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Twice-Told Tales: Reexamining Past Precedents

LUNCHEON KEYNOTE

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STATUTORY INTERPRETATION

Bank of Marin v. Eng., 385 U.S. 99 (1966)

Bankrupty trustee asked for turnover order requiring bank to pay to the trustee the amount of checks paid by it after the debtor filed bankruptcy. The bank had no knowledge or notice of the bankruptcy proceedings when it transferred the funds from the debtor's account. Although the relevant statute, Section 70d(5) of the Bankruptcy Act, invalidated all transfers made after the date of bankruptcy, the Supreme Court concluded that it would be inequitable to hold the bank liable for transferring the funds out of the debtor's account when the bank had no notice of the bankruptcy. Justice Douglas, writing for the majority, said, "There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction." *Id.* at 101. Justice Harlan dissented, stating that the Court, "in its haste to alleviate an indisputable inequity to the bank," improperly disregarded "the the proper principles of statutory construction" and allowed equity to override the clear intent of Congress. *Id.*at 103.

Flygare v. Boulden, 709 F.2d 1344 (10th Cir. 1983)

Bankruptcy court denied confirmation of a Chapter 13 bankruptcy plan because it provided that the unsecured creditors would only be repaid approximately 3% of their claims, which was insufficient to meet the requirement of 11 U.S.C. § 1325(a)(3) that Chapter 13 plans be proposed in "good faith." The Tenth Circuit reversed, holding that a debtor's ability to make payments under a Chapter 13 plan is only one of many factors in determining whether the plan has been proposed in good faith. Noting the diverse interpretations of the undefined "good faith" requirement in courts around the country, the Tenth Circuit adopted the reasoning of six other circuits in its interpretation of good faith.

United States v. Ron Pair Enters., 489 U.S. 235 (1989)

Debtor filed for bankruptcy under Chapter 11, and the government filed a claim for taxes that was oversecured by a lien on property. Pursuant to 11 U.S.C. § 506(b), the government requested postpetition interest on the taxes because the value of the property was greater than the tax due. Looking to pre-Code precedent, the Sixth Circuit interpreted Section 506(b) to allow postpetition interest only on a consensual oversecured claim, and since the tax lien was nonconsenual, the government was not entitled to interest. The Supreme Court reversed, holding that the plain language of Section 506(b) clearly indicated that Congress intended to allow postpetition interest

on nonconsensual as well as consensual claims. Although the payment of postpetition interest was arguably somewhat in tension with the desirability of paying all creditors as uniformly as practicable, Congress expressly chose to create that alleged tension. Four justices, led by Justice O'Connor, dissented, criticizing the Court's singular reliance on the "plain meaning" of the text while ignoring legislative history and past precedent.

Midland Funding, LLC v. Johnson, 137 S. Ct. 1407 (2017)

Creditor filed claim in a Chapter 13 case which was clearly barred by the statute of limitations. Debtor sued the creditor for violation of the Fair Debt Collection Practices Act's provision that a debt collector may not use any false, unfair, or unconscionable means to collect a debt. The Supreme Court held that the creditor did not violate the FDCPA because the debt fell within the bankruptcy definition of a claim as a right to payment, and the unenforceability of the claim did not constitute the assertion of any false, deceptive, or misleading representation, or use of any unfair or unconscionable means, to collect or attempt to collect the debt. In a policy-driven dissent, Justice Sotomayor argued that filing a claim which would be unenforceable outside of a bankruptcy proceeding was obviously unfair, and that the Court's decision undermined the purpose and execution of the FDCPA.

ABSOLUTE PRIORITY RULE

Northern Pacific Railway Co. v. Boyd, 228 U.S. 482 (1912)

Creditor obtained a judgment against a railway company. By the time the Creditor could execute the judgment, all property of the railway company had been sold to a new company, Northern Pacific, as part of a reorganization orchestrated by the stockholders and bondholders of the company. The Supreme Court held that the Creditor's judgment lien against the property of the former company was valid against Northern Pacific. "A transfer by stockholders from themselves to themselves [in a reorganization] cannot defeat the claim of a non-assenting creditor. As against him the sale is void in equity, regardless of the motive with which it was made." *Id.* at 502.

Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939)

Debtor filed a petition for reorganization under § 77B of the Bankruptcy Act and presented a plan which over 80 percent of the bondholders and over 90 percent of the stockholders assented. Minority bondholders, who did not assent to the proposed plan, claimed that the plan was not fair and equitable as required by the Act. In an opinion by Justice Douglas, the Supreme Court held that the percentage of stockholders that approved the plan was immaterial; the plan was not fair and equitable because it failed to grant bondholder creditors priority over stockholders. Creditors enjoy a "full right of priority against the corporate assets" in a reorganization. *Id.* at 122.

Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988)

In a Chapter 11 case, Debtor farmers' plan of reorganization allowed the debtors to retain their junior equity interest in the farm. The Eighth Circuit concluded that the plan could be crammed

down on the objecting unsecured creditors because the debtors' yearly contributions of labor and expertise would constitute a contribution of "money or money's worth," bringing debtors within an equitable exception to the absolute priority rule of 11 U.S.C. § 1129(b). The Supreme Court reversed and remanded, holding that even if the "money or money's worth" exception to the absolute priority rule under the old Act had survived enactment of the Bankruptcy Code, debtors' proposed contributions were inadequate to fall within the exception, because their promise of future services was intangible, inalienable, and probably unenforceable. The court held that the equity interest debtors would retain under reorganization would be "property," even if the farm had no value and, therefore, could only be retained pursuant to a plan accepted by their creditors or formulated in compliance with the absolute priority rule.

In re Braniff Airways, Inc., 700 F.2d 935 (5th Cir. 1983)

Debtor airline filed for reorganization under Chapter 11, and proposed to sell all of its assets to another airline under 11 U.S.C. § 363(b). The Fifth Circuit held that the sale was improper because it would "require significant restructuring of the rights of Braniff creditors" and "had the practical effect of dictating some of the terms of any future reorganization plan." *Id.* at 939-940. Such a sale would allow the debtor to "short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with the sale of assets."

In re SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993)

In a Chapter 7 liquidation case, an under-secured lender with a conclusively determined and uncontested perfected, first security interest in all of the debtor's assets, agreed in a settlement to share the proceeds of its secured claim with the unsecured creditors' committee. Other priority creditors, excluded from the agreement, objected that the agreement violated the statutory scheme for distribution by paying unsecured creditors before priority creditors. The First Circuit held that, because the Bankruptcy Code did not give the estate any power to direct how the secured lender used the proceeds of its secured claim, the agreement did not violate the provisions of the Code.

Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007)

In a Chapter 11 case, lenders and the unsecured creditors committee agreed to settle their claims against one another pre-plan under Fed. R. Bankr. P. 9019. Senior creditor Motorola objected that the proposed settlement agreement would transfer money from the bankruptcy estate to unsecured creditors before senior creditors' claims are satisfied, thus violating the absolute priority rule. The Second Circuit held that when evaluating a 9019 settlement in the Chapter 11 context, whether the settlement's distribution plan complies with the absolute priority rule will often be dispositive; however, when other factors weight heavily in favor of settlement, a bankruptcy court may approve a settlement which "does not comply in some minor respects with the priority rule." *Id.* at 465.

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

Parties in a Chapter 11 case agreed to a "structured dismissal" in which the bankrutpcy court would dismiss the Chapter 11 case, but direct that lower-priority unsecured creditors would be paid while higher-priority judgment creditors would receive nothing. The priority judgment creditors objected, and the Supreme Court held that a bankruptcy court cannot approve a structured dismissal providing for distributions that violate ordinary priority rules without the affected creditors' consent.

