Diamonds in the Rough: Top 10 Countdown of Significant Bankruptcy Decisions[1]

#10. *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004). A plurality of the Supreme Court adopted the formula approach (prime rate plus risk factors) to determine cram-down interest rate in Chapter 13 case, rejecting contract rate approach.

Facts:

In *Till v. SCS Credit Corp.*,[2] the Tills bought a used truck for $6,395, putting $300 down and financing the balance under a retail installment contract with 21% annual interest, for a total debt of $8,285.24. When the Tills filed for Chapter 13 bankruptcy, they owed $4,894.89, but the truck securing the claim was worth only $4,000. The Tills had to satisfy the Chapter 13 cram-down provision, 11 U.S.C. § 1325(a)(5)(B), which requires that the property to be distributed to a particular secured creditor over the life of a bankruptcy plan has a total "value, as of the effective date of the plan," that equals or exceeds the value of the creditor's allowed secured claim—here, $4,000. The Tills proposed to pay the $4,000 secured portion of the claim through their Chapter 13 plan in monthly installments that included 9.5% annual interest. The Tills arrived at the 9.5% figure using the "prime-plus" formula, which augments the then national prime rate (8%) to account for the risk of nonpayment. The secured lender, SCS Credit Corp., objected to this treatment, arguing that it was entitled to the 21% contract interest rate that they would otherwise be able to obtain if they could foreclose on the truck and reinvest the proceeds in an equivalent loan.[3]

Holding:

After analyzing the approaches taken by other courts,[4] the Supreme Court ultimately sided with the Tills, holding that "the prime-plus or formula rate best comports with the purposes of the Bankruptcy Code,"[5] and is consistent with other Bankruptcy Code sections that require the bankruptcy court to discount a stream of payments to their present value.[6] The other approaches were complicated, costly, and mistakenly focused on making creditors whole rather than on making sure the debtor's payments have the required present value.[7]

The prime-plus formula advanced by the Tills had none of these defects. The prime-plus formula "entails a straightforward, familiar, and objective inquiry [that] minimizes the need for potentially costly evidentiary proceedings."[8] The national prime rate provides an objective and readily ascertainable starting figure that already

---

[1] Written by Michael Berthiaume & Scott W. Everett (Presented by the Honorable H. Christopher Mott & the Honorable Mark X. Mullin at the 14th Anniversary of the Bankruptcy Bench Bar Conference for the Bankruptcy Law Section of the State Bar of Texas, April 8–9, 2021).

[2] 541 U.S. 465 (2004).

[3] *Till*, 541 U.S. at 470–71.

[4] The lower courts pondered three approaches aside from the prime-plus formula: the coerced-loan rate, the presumptive contract rate, and the cost-of-funds approach. *Id*. at 477–481.

[5] *Id*. at 479–80.

[6] *Id*. at 474 (numerous provisions of the Bankruptcy Code require the Court to discount the "stream of deferred payments back to the[ir] present dollar value")

[7] *Id*. at 474–77.

[8] *Id*. at 479.

accounts for opportunity costs, the risk of inflation, and a slight risk of default.[9] Further, the adjustments required to account for a greater risk of nonpayment can be determined without significant additional expense from information in the debtor's bankruptcy filings and from other relevant information (such as market rates) to which creditors are more likely to have readier access.[10] In all, the Supreme Court determined the prime-plus formula more closely aligned with the mandate of the cram-down provision and the Bankruptcy Code generally.

Importance:

Since *Till*, the interest rate for cram-down in Chapter 13 plans is determined using the prime-plus formula. By implementing a uniform approach to valuation in consumer reorganization plans, the confirmation battlefield narrowed significantly largely to the benefit of consumer debtors. However, the benefit has not been limited to consumer debtors. The "prime-plus" formula approach adopted by *Till* in Chapter 13 cases has been widely used by bankruptcy courts in Chapter 11 cases to determine cram down interest rates. *See, e.g., Wells Fargo N.A. v. Texas Grand Prairie Hotel Realty, LLC (In re Texas Grand Prairie Hotel Realty, LLC*), 710 F.3d 324 (5th Cir. 2013). *But see In re Couture Hotel Corp.*, 536 B.R. 712 (Bankr. N.D. Tex. 2015).

---

[9] *Id*. at 478–79.

[10] *Id*. at 479.

