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The Most Important Bankruptcy Cases in the 40 Years of the U.S. Bankruptcy Code

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CONCURRENT SESSION

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Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017)

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I. Issue

Whether a bankruptcy court has the legal power to approve a Chapter 11 structured dismissal containing a distribution scheme which violates the priority rules set out in the U.S. Bankruptcy Code without the affected creditor's consent.

II. Statutory Context

In a Chapter 11 bankruptcy, there are three foreseeable conclusions. First, the debtor and creditors may negotiate a plan which the bankruptcy court confirms that distributes the estate's value. Second, a bankruptcy court may convert the case to a Chapter 7 liquidation of the business. Third, a bankruptcy court may dismiss the proceedings. If, in a dismissal, perfect restoration of the prepetition financial status quo is difficult or impossible, the bankruptcy court may order a "structured dismissal" allowing the court to add in certain conditions "for cause" under section 349(b). Priority rules are dictated by section 507, but the U.S. Bankruptcy Code (the "Code") does not explicitly state what priority rules apply to the distribution of assets in a structured dismissal.

III. Facts

Jevic Transportation Company ("Jevic") was acquired in 2006 in a "leveraged buyout" by the private equity firm Sun Capital Partners ("Sun") with money provided by a group of lenders that included CIT Group ("CIT"). In 2008, Jevic filed for voluntary Chapter 11 bankruptcy. During bankruptcy proceedings, two separate lawsuits were filed. The first was a class-action suit made up of Jevic's truck drivers who were terminated by Jevic ("Drivers"), allegedly without the required 60-day notice required by the Worker Adjustment and Retraining Notifications Acts ("WARN") and in violation of other labor laws. The second suit was brought by a committee representing Jevic's unsecured creditors (the "Committee") for fraudulent conveyance, as is often the case following a leveraged buyout shortly before a bankruptcy filing. The Committee alleged that Sun acquired Jevic with almost none of Sun's own money and "saddled [Jevic] with debts" with the intention of hastening Jevic's financial demise. In March 2012, the Committee, Sun, CIT, and Jevic reached an agreement in the form of a structured settlement.

Despite their objections, the Drivers received no proceeds from the settlement while the more junior unsecured creditors received a distribution in exchange for dismissing the fraudulent transfer claim. The Drivers challenged the settlement but the bankruptcy court allowed it, and the U.S. District Court of Delaware and the Third Circuit both affirmed. The bankruptcy court reasoned that because anyone other than the secured creditors receiving a distribution was unrealistic, the settlement should be approved cine it benefitted more parties. The Drivers challenged the holding on the grounds that the Code does not permit a bankruptcy court to authorize a settlement that violates the Code's priority scheme. Jevic and the rest of the respondents contended that the Drivers did not have standing since

they would not have received any money even in the absence of the settlement and dismissal. However, during the appeals process the bankruptcy court entered summary judgment in favor of the truck drivers for a judgment that the Drivers claim was worth $12.4 million, of which $8.3 million was a wage claim with higher priority than the unsecured creditors' claim. This claim, the Driver's argued, represented a monetary value sufficient to support standing. The U.S. Supreme Court granted cert in June of 2016 to decide the issue.

IV. Holding

In a 6-2 opinion authored by Justice Breyer, the Court reversed and remanded the decision of the lower courts, including the Third Circuit. The Court held that without the consent of the creditors, a bankruptcy court lacks the authority to allow asset distribution outside the basic priority rules set out in the Code.

First, the Court hastily disposed of the standing issue, holding that the Drivers not receiving the opportunity to pursue a settlement that "respected their priority", as opposed to the exclusionary settlement that the respondents agreed to, was a sufficient injury in fact to give the Drivers standing.

Turning to the main issue, Justice Breyer first emphasized the lack of evidence of any congressional intent to create a "backdoor" to the priority scheme which is so crucial to the Bankruptcy Code via structured dismissals. The Court would expect more than mere silence from Congress, given the magnitude of change that allowing a priority-violating distribution represents to the Code. In fact, the words "structured" and "conditions" do not appear in the relevant part of the Code at all. While courts have allowed priority-violating distributions at times, those instances have always contained an offsetting bankruptcy-related justification the type of which was absent before the Court. The bankruptcy court's power to dismiss is limited by the procedural safeguards in the Code itself.

While the Third Circuit reasoned that the nonconsensual priority-violating structured dismissal should only be available in "rare cases", the Supreme Court concluded that Congress had not authorized any such exception, no matter how limited. Further, Breyer expressed concern over the difficulty in defining which cases are rare and which lack sufficient justification, leading to unpredictable outcomes and a rise in structured dismissal litigation. Allowing priority-violating dismissals has the potential to disparately affect certain classes of creditors that Congress has specifically sought to protect, such as the Drivers who were laid off by Jevic. For these reasons, the Court declined to "alter the balance" struck by the Code, and disallowed the settlement. The Court did make a distinction between final distributions that violate the priority scheme, as was the case in *Jevic*, and interim distributions such as "first day" wages, critical vendor payments, and "roll-ups", all of which are the type that preserve the debtor as a going concern. These types of interim distributions, the Court stated, have been upheld in the past and remain a legitimate avenue for priority-violating in contrast to the structured dismissal that the respondents agreed to.

