Oyez! Oyez! Oyez! Supreme Court Update

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OYEZ!, OYEZ!, OYEZ!
SUPREME COURT UPDATE

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Case Summaries Prepared By:

Wellness International Network, Ltd. v. Sharif
135 S. Ct. 1932 (May 26, 2015)
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American Bankruptcy Institute
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Analysis of Decision by the United States Supreme Court in *Wellness International Network, Ltd. v. Sharif*, __ U.S. __ (May 26, 2015)[1]

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I. Introduction and Background:

Wellness International Network, Ltd. v. Sharif [No. 13-935] was the second opportunity for the Supreme Court to revisit its much-discussed opinion in *Stern v. Marshall,*[2] and presented 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).*[3]

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 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."[4]

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[1] A portion of this presentation was previously used in connection with the "Hot Topics & The Latest & Greatest: Supreme Court Case Update" presented by Paul R. Hage and the Hon. David S. Kennedy at the American Bankruptcy Institute's Memphis Consumer Bankruptcy Conference held in Memphis, Tennessee in June 2015.

[2] *Stern v. Marshall,* 131 S. Ct. 2594 (2011).

[3] *Executive Benefits Insurance Agency v. Arkinson (In re Bellingham),* 134 S. Ct. 2165 (2014).

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

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 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.'"[5] Relying on 19th Century decisions, the majority reasoned that there was no room for any approach that would "chip away" at Article III jurisdiction.[6] 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" consent; and (ii) whether a bankruptcy judge may submit proposed findings of fact and

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[5] *Id.* at 2609.

[6] *Id.* at 2620.

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.*[7] 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.

II. The Lower Court Decision in *Wellness*:

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

[7] *Id.* at 2168.

bankruptcy estate.[8]

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.

III. Appeal of Wellness to the Seventh Circuit Court of Appeals:

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."[9] However, the court held, under *Stern,* that the bankruptcy court lacked constitutional authority to enter a final judgment on the alter-ego claim because it: (i) was between private parties, (ii) stemmed from state law rather than a federal regulatory scheme, (iii) did not involve a particularized area of law and (iv) was intended only to augment the bankruptcy estate.[10] 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 Sharif 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*

[8] 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 of the Bankruptcy Code and the determination of what constitutes "property of the estate" enhanced their constitutional authority argument.

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

[10] *Id.* at 774.

Commission v. Schor[11] 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 out the waivable personal safeguard from the nonwaivable structural safeguard."[12] Ultimately, the court concluded that the safeguards could not be separated due to the importance of the structural concerns, noting:

> [T]he 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."[13]

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."[14]

IV. Appeal to the United States Supreme Court:

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.

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

[12] *Wellness,* 727 F.3d at 769.

[13] *Id.* at 771. (quoting *Stern,* 131 S.Ct. at 2609).

[14] *Id.* at 773.

At the January 14th hearing, 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, Justices Scalia, Kennedy and 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 was essential that 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, Sharif argued that the issue in dispute here was 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, was purely an issue of state law and was 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.

V. Analysis of the Supreme Court Decision:

(a) Justice Sotomayor's Majority Decision:

Justice Sotomayor delivered the majority opinion of the Supreme Court in a 5-4 decision on May 26, 2015, in which she reversed the decision of the Seventh Circuit Court of Appeals and held, in reliance of *Commodities Futures Trading Commission v. Schor,* 478 U.S. 833 (1986) and focusing exclusively on the consent issue, that parties may waive their "personal right" to an Article III court adjudicating their claim as long as: (i) such consent is "knowing and voluntary," and (ii) the "structural principle of having an impartial and independent federal adjudication of

claims is not implicated in a given case." No such structural concerns were implicated by having the CFTC adjudicate the counterclaims against Schor as Congress has given the CFTC the authority to do so. As the Supreme Court stated in *Schor*:

> . . . In such circumstances, separation of powers concerns are diminished, for it seems self-evident that just as Congress may encourage parties to settle a dispute out of court or resort to arbitration without impermissible incursions on the separation of powers, Congress may make available a quasi-judicial mechanism through which willing parties may, at their option, elect to resolve their differences.[15]

Moreover, according to Justice Sotomayor, again in reliance of *Schor*:

> The option for parties to submit their disputes to a non-Article III adjudicator was at most a "*de minimis*" infringement on the prerogative of the federal courts.[16]

Thus, as no structural principle was implicated in *Schor* to preclude the waiver of a right to adjudication by an Article III judge, Judge Sotomayor had no difficulty in finding that the same circumstances applied in this case to permit the waiver.

