Bankruptcy Controversies Roundtable:
Stern v Marshall

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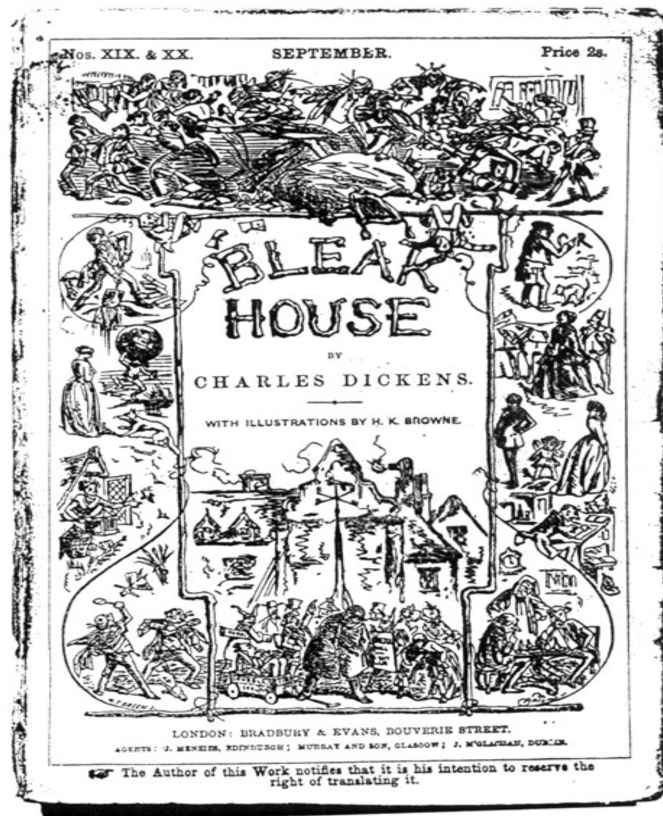
Introduction



"This 'suit has, in course of time, become so complicated that … no two … lawyers can talk about it for five minutes without coming to a total disagreement as to all the premises. Innumerable children have been born into the cause: innumerable young people have married into it;' and, sadly, the original parties 'have died out of it.' A 'long procession of [judges] has come in and gone out' during that time, and still the suit 'drags its weary length before the Court.'"

--Chief Justice Roberts, in Stern v. Marshall, 131 S. Ct. 2594 (2011), quoting from Charles Dickens, Bleak House

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Just the Facts

- Vickie Lynn Marshall, a.k.a. Anna Nicole Smith, married J. Howard Marshall II, approximately one year before his death
- Shortly before J. Howard's death, Vickie filed a suit against J. Howard's son, Pierce, in Texas state probate court asserting that Pierce fraudulently induced his father to sign a living trust that did not include Vickie
- After J. Howard died, Vickie filed for bankruptcy in the Central District of California
- Pierce filed a complaint in the bankruptcy proceeding contending that Vickie had defamed him by inducing her lawyers to tell members of the press that he had engaged in fraud to gain control of his father's assets
- Pierce subsequently filed a proof of claim for the defamation action
- Vickie responded to Pierce's initial complaint by asserting truth as a defense and by filing a counterclaim for tortious interference with the gift she expected from J. Howard

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Just the Facts

- The bankruptcy court granted Vickie summary judgment on the defamation claim and awarded her more than $400 million in compensatory damages and $25 million in punitive damages on her counterclaim

- In post-trial proceedings, Pierce argued that the bankruptcy court lacked jurisdiction over Vickie's counterclaim

- The district court concluded that Vickie's counterclaim was not core, and treated the bankruptcy court's holding as "proposed[,] rather than final"

- After conducting an independent review, the district court decided the matter in Vickie's favor, despite the fact that the Texas state court had in the interim tried the case and entered judgment in Pierce's favor

- The Ninth Circuit reversed the district court on a different ground

- The Supreme Court reversed the Court of Appeals on that issue

- On remand from the Supreme Court, the Court of Appeals held that the bankruptcy court lacked authority to enter a final judgment on Vickie's counterclaim because it was not so closely related to Pierce's proof of claim that the resolution of the counterclaim was necessary to resolve the allowance or disallowance of Pierce's claim for defamation itself

- The Supreme Court again granted certiorari

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Issues Before the Supreme Court in Stern

- **Whether the Bankruptcy Court had the statutory authority under 28 U.S.C. § 157(b) to issue a final judgment on Vickie's counterclaim?**

- **If so, whether conferring that authority on the Bankruptcy Court is constitutional?**

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Statutory Authority

Source	Relevant Language
United States Code 28 U.S.C. § 1334	"…the district courts shall have original and exclusive jurisdiction of all cases under title 11."
United States Code 28 U.S.C. § 157(a)	"Each district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district."
United States Code 28 U.S.C. § 157(b)(1)	"Bankruptcy judges may hear and determine . . . All core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments[.]"
United States Code 28 U.S.C. § 157(b)(2)	"Core proceedings include, but are not limited to . . . counterclaims by the estate against persons filing claims against the estate[.]"

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Core Proceedings
11 U.S.C. § 157(b)(2)

- Matters concerning the administration of the estate
- Allowance or disallowance of claims against the estate
- Counterclaims by the estate against persons filing claims against the estate
- Orders in respect to obtaining credit
- Orders to turn over property of the estate
- Proceedings to determine, avoid, or recover preferences
- Motions to terminate, annul, or modify the automatic stay
- Proceedings to determine, avoid, or recover fraudulent conveyances
- Determinations as to the dischargeability of particular debts
- Objections to discharges
- Determinations of the validity, extent, or priority of liens
- Confirmations of plans
- Orders approving the use or lease of property, including cash collateral
- Orders approving the sale of property
- Other proceedings affecting the liquidation of assets of the estate
- Recognition of foreign proceedings

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"Core" vs. "Non-Core"

28 U.S.C. § 157(b)

"Core"

Impact

Bankruptcy court may enter final judgment

"Non-Core"

Impact

Bankruptcy court may submit findings of fact and conclusions of law

Parties may consent to entry of final judgment by bankruptcy judge

- **The Supreme Court determined that the bankruptcy court had the <u>statutory</u> authority to enter a final judgment, as Vickie's counterclaim was a core proceeding under 28 U.S.C. § 157(b)(2)**

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Article I v. Article III Courts

- **As Judge Rakoff has explained, “the heart of the <u>Stern</u> decision rests on the distinction between ‘private rights’ claims, the ‘stuff’ of common law, over which only an Article III court can render final judgment, and ‘public rights’ claims that assert claims ‘derived from’ or ‘closely intertwined’ with a federal regulatory scheme and that therefore can be fully adjudicated by an Article I bankruptcy court without intruding on the separation of powers set out by Article III.” <u>Kirschner v. Agoglia</u>, 2012 WL 1622496, at *3 (S.D.N.Y. May 9, 2012)**

