcy estate. Vickie responded to the proof of claim by filing an unrelated counterclaim against Pierce claiming that he had tortuously interfered with the gift she should have received from her husband's estate when he died. Vickie received a $450M judgment on her counterclaim against Pierce. Pierce appealed the judgment all the way to the

[3] *Murray's Lessee v. Hoboken Land & Improvement Co.,* 59 U.S. 272, 284 (1855).

Supreme Court, claiming that the bankruptcy court did not have authority to award that judgment.

The Supreme Court first determined that the bankruptcy judge had the statutory jurisdiction to enter the judgment under 28 U.S.C. § 157(b)(2)(C). Nevertheless, noting that its ruling was a "narrow one," the Court held that the judgment was invalid because the statute violated the Constitution. "In general," the Court stated, "Congress may not 'withdraw from [Article III] judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty.'"[4] Relying on 19th Century decisions, the majority reasoned that there was no room for any approach that would "chip away" at Article III jurisdiction.[5] The Court found that separation of powers principles requires a judiciary that: (i) is independent of the legislative and executive branches, and (ii) has life tenure and salary security, at least with those matters involving common law claims.

The counter-claim at issue in *Stern* arose under common law and Pierce did not consent to adjudication by the bankruptcy court. Such matters involve "private" rather than "public rights", the Court found, and cannot be finally adjudicated by anyone other than an Article III judge unless they would necessarily be resolved in conjunction with the allowance or disallowance of the creditor's claim against the estate.

Thereafter, in *In re Bellingham,* a case involving a fraudulent transfer claim brought by a chapter 7 trustee, the Court granted *certiorari* to address two questions left unresolved by its decision in *Stern*: (i) whether Article III of the Constitution permits bankruptcy judges to exercise the judicial power of the United States to finally decide a private-right controversy on the basis of litigant consent and, if so, whether a litigant's conduct can constitute "implied"

[4] *Id.* at 2609.
[5] *Id.* at 2620.

consent; and (ii) whether a bankruptcy judge may submit proposed findings of fact and conclusions of law for *de novo* review in the district court in a "core" proceeding under 28 U.S.C. § 157(b) or, alternatively, whether there is a statutory gap.

In answering the second question in the affirmative, the Court first determined that the trustee's fraudulent transfer claim was a "*Stern* claim" (*i.e.* a private rights claim that a bankruptcy court may fully adjudicate under 28 U.S.C. § 157(b)(1), but not under the Constitution). In such cases, the Court held, the bankruptcy court should follow the procedures for a non-core claim in section 157(c)(1) and issue proposed findings of fact and conclusions of law that the district court may review *de novo*.[6] Having resolved the second question, the Court did not reach the much more intriguing issue, specifically, whether a litigant can consent to have its private rights claims finally determined by a bankruptcy judge. A few weeks later, the court granted *certiorari* in *Wellness,* ostensibly to address the first question.

Wellness involves lengthy litigation in the Texas courts between Richard Sharif and Wellness International Network. This litigation resulted in the entry of a judgment of over $655,000 against Sharif in the Northern District of Texas as a sanction for his discovery abuses. Thereafter, Sharif filed a chapter 7 petition in the Northern District of Illinois. Wellness subsequently brought a five-count adversary proceeding in the bankruptcy court against Sharif. The first four counts of the complaint sought, pursuant to section 727 of the Bankruptcy Code, denial of discharge on four grounds. The fifth count sought a declaratory judgment that a trust for which Sharif was the trustee was his alter ego and, thus, its assets were property of the bankruptcy estate.[7]

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[6] *Id.* at 2168.

[7] The Seventh Circuit referred to this claim as an "alter-ego claim." In the pleadings filed before the Supreme Court, however, petitioners refer to it as a section 541 claim, perhaps thinking that tying the cause of action to section 541

As was the case in the prior state court litigation, Sharif failed to respond to discovery requests in the adversary proceeding and violated the bankruptcy court's discovery order. As a sanction for the debtor's failure to comply, the bankruptcy court entered a default judgment in favor of Wellness on all counts of its complaint and awarded attorney's fees and costs. On appeal, the district court affirmed after rejecting Sharif's *Stern* objection – raised for the first time after briefs were filed in that court – as untimely.

On further appeal, the Seventh Circuit Court of Appeals held that the bankruptcy court had authority to enter a final judgment on the objection to discharge counts because they were core matters that arose under federal law and were "central to the restructuring of the debtor-creditor relationship."[8] However, the court held, under *Stern,* the bankruptcy court lacked constitutional authority to enter a final judgment on the alter-ego claim because it was between private parties, stemmed from state law rather than a federal regulatory scheme, did not involve a particularized area of law and was intended only to augment the bankruptcy estate.[9] In short, the Seventh Circuit concluded that Wellness' state law alter ego claim was indistinguishable for these purposes from the state law counterclaim at issue in *Stern.*

The Seventh Circuit also considered whether Shariff had waived the constitutional argument through his litigation conduct and his failure to raise the issue earlier in the litigation. The court noted that the Supreme Court had previously stated in *Commodities Futures Trading Commission v. Schor*[10] that the protections of Article III operate to safeguard both litigants' rights and separation of powers principles and that only the former protections were waivable. Accordingly, the Seventh Circuit noted, it was faced with the "practical problem … of separating

of the Bankruptcy Code and the determination of what constitutes "property of the estate" enhances their constitutional authority argument.