In making this ruling, Justice Sotomayor justified her decision on several additional grounds. First, the Supreme Court had held that magistrate judges – non-Article III judges – have the right to preside over a civil trial upon consent of the parties. Second, bankruptcy judges, like magistrate judges, are appointed and subject to removal by Article III judges and serve as judicial officers of the United States district court. Third, bankruptcy judges hear matters solely on a district court's reference under 28 U.S.C. § 157(a), which the district court may withdraw *sua sponte* or at the request of a party under 28 U.S.C. § 157(d).

Fourth, according to Justice Sotomayor:

> . . . bankruptcy courts possess no free-floating authority to decide claims traditionally heard by Article III courts. Their ability to resolve such

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[15] *Commodities Futures Trading Commission v. Schor,* 478 U.S. at 855.

[16] *Id.* at 856.

> matters is limited to a "narrow class of common law claims as an incident to the [bankruptcy courts'] primary, and unchallenged, adjudicative function. In such circumstances, the magnitude of any intrusion on the Judicial Branch can only be termed *de minimus*. (citations omitted)[17]

Fifth, permitting the bankruptcy court to decide *Stern* claims did not reflect an indication by Congress "to aggrandize itself or humble the Judiciary." To rule otherwise and require that all such issues be decided by an Article III court would require, among other things, a substantial increase in the number of district court judgeships. "So long as those judges [bankruptcy judges] are subject to control by the Article III courts, their work poses no threat to the separation of powers."

Justice Sotomayor distinguished the facts in *Wellness* to the facts in *Stern.* In *Stern*, unlike *Wellness*, the parties did not consent to adjudication by the bankruptcy court. Moreover, to read and interpret *Stern* in a more expansive, rather than narrower manner, would be inconsistent with Justice Roberts' statement in *Stern* that "the question before [the Court] was a 'narrow' one and that its answer did "not change all that much" about the division of labor between district courts and bankruptcy courts. To interpret *Stern* otherwise and preclude parties from waiving their right to an Article III judge, according to Justice Sotomayor, would "meaningfully chang[e] the division of labor" in our judicial system."

Justice Sotomayor disagreed with the principal dissent by Justice Roberts, in which he suggested that ominous predictions impacting the separation of powers and structural projections imposed by the Constitution will inure from this ruling, as being without justification. In so holding, Justice Sotomayor stated:

> Adjudication based on litigant consent has been a consistent feature of the federal court system since its inception. Reaffirming that

[17] *Id.* at 854, 856

> unremarkable fact, we are confident, poses no great threat to anyone's birthrights, constitutional or otherwise.

Finally, Justice Sotomayor dismissed the argument asserted by Sharif that to have a valid consent it must be express, noting that there is nothing in the Constitution or any relevant statute that mandates express consent. According to Justice Sotomayor, while recognizing that it is good practice for courts to seek express statements of consent, the Article III right is substantially honored by permitting waiver based on actions rather than words.

The Supreme Court remanded the case to the Seventh Circuit Court of Appeals to decide "whether Sharif's actions evinced the requisite knowing and voluntary consent" to justify a waiver of his right to insist on an Article III determination.

(b) Justice Alito's Concurring Opinion:

Justice Alito concurred in part of the majority decision and concurred in the judgment in so far as it held that a bankruptcy judge's resolution of a *Stern* claim with the consent of the parties does not violate Article III of the Constitution. He believed that this holding was consistent with *Schor*, represented the law of this Court, and no one had asked the Court to revisit it, thereby suggesting that if someone had asked the Court to revisit *Schor*, maybe the ruling would have been different. However, Justice Alito would not have decided as part of the decision whether consent may be implied as there was not need to decide that question, noting that Bankruptcy Rule 7012(b) requires express consent for a bankruptcy judge to enter final orders in non-core matters under 28 U.S.C. § 157(c)(2). In light of this rule, it is unlikely that "implied consent," while constitutionally permitted, will be an issue in the future.