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The Constitutional Question

- **Article III, § 1 of the Constitution provides that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish"**
  - Article III also provides that judges of those courts shall hold their offices during good behavior without diminution in salary
- **Drawing upon the principle of the separation of powers, the Supreme Court has adopted the so-called public rights doctrine**
  - If the executive or legislative branches accorded rights to individuals based on matters exclusively within their respective domains, then those branches could also identify non-Article III methods for adjudicating those rights
- **A bankruptcy court's authority to finally adjudicate a claim is not simply a matter of statutory interpretation. A court must also analyze "whether the claim to be adjudicated involves a 'public' or 'private' right." <u>In re Coudert Bros. LLP</u>, 2011 WL 5593147, at *7 (S.D.N.Y. Feb. 1, 2012)**

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Private Rights – Westminster 1789

- **Article III does not allow a bankruptcy court to make a final determination in actions that arise solely as a matter of common law, equity, or admiralty law**
  - When a suit is made of "the stuff of the traditional actions at common law tried by the courts at Westminster in 1789," the responsibility for deciding that suit rests with Article III courts. See Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982)
- **There are, however, certain "public rights" that non-Article III courts can finally adjudicate**
  - "Public rights" do not define the liability between one individual and another and are rights that are not otherwise "traditionally cognizable in the courts of law and equity." Northern Pipeline, 458 U.S. at 69-70

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Private v. Public Rights

"Private" Rights

- **While Congress can create public rights, and remove those from the purview of Article III judges, it may not "withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law," or "matters 'of private right, that is, of the liability of one individual to another under the law as defined.'" Stern, 131 S. Ct. at 2612 (citations omitted)**
- **If a claim involves private rights and would not necessarily be resolved as part of the claims determination process, Congress cannot vest final adjudicative power over such matters in the bankruptcy court consistent with Article III**

"Public" Rights

- **The majority in Stern offered a number of tests to distinguish public from private rights (see next slide)**
- **Justice Scalia, in his concurrence, noted many of the tests "have nothing to do with the text or tradition of Article III [. . .] and seem to have entered our jurisprudence almost randomly." Id. at 2621**

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Tests for Public Rights

Matter that could be pursued only by the grace of the other branches

Right to relief flows from a federal regulatory scheme

Matter that historically could have been determined exclusively by the other branches

Completely dependent upon adjudication of a claim created by federal law

Limited to a "particularized area" of the law

Asserting a "right of recovery created by federal bankruptcy law"

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The Court's Holding

- **Vickie's counterclaim arose under state common law, was in no way dependent upon the will of Congress for its existence, and was neither related to or arising under a particular provision of the Bankruptcy Code and, thus, must be finally determined by an Article III judge**

- **Vickie's counterclaim was not completely dependent upon adjudication of a claim created by federal bankruptcy law, nor did it "stem from the bankruptcy itself or would necessarily be resolved in the claims allowance process"**

- **As such, Vickie's counterclaim constituted a "private right" that could not be finally adjudicated by the bankruptcy court**

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Stern Rationale

Majority	Dissent
➢ Counterclaim did not fit within “public rights” historical exception to Article III jurisdiction ➢ Article III provides life tenure and irreducible salary to Article III judges ➢ Filing claim was not enough to consent to resolution of Vickie’s counterclaim in the bankruptcy proceeding	➢ Non-Article III adjudication is not necessarily unconstitutional, here the counterclaim was compulsory and bankruptcy courts often decide common law claims ➢ Bankruptcy judges enjoy considerable protection from improper political influence: appointed by federal courts of appeals, are removable by the circuit judicial counsel, and salaries are pegged to those of federal district court judges ➢ Parties consented to bankruptcy court jurisdiction

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Current Issues: Putting the Pieces Together Post-Stern

Statutory Gap?

Validity of Consent?

Other Core Proceedings Affected?

Subject Matter Jurisdiction?

Withdrawal of Reference?

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Current Issues: Other Core Proceedings Affected By Stern?

- **The Supreme Court has rendered a handful of other rulings that, taken together with Stern, suggest that the bankruptcy judges' authority to enter final rulings and/or to propose findings of fact and conclusions of law in other categories of core proceedings may be in doubt. See Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982); Langenkamp v. Culp, 498 U.S. 42 (1990); Granfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989)**

- **The Supreme Court explained that, in particular, fraudulent transfer and preference actions effectively are private lawsuits that seek recovery of damages. See Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 44 (1989); see also Langenkamp v. Culp, 498 U.S. 42, 44 (1990)**

- **Prior to Stern, bankruptcy judges and practitioners had long understood such disputes to be the proper domain of the bankruptcy courts**

- **Post-Stern, courts around the country have struggled with the meaning of the decision and its implications**

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Current Issues: Other Core Proceedings Affected By Stern?

- **Bankruptcy Code specifies that proceedings to determine the validity, extent, and priority of a lien are core – but these are all predicated upon questions of state law. As such, under Stern, there is a question as to whether a bankruptcy court may enter a final judgment**

- **Equitable subordination arguably is simply one type of claim determination; however, lender liability is a creature of state law which arguably could not be adjudicated on a final basis, at least without the parties' consent**

- **Bankruptcy judges often must decide whether to confirm plans which may include a settlement of claims of the debtor, its creditors, and third parties**
  - These settlements often seek to resolve state law claims, which may include releases by one set of non-debtors against other non-debtors.
  - Objectors may argue that releasing such state law claims is beyond the court's constitutional authority to approve on a final basis, and/or are at best non-core matters
  - A counter-argument would be that such settlements and releases are integral and inseparable components of the reorganization process

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Current Issues: Statutory Gap?

- **28 U.S.C. § 157(b)(2) defines what is "core" and allows the bankruptcy judge to enter a final judgment in core proceedings**

- **28 U.S.C. § 157(c)(1) allows the bankruptcy judge to submit proposed findings of fact and conclusions of law to the district court in proceedings that are "non-core"**

- **If the bankruptcy court cannot enter a final judgment on a particular "core" proceeding, what authority does it have to enter proposed findings and recommendations?**
  - Some courts have ruled post-Stern that a bankruptcy court can still hear the matter but must proceed as if such litigation is non-core
  - Others, however, fear that bankruptcy courts may no longer have the power to act at all, reasoning that as currently written, the Bankruptcy Code does not permit a statutorily core proceedings to be treated as non-core

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Current Issues: Statutory Gap?