[8] *Wellness International Network, Ltd. v. Sharif,* 727 F.3d 751, 773 (7th Cir. 2013).

[9] *Id.* at 774.

[10] *Commodities Futures Trading Commission v. Schor,* 478 U.S. 833 (1986).

out the waivable personal safeguard from the nonwaivable structural safeguard."[11] Ultimately, the court concluded that the safeguards could not be separated due to the importance of the structural concerns, noting:

> the Supreme Court has already held that the statutory scheme granting bankruptcy judges authority to enter final judgment in core proceedings *does* implicate structural concerns where the core proceeding at issue is the "stuff of the traditional actions at common law tried by the courts at Westminster in 1789."[12]

Accordingly, the Seventh Circuit held that "under current law a litigant may not waive an Article III, § 1 objection to a bankruptcy court's entry of final judgment in a core proceeding."[13]

While it is difficult to read anything from oral argument, it is very possible that the Supreme Court will once again pass on the consent issue. On January 14th, nearly all of the questioning focused on the constitutional authority issue. There was surprisingly little discussion regarding consent. The limited discussion that there was focused on whether consent must be knowing or voluntary consent, and whether such consent must be expressly stated.

Indeed, Justice Scalia, Justice Kennedy and Justice Ginsberg each asked whether the court needed to decide both issues or if they could decide just one. Noting that Supreme Court protocol was to only decide one issue if resolution of that issue meant that the second issue need not be decided, the Justices inquired which of the two issues was the most important, or the most troubling to lower courts. The consensus seemed to be that the 541 issue was most important. Justice Breyer disagreed, stating that both issues were important and, thus, both should be resolved.

Turning to the issue of whether the alter-ego/section 541 claim was a "*Stern* claim" that could not be finally determined by the bankruptcy court, Wellness stressed that it is essential that

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[11] *Wellness,* 727 F.3d at 769.
[12] *Id.* at 771. (quoting *Stern,* 131 S.Ct. at 2609).
[13] *Id.* at 773.

bankruptcy courts have the authority to determine what property is property of the estate under section 541 of the Bankruptcy Code. A section 541 action, they posited, clearly stems from the bankruptcy itself, and is as fundamental an issue of bankruptcy law as there is. Additionally, a key difference between the claim at issue and the claim in *Stern*, Wellness argued, is that the alter-ego/section 541 claim was being brought against the debtor and not against a third party "who's been hauled in bankruptcy court against their will." Justice Breyer seemed to adopt this view.

Conversely, Shariff argued that the issue in dispute here is not a 541 claim but, rather, a state law alter ego claim seeking to determine whether the trust was valid or not. This, he argued, is purely an issue of state law and is no different than the state law counterclaim that was at issue in *Stern.* Thus, he reasoned, all we are doing here is applying *Stern*. Justice Scalia in particular seemed to champion this view.

Justice Sotomayor articulated a "simpler" test, suggesting that bankruptcy courts have constitutional authority to determine a dispute where the bankrupt is either in possession of, or has title to, the property at issue. She repeatedly posed this view throughout oral argument. This test appears similar to the summary/plenary jurisdiction test that existed under the Bankruptcy Act (focusing on whether the property was in the actual or constructive possession of the court). Neither litigant, nor any of the other Justices, seemed to agree with Justice Sotomayor's proposed test. Whether such an approach would really be "simpler" is certainly open for debate.

The Justices also appeared very interested in the implications of any further limitations of the power and authority of bankruptcy judges on the magistrate courts as well as the federal arbitration system. This was clearly a concern of the Justices in *Bellingham* also. Indeed, based on some of the questions that were asked, *Stern's* impact on the magistrate courts and the arbitration system may be perceived as a bigger threat to our judicial system than a continued limitation on the power of bankruptcy courts.

II. *Baker Botts LLP v. ASARCO, LLC* – Whether Bankruptcy Judges Have Discretion to Award Compensation for the Defense of a Fee Application.

In *Baker Botts LLP v. ASARCO, LLC* [14-103], the Supreme Court will address the issue of whether section 330(a) of the Bankruptcy Code grants bankruptcy judges discretion to award compensation for the defense of a fee application. Oral argument was held before the Supreme Court in this case on February 25, 2015.

This case stems from the four-plus year chapter 11 proceeding of ASARCO, a copper mining company, which was characterized by the Fifth Circuit as one of the most successful chapter 11 cases of all time. The proceeding culminated in confirmation of a plan of reorganization that left the company with little debt and $1.4 billion in cash, and resolved potentially difficult environmental, asbestos and tort claims. ASARCO's plan was funded with the proceeds generated from fraudulent transfer litigation between ASARCO and its corporate parent. The judgment obtained by the debtor, valued at $7-10 billion, was the largest ever obtained in the history of chapter 11.

In their final fee applications, the debtors' law firms sought fees and expenses in excess of $135 million based on a lodestar calculation, a 20 percent fee enhancement (approximately $22.6 million) for the successful result in the fraudulent transfer litigation, and expenses incurred in preparing and litigating their final fee applications. The reorganized debtor objected to the last two components of the fee applications on various grounds.