(c) Justice Roberts' Dissenting Opinion:

Justice Roberts, joined by Justices Scalia and Thomas, as to Part I only, filed a dissenting opinion. In large part, Justice Roberts criticized the majority for minimizing the impact and

seriousness of the Constitutional issues facing the Court and definitively concludes that private parties cannot consent to an Article III violation. Put another way, if the issue pending before the Court requires adjudication by an Article IIII court, a party may not waive and consent to adjudication by a non-Article III body as to do so constitutes "an inseparable element of the constitutional system of checks and balances," a structural safeguard that must be "jealously guarded."[18] The pragmatic grounds on which the majority justified its decision – so-called "functionalism," according to Justice Roberts – could not yield to the separation of powers and structural safeguards protected under the Constitution. While the majority viewed the action it authorized as being a "modest encroachment," Justice Roberts expressed concern that such action established precedent that represented "an erosion of our constitutional power that [he] fear[ed] we will regret." While the encroachment at issue here may seem benign enough, nevertheless, Justice Roberts was concerned that this decision would ultimately open the flood-gates for further encroachments on a "constitutional birthright" as long as two private parties agree, stating:

> Perhaps the majority's acquiescence in this diminution of constitutional authority will escape notice. Far more likely, however, it will amount to the kind of "blueprint for extensive expansion of the legislative power" that we have resisted in the past.

Justice Roberts reaffirmed in his dissenting opinion Congress' ability to confer power on non-Article III tribunals to decide federal cases and controversies is subject to narrow exceptions, to wit: (i) courts exercising general jurisdiction in the territories and the District of Columbia, (ii) military tribunals, and (iii) courts adjudicating "public rights." Moreover, while again recognizing that "Congress may assign some bankruptcy proceedings to non-Article III

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[18] *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.,* 458 U.S. 50, 58, 60 (1982) (plurality opinion).

courts, there are limits on the power," which included the assignment of the resolution of a *Stern* claim to a judge that lacked the structural protections of Article III.

Justice Roberts challenged the majority's factual interpretation of *Stern* – that being that in *Stern*, the litigant did not truly consent to the resolution of the claim against him in the Bankruptcy Court – as not being a proper reading of the decision. According to Justice Roberts:

> *Stern*'s subsequent sentences made clear that the notions of consent relied upon by the Court in *Schor* did not apply in bankruptcy because "creditors lack an alternative forum to the bankruptcy court in which to pursue their claims." Put simply, the litigant in *Stern* did not consent because he *could not* consent given the nature of bankruptcy.

Justice Roberts further stated that *Stern* held that "it does not matter who" authorized a bankruptcy judge to render final judgments on *Stern* claims because the "constitutional bar remains." Thus, according to Justice Roberts, the majority's conclusion that two litigants can authorize a bankruptcy judge to render final judgment on *Stern* claims was incompatible with *Stern*.

Justice Roberts also rejected the majority's heavy reliance on the supervision and control that the district courts (*i.e.*, Article III courts) exercise over the bankruptcy courts to justify the ruling, an argument that had previously been considered and rejected in *Stern*. According to Justice Roberts, "[t]he fact that Article III judges played a role in the Article III violation does not remedy the constitutional harm." . . . Article III judges have no constitutional authority to delegate the judicial power – the power to "render dispositive judgments" – to non-Article III judges, no matter how closely they control or supervise their work."

The next argument rejected by Justice Roberts related to the majority's considerable attention given to the authority of magistrate judges, non-Article III judges, to conduct certain proceedings with the consent of the parties under 28 U.S.C. § 636. According to Justice Roberts,

no one challenged their constitutional authority as part of this case. Moreover, like bankruptcy judges, the decisions of the magistrate judges are subject to reports and recommendations reviewed *de novo* by the district court and, thus, they do not present a constitutional challenge to the entry of a final judgment by a non-Article IIII judge.

