Supreme Court Update: Review of Recent Bankruptcy-Related Decisions

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Supreme Court Holds that Attorneys Cannot get Paid out of Estate for Defending a Bankruptcy Fee Application

by

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In *Baker Botts, LLP v. ASARCO, LLC*, the Supreme Court had to decide "whether § 330(a)(1) permits a bankruptcy court to award attorney's fees for work performed in defending a fee application." By a vote of 6-3, with Justice Thomas writing for the majority, the Court held that § 330(a) does not give the bankruptcy court the discretion to award fee-defense fees under any circumstances. The Court reasoned that the plain text of the statute, which only permits "*reasonable compensation for actual, necessary services rendered by*" a professional retained by the estate, does not suffice in the context of fee-defense awards to override the "American Rule" that each party bears its own attorney's fees. While fees may be awarded for work done in *preparing* a fee application (as § 330(a)(6) obviously infers), the Court found no comparable basis for authorizing compensation for fees incurred in *defending* an application. That fee-defense work, the Court opined, redounds solely to the benefit of the attorney, not the estate, and cannot be characterized as a "service" "rendered" to the estate. In so holding, the Court affirmed the Fifth Circuit, which in disallowing fee-defense fees had parted company with the Ninth Circuit and most bankruptcy courts. The Court declined to read the Bankruptcy Code in the same manner as it had the Equal Access to Justice Act in its 1990 *Jean* decision, which did allow fee-defense fees to be compensated. Justice Breyer, joined by Justices Ginsburg and Kagan, dissented.

The Court's decision is unfortunate, myopic, and misguided, for at least six related reasons. First, the Court's worshipful invocation of the American Rule in the context of a bankruptcy fee application is puzzling at best. Bankruptcy is not inherently a private "me" against "you" adversarial system; rather, it is by nature a collective proceeding seeking to maximize value for the common good of all stakeholders. As attorneys for the estate, Baker Botts was required to file a detailed fee application in order to get paid, and that payment was to come out of the estate, the common fund for all claimants. In short, as Justice Breyer cogently explained in dissent, the statute itself, and the logic behind it, explicitly displace the American Rule with regard to fee applications by estate professionals. Indeed, it is for precisely that reason that it is understood and conceded – even by the majority in *Baker Botts* -- that fees incurred in preparing the fee application are compensable, as § 330(a)(6) makes plain.

That observation leads to the second criticism of the Court's opinion, which is that its attempt to distinguish compensation for fee preparation from that for fee defense is illogical and ill-founded. As Justice Breyer observed, it is not § 330(a)(6) that awards fee preparation compensation, but § 330(a)(1)'s general provision for compensation for actual, necessary services rendered. All that subsection (6) speaks to is how to calculate the compensation under subsection (1). And the reason that fee preparation awards are allowed *under subsection (1)* is that the bankruptcy system itself requires estate professionals to apply for their fees out of the estate in order to get paid for their professional duties to the estate. If a challenge to the fee application is made, the estate professional must defend those fees in order to get paid, just as it must file a fee application in the first place to get paid. The majority's curious analogy to a car mechanic submitting a bill for services falls apart because, as the dissent notes, a customer is not paying the mechanic for his fees in preparing the invoice, but in working on the car.

That insight leads to the third critique of the Court's opinion, which is that it misreads and misunderstands the statute as applied to fee applications. The heart of the matter is revealed in Justice Breyer's telling explanation in his dissent that "[t]he statute permits compensation for fee-defense work as a part of compensation *for the underlying services*" – not for the service of defending the fee application. It is for exactly that reason that compensation for fee preparation is allowed – it is part and parcel of the compensation scheme for the underlying service to the estate.