Justice Thomas dissented, with Justice Alito joining in full, stating that the Court had addressed the wrong issue after petitioners had, according to Thomas, engaged in a bait-and-switch reformulation of the question on appeal. Additionally, it was Thomas' opinion that the Court should be hesitant to wade

into the still-developing field of structured dismissal and opt instead to wait for additional case law on the issue. The majority responded to the dissent, stating that it was not passing on the legality of structured dismissals at large, but rather the violation of priority rules accompanying structured dismissals of the type before the Court.

V. Significance

The Supreme Court's decision in *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 closed the loop on structured dismissals of a Chapter 11 petition that distributes assets in a way not in compliance with the Code's priority scheme, but other questions remain. Specifically, the Court's citation of cases outside the dismissal context suggests that the holding may be broader, requiring the Code's priority scheme and procedural protections to control transactions in more instances. The Court cited numerous lower court decisions that it viewed as analogous to the structured dismissal in *Jevic* in that each case involved a transaction proposal that sought to circumvent Chapter 11's safeguards and "alter parties' rights without their consent." In doing so, the Court heavily emphasized the importance of the priority system to the Code at large.

In the time since the decision, lower courts have interpreted *Jevic*'s holding beyond the structured dismissal context to other areas. In *In re Fryar,* 570 B.R. 602, decided by a bankruptcy court shortly after *Jevic* was handed down, a general framework was laid out for how parties seeking priority-violating distributions should operate. Parties must prove not only that the settlement is "fair and equitable", but that all deviations from the Code's priority scheme serve a significant Code-related objective such as enabling a successful reorganization or reviving the business to maximize its value. The settlement must also state how the proposal will reach that objective and should demonstrate that it makes all creditors (including the disfavored like the Drivers in *Jevic*) better off. A plan that serves as a precursor for dismissal that ignores the Code's priority scheme cannot be approved. A bankruptcy court in *In re Pioneer Health Servs.,* 570 B.R. 228 recognized that *Jevic* stood for increased scrutiny when considering allowing the circumvention of the procedural safeguards of the Code even in the context of interim critical vendor payments which *Jevic* seemed to exclude from strict compliance.

After *Jevic,* is there a requirement that all priority-violating transfers (regardless of type) be accompanied by evidence that a "significant Code-related objective" is being served? What does this decision mean for the already controversial practice of "gifting"? At a minimum, *Jevic* stands for the proposition that a party seeking a distribution that violates the Code's priority scheme should at least be prepared to make a showing that the transaction is serving a significant Code-related objective, irrespective of whether the transaction is a structured dismissal.

***Committee of Equity Security Holders v. Lionel Corp (In re Lionel Corp.)* 722 F.2d 1063 (2d Cir. 1983)**

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I. Issue

Whether a bankruptcy court may approve a sale of a debtor's asset outside the ordinary course of business and prior to a plan of reorganization.

II. Statutory Context

§363(b) of the U.S. Bankruptcy Code versus the confirmation process set forth in §§1121-1129.

III. Facts

Lionel Corporation ("Lionel") and its subsidiaries filed for Chapter 11 bankruptcy protection. Lionel was a manufacturer of toy trains, but its most valuable asset at the time of filing was its 82% stake in Dale Electronics, Inc. ("Dale"), a profitable electric components manufacturer. Lionel's interest in Dale represented approximately 34% of Lionel's consolidated assets. The filing was made in the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court").

Responding to the desire of the Creditor's Committee to finance the reorganization plan, Lionel filed an application for bankruptcy court approval to sell its Dale stock under §363 of the Bankruptcy Code for $43 million. Shortly after, Lionel then filed a plan of reorganization based on the stock sale of Dale with the proceeds being distributed to creditors. At the sale hearing conducted by the Bankruptcy Court, the presiding judge confirmed the sale for $50 million to Peabody International Corp., reasoning that the Creditors' Committee's insistence on the sale was reason enough to find cause.

The only witnesses at the hearing were the CEO of Lionel and a VP of Salomon Brothers who were both in support of the application. Although their testimony did establish the fairness of the $50 million price tag, it also established that the asset being sold was not "wasting away in any sense" and that the stock sale could easily have been a part of the reorganization plan that was in process.

The Committee of Equity Security Holders representing Lionel's public shareholders (the "Equity Committee") appealed the sale order claiming that a sale prior to approval of a plan deprived Lionel's equity holders of the Chapter 11 plan safeguards of disclosure, solicitation and acceptance and divested the debtor of a profitable asset that could fund the reorganization plan. The SEC supported the Equity Committee's appeal, entering an appearance to argue that the sale would circumvent the Code's requirements. The Creditors' Committee argued that §363 gives a bankruptcy judge unfettered discretion to approve pre-plan sales and the Code did not otherwise prohibit.