Justice Roberts also dismissed the majority's reliance on 19th Century cases in which courts referred disputes to non-Article III referees, or arbitrators as, ultimately, an Article III court entered the final judgment associated therewith. Comparing the role of bankruptcy judges to arbitrators was also rejected because arbitration, unlike litigation, was a matter of contract where the parties agreed to resolve disputes in a private forum, thereby not creating any constitutional concerns.

Interestingly, Justice Roberts could have justified determination of the case by a non-Article III judge if the issues to be determined were limited to whether Sharif and his trust were alter egos of each other because this type of determination merely involved "identifying the property of the estate" – something that is "inescapably central to the restructuring of the debtor-creditor relationship" – a position that had been proffered by the Solicitor General in its brief. Justice Roberts noted, however, that the majority never addressed whether the claim at issue in this case was a *Stern* claim as making that distinction was irrelevant to their holding.

(d) Justice Thomas' Dissenting Opinion:

Justice Thomas filed a separate dissenting opinion as he would have decided the case on narrower grounds and remanded the case to the lower courts to determine whether the alter ego claim was a *Stern* claim. He further indicated that while he agreed with Justice Roberts' holding in so far as individuals cannot consent to violations of the Constitution, it didn't matter whether the particular violation threatens the structure of the government as the Court's "duty is to

enforce the Constitution as written, not as revised by private consent, innocuous or otherwise." Justice Thomas also takes issue with both the majority and Justice Roberts having failed to determine whether a violation of the Constitution actually had occurred here.

Justice Thomas devoted most of his separate dissenting opinion to highlight the complexity of the issues that the majority glossed over, to wit: whether a constitutional violation had actually occurred. In so doing, he noted that consent to adjudication of a *Stern* claim by a bankruptcy court is far more complex that waiver of a jury trial. Furthermore, to the extent that *Schor* suggests that individual consent could authorize non-Article III courts to exercise judicial power, he believed that the case was wrongly decided and should be abandoned. Pragmatism does not justify encroachments on the system of separation of powers, as Justice Thomas stated: "Our Constitution is not a matter of convenience, to be invoked when we with uncomfortable with some Government action and cast aside when we do not." Finally, Justice Thomas addressed whether parties may consent to adjudication of *Stern* claims by a bankruptcy court and, after some analysis, concluded that the issues were not adequately considered by the Court or briefed by the parties to reach a proper determination, but merited closer consideration. Ultimately, it appears that Justice Thomas believes that if the particular aspect of the adjudication of a private right involves the core of the judicial power – a so-called "quintessential judicial function" – then it is not subject to waiver and consent.

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State Bar of Michigan Business Law Section
Debtor/Creditor's Rights Committee Meeting

Bank of America, N.A. v. Caulkett

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In *Bank of America, N.A. v. Caulkett* [14-163], the Supreme Court unanimously applied its prior decision in *Dewsnup,* which precluded the strip down of a mortgage backed by some value, to a wholly underwater junior mortgage. The Court thus held that a chapter 7 debtor could not strip off an entirely underwater junior mortgage, even though the opinion acknowledged that the identical words, "secured claim," were used in subsections 506(a) and (b), and that under a "straightforward reading of the statute, the debtor would be able to void the Bank's [mortgage] claims." The Court reasoned that it had already adopted a construction of "secured claim" in *Dewsnup* that foreclosed this textual analysis, namely that a claim constitutes a "secured claim" if it is "supported by a security interest in property, regardless of whether the value of that property would be sufficient to cover the claim." Consequently, a chapter 7 debtor may not "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.