The fourth criticism of the Court's decision follows logically from Justice Breyer's insight, which focuses on the fundamental requirement and provision in § 330(a)(1) that the estate professional be paid reasonable compensation for its actual, necessary services. The facts of the present case are revealing. The bankruptcy court found as a matter of fact that Baker Botts should be awarded $113 million as compensation for the services it rendered to the estate. Given that the Court has disallowed compensation for the $5 million in fees that Baker Botts incurred in successfully defending the merits of its $113 million application, the practical reality is that Baker Botts received a net total of $108 million for its work – obviously less (by $5 million) than the $113 million that was held to be the reasonable value of the services.

Fifth, it is hard to square the *Baker Botts* decision with the Court's decision a quarter century ago in *Jean*, where it held that both fee-defense and fee-preparation compensation could be awarded under the Equal Access to Justice Act.

Sixth and last, the Court's decision significantly undermines the congressional policy under the 1978 Bankruptcy Reform Act to encourage professionals to serve in bankruptcy cases on a fully compensated basis. By any count, Baker Botts is now $5 million short. That is precisely the sort of negative incentive that Congress sought to eradicate in the Bankruptcy Code.

The bottom line is this: here, although Baker Botts superintended an incredibly successful and complex reorganization, and then successfully defended its fees against all challenges, it took a $5 million hit. They should have been allowed to recover compensation for that defense. Not allowing that compensation is unfair to estate professionals and weakens the incentives for the best and brightest professionals to work in the bankruptcy arena.

Dewsnup Lives -- Even for Underwater Mortgages by Charles Tabb Jones Chair in Law, University of Illinois Of Counsel, Foley & Lardner LLP

On June 1, 2015, the United States Supreme Court unanimously held in Bank of America, N.A. v. Caulkett that a chapter 7 debtor cannot "strip off" even a totally underwater mortgage under section 506(d), reversing the Eleventh Circuit. In so holding, the Court not only reaffirmed but extended its controversial decision in Dewsnup v. Timm, 502 U.S. 410 (1992), in which the Court had held that a chapter 7 debtor cannot "strip down" a partially underwater mortgage under 506(d).

Many observers had thought -- especially after oral argument in Caulkett -- that the Court might take this opportunity to overturn its much-criticized Dewsnup decision, or at the very least confine it to partially underwater mortgages. Instead, much as Mark Twain once quipped that "the reports of his death were greatly exaggerated," the reports of Dewsnup's demise proved premature. Writing for the Court, Justice Thomas concluded that "Dewsnup’s construction of “secured claim” resolves the question presented here."

The technical statutory issue is as follows. Under section 506(d), "'To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void.'” No one questioned that Bank of America's claims were "allowed" and were "claims," but were they "secured"? The statute appears to say that if they are not secured, they are void. The claims of Bank of America the debtors were seeking to strip off were junior mortgages, and the amounts of the senior liens exceeded the value of the property, meaning that at the time of bankruptcy, the Bank of America liens were valueless. Section 506(a) says that "“[a]n allowed claim of a creditor secured by a lien on property . . . is a secured claim to the extent of the value of such creditor’s interest in . . . such property,” and “an unsecured claim to the extent that the value of such creditor’s interest . . . is less than the amount of such allowed claim.” Given that the "value of [Bank of America's] interest in [the junior mortgages]" was zero, the debtors argued that it was not a "secured claim" at all. The Eleventh Circuit had agreed.

In Dewsnup, however, the Court had held that 506(d) did not apply at all if the mortgage holder's claim was "allowed" and "secured," and that a claim was "secured" for the purposes of section 506(d) if the mortgagee held an unavoided lien on the collateral -- irrespective of the value of that lien. In Caulkett, the Court held that "Because the Bank’s claims here are both secured by liens and allowed under §502, they cannot be voided under the definition given to the term “allowed secured claim” by Dewsnup." The Court was unwilling to confine Dewsnup to partially underwater liens, noting first that the reasoning of that opinion applied equally whether the lien was partially or totally underwater, and second that otherwise illogical results could result depending on minute variations in valuation. That is, otherwise, if there were even a dollar of value to support the mortgage, it could not be stripped down at all. The Court thought that for such an all-or-nothing outcome to turn on a dollar's difference in an inexact valuation would be foolish.

