

# **The Common Law System Has Really, Terribly, Horribly, Gotten These Cases Wrong**

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## STERN

“To understand how we got where we are, it is necessary to understand where we were.”<sup>1</sup> Professor Countryman made that statement when discussing the 1984 amendments to the Bankruptcy Code, but the tenet remains true today. The historical context behind the formation of the Constitution and our bankruptcy laws are essential to understanding the jurisdiction of our nation’s bankruptcy courts. The Framers of our Constitution “lived among the ruins of a system of intermingled legislative and judicial powers which had been prevalent in the colonies long before the Revolution, and which after the Revolution had produced factional strife and partisan oppression.”<sup>2</sup> In order to correct this problem in their new country, the Framers conceived a system wherein the judiciary would remain independent with “clear heads . . . and honest hearts.”<sup>3</sup> This idea led to Article III of the Constitution and the principle that all issues of private rights must be determined by a judge insulated from the pressures of other branches of our government.<sup>4</sup> Despite the Framers’ clear intentions, however, the boundary between private and public rights is far from clear, even (some would say especially) for our nation’s highest court. A clear example of the “potluck quality”<sup>5</sup> of the public rights doctrine is *Stern v. Marshall*.<sup>6</sup>

On June 23, 2011, the Supreme Court handed down a 5-4 decision in the *Stern v. Marshall* case,<sup>7</sup> holding that a bankruptcy court’s exercise of statutory jurisdiction was unconstitutional when it adjudicated a counterclaim relating to a purely state law cause of action. This decision made it more difficult for debtors and others to sue third parties in the bankruptcy court and allowed defendants to have cases tried in a potentially more favorable forum. This decision is of particular importance to lenders, investment funds, investment banks, and others who are often the targets of suits by debtors.

The proper bounds of bankruptcy court jurisdiction have remained somewhat of an open issue since Congress amended the jurisdiction of bankruptcy courts in 1984 to comply with the Supreme Court’s *Northern Pipeline*<sup>8</sup> decision finding the jurisdictional provisions unconstitutional as they were created in 1978. The tension regarding bankruptcy court jurisdiction arises because bankruptcy judges are Article I judges, lacking important characteristics of Article III judges, such as life tenure and salary protection. Bankruptcy judges can, therefore, only exercise powers available under Article I of the Constitution, as opposed to Article III of the Constitution, which grants the core judicial powers to the judicial branch of the federal government. As the Supreme Court observed in this case, “Article III could neither serve

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<sup>1</sup> Vern Countryman, *Scrambling to Define Bankruptcy Jurisdiction: The Chief Justice, the Judicial Conference, and the Legislative Process*, 22 Harv. J. on Legis. 1, 2 (1985).

<sup>2</sup> *Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211, 219 (1995).

<sup>3</sup> 1 Works of James Wilson 363 (J. Andrews ed., 1896) (alteration omitted), quoted in *Stern v. Marshall*, 564 U.S. 462 (2011).

<sup>4</sup> One of the earliest mentions of restrictions upon the King's ability to proceed against private rights was in the Magna Carta. The original 1215 charter included many protections, including the provision that “[n]o free man shall be taken, imprisoned, disseised, outlawed, banished, or in any way destroyed, ... except by the lawful judgment of his peers and by the law of the land.” A. Howard, *Magna Carta: Text and Commentary* 43 (1964).

<sup>5</sup> *Waldman v. Stone*, 698 F.3d 910, 918 (6th Cir. 2012).

<sup>6</sup> 564 U.S. 462 (2011).

<sup>7</sup> *Id.*

<sup>8</sup> *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

its purpose in the system of checks and balances nor preserve the integrity of judicial decision making if the other branches of the Federal Government could confer the Government's 'judicial power' on entities outside Article III."

### Factual Background

At its heart, the substance of this case revolved around a will dispute. The saga began when Vickie Lynn Marshall (aka Anna Nicole Smith)<sup>9</sup> married billionaire J. Howard Marshall II about a year before his death and did not receive the gift she expected in his will when he died. Vickie sued the deceased's son, E. Pierce Marshall,<sup>10</sup> in state court, alleging that he fraudulently induced his father, J. Howard, to sign a living trust that did not include Vickie. Later, when Vickie filed for bankruptcy, Pierce filed a complaint in Vickie's bankruptcy case (and a related proof of claim) seeking damages for Vickie's allegedly defamatory statements accusing Pierce of engaging in fraud to acquire his father's wealth. Pierce also asked the bankruptcy court to find that his defamation claim was non-dischargeable because the defamatory statements were willful and malicious. As a counterclaim (the "Counterclaim"), Vickie asked the bankruptcy court to find Pierce liable on the bases alleged in the state court action that Vickie had previously filed against Pierce (*i.e.*, that Pierce tortiously interfered with Vickie's expectancy of a gift from J. Howard).

### Procedural Background

The bankruptcy court first ruled against Pierce on his defamation claim against Vickie and then, nearly a year later, held a bench trial and ruled in favor of Vickie on the Counterclaim against Pierce. On appeal to the district court, Pierce argued that the bankruptcy court lacked jurisdiction to enter a final order on the Counterclaim. The district court disagreed with Pierce's reasoning, but agreed that the Counterclaim was not a "core" proceeding before the bankruptcy court as defined in 28 U.S.C. § 157. As a result, the district court chose to treat the bankruptcy court's judgment as proposed, rather than final, and conducted an independent review before entering a judgment in favor of Vickie. Before the federal district court entered its judgment, however, the state court in which Vickie had filed a lawsuit based on the same theories of recovery conducted a jury trial and issued a ruling in favor of Pierce, but the federal district court decided not to give preclusive effect to that judgment. The Ninth Circuit Court of Appeals agreed with the district court that the Counterclaim was a non-core proceeding, but also held that the district court was required to give preclusive effect to the state court's prior judgment.