Caulkett actually involved two separate cases, which were consolidated for argument and decision.[1] The cases had similar and familiar facts, involving a debtor filing a chapter 7 with two mortgages on its home. In both cases, the first mortgage was underwater. Thus, the second mortgage was wholly unsecured. In both cases, the debtors asked the bankruptcy courts to void

[1] *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).

their second mortgage liens under section 506(d) of the Bankruptcy Code, because such liens were completely underwater and, thus, unsecured under section 506(a). 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 Eleventh Circuit said it was bound by its prior decisions in *McNeal v. GMAC Mortgage, LLC* and *Folendore v. U.S. Small Business Administration,*[2] 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.*[3]

In *Dewsnup,* the Court considered whether a chapter 7 individual debtor could use section 506(d) of the Bankruptcy Code to "strip down" an undersecured real property lien to the judicially-determined value of the collateral. As all bankruptcy practitioners 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 in *Dewsnup* 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 (based in part on the fact that the litigants could

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[2] *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).
[3] *Dewsnup v. Timm,* 502 U.S. 410 (1992).

not agree what the statute meant). 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.[4]

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. Since its issuance, the opinion in *Dewsnup* has been amongst the most criticized of all Supreme Court opinions dealing with bankruptcy law.

The Eleventh Circuit was alone in its limited view of the scope of *Dewsnup*, as all other circuit courts that have addressed the "strip off" issue have relied on *Dewsnup* to hold that subordinate mortgages survive in full in chapter 7, regardless of the value of the property. In its briefs and at oral argument, Bank of America contended 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 argued, the context, structure, and drafting history of the statute all indicate that section 506 was 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

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[4] *Id.*

warned of the practical problems that would follow a decision upholding the Eleventh Circuit's ruling. As a result of the recession, the bank noted, 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 posited, to allow debtors to void such liens in that scenario.

Conversely, the debtors contended that, because each of the homes at issue in this case were completely underwater on the first mortgage, there was nothing left to secure the banks second mortgages. As such, they argued, 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 argued, 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 noted that in *Dewsnup,* the Court specifically declined to address the hypothetical involving a second mortgage that was *completely* underwater.

More generally, the debtors contended, 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 argued, 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.

At oral argument, Justice Scalia blasted *Dewsnup,* 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.

On June 1, 2015, the Court, in a unanimous seven-page opinion penned by Justice Thomas, rejected any distinction between "stripping down" and "stripping off" junior liens and applied *Dewsnup* to preclude a chapter 7 debtor from "stripping off" an entirely underwater junior mortgage.

The Court began its analysis by noting that the debtors would prevail only if the bank's claims were "not … allowed secured claims." Since it was undisputed that the banks claims were allowed, the only issue, the court found, was whether such claims were "secured." In

finding that the banks had "secured claims", the court acknowledged that a straightforward reading of section 506(a) of the Bankruptcy Code would seem to favor the debtors, given that the value of the bank's interest in the properties was zero.

Nevertheless, the Court noted, its prior construction of section 506(d) in *Dewsnup* foreclosed that reading and resolved the question in this case. Under *Dewsnup,* the Court found, a "secured claim" is a claim supported by a security interest in property, regardless of whether the value of that property would be sufficient to cover the claim. Justice Thomas noted three times in the seven-page opinion that "The Debtors do not ask us to overrule *Dewsnup*" and even went as far as to note the criticism of *Dewsnup* (citing Justice Scalia, himself and various academics) in a footnote:

> From its inception, *Dewsnup v. Timm*, 502 U.S. 410 (1992), has been the target of criticism. *See, e.g., id.,* at 420–436 (SCALIA, J., dissenting); *In re Woolsey,* 696 F. 3d 1266, 1273–1274, 1278 (CA10 2012); *In re Dever,* 164 B. R. 132, 138, 145 (Bkrtcy. Ct. CD Cal. 1994); Carlson, Bifurcation of Undersecured Claims in Bankruptcy, 70 Am. Bankr. L. J. 1, 12–20 (1996); Ponoroff & Knippenberg, The Immovable Object Versus the Irresistible Force: Rethinking the Relationship Between Secured Credit and Bankruptcy Policy, 95 Mich. L. Rev. 2234, 2305–2307 (1997); *see also Bank of America Nat. Trust and Sav. Assn. v. 203 North LaSalle Street Partnership*, 526 U. S. 434, 463, and n. 3 (1999) (THOMAS, J., concurring in judgment) (collecting cases and observing that "[t]he methodological confusion created by Dewsnup has enshrouded both the Courts of Appeals and . . . Bankruptcy Courts"). Despite this criticism, the debtors have repeatedly insisted that they are not asking us to overrule Dewsnup.