Importantly, the Court also noted that its decision in Nobelman v. American Savings Bank, 508 U. S. 324 (1993), did not require a different result. In that case, the Court prohibited strip down of a partially underwater mortgage in chapter 13 cases under section 1322(b)(2), and similarly rejected a narrow reading of "secured claim" based on section 506(a)(1)'s value-based definition. In Caulkett, the Court found that Nobelman simply did not address the interpretation of 506(d). What is interesting is that many Courts of Appeals have held that notwithstanding Nobelman, a totally underwater mortgage can be stripped off in chapter 13, even though a secured claim with even a dollar of value cannot be stripped down at all. After Caulkett, are those decisions that distinguish between strip down and strip off in chapter 13 now of doubtful validity? Perhaps. One can certainly expect that debtors will soon test this out when their main goal in bankruptcy is to strip off an underwater junior mortgage, since the chapter 7 door to effecting such avoidance has now been closed by the Caulkett decision.

It is beyond cavil that Caulkett is a huge victory for mortgagees and a significant setback for debtors. Now mortgage liens are sacrosanct in chapter 7, irrespective of whether they are partially or totally underwater. Whether they will be so in chapter 13 remains to be seen, but mortgagees have a plausible argument to extend Caulkett there as well.

Today, the Supreme Court held in *Wellness International Network, Ltd. v. Sharif* that with the consent of the litigants, a non-Article III bankruptcy judge constitutionally may enter a final order on a matter that absent consent would have to be decided in a federal court by an Article III judge. In addition, the Court held that such consent need not be express, but can be implied, as long as it is knowing and voluntary.

The practical importance of the Court's decision for the administration of the bankruptcy system can hardly be overstated. Now it is possible for bankruptcy judges to enter final orders on almost any matter brought before them, as long as the parties consent. This will greatly smooth and facilitate the processing of controversies connected with bankruptcy cases. A contrary decision would have required de novo review of all bankruptcy court decisions on "*Stern*" claims by the Article III federal district court, adding a cumbersome layer of wasteful litigation. In addition, the *Wellness* decision is of paramount importance for the magistrate system, which relies heavily on consent.

Wellness answers the critical question left unanswered by the Court's 2011 decision in *Stern v. Marshall*, in which the Court held that a bankruptcy judge could not constitutionally enter a final order on a state law tort claim not necessarily resolved in the bankruptcy claims allowance process. The consent question decided today was not reached in that case because the Court found no real consent on the facts in *Stern*. After *Stern,* the open question was whether the right Article III adjudication was waivable, which turned on the extent to which Article III is seen as an immutable structural feature of the core doctrine of separation of powers, as opposed to more of a personal right of the litigants. In *Wellness*, Justice Sotomayor for the 6-Justice majority held that Article III primarily affords a personal right to the litigants, which is then waivable, with the structural command of Article III being satisfied even when an Article I adjudicator decides a matter "so long as Article III courts retain supervisory authority over the process." In the bankruptcy system, the Court had little difficulty finding substantial and constitutionally sufficient supervisory authority retained by Article III courts over the Article I bankruptcy courts. The Court's holding relied primarily on its prior decisions in the magistrate context and on its foundational decision upholding consent for non-Article III judges to decide Article III claims in *Commodity Futures Trading Comm'n v. Schor,* 478 U. S. 833 (1986).

Almost significant was the Court's decision that the consent need not be express or written, but could be implied from the conduct of the parties. The Court did require that consent be knowing and voluntary.

Chief Justice Roberts, the author of the *Stern* decision, and Justices Scalia and Thomas dissented.