Fraudulent and preferential transfer litigation (and other "core" proceedings)

Post-Stern, decided in one of three ways:

(1) Bankruptcy Court provides final ruling

(2) Bankruptcy Court provides recommendations to district court

(3) Withdrawn to district court

- **Due to the current split in the bankruptcy courts on the matter post-Stern, litigants must seriously consider how to proceed, especially in fraudulent conveyance and similar litigation**
- **Arguably, a party could litigate a matter and, if it is unhappy with the result, later attempt to void the result on appeal by asserting that the bankruptcy court lacked constitutional jurisdiction to finally adjudicate their claim**
  - Case law, however, suggests that insofar as Article III preserves a personal right to an impartial and independent adjudication by an Article III judge, this individual right may be waived

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Current Issues: Validity of Consent

- **A district court, "with the consent of all the parties to the proceeding," may refer a proceeding related to a bankruptcy case to a bankruptcy judge to "hear and determine and to enter appropriate orders and judgments," subject to appellate review. 28 U.S.C. § 158(c)(2)**

- **What type of consent is necessary to agree to entry of final orders by a bankruptcy judge?**
  - Stern held that Pierce had not effectively consented to adjudication of Vickie's counterclaim because he had no choice but to file his claim to reserve his right to a distribution from her estate

- **Some courts have ruled post-Stern that implicit consent will suffice; others require explicit consent.**
  - For example, one bankruptcy judge entered an order requiring that parties state whether or not they consent to its final adjudication of each and every claim asserted in the complaint. In re Lehman Bros. Holdings, Inc., Adv. No. 10-03266, Docket No. 93 (Bankr. S.D.N.Y. Aug. 15, 2011)
  - Consent procured by this method, however, may or may not be considered free and uncoerced, and does not solve the "statutory gap" issues

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Current Issues: Validity of Consent

- **Article III protects not only the personal right to an impartial and independent adjudication by an Article III judge, but also serves as "an inseparable element of the constitutional system of checks and balances." <u>Northern Pipeline</u>, 458 U.S. at 58**

- **To the extent that this structural concern is implicated, parties cannot cure the constitutional difficulty by consent.**
  - "[N]otions of consent and waiver cannot be dispositive because the [structural] limitations serve institutional interests that the parties cannot be expected to protect." <u>CFTC v. Schor</u>, 478 U.S. 833, 850 (1986)

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Current Issues: Subject Matter Jurisdiction Implicated?

- **Subject matter jurisdiction ("SMJ") refers to a court's authority to hear and determine a particular matter**
  - Without an explicit statutory grant of SMJ, a court has no power to act at all – parties cannot create SMJ by agreement among themselves; orders entered by a court without SMJ have no effect; and a court's lack of SMJ can be raised at any time, even after the matter has been fully litigated

- **Post-Stern, a number of litigants have filed motions to dismiss a variety of adversary proceedings based on the bankruptcy court's alleged lack of SMJ**

- **Most courts, however, have relied on the Supreme Court's own words to determine that Stern did not deal with SMJ**
  - "The statutory context also belies Pierce's jurisdictional claim. Section 157 allocates authority to enter final judgment between the bankruptcy court and the district court. That allocation does not implicate questions of subject matter jurisdiction." Stern, 131 S.Ct. at 2607 (internal citations omitted)

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Current Issues: Withdrawal of Reference?

Litigation Strategies → Impact → Parties may use Stern to increase leverage in a case (e.g. forum shopping, etc.)

- **Post-Stern, an increase in motions to withdraw the reference**
  - Many courts have refused

- **Withdrawal of the Reference**
  - The district court may withdraw, in whole or in part, any case or proceeding for cause. See 28 U.S.C. § 157(d)
    - Orion Pictures Corp. v. Showtime Networks, Inc., 4 F.3d 1095 (2d Cir. 1993) set out the test for "cause"
      - Weighing of prudential factors: effective use of judicial and party resources, uniformity in bankruptcy administration, whether withdrawal would occasion undue delay or impose undue costs, which course of action would best prevent forum shopping
  - Some courts have noted that, post-Stern, the test for withdrawal of the reference should be preceded by a threshold determination—untethered to the core v. non-core distinction—as to whether the bankruptcy court may adjudicate the matter fully, may only "hear and recommend" subject to de novo review by an Article III court, or do neither. Dev. Specialists, Inc. v. Akin Gump, 462 B.R. 457 (S.D.N.Y. 2011)

- **Abstention by the Bankruptcy Court**

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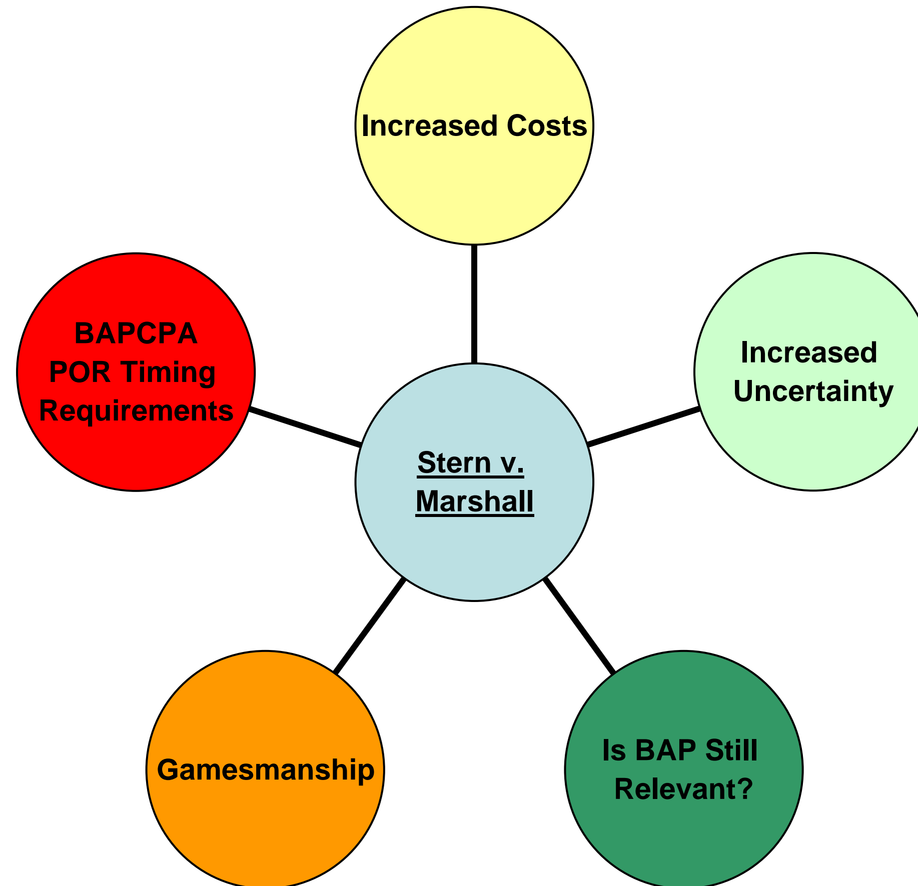
Practical Concerns and Challenges for the Practitioner



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Next Steps/Solutions

- Do Nothing
- Amend Standing Orders and/or Local Bankruptcy Rules
- Amend Fed. R. Bankr. P. 7008, 7012, 7016, 9027 and 9033 / Adopt New Rule re Consent
- Amend 28 U.S.C. § 157
- Make Bankruptcy Judges Article III Judges

Statistical Gap Concern → Clarify Effect of Consent → Authority Absent Consent → Article III Concern

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Rejecting Trademark Licenses in Bankruptcy

Douglas G. Baird

This past July, in Sunbeam Products, Inc., v. Chicago American Manufacturing, LLC, 686 F.3d 372 (7th Cir. 2012), Judge Easterbrook confronted the consequences of rejecting a contract that includes the license of a trademark, an issue of first impression in the Seventh Circuit. Lakewood made and sold a variety of consumer products covered by its patents and trademarks. Lakewood contracted their manufacture to Chicago American Manufacturing (CAM). The contract authorized CAM to practice Lakewood's patents and put its trademarks on the completed fans. Three months into the contract, Lakewood's creditors filed an involuntary bankruptcy petition against it. In bankruptcy, Sunbeam Products bought the assets, including Lakewood's patents and trademarks. Lakewood's trustee rejected its executory with CAM contract. When CAM continued to make and sell Lakewood-branded fans, Sunbeam filed an adversary action, contending that, in the wake of the rejection, CAM no longer had the right to continue to use the trademark.