Notably, Justices Kennedy, Breyer and Sotomayor did not join in this footnote.

Since the debtors had not asked the Court to overrule *Dewsnup,* but instead asked the Court to limit that decision to partially – as opposed to wholly – underwater liens, the Court then focused on that distinction. The Court concluded that none of the reasons for distinguishing between partially and wholly underwater liens were compelling. First, the Court found that nothing in its prior opinion suggested that such a distinction existed. Second, in response to the

debtors' contention that the term "secured claim" in section 506(d) could be redefined as any claim that is backed by collateral with *some value* (*i.e.* its secured so long as it wasn't wholly underwater), the Court held that embracing such a reading would give the term "allowed secured claim" in section 506(d) a different meaning than its statutory definition in section 506(a). The Court refused to adopt such an artificial definition.

In response to the debtors' suggestion that the Court limited *Dewsnup's* definition to the facts of that case because the historical and policy concerns that motivated the Court do not apply in the context of wholly underwater liens, the Court stated that even if true, such concerns were an insufficient justification for giving the term "secured claim" in section 506(d) a different definition depending on the value of the collateral.

Finally, the Court stated that embracing the debtors' distinction between partially and wholly underwater liens "would not vindicate section 506(d)'s original meaning, and it would leave an odd statutory framework in its place." Under the debtors' approach, the Court explained, "if a court valued the collateral at one dollar more than the amount of a senior lien, the debtor could not strip down a junior lien under *Dewsnup*, but if it valued the property at one dollar less, the debtor could strip off the entire junior lien." Such a reading, the Court found, could lead to arbitrary results.

In closing, the Court noted once again that the debtor had not asked it to reverse *Dewsnup.* Accordingly, it held that, "the reasoning of *Dewsnup* dictates that a debtor in a Chapter 7 bankruptcy proceeding may not void a junior mortgage lien under § 506(d) when the debt owed on a senior mortgage lien exceeds the current value of the collateral." *Caulkett* is a big win for banks and a big loss for chapter 7 debtors. In light of the Court's ruling, and the unanimous following of *Dewsnup* in all judicial circuits other than the Eleventh Circuit,

Dewsnup is probably bullet-proof now absent a judicial fix. One can certainly wonder whether a different result would have been reached had the debtors simply asked for *Dewsnup* to be overruled (the *amici* parties did request that it be overruled). Nevertheless, it is not at all clear why such a request would be necessary. If a majority of the Justices think *Dewsnup* was wrongly decided (based on oral argument, it appears that at least a few of the Justices think this to be true), then why not say so and get it right going forward?

HARRIS v. VIEGELAHN

Facts:

Charles Harris, III ("Debtor") filed a petition for relief under Chapter 13 of the Bankruptcy Code. On the date of the filing of the case, the Debtor was behind on making payments to his mortgage lender. Subsequently, Debtor proposed a Chapter 13 Plan ("Plan") that was ultimately confirmed by the bankruptcy court. The confirmed Plan provided: (i) the Debtor would immediately resume making monthly mortgage payments directly to the mortgage lender, (ii) $530 would be withheld monthly from the Debtor's post-petition wages and remitted to the Chapter 13 trustee, Mary Viegelahn ("Trustee"), (iii) the Trustee would distribute $352 per month to the mortgage lender to pay down the Debtor's outstanding mortgage debt and $75.23 per month to the Debtor's other secured lender (a consumer-electronics store), and (iv) after the Debtor's secured lenders were paid in full, the Trustee would begin distributing funds to the Debtor's unsecured creditors.

The Debtor quickly fell behind on payments to the mortgage lender after the Plan was confirmed. The mortgage lender obtained relief from the automatic stay and foreclosed its lien. Following the foreclosure, the Trustee continued to receive $530 per month from the Debtors' wages, but stopped making payments to the mortgage lender; therefore, the funds formerly reserved for the mortgage lender accumulated in the Trustee's possession.