IV. Holding

The Second Circuit reversed and remanded the Bankruptcy Court's decision to approve the sale, holding that a bankruptcy court must find good business justifications to sell, use, or lease assets outside of a plan of reorganization. The Second Circuit held that the insistence of the Creditors' Committee that the sale of the stock take place was insufficient cause to justify the sale. In making this determination, the Court rejected the Equity Committee's position that §363 sales should only be allowed in emergency situations and the Creditors' Committee's argument that bankruptcy judges have unchecked discretion to do what they think appropriate. In doing so, the Second Circuit actively sought to "avoid the extremes" that the two committees argued.

In fashioning its own test, the Second Circuit turned to the Bankruptcy Act of 1867 and the Chandler Act of 1938. Courts had interpreted both Acts to allow such sales in exceptional circumstances where there was sufficient cause. These were instances where the debtor's assets were of a "perishable nature" or "liable to deteriorate in value." Additionally, an emergency could constitute cause, or if the sale was in the best interests of the estate and such a sale made good business sense.

The *Lionel* Court then analyzed the Bankruptcy Reform Act of 1978 and §363(b) and conceded that the language of §363(b) may appear to give judges unfettered discretion to approve sale motions on its face. However, the Court could not justify such a result based upon the history noted above and other provisions of the Code. Specifically, the required notice and hearing procedures along with the legislative history of the Bankruptcy Reform Act of 1978's enactment were evidence that Congress desired to protect creditors through the safeguards of Chapter 11, which included the sale process. The Second Circuit was also persuaded that bankruptcy judges need some flexibility to administer Chapter 11's goals, so the Equity Committee's extremely narrow reading of §363 would be too restrictive on potentially justified pre-plan sales.

The Second Circuit then set out to articulate a standard which found a suitable middle-ground between the two extremes. Under §363(b) and the history of Chapter 11, a bankruptcy judge may approve a pre-plan sale if there is "some articulated business justification" put forth for selling, leasing, or otherwise using the property outside of the ordinary course of business. In analyzing whether there is a fitting business justification based on the salient factors in the case, a bankruptcy judge must attempt to further the interests of the debtor, creditors, and equity holders alike and not "blindly follow" the desires of the most vocal group.

In the case on appeal before the court, the bankruptcy judge below approved the sale based solely on the pressure from the Creditors' Committee and risk of delay. This, the Second Circuit stated, was an abuse of discretion. The *Lionel* Court then listed out several factors that a court could study in reaching a decision on approval for a sale, including: (i) proportionate value of the asset to the estate as a whole; (ii) the amount of elapsed time since the bankruptcy filing; (iii) the likelihood that a plan of reorganization will be proposed and confirmed in the near future; (iv) effect of the proposed disposition on future plans of reorganization; (v) the proceeds to be obtained from the disposition vis-a-vis any

appraisals of the property; (vi) which of the alternatives of use, sale or lease the proposal envisions; and (vii) whether the asset is increasing or decreasing in value.

In *Lionel*, the court found that the Bankruptcy Court did not make a sufficient finding of an appropriate business justification. The bankruptcy judge's stated justification that the Creditors' Committee's insistence was the reason for the pre-plan sale was insufficient and the case was remanded to assess against the standard that the Court had espoused.

V. Significance

Despite the court in *Committee of Equity Security Holders v. Lionel Corp.* 722 F.2d 1063 (2d Cir. 1983) ultimately reversing the approval of the sale, the case ultimately stands for the proposition that sales of assets outside of a confirmed plan are acceptable. Although the plain language of the *Lionel* decision creates a seemingly low bar of "some articulated business justification", the listed factors and holding itself have led lower courts to take on a highly measured approach to analyzing the evidence. *Lionel* requires careful scrutiny of each transaction and what business justifications are put forth. Regardless, the case and those that followed it have caused §363 sales to govern the heavy majority of Chapter 11 cases, even from the initial pleadings stage where the assets are potentially the most valuable.

Courts have interpreted *Lionel* to stand primarily for the proposition that Chapter 11's safeguards must be preserved, but have allowed parties more leeway to recoup the greatest value for their assets when possible. *Lionel* was relied heavily upon in the §363 sales that followed the 2008 housing crisis, where bankruptcy courts approved the sales of some of the U.S.'s largest companies in very short periods of time from the initial bankruptcy filing.

The Second Circuit's decision in *Lionel* has paved the way for debtors to sell assets before going through the plan confirmation process. The decision likewise has given bankruptcy judges the ability to use their discretion to make determinations on when a pre-plan sale is to the benefit of the parties/stakeholders. In the more than three decades since *Lionel* was decided, it remains a seminal decision for Chapter 11 practitioners and judges alike.

Husky Int'l Elecs., Inc. v. Ritz, 136 S. Ct. 1581 (2016)

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I. Issue

Whether the nondischargeability of a debt under Section 523(a)(2)(A) based upon "actual fraud" requires a false representation or whether it encompasses other traditional forms of fraud that can be accomplished without a false representation, such as a fraudulent conveyance of property made to evade payment to creditors.