The problem is easy to analyze as a matter of first principle. Giving the trustee the ability to breach ensures equal treatment among those who are similarly situated. As far as their legal rights are concerned, a party who has a contract with the debtor is in the same situation as someone who has lent the debtor money. Both have the right to sue for damages if the debtor does not do what was promised. There is no bankruptcy policy in favor of "executoriness." See Michael Andrew, Executory Contracts in Bankruptcy: Understanding "Rejection," 59 U. Colo. L. Rev. 845 (1988). Section 365 is not an avoiding power designed to expand the assets of the estate and give creditors inside of bankruptcy something they would not have had outside.

Section 365 also applies to leases, and leases provide a straightforward illustration of the basic principles at work. I own a piece of real property that you rent from me. You agreed to pay me $5,000 a month for six years. The lease obliges me to heat and cool the building, which costs me $2,000 a month. A year into the lease, there is a real estate boom. If you were to lease the property from me now, you would have to pay me $10,000 a month. But I encounter financial

problems because of bad deals I have done elsewhere. I file a bankruptcy petition. What can my trustee do? More specifically, is there any way that the trustee can take advantage of the dramatic increase in the rental value of the property?

Outside of bankruptcy, if the landlord cuts off the heating and cooling of the building, a tenant can respond by either (1) leaving the property and suing for damages or (2) remaining in possession of the property and paying for the heating and cooling by deducting it from the rent. If we raise these questions in bankruptcy, we find much the same answers. The trustee has the ability to reject the lease and cease heating and cooling the building. Just as outside of bankruptcy, a tenant can call off the whole deal and sue for damages. Alternatively, the tenant can pay for heating and cooling herself and deduct these expenses out of the rental payments that would otherwise be owing.

What is key is that the trustee's rejection of the debtor's obligations under the lease, however, does nothing to dispossess the tenant of the property. The tenant has a right to stay in possession of the property. She has a leasehold interest. This property interest gives her a right to the asset that primes that of any of the debtor's creditors. Not even a bona fide purchaser of the property from the debtor can take it free of the tenant's right to enjoy the property for the remainder of the lease term. Although the result seems to flow from an application of general principles, §365(h) makes the point explicitly.

The drafters of the Bankruptcy Code created problems by providing such an explicit rule for real property in §365(h) but remaining silent with respect to personal property. Can one infer from the presence of the section that there would be a different result in its absence? Should one infer that personal property is to be treated differently?

Suppose I lease you a fancy computer. You pay $5,000 a month in rent. This computer now leases for $10,000 a month. I file a bankruptcy petition. The trustee can reject this lease, but what does it mean to reject it? Under nonbankruptcy law, I cannot force you to give the computer back by declaring that I am in breach. I have conveyed a property interest to you. It is a done deal. You are in possession. I can yell "I breach!" all I want, but I cannot force you to give me the computer back.

In bankruptcy, the trustee can convert any service obligations I owed you into a general claim you have against my bankruptcy estate. It is just like the heating and cooling obligation in the case of real property. But does rejection mean anything more than that? Does it mean that the trustee can get the computer back? There is no §365(h) to which we can turn. There is nothing to say that you can keep the computer in the face of the rejection.

We could infer that the absence of an analog to §365(h) means that when my trustee breaks a lease of personal property, you cannot remain in possession. Under the maxim of statutory interpretation of *expressio unius*, one infers from the inclusion of one thing the exclusion of another. One can infer that Congress, by providing explicitly that lessees of real property could remain in possession after rejection, implicitly found that lessees of personal property could not.

One can also reach the opposite conclusion, however. An equally plausible view begins with the observation that few cases arise in which the trustee wants to reject a personal property lease. Rejection becomes attractive only when the property increases in value. This is unlikely to happen in the case of personal property. When Congress enacted §365(h), it merely confronted the case that was most likely to arise. Congress may have decided not to trust courts to rely on general principles in the case of real property, but not have thought about the analogous case of personal property at all. Setting out the rule explicitly in the case of real property does not require the inference that Congress was repudiating the general principle elsewhere. Indeed, why would Congress repudiate so important a doctrine by indirection?

It is one thing to say that the trustee can reject and free the estate from ongoing obligations with respect to a lease or an executory contract. It is quite another thing to identify the consequences that flow in the wake of such a rejection. Rejection does not necessarily return the parties to the position they were in before they entered into the deal. A trustee can reject a lease of property, but that does not mean that the leasehold is extinguished and that the estate regains ownership of the property. Nothing about the nature of "rejection" requires that the trustee be able to undo (or "avoid") what is tantamount to a consummated property transfer.

Two circuit courts have recently confronted the same question about negative inferences with respect to trademarks. The issue, however, has been brewing for a long time. In Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), the Fourth Circuit interpreted the power to reject expansively and allowed debtors to use the power to reject executory contracts to recapture technology licenses. Congress acted quickly to overrule *Lubrizol* with respect to patents and similar technology. Allowing a business to recapture any technology they licensed in bankruptcy makes no sense. Among other things, it makes it impossible for small businesses to license technologies in the first place. No one wants to pay twice for the same piece of property.

The specific rules Congress established in the wake of *Lubrizol* governing technology licenses in §365(n) are analogous to the specific rules governing real property in §365(h). The definition of "intellectual property," however, does not include trademarks. The effect of §365(n) on intellectual property it does not specifically cover (such as trademarks and franchise agreements) remains unclear. As with §365(h), a court might apply the maxim of *expressio unius*. Congress's decision to deny debtors the ability to recapture rights they have already conveyed in the case of technology licenses might be used to justify granting debtors this right in analogous cases that are not explicitly covered. Recent cases in the circuit courts, however, suggest that courts will likely not take this course.

Thomas Ambro sits on the Third Circuit and is one of this country's most respected judges, especially when it comes to questions of bankruptcy law. It was his dissenting opinion that likely led the Supreme Court to hear *RadLAX*. He spoke to the treatment of trademarks under §365 in a concurring opinion in In re Exide Technologies, 607 F.3d 957 (3d Cir. 2010). Judge Ambro found that general principle trumped the maxim of *expressio unius*.

> But while the Supreme Court has endorsed reasoning from negative inference in the context of §365, I believe such reasoning is inapt for trademark license rejections.
>
> When Congress enacted §365(n), it explicitly explained why it excluded trademark licensees from the protection afforded to "intellectual property" licensees:

> [T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor-licensors. While such rejection is of concern because of the interpretation of §365 by the *Lubrizol* court and others, such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.