### The Issues

The Supreme Court recognized two issues in this case. First, did the bankruptcy court have the statutory authority to enter a final order on Vickie's Counterclaim? Under the jurisdictional statute, the bankruptcy court could enter a final order only if the matter were a

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<sup>9</sup> Vickie is now deceased, and the action was carried on by her estate. For simplicity, the term "Vickie" refers to the estate of Vickie Lynn Marshall.

<sup>10</sup> E. Pierce Marshall is also now deceased, and the action was carried on by his estate. For simplicity, the term "Pierce" refers to the estate of E. Pierce Marshall.

“core” bankruptcy matter; otherwise, the bankruptcy court had to enter proposed findings of fact and conclusions of law for the district court. Second, if the bankruptcy court was authorized by statute to enter a final order on this compulsory Counterclaim, is that statute unconstitutional? Both the majority opinion and the dissenting opinion agreed that 28 U.S.C. § 157(b)(2)(C) plainly authorized the bankruptcy court to adjudicate the Counterclaim as a core proceeding,<sup>11</sup> but the majority opinion also held that the statute itself was unconstitutional.

### The Majority’s Analysis

In analyzing the constitutionality of the statute giving bankruptcy courts the authority to finally adjudicate all counterclaims by the estate against persons filing claims against the estate, the Court looked to its own precedent in which it has recognized a category of rights referred to as “public rights,” which Congress could constitutionally authorize non-Article III courts to adjudicate. Public rights were found to include “matters arising between individuals and the Government in connection with the performance of the constitutional functions of the executive or legislative departments that historically could have been determined exclusively by those branches,” but the rule was later broadened to include actions in which the Government is not directly a party. In other words, for the rights to be public rights, they would need to derive from a federal regulatory scheme or be completely dependent upon adjudication of a claim integrally related to particular federal government action. In stark contrast, the Counterclaim was a cause of action derived from state law and “not necessarily resolvable by a ruling on the creditor’s proof of claim in bankruptcy.” The Court distinguished its prior holdings in *Granfinanciera, S.A. v. Nordberg*<sup>12</sup> and *Langenkamp v. Kulp*,<sup>13</sup> which involved fraudulent transfer actions and preference actions by the bankruptcy estate against creditors who had filed proofs of claim, because in those types of actions, section 502(d) of the Bankruptcy Code requires a determination of the preference or fraudulent transfer allegation as part of the claims allowance process. The dissent failed to make this distinction.

As somewhat broader guidance, the Court stated, “When a suit is made of ‘the stuff of the traditional actions at common law tried by the courts at Westminster in 1789,’ *Northern Pipeline*, 458 U. S., at 90 (Rehnquist, J., concurring in judgment), and is brought within the bounds of federal jurisdiction, the responsibility for deciding that suit rests with Article III judges in Article III courts.” A suit for tortious interference involves that sort of stuff.

The Court also analyzed whether Pierce gave the bankruptcy court authority to rule on the Counterclaim because he filed a proof of claim in the bankruptcy case.<sup>14</sup> Even though the parties agreed that Vickie’s tortious-interference Counterclaim was a compulsory counterclaim to Pierce’s defamation claim filed in the bankruptcy case, the Court noted that the Counterclaim was in no way derived from or dependent upon bankruptcy law and did not need to be resolved

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<sup>11</sup> In making this determination, the Court concluded that all core proceedings either arise in a Title 11 case or arise under Title 11.

<sup>12</sup> 492 U.S. 33 (1989).

<sup>13</sup> 498 U.S. 42 (1990).

<sup>14</sup> Pierce had consented to a determination of his defamation claim notwithstanding the dictates of 28 U.S.C. § 157(b)(5), which provides that personal injury claims should be tried in the district court. The Court acknowledged that 28 U.S.C. § 157(b)(5) is not jurisdictional.

in order to address the defamation claim that Pierce filed against the bankruptcy estate. In addition, the Court was convinced that Pierce had nowhere else to go to recover on his claim, and that he could not be said to have waived his constitutional right to adjudication of the Counterclaim by an Article III court simply because he was forced to bring his claim in the bankruptcy proceeding. The Court also held that the bankruptcy court was not an “adjunct” of the district court since the bankruptcy court can enter final judgments.<sup>15</sup>

### The Concurrence

The concurring opinion by Justice Scalia comments on the “factors” that the majority opinion uses to determine “public rights” as having entered the jurisprudence “almost randomly.” This observation holds true for many of the “factors” that now seem to dominate briefing and court rulings. Scalia then takes a narrow view of the authority of Article I courts and limits it to territorial courts, courts-martial, true “public rights” cases (presumably arising between the government and others), and possibly adjudications by federal administrative agencies.

### The Dissent

The dissent argued in favor of a “more pragmatic” approach to the constitutional question and would strike down the statutory bankruptcy scheme only if it presented a “genuine and serious threat” to the separation of powers. The dissent found no such serious threat, citing factors such as the common factual issues involved in the defamation claim and tortious-interference Counterclaim and the supervisory role Article III judges have over bankruptcy cases through appeals to the district court and through the district court’s ability to withdraw the reference. The dissent surprisingly compared the bankruptcy judges to law clerks and the Judiciary’s administrative officials (along with the somewhat more apt comparison with magistrate judges) in an attempt to minimize the importance of the lifetime appointment and salary protection afforded to Article III judges. The dissent also seems to contend that Pierce did not need to file a proof of claim and could have litigated the non-dischargeability of his claim in a state or federal court after the bankruptcy, apparently overlooking the requirements of section 523(c)(1) of the Bankruptcy Code and Bankruptcy Rule 4007, which require a determination of dischargeability by the bankruptcy court. More defensible is the argument by the dissent that the ability of the district court to withdraw the reference under 28 U.S.C. § 157(d) satisfies the Article III requirement. According to the dissent, the Stern ruling would prevent bankruptcy judges from finally determining numerous matters that they currently decide, citing as an example the claim of a landlord for unpaid rent and a counterclaim by the tenant/debtor for breach of the lease and improper recovery of possession of the premises.

This hypothetical may not be universally applicable if a determination of the debtor’s counterclaim would be required to determine the validity and amount of the landlord’s claim under the terms of the lease and the applicable state law and therefore be part of the claims resolution process to be heard by an Article I court, even under the holding of the majority.