Official Comm. of Unsecured Creditors v. Cajun Elec. Power Coop. (In re Cajun Elec. Power Coop.), 119 F.3d 349 (5th Cir. 1997)

When debtor's two largest creditors sued for claims arising out of debtor's imprudent investment in a nuclear power plant, debtor filed for bankruptcy under Chapter 11. Debtor and two largest creditors settled their litigation and the district court approved. However, the unsecured creditors' committee objected that the settlement was an impermissible *sub rosa* reorganization plan which removed more than $100 million from the estate, and that it was not fair and equitable. The Fifth Circuit affirmed the settlement, holding that it was not a sub rosa reorganization plan, as it did not alter the creditors' rights by disposing of assets and releasing claims and making further reorganization impossible. The unsecured creditors could still vote on a proposed reorganization plan. The settlement was also fair and equitable. Debtor had little probability of success in the litigation against its two largest creditors, and the complexity and expense of litigation wasted debtor's assets, while in contrast the settlement disposed of an impediment to reorganization.

INDUBITABLE EQUIVALENT

In re Murel Holding Corp., 75 F.2d 941 (2d Cir. 1935)

Debtors sought to reorganize under the Section 77B of the Act by cramming down a proposed plan which would pay the objecting creditor interest on its loan, but force it to wait ten years to receive the value of its claim. The Second Circuit found that this did not provide adequate protection to the dissenting creditor. Judge Learned Hand explained that if a plan does not provide adequate protection to a secured creditor by either maintaining the creditor's lien, selling the collateral, or otherwise paying off the lien, the plan must provide "a substitute of the most indubitable equivalence" for the creditor's lien. Compelling the creditor to "forego all amortization payments for ten years and take its chances as to the fate of its lien at the end of that period" did not meet this standard; "there must be some reasonable assurance that a suitable substitute will be offered" to the creditor. *Id.* at 942-943.

In re Pikes Peak Water Co., 779 F.2d 1456 (10th Cir. 1985)

In Chapter 11 case, creditor with a secured claim to virtually all of debtor's assets objected to proposed plan which would defer payments on its claim for three years. The Tenth Circuit held that the plan provided the creditor the "indubitable equivalent" of its claim because the collateral securing the claim was valued as 20% greater than the value of the claim. The Tenth Circuit adopted the reasoning that "where a dissenting claimant is receiving payment in full over a

reasonable period of time, with an appropriate interest or discount factor being paid, that creditor is receiving all the law requires." *Id.* at 1461.

Gen. Elec. Credit Equities, Inc. v. Brice Rd. Devs., L.L.C. (In re Brice Rd. Devs., L.L.C.), 392 B.R. 274 (B.A.P. 6th Cir. Aug. 14, 2008)

Debtor owned a partially completed apartment complex, and creditor held a note and mortgage which granted liens on substantially all of the debtor's assets, including the apartment complex. The creditor filed a proof of claim for nearly $16.5 million and filed an election under § 1111(b)(2) to have its claim treated as fully secured. The bankruptcy court valued the apartment complex at $10,258,000. Pursuant to the debtor's plan, the creditor had an allowed secured claim that would be paid at the rate of 6 percent per annum in equal monthly installments based on an amortization period of 40 years, with a balloon payment at the end. The bankruptcy court overruled the creditor's objection and confirmed the plan. On appeal, the 6th Circuit B.A.P. held that the bankruptcy court did not err in assigning a 6 percent interest rate over 40 years under the cramdown provisions in § 1129(b). The bankruptcy court, however, did err in finding that the debtor's plan accorded the creditor its rights as an electing secured creditor under § 1111(b)(2) because deferred cash payments to the creditor under the plan did not total at least the allowed amount of the creditor's total claim.

PROPERTY OF THE ESTATE

United States v. Knight, 336 U.S. 505 (1949)

In a reorganization under chapter X of the Bankruptcy Act, creditor purchased all of the debtor's assets for a certain amount, and also paid $3,000 to the the trustee and his counsel for which they did not account. In subsequent criminal proceedings related to the transfer, the prosecution argued that the $3,000 was property of the estate because the creditor colluded with the trustee to devalue the estate by $3,000 and divert the funds to the trustee, while the defense argued that the $3,000 was the creditor's own property which it was free to use as it saw fit. The Supreme Court held that the $3,000 formed part of the consideration paid for the debtor's assets, and therefore constituted property of the estate which the trustee and others unlawfully diverted.