As part of the discovery process with respect to the fee disputes, the debtors' lawyers were required to produce every document they created as part of the bankruptcy. The firms responded with more than 2,300 boxes of documents and 189 GB of data. Ultimately, a six-day trial was required to resolve ASARCO's objections, after which the bankruptcy court approved all of counsel's core fees and awarded fee enhancements for the work performed in the fraudulent transfer litigation. The court also authorized payment of the fees and expenses exceeding $5 million incurred by the firms in litigating the defense of their fees. On appeal, the district court approved the fee award granted by the bankruptcy court.

The Fifth Circuit Court of Appeals affirmed the award of the fee enhancements but reversed the awards of the fees for litigating the firms' fee applications in *In the Matter of ASARCO, LLC*.[14] The court began its analysis by noting that section 330(a)(3) of the Bankruptcy Code provides a non-exclusive list of factors that bear on a court's determination of the reasonable compensation for actual necessary services and expenses rendered by attorneys and other court-supervised bankruptcy professionals. Thus:

> [T]he court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including—
> (A) the time spent on such services;
> (B) the rates charged for such services;
> (C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;
> (D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed;
> (E) with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field; and
> (F) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.[15]

Additionally, section 330(a)(4) prohibits a court from granting compensation for services that were not: (i) reasonably likely to benefit the debtor's estate, or (ii) necessary to the administration of the case.[16]

[14] *In the Matter of ASARCO, LLC,* 751 F.3d 291 (5th Cir. 2014).
[15] 11 U.S.C. § 330(a)(3).

In denying the award of fees associated with the fee litigation, the court noted that the plain language of section 330(a) of the Bankruptcy Code does not explicitly authorize the payment of such fees. Rather, the court explained, section 330(a)(4) expressly does not permit compensation for services that are not reasonably likely to benefit the debtor's estate or necessary to the administration of the bankruptcy estate. The fees incurred in defending the fee dispute, the court reasoned, did not meet this standard. Rather, the primary beneficiary of such fees was the professionals.

The court also noted that section 330(a)(6) of the Bankruptcy Code, which specifically authorizes fee awards for time expended preparing fee applications "based on the level and skill reasonably required to prepare the application," was fundamentally different than authorizing fees related to litigation over the reasonableness of fees previously requested.[17] According to the court, the express authorization "of an award for '*preparation* of a fee application' implies that Congress was excluding fees for *defending* a fee application by the omission of such language."[18] The court concluded that requiring professionals to defend their fee applications without estate compensation was a "cost of doing business consistent … with the reality of the bankruptcy process."[19]

Turning to policy issues, the court expressed concerns about "[t]he perverse incentives that could arise from paying bankruptcy professionals to engage in satellite fee litigation."[20] In response to the law firms' arguments that their inability to recover fees for the defense of their fee applications would dilute their effective billing rates and prejudice bankruptcy attorneys in comparison to other attorneys, the court stated "[t]he claim for comparability is easily made but

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[16] 11 U.S.C. § 330(a)(4).
[17] *In the Matter of ASARCO, LLC,* 751 F.3d at 299 (citing 11 U.S.C. § 330(a)(6)).
[18] *Id.* at 300 (emphasis added).
[19] *Id.*
[20] *Id.* at 301.

difficult to analyze."[21] Finally, in response to arguments that its opinion could be read to allow "tactical or ill-supported objections to fee objections," the Fifth Circuit suggested that "[w]here appropriate, the courts should not hesitate to implement the exception to the American Rule that allows fee shifting where an adverse party has acted in bad faith, vexatiously, or for oppressive reasons."[22]

The ruling by the Fifth Circuit created a circuit split, as the Ninth Circuit Court of Appeals has ruled to the contrary in *In re Smith.*[23] In that case, the court concluded that a bankruptcy court maintains discretion to award defense fees in appropriate circumstances under section 330(a). The Ninth Circuit based its conclusion, in part, upon a broader interpretation of sections 330(a)(3) and (a)(4), concluding that services related to the preparation of fee applications are "actual and necessary services" for purposes of section 330(a), and that time spent litigating fee awards should be compensable because the failure to award defense fees would dilute fee awards reducing the effective compensation of bankruptcy attorneys to levels below the compensation available to attorneys generally.[24]

It will be interesting to see what the Court does with this case. At oral argument, the Court appeared divided. The Justices focused heavily on the statutory language, and whether the fee defense could fall within the ambit of case administration or, alternatively, whether the "reasonably likely to benefit the estate" rule controlled. Since the statutory language is less than clear, the Court may focus on some of the policy issues discussed both in *ASARCO* and in *In re Smith.* While it is dangerous to make predictions based solely on questions asked at oral argument, the Justices did ask counsel for the law firms on more than one occasion how the

[21] *Id.*
[22] *Id.* at 302.
[23] *In re Smith,* 317 F.3d 918, 929 (9th Cir. 2002).
[24] *Id.* at 928.

defense of fees benefitted the estate. Unfortunately for bankruptcy professionals, counsel did not have a good answer to this question.

III. *Bank of America v. Toledo-Cardona* – The End of *Dewsnup*? Supreme Court to Address Whether Individual Chapter 7 Debtors Can "Strip Off" Junior Mortgage Liens When The Senior Lien is Underwater.