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<sup>15</sup> No reference is made in the opinion to 28 U.S.C. § 151, which formerly referred to the bankruptcy court as an “adjunct” of the district court but now refers to the bankruptcy court as a “unit” of the district court.

## Takeaways

Ultimately, the Court emphasized that the relevant question is whether the action at issue stems from the bankruptcy itself and would necessarily be resolved in the claims allowance process. While the four dissenting justices urge a “pragmatic” approach to evaluating the constitutionality of Congress vesting adjudicatory authority in a non-Article III court, a majority of the Court rejected this approach. The dissenting justices apparently believed that the delegation of authority in this case represented a *de minimis* intrusion into the power granted to the Judicial Branch, if any, but the majority opinion took a stricter approach to interpreting the Constitution and noted that “[s]light encroachments create new boundaries from which legions of power can seek new territory to capture.”

The result in this case may have been different if the bankruptcy court had concluded that in order to resolve the Pierce claim for defamation, it was required to determine simultaneously Vickie’s counterclaim for tortious interference. If Vickie was right that Pierce had cheated her, then there would be no claim for defamation. It could then have been argued that determination of the Counterclaim was part of the claim adjudication process permissible under *Granfinanciera* and *Langenkamp*. This apparently was not the case since Pierce’s claim was denied on summary judgment almost a year prior to the trial of Vickie’s Counterclaim on questions relating to Vickie’s knowledge and approval of statements by her attorneys. The dissent recognizes that determination of a claim might require the resolution of a counterclaim but seems to ignore that Pierce’s claim was independently determined.

Footnote 7 of the majority opinion seems to leave open to discussion whether the restructuring of debtor-creditor relations is a public right, and the concurrence of Justice Scalia says that he states no position on the issue. If the collective bankruptcy process that is constitutionally authorized involving an equitable distribution of the property of a bankrupt estate is not a public proceeding involving public rights, then what is it? Are we potentially back to the *in rem* and summary/plenary jurisdictional arguments that existed prior to the enactment of the current Bankruptcy Code in 1978? At least one court has stated that our current bankruptcy system has roots in English common law, stems from the sort of “stuff” reserved for Article III judges, and that an “argument can certainly be made” that every aspect of the bankruptcy process should be overseen by Article III judges.<sup>16</sup>

## The Aftermath

Justice Robert’s assurances that *Stern* “does not change all that much” has not ultimately been true. Regardless of the majority’s intent, *Stern* has resulted in a massive amount of litigation and disagreement. *Stern* has left many bankruptcy judges questioning their role, and whether bankruptcy judges are, in fact, the functional equivalents of “magistrate judges, law clerks, and the Judiciary’s administrative officials.”<sup>17</sup>

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<sup>16</sup> *In re Teleservices Grp., Inc.*, 456 B.R. 318, 327 (Bankr. W.D. Mich. 2011).

<sup>17</sup> *Stern*, 564 U.S. at 515 (Breyer, J., dissenting).

The Supreme Court later expanded upon its holding in *Stern* in *Exec. Benefits Ins. Agency v. Arkison*, by explaining how bankruptcy courts should proceed when encountering a *Stern* claim.<sup>18</sup> In such a case, courts may proceed over the *Stern* claims as non-core within the meaning of section 157(c). Thus, bankruptcy courts can submit proposed findings of fact and conclusions of law to the district court for *de novo* review. The Court held that such review by the district court would cure any potential error in the bankruptcy court’s entry of judgment.

To the relief of many practitioners, our nation’s highest court later expanded further upon its holding in *Stern* by allowing bankruptcy courts to decide *Stern* claims so long as all parties knowingly and voluntarily consented—whether expressly or impliedly.<sup>19</sup> In *Wellness*, the Court addressed the question of whether a party can waive an objection to the constitutional inability of a bankruptcy court to enter a final order. In the case, a judgment creditor brought an adversary proceeding seeking *inter alia* a declaration that a specific trust was the debtor’s alter ego and that the trust assets were property of the estate. The judgment creditor did not challenge the bankruptcy court’s authority to enter a final judgment after *Stern* was decided. In holding that the bankruptcy court had authority to enter a judgment on the judgment creditor’s claim with the parties’ consent, Justice Sotomayor, writing for the majority, reasoned that allowing parties to consent to bankruptcy court determination for *Stern* claims would have a *de minimis* impact on the Judicial Branch.<sup>20</sup> According to the Court, separation of powers concerns are nonexistent when bankruptcy judges remain “subject to control” by the district court and bankruptcy cases are subject to potential withdrawal of the reference to the district court.<sup>21</sup> Justice Sotomayor emphasized *Stern*’s narrow holding and stated that disallowing bankruptcy courts from hearing *Stern* claims with consent would “meaningfully change the division of labor in our judicial system,” contrary to the intent of the Court.<sup>22</sup> Furthermore, Justice Sotomayor explained, “[a]djudication based on litigant consent has been a consistent feature of the federal court system since its inception.” Essentially, private rights are subject to waiver.

Along with its central conclusion, the Court in *Wellness* further discussed the difference between public and private rights. As explained by Justice Sotomayor,

Historically, “*public* rights” were understood as rights belonging to the people at large, as distinguished from the *private* unalienable rights of each individual. This distinction is significant to our understanding of Article III, for while the legislative and executive branches may dispose of public rights at will—including through non-Article III adjudications—an exercise of the judicial power is required when the government want[s] to act authoritatively upon core private rights that had vested in a particular individual. . . .

The Founders carried this idea forward into the Vesting Clauses of our Constitution. Those Clauses were understood to play a role in ensuring that the

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<sup>18</sup> 134 S. Ct. 2165 (2014).

<sup>19</sup> See *Wellness Intern. Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015).

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 1945.

