AMERICAN BANKRUPTCY INSTITUTE
National Conference of Bankruptcy Judges' Roundtable

Elite Eight–Eight of the Most Important Supreme Court Cases Ever

October 28, 2016
10:30 a.m. – 11:30 a.m.

Hon. Hannah L. Blumenstiel
United States Bankruptcy Court
Northern District of California

Hon. Daniel P. Collins
United States Bankruptcy Court
District of Arizona

Reginald W. Jackson
Vorys Sater Seymour & Pease LLP
Columbus, OH

Brian L. Shaw
Shaw Fishman Glantz & Towbin LLP
Chicago, IL

Moderator
Richard Levin
Jenner & Block LLP
New York, NY

***Local Loan Co. v. Hunt*, 292 U.S. 234 (1934)**

Hon. Hannah L. Blumenstiel
United States Bankruptcy Court
Northern District of California

I. Issue

Whether a bankruptcy court has the authority to enjoin the post-discharge prosecution of a state court action in which a creditor attempts to enforce a prepetition assignment of a debtor's wages.

II. Statutory Context

Decided under the Bankruptcy Act of 1898.

III. Facts

Debtor William Hunt borrowed $300 from Creditor Local Loan Co. and assigned his wages as security for repayment of the loan. Approximately six months later, Debtor filed a petition for relief in bankruptcy. After Debtor received his discharge, Creditor sued Debtor's employer in state court to enforce the pre-petition assignment. Debtor then commenced an action in the bankruptcy court to enjoin the state court action.

IV. Holding and Analysis

A. The bankruptcy court had jurisdiction to enjoin state court action, as it is "well-settled" that a federal court may enforce its prior orders, and this principle applies with equal force in bankruptcy courts. *Local Loan*, 292 U.S. at 239. While the state court might have been able to afford similar relief to the Debtor, such a remedy only could have been reached after long, costly litigation and would have been "inadequate because of the wholly disproportionate trouble, embarrassment, expense, and possible loss of employment which it involves." *Id*. at 242.

B. Following discharge, Debtor's post-petition earnings were not subject to creditor's pre-petition assignment of wages. *Id*. at 243.

C. Bankruptcy court was not bound by state law, which recognized that a wage assignment constituted a lien on subsequent earnings, as such a result contravened one of the "primary purposes" of the Bankruptcy Act: the fresh start for the honest debtor. *Id*. at 244.

V. Significance

The concept of a “fresh start” for the “honest debtor” is by now ubiquitous. But remember that imprisonment for debtors remained common until the mid-nineteenth century, and Congress did not enact permanent federal bankruptcy legislation until 1898. The temporary bankruptcy legislation that was in effect for just 16 of the first 109 years following ratification of the U.S. Constitution largely favored creditors. For most of that time, debtors lacked the ability to discharge debts, avoid debtors’ prison, or voluntarily seek relief from their creditors. Even when bankruptcy legislation was in effect, it frequently was not available or did not offer meaningful remedies. Under the Bankruptcy Act of 1800, for example, only merchants were eligible for relief and petitions were strictly involuntary: Only creditors could commence bankruptcy cases. Later legislation imposed oppressive “minimum dividends” to creditors and incorporated many grounds upon which a debtor’s discharge could be denied.

The Bankruptcy Act of 1898, under which *Local Loan* was decided, ushered in a new era, in which debtors were treated much more humanely. *Local Loan* served to cement this perspective. According to one prominent legal scholar, *Local Loan*’s “powerful” statements concerning the purpose of the Bankruptcy Act and the impact of a discharge would “serve as the backbone of American consumer bankruptcy law for the next 70 years.” Kenneth N. Klee, *Bankruptcy and the Supreme Court*, pp. 407 and 452 (LexisNexis 2008).

Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935)

Reginald W. Jackson
Vorys Sater Seymour & Pease LLP
Columbus, OH

I. Issue

Can bankruptcy laws promulgated under the Bankruptcy Clause of the U.S. Constitution override the provisions of the Taking Clause of the U.S. Constitution so as to impair the rights of a secured creditor without compensation?

II. Statutory Context

This case was decided under the Bankruptcy Act of 1898.

III. Facts

In *Radford*, the Supreme Court considered a challenge to the 1934 Frazier-Lemke Farm Bank Act, a cornerstone of President Roosevelt's New Deal policies aimed at providing relief to distressed farmers. Radford, a Kentucky farmer, had twice mortgaged the family farm to the Louisville Joint Stock Land Bank as security for approximately $9,000 in debt. Radford made regular principal and interest payments on the mortgages until 1931, when, like hundreds of thousands of other American farmers, Radford fell victim to the Great Depression and defaulted in payment of property taxes and mortgage obligations. After Radford declined to refinance the mortgages in early 1933, the Bank declared the indebtedness secured thereby immediately due and payable, filed for foreclosure of the mortgages and requested the appointment of a receiver to take possession and control of the farm.

Shortly after the Bank's foreclosure and receivership actions commenced, Radford petitioned for relief under Section 75 of the Bankruptcy Act, requesting a stay of the Bank's state court actions and proposing a composition of his debts in Kentucky federal court. Though Radford's petition was approved, he failed to obtain the requisite creditor consent to his proposed composition. The Bank thereafter obtained a Kentucky state court order authorizing a foreclosure sale of the farm.