In *Bank of America v. Toledo-Cardona* [14-163], the Supreme Court will address whether, under section 506(d) of the Bankruptcy Code, which provides that "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void," 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. Oral argument was held before the Supreme Court in this case on March 24, 2015.

This case actually involves two separate cases, which were consolidated for argument and decision.[25] The cases have similar and familiar facts, involving a homeowner filing a chapter 7 with two mortgages on its home. In both cases, the first mortgage was underwater. Thus, the second mortgage is wholly unsecured. In both cases, the debtors asked the bankruptcy courts to void their second mortgage liens under section 506(d) of the Bankruptcy Code, because both of them were completely underwater. In both cases, the bankruptcy courts permitted the debtors to strip off the junior liens. The district courts affirmed

On appeal, the Eleventh Circuit Court of Appeals affirmed the decisions of the lower courts, holding that homeowners in chapter 7 can strip off a second mortgage that is wholly underwater, terminating the lender's ability to foreclose, even if the property value later rises. The court said it was bound by its prior decisions in *McNeal v. GMAC Mortgage, LLC* and

[25] *Bank of Am. v. Caulkett,* 566 Fed. Appx. 879 (11th Cir. 2014); *Bank of Am. v. Toledo-Cardona,* 556 Fed. Appx. 911 (11th Cir. 2014).

Folendore v. U.S. Small Business Administration,[26] which held that section 506(d) of the Bankruptcy Code, which provides that a lien is void when it "secures a claim against the debtor that is not an allowed secured claim," allows courts to void second mortgages that are completely underwater because no part of such claim is "secured." That ruling, the Eleventh Circuit explained, was unaffected by the Supreme Court's 1992 decision in *Dewsnup v. Timm.*[27]

In *Dewsnup,* the Court considered whether a chapter 7 individual debtor could use section 506(d) of the Bankruptcy Code to strip an undersecured real property lien down to the judicially-determined value of the collateral. As we all know, section 506(a) bifurcates an undersecured recourse claim into an allowed claim equal to the value of the collateral and an unsecured claim for the deficiency. Despite the plain language of sections 506(a) and (d), the Court prohibited a chapter 7 individual debtor from using section 506(d) to strip-down liens securing claims of undersecured creditors. In doing so, the Court found the statutory language to be ambiguous. Instead of reading section 506(a) and (d) together, the Court instead embraced the secured creditor's position that subsection (d) could be construed without regard to subsection (a), stating:

> [T]he words "allowed secured claim" in § 506(d) need not be read as an indivisible term of art defined by reference to § 506(a), which by its terms is not a definition provision. Rather, the words should be read term-by-term to refer to any claim that is, first, allowed, and, second, secured. Because there is no question that the claim at issue here has been "allowed pursuant to § 502 of the Code and is secured by a lien with recourse to the underlying collateral, it does not come within the scope of § 506(d), which voids only liens corresponding to claims that have *not* been allowed and secured.[28]

[26] *McNeal v. GMAC Mortgage LLC,* 735 F.3d 1263 (11th Cir. 20120); *Folendore v. U.S. Small Business Administration,* 862 F.2d 1537 (11th Cir. 1989).
[27] *Dewsnup v. Timm,* 502 U.S. 410 (1992).
[28] *Id.*

Accordingly, the Court held, when a mortgage lien is worth more than the market value of the property, section 506(d) does not allow courts to reduce the value of the lien to that market value.

The Eleventh Circuit is alone in its ruling, as all other circuit courts that have addressed the issue have relied on *Dewsnup* to hold that subordinate mortgages survive in full in chapter 7, regardless of the value of the property. Similarly, Bank of America contends that the Court's decision in *Dewsnup* made clear that section 506(d) does not apply to claims that have been allowed and are secured by liens on the underlying collateral, even if such liens are underwater. Moreover, the bank argues, the context, structure, and drafting history of the statute all indicate that section 506 is intended to deal with the treatment of secured claims, rather than the treatment of liens, which pass through bankruptcy unaffected. The bank noted that although Congress has made extensive changes to the Bankruptcy Code in the twenty-three years since the Court's decision in *Dewsnup*, it has never given any sign that it disagreed with *Dewsnup*'s holding.

The bank also warned of the practical problems that would follow a decision upholding the Eleventh Circuit's ruling. As a result of the recession, the bank notes, scores of second mortgages are completely underwater. As the housing market rebounds, however, and home values rise, second mortgages that had been completely underwater may regain their value. It would be inequitable, they posit, to allow debtors to void such liens in that scenario.

Conversely, the debtors contend that, because each of the homes at issue in this case is completely underwater on the first mortgage, there is nothing left to secure the banks second mortgages. As such, they argue, the bank's claims resting on those second mortgages cannot be secured claims, because section 506(a) provides that a claim is secured only "to the extent of the value of such creditor's interest in … such property" which, in this case, is zero. And if the claims are not secured claims, they argue, then "the lien associated with that claim is void."