#9. *BFP v. Resolution Trust Corp*., 511 U.S. 531 (1994). The Supreme Court held that a price received at foreclosure sale "properly conducted under state law" is "reasonably equivalent value" and may not be challenged as constructive fraudulent transfer.

Facts:

BFP owned a home in Newport Beach, California and financed the purchase with a secured loan from Imperial Savings Association. Upon default, Imperial foreclosed on the home and sold it to a third party, Paul Osborne. BFP then filed Chapter 11 bankruptcy and a related adversary proceeding to set aside the foreclosure sale as a constructive fraudulent transfer under 11 U.S.C. § 548, asserting that the home Osborne paid only $433,000 at foreclosure was actually worth $725,000.[11]

Holding:

Under 11 U.S.C. § 548(a)(2)(A), a transfer of a debtor's property may be set aside if, among other things, the transfer netted "less than a reasonably equivalent value in exchange for such transfer."[12] The Supreme Court held that the price received at a regularly conducted, noncollusive foreclosure sale constitutes "reasonably equivalent value" as a matter of law and cannot form the basis of a constructively fraudulent transfer.[13]

The Supreme Court rejected BFP's arguments that fair market value was the benchmark when determining whether a debtor receives reasonably equivalent value. The term "fair market value" does not appear in 11 U.S.C. § 548 but does appear in other sections of the Code.[14] Section 548 describes an "entirely novel phrase 'reasonably equivalent value'" that suggests Congress intended something other than fair market value.[15] Further, the Supreme Court noted that "market value" could not possibly be the proper test in the forced-sale context (such as a foreclosure) because forced-sale value is the antithesis of market value.[16] In the words of the Supreme Court, to hold otherwise would create an untenable result—the "title of every piece of realty purchased at foreclosure would be under a federally created cloud."[17] In *BFP*, the Supreme Court also specifically rejected the *Durrett* rule adopted by the Fifth Circuit that if a foreclosure sale yielded less than 70% of fair market value of the property, the foreclosure sale could be challenged as a constructive fraudulent transfer.

Importance:

Under *BFP*, state law real-property foreclosures will be protected from avoidance as a constructive fraudulent transfer under § 548 if the foreclosure was noncollusive and conducted in compliance with state law. But the Supreme Court specifically limited its holding to mortgage foreclosures of real estate and hinted that the result might be different in other contexts, such as tax-lien foreclosures.[18] And beware that state-law foreclosures

---

[11] *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 533–34 (1994).

[12] 11 U.S.C. § 548(a)(2)(A).

[13] *BFP*, 511 U.S. at 545.

[14] *Id*. at 537.

[15] *Id*.

[16] *Id*. at 538.

[17] *Id*. at 544.

[18] *Id*. at 537 n. 3.

arguably are still potentially subject to avoidance as a preferential transfer under § 547 because that section does not use the term "reasonably equivalent value." *BFP* also does not preclude a debtor from bringing a constructive fraudulent transfer suit by challenging whether the lender complied with state foreclosure laws.

#8. ***<u>In re Pilgrims Pride Corp,</u>*** 690 F.3d 650 (5th Cir. 2012). The Fifth Circuit clearly set forth the analytical framework for awarding compensation of professionals in bankruptcy cases.

Facts:

In *In re Pilgrim's Pride Corp.*,[19] the bankruptcy court granted a fee-enhancement request by the chief restructuring officer (CRO) for a Chapter 11 debtor based on superb results in the case. The UST appealed directly to the Fifth Circuit arguing that, under the then-recent Supreme Court opinion *Perdue v. Kenny*,[20] a bankruptcy judge no longer had discretion to enhance a professional's fees. The CRO argued that *Perdue*, a federal fee-shifting case, did not overrule circuit precedent in the bankruptcy arena[21] and did not prohibit fee enhancements for stellar performance.[22]

Holding:

The Fifth Circuit held that *Perdue* did not unequivocally overrule previous precedent in the Fifth Circuit.[23] In the process, the Fifth Circuit went on to summarize the existing framework governing compensation of professionals in bankruptcy cases. The court affirmed that bankruptcy courts have broad discretion to adjust a professional's fees using the existing framework that largely predated the enactment of the Bankruptcy Code.[24] Under that framework, bankruptcy courts should first consider the Lodestar method, which is the number of hours reasonably expended multiplied by the prevailing hourly rate in the community for similar work. The bankruptcy court may then adjust that number upward or downward upon consideration of the twelve *Johnson* factors[25] and the non-exhaustive factors enumerated in the later-enacted 11 U.S.C. § 330(a)(3).[26]

Importance:

[19] 690 F.3d 650 (5th Cir. 2012).