Two days before the issuance of the foreclosure sale order, Congress enacted the Frazier-Lemke Emergency Farm Mortgage Act which, among other things, allowed farmers to stay foreclosure proceedings and restructure farm mortgage debt on more favorable terms. Two provisions of the Act provided farmers who were adjudged bankrupt but unable to successfully complete a composition proceeding under Section 75 of the Bankruptcy Act with attractive restructuring options. Paragraph 3 of the Act provided that a bankrupt farmer could, with the mortgagee's consent, purchase the mortgaged farm at its then-appraised value and immediately acquire title and possession to the farm, with deferred payments due over the course of six years. If the mortgagee refused consent for such a sale, under paragraph 7 the mortgagor could petition the bankruptcy court for a five year stay on all proceedings against the mortgaged farm. During this five year period, the farmer would retain possession of the farm, subject to payment of a reasonable rental amount, and mortgage payments would be deferred and accrue interest at 1.0% per year. At any time within this five-year period, the mortgagor could elect to purchase the mortgaged farm at its then-appraised value or, at the request of the mortgagor, at a price equal to any subsequent, court-approved re-appraisal value. These alternatives applied to mortgage debt arising prior to the enactment of the Act as well as all future farm mortgages.

A Kentucky federal court adjudged Radford bankrupt and appointed a bankruptcy referee. Radford invoked paragraph 3's provisions and sought to purchase the property at the referee-appraised value, which equaled only half of Radford's indebtedness to the Bank. The Bank refused to consent to the sale and instead offered to pay the mortgage in full in exchange for the farm. The referee rejected the Bank's proposal and ordered all pending foreclosure actions against the farm stayed under paragraph 7 of the Act. Radford retained possession of the farm, subject to his obligation to pay the referee-established annual rent. The Bank appealed the referee's orders, asserting that the Act resulted in an unconstitutional taking of certain property rights under the mortgage. The orders were affirmed on appeal by the district court and again by the Sixth Circuit Court of Appeals.

IV. Holding

Writing for a unanimous Court, Justice Brandeis struck down the Act, holding that paragraphs 3 and 7 of the Act affected an unconstitutional taking of private property prohibited by the Fifth Amendment as it was applied to existing mortgages. Looking first to centuries of equity court practice concerning the defense of mortgagee rights, the Court noted that "the right of the mortgagee to insist on full payment before giving up his security" was the quintessence of a mortgage. *Id.* at 580-81. Prior legislation providing mortgagor-friendly relief had always hewed to this principle by refraining from disturbing the mortgagee's right to receive payment in full of the mortgage debt. *Id.* at 581.

The Act also impaired other property rights of the Bank. If the Bank consented to a sale under paragraph 3, it would be forced to forfeit its security in exchange for six years of deferred payments and an unsecured promise to pay the balance at the end of this six year period. If the Bank refused to consent to such a sale, it would similarly forfeit its right to security in exchange for five years of rent payments and the opportunity costs associated with uncertainty as to if, or when, the mortgagor might elect to purchase the property for the appraisal price during this five-year period. In either case, the Bank would forfeit its right to repossess the property and endure the risk of waste or destruction of the farm while Radford retained possession. *Id.* at 592-93. Additionally, the Court noted that sales free and clear of liens were not permitted when the debt exceeded the value of the property, and no court had ever authorized a sale of property at a price less than the mortgagee's cash offer. *Id.* at 584. In sum, the Act represented "the first instance of an attempt [… to impair] a substantive right of [a] mortgagee in specific property held as security." *Id.*

In rejecting this attempt, the Court stated that the act infringed on five key state property rights provided under Kentucky state law:

1) The right to retain the lien until the indebtedness thereby secured is paid.
2) The right to realize upon the security by a judicial public sale.
3) The right to determine when such sale shall be held, subject only to the discretion of the court.
4) The right to protect its interest in the property by bidding at such sale whenever held, and thus to assure having the mortgaged property devoted primarily to the satisfaction of the debt, either through receipt of the proceeds of a fair competitive sale or by taking the property itself.
5) The right to control meanwhile the property during the period of default, subject only to the discretion of the court, and to have the rents and profits collected by a receiver for the satisfaction of the debt.

Id. at 594-95. These property rights could not be subverted by Congress's power to establish uniform bankruptcy laws under the Bankruptcy Clause of Article I of the Constitution and remained subject to the Fifth Amendment's prohibition against uncompensated public takings. *Id.* at 586-88. Even the most compelling public policy justifications, such as Congress's interest in combating the scourge of farm foreclosures and staving off the eradication of the American owner-operator farmer, could not justify Congressional overreach. "[T]he Fifth Amendment commands that, however great then Nation's need, private property shall not be thus taken even for a wholly public use without just compensation." *Id.* at 602. The Court struck down the Act and voided the actions taken against the Bank under the Act.

V. Significance

Radford stands today as an early and significant check on the scope of Congress's bankruptcy power in respect of the rights of secured creditors. It is credited as being the first case to rely on the Fifth Amendment in limiting the operation of the Bankruptcy Clause, an approach which has been employed in numerous other cases to rein in the bankruptcy power. *See* Kenneth N. Klee, BANKRUPTCY AND THE SUPREME COURT (LexisNexis 2009), 440-41; Charles J. Tabb, *Illinois ABI Symposium on Chapter 11 Reform: The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, 2015 U. ILL. L. REV. 765, 790 (2015). The Supreme Court has relied on *Radford* in invalidating numerous Congressional attempts to use the bankruptcy power to impair existing liens. *See, e.g., Ashton v. Cameron Cty. Water Impr. Dist.*, 298 U.S. 513 (1936) (striking down a municipal bankruptcy statute that unconstitutionally altered municipal bondholders' rights); *Armstrong v. United States*, 364 U.S. 40 (1960) (rejecting a Congressional attempt to eliminate valid mechanic's liens on certain manufacturing property). The Supreme Court's later decision in *Wright v. Vinton Branch of the Mountain Trust Bank of Roanoke,* 300 U.S. 440, 458 (1937), seemingly narrowed the five protected rights cited in *Radford* to three: the right to retain the lien until the secured indebtedness is paid, the right to realize on the security by a judicial public sale, and the right to bid in the secured debt at a foreclosure sale. Nevertheless, these three rights survive today as baseline protections for secured creditors against the bankruptcy power throughout the United States. Klee, BANKRUPTCY AND THE SUPREME COURT, at 441.