The difficulty with the debtors' argument is distinguishing it from the similar argument that was rejected by the Court in *Dewsnup.* At oral argument, Justice Scalia (who dissented in *Dewsnup*), stated:

> I've – I've lost in *Dewsnup.* What I am concerned about is the – what should I say – the ridiculousness of saying if under *Dewsnup* – and you haven't asked us to overrule *Dewsnup* – under *Dewsnup,* if – there's $1 worth of value, okay, you don't lose your lien. But if there is zero value, $1 less and its stripped entirely, it seems to me a – very strange – strange outcome. Why would any intelligent system want to produce an outcome like that?

The debtors argue that the Court could limit *Dewsnup* to its facts. They argued that the Court had been "unusually careful, to phrase the holding in terms of particular parties" and to use the words "stripped down," thereby referring only to a "partially secured mortgage." They also note that the *Dewsnup* Court specifically declined to address the hypothetical involving a second mortgage that was *completely* underwater.

More generally, the debtors contend, allowing debtors to strip off a junior mortgage is a good thing. It can help prevent foreclosures and the problems that come with it, because it makes it easier for debtors and the holders of the first mortgage to work together to modify a loan to allow the debtors to keep making payments and stay in their houses. This, they argue, is not necessarily unfair to the banks that hold the junior mortgages, as second mortgagees bargained for their subordinate position and should expect that if their mortgages sink completely underwater, their worthless liens can be extinguished in foreclosure.

Perhaps the biggest issue here is what to do with *Dewsnup,* amongst the most criticized bankruptcy opinions to come out of the Court. Justice Scalia blasted *Dewsnup* in oral argument, but noted that he was in the dissent in that opinion anyway. Justice Alito asked why the debtors had not asked the Court to overrule *Dewsnup* and Justice Ginsberg stated that the "law would be much more coherent if either *Dewsnup* applies to the totally underwater as well as partially underwater, or *Dewsnup* is overruled." Finally, Justice Kagan pressed counsel for the debtors to explain why they had not argued that the Court should overrule *Dewsnup,* asking:

> [C]an I take you back to Justice Alito's question, which was about stare decisis, and why you haven't argued it? Because I tell you that my sort of reaction to this case is that these distinctions that you are drawing between partially underwater and fully underwater are not terribly persuasive. But the only thing that may be less persuasive is *Dewsnup* itself.

Time will tell if the Court reaffirms *Dewsnup* (perhaps while pinching its nose)*,* attempts to distinguish it on its facts or, perhaps, finally puts this much criticized opinion to bed.

IV. *Bullard v. Hyde Park Savings Bank* – Whether an Order Denying Confirmation of Bankruptcy Plan is a Final Order for Purposes of Appeal.

In *Bullard v. Hyde Park Savings Bank* [14-116], the Supreme Court will address the issue of whether an order denying confirmation of a bankruptcy plan is appealable pursuant to 28 U.S.C. § 158(d)(1). Oral argument was held before the Supreme Court in *Bullard* on April 1, 2015.

In *Bullard,* the debtor filed for relief under chapter 13. The debtor proposed a chapter 13 plan that was denied by the bankruptcy court. The court gave the debtor 30 days to file an amended plan. Instead of filing an amended plan, the debtor filed a notice of appeal to the First Circuit Bankruptcy Appellate Panel. On the debtor's motion, the bankruptcy court continued the deadline to file an amended plan pending the outcome of the appeal.

The BAP granted leave to appeal after determining that the debtor had satisfied the criteria necessary to proceed with an interlocutory appeal to the district court, pursuant to 28 U.S.C. § 158(a)(3). Thereafter, the BAP affirmed the bankruptcy court's decision on the merits. The debtor then filed a notice of appeal to the First Circuit Court of Appeals, and moved the

BAP to certify that appeal under 28 U.S.C. § 158(d)(2), which governs certified appeals to appellate courts. The BAP denied the motion for certification. The First Circuit Court of Appeals then issued an order to show cause why the case should not be dismissed for lack of jurisdiction because the BAP's order affirming the denial of confirmation did not appear to be a final order, as required by 28 U.S.C. § 158(d)(1). After receiving the debtor's response, the First Circuit determined that the case should proceed to full briefing on both the jurisdictional and merits questions.

While acknowledging that the appeal presented an "important and unsettled question of bankruptcy law," the First Circuit dismissed the appeal for lack of jurisdiction.[29] The First Circuit noted that Congress has granted appellate courts "jurisdiction of appeals from all final decisions, judgments, orders, and decrees entered" by a BAP or district court sitting in an appellate capacity in bankruptcy proceedings, pursuant to 28 U.S.C. § 158(d)(1). In 2005, it extended appellate jurisdiction to reach direct appeals of the bankruptcy court's orders (final or interlocutory), upon certification by the bankruptcy court, district court, or BAP and authorization by the court of appeals, pursuant to 28 U.S.C. § 158(d)(2). Such certification generally requires a question of law with no controlling authority or a matter of public importance.