S. Rep. No. 100-505, at 5. "Nor does the bill address or intend any inference to be drawn concerning the treatment of executory contracts which are unrelated to intellectual property." Id.

In light of these direct congressional statements of intent, it is "simply more freight than negative inference will bear" to read rejection of a trademark license to effect the same result as termination of that license. . . .

Courts may use §365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not—as occurred in this case—use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve.

In resolving the dispute in *Sunbeam*, Judge Easterbrook chose to follow Judge Ambro's lead:

> [O]utside of bankruptcy, Lakewood could not have ended CAM's right to sell the box fans by failing to perform its own duties, any more than a borrower could end the lender's right to collect just by declaring that the debt will not be paid.
>
> What §365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of

specific performance. The debtor's unfulfilled obligations are converted to damages; when a debtor does not assume the contract before rejecting it, these damages are treated as a pre-petition obligation, which may be written down in common with other debts of the same class. But nothing about this process implies that any rights of the other contracting party have been vaporized. . . .

Bankruptcy law does provide means for eliminating rights under some contracts. . . . But Lakewood's trustee has never contended that Lakewood's contract with CAM is subject to rescission. The trustee used §365(a) rather than any of the avoiding powers—and rejection is not "the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed." Thompkins v. Lil' Joe Records, Inc., 476 F.3d 1294, 1306 (11th Cir. 2007). It "merely frees the estate from the obligation to perform" and "has absolutely no effect upon the contract's continued existence." Id.

American College of Bankruptcy
Fraudulent Transfer Update

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There have been a number of recent cases in the fraudulent transfer arena warranting discussion of the implications and impact of such cases in fraudulent transfer jurisprudence. *First* and foremost, the *TOUSA* case, is a case most well known and prolific in terms of articles and speeches, and a hallmark case for the liability of lenders to affiliate and/or subsidiary entities. *Second*, a case arising from the Petters Ponzi scheme, *Stoebner v. Ritchie,* addresses an issue of apparent first impression, ruling that the Ponzi scheme presumption may be extended to related entities, not themselves operating as a Ponzi scheme, where the controller of such entities is one in the same: in this case, Tom Petters. *Third,* the Seventh Circuit, in *In re Sentinel Management Group,* ruled that a investment manager lacked intent to delay hinder and defraud its creditors when it removed customer funds from segregation, in violation of federal law and its fiduciary duty, and pledged such funds as collateral for a loan of hundreds of millions of dollars with Bank of New York to fund its proprietary trading. *Fourth,* the *Everseroff* case, a case on remand from the Second Circuit to the Eastern District of New York, provides more of a run of the mill actual fraudulent transfer analysis in the context of a father trusting assets to his sons in a time of both divorce and tax liability. *Last,* but certainly not least, is the case of *In re Global Technovations Inc.,* a Sixth Circuit case, which analyzes the reasonably equivalent value exchanged by a debtor in the purchase of a company from its parent. All of these recent cases are summarized in more detail below.

1. ***Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (In re TOUSA, Inc.)*, 680 F.3d 1298 (11th Cir. 2012).**

Debtors operated a homebuilding enterprise (TOUSA) with subsidiaries which owned most of the assets of the enterprise and generated nearly all its revenue. TOUSA borrowed unsecured debt that was guaranteed by the subsidiaries and also borrowed funds under a revolving line of credit secured by liens on the assets of the companies. After the downturn in the housing market, TOUSA paid a settlement of $421 million to a new lender who was funding a joint venture in Florida. To fund this settlement, TOUSA and some subsidiaries incurred additional loans, secured by first and second priority liens on the assets of the subsidiaries and TOUSA. Six months later, TOUSA and the subsidiaries filed for bankruptcy. The official committee of unsecured creditors claimed that the subsidiaries' transfer of the liens to these new lenders to fund the settlement was a fraudulent transfer under section 548(a)(1)(B). The committee argued that the subsidiaries were insolvent or made insolvent by the transfer, had unreasonably small capital, or were unable to pay their debts when due, and they did not receive reasonably equivalent value in exchange for their transfer. The committee sought to recover the payment of the $421 settlement to the Florida lender as the entity for whose benefit the transfer was made. The bankruptcy court avoided the transfer as fraudulent and the district court quashed the ruling. The Eleventh Circuit reversed and remanded the district court order.

The Eleventh Circuit held that the bankruptcy court did not err when it found that the subsidiaries did not receive reasonably equivalent value in exchange for the liens. The court declined to decide whether the possible avoidance of bankruptcy can confer value, because the bankruptcy court found that the benefits of the transaction were not reasonably equivalent in value to what the subsidiaries surrendered, noting this was a question of fact. Further the court found evidence of avoidance or delay of bankruptcy irrelevant because the transaction was still the more harmful option and at most delayed the inevitable. The Eleventh Circuit also held that

the bankruptcy court did not err when it ruled that the transferee lender was an entity for whose benefit the liens were transferred. The court noted cases holding that a creditor similarly situated to the transferee lender could be liable as an entity for whose benefit a transfer was made under section 550(a)(1). The court also dismissed concerns that such a reading of section 550(a) would drastically expand which entities could be liable for a transaction, noting that "every creditor must exercise some diligence when receiving payment from a struggling debtor. It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than its debtor." The Eleventh Circuit, therefore, reversed and remanded to the district court.

2. ***Stoebner v. Ritchie Capital Mgmt., L.L.C. (In re Polaroid Corp.)*, 472 B.R. 22 (Bankr. D. Minn. 2012).**

The trustee brought adversary proceedings to avoid the grant to security interests in the debtor's intellectual property, including trademarks. The ownership of the debtor was traceable to a Ponzi scheme and one of the members of that scheme executed the documents that granted the security interest. The trustee sought to avoid the grant of the security interests as actually and constructively fraudulent as well as other alternative and additional relief. The trustee invoked the Ponzi scheme presumption and the court addressed whether the presumption could be applied only as to transfers made by entities that directly purveyed the Ponzi schemes.

The court first dismissed any flat rejection of the Ponzi scheme presumption. Next, the court quickly came to the conclusion that a Ponzi scheme was present and operated within an enterprise structure, which include acquisition of the debtor. Finally, the court applied the presumption to the transfer, which was made by a related entity (the debtor) and was outside the main operation of the scheme. The court determined that the Ponzi scheme operator's intent was attributed to the debtor as transferor because he controlled the artificial entity. While the court

noted that the inference can always be rebutted by proof of contrary intent "a credible motivation to make the transfer that is grounded in good economic reason, *as to the transferor-entity*," it found that there was no probative, direct, admissible evidence to defeat the inference that the pledge was made in furtherance of the scheme. Therefore, the court held that the trustee was entitled to judgment on his fraudulent transfer claims.

3. *In re Sentinel Mgmt. Grp.*, Nos. 10-3787, 10-3990, 11-1123, 2012 U.S. App. LEXIS 16546 (7th Cir. Aug. 9, 2012).