[20] 559 U.S. 542 (2010). In *Perdue*, the Supreme Court analyzed whether attorney's fees under the federal fee-shifting statute, which is based on the lodestar method, may be adjusted to account for extraordinary results. In that case, the Court held that the lodestar method, in isolation, was appropriate because its objective approach "cabins the discretion of trial judges, permits meaningful judicial review, and produces reasonably predictable results." District judges interpreting these fee-shifting statutes do not have discretion to adjust the lodestar amount except in "rare and exceptional circumstances." *Perdue*, 559 U.S. at 552–54.

[21] *See, e.g., In re Mirant,* 354 B.R. 113 (Bankr. N.D. Tex. 2006) (establishing a four-factor test to determine whether a professional may receive an enhancement pursuant to 11 U.S.C. § 330(a)).

[22] *In re Pilgrim's Pride*, 690 F.3d at 653.

[23] "[W]e exercise restraint when determining whether a Supreme Court decision has produced an intervening change in the law: 'for a Supreme Court decision to change our Circuit's law, it must be more than merely illuminating with respect to the case before the court and must unequivocally overrule prior precedent.'" *In re Pilgrim's Pride*, 690 F.3d at 663 (quoting *Technical Automation Servs. Corp. v. Liberty Surplus Ins. Corp.*, 673 F.3d 399, 405 (5th Cir. 2012)).

[24] *See, e.g., In re Lawler*, 807 F.2d 1207 (5th Cir. 1987) (applying Loadstar method in Bankruptcy Act case, followed by application of *Johnson* factors, discussed below).

[25] *Johnson v. Ga. Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974).

[26] *In re Pilgrim's Pride*, 690 F.3d at 656.

Although *Pilgrim's Pride* dealt primarily with fee-enhancement, the Fifth Circuit clearly set forth the framework for analyzing professional compensation to be awarded in bankruptcy cases.[27] In sum, that framework is a two-step process as follows:

> First—bankruptcy courts are to calculate the "Lodestar Amount," which is the number of hours reasonably and necessarily expended times the prevailing hourly rate in the community for similar work.
>
> Second—the "Lodestar Amount" may be *adjusted up or down* by the bankruptcy court, in its discretion, based on the (A) Statutory Factors set forth in §330(a)[28] of the Bankruptcy Code AND (B) the 12 traditional "*Johnson*" factors[29] enumerated in *Johnson v. Ga. Highway Express, Inc.*, 488 F.2d 714, 719 (5th Cir. 1974).

In *Pilgrim's Pride,* the Fifth Circuit continued to recognize that bankruptcy courts have considerable discretion with respect to awarding professional fees.

---

[27] The Fifth Circuit echoed the analytical framework again in the context of fee defense. *See Asarco v. Baker Botts (In re Asarco)*, 751 F.3d 291 (5th Cir. 2014), aff'd, *Baker Botts v. Asarco*, 576 U.S. 121 (2015).

[28] Section 330 Statutory Factors: The Statutory Factors for determining "reasonable compensation" are set forth in section 330(a)(3) of the Bankruptcy Code, which provides, in pertinent part: "In determining the amount of reasonable compensation to be awarded to a professional person, the court shall consider the (i) nature; (ii) the extent; and (iii) the value of such services, taking into account all relevant factors, including: (A) the time spent on such services; (B) the rates charged for such services; (C) whether the services were necessary to the administration of, or beneficial at the time the services were rendered toward completion of, the bankruptcy case; (D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; (E) whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field; (F) whether the compensation is reasonable based on the customary compensation charged by comparably skilled professionals in non-bankruptcy cases

[29] Johnson Factors. The Traditional 12 Johnson factors to be considered by the bankruptcy court are as follows: (1) time and labor required; (2) novelty and difficulty of questions-which is presumably reflected in lodestar amount; (3) skill required to properly perform the legal services-which is presumably reflected in lodestar amount; (4) preclusion of other employment by attorney due to acceptance of the case; (5) customary fee; (6) whether fee is fixed or contingent; (7) time limitations imposed by client or other circumstances; (8) amount involved and results obtained-which is presumably reflected in lodestar amount; (9) experience, reputation, and ability of attorneys and quality of representation- which is presumably reflected in lodestar amount; (10) the undesirability of the case; (11) nature and length of professional relationship with client; and awards in *similar* cases; (12) awards in similar cases.