Because the present appeal came before the First Circuit under section 158(d)(1) (given that the BAP denied certification), the court found that it only had jurisdiction if the BAP's order rejecting the debtor's plan was a final order. The court then noted that "because bankruptcy cases typically involve numerous controversies bearing only a slight relationship to each other, 'finality' is given a flexible interpretation in bankruptcy."[30] This flexibility means that an order

[29] *In re Bullard,* 752 F.3d 483 (1st Cir. 2014).
[30] *Id.* at 485.

may be final even if it does not resolve all issues in the case, "but it must finally dispose of all the issues pertaining to a discrete dispute within the larger proceeding."[31] When an intermediate appellate court remands a matter to the bankruptcy court for significant further proceedings, there is no final order for purposes of section 158(d) and the court of appeals lacks jurisdiction. Conversely, when a remand leaves only ministerial proceedings (such as computation of amounts according to established formulae), then the remand may be considered final.

The First Circuit noted that there is a split in the circuits regarding the finality of an order denying confirmation of a reorganization plan, with the Second Circuit,[32] Sixth Circuit,[33] Eighth Circuit,[34] Ninth Circuit[35] and Tenth Circuit[36] finding that an order denying confirmation of a chapter 13 plan is interlocutory if the case is not dismissed and, thus, not appealable. Conversely, the Third Circuit,[37] Fourth Circuit[38] and Fifth Circuit[39] permit a debtor to proceed to an immediate appeal from an order denying plan confirmation.

Ultimately, the First Circuit adopted the majority view, concluding that "an intermediate appellate court's affirmance of a bankruptcy court's denial of confirmation of a reorganization plan is not a final order appealable under § 158(d)(1) so long as the debtor remains free to propose an amended plan."[40] The rejection of the debtor's plan, the court found, "plainly does not 'finally dispose of all the issues pertaining to a discrete dispute within the larger proceeding, nor are the bankruptcy court's responsibilities on remand only ministerial.'"[41] The court

[31] *Id.* at 485-86.
[32] *Maiorino v. Branford Sav. Bank ,* 691 F.2d 89, 90 (2d Cir. 1982).
[33] *In re Lindsey,* 726 F.3d 857 (6th Cir. 2013).
[34] *In re Pleasant Woods Assocs. Ltd. P'ship,* 2 F.3d 837 (8th Cir. 1993).
[35] *In re Lievsay,* 118 F.3d 661 (9th Cir. 1997).
[36] *In re Gordon,* 743 F.3d 720 (10th Cir. 2014).
[37] *In re Armstrong World Indus. Inc.,* 432 F.3d 507 (3d Cir. 2005).
[38] *Mort Ranta v. Gorman,* 721 F.3d 241 (4th Cir. 2013).
[39] *In re Bartee,* 212 F.3d 277 (5th Cir. 2000).
[40] *In re Bullard,* 752 F.3d at 486.
[41] *Id.* at 486-87.

reasoned: "Essentially everything remains unresolved in the Chapter 13 below … [A]n order cannot sensibly be final when it not only fails to dismiss the underlying case but additionally advises that a party may revise its own court filings."[42]

The debtor argued that the ability to propose an alternative plan was illusory, as the plan he proposed was the only feasible plan. If he was unable to appeal, he argued, his only options were to propose an unwanted plan, object to it, and appeal its confirmation, or to allow his petition to be dismissed and appeal the dismissal, which options were inefficient and risked losing the automatic stay. The court responded, stating:

> Bullard's options may be unappealing at this stage in the game, but he ignores the fact that Congress laid out other options for him – options that he did not pursue. He could have sought certification and authorization to directly appeal the bankruptcy court's order to this court under 28 U.S.C. 158(d)(2). Likewise, had he chosen to take his intermediate appeal to the district court rather than the BAP, he could have sought permission to appeal the district court's interlocutory order under 28 U.S.C. § 1292(b). Although neither of these routes provides for appeals as of right, they do provide a safety valve for situations in which delaying review by the court of appeals would be unjust or inappropriate. In any event, we do not think it problematic to adopt a rule that encourages, to the greatest extent possible, debtors and creditors to negotiate a mutually agreeable plan without requiring appellate intervention. That such a harmonious outcome may be unlikely or even impossible in some cases does not require adopting a different rule.[43]

In response to the debtor's argument that these alternative options were inefficient, the First Circuit stated "any rule that routinely treats the denial of confirmation as a final order would introduce its own form of inefficiency" as such appeals would "clog the appellate dockets with issues that could, and should, be decided elsewhere."[44]

Accordingly, the court held that an intermediate appellate court's affirmance of a bankruptcy court's denial of confirmation of a plan is not a final order appealable under 28

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[42] *Id.* at 487.
[43] *Id.*
[44] *Id.* at 489.

U.S.C. § 158(d)(1) "so long as the debtor remains free to propose an amended plan."[45] This approach, the court stated, "promotes judicial efficiency and is faithful to the limitations that Congress has placed on our jurisdiction."[46]

At oral argument, Chief Justice Roberts and Justice Sotomayor initially probed the debtor about why he and other similarly situated debtors could not use the multiple avenues that are provided for an interlocutory appeal. Counsel for the debtor responded that interlocutory appeals are generally reserved for issues that benefit the system or in important cases. That standard, he suggested, excludes from appellate review a lot of important issues in bankruptcy, including the present issue.

Chief Justice Roberts suggested that he believed denial of confirmation clearly was not final given that the bankruptcy judge set a thirty day deadline for the debtor to file a new plan. If the bankruptcy judge didn't think "it was done and over," he stated, then why consider the judge's order a final one. The debtor responded that the issue comes down to what is the proceeding at issue, *i.e.* whether the proceeding is the confirmation or denial of *this* plan, or if the proceeding is whether to confirm or deny *a* plan.