Radford is also significant for the contributing role it played in shaping American history. The *Radford* Court's steadfast adherence to the Fifth Amendment's protection of private property in the face of calamitous financial hardships faced by American farmers during the Depression was a blow to President Roosevelt's New Deal legislation. The Court's unwillingness to yield to the necessities of the times challenged President Roosevelt's agenda and placed the Court at loggerheads with Congress and the President. Scholars have considered *Radford* to be among a handful of landmark cases that inspired President Roosevelt's unsuccessful attempt to "pack" the Supreme Court through the Judicial Procedures Reform Bill of 1937 and later appointment of justices more sympathetic to the New Deal. *See* Howard Ball, Hugo L. Black: Cold Steel Warrior, 90 (Oxford U. Press 2006).

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

Reginald W. Jackson
Vorys Sater Seymour & Pease LLP
Columbus, OH

I. Issue

The rejection of the relative priority rule, the clear and "absolute" endorsement of the absolute priority rule and the genesis of the new value exception to the absolute priority rule.

II. Statutory Context

This case was decided under the Bankruptcy Act of 1898.

III. Facts

The Debtor Los Angeles Lumber Products Co. was a holding company whose assets consisted of all outstanding capital stock of six subsidiary companies. The Debtor's principal asset was its ownership interest in the Los Angeles Shipbuilding and Drydock Corporation (the "Subsidiary"). The Debtor's liabilities consisted mainly of obligations under certain first lien mortgage bonds secured by the Debtor's interest in the Subsidiary. After negotiating various out-of-court arrangements with its bondholders over the course of several years, the Debtor filed for bankruptcy protection under Section 77B of the Bankruptcy Act and submitted a proposed plan of reorganization to the district court. Under the proposed plan of reorganization, a new corporation would be created to acquire the assets of the Subsidiary. The new corporation would then issue preferred stock to the bondholders and common stock to certain of the Debtor's existing stockholders.

Though in excess of 90% of the Debtor's existing stockholders and approximately 92.8% of bondholders (by face value) consented to the plan of reorganization, two bondholders objected. The objecting bondholders argued that the distribution of common stock to existing stockholders was neither fair nor equitable given that the stockholders had not contributed any new value to the Debtor. The district court overruled the bondholders' objection, finding that the existing stockholders would provide value by virtue of "their familiarity with the operation" of the Debtor's business, "standing and influence in the community" and the "continuity of management", and that the bondholders would still receive less than the full appraised value of the Debtor's assets if they were permitted to foreclose on the bonds. *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 113 (1939). The district court further found that because the preferred stock issued to bondholders was senior to the stockholders' common stock and gave bondholders effective control of the new company, the plan of reorganization preserved the relative priorities of the bondholders and stockholders and was therefore fair and equitable. *Id*. Thus, the district court confirmed the plan of reorganization, and the Ninth Circuit Court of Appeals affirmed.

IV. Holding

Writing for a unanimous Court, Justice Douglas reversed the Ninth Circuit and found that the plan of reorganization was not "fair and equitable" and therefore not confirmable. The Court began by pointing to a triumvirate of prior Supreme Court cases setting forth the "absolute priority rule." *Louisville Trust Co. v. Louisville, N.A. & C. Ry. Co.*, 174 U.S. 674 (1899); *N. Pac. Ry Co. v. Boyd*, 228 U.S. 482 (1913); *Kansas City Term. Ry. Co. v. Cent. Union Tr. Co.*, 271 U.S. 445 (1926). Under the absolute priority rule, a "stockholder's interest in the [debtor's] property is subordinate to the rights of creditors; first of secured and then of unsecured creditors." *Louisville Trust Co.*, 174 U.S. at 684. As such, stockholders are generally forbidden from receiving a distribution at the expense of creditors senior to the stockholders' interests. *See Boyd*, 228 U.S. at 508. Such a distribution would not be "fair and equitable" as required under the 1898 Bankruptcy Act (and under the later-adopted Bankruptcy Code). *Id*. Therefore, the Debtor's existing stockholders could not receive a distribution under the Debtor's plan unless the bondholders received a full recovery. The Court also rejected the Debtor's argument that the plan of reorganization was "fair and equitable" because bondholders would still receive less than the appraised value of the Debtor's assets upon foreclosing on the bonds. The Court considered this line of reasoning to amount to "coercion" of the bondholders into consenting to the plan of reorganization and concluded that such considerations had no bearing on whether the plan of reorganization was confirmable. *Case,* 308 U.S. at 124.

In dicta, the Court noted that there are circumstances under which a stockholder might be entitled to a distribution notwithstanding the absolute priority rule. One such circumstance exists where the Debtor is in need of an infusion of capital, and existing stockholders make a "fresh contribution" of capital to the Debtor. *Id*. at 121. This contribution of new value must be "in money or in money's worth," and cannot be in the form of intangible benefits such as those offered by the existing stockholders. *Id*. at 122. The Court concluded that the plan of reorganization's distribution of common stock to existing stockholders was not fair and equitable, rendering the plan of reorganization unsuitable for confirmation. *Id*. at 132.

V. Significance

The *Case* decision has a far-reaching impact on the bankruptcy and restructuring world. *Case*'s full-throated endorsement of the absolute priority rule finally dispensed with the competing relative priority rule, under which a plan of reorganization could be considered "fair and equitable" as long as it preserved the relative pre-bankruptcy priorities among the debtor's creditors and equity holders. When *Case* was decided, the aforementioned triumvirate of Supreme Court cases—*Louisville Trust Co*., *Boyd* and *Central Union Tr. Co.* —had explored the absolute priority rule, but had not explicitly rejected the relative priority rule. *Case* firmly established the rule as the law of the land and was later codified in Section 1129 of the Bankruptcy Code, 11 U.S.C. § 1129(b), although the rule may presently be invoked only by a dissenting class of creditors in a chapter 11 reorganization. The absolute priority rule has also survived challenges to its validity resulting changes to the Bankruptcy Code under the 2005 BAPCPA amendments. *See In re Lively*, 717 F.3d 406 (5th Cir. 2011); *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012). *Case*'s promulgation of the absolute priority rule has stood the test of time.