Debtor investment manager failed to maintain customer assets in segregated accounts as required by law and, instead, pledged hundreds of millions of customer assets to secure a loan at bank. The bank was, thus, secured, but its customers lost millions after debtor filed for bankruptcy. The liquidation trustee filed an adversary proceeding against bank, arguing that the debtor fraudulently used customer assets to finance the loan and alleging claims of fraudulent and preferential transfer, as well as avoidance of lien and equitable subordination. The district court held a bench trial and found that the trustee failed to prove actual intent to delay hinder or defraud as required for the actual fraudulent transfer count, and also rejected the other counts. On appeal, the Seventh Circuit affirmed.

The issue was whether the district court clearly erred in finding the trustee failed to prove actual fraudulent intent and that the bank engaged in inequitable conduct. The trustee argued that the court erred as a matter of law because the transfers violated federal laws requiring segregation of customer funds, arguing that this demonstrated actual intent to defraud customers. The court, however, concluded that the failure to segregate was not sufficient to find actual fraud as a matter of law. The transfers were made "to pay off one set of creditors in an attempt to save the enterprise from sinking", but according to the Seventh Circuit, "that does not mean that actions taken to survive a financial storm require a legal finding that the debtor

intended to hinder, delay, or defraud." The Seventh Circuit also upheld the district court's decision that a modified Ponzi presumption did not apply, because the trustee failed to prove that the debtor knew at the time of the transfers that the scheme would collapse. Finally, the Seventh Circuit upheld the district court's determination as to equitable subordination, holding that the district court did not clearly err in concluding that the bank did not engage in sufficiently inequitable conduct. The district court had found that the bank officials "were such artless liars that they couldn't have been concealing deliberate wrongdoing" and "were simply trying to cover up their own incompetence." The Seventh Circuit explained "incompetence alone, however problematic, won't require the equitable subordination of the bank's lien."

***4. US v. Evseroff,* Case No. 00-06029 (E.D.N.Y.)**

The US government brought both actual and fraudulent transfer claims to collect taxes owed by defendant. On remand from the Second Circuit, the district court was directed to reconsider its findings regarding whether certain conveyances by defendant to a trust created by him for the benefit of his sons were actually fraudulent and whether the trust was defendant's alter ego or held property as his nominee. Around the time of learning that he owed approximately $700,000 in tax liability due to a series of tax shelters, defendant set up a trust with his sons as the named beneficiaries and transferred $220,000 and his primary residence to the trust.

While the district court had originally held that the transfers were not actually fraudulent because (1) defendant remained solvent and (2) his primary motives for creation of the trust were to prevent his estranged wife from reaching the assets and to engage in estate planning (and avoid the estate tax), the Second Circuit held that (1) a finding that the transfers did not leave defendant insolvent did not preclude a finding that the transfers constituted actually fraudulent

transfers, and (2) for nominee and alter ego findings, the critical issue is not motive, but control. The district court on remand held that defendants transfers to the trust were actually fraudulent, finding the following badges of fraud: (1) the transfers made collection efforts much more difficult; (2) his debts likely exceeded his available assets; (3) he was well aware of his mounting liabilities; (4) he engaged in a pattern or series of transactions or course of conduct after incurring the debt that establish his intent to impair the IRS's collection; and (5) he maintained the benefits of ownership of his primary residence after he transferred it to the trust for no consideration.

The district court on remand also found the real property transferred to the trust to be nominee for defendant based on the following factors: (1) the trust paid no consideration for the property; (2) the trust was created and property transferred in anticipation of defendant's liabilities; (3) defendant remained in possession and control of the property; (4) defendant had a close relationship with the trustees, having selected close friends and associates to manage the trust; and (5) defendant retained and enjoyed possession and control over the property.

5. ***Onkyo Europe Electronics GMBH v. Global Tech. Inc. (In re Global Technovations Inc.),* No. 11-1582, 2012 WL 4017386 (6th Cir. Sept. 13, 2012)**

Debtor purchased a subsidiary company from its parent company for a total of $25 million: $13 million in cash and $12 million in promissory notes. When Debtor filed for bankruptcy, parent company filed proof of claim for $12 million in unpaid notes. Debtor responded by suing parent under the theory that purchasing its subsidiary was a fraudulent transfer. Bankruptcy Court agreed and found that subsidiary was worth only $6.9 million, not $25 million, and thus avoided Debtor's remaining obligation and ordered parent to pay Debtor the difference: $6.1 million. District Court affirmed. Sixth Circuit affirmed holding that (1)

indirect benefits were properly analyzed by Bankruptcy Court, and any such value of indirect benefits were outweighed by economic damage Debtor suffered from acquiring subsidiary because it was "a serious cash *drain* on [Debtor] from the time of the acquisition forward;" (2) hindsight bias was not impermissibly relied upon because there was no indication that bankruptcy court's methodology was flawed; and (3) the bankruptcy court's determination of the best value for the subsidiary's stock was not clearly erroneous (and thus adopting a clear error standard of review to bankruptcy court's determination of reasonably equivalent value).

American College of Bankruptcy
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Bankruptcy: Back to the Future

Bankruptcy Controversies Recently Addressed by the Supreme Court and Courts of Appeal

Recent Developments in Credit Bidding

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I. RELEVANT STATUTORY SECTIONS

A. Section 1129(b)(2)

For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class *includes* the following requirements:

(A) With respect to a class of secured claims, the plan *provides* –

(i) (I) that holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalence of such claims.

B. Section 363(k)

At a sale under subsection (b) of this section of property that is subject to a lien that secured an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

C. Section 1123(a)(5)(D)

Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall –

(5) provide adequate means for the plan's implementation, such as –

(D) sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate;

D. Section 1123(b)

Subject to subsection (a) of this section (required plan contents), a plan may –

(4) provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests

E. Section 1111(b)

(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless

(i) the class of which such claim us a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have recourse and such property is sold under section 363 of this title or is to be sold under a plan.

(B) A class of claims may not elect application of paragraph (2) of this subsection if –

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.

II. RELEVANT COURTS OF APPEALS CASES

A. In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3rd Cir. 2010)

1. Facts

a. debtors own several newspapers; acquired in 2006 for $515 million

b. debtors obtained $295 million loan from group of lenders secured by all of the debtors' assets; current amount of loan is $318 million

c. debtors file plan to sell assets at public auction free and clear of all liens

d. debtors' stalking horse is 50% owned by insiders (Carpenters Union and Bruce Toll)

e. stalking horse bid will generate $37 million for lenders; lenders will also get title to debtors' headquarters (valued at $29.5 million), subject to two-year rent-free lease to winning bidder

f. debtors file motion to approve bid procedures; seek to preclude lenders from credit bidding

2. Bankruptcy Court

a. denies motion

b. finds that a plan sale must proceed under Section 1129(b)(2)(A)(ii) reading Sections 1129, 363(k) and 1111(b) together

3. District Court

a. reverses bankruptcy court

b. finds that plain language of Section 1129(b)(2)(A) is written in the disjunctive and allows alternate paths to a plan sale and that there is no credit bid right in (iii)