<sup>22</sup> *Id.* at 1947 (internal quotation marks omitted).

federal courts alone could act to deprive individuals of private rights because the power to act conclusively against those rights was the core of the judicial power. . . . Nineteenth-century American jurisprudence confirms that an exercise of the judicial power was thought to be necessary for the disposition of private, but not public, rights.<sup>23</sup>

Even with the flexibility granted by *Wellness* and *Exec. Benefits*, application of *Stern* remains puzzling. Courts are still questioning their authority to enter final orders even on issues that seem to clearly fall under the scope of the bankruptcy court. For instance, courts have called into question the authority of bankruptcy courts to determine what interest a debtor or the estate has in property, since many of these determinations require application of state law.<sup>24</sup> Uniformly, though, courts have held that the determination of this interest is within the authority of bankruptcy courts. Courts have also held that disputes regarding the failure of a debtor to disclose assets of the estate<sup>25</sup> and objections to exemptions are also within the authority of bankruptcy courts.<sup>26</sup> However, one court has held that an action by a bankruptcy trustee to recover an amount allegedly due to the debtor was outside the constitutional authority of the bankruptcy court when the alleged debt was not clearly a receivable.<sup>27</sup>

The claims allowance process has also been cause for discussion notwithstanding *Stern*'s specific reference to adjudication of these issues by the bankruptcy courts.<sup>28</sup> However, a fairly consistent body of law has started to develop in this area. Even if a claim has a state-law element, if the issues to be decided are necessary to the resolution of the claim and are not unrelated to the resolution, the issues may be determined through the claims allowance process as contemplated by *Stern*.

Courts have similar concerns when reviewing liens in the context of a bankruptcy proceeding.<sup>29</sup> Even if a proceeding requires reviewing, discussing, and deciding state law issues,

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<sup>23</sup> *Id.* at 1965–66 (internal citations omitted) (emphasis in original).

<sup>24</sup> *See, e.g., In re Felice*, 480 B.R. 401 (Bankr. D. Mass. 2012); *In re Velo Holdings Inc.*, 475 B.R. 367 (Bankr. S.D.N.Y. 2012); *In re Salander O'Reilly Galleries*, 453 B.R. 106 (Bankr. S.D. N.Y. 2011), *judgment aff'd on other grounds*, 475 B.R. 9 (S.D.N.Y. 2012); *In re AFI Servs., LLC*, 486 B.R. 827 (Bankr. S.D. Tex. 2013); *In re Montemayor*, 547 B.R. 684 (Bankr. S.D. Tex. 2016); *In re Carlew*, 469 B.R. 666 (Bankr. S.D. Tex. 2012), *aff'd on other grounds West v. Carlew*, BR 11-37886-H4, 2012 WL 3002197 (S.D. Tex. July 23, 2012).

<sup>25</sup> *See, e.g., In re Watts*, No. 09-35864, 2012 WL 3400820 (Bankr. S.D. Tex. Aug. 9, 2012); *In re Jackson*, No. 06-36268, 2012 WL 3071218 (Bankr. S.D. Tex. July 27, 2012).

<sup>26</sup> *See, e.g., In re Hill*, No. 08-36267, 2011 WL 6936357 (Bankr. S.D. Tex. Dec. 30, 2011); *In re Saldana*, 531 B.R. 141 (Bankr. N.D. Tex.), *aff'd in part, remanded in part on other grounds*, 534 B.R. 678 (N.D. Tex. 2015), *appeal dismissed* (Oct. 1, 2015).

<sup>27</sup> *In re AFY, Inc.*, No. A10-4060-TLS, 2011 WL 3800120 (Bankr. D. Neb. Aug. 18, 2011).

<sup>28</sup> *See, e.g., Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012); *In re USDigital, Inc.*, 461 B.R. 276 (Bankr. D. Del. 2011); *In re McElwee*, 469 B.R. 566 (Bankr. M.D. Pa. 2012); *In re Connelly*, 476 B.R. 223 (Bankr. E.D. Va. 2012); *In re Stout*, 474 B.R. 803 (Bankr. S.D. Tex. 2012); *In re Ruth*, 473 B.R. 152 (Bankr. S.D. Tex. 2012); *In re Rouette*, 564 B.R. 157 (Bankr. D. Conn. 2017); *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 522 B.R. 41 (Bankr. S.D.N.Y. 2014); *In re Ne. Indus. Dev. Corp.*, 513 B.R. 825 (Bankr. S.D.N.Y. 2014), *adopted*, No. 14-CV-7056 NSR, 2015 WL 3776390 (S.D.N.Y. June 16, 2015); *In re Bavelis*, 773 F.3d 148 (6th Cir. 2014).

<sup>29</sup> *See, e.g., In re Plaza Resort at Palmas, Inc.*, 488 B.R. 50 (D.P.R. 2013); *In re Porst*, 480 B.R. 97 (Bankr. D. Mass. 2012), *aff'd on other grounds*, No. BAP 12-080, 2013 WL 7118196 (B.A.P. 1st Cir. Nov. 20, 2013); *In re Frazer*, 466 B.R. 107 (Bankr. S.D. Tex. 2012); *In re Bigler LP*, 458 B.R. 345 (Bankr. S.D. Tex. 2011); *In re*



if it concerns the determination of the validity, extent, or priority of a lien a bankruptcy court can finally adjudicate such a proceeding. Indeed, these types of determinations are tasks “frequently performed by bankruptcy courts in the course of the claims-allowance process, restructuring the debtor-creditor relationship, liquidation of estate assets, and administration of the estate.”<sup>30</sup>

Adjudication of disputes involving setoff, too, remains unclear. To the extent that a counterclaim of the debtor affords the creditor a right of setoff, section 506 of the Bankruptcy Code treats the creditor as a secured creditor, which may implicate the determination of the counterclaim in the claims resolution process, thus bringing the entire dispute into the authority of the bankruptcy court.