II. Statutory Context

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> * * *
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
>
> (A) false pretenses, a false representation, or actual fraud . . . .

III. Facts

Husky International Electronics, Inc. ("Husky"), a supplier electronic device components, sold products to Chrysalis Manufacturing Corp. ("Chrysalis") for which Chrysalis incurred a debt to Husky of $163,999.38. Daniel Lee Ritz, Jr. ("Ritz"), director and at least 30% common stock owner of Chrysalis, drained Chrysalis of assets and transferred large sums of Chrysalis' funds to other Ritz-controlled entities.

Husky filed a lawsuit against Ritz seeking to impose liability on Ritz under Texas law allowing a corporate creditor to hold a shareholder responsible for corporate debt when that shareholder used the corporation to perpetuate actual fraud against the creditor. Ritz filed for Chapter 7 bankruptcy in the Southern District Texas Bankruptcy Court. Husky commenced an adversarial proceeding seeking personal liability against Ritz for Chrysalis' debt and a determination that Ritz could not discharge that liability because Ritz's intercompany-transfer scheme constituted "actual fraud" under Section 523(a)(2)(A).

The District Court held that Ritz was personally liable for the debt under Texas law, but that the debt was dischargeable because it was not "obtained by . . . actual fraud" under Section 523(a)(2)(A). Without addressing whether Ritz was personally responsible for Chrysalis' debt under Texas law, the Fifth Circuit affirmed—holding that a necessary element of "actual fraud" is a misrepresentation from the debtor to the creditor. The Fifth Circuit disagreed with Husky's argument that Ritz's intercompany-transfer scheme was effectuated through a series of fraudulent conveyances, i.e. transfers intended to obstruct the collection of debt, which Husky contended constituted a form of "actual fraud." Even if Ritz had hindered Husky's ability to recover its debt by transferring Chrysalis' assets, the Fifth Circuit found

that Ritz had not made any false representations to Husky regarding those assets or the transfers and therefore did not commit "actual fraud." The U.S. Supreme Court granted certiorari to resolve a Circuit split regarding whether "actual fraud" required a false representation.

To be continued…

IV. The Path to *Husky*

A. *Grogan v. Garner*, 498 U.S. 279 (1991)

Held: A creditor need only establish fraud by a preponderance of the evidence in order to except a debt from discharge under Section 523(a). A heightened standard of proof is not required to effectuate the "fresh start" policy underlying the Bankruptcy Code, as such an fresh start should be for the "honest but unfortunate debtor."

B. *Field v. Mans*, 516 U.S. 59 (1995)

Held: A creditor need only establish justifiable reliance on a fraudulent representation rather than reasonable reliance in order to except a debt from discharge for such fraudulent representation under Section 523(a)(2)(A).

C. *Cohen v. de la Cruz*, 523 U.S. 213 (1998)

Held: Section 523(a)(2)(A) contains no limitation as to the extent to which the liability arising from fraud should be excepted from discharge. Accordingly, treble damages (plus attorney's fees and costs) awarded on account of the debtor's fraud appropriately fall within the exception.

D. *Raleigh v. Illinois Dept. of Revenue*, 530 U.S. 15 (2000)

Held: The burden of proof imposed upon a claim under state law shall remain placed on the same party in the bankruptcy court as it would be placed outside the bankruptcy case. "Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code itself provides."

E. *Archer v. Warner*, 538 U.S. 314 (2003)

Held: The conversion of a creditor's fraud claim into a settlement debt for money with a release of the underlying fraud claim does not preclude a bankruptcy court from determining that such a debt for money was obtained by fraud and therefore nondischargeable under Section 523(a)(2)(A).

V. The *Husky* Holding

The Supreme Court reversed the Fifth Circuit in a 7-1 decision, holding that the term "actual fraud" used in Section 523(a)(2)(A) encompasses fraudulent conveyance schemes, even though no false representation has been made by the debtor to the creditor. The Court concluded that when Congress added "actual fraud" to Section 523(a)(2)(A) it did not intend for that term to have the same meaning as "false representations." The Court further explained that the historical meaning of "actual fraud" included any fraud committed with wrongful intent, and that the term "fraud" has always been used in the bankruptcy practice to describe asset transfers that impair a creditor's ability to collect a debt.

Accordingly, because fraudulent conveyance schemes constitute fraud by acts of concealment and hindrance, whether or not a false representation occurred, such schemes fall within the term "actual fraud" and thus are not dischargeable under Section 523(a)(2)(A). Rejecting the dissent's opinion that such a holding is incompatible with the "obtained by" requirement under Section 523(a)(2)(A), the Court further reasoned that the transferee of a fraudulent conveyance, with the requisite intent, does "obtain" a debt by fraud, even though the transferor incurred the original debt prior to the fraudulent conveyance.