Also of significant import is *Case*'s formulation of the "new value exception" to the absolute priority rule. *Case* is credited with first setting forth the new value exception, whereby stockholders can participate in a reorganization plan and receive a distribution (or retain an equity interest) if they contribute new capital to the debtor. Despite the 1978 Bankruptcy Code's silence on the new value exception and a series of federal appellate decisions following the enactment of the 1978 Bankruptcy Code questioning the exception's vitality, the exception remains good law. S*ee, e.g*., *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197 (1988) (while refusing to rule specifically on whether the new value exception survived codification of the absolute priority rule, the Court held that the contribution of future "labor, experience, and expertise" did not constitute new value—new capital, not mere sweat equity is required); *In re Bryson Props, XVIII*, 961 F.2d 496 (4th Cir. 1992) (noting a split among courts as to the effect of the 1978 Bankruptcy Code's silence as to the new value exception). Indeed, when presented with its latest opportunity to rule on the continued validity of the exception, the Supreme Court simply noted the adoption of the exception by certain lower courts without accepting or rejecting it. *Bank of America Nat'l Trust & Svgs. Ass'n. v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999). While the future of the new value exception remains uncertain, the debate regarding its vitality continues.

The importance of *Case* may be best captured by imagining a world in which the Supreme Court had instead adopted the relative priority rule and thereby never conceived of the new value exception. Such a ruling would fundamentally alter the current bankruptcy priority scheme and tear asunder the bankruptcy and restructuring landscape as we know it.

Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950)

Brian L. Shaw
Shaw Fishman Glantz & Towbin LLP
Chicago, IL

I. Issue

Whether the notice requirements imposed on investment trustees with regard to known and unknown beneficiaries under New York Banking Law, § 100-c (c. 687, L.1937, as amended by c. 602, L. 1943 and c. 158, L. 1944) (the "Act") is compatible with the Fourteenth Amendment of the United States Constitution.

II. Statutory Context

The Fourteenth Amendment and the Act.

III. Facts

By the mid-twentieth century, banking laws as prescribed under the Act, as well as under other states' laws, permitted small investment trusts to pool their assets together into a single larger trust that would be managed as a common fund. The common fund shared profits and expenses *pro rata* among the participating smaller trusts. In this way, smaller trusts could share management costs and get exposure to diversified risks to which they otherwise had no access.

Trustees of the funds had exclusive management and control over the common fund, and the Act imposed certain fiduciary obligations on trustees. The Act also provided that periodically, a trustee could petition the state court for a judicial "settlement" and accounting of the fund. Entry of the settlement decree discharged the trustee from claims of mismanagement that arose during the period covered by the accounting, and the decree was binding on all parties with an interest in the fund. To give notice of the settlement request, the Act required the trustee to publish notice in a newspaper for "four successive weeks" and "not less than once in each week."

In 1946, Central Hanover Bank and Trust Company was trustee of a common fund with approximately 113 participating trusts and assets of almost $3 million. Various beneficiaries of the common fund lived outside of New York. Hanover petitioned the Surrogate Court in New York for a judicial settlement of the common fund and provided notice by newspaper publication as allowed under the Act. The state court appointed Mullane as a special representative to represent the interests of the beneficiaries. Mullane objected that the notice, both as provided by Hanover and as required under the Act, was "inadequate to afford due process under the Fourteenth Amendment." The Surrogate Court overruled the objection and entered a final decree, which was affirmed by the Appellate Division of the Supreme Court and the Court of Appeals of the State of New York.

IV. Holding

On appeal, the Supreme Court reversed, finding the Act's notice provisions to be "incompatible" with the Fourteenth Amendment. The Due Process Clause of the Fourteenth Amendment provides: "nor shall any state deprive any person of life, liberty, or property, without due process of law." The Court found that a judicial settlement under the Act deprived beneficiaries of property in two ways: first, by cutting off beneficiaries' rights to sue the trustee for negligence or malfeasance, and second, by potentially allowing the trustee to obtain unreasonable fees. Therefore, "notice and hearing" of the petition "must measure up to the standards of due process."

The Court identified several principles that guide the sufficiency of due process. Notice must be "reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." Notice must "afford … reasonable time for those interested to make an appearance." Also, the "means employed must be such as one desirous of actually informing the absentee might reasonably adopt to accomplish it." And finally, the chosen form of notice may not be "substantially less likely to bring home notice than other of the feasible and customary substitutes."

With these principles in mind, the Court held that notice by newspaper publication was little "more than a feint" when compared with actual notice. However, it carved out two specific exceptions. First, notice by publication is adequate for persons who are missing or unknown. Those parties are unlikely to get notice no matter what method is employed. Second, publication is adequate for beneficiaries with "conjectural or future" interests. Attempting to give these parties notice would be highly impractical, and the expense "would impose a severe burden" on the common fund.

For parties with known addresses, however, the Court held that Hanover must provide notice by U.S. Mail. "Where the names and post office addresses of those affected by a proceeding are at hand, the reasons disappear for resort to means less likely than the mails to apprise them of its pendency." However, the Court held that Hanover need not personally serve notice. The Court reasoned that any sustained objection to the proceeding would benefit all beneficiaries. Thus, "notice reasonably certain to reach most," like the U.S. Mail, "is likely to safeguard the interests of all."

V. Significance

The phrase "notice and hearing" appears over 100 times in the Bankruptcy Code. At its essence, the concept of required notice, and the ability to satisfy the same, comprise the oil that lets the bankruptcy engine operate. *Mullane* not only set forth the parameters for notice to known creditors and interest holders, but it also constitutionally blessed the practice of reasonable general notice for unknown creditors and interest holders (i.e. notice by publication). Notice provisions as outlined in *Mullane* allow bar dates and confirmed chapter 11 plans of reorganization to be treated with the necessary finality, even when not all creditors are known or locatable. Most importantly, *Mullane* and its omnipresent notice analysis still provide the baseline to which all challenged notices are compared. Without *Mullane*, the Bankruptcy Code's machinery would have ground to a halt decades ago.