#7. *Katchen v. Landy*, 382 U.S. 323 (1966). The Supreme Court held that the Seventh Amendment right to a jury trial did not attach to a preference claim against a creditor who had submitted a claim against the bankruptcy estate.

Facts:

In *Katchen v. Landy*,[30] the debtor's former officer was an accommodation maker on the debtor's two notes to a bank. The officer made payments on the notes, both from the company's funds and from his own funds. When the debtor filed for bankruptcy, the officer filed a claim for the personal-fund payments he made, and was met by the trustee's preference claim for the payments made to the bank with company funds. On appeal from an adverse ruling below, the officer argued that the adverse judgment arising from the avoidable transfer was obtained in violation of his Seventh Amendment right to a jury trial.[31]

Holding:

The Supreme Court determined that, despite the Seventh Amendment's right to trial by jury, bankruptcy courts have summary jurisdiction to decide preference actions *when the defendant has filed a proof of claim*.[32]

Importance:

Katchen v. Landy resolved a conflict between seemingly inapposite tenets of federal law: the right to a trial by jury under the Seventh Amendment to the Constitution, and the original jurisdiction vested in bankruptcy courts to conduct proceedings and administer assets of the bankruptcy cases over which they preside. Under *Katchen*, a preference defendant who files a proof of claim submits himself to the equitable process of claims allowance, and no Seventh Amendment jury trial attaches to that equitable process. *Katchen* has been expanded since its announcement. First, in *Granfinanciera, S.A. v. Nordberg*,[33] the Supreme Court held that a defendant in a § 548 fraudulent-transfer action was entitled to a jury trial because that defendant had not filed a proof of claim. The Supreme Court then confirmed the converse in *Langenkamp v. Culp*,[34] holding that a defendant in a preference action is not entitled to a jury trial if that defendant has filed a proof of claim.

---

[30] 382 U.S. 323 (1966).

[31] *Katchen*, 382 U.S. at 328.

[32] *Id*. at 335.

[33] 492 U.S. 33 (1989).

[34] 498 U.S. 42 (1990).

#6. *The Cadle Co. v. Mims (In Re Moore)*, 608 F.3d 253 (5th Cir. 2010). The Fifth Circuit held that a Chapter 7 trustee's proposed settlement of causes of action was a "disposition" (sale) of estate property, and an auction should be conducted to determine the highest and best bid for the causes of action if a creditor is willing to pay more than the settling defendant is offering.

Facts:

In *The Cadle Co. v. Mims (In re Moore)*,[35] Cadle sued Moore, Moore's wife, and two affiliated companies for various claims, including reverse veil-piercing and fraudulent transfers under state law. Moore then filed Chapter 7 bankruptcy, and the veil-piercing and fraudulent-transfer claims became property of Moore's bankruptcy estate. Cadle offered to purchase the claims, but the Chapter 7 trustee elected instead to accept a settlement offer from the defendants for $37,500. After learning of the proposed settlement, Cadle offered $50,000 to purchase the claims and objected to the proposed settlement. Despite Cadle's higher offer, the bankruptcy court and the district court determined that the proposed settlement was in the best interest of the estate and approved the settlement.[36] Cadle appealed.

Holding:

In a matter of first impression, the Fifth Circuit determined that a proposed settlement of estate claims constitutes a disposition of property of the estate under 11 U.S.C. § 363.[37] Because the Chapter 7 trustee's proposed settlement triggered the requirements of § 363, the bankruptcy court was obligated to consider Cadle's higher bid and whether an auction and § 363 sale would be appropriate.[38] The Fifth Circuit did not address whether a trustee could sell all Chapter 5 avoidance powers, noting instead that this sale of a § 544(b) action was merely a sale of the trustee's right to bring claims that existed outside of bankruptcy under state law.