VI. The Significance of *Husky*

The Supreme Court's decision in *Husky* doubled down on the Court's prior warnings that the "fresh start" policy underlying the Bankruptcy Code is only for the "honest but unfortunate" debtors. Read in conjunction with its prior significant nondischargeability rulings, the *Husky* decision probably should not have been all too surprising to debtors. The Court yet again reaffirmed its view that the term "actual fraud" under Section 523(a)(2)(A) should continue to be read broadly to expand the reach of the discharge exception, thereby placing a new beginning further out of reach for dishonest debtors—dishonesty encompassing acts of concealment and hindrance rather than only false representations. Such a view certainly influenced the Court's reasoning that fraudulent conveyance schemes involve debts obtained by actual fraud despite the fact that the debt originated prior to the fraudulent conveyance. The *Husky* decision provides a sobering reminder that a fresh start is certainly not guaranteed by the Bankruptcy Code. Debtors be warned.

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

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I. Issue

Whether Article III of the Constitution permits a bankruptcy court to enter a final judgment on a compulsory state-law counterclaim filed in the bankruptcy.

II. Statutory Context

Congressional authority to hear matters under section 157 of the U.S. Bankruptcy Code versus constitutional authority for the judiciary under Article III of the U.S. Constitution.

III. Bankruptcy Court Proceedings: *Marshall v. Marshall (In re Marshall)*, 253 B.R. 550 (Bankr. C.D. Cal. 2000).

IV. Appeals Court Proceedings:

A. District Court: *Marshall v. Marshall (In re Marshall)*, 275 B.R. 5 (C.D. Cal. 2002).

B. Appeals Court: *Marshall v. Stern (In re Marshall)*, 600 F.3d 1037 (9th Cir. 2010).

V. Facts

Vickie Lynn Marshall ("Marshall"), better known to the public as Anna Nicole Smith, filed bankruptcy in the Southern District of California. Before the bankruptcy filing, Marshall sued her late husband's son, Pierce, alleging that Pierce had fraudulently induced Marshall's late husband to exclude her from his will.

Pierce filed a complaint in Marshall's bankruptcy alleging that Marshall had defamed him based on the lawsuit over his father's will. Pierce also filed a proof of claim in the bankruptcy seeking to recover damages under his defamation claim from Marshall's bankruptcy estate. In response, Marshall filed a tortious interference counterclaim against Pierce alleging that he had interfered with the gift that she expected from her late husband.

The bankruptcy court granted summary judgment in Marshall's favor on Pierce's defamation claim. After a bench trial in the bankruptcy court on Marshall's counterclaim against Pierce, the court awarded Marshall $400 million in compensatory damages and $25 million in punitive damages. In his appeal to the district court, Pierce argued that the Bankruptcy Court lacked jurisdiction to hear Marshall's counterclaim because it was not a "core proceeding" in the bankruptcy case under Section 157 of the Bankruptcy Code

The District Court reversed, reading the Supreme Court's precedent in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, to "suggest[ ] that it would be unconstitutional to hold that any and all counterclaims are core." The court held that Marshall's counterclaim was not core because it was only somewhat related to Pierce's claim, and, accordingly, it treated the Bankruptcy Court's judgment as proposed findings of fact and conclusions of law, not final. The District Court ultimately held in Marshall's favor and Pierce appealed to the Ninth Circuit.

The Ninth Circuit Court of Appeals interpreted section 157 of the Bankruptcy Code as requiring a two-part test to determine if a bankruptcy judge could enter a final judgment on the claim. The test required that the claim meet Congress' definition of a core proceeding and arise from title 11. The Ninth Circuit held that Marshall's counterclaim in this case did not pass the test and thus the district court's judgment should have been reversed because Marshall's claim did not arise out of Title 11.

VI. Holding

The Supreme Court upheld the Ninth Circuit's holding that a bankruptcy court lacks the constitutional authority to enter a final judgment on a compulsory state law counterclaim filed in bankruptcy that is not necessarily resolved in the process of deciding a creditor's proof of claim.

The Supreme Court first engaged in an analysis of the text of section 157 of the Bankruptcy Code, which permits bankruptcy judges to hear and enter final judgments in all core proceedings under title 11. The court recognized that all counterclaims filed in a bankruptcy are to be considered core proceedings under the plain language of the Bankruptcy Code. Thus, Marshall's counterclaim for tortious interference was in fact a core proceeding under the statute, which would have enabled the bankruptcy judge to enter a final order on the claim under the code.

Despite the statutory authority for the district court's decision, the Court recognized that the broad designation of all counterclaims as core proceedings under section 157 raised serious constitutional concerns.

The Supreme Court began its analysis of section 157's constitutional implications with the text of Article III. The Court stated that under Article III, when common law actions are brought under federal jurisdiction, the Article III judiciary is solely responsible for exercising the judicial power and deciding that suit. The Supreme Court further noted that Congress may not withdraw from the judiciary's province any matter which is a suit in common law, equity, or admiralty.

In affirming the Ninth Circuit, the Supreme Court held that the bankruptcy court exercised the judicial power of the United States when it entered a final judgment on Marshall's state-law counterclaim. Marshall argued that the bankruptcy court was constitutionally permitted to resolve Marshall's counterclaim, as an adjunct to the district court. But the Supreme Court was clear in explaining that the Bankruptcy Court is independent from the Article III judiciary and is not an adjunct of the district court

or the court of appeals. As a separate "legislative" court, the Bankruptcy Court was not permitted to exercise the judicial power of resolving a common law claim that did not arise out of the bankruptcy.