Butner v U.S., 440 U.S. 48, 99 S. Ct. 914 (1979)

Hon. Daniel P. Collins
United States Bankruptcy Court
District of Arizona

I. Issue

Are property rights in bankruptcy determined by the law where the property is located or by a federal rule of equity?

II. Statutory Context

This case was decided under the Bankruptcy Act of 1898.

III. Facts

This case involved a Chapter XI proceeding under the Bankruptcy Act of 1898. The case trustee was ordered by the Bankruptcy Court to collect and retain rents generated by certain properties. The properties were ultimately sold to Butner, holder of a second mortgage against the properties, for a credit bid of $174,000, leaving an unpaid balance of $185,000. The court was then faced with Butner's motion seeking to have the accumulated rents of $162,971.32 turned over to be applied to the outstanding balance of his second mortgage. The Bankruptcy Court held that, after foreclosure, Butner held only an unsecured claim. The District Court reversed, holding that the pre-bankruptcy appointment of a rental collection agent satisfied North Carolina's requirement of a change of possession for the mortgagee be granted a secured interest in the rents generated by the properties. The Fourth Circuit Court of Appeals reversed, holding that because Butner made no post-bankruptcy demand for rent sequestration, he failed to acquire a security interest in the rents collected by the bankruptcy trustee. The U.S. Supreme Court granted certiorari to resolve a split among the circuits. The Third and Fourth Circuits had adopted a federal rule of equity, which granted mortgagees a secured interest in rents even if state law would not recognize such lien interest until after foreclosure. The Second, Fourth, Sixth, Eighth and Ninth Circuits ruled that the question of whether a mortgagee's lien extended to rents of a property should be resolved by reference to state law.

IV. Holding

Writing for a unanimous court, Justice Stevens stated:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding .... The justifications for application of state law

> are not limited to ownership interests, they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property. *Butner v. U.S.*, 440 U.S. at 55, 99 S. Ct. at 2918.

While the Court noted the bankruptcy court's equitable powers play an important role in the administration of a bankruptcy estate, it went on to state:

> [U]ndefined considerations of equity provide no basis for adoption of a uniform federal rule affording mortgagees an automatic interest in the rents as soon as the mortgagor is declared bankrupt. *Id*. at 56 and 918.

The Supreme Court noted that the resolution of the rights to the collected rents would likely differ from state to state, because some states are so-called "title states" and others are "lien states." The Court, however, did not choose a winner. Rather, it held that federal judges who regularly deal with state law are in a better position to determine how state courts would rule on property issues. The Supreme Court then left it to lower courts to determine the correct application of North Carolina law in this case.

V. Significance

The nature and extent of a bankruptcy estate's property interests is a crucial question in every bankruptcy case. Section 541 of the Bankruptcy Code describes what property is included in a bankruptcy estate, but *Butner* tells us that, unless federal law provides otherwise, property rights in bankruptcy will be determined by reference to applicable state law. This will, of course, result in a lack of uniformity in property rights in bankruptcies across the country. However, this case does serve the Court's apparent desire to not "create asymmetry between bankruptcy and nonbankruptcy property rights unless Congress has clearly forced the difference." Kenneth N. Klee, BANKRUPTCY AND THE SUPREME COURT 97 (2008). This principle is so fundamental to bankruptcy cases that it is cited in over 3,400 reported decisions.

***Till v. SCS Credit Corp.*, 541 U.S. 465, 124 S. Ct. 1951 (2004).**

Hon. Daniel P. Collins
United States Bankruptcy Court
District of Arizona

I. Issue

In the context of a chapter 13 cramdown, which is the proper method for adjusting payments to a creditor to arrive at the present value of the allowed secured claim?

II. Statutory Context

To confirm a chapter 13 plan, with respect to allowed secured claims, a debtor must either: (1) obtain the creditor's acceptance, (2) surrender the collateral securing the claim, or (3) provide for distributions worth at least the allowed amount of the claim. 11 U.S.C. § 1325(a)(5). This third alternative is known as 'cramdown,' because it does not require the secured claimant's acceptance. Because cramdown involves deferred payments, the total dollars paid must be adjusted to compensate for risk, the time value of money, and market trends to arrive at the present value of the allowed secured claim required under 11 U.S.C. § 1325(a)(5)(B)(ii).

III. Facts

Debtors Lee and Amy Till purchased a used truck from Instant Auto Finance, who immediately assigned the debt to SCS Credit Corporation. At the time the bankruptcy was filed, the Debtors owed $4,849.89. The parties agreed the truck was worth only $4,000. The Debtors' proposed plan was to distribute $740 per month to their creditors for three years. The proposed discount rate for valuing the truck was 9.5%, which the Debtors reached via the "prime-plus" formula. SCS objected to this discount rate, arguing that if it was allowed to repossess the vehicle, it could reinvest the proceeds at a 21% interest rate.

IV. Holding

Till offered some uniformity in what was at the time a convoluted and unpredictable arena. In reaching its decision, the Supreme Court was faced with four different approaches to calculating the discount rate. The bankruptcy court overruled SCS's objection and confirmed the plan, approving the formula approach. On appeal, the District Court sided with SCS, favoring the coerced loan approach. The Seventh Circuit modified the coerced approach, arriving at the presumptive rate approach. The Supreme Court also considered the cost-of-funds approach, which was used in some bankruptcy and district courts at the time. Depending on where a debtor filed, or even which judge was assigned to the case, a

Debtor could be faced with any of these methods. So, at first glance, *Till* created predictability and put an end to the confusion.