Somewhat surprisingly, even bankruptcy court authority to enter a final decision in disputes regarding the automatic stay -- relief undeniably granted under the Bankruptcy Code -- has been called into question. Unsurprisingly, however, courts have uniformly held that bankruptcy courts have constitutional authority to resolve issues regarding the automatic stay, like claims for a violation of the stay, because such claims are derived directly from the Bankruptcy Code and the resolution of these types of issues do not implicate state law.<sup>31</sup>

Furthermore, bankruptcy courts retain authority in non-dischargeability proceedings to fully adjudicate a creditor’s claim, including instances in which the claim arises from unadjudicated state law causes of action.<sup>32</sup> However, if such a determination involves a counterclaim, the resolution of the counterclaim must be necessary to the court’s determination of whether the claims are dischargeable. In such a case, the determination of the state law cause of action is inextricably tied to the bankruptcy scheme and involves the adjudication of rights created by the Bankruptcy Code. However, the authority to enter a final dollar judgment as part of the adjudication of non-dischargeability may be affected by *Stern*.<sup>33</sup>

The largest split among courts after *Stern* seems to be regarding fraudulent transfer issues.<sup>34</sup> In *Stern*, the majority (albeit in dicta) included a comparison of the Counterclaim at

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*Hudson*, 455 B.R. 648 (Bankr. W.D. Mich. 2011); *In re AFY, Inc.*, 461 B.R. 541 (B.A.P. 8th Cir. 2012); *In re Yotis*, 518 B.R. 481 (Bankr. N.D. Ill. 2014).

<sup>30</sup> *In re Quality Properties, LLC*, No. 10-42783-JJR-11, 2011 WL 6161010, at \*3 (Bankr. N.D. Ala. Nov. 29, 2011).

<sup>31</sup> See, e.g., *In re Cowen*, 849 F.3d 943 (10th Cir. 2017); *Martinez v. Scotiabank De Puerto Rico*, 484 B.R. 536 (D.P.R. 2012); *In re Turner*, 462 B.R. 214 (Bankr. S.D. Tex. 2011), *aff’d on other grounds*, No. 10-3300, 2012 WL 12535013 (S.D. Tex. Mar. 15, 2012); *In re Murrin*, 477 B.R. 99 (D. Minn. 2012); *In re Jefferson Cty., Ala.*, 491 B.R. 277 (Bankr. N.D. Ala. 2013); *In re Williams*, 545 B.R. 917 (Bankr. S.D. Tex. 2016); *In re Acosta*, 540 B.R. 308 (Bankr. S.D. Tex. 2015); *In re Renewable Energy Dev. Corp.*, 500 B.R. 77 (D. Utah 2013).

<sup>32</sup> See, e.g., *In re Cowin*, 492 B.R. 858 (Bankr. S.D. Tex. 2013), *aff’d on other grounds*, 538 B.R. 721 (S.D. Tex. 2015); *In re Nugent*, 484 B.R. 671 (Bankr. S.D. Tex. 2012); *In re Ryckman*, 468 B.R. 754 (Bankr. W.D. Pa. 2012); *In re Hobbs*, No. 10-42736, 2012 WL 4434469 (Bankr. E.D. Tex. Sept. 24, 2012); *In re Sherali*, 490 B.R. 104 (Bankr. N.D. Tex. 2013).

<sup>33</sup> Compare *In re Young-Soo Che*, No. 11 B 700, 2013 WL 2109438 (Bankr. N.D. Ill. May 15, 2013); *In re Weihert*, 489 B.R. 558 (Bankr. W.D. Wis. 2013); *In re Neves*, No. 11-24505-CIV, 2012 WL 1831717 (S.D. Fla. May 17, 2012); *In re Wood*, 503 B.R. 705 (Bankr. W.D. Wis. 2013); with *In re Egbo*, 551 B.R. 869 (D. Or. 2016); *Jacobsen v. Sramek*, No. 4-11-CV-822, 2013 WL 694045 (E.D. Tex. Feb. 26, 2013), *aff’d sub nom. on other grounds In re Jacobsen*, 561 F. App’x 375 (5th Cir. 2014).

<sup>34</sup> Compare *White v. Kubotek Corp.*, 487 B.R. 1 (D. Mass. 2012); *In re Khan*, 488 B.R. 515 (Bankr. E.D.N.Y. 2013); *In re Am. Bus. Fin. Servs., Inc.*, 471 B.R. 354 (Bankr. D. Del. 2012); *Feuerbacher v. Moser*, No. 4:11-CV-272, 2012

issue to fraudulent transfer claims in *Granfinanciera*.<sup>35</sup> Thus, some courts have taken a broad view of *Stern* and have found that the similarities between fraudulent transfer causes of action and counterclaims prohibit fraudulent transfers from being considered “core.”

However, other courts have taken a narrow view of *Stern*, by looking to the thrust of the reasoning of the case. One court made the astute observation that:

[T]he language from *Granfinanciera* that some courts and commentators fear may limit bankruptcy courts' jurisdiction—language relied on by the *Stern* Court -- has been the law for over twenty years. Yet, this Court is not aware of a single case during the twenty years preceding *Stern* challenging a bankruptcy court's authority to enter final judgments in fraudulent conveyance actions.<sup>36</sup>

Courts taking the narrow view of *Stern* have found that unlike the Counterclaim at issue there, “fraudulent conveyance claims ‘flow from a federal statutory scheme,’ and are ‘completely dependent upon adjudication of a claim provided by federal law,’ and the asserted authority to decide them is limited to a ‘particularized area of law.’”<sup>37</sup> Also, as pointed out by some, it is often not possible to rule on the allowance of a proof of claim without first resolving a fraudulent transfer issue.<sup>38</sup>

Understandably, courts are also split regarding a bankruptcy court’s authority over state law contract and tort claims. A minority of courts have found justification for bankruptcy court authority by finding that resolution of the contract or tort claim is necessary to determine the