Marshall also argued that her case was a "public right" exception that warranted a departure from compliance with Article III wherein Congress could constitutionally assign cases to "legislative" courts for resolution. The Court has previously recognized this "public right" exception in matters between individuals and the government regarding government performance of constitutional functions. The Court was clear that this case was markedly different from the agency cases in which the "public right" doctrine had been invoked, and held that it was not applicable to the facts of this case.

The Court took the opportunity to be clear that: "Congress may not bypass Article III simply because a proceeding may have *some* bearing on a bankruptcy case; the question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process." The Marshall in this case failed to show any reason for the court to abandon its preference for Article III courts because Marshall's counterclaim did not stem from the bankruptcy itself, nor would it be resolved in the claims allowance process.

VII. Significance

Despite its attempt to offer some guidance for what constitutes a "core" claim in a bankruptcy proceeding, *Stern* called into question the kinds of claims upon which a bankruptcy would be permitted to enter final judgment. In *Executive Benefits Insurance Agency v. Arkinson*, 573 U.S. 25 (2014), the Supreme Court clarified that when a bankruptcy court is potentially blocked from entering final ruling by Article III, the bankruptcy court should enter proposed findings of fact and law to be reviewed *de novo* by the district court.

When the *Stern* case was originally decided, practitioners had a great deal of concern over whether there would be a shift in the division of labor between bankruptcy and district courts. The *Executive Benefits* Court, however, noted that despite all the concern, there had not been a meaningful change in the division of labor between the courts based on the *de novo* review system created under *Stern*.

Another unanswered question resulting from the *Stern* decision is whether or not the parties can consent to having the bankruptcy court decide the compulsory state-law counterclaim in the bankruptcy proceeding.

Baker Botts LLP v. ASARCO LLC, 135 S.Ct. 2158 (2015)

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I. Issue

Whether attorney's fees can be awarded for work performed in defending a fee application.

II. Statutory Context

Section 330(a)(1) of the U.S. Bankruptcy Code addressing compensation of section 327 professionals.

III. Bankruptcy Court Proceedings: *In re ASARCO*, Case No. 05-21207, 2011 WL 2974957 (Bankr. S.D. Tex. 2011).

IV. Appeals Court Proceedings:

A. District Court: *ASARCO, LLC v. Baker Botts, LLP (In re ASARCO)*, Case No. 05-21207, 2013 WL 1292704 (S.D. Tex. 2013).

B. Court of Appeals: *ASARCO, LLC v. Baker Botts, LLP (In re ASARCO)*, 751 F.3d 291 (5th Cir. 2014).

V. Facts

ASARCO LLC ("ASARCO"), a copper mining, smelting, and refining company, filed for Chapter 11 bankruptcy after experiencing financial problems stemming from falling copper prices, debt, cash flow deficiencies, environmental liability and a striking work force. Acting under section 327 of the Bankruptcy Code, ASARCO obtained the Bankruptcy Court's permission to hire two law firms, Baker Botts L.L.P. and Jordan, Yden, Womble, Culbreath & Holzer, P.C. (the "Firms"), as its bankruptcy counsel.

The Firms provided ASARCO legal representation, including the prosecution of fraudulent-transfer claims against ASARCO's parent company—ultimately obtaining a judgment between $7 and $10 billion—which allowed ASARCO to pay off all of its creditors and undergo a successful reorganization. After over four years in bankruptcy, ASARCO emerged with $1.4 billion in cash, little debt, and resolution of its environmental liabilities.

Following the bankruptcy, the Firms sought compensation under section 330(a)(1), which provides that a bankruptcy court "may award . . . reasonable compensation for actual, necessary services rendered by" professionals hired pursuant to section 327. The Firms filed fee applications according to the bankruptcy rules, but ASARCO (controlled by its parent company) challenged the compensation.

After a six day trial, the bankruptcy court overruled ASARCO's objections and awarded the Firms approximately $120 million for their work in the bankruptcy proceeding plus a $4.1 million dollar enhancement for exceptional performance. The bankruptcy court also granted an additional $5 million

award to the Firms for "defending their fee application." ASARCO appealed the $5 million additional award, arguing that the section 330(a) did not authorize payment fees in defense of a fee application.

The district court noted a split among bankruptcy courts concerning whether a law firm could be compensated for time spent in defense of a fee application. It noted that the vast majority of courts at the time found that compensating a bankruptcy professional for the preparation and successful defense of their fee applications was necessary to avoid "unfair dilution of their fees." However, it also recognized that a few courts declined such awards, finding that the pursuit of fees does not benefit the bankruptcy estate and therefore is not authorized under section 330. With no Fifth Circuit cases on point by which to go by, the district court affirmed the bankruptcy court's findings, stating that time spent defending a fee application "is necessary and beneficial to the bankruptcy system as a whole, and indirectly, to each estate participating in the system." The matter was appealed to the Fifth Circuit Court of Appeals.