A plurality of the Court selected the "prime-plus" formula over the coerced loan, presumptive rate, and cost-of-loan approaches. Each of the rejected methods was determined to require a fact-intensive inquiry which would incur significant evidentiary costs which the chapter 13 debtor could not bear. Further, each of the rejected approaches intended "to make each individual creditor whole rather than to ensure the debtor's payments have the required present value." *Till,* 541 U.S. at 477. The plurality found the formula approach did not suffer from any of these problems. It simply augments the national prime rate to compensate for the risk in lending to a debtor who is already in default. How much the prime rate is adjusted depends on "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." *Id.* at 479. While the plurality did not directly hold that the adjustment rate should range between 1% and 3%, it noted that other courts had approved adjustments of 1% to 3%. *Till*, 541 U.S. at 480, *see also In re Valenti,* 105 F.3d 55, 64 (2d Cir. 1997) (collecting cases), abrogated on other grounds by *Assocs. Comm'l Corp. v. Rash,* 520 U.S. 953, 117 S. Ct. 1879 (1997). The Court further suggested that "large adjustments would not be appropriate because a plan cannot be confirmed unless the bankruptcy court finds it feasible." Bruce A. Markell, *To Market, To Market: Momentive and Secured Creditor Cram Down Interest Rates*, THOMPSON REUTERS BANKRUPTCY LAW LETTER, Feb. 2016 at 4.

V. Significance

On a much larger scale, the *Till* decision affirmed that an important purpose of the Bankruptcy Code is to provide relief to debtors, in addition to seeking fair results for creditors. It marked a paradigm shift in the purpose of chapter 13 bankruptcies. The formula approach "depends only on the state of financial markets, the circumstances of the bankruptcy estate, and the characteristics of the loan, not on the creditor's circumstances or its prior interactions with the debtor." *Till,* 541 U.S. at 479. The formula approach often results in creditors being required to carry a loan at rates much lower than they would ordinarily lend given the circumstances. In this way, chapter 13 bankruptcy can now be used by debtors to escape high interest loans, as opposed to merely managing higher rates through a plan which would extend the maturity date.

Additionally, the *Till* plurality pointed out that the Code requires the calculation of a discount rate in a number of contexts beyond §1325(a)(5)(B)(ii), and that it was the plurality's intention that in those contexts, the prime plus formula also be applied. *Till*, 541 U.S. at 474 ("We think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions."). This includes the Chapter 11 context. Within that context, *Till* "significantly alter[ed] the longstanding trend whereby chapter 11 ha[d] evolved into more of an effective creditor remedy than a source of debtor relief." Adrienne K. Walker & Richard E. Mikels, *The Developing Impact of Till v. SCS on Chapter 11 Reorganizations*, ABI Journal, Dec./Jan. 2005. This further demonstrates the plurality's emphasis on providing relief to the debtor, even at the cost of market fairness to the creditor.

VI. Till in the Chapter 11 Context

There is still some uncertainty as to whether or how to apply *Till* in the context of chapter 11 cases. Markel *supra* at 5. While the above-quoted passage seems to suggest that the formula approach should be used wherever interest rates are calculated under the Code, the plurality then goes on to discuss the existence of a market of willing debtor in possession lenders in the chapter 11 context that perhaps make the formula rate approach unnecessary. *Till*, 541 U.S. at n.14. The Sixth Circuit addressed this confusion in *American HomePatient* by holding that the "market rate should be applied in Chapter 11 cases where there exists an efficient market. But where no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the *Till* plurality." *In re Am. HomePatient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005). Despite the acknowledged confusion regarding *Till's* applicability in chapter 11, it seems the trend is to apply the prime plus formula in Chapter 11 cases, as discussed by the Fifth Circuit in *In re Texas Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324, 333 (5th Cir. 2013) ("the vast majority of bankruptcy courts have taken the *Till* plurality's invitation to apply the prime-plus formula under Chapter 11."). Recently, the United States District Court for the Southern District of New York held in *In re MPM Silicones, LLC*, (*Momentive*) that *Till* does apply in the context of chapter 11 cram down. 531 B.R. 321 (S.D.N.Y. 2015). The *Momentive* court further held that the bankruptcy court could choose the 7-year treasury rate as its risk-free rate, instead of the national prime rate, and a 1% to 3% risk adjustment was appropriate. *In re MPM Silicones, LLC*, 531 B.R. at 334-35. That decision is currently on appeal to the Second Circuit.

Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982); *Stern v. Marshall,* 564 U.S. 462 (2011); *Executive Benefits Ins. Agency v. Arkison,* 134 S. Ct. 2165 (2014); *Wellness Int'l Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015)

Brian L. Shaw
Shaw Fishman Glantz & Towbin LLP
Chicago, IL

I. Issue

Did 28 U.S.C. § 1471, and subsequently, does 28 U.S.C. § 157, unconstitutionally confer Article III judicial power on a non-Article III judge?

II. Statutory Context

Articles I and III of the United States Constitution; 28 U.S.C. § 1471 and 28 U.S.C. § 157.

III. Facts and Holdings

The current issue of whether bankruptcy courts have the constitutional authority to resolve disputes "related to" a bankruptcy case reaches back over 30 years to the Supreme Court's decision in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.,* 458 U.S. 50 (1982), and the advent of the Bankruptcy Code in 1978. Courts and bankruptcy practitioners alike continue to grapple with the repercussions of this decision, which has again come to the forefront of bankruptcy law with a string of recent Supreme Court cases that both resolve some old problems yet raise new questions.

In *Marathon*, the debtor, Northern Pipeline filed suit against Marathon Pipeline for breach of contract and other common law causes of action in the bankruptcy court as a proceeding "related to" its bankruptcy case under 28 U.S.C. § 1471. Marathon moved to dismiss the Debtor's complaint, arguing that 28 U.S.C. § 1471 impermissibly conferred Article III judicial power to a non-Article III judge. The Supreme Court eventually agreed with Marathon and, in a plurality opinion, held that "Article III of the Constitution bars Congress from establishing … courts to exercise jurisdiction over all matters arising under the bankruptcy laws." The Supreme Court held that 28 U.S.C. § 1471 "impermissibly removed most, if not all, of the essential attributes of the judicial power from the Article III district court and vested those attributes in a non-Article III adjunct."