Counsel for the objecting secured creditor argued that the debtor's expanded rule of finality exposed the bankruptcy system to strategic gamesmanship by debtors, suggesting that a "person who is trying to save their home and thinks that they'll be able to stay there longer if they're able to take multiple appeals, each of which could take two years," might file an appeal of plan confirmation solely to buy time. This argument did not go far. Indeed, in response to this concern, Justice Kagan noted that those circuits which apply the minority rule have done so for 10 years "and it hasn't really led to the kinds of bad consequences that we're all surmising

[45] *Id.*
[46] *Id.*

about." Additionally, several Justices inquired why, if the debtor's proposed rule would result in such dire consequences, major creditors were not supporting the secured creditor's position by way of amicus briefs. Indeed, the United States and even Bank of America filed briefs siding with the debtor.

Based on the questions asked by the Justices, it appears that they would like to provide parties with increased ability to appeal denial of plan confirmation. How they do this remains to be seen. The Court may rule that an order denying confirmation of a plan is, in fact, a final order. Alternatively, it may simply direct that lower courts should more liberally grant leave to appeal orders denying confirmation.

V. *Harris v. Viegelahn* – Whether, When a Debtor Converts a Case to a Chapter 7 After Confirmation of a Chapter 13 Plan, Undistributed Funds Held by the Chapter 13 Trustee are Refunded to the Debtor or Distributed to Creditors.

Finally, in *Harris v. Viegelahn* [No. 14-400], the Supreme Court will address whether, when a debtor in good faith converts a bankruptcy case to a chapter 7 after confirmation of a chapter 13 plan, undistributed funds held by the chapter 13 trustee are refunded to the debtor or distributed to creditors. Oral argument was held in *Harris* on April 1, 2015.

In this case, the debtor filed a chapter 13 petition in February 2010. At the time of filing, the debtor was $3,700 behind on his home mortgage loan, which was held by Chase. His proposed chapter 13 plan, which was confirmed in April 2010, called for the debtor to make monthly payments of $530 to the chapter 13 trustee out of his gross monthly income for 60 months. From each payment, $352 was to go to Chase to pay off the arrearage on his mortgage and approximately $75 was to go to another secured creditor. After these debts were paid in full, the plan provided that such payments would go to the debtor's unsecured creditors. As in all chapter 13 cases, the plan also called for the debtor to make monthly mortgage payments going forward directly to Chase.

In November 2010, Chase was granted relief from the automatic stay to foreclose on the home. The debtor had failed to make monthly mortgage payments post-confirmation and had moved out of the house. Approximately one year later, the debtor converted his case to a case under chapter 7. In the interim, however, the debtor had continued making the full monthly plan payments to the chapter 13 trustee. Consistent with the plan, the trustee distributed the funds received to the debtor's creditors. However, the trustee held in her trust account the $352 per month portion of the payment which, prior to stay relief, was to be paid to Chase on account of the arrearage owed on the petition date. As a result, the funds in the trustee's possession began to accumulate.

Upon conversion of the case, the chapter 13 trustee paid herself a commission and distributed the remaining $4,300 in her possession to the debtors' remaining creditors. Thereafter, the debtor moved to compel the return of the $4,300 that had been distributed, arguing that the trustee had no authority to disburse funds after conversion of the case. The bankruptcy court agreed, issuing an order compelling the return of the payments. The district court subsequently affirmed. The trustee then appealed to the Fifth Circuit Court of Appeals.

The Fifth Circuit Court of Appeals reversed, holding that upon a case's post-confirmation conversion to chapter 7, undistributed funds held by a chapter 13 trustee must be distributed to creditors.[47] The court began its analysis by discussing the statutory provisions dealing with conversion from chapter 13 to chapter 7. The court noted that a chapter 13 debtor may convert his or her case to chapter 7 liquidation at any time under section 1307 of the Bankruptcy Code, even after confirmation of a plan. The court explained that conversion of a chapter 13 case

[47] *Harris v. Viegelahn,* 757 F.3d 468 (5th Cir. 2014).

creates a unique issue: does the chapter 7 estate include all property held by the debtor at the time of conversion, or does it include only the property held at the time of the original bankruptcy filing (as is generally the case in chapter 7)?[48] The court noted that an earlier split in the case law regarding this issue was resolved by Congress in 1994 when it enacted section 348(f) of the Bankruptcy Code, which provides:

> when a case under chapter 13 … is converted to a case under another chapter … property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion.[49]

On the other hand, the court noted, "[i]f the debtor converts a case under chapter 13 … in bad faith, the property of the estate in the converted case shall consist of the property of the estate as of the date of conversion."[50] Thus, the court explained, while it is clear that property acquired after the filing of a chapter 13 petition does not become part of the chapter 7 estate upon conversion (absent bad faith), no statute explicitly states what should happen to such funds when they had not yet been distributed to creditors. Specifically, should they be returned to the debtor or, alternatively, should they be distributed to creditors pursuant to the previously confirmed chapter 13 plan. Only one court of appeals, the Third Circuit Court of Appeals, had ruled on this issue, and had held that undistributed funds held by a chapter 13 trustee upon conversion must be returned to the debtor.[51]

The court then analyzed the statute-based arguments of both parties. The court first rejected the debtor's argument that section 1326(a)(2) (which provides that if a proposed chapter 13 plan is not confirmed, any payments made under such plan must be returned to the debtor) governs because that section deals solely with payments made prior to confirmation.