Importance:

The Fifth Circuit explicitly recognized that a settlement of estate causes of action can be a disposition of estate property, triggering a § 363 sale and auction if a higher offer for the estate causes of action being settled is made by a creditor. Notably, the *Moore* case dealt with state law causes of action that belonged to estate (state law fraudulent transfers brought by a trustee under § 544(b) and alter ego claims). The Fifth Circuit in *Moore* declined to address whether a trustee could or should sell Chapter 5 avoidance powers that arise only under the Bankruptcy Code (such as the power to avoid preferences under § 547 or the power to avoid fraudulent transfers under § 548).

---

35 608 F.3d 253 (2010).

36 *In re Moore*, 608 F.3d at 255–57.

37 *Id*. at 263–64.

38 *Id*. at 265.

#5. ***In re Gober***, 100 F.3d 1195 (5th Cir. 1996). The Fifth Circuit addressed the collateral estoppel effect of state court default judgments in § 523(a) dischargeability actions, including a detailed analysis of (i) applicability in no-answer defaults, pre-answer defaults, and post-answer defaults, (ii) the distinction between void and voidable judgments, (iii) the effect of a default judgments on counterclaims and recoupment, setoff and other defensive claims, (iv) the inclusion of attorney's fees and post-judgment interest in the nondischargeable judgment, and (v) the requirements for mandatory and permissive abstention.

Facts:

Gober was a director, officer, and shareholder of architectural firm Terra. Terra terminated Gober and sued him in state court for unauthorized loans and misappropriation of loans and client funds. During the litigation, the court imposed a $1,000 sanction on Gober for discovery abuses and ordered Gober to deposit $1,500 as security for costs for his counterclaims. When Gober failed to comply with this order and failed to respond to discovery, the court granted Tarra's motion to strike his answer, dismissed Gober's counterclaims, and entered a default judgment against him. The court, "after hearing the evidence and arguments of counsel," found that Gober "acted with fraudulent intent" and "acted maliciously and willfully" when he "embezzled, converted, appropriated, and . . . stole $307,284.96" from Terra. The state court entered a final judgment awarding Terra actual damages, exemplary damages, attorney's fees, and post-judgment interest.[39]

When Gober filed a Chapter 7 petition nine years later, Terra objected to the discharge of the judgment debt under 11 U.S.C. § 523(a)(2), (4), and (6). In response, Gober denied Terra's allegations, but Terra filed a motion for summary judgment, arguing that issue preclusion barred Gober from contesting the factual and legal findings of the state court judgment. Gober responded claiming (i) the state court judgment was not a final judgment; (ii) the state court struck Gober's pleadings as a discovery sanction and then improperly entered default judgment; (iii) the state court judgment was void because it failed to conform to the pleadings; (iv) Terra's claims were never "actually litigated," so Terra did not satisfy its burden of proof to establish liability or damages; and (v) the bankruptcy court erred in abstaining from hearing Gober's counterclaims and claims for offsets and credits. The bankruptcy court granted Terra's motion for summary judgment and abstained from considering Gober's offsets, and credits. The bankruptcy court's ruling was affirmed by the district court.[40]

Holding:

Applying Texas rules of issue preclusion,[41] the Fifth Circuit observed that collateral estoppel would bar relitigation of issues of fact between the same adversaries that were actually, fully, and fairly litigated and that were essential to a final judgment in a previous action.[42] A no-answer default judgment, where the defendant fails to answer the plaintiff's complaint, does not meet the "actually litigated" prong of the issue-preclusion test. But the default judgment in *Gober* was a post-answer default judgment, which requires a plaintiff to offer sufficient evidence to meet his burden of proof as if at trial. Post-answer default judgments that are actually litigated for purposes of collateral estoppel may be given preclusive effect in a subsequent dischargeability proceeding in bankruptcy.

---

39 *In re Gober*, 100 F.3d 1195, 1199–1200 (5th Cir. 1996).

40 *Id*. at 1200.

41 Pursuant to the full faith and credit statute, a court must look to the state that rendered the judgment to determine whether the courts of that state would afford the judgment preclusive effect. *Id*. at 1201.

42 *Id*.

Because the state court specifically found malicious and willful conduct "after hearing the evidence and arguments of counsel," Gober was precluded from relitigating the issue of whether his conduct was willful and malicious for the purposes of dischargeability.[43] The Fifth Circuit also found that the state court judgment was not void and that Terra's attorney's fees and post-judgment interest were also nondischargable. Finally, the Fifth Circuit found that the bankruptcy court did not abuse its discretion when deciding to abstain from hearing Gober's counterclaims and claims for offsets and credits.