In response to *Marathon*, Congress enacted 28 U.S.C. § 157, which authorized bankruptcy courts to enter final orders in "core" matters and "proposed findings of fact and conclusions of law" in noncore matters. Then, almost thirty years later, the Supreme Court again addressed the question of whether the Bankruptcy Code's statutory predicate, this time 28

U.S.C. § 157 and its core/non-core distinction, impermissibly conferred Article III judicial power on an Article I judge, in *Stern v. Marshall,* 564 U.S. 462 (2011). In *Stern*, the Supreme Court followed the reasoning of *Marathon* and held that 28 U.S.C. § 157 violated Article III of the Constitution by allowing a bankruptcy court to enter a final order resolving a state law counter-claim against a creditor of the bankruptcy estate when such action would not necessarily be resolved in the claim resolution process. The Court held that only an Article III judge (e.g., a district court judge) may enter a final order resolving such a dispute, even though Congress defined the action as "core" to the bankruptcy judge's authority in 28 U.S.C. § 157.

Thus the "*Stern* claim" was born: an action that was "statutorily core" under 28 U.S.C. § 157, but constitutionally non-core after *Stern*. The immediate problem after the *Stern* decision was whether bankruptcy courts had the authority to even hear *Stern* claims in light of the *Stern* holding that such claims were not constitutionally "core," but at the same time, could not be defined as non-core under 28 U.S.C. § 157 (because, somewhat circularly, it was already defined statutorily as core under 28 U.S.C. § 157). Essentially, it was an argument that would preclude bankruptcy courts from hearing *Stern* claims until such time as Congress fixed the statutory loop-hole. Appropriately, however, after *Stern*, most bankruptcy courts addressed this problem by holding that the newly defined *Stern* claims were, by default, non-core claims for which they could not enter final judgment, but could enter proposed findings of fact and conclusions of law. Ultimately, the Supreme Court agreed with that proposition in *Executive Benefits Insurance Agency v. Arkison,* 134 S. Ct. 2165 (2014). The Court held that that bankruptcy courts may enter proposed findings of fact and conclusions of law on *Stern c*laims, subject to *de novo* review by the district court. Yet despite the clarity of *Arkison*, the Court did not address one other issue that seemed to go hand in hand with that decision; namely, whether litigants may consent to final adjudication of *Stern* claims by the bankruptcy court. That decision was frustratingly reserved for another day.

That day occurred the following year (mere minutes in Supreme Court time), when the Court issued its opinion in *Wellness Int'l Network Ltd. v. Sharif,* 135 S. Ct 1932 (2015). In *Wellness,* the Court resolved a significant Circuit split, notably disagreeing with the Sixth and Seventh Court of Appeals, and held that "allowing bankruptcy litigants to waive the right to Article III adjudication of a *Stern* claim does not usurp the constitutional prerogatives of Article III courts." Although consent "need not be express," it must be "knowing and voluntary." Thus, some additional clarification was added to the confusion raised by *Stern*.

IV. Significance

Marathon and its progeny are significant for three principal reasons. First, quite simply, is the fact that the 1978 *Marathon* decision rendered the judicial system enacted under the 1978 Bankruptcy Code unconstitutional. Arguably, no other bankruptcy holding by the Supreme Court has resonated throughout the bankruptcy community more than *Marathon* and it progeny.

Second, *Stern*, which brought new life to the decades-old *Marathon* analysis, also brought confusion and the fear of open-ended mayhem to bankruptcy litigation. *Stern's* effects were amplified by the increased number of bankruptcy estates in which principal assets were litigation claims. The uncertainty of how litigants should assert and defend *Stern* claims and how the bankruptcy courts should treat such claims further threatened the concept of expedience and finality necessary to bankruptcy cases, generally. Thankfully, much of this uncertainty was resolved by the Court's decisions in *Arkison* and *Wellness*.

Finally, no series of Supreme Court cases better exemplifies the tortured psyche of the bankruptcy practitioner than *Marathon* and its recent progeny. Whether Article III vs Article I, constitutional verses unconstitutional, or, simply, why is bankruptcy jurisdiction so obtuse, it is not hard to understand why topics related to jurisdiction and constitutionality, especially when in front of the Supreme Court, draw so much interest, concern and trepidation from bankruptcy professionals. And nowhere is this more relevant than with *Marathon, Stern* and their progeny.

Law v. Siegel, 134 S. Ct. 1188 (2014)

Hon. Hannah L. Blumenstiel
United States Bankruptcy Court
Northern District of California

I. Issue

Where a debtor has exempted certain assets from his bankruptcy estate in accordance with specific provisions of the Bankruptcy Code, may a bankruptcy court nevertheless order that those "exempt assets be used to pay administrative expenses incurred as a result of the debtor's misconduct?" *Law*, 134 S. Ct. at 1192.

II. Statutory Context

The filing of a petition for relief under the Bankruptcy Code creates an "estate," consisting of all of a debtor's real or personal property. 11 U.S.C. § 541(a)(1). When the debtor files his petition under chapter 7 of the Bankruptcy Code, the estate is placed under the control of a trustee, who is charged with analyzing the estate and determining whether any assets could be liquidated and the proceeds used to satisfy creditors' claims. 11 U.S.C. § 704(a)(1). If so, the trustee should administer the estate expeditiously. *Id.*

The debtor may, however, exempt from his bankruptcy estate certain kinds of property. 11 U.S.C. § 522(b)(1). Subject to certain exceptions, exempt property "is not liable" for the payment of prepetition debts or "any administrative expense." 11 U.S.C. §§ 522(c), (k). The Bankruptcy Code sets forth an exemption scheme that includes a "homestead exemption," pursuant to which an individual may exempt up to $22,975 of equity in the debtor's residence. 11 U.S.C. § 522(d)(1). A debtor may, however, forego the Bankruptcy Code's exemption scheme in favor of those that might be available under state law. 11 U.S.C. § 522(b)(3)(A).