The Fifth Circuit reversed the Bankruptcy Court's decision, reasoning that the common law American Rule—each side must pay its own attorney's fees—applied absent some explicit statutory authority otherwise. The Fifth Circuit observed that the compensation provided in section 330(a)(1) was only available if the professional services rendered were "likely to benefit a debtor's estate or [were] necessary to case administration." The Firms appealed, and the Supreme Court granted certiorari.

VI. Holding

The Supreme Court affirmed the Fifth Circuit, holding that because section 330(a)(1) did not explicitly override the American Rule with respect to fee-defense litigation, it did not permit bankruptcy courts to award compensation for fee-defense litigation. The Supreme Court noted that it had only recognized departures from the American Rule in the context of "fee shifting statutes" or other explicit statutory authority and declined to deviate from that practice.

The Court began by clarifying that the purpose of section 327(a) professional is to serve the administrator of the estate for the *benefit* of the estate. Further, those same professionals could not hold or represent interests adverse to the estate. Consequently, the court determined that time spent litigating a fee application against the administrator of a bankruptcy estate could not be considered "labor performed for" or "disinterested service to" that administrator.

The Supreme Court then rejected arguments brought forth by the Firms, the United States as *amicus curiae*, and the dissent. The Firms argued that fee-defense litigation was part of the "services rendered" to the estate administrator. Unpersuaded by this interpretation of the statute, the Court found that the Firms' interpretation could result in attorneys being compensated for the unsuccessful defense of a fee application. Such a reading was untenable and an unusual deviation from the American Rule. The Court went on to explain that any statutory departures from the American Rule included some language which specifically awarded fees to the prevailing party, which section 330(a)(1) noticeably lacked.

On the other hand, the Government argued (and the dissent agreed) that money awarded from fee-defense litigation was instead part of the compensation "for the underlying services in the bankruptcy proceeding." However, under section 330(a)(1), only the preparation of a fee application could be considered a "service rendered" to the estate administrator, not the defense of that application. The Government's position was based on its understanding of *Commissioner v. Jean*, 496 U.S. 154 (1990), in which the Court found no distinction between "a party's preparation of a fee application and its ensuing efforts to support that same application." The majority disagreed with *Jean*'s application, holding that *Jean* turned on what findings were necessary to award fee-defense compensation, not whether or not fee-defense awards were proper.

Finally, the Supreme Court found the Government's policy argument unconvincing. The United States contended that awarding fees for fee-defense litigation was a "judicial exception" necessary to the proper functioning of the Bankruptcy Code and failing to apply such an exception would result in bankruptcy lawyers receiving less compensation than nonbankruptcy lawyers. In our legal system, however, no attorneys, bankruptcy or otherwise, are entitled to receive fees for fee-defense litigation absent statutory authorization. Citing inconsistencies in the arguments of the briefs filed by the Government, the Supreme Court reasoned against "substituting policy-oriented predictions for statutory text." Ultimately, the language of section 330(a)(1) does not permit bankruptcy courts to award compensation for fee-defense litigation.

VII. Significance

The Court's approach in *Baker Botts LLP v. ASARCO LLC*, 135 S.Ct. 2158 (2015) is ultimately a textualist one. Writing for the majority, Justice Thomas emphasized his "straightforward interpretation of the statute" and was unpersuaded by either the Firms' or the government's contention that section 330(a)(1) expressly awards compensation in the context of fee-defense litigation. Thomas notes that the statute provides "reasonable compensation" to section 327 professionals for "services rendered." Citing section 330(a)'s predecessor, such language only implies "loyal and disinterested service in the interest of" a client. By its very nature, that does not include fee-defense litigation.

Following the Court's decision in *ASARCO*, estate professionals have sought ways to limit the impact of the decision, including circumvention via contract. Such attempts have had mixed results. For example, a Delaware court held that fee-defense provisions in a contract do not comply with the Court's decision in *ASARCO* because such provisions would only benefit the interest of the party who sought to defend their fees, not the party they represented. *See In re Boomerang Tube, Inc.*, 548 B.R. 69 (Bankr. D. Del. 2016). By contrast, the New Mexico Bankruptcy court held that an indemnification provision in a retention agreement was reasonable under section 328 of the Bankruptcy Code. *See In re Hungry Horse LLC*, 2017 Bankr. LEXIS 3183, **1 (Bankr. D.N.M. Sept. 20, 2017). Taking a more holistic view than the Delaware court, the New Mexico court found that the "contract exception to the American Rule remain[ed] viable in bankruptcy cases."

In light of *ASARCO* and *Boomerang Tube*, for such contracts to prevail, certain provisions should be included, such as allowing the Bankruptcy Court to review and approve the reasonableness of compensation resulting from fee-defense litigation, and compensation only being viable in successful fee defense work.

Jay Alix v. McKinsey & Company

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I. Issue

To what extent must a bankruptcy adviser disclose potential conflicts of interest.