Importance:

In re Gober answered when (and what type of) a state court default judgment—that contains the required findings to support nondischargeability—is entitled to preclusive effect in a subsequent bankruptcy proceeding. In addition, the Fifth Circuit made clear that attorney's fees and post-judgment interest in such judgments may also be nondischargeable. State court counsel attempting to obtain a post-answer default judgment would be wise to consult a bankruptcy attorney to make sure the default judgment contains sufficient findings to support a nondischargeability judgment.

[43] *Id*. at 1205.

#4. *Brown v. Chesnut*, 422 F.3d 298 (5th Cir. 2005). The Fifth Circuit held that the automatic stay of § 362 applies to "arguable" property of estate, and a creditor can be liable for stay violation for taking action against "arguable" property of estate**.**

Facts:

Brown v. Chesnut[44] occurs at the intersection of bankruptcy law and family law. Three years after her marriage to eventual-debtor Vance Chesnut, Jacqueline Chesnut purchased 2.52 acres of land. Mrs. Chesnut attended the closing without her husband and signed all relevant legal documents alone, including the note, deed of trust, title policy, and warranty deed. The warranty deed recited that the property was acquired by "Jacqueline Chesnut, as her sole and separate property and estate." Even though the debtor Mr. Chesnut did not attend the closing or sign any documents, he asserted that the property was paid for with community funds.[45]

When Mrs. Chesnut became delinquent on the note, the noteholder, John Brown, set the property for foreclosure sale. Mr. Chesnut filed Chapter 13 bankruptcy before the scheduled foreclosure, however, and notified Mr. Brown that he claimed the property as community property under the protection of the automatic stay. Despite notice of the bankruptcy filing and the claimed protections of § 362, Mr. Brown continued with the foreclosure sale and sold the property. Mr. Chesnut then filed an action against Mr. Brown for willful violation of the automatic stay under 11 U.S.C. § 362(h). The bankruptcy court—without deciding whether the property was community property or estate property—concluded that the automatic stay protected the arguable estate property. The district court reversed, concluding that the property was Mrs. Chesnut's separate property and was not protected by the automatic stay.

Holding:

The Fifth Circuit determined that "arguable" property of the estate is protected by the automatic stay, and defined"arguable" property of the estate as "an asset to which the debtor only has an arguable claim of right." Although it was uncertain at the time of the bankruptcy whether the property belonged to Mr. Chesnut's estate, it was subject to a non-frivolous dispute that required examination of legal presumptions and facts regarding Texas community property and separate property issues.[46] The Fifth Circuit found support for its holding in the policy and structure of the Bankruptcy Code that suggested the automatic stay should apply in this scenario. First, the automatic stay, generally, should be construed broadly. Second, the Bankruptcy Code gives bankruptcy courts broad discretion to lift the automatic stay where it deems appropriate, which "evinced an intent to constitute the bankruptcy court as the proper forum for the vindication of creditor rights."[47] Therefore, a creditor who seeks to seize "arguable" property of the estate must ask for permission from the bankruptcy court rather than retroactively seek forgiveness. Otherwise, a retroactive classification of the property to shape the scope of the stay would encourage creditor abuse and foist upon the debtor the burden of vindicating its rights in a later adversary proceeding.[48] Finally, the Fifth Circuit observed that not every bankruptcy involving a claim of a right to property will transform what is obviously not property of the estate into "arguable" property covered by the automatic stay.

---

[44] 422 F.3d 298 (5th Cir. 2005).

[45] Texas law provides for a rebuttable presumption that property purchased during marriage is community property. *Brown*, 422 F.2d at 301.

[46] *Id*. at 303.

[47] *Id*.

[48] *Id*. at 304.

Importance:

At first glance, *Brown v. Chesnut* appears mind-boggling as it seems to extend the protections of the automatic stay from property of the bankruptcy estate to a new category of property—"arguable" property of the bankruptcy estate. At bottom, the Fifth Circuit may basically be saying two things to creditors: (1) if it a close call on whether an asset is property of the estate, the creditor should seek permission of the bankruptcy court before taking action against the asset; and (2) if it is a close call and prior permission of the bankruptcy court is not obtained, the creditor may lose (be held liable for a stay violation) even if the creditor is right (the asset is not property of the bankruptcy estate).