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WL 1070138 (E.D. Tex. Mar. 29, 2012); *In re TSC Sieber Services, LC*, No. 09-61042, 2012 WL 5046820 (Bankr. E.D. Tex. Oct. 18, 2012); *In re Tyler*, 493 B.R. 905 (Bankr. N.D. Ga. 2013); *In re Prince*, No. 09-43627, 2012 WL 1095506 (Bankr. E.D. Tex. Mar. 30, 2012); *In re Great Gulfcan Energy Texas, Inc.*, 488 B.R. 898 (Bankr. S.D. Tex. 2013); *with In re Lehman Bros. Holdings Inc.*, 480 B.R. 179 (S.D.N.Y. 2012); *In re Se. Materials, Inc.*, 467 B.R. 337 (Bankr. M.D.N.C. 2012); *FTI Consulting, Inc. v. Merit Mgmt. Grp., LP*, 476 B.R. 535 (N.D. Ill. 2012); *In re Bellingham Ins. Agency, Inc.*, 702 F.3d 553 (9th Cir. 2012), *aff'd sub nom. Exec. Benefits Ins. Agency v. Arkison*, 134 S. Ct. 2165, 189 L. Ed. 2d 83 (2014); *In re Pigg*, 515 B.R. 274 (Bankr. D.S.C. 2014), *aff'd*, No. 3:14-CV-03210-JFA, 2014 WL 4536642 (D.S.C. Sept. 9, 2014); *In re HDD Rotary Sales, LLC*, 512 B.R. 877 (Bankr. S.D. Tex. 2014).

<sup>35</sup> “In *Granfinanciera* we rejected a bankruptcy trustee's argument that a fraudulent conveyance action filed on behalf of a bankruptcy estate against a noncreditor in a bankruptcy proceeding fell within the ‘public rights’ exception. We explained that, ‘[i]f a statutory right is not closely intertwined with a federal regulatory program Congress has power to enact, and if that right neither belongs to nor exists against the Federal Government, then it must be adjudicated by an Article III court.’ We reasoned that fraudulent conveyance suits were ‘quintessentially suits at common law that more nearly resemble state law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res.’ As a consequence, we concluded that fraudulent conveyance actions were ‘more accurately characterized as a private rather than a public right as we have used those terms in our Article III decisions.’” *Stern*, 564 U.S. at 492 (internal citations omitted).

<sup>36</sup> *In re Safety Harbor Resort and Spa*, 456 B.R. 703, 717 (Bankr. M.D. Fla. 2011).

<sup>37</sup> *In re Lyondell Chem. Co.*, 467 B.R. 712, 721 (S.D.N.Y. 2012) (citing *Thomas v. Union Carbide Agr. Products Co.*, 473 U.S. 568, 584–585, (1985); *Commodity Futures Trading Com'n v. Schor*, 478 U.S. 833, 856 (1986); *N. Pipeline Const. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982); and *Stern*, 131 S.Ct. at 2614–15 (Scalia, J., concurring)).

<sup>38</sup> See, e.g., *In re Glob. Technovations Inc.*, 694 F.3d 705 (6th Cir. 2012); *In re 4100 W. Grand LLC*, 481 B.R. 444 (Bankr. N.D. Ill. 2012);

creditor's entitlement to relief from the automatic stay,<sup>39</sup> or necessarily resolved in the process of ruling on a creditor's proof of claim.<sup>40</sup> However, clearly, when facing a state law claim that does not stem from the bankruptcy itself, that would not necessarily be decided in the claims allowance process, and that is asserted solely for the purpose of augmenting the estate, bankruptcy courts do not have authority to enter a final decision.

Other issues seem clear as well. For example, all cases that these authors have found to breach the issue have held that motions to dismiss, convert, or reopen a bankruptcy court fall under the constitutional authority of bankruptcy courts because these are matters stemming from the bankruptcy itself.<sup>41</sup> Additionally, courts seem to agree that bankruptcy courts are authorized to enter interlocutory orders, even in proceedings in which the court does not have the authority to issue a final judgment.<sup>42</sup> Courts have also concluded that bankruptcy courts can finally decide issues regarding the employment and payment of estate professionals,<sup>43</sup> consolidation of bankruptcy cases,<sup>44</sup> eligibility for Chapter 13 relief,<sup>45</sup> a debtor's right of redemption,<sup>46</sup> approval of executory contracts and unexpired leases,<sup>47</sup> a trustee's strong-arm powers,<sup>48</sup> turnover orders,<sup>49</sup>

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<sup>39</sup> *In re DiVittorio*, 670 F.3d 273 (1st Cir. 2012).

<sup>40</sup> See, e.g., *In re Black, Davis and Shue Agency, Inc.*, 471 B.R. 381 (Bankr. M.D. Pa. 2012); *In re Somerset Properties SPE, LLC*, No. 10-09210-8-SWH, 2012 WL 3877791 (Bankr. E.D.N.C. Sept. 6, 2012); *In re Freeway Foods of Greensboro, Inc.*, 466 B.R. 750 (Bankr. M.D.N.C. 2012); *In re Oxford Expositions, LLC*, 466 B.R. 818 (Bankr. N.D. Miss. 2011); *In re Sundale, Ltd.*, 499 Fed. Appx. 887 (11th Cir. 2012); *In re TP, Inc.*, 479 B.R. 373 (Bankr. E.D. N.C. 2012).

<sup>41</sup> See *In re McMahan*, 481 B.R. 901 (Bankr. S.D. Tex. 2012); *In re Thalmann*, 469 B.R. 677 (Bankr. S.D. Tex. 2012); *In re Gow Ming Chao*, No. 11-38131, 2011 WL 5855276 (Bankr. S.D. Tex. Nov. 21, 2011); *In re Chovev*, 559 B.R. 339 (Bankr. E.D. N.Y. 2016); *In re Johnson*, 546 B.R. 83 (Bankr. S.D. Ohio 2016); *In re Victor & Stacy Watts*, 557 B.R. 640 (Bankr. N.D. Ill. 2016); *In re Odin Demolition & Asset Recovery, LLC*, 544 B.R. 615 (Bankr. S.D. Tex. 2016); *In re DeRosa-Grund*, 544 B.R. 339 (Bankr. S.D. Tex. 2016).