II. Statutory Context

Conflicts of interest in bankruptcy proceedings under Rule of Bankruptcy Procedure 2014.

III. Bankruptcy Court Proceedings: *In re Westmoreland Coal Company*, Bankr. S.D. Tex., No. 18-bk-35672; *In re Alpha Natural Resources, Inc.*, Case No. 15-33947-KRH (E.V. Va. 2015).

IV. Appeals Court Proceedings:

- **A. District Court:** *Mar-Bow v. McKinsey Recovery & Transformation (In re Alpha Natural Resources Inc.)*, 578 B.R. 325 (E. B. Va. 2017).
- **B. Appeals Court:** *Mar-Bow Value Partners LLC v. McKinsey Recovery & Transformation Services US LLC* (*In re Alpha Natural Resources Inc.),* Nos. 17-2268; 17-2269 (4th Cir. Sept. 6, 2018).

V. Facts

Jay Alix ("Alix"), founder and board member of AlixPartners, a bankruptcy advisory firm, sued an AlixPartners' competitor, McKinsey & Company ("McKinsey"), for failing to disclose conflicts of interest in violation of the Bankruptcy Code. Since 2016, Alix has brought five lawsuits in federal bankruptcy courts against McKinsey. In order to achieve standing for his lawsuits, Alix created an investment company called Mar-Bow Value Partners, which purchased distressed debt of companies that had filed for bankruptcy and retained McKinsey as an adviser. Mar-Bow filed a joint lawsuit on behalf of three companies it obtained: Westmoreland, SunEdison, and Alpha Natural Resources.

Alix contends that McKinsey "unlawfully schemed to harm [AlixPartners], which is McKinsey's chief competitor[,]" by "knowingly and intentionally submitt[ing] false and materially misleading affidavits and declarations . . . in order to unlawfully conceal its many significant connections to 'Interested Parties' . . . and in order to avoid revealing numerous conflicts of interest that would disqualify McKinsey and [its affiliate] McKinsey [Recovery and Transformation Services U.S. LLC] from being hired as bankruptcy professionals" in a number of Chapter 11 cases.

Alix alleges that McKinsey "deliberately parsed and crafted disclosure declarations to create the false and misleading appearance of McKinsey's . . . compliance with the disclosure requirements, and disinterestedness under law." Alix contends that McKinsey "schemed to create [its] own separate set of bankruptcy disclosure rules designed to excuse [it] from the requirements that all other professionals must follow under the assumption that few would be willing to question the consultancy powerhouse."

Alix claims that McKinsey illegally earned over $50 million during its representation of Alpha Natural Resources in large part due to it taking advantage of its conflicts of interest. McKinsey claims the actual sum was only a fraction of that amount.

Alix has also filed a civil racketeering lawsuit against McKinsey and seven of its executives in the Southern District of New York. Following alleged attempts to bribe him, the RICO action claims that McKinsey is a criminal enterprise engaging in bankruptcy fraud, mail and wire fraud, obstruction of justice, money laundering, and other illegal acts.

VI. Outcome

In January of 2019, a federal bankruptcy judge ordered the parties Mar-Bow had targeted, Westmoreland, SunEdison, and Alpha Natural Resources, into mediation. The U.S. Trustee Program ("USTP") also joined the proceeding, heeding Alix's tips to investigate McKinsey. While mediation was suspended in those cases, McKinsey agreed to pay $15 million to settle disputes with the USTP stemming from its failure to fully disclose its connections. In response to the settlement, USTP director Cliff White said that "McKinsey failed to satisfy its obligations under bankruptcy law and demonstrated a lack of candor with the court and USTP." White also mentioned that any more foul play by McKinsey would result in more severe action by the USTP. McKinsey maintains that its firm's "mistakes" were mainly the result of bad legal advice the firm was given about how to make its disclosures. The firm admitted no wrongdoing as part of its settlement with the USTP, and maintains that Alix's allegations are false and are the result of a deep-seated grudge against it for competing against AlixPartners and poaching some of its employees.

McKinsey has called for Alix's RICO lawsuit to be dismissed, citing Alix's personal vendetta against the firm as a root cause for the lawsuit. The dismissal is still awaiting decision. While, the joint lawsuit involving companies obtained by Mar-Bow is not undergoing mediation at this time, a group of SunEdison creditors reached a private settlement with McKinsey for $17.5 million in December of 2018.

VII. Significance

Alix's lawsuits against McKinsey are certainly uncommon for a private individual. Through legal action, he has sought to be a self-proclaimed "private attorney general," seeking to bring McKinsey to justice for allegedly corrupting the U.S. bankruptcy system. As a billionaire, Alix has the resources to pursue his claims, and given his experience in the industry, he also has the knowledge and connections to do so.

As for now, determining the truth of the allegations against McKinsey is difficult. Nevertheless, Alix seems to be just getting started in his crusade against McKinsey. However, the case has highlighted the importance of being candid with the Bankruptcy Court when seeking approval of an employment application. Failure to properly disclose potential conflicts can result in large fines and potentially more.

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