#3. ***Case v. Los Angeles Lumber Products*** 308 U.S. 106 (1939). The Supreme Court recognized the establishment of absolute-priority rule under Bankruptcy Act.

Facts:

The debtor in *Case v. Los Angeles Lumber Products*[49] was a holding company whose principal asset consisted of stock in a shipbuilding subsidiary. The subsidiary's assets, worth approximately $830,000, were dwarfed by the debtor's $3.8 million of liabilities to bondholders. Eight years after filing a "voluntary reorganization," the debtor filed for bankruptcy and proposed a plan that called for the formation of a new corporation that would acquire the assets of the shipbuilding subsidiary. Most of the preferred stock in the new company would be distributed to bondholders, and the common stock would be distributed to certain existing shareholders. This common stock distribution gave those existing shareholders 23% of the assets and voting power in the new corporation, even though they were not providing fresh contributions to the company. Over 90% of the bondholders assented to the plan, but a minority objected. Over the minority bondholders' objections, the district court approved the reorganization, justifying the stock distribution to existing shareholders because of their familiarity with the business and because the bondholders—due to their preferred shares—maintained their relative priority over the shareholders that the bondholders enjoyed before the bankruptcy.[50]

Holding:

The Supreme Court determined that a plan of reorganization cannot be approved where it is not fair and equitable, even though a vast majority of creditors has consented.[51] Citing *Northern Pacific Ry. Co. v. Boyd*,[52] the Court described the "fixed principle" under which creditors are entitled to absolute priority over stockholders against all property of an insolvent corporation.[53] It was not sufficient that the bondholders' preferred shares would have priority over the stockholders' common shares; that priority was still untenable because the stockholders were receiving 23% of the value of the enterprise even though the bondholders would receive less than a 25% distribution in a liquidation.[54] Therefore, the reorganization, as planned, could not be fair and equitable unless the shareholders contributed money or money's worth in capital reasonably equivalent to their distributions. Mere business knowledge and management continuity would not suffice for this new-value contribution.[55]

Importance:

Case established a seminal rule in restructuring cases: the absolute-priority rule. This decision also marks the infancy of the potential "new-value" exception to the absolute priority rule. When later presented with the opportunity, the Supreme Court declined to squarely address whether the "new-value" exception to the absolute priority rule existed under Bankruptcy Code. *See Bank of America Nat'l Trust & Savings Ass'n v. 203 N. LaSalle Street Partnership*, 526 U.S. 434 (1999)(but holding that old equity would be disqualified from participating in a Chapter 11 plan by contributing new value if the opportunity is given exclusively to old equity). Then, the Fifth

[49] 308 U.S. 106 (1939).

[50] *Id*. at 108–113.

[51] *Id*. at 114.

[52] 228 U.S. 482 (1913).

[53] *Case*, 308 U.S. at 115–16.

[54] *Id*. at 119–120.

[55] *Id*. at 122.

Circuit held that the absolute priority rule applied in individual chapter 11 cases, as a matter of statutory construction of the Bankruptcy Code. *See In re Lively*, 717 F.3d 406 (5th Cir. 2013). Finally, with the recent enactment of Subchapter V in 2020, the absolute priority rule was thrown out the window for small business debtors and the "new-value" exception has become irrelevant for this particular class of debtors.

#2. *__Wellness Intl Network v. Sharif__*, 135 S.Ct. 1932 (2015). The Supreme Court held that a bankruptcy court has the constitutional authority to enter final judgment on *Stern* claims with parties' consent, which may be express or implied.

Facts:

In *Wellness Int'l Network, Ltd. v. Sharif*,[56] prior to bankruptcy, a creditor obtained a judgment in federal district court as sanction for the debtor's discovery failures. After the debtor filed Chapter 7, the judgment creditor filed an adversary proceeding seeking denial of the debtor's discharge and a declaration that a particular trust was the debtor's alter ego. The debtor continued his evasive tactics, so the bankruptcy court eventually entered a default judgment in favor of the judgment creditor, which the debtor appealed.[57] During the debtor's appeal, the Supreme Court's *Stern v. Marshall*[58] was published, and the debtor argued that "the bankruptcy court's order should only be treated as a report and recommendation."[59] The district court affirmed, but the Seventh Circuit reversed in part, determining that the debtor's *Stern* objection could not be waived because it implicated structural interests, and holding that the bankruptcy court lacked constitutional authority to enter a final judgment on the alter-ego claim.