<sup>42</sup> See e.g. *In re ATP Oil & Gas Corp.*, 550 B.R. 325, 329 (Bankr. S.D. Tex. 2016); *In re Lehman Bros. Holdings Inc.*, 469 B.R. 415 (Bankr. S.D.N.Y. 2012); *In re TMG Liquidation Co.*, No. ADV 11-80212-HB, 2012 WL 4467553 (Bankr. D.S.C. Sept. 26, 2012); *In re Gulf Fleet Holdings, Inc.*, 491 B.R. 747 (Bankr. W.D. La. 2013); *In re Hernandez*, No. 11-10249, 2013 WL 705351 (Bankr. S.D. Tex. Feb. 25, 2013); *In re Pompa*, No. 06-31759, 2012 WL 2571156, (Bankr. S.D. Tex. June 29, 2012); *In re Noram Res., Inc.*, No. 08-38222, 2012 WL 2571154 (Bankr. S.D. Tex. July 2, 2012); *In re Jackson*, 484 B.R. 141 (Bankr. S.D. Tex. 2012); *In re Tri-Union Dev. Corp.*, 479 B.R. 425 (Bankr. S.D. Tex. 2012); *In re ATOM Instrument Corp.*, 478 B.R. 252 (Bankr. S.D. Tex. 2012); *In re Lancelot Inv'rs Fund, L.P.*, 467 B.R. 643 (Bankr. N.D. Ill. 2012); *In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, 2012 WL 2921012 (Bankr. D. Mont. July 17, 2012), *subsequently dismissed*, 585 F. App'x 393 (9th Cir. 2014); *In re Belmonte*, 551 B.R. 723 (Bankr. E.D.N.Y. 2016).

<sup>43</sup> See, e.g. *In re SBMC Healthcare, LLC*, 473 B.R. 871 (Bankr. S.D. Tex. 2012); *In re Bechuck*, 472 B.R. 371 (Bankr. S.D. Tex. 2012); *In re Whitley*, No. 08-60098, 2011 WL 5855242 (Bankr. S.D. Tex. Nov. 21, 2011), *aff'd sub nom. on other grounds* *Baker v. Cage*, No. BR 08-60098, 2012 WL 4486273 (S.D. Tex. Sept. 27, 2012), *rev'd sub nom. on other grounds* *In re Whitley*, 737 F.3d 980 (5th Cir. 2013); *In re Sea Island Co.*, No. 10-21034, 2012 WL 1499489 (Bankr. S.D. Ga. Apr. 10, 2012); *In re Barkany*, 542 B.R. 662 (Bankr. E.D.N.Y. 2015).

<sup>44</sup> See, e.g. *In re LLS Am., LLC*, No. 09-06194-PCW11, 2011 WL 4005447 (Bankr. E.D. Wash. Sept. 8, 2011); *In re Petters Co., Inc.*, 506 B.R. 784, 792 (Bankr. D. Minn. 2013); *In re Owner Mgmt. Serv., LLC Tr. Corps*, 530 B.R. 711, 721 (Bankr. C.D. Cal. 2015), *aff'd sub nom. on other grounds* *OMS, LLC v. Bank of Am., N.A.*, No. CV 15-3876-R, 2015 WL 12712307 (C.D. Cal. Nov. 6, 2015).

<sup>45</sup> See, e.g. *In re Shukla*, 550 B.R. 204 (Bankr. E.D.N.Y. 2016).

<sup>46</sup> See, e.g. *In re Airhart*, 473 B.R. 178 (Bankr. S.D. Tex. 2012).

<sup>47</sup> See, e.g. *In re Great Atl. & Pac. Tea Co., Inc.*, 467 B.R. 44, 58 (S.D.N.Y. 2012), *aff'd sub nom. on other grounds* *Grocery Haulers, Inc. v. Great Atl. & Pac. Tea Co.*, 508 F. App'x 63 (2d Cir. 2013); *In re Lack's Stores, Inc.*, No.

marshalling assets,<sup>50</sup> preferential transfers,<sup>51</sup> and approval of settlements.<sup>52</sup> However, certain other issues may preclude determination by a non-Article III judge, including liability for voidable transfers<sup>53</sup> and breach of fiduciary duty.<sup>54</sup>

The “sheer complexity”<sup>55</sup> of *Stern* has, and will continue to lead to confusion among courts, even in areas that seemed to clearly fall under bankruptcy court jurisdiction prior to *Stern*. As predicted by Justice Breyer in his dissent, the majority’s assertion that *Stern* “does not change all that much” is not necessarily so. If nothing else, *Stern* has forced bankruptcy courts to engage in a “game of jurisdictional ping-pong between courts”<sup>56</sup> and defend their ability to hear even issues related to the most ubiquitous area of bankruptcy law, the automatic stay.

Much of the confusion could be simplified by considering the reasons why the Constitution dictates Article III judges. In 1789, citizens of England had common law rights like contract and tort etc. The problem was that the king had effective control of the courts where people went to have those rights adjudicated. To keep that from happening in the United States, our Constitution set up the federal courts with judges who would be independent, with life tenure and a salary that the king or the Parliament couldn’t reduce. So, if a citizen wanted a

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10-60149, 2012 WL 3043093 (Bankr. S.D. Tex. July 25, 2012), *aff’d*, No. 6:12-CV-37, 2013 WL 4647681 (S.D. Tex. Aug. 29, 2013).

<sup>48</sup> See, e.g. *In re Traverse*, 485 B.R. 815 (B.A.P. 1st Cir. 2013), *rev’d on other grounds*, 753 F.3d 19 (1st Cir. 2014); *In re Universal Mktg. Inc.*, 459 B.R. 573 (Bankr. E.D. Pa. 2011); *In re Perrow*, 498 B.R. 560 (Bankr. W.D. Va. 2013).