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[48] *Id.* at 472.
[49] *Id.* (discussing 11 U.S.C. § 348(f)(1)).
[50] *Id.* (discussing 11 U.S.C. § 348(f)(2)).
[51] *Id.* at 473 (citing *In re Michael,* 699 F.3d 305 (3d Cir. 2012)).

Second, the court concluded that while, upon conversion, the chapter 13 trustee's service was terminated, that does not, as argued by the debtor, literally deprive the trustee of any authority whatsoever to disburse funds pursuant to section 348(e) (providing that "Conversion of a case … terminates the service of any trustee or examiner that is serving in the case before such conversion"). If section 348(e) did so require, the court found, the trustee would then be powerless to even return the funds to the debtor, an absurd result. The court reasoned, "[t]o the extent that she is still holding funds belonging to someone else, she is plainly a trustee in some real sense, even if her services have been 'terminated.'"[52] Accordingly, section 348(e) "cannot be taken too literally."[53]

Third, the court rejected the debtor's argument that conversion vacates the confirmed plan in its entirety. While conversion may release the debtor from his or her duties to make plan payments and remove the plan's binding effect on creditors, the court found, it does not retroactively undo the plan entirely.

Similarly, the court rejected the trustee's primary statutory argument, based on section 1326(a)(2) of the Bankruptcy Code (which uses the word "shall" when describing the trustee's obligation to distribute funds), that the "debtor's payment of funds to the trustee vests the class of creditors in general with a right to payment" as lacking any basis in statute or legislative history.[54] Even if section 1326(a)(2) did create an interest in property in favor of creditors, the court found, the funds at issue here would be property of Chase, not the ultimate recipients of the funds.

Additionally, the court disagreed with the proposition that section 1327(a) of the Bankruptcy Code (providing that "[t]he provisions of a confirmed plan bind the debtor and each

[52] *Id.* at 474.
[53] *Id.*
[54] *Id.* at 475-76.

creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has object to, has accepted, or has rejected the plan") compels the trustee to distribute the funds as if the plan were effective since they were received by her prior to conversion because, the court found, the binding effect of a confirmed chapter 13 plan is lost upon conversion.[55]

Because the court found "little guidance in the Bankruptcy Code" on this issue, it turned to considerations of policy and equity to reach its ultimate decision.[56] The court disagreed with the *In re Michael* holding that distributing to creditors the plan funds held by the chapter 13 trustee upon case conversion would pose a disincentive to a debtor's attempting to reorganize and repay his creditors under chapter 13. Rather, the court determined that returning those funds to the debtor would provide him with an underserved windfall. Furthermore, the court reasoned, it is fair for creditors to receive payments in exchange for the protections against them that the debtor enjoyed prior to conversion of his case (such as an automatic stay and the staving off of foreclosure). Conversion, the court stated, should not retroactively unwind this balanced treatment. Accordingly, the court held, creditors have a superior right to the funds and should receive them from the trustee upon conversion.

At oral argument, the Justices likewise bemoaned the lack of any guidance on this issue in the statutory text. As Justice Scalia stated: "there isn't any statutory requirement. I mean, that's what we're dealing with. We're dealing with an absolute void. The statute doesn't say what will happen to this money." Justice Breyer agreed with this proposition.

Counsel for the debtor argued that section 348(f)(2), which penalizes a debtor who converts his chapter 13 case in bad faith by providing that property of the estate in the converted

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[55] *Id.* at 477.
[56] *Id.* at 478.

case consists of "property of the estate as of the date of conversion," held the key. He argued that "by creating a penalty for debtors who have converted their case in bad faith, Congress has said that debtors should retain the funds if they have converted the case in good faith." Justice Kennedy seemed to appreciate this argument, but Justice Breyer and Justice Scalia rejected it as reading something into the statute that simply wasn't there.

Much of the questioning also focused on policy arguments. Justice Kagan asked counsel for the debtor why the debtor did not lose his right to funds held by the chapter 13 trustee at conversion as the price of enjoying the benefits of chapter 13 prior to conversion. The debtor responded that chapter 13 benefits not only debtors, but also creditors because creditors must receive at least as much as they would in a chapter 7 case. Thus, he argued, chapter 13 is better for everyone and the "idea that a debtor sort of rents the benefits of chapter 13 from his creditors who stand to gain from him doing so doesn't make a whole lot of sense under the way the Bankruptcy Code is structured."

Regarding the suggestion of the Third Circuit that disbursing the funds to creditors would create a disincentive for debtors to file chapter 13 cases, counsel for the trustee stated that "the opportunity to try" is the benefit of chapter 13. The debtor had received such benefit (he had the opportunity to negotiate with Chase to save his home, even though the effort ultimately failed), and that benefit of chapter 13 would ensure that future debtors would not be deterred from filing chapter 13 cases in the future if the Court adopted the First Circuit ruling.