Mabey v. Sw. Elec. Power Co. (In re Cajun Elec. Power Coop.), 150 F.3d 503, 506 (5th Cir. 1998)

During a bankruptcy proceeding under Chapter 11 of debtor power cooperative, three plans of reorganization were proposed. The proponent of one plan, a power company, made payments to members of debtor with the understanding that they were for some of the costs of the bankruptcy proceeding and had to be returned if members supported a reorganization plan other than that proposed by the power company. The trustee moved to disqualify the power company's plan on the basis that it was buying votes, but the bankruptcy court found that the payments were transition assistant payments not prohibited by 18 U.S.C.S. § 1129(a)(4), rather than vote buying. In contrast, the district court ruled the payments were impermissible and invalidated the plan. The Fifth Circuit agreed with the bankruptcy court, holding that the payments were not a violation and did not call for the disqualification of the power company's plan. The court noted the payments did not come out of the bankrupt's estate.

DISCHARGEABILITY AND RES JUDICATA

Brown v. Felson, 442 U.S. 127 (1979)

Prior to bankruptcy, debtor and creditor were involved in a state court collection suit in which creditor accused debtor of fraud. The suit settled with a stipulated judgment against the debtor for the debt which did not indicate the fraud basis for suit. Soon after, debtor filed a petition for voluntary bankruptcy and sought to have his debt to creditor discharged. Creditor alleged that the debt was not dischargeable because it was the product of the debtor's fraud, deceit, and malicious conversion and came within § 17a(2), (4) of the Bankruptcy Act. Respondent argued that, because the prior state-court proceeding had not resulted in a finding of fraud, res judicata barred relitigation of the nature of the debt. The lower courts held that res judicata barred them from relitigating the issue of fraud in deciding dischargeability. The Supreme Court rejected the application of res judicata, finding that bankruptcy courts are the proper place to determine questions of dischargeability.

In re Halpern, 810 F.2d 1061 (11th Cir. 1987)

Prior to bankruptcy, creditor bank filed suit against debtor, alleging that debtor engaged in a check kiting scheme designed to defraud creditor bank. The parties entered into a consent judgment, holding debtor monetarily liable to creditor bank and admitting debtor engaged in fraudulent activity. Debtor filed a bankruptcy petition, and creditor bank brought an action in bankruptcy court to determine that creditor bank's debts, as a result of the consent judgment, were nondischargeable. The bankruptcy court held that debtor was collaterally estopped by the consent judgment from relitigating the facts and that the debts were nondischargeable under 11 U.S.C.S. § 523(a)(2)(A). The Eleventh Circuit affirmed, finding that the bankruptcy court properly utilized collateral estoppel to reach conclusions about the facts, and then properly considered those facts as evidence of nondischargeability. The court found that the consent judgment operated as a final adjudication of the factual issues.

In re Raynor, 922 F.2d 1146 (4th Cir. 1991)

Prior to bankruptcy, creditor obtained a default judgment in state court against debtor based on allegations of fraud. Debtor then filed for bankruptcy, and creditor sought to have the judgment debt found non-dischargeable. Both the bankruptcy and the district court held that, because the default judgment was based on a fraud cause of action, the judgment debt was non-dischargeable. The Fourth Circuit reversed, finding that res judicata did not apply because the issue of fraud was not actually litigated in the state court; the creditor won by default when the debtor never showed up for trial.

Bay Area Factors v. Calvert (In re Calvert), 105 F.3d 315 (6th Cir. 1997)

Prior to bankruptcy, creditor obtained a default judgment against debtor in a state court proceeding, which debtor did not defend. Debtor subsequently filed bankruptcy and sought to have the default judgment discharged. The bankruptcy court ruled the default judgment was dischargeable pursuant to the Bankruptcy Code, 11 U.S.C.S. § 523(a), and the district court affirmed. The Sixth Circuit reversed and remanded, holding that federal courts must look to state preclusion law to determine whether a judgment debt is entitled to res judicata effect in bankruptcy nondischargeability. The court found that, because the applicable state law would have given this true default judgment collateral estoppel effect, the judgment debt was not dischargeable.