<sup>49</sup> *In re Garcia*, 471 B.R. 324 (Bankr. D. P.R. 2012); *In re Prosser*, No. 06-30009, 2013 WL 996367 (D.V.I. Mar. 14, 2013), *aff’d on other grounds*, 574 F. App’x 82 (3d Cir. 2014); *In re Porretto*, 481 B.R. 874 (Bankr. S.D. Tex. 2012); *In re McCrory*, No. 10-36998, 2011 WL 4005455, at (Bankr. N.D. Ohio Sept. 8, 2011); *In re Miles*, No. 09-92601-MHM, 2012 WL 5355960 (Bankr. N.D. Ga. Sept. 20, 2012); *In re Fine Diamonds, LLC*, 501 B.R. 159 (Bankr. S.D.N.Y. 2013).

<sup>50</sup> See, e.g. *In re Lee’s Famous Recipes, Inc.*, No. A11-68463-REB, 2011 WL 7068916 (Bankr. N.D. Ga. Dec. 12, 2011).

<sup>51</sup> See, e.g. *In re Direct Response Media, Inc.*, 466 B.R. 626 (Bankr. D. Del. 2012); *In re R & K Fabricating, Inc.*, No. 10-33878, 2012 WL 2118178 (Bankr. S.D. Tex. June 11, 2012), *adhered to on reconsideration on other grounds*, No. 10-33878, 2012 WL 5928524 (Bankr. S.D. Tex. Nov. 26, 2012); *In re Bison Bldg. Holdings, Inc.*, 473 B.R. 168 (Bankr. S.D. Tex. 2012); *In re Apex Long Term Acute Care—Katy, L.P.*, 465 B.R. 452 (Bankr. S.D. Tex. 2011); *In re MCK Millennium Centre Parking, LLC*, 532 B.R. 716 (Bankr. N.D. Ill. 2015); *In re Miskowicz*, 513 B.R. 553 (Bankr. N.D. Ill. 2014); see also *Katchen v. Landy*, 382 U.S. 323 (1966); *Langenkamp v. Culp*, 498 U.S. 42 (1990).

<sup>52</sup> See, e.g. *In re Ambac Fin. Grp., Inc.*, No. 10-B-15973 SCC, 2011 WL 6844533 (S.D.N.Y. Dec. 29, 2011), *aff’d on other grounds*, 487 F. App’x 663 (2d Cir. 2012); *In re Washington Mut., Inc.*, 461 B.R. 200 (Bankr. D. Del. 2011), *vacated in part on other grounds*, No. 08-12229 MFW, 2012 WL 1563880 (Bankr. D. Del. 2012); *In re Okwonna-Felix*, No. 10-31663-H4-13, 2011 WL 3421561 (Bankr. S.D. Tex. Aug. 3, 2011); *In re ISE Corp.*, No. BR 10-14198 MM 11, 2012 WL 1377085 (Bankr. S.D. Cal. Apr. 13, 2012); *In re Palm Beach Fin. Partners, L.P.*, 527 B.R. 518 (S.D. Fla. 2015), *appeal dismissed* (July 15, 2015); see also James L. Buchwalter, *Construction and Application of United States Supreme Court Decision in Stern v. Marshall*, 131 S. Ct. 2594 (2011), 77 A.L.R. Fed. 2d 23 (originally published in 2013) (discussing cases construing or applying *Stern*).

<sup>53</sup> See, e.g. *In re Teleservices Group, Inc.*, 456 B.R. 318 (Bankr. W.D. Mich. 2011).

<sup>54</sup> *In re Soporex, Inc.*, 463 B.R. 344 (Bankr. N.D. Tex. 2011); *Sergent v. McKinstry*, 472 B.R. 387 (E.D. Ky. 2012); *In re Emerald Casino, Inc.*, 467 B.R. 128 (N.D. Ill. 2012); *Thompson v. Titus Transp., LP*, No. 11-CV-1338-EFM-KMH, 2012 WL 5933075 (D. Kan. Nov. 27, 2012).

<sup>55</sup> *In re Tyler*, 493 B.R. 905, 914 (Bankr. N.D. Ga. 2013).

<sup>56</sup> *Stern*, 564 U.S. at 521 (Breyer, J., dissenting).

determination of his or her basic common law rights, that citizen was entitled to a determination of that dispute by an independent Article III judge that the President or the Congress couldn't fire or penalize with a reduction in salary. However, if the dispute didn't involve one of those basic common law rights but, instead, a right given to the citizen by the Congress or the President, like an equitable share of a bankrupt estate, then adjudication of that dispute could be by someone else, such as an Article I judge. Effectively, this is roughly the distinction between private and public rights. If a dispute is properly determined by an Article I judge, and in the course of that determination the judge determines facts, or rules on legal issues, principles of *res judicata* and collateral estoppel would be applicable to prevent relitigation of those same determinations even if those determinations, if litigated separately, would require an Article III judge. So, the moral of the story is that when confronted with a *Stern* problem, remember the king.

## TILL

Before the United States Supreme Court's decision in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), there were three prevailing approaches in cramdown interest rates: (1) the "cost of funds approach," which sets the rate at the lender's cost of funds;<sup>57</sup> (2) the formula method, which starts with the risk-free rate and then adjusts for risk; and (3) the "coerced loan" approach, which applies the market rate for loans made under similar circumstances. Some courts, in response to the criticism that the coerced loan theory fails because there is no actual market for 100% loan-to-equity financing, employed a "Debt-Equity/Band of Investment Analysis."<sup>58</sup> Under this framework, courts (through expert testimony) determined the rate of return that would be required by the marketplace to provide the financing presented to the secured creditor in the plan. This financing usually consists of a debt component in the maximum loan-to-equity percentage generally accepted by the market and a second priority debt and/or equity component for the remaining percentage. This approach is consistent with the statutory language and economic reality. Other courts held that, in the absence of special circumstances, the prepetition contract rate should be applied.

On May 17, 2004, the Supreme Court announced its decision in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004). In a plurality opinion authored by Justice Stevens, four of the justices rejected the cost of funds and coerced loan approaches to determining the rate of return on cramdown of a secured lender in a Chapter 13 case, and adopted the formula approach which starts with a base rate and then adds percentage points to compensate for risk. Although *Till* is a Chapter 13 consumer debtor case involving a \$4000 truck, the case interprets statutory provisions virtually identical to those in Chapter