On November 22, 2011, the Debtor converted his case to Chapter 7. At the time the case was converted, the post-petition wages accumulated by the Trustee amounted to $5,519.22. Approximately ten days after the case was converted, the Trustee disposed of the funds by giving $1,200 to the Debtor's attorney, paying herself a $267.7 fee, and distributing the remaining money to the consumer-electronics store and six unsecured creditors.

The Debtor filed motion seeking a refund of the $5,519.22, asserting that the Trustee lacked authority to disperse funds to creditors after the case was converted to Chapter 7. The bankruptcy court granted the motion and the district court affirmed. The Fifth Circuit reversed, finding that the Bankruptcy Code provided little guidance on the issue and considerations of equity and policy rendered the creditors' claim to the funds superior to that of the debtor.

Issues:

When a debtor that initially files a petition for relief under Chapter 13 exercises his/her right to convert the case to Chapter 7, who is entitled to post-petition wages still in the hands of the Chapter 13 trustee?

Holding:

Post-petition wages held by a chapter 13 trustee at the time a case is converted from chapter 13 to chapter 7 must be returned to the debtor.

Rationale:

The Court relied exclusively on §348 of the Bankruptcy Code to make its decision. Section 348(f)(1)(A) provides that when a case under Chapter 13 is converted to another chapter of the Code "property of the estate of the converted case shall consist of property of the estate, as of the date of the filing of the petition, that remains in the possession of or is under the control of the debtor on the date of the conversion." The Court found that, on its face, §348(f)(1)(A) excludes post-petition wages from a converted chapter 7 estate and removes post-petition wages from the pool of assets that may be liquidated and distributed to creditors. The Court reasoned that allowing a terminated Chapter 13 trustee to disburse post-petition wages to creditors is incompatible with the design of §348. The Court further reasoned that the language in other subsections of §348, such as §348(f)(2) and §348(e), supported its findings.

In response to the Trustee's argument that distributing funds to creditors is part of a trustee's obligation to wind up the affairs of the Chapter 13 estate following a conversion, the Court found that the Federal Rules of Bankruptcy Procedure specify what a terminated Chapter 13 trustee must do post-conversion and distributing funds to creditors is not included in the applicable rules.

In response to the Trustee's argument that the Bankruptcy Code requires a terminated Chapter 13 trustee to distribute undisbursed funds because 1) §1327(a) binds the debtor and each creditor, and 2) §1326(a)(2) instructs the Trustee to distribute payments in accordance with the Plan, the court found that the cited provisions had no force because they ceased to apply after the case was converted to Chapter 7.

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Baker Botts L.L.P. v. ASARCO LLC, 135 S. Ct. 2158 (June 15, 2015)

Issue: Does 11 U.S.C. § 330 authorize the bankruptcy court to award fees to the debtor's law firm for defending its fee application in court?

Holding: 11 U.S.C. § 330 does *not* authorize the bankruptcy court to award fees to the debtor's law firm for defending its fee application in court.

Rationale: The Court began its analysis with the American Rule regarding attorney fees – each litigant is responsible for its own attorney fees, unless a statute or contract provides otherwise. *Hardt v. Reliance Standard Life Ins. Co.*, 560 U.S. 242, 252–253 (2010).

The Court then held that "Congress did not expressly depart from the American Rule to permit compensation for fee-defense litigation by professionals hired to assist trustees in bankruptcy proceedings." Examining the text of § 330, it held that § 330 "cannot displace the American Rule with respect to fee-defense litigation." It sated, "'the phrase "reasonable compensation for actual, necessary services rendered' neither specifically nor explicitly authorizes courts to shift the costs of adversarial litigation from one side to the other—in this case, from the attorneys seeking fees to the administrator of the estate—as most statutes that displace the American Rule do."

The Court rejected the law firms' argument that "fee-defense litigation is part of the 'services rendered' to the estate administrator under § 330(a)(1)." It reasoned that "reading 'services' in this manner could end up compensating attorneys for the unsuccessful defense of a fee application." The Court concluded that this would be "a particularly unusual deviation from the American Rule[.]"