4. Court of Appeals Majority Opinion

a. stays implementation of the order pending appeal

b. lenders' arguments

(1) plain language of § 1129(b)(2)(A) requires all sales to occur under (ii)

(2) indubitable equivalent is ambiguous, thus look at other Code provisions

(3) denying credit bidding is inconsistent with other Code provisions

c. finds Section 1129(b)(2)(A) unambiguous

(1) Section 102(5) – "or" is not exclusive, as supported by the legislative history ("if a party 'may do (a) or (b), then that party may do either or both")

(2) rejects argument that specific controls over the general, finding that principle only applies where the specific operates as a limitation on the general (relying on Supreme Court's Varity Corp. decision)

(3) holds that lenders' argument would restrict a debtor's ability to fund its plan, "an outcome at odds with the fundamental function of the asset sale, to permit debtors 'to provide adequate means for the plan's implementation,'" citing Section 1123(a)(5)(D)

(4) relies on Pacific Lumber, which held that the three subsections of Section 1129(b)(2)(A) were alternatives and not even exhaustive

(5) § 1129(b)(2)(A) provides examples of treatment that would be fair and equitable

d. finds "indubitable equivalence" language unambiguously excludes right to credit bid

(1) no need to resort to cannons of statutory construction

(a) that language is broad does not mean it is ambiguous

(2) Webster's Dictionary – "indubitable" means "not open to question or doubt"; "equivalent" means one that is "equal in force or amount" or "equal in value"

(3) Bankruptcy Code fixes the relevant value as that of the collateral

(4) therefore, indubitable equivalence means the unquestionable value of a lender's secured interest in the collateral

(5) the scope of indubitable equivalence is to protect a fair return to secured lenders

(6) lists examples of cases finding indubitable equivalence

(7) because Section 1129(b)(2)(A)(iii) is unambiguous and does not provide a right to credit bid, no such right exists under that section

(8) holding is consistent with SubMicron, in which court held that the lender's credit bid set the value of the collateral under Section 363; the plan (not the auction) must establish the indubitable equivalent (other forms of compensation or security may be offered)

(9) lenders can still argue at plan confirmation hearing that they are not receiving the indubitable equivalent

d. Plain meaning of Section 1129(b)(2)(A) is not inconsistent with Congressional intent

(1) no extraordinary showing of contrary legislative intent to override the plain meaning of the statute

(2) lenders argue that because they cannot make an 1111(b) election, they must be able to credit bid

(3) however, Section 363(k) provides that the right to credit bid is not absolute ("unless the court for cause orders otherwise")

(4) lender has no entitlement to the upside of its collateral; contrary to Code sections limiting value of lender's secured claim as determined at time of plan confirmation (cites Pacific Lumber and its example that an oversecured creditor could not demand its collateral back as opposed to payment in full)

(5) rejects legislative comments as inconsistent with the statute because of several instances where no credit bidding rights exist (transfer of encumbered assets subject to liens and the for cause exception)

(6) Congress should amend the statute if it disagrees with the Court

5. Court of Appeals Concurring Opinion

a. no need to resort to legislative history as the statute is unambiguous and does not lead to an absurd result

b. refers to dissent's "near-gymnastics" to reach its result

6. Judge Ambro's Dissent

a. concerned with motivations by debtors to preclude credit bidding

(1) "Keep it Local" ad campaign

(2) two years rent-free building

(3) bankruptcy court found debtor's strategies not designed to obtain highest price

(4) stalking horse trying to pay as little as possible

(5) denial of credit bidding will benefit the debtor's insiders

b. credit bidding

(1) lender will only do it if it thinks it can get a higher return by taking collateral back; if lender is credit bidding too low, a buyer will make a higher bid

(2) credit bidding no more chills bids than a deep-pocketed cash bidder (having the ability to pay a certain price does not mean a willingness to do so)

c. finds more than one reasonable way to read the statute

(1) "or" is sometimes exclusive in practice (citing Code sections)

(2) the three alternatives in Section 1129(b)(2)(A) are exhaustive as the operative word is "provides" not includes" (disagreeing with Pacific Lumber)

(3) plan's proposed treatment of the secured creditor's claim determines which of the three alternative subsections applies (citing Brubaker's article); debtor cannot choose under which alternative subsection to proceed

d. rules of statutory interpretation determine which reading is correct

(1) specific prevails over the general

(2) (iii) deals with situations not addressed in (i) or (ii)

(3) to read (iii) to allows sales without credit bidding causes it to conflict with (ii)

(4) majority causes the language in (i) and (ii) to be superfluous

(5) context shows that Congress intended secured creditor to be able to take back its collateral

(a) Section 1123(a)(5)(D) ties out to Section 1129(b)(2)(A)

(b) Section 363(k) allows lenders to protect themselves from undervaluation when their collateral is sold

(c) Section 1111(b) allows lenders to protect themselves from undervaluation when their collateral is not being sold

(d) credit bidding and the 1111(b) election also minimize deficiency claims against the estate

(e) sections reflect what would happen outside of BK

(6) legislative history supports his reading

(a) sale of property under Section 363 or a plan is excluded from 1111(b) because the secured creditor can credit bid

(b) Code made secured creditor rights stronger than under the Act

(c) examples of (iii) are abandonment of collateral and a lien on similar collateral

(7) policy supports his reasoning

(a) insider debtor is undervaluing collateral

(b) not a loan-to-own scenario

(c) syndicated lender may not be able to bid cash

(d) cost of credit will increase under the majority's holding

B. In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009)

1. Facts

a. Palco owned and operated a saw mill, a power plant and the town of Scotia, CA

(1) Marathon held secured debt of $160 million

b. Scopac was wholly owned by Palco; it owned 200,000 acres of redwood forest

(1) Noteholders held secured claim of $740 million

(2) BofA held secured claim of $36.2 million

(3) Palco had sole right to harvest Scotia's timber

c. exclusive period was terminated and noteholders filed a plan for Scotia; Marathon and MRC filed a plan for all debtors

(1) Marathon/MRC plan proposed to create Townco and Newco

(a) Palco's assets would go to Townco

(b) the timberland and sawmill assets would go to Newco

(c) Marathon/MRC would pay $580 million to Newco to pay claims against Scopac and Marathon converted its secured claim to equity

(2) two impaired classes voted for plan; noteholder deficiency claim class voted against it

(3) court held valuation hearing and found value of timberlands at not more than $510 million (other noteholder collateral had net value of $3.6 million)