California opted out of the Bankruptcy Code's exemption scheme and enacted two sets of exemptions. Cal. Civ. Proc. Code § 703.010 *et seq*. and Cal. Civ. Proc. Code § 704.010 *et seq*. Cal. Civ. Proc. Code § 704.730(a)(1) offers a $75,000 homestead exemption.

The Bankruptcy Code empowers bankruptcy judges to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a).

III. Facts

Chapter 7 Debtor Stephen Law claimed a $75,000 homestead exemption under California law and further claimed that his homestead was encumbered by two mortgages, which soaked up any equity that otherwise could have been used to pay his debts. After slogging through five years of litigation, Chapter 7 Trustee Alfred Siegel successfully avoided the junior lien as fraudulent and convinced the bankruptcy court to surcharge the Debtor's homestead exemption under Bankruptcy Code section 105(a) to satisfy the attorneys' fees and costs the Trustee incurred in prosecuting the fraudulent transfer action. The Bankruptcy Appellate Panel for the Ninth Circuit affirmed, 2009 WL 7751415 (Oct. 22, 2009) (per curiam), as did the Ninth Circuit Court of Appeals. *In re Law*, 435 Fed. Appx. 697 (2011) (per curiam). [**Note:** The BAP and 9th Circuit opinions were not published and Mr. Law's petition for certiorari to the Supreme Court of the United States was filed *pro se*].

IV. Holding and Analysis

Notwithstanding the Debtor's "egregious misconduct," section 105(a) did not permit the bankruptcy court to ignore the express provisions of section 522, which remove exempt property from that which may be used to satisfy administrative claims. "It is hornbook law that section 105(a) 'does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code." 134 S. Ct. at 1194 (citing 2 COLLIER ON BANKRUPTCY ¶ 105.01[2], p. 105-6 (16th ed. 2013)).

The Bankruptcy Code vests in the debtor—not the court—the discretion to declare certain property exempt. 11 U.S.C. § 522(b). If a debtor exercises that discretion, the bankruptcy court "may not refuse to honor the exemption absent a valid statutory basis for doing so." *Law*, 134 S. Ct. at 1196. The statutory bases upon which a bankruptcy court may disregard otherwise acceptable exemptions are "mind-numbingly detailed," *id.*, and prove that "Congress balanced the difficult choices that exemption limits impose on debtors with the economic harm that exemptions visit upon creditors." *Law*, 134 S. Ct. at 1197-98 (citing *Schwab v. Reilly*, 560 U.S. 770 (2010)).

Acknowledging the "heavy financial burden" its ruling would impose on Trustee Siegel, as well as the fact that it might lead to "inequitable results for trustees and creditors in other cases," the Court pointed to other means available under the Bankruptcy Code to address debtor misconduct. These include: denial of discharge (11 U.S.C. § 727); Federal Rule of Bankruptcy Procedure 9011 (the bankruptcy counterpart to Federal Rule of Civil Procedure 11); criminal prosecution (18 U.S.C. § 152); and imposition of sanctions (inherent authority and/or 11 U.S.C. § 105(a)).

V. Significance

Law's significance has yet to fully manifest, but it has been discussed in the farthest corners of bankruptcy practice. Certainly it resolved in the negative the issue of whether a bankruptcy court may disallow an exemption solely because the debtor claimed it through fraud or bad faith. *See, e.g.*, *In re Gray*, 523 B.R. 170 (B.A.P. 9th Cir. 2014); *In re Baker*, 791 F. 3d 677 (6th Cir. 2015). But *Law* also has impacted areas in which bankruptcy courts once routinely exercised their equitable powers. For example, in *LightSquared*, Judge Chapman predicted that *Law* would prohibit, as she did, equitable disallowance of claims under Bankruptcy Code § 105(a). *In re LightSquared, Inc*., 504 B.R. 321, 341-42 (Bankr. S.D.N.Y. 2013). And in fact, once *Law* came down, *Picard v. Merkin* (*In re Bernard L. Madoff Inv. Secs. LLC*), 515 B.R. 117 (Bankr. S.D.N.Y. 2014), and *Sher v. JPMorgan Chase Funding, Inc.* (*In re TMST, Inc.*), 518 B.R. 329 (Bankr. D. Md. 2014), ruled exactly that. *In re Headlee Mgmt. Corp*., 519 B.R. 452 (Bankr. S.D.N.Y. 2014) cited *Law* as among many reasons why the bankruptcy court lacked authority under Bankruptcy Code section 105(a) to require disgorgement of fees paid to Chapter 11 counsel purely due to the later Chapter 7 estate's administrative insolvency.

The Tenth Circuit found that *Law* did not prohibit equitable recharacterization. *In re Alternate Fuels, Inc*., 789 F.3d 1139 (10th Cir. 2015). The Ninth Circuit's Bankruptcy Appellate Panel rejected a debtor's argument that *Law* precludes substantive consolidation under Bankruptcy Code section 105(a). *In re Clark*, 548 B.R. 246 (B.A.P. 9th Cir. 2016). And the Seventh Circuit recently recognized that bankruptcy courts continue to have broad statutory authority, which includes the power to enjoin litigation brought in another forum against a non-debtor, when doing so will likely improve the prospects for successful resolution of issues central to the bankruptcy case. *Caesars Entm't. Operating Co., Inc. v. BOKF, N.A.* (*In re Caesars Entm't. Operating Co., Inc.*), 808 F.3d 1186, 1188-89 (7th Cir. 2015).

A case that has generated such a volume of discussion in such a wide variety of contexts certainly merits consideration as one of the most significant Supreme Court cases ever.