The Court also rejected the government's argument that compensation for defending a fee application is part of the compensation for the underlying services in the bankruptcy proceeding. It held that the theory "cannot be reconciled with the relevant text."

The Court also rejected the governments argument that "awarding fees for fee-defense litigation is a 'judicial exception' necessary to the proper functioning of the Bankruptcy Code." It stated, "In our legal system, no attorneys, regardless of whether they practice in bankruptcy, are entitled to receive fees for fee-defense litigation absent express statutory authorization. Requiring bankruptcy attorneys to pay for the defense of their fees thus will not result in any disparity between bankruptcy and nonbankruptcy lawyers." Moreover, the Court held that it lacked "the authority to rewrite the statute even if we believed that uncompensated fee litigation would fall particularly hard on the bankruptcy bar."

Impact: Does this case really incentivize disgruntled parties to make retaliatory objections to fee applications, as some have speculated? If that is a problem, does Bankruptcy Rule 9011 solve it?

Can the result of the case be avoided if the retainer agreement includes a provision that the debtor will pay the costs of any necessary fee defenses?

Bullard v. Blue Hills Bank, 135 S. Ct. 1686 (May 4, 2015)

Issue: Is a bankruptcy court order denying confirmation of a chapter 13 plan, with leave to file an amended plan, a "final order" for purposes of appeal under 28 U.S.C. § 158?

Holding: A bankruptcy court order denying confirmation of a chapter 13 plan, with leave to file an amended plan, is *not* a "final order" for purposes of appeal under 28 U.S.C. § 158.

Rationale: The Court first observed that unlike in civil litigation, § 158(a) "authorizes appeals as of right not only from final judgments in cases but from 'final judgments, orders, and decrees ... in cases and proceedings.'" The Court rejected the debtor's argument that each distinct plan in a chapter 13 case initiates a distinct piece of litigation, the result of which is final for purposes of appeal under § 158(a). The Court agreed with the creditor that "[t]he relevant proceeding is the process of attempting to arrive at an approved plan that would allow the bankruptcy to move forward." It reasoned that "only plan confirmation—or case dismissal—alters the status quo and fixes the rights and obligations of the parties."

The Court contrasted denial of confirmation accompanied by dismissal. "When confirmation is denied and the case is dismissed as a result, the consequences are similarly significant. Dismissal of course dooms the possibility of a discharge and the other benefits available to a debtor under Chapter 13." However, "[d]enial of confirmation with leave to amend, by contrast, changes little. . . . The parties' rights and obligations remain unsettled."

The Court further noted, "As Bullard's case shows, each climb up the appellate ladder and slide down the chute can take more than a year. Avoiding such delays and inefficiencies is precisely the reason for a rule of finality."

The Court rejected as "implausible" the government's argument that any order resolving a contested matter is a final order. It noted, "it is of course quite common for the finality of a decision to depend on which way the decision goes. An order granting a motion for summary judgment is final; an order denying such a motion is not."

Finally, the Court addressed the debtor's argument that "[i]f denial orders are not final, . . . there will be no effective means of obtaining appellate review of the denied proposal. The debtor's only two options would be to seek or accept dismissal of his case and then appeal, or to propose an amended plan and appeal its confirmation." It responded, "But our litigation system has long accepted that certain burdensome rulings will be 'only imperfectly reparable' by the appellate process. . . . This prospect is made tolerable in part by our confidence that bankruptcy courts, like trial courts in ordinary litigation, rule correctly most of the time."

Beyond that, the Court observed, "First, a district court or BAP can (as the BAP did in this case) grant leave to hear such an appeal. 28 U.S.C. § 158(a)(3). A debtor who appeals to the district court and loses there can seek certification to the court of appeals under the general interlocutory appeals statute, § 1292(b)." Or, under 28 U.S.C. § 158(d)(2), "a bankruptcy court, district court, BAP, or the parties acting jointly to certify a bankruptcy court's order to the court of appeals, which then has discretion to hear the matter."

Impact: Will this case result in more of the appeals that the Court suggested?