(4) noteholders did not make a § 1111(b) election

2. Bankruptcy Court

a. confirms Marathon/MRC plan

b. does not apply Section 1129(b)(2)(A)(ii) because it does not find the transfer of assets from the debtors to be a sale

c. grants direct appeal to Fifth Circuit, but denies stay pending appeal

3. Court of Appeals

a. does not find appeal equitably moot

b. finds that the transfer of assets from the debtors was a sale

c. rejects noteholders' arguments that (1) the specific governs over the general and (2) a contrary reading would cause subpart (ii) to be superfluous

d. Section 1129(b)(2)(A) is joined by the disjunctive "or" and the three alternatives are not even exhaustive

e. the introduction to § 1129(b)(2) uses the word "includes", which is defined as "not limiting"

f. credit bid may be imperative in some cases, but not here because the noteholders were getting paid cash

g. intent of Section 1129(b)(2)(A) alternatives (as borne out by the examples of what is indubitable equivalence) is to protect repayment of secured creditor's principal and the time value of money

h. paying off secured creditors in cash is the indubitable equivalent of the claim if the payment accurately reflects the collateral value

i. Code does not protect the creditor's upside potential; an oversecured creditor could not demand to keep its collateral rather than be paid in full; indubitable equivalence does not require more than its preceding two clauses

j. ex; Marathon/MRC could have proposed a note equal to present value of collateral and paid it off one day after plan confirmation

(1) rejects noteholders' argument that they could have made 1111(b) election and been entitled to receive more than $700 million because the present value of the payment stream still would be capped at the collateral value determined by the court

C. River Road Hotel Partners, LLC v. Amalgamated Bank, 651 F.3d 642 (7th Cir. 2011)

1. Facts

a. River Road debtors

(1) obtained $155.5 million construction loan to build InterContinental Chicago O'Hare hotel

(2) following default by debtors, lenders refused to extend additional funding for completion of restaurant and payment of contractors/suppliers

(3) $140 million owed on loans as of petition date; $9.5 million in mechanics' liens asserted against properties

b. RadLAX debtors

(1) obtained $142 million construction loan to purchase the Radisson Hotel at LAX, renovate the hotel and build a parking structure

(2) construction halted when debtors exhausted loan funds

(3) $120 million owed on loans as of petition date; $15 million in mechanics' liens asserted against properties

c. River Road and RadLAX debtors file respective plans to sell assets free and clear of all liens; bid procedures motions filed

(1) River Road stalking horse bid will generate $42 million for lenders; RadLAX stalking horse bid will generate $47.5 million for lenders

d. lenders object because the proposed procedures preclude them from credit bidding

e. debtors argue that the plans are confirmable because they provide lenders with the "indubitable equivalent" of their claims

2. Bankruptcy Court

a. holds Section 1129(b)(2)(A)(ii) provides exclusive means to confirm a plan that has not been approved by secured creditors and that sells encumbered assets free and clear of liens

b. denies bid procedures motions

c. grants direct appeal to Seventh Circuit; appeals consolidated

3. Court of Appeals

a. holds appeal not mooted by expiration of deadlines in original asset purchase agreement or alleged abandonment of plans by debtors

(1) filing of amended asset purchase agreements evidences debtors' desire to pursue asset sale plans

(2) confirmation deadlines within asset purchase agreements inherently subject to expiration prior to time required for appellate review

(3) issue capable of repetition; if dismissed for mootness, debtors would re-file plans with new asset purchase agreements, bankruptcy court would deny confirmation on same grounds and debtors would bring same appeal

b. finds Section 1129(b)(2)(A) ambiguous (agreeing with Judge Ambro's dissent in Philadelphia Newspapers)

(1) nothing in (iii) indicates whether it can be used to confirm every type of plan or only those not covered by (i) and (ii)

(a) use of "or" is insufficient to resolve the ambiguity because it is not always non-exclusive

(b) credit bidding is a protection to prevent undervaluation

(c) there are many risks of undervaluation in bankruptcy sales (see infra)

c. rules of statutory construction determine which reading is correct

(1) disfavor reading a statute in such a way that any portion of it would be superfluous (and debtors' suggested interpretation would render (i) and (ii) superfluous)

(a) (i) sets standards for cases where the debtor retains an asset or sells an asset that remains subject to lien

(b) (ii) sets standards for cases with free and clear asset sales

(c) (iii) applies only in cases where a debtor disposes of assets in a manner other than those contemplated by (i) or (ii)

(2) specific prevails over general

(a) allowing plans to use (iii) to accomplish a sale without providing the protections of (ii) creates a conflict and would allow the general to prevail over the specific (citing Judge Ambro's dissent in Philadelphia Newspapers)

(b) legislative history indicates that (iii) was intended to cover situations not covered by (i) or (ii) such as abandonment of collateral or replacement collateral

(3) sections should be interpreted in context of the entire Code

(a) other areas of the Code afford protection to secured creditors (Sections 363(k), 1129(b)(2)(A)(ii), 1111(b)) which debtors' interpretation of 1129(b)(2)(A) does not provide

(b) Bankruptcy Code nowhere recognizes sale of assets without credit bidding to be legitimate

d. finds that allowing the debtors to sell assets free and clear without permitting credit bidding by the lenders is not "fair and equitable" and increases risk of undervaluation of encumbered asset

(1) "indubitable equivalent" of a creditor's secured claim depends on amount of creditor's lien and the current value of the asset; difficult to determine, though Code recognizes judicial valuation and free market valuation established at open auction

(2) auctions recognized under Sections 363(k) and 1129(b)(2)(A)(ii) require that secured creditors be permitted to credit bid, minimizing risk of undervaluation

(3) several factors create risk of undervaluation

(a) speed and timing of bankruptcy auction

(b) inability to provide sufficient notice to interested parties

(c) inherent risk of self-dealing on part of existing management

(d) liquidity constraints

(e) bids impacted by bidder's own financing costs

III. **U.S. SUPREME COURT RESOLUTION OF DISPUTE**

A. RadLAX Gateway Hotel, LLC v. Amalgamated Bank, __ U.S. __ (5/29/12)

1. Facts

a. Court considers appeal by RadLAX debtors

b. Lender confirms plan in River Road case

2. Holding

a. debtor must comply with Section 1129(b)(2)(A)(ii) when it seeks to sell its property; must allow lender to credit bid its indebtedness

3. Purpose of credit bidding

a. to protect creditor against sale of its collateral for a depressed price

b. especially important to Federal Government, which often cannot bid cash

c. whether it should be required is a policy decision best left to Congress

4. <u>Rules of statutory construction</u>

a. debtors' reading is "hyperliteral and contrary to common sense"

b. specific governs the general

(1) can apply when general and specific exist side-by-side

(2) superfluousness is to be avoided

(3) clause (ii) describes requirements for selling collateral free of liens whereas clause (iii) is broadly worded and does not discuss sales

c. structure of Section 1129(b)(2)(A) suggests that (iii) applies to situations not covered by (i) or (ii)

5. <u>Rejects debtors' arguments</u>

a. Court's reading does not render "or" to be "and"

(1) only clause (ii) need be satisfied when selling property, not clauses (ii) and (iii)

b. general v. specific cannon not limited to situations where specific is a subset of the general

(1) clause (ii) is a subset of clause (iii) in any event

c. appropriate to look at plan confirmation setting at this point because a plan that proposes a sale without credit bidding could never be confirmed

6. <u>Policy considerations cannot override statutory text</u>

a. no textual ambiguity

b. pros and cons of credit bidding are best left for Congress

c. Court is obligated to interpret the Bankruptcy Code clearly and predictably using well established principles of statutory construction ("Under that approach, this is an easy case.")