Supreme Court Preserves Viability of Chapter 13

By **Jonathan Randles**

Law360, New York (May 18, 2015, 7:27 PM ET) -- Chapter 13 bankruptcy will remain a viable, albeit difficult, option for individual debtors after the U.S. Supreme Court unanimously ruled wages and assets they acquire after filing for protection are shielded from creditors in the event the case gets converted to a Chapter 7, experts say.

The justices **ruled Monday** that protecting assets a debtor has accumulated after seeking relief from the court, even when a Chapter 13 case is converted to a Chapter 7, is in keeping with the U.S. Bankruptcy Code's intent to enable individuals to get a "fresh start." The ruling overturned a Fifth Circuit decision from July that found those assets could be divvied up by creditors.

In Chapter 13 cases, individuals who are financially underwater can still keep their home, car or other major assets while they work to pay off their debts under a supervised repayment plan that lasts between three and five years, according to Dechert LLP's G. Eric Brunstad Jr.

Because a Chapter 13 filing is voluntary, a debtor has the option to convert the case to a Chapter 7, where the assets are liquidated. This outcome is fairly common because rules governing Chapter 13 are "draconian" and difficult for the debtor to comply with, Brunstad said.

Justice Ruth Bader Ginsburg, who wrote the court's opinion, acknowledged as much in the ruling, recognizing the difficult financial position most Chapter 13 debtors find themselves in. In the decision, Justice Ginsburg directly challenged the Fifth Circuit's assertion that keeping these post-petition wages and assets from creditors would give a "windfall" to debtors.

"We do not regard as a 'windfall' a debtor's receipt of a fraction of the wages he earned and would have kept had he filed under Chapter 7 in the first place," Justice Ginsburg wrote.

The decision is a victory for individual debtors. If the Supreme Court affirmed the Fifth Circuit, debtors would have been penalized if they had made a go of Chapter 13 but failed, Brunstad said.

It's likely that such a holding would have created a chilling effect on Chapter 13 filings — an outcome at odds with congressional intent — but it's difficult to say how dramatic the impact would have been, he said.

Brunstad, who is also an adjunct professor at the New York University School of Law and a visiting lecturer at Yale Law School, filed an amicus brief that advocated overturning the Fifth Circuit's decision. In the Supreme Court case, Brunstad said, the outcome supports the proposition that debtors should not be forced to work in order to pay off their debts, a principle that is in the Constitution.

"The decision is vitally important because it underscores Congress' intention to protect the debtor's right to his or her post-bankruptcy wages in a Chapter 7 case in order to provide the debtor with a fresh start, and also the principle that a debtor cannot be forced to work to pay his or her creditors, which is why the Chapter 13 process is strictly voluntary," Brunstad said.

The case involved debtor Charles E. Harris III, who filed for Chapter 13 bankruptcy in 2010 after he fell about $4,000 behind on his mortgage and owed about $20,000 to unsecured creditors. He agreed to pay $530 a month to trustee Mary K. Viegelahn, to be split between his bank and an electronics store he owed for a television.

The bank successfully lifted the Chapter 13 stay on the house once Harris failed again to make mortgage payments a few months later. Harris' trustee held onto the portion of the monthly payments that had been for the bank, accumulating $5,500 by the time Harris converted to Chapter 7 in November 2011. She distributed more than $4,000 to the electronics store and some unsecured creditors, prompting Harris' suit.

Charles Tabb, a professor at the University of Illinois College of Law, said the Fifth Circuit's decision was at odds with the intent of a 1994 amendment to the Bankruptcy Code. The amendment states that a debtor's postpetition earnings don't become part of the Chapter 7 estate, according to the ruling. Tabb said the amendment was intended to ensure that payments like the ones Harris made go back to the debtor in the event a case is converted to a Chapter 7.

Tabb agreed that the Fifth Circuit's decision likely would have created a chilling effect on Chapter 13 filings because the benefit of getting some of your money back if you're unable to follow the plan would be lost.

"If you know before you file Chapter 13 that you won't get the money back, you might just say the heck with it," Tabb said.