Holding:

Despite *Stern's* holding, the Supreme Court determined that bankruptcy judges may adjudicate *Stern* claims (claims designated for final adjudication in the bankruptcy court as a statutory matter but prohibited from proceeding in that way as a constitutional matter) with the parties' knowing and voluntary consent.[60] According to the Supreme Court, the right to personal adjudication before an Article III court is personal and, therefore, subject to waiver.[61] In situations where parties may consent, separation of powers concerns are diminished because parties may, at their option, elect to resolve their dispute without infringement on the prerogative of the federal court.[62] In light of this principle, the Supreme Court found that *Stern* would not compel a different result.[63] Instead, to prevent consent to adjudication in the bankruptcy court would "meaningfully chang[e] the division of labor" in the judicial system.[64] Further, the Supreme Court also held that consent to adjudication in the bankruptcy court need not be express, so long as it is knowing and voluntary.[65] The Supreme Court reversed and remanded to the Seventh Circuit to decide whether the debtor's actions evinced the requisite knowing and voluntary consent, and also whether, as the creditor alleged, the debtor forfeited his *Stern* argument below.

---

[56] 575 U.S. 665; 135 S.Ct. 1932 (2015).

[57] 135 S.Ct. at 1940–41.

[58] 564 U.S. 462 (2011).

[59] *Wellness*, 135 S.Ct. at 1942.

[60] *Id*. at 1944.

[61] *Id*. (citing *Commodity Futures Trading Com'n v. Schor*, 478 U.S. 833 (1986)).

[62] *Id*. at 1944.

[63] *Id*. at 1946.

[64] *Id*. at 1946–47.

[65] *Id*. at 1948.

Importance

The *Wellness* decision of the Supreme Court in 2015 was particularly significant to judges and attorneys in the Fifth Circuit. This is because, using the Supreme Court's 2011 decision in *Stern*, the Fifth Circuit then repeatedly held that a bankruptcy court did not have authority to enter a final judgment on "related to" and "Stern" claims—even if the parties had consented to final adjudication in bankruptcy court. *See Galaz v. Galaz (In re Galaz),* 765 F. 3d 426 (5th Cir. 2014); *BP RE, LP v. Waxahachie Dodge, LLC (In re BP RE, LLC)*, 735 F.3d 279 (5th Cir. 2013); *Frazin v. Haynes & Boone, LLP (In re Frazin),* 732 F.3d 313 (5th Cir. 2013). As a result, for much of 2011 through 2015, bankruptcy judges and litigants in the Fifth Circuit were trying to figure out what claims were "*Stern*" or "related to" claims, were wrestling with proposed findings of fact and conclusion of law, and were requesting district court judges to enter final judgments and final orders—even when all parties had consented to a final adjudication by a bankruptcy judge. That came to an end with the *Wellness* decision of the Supreme Court, which held that the bankruptcy court had constitutional authority to enter final judgments and orders on "related to" and "*Stern*" claims with the express or implied consent of the parties.

By recognizing the efficacy of "implied consent," the *Wellness* decision also helped to prevent bankruptcy litigants from lying behind the log and raising a *Stern* issue on appeal only if they lost in bankruptcy court. In adversary proceedings, revised Bankruptcy Rules 7008 and 7012 now require the pleader to state whether or not they consent to entry of a final judgments or final order of the bankruptcy court.

The *Wellness* decision also re-emphasized the <u>type</u> of limitation that *Stern* placed on adjudication by an Article I bankruptcy judge. *Stern* did not limit the subject matter <u>jurisdiction</u> of a bankruptcy court, which exists regardless of consent of the parties. Instead, *Stern* involved the constitutional <u>authority</u> of a bankruptcy court to enter a final judgment on "related to" and "Stern" claims, which it may do with the express or implied consent of the parties.

#1. ***SURPRISE TO BE REVEALED AT THE 14th ANNIVERSARY OF THE BANKRUPTCY BENCH BAR CONFERENCE FOR THE BANKRUPTCY LAW SECTION OF THE STATE BAR OF TEXAS, APRIL 8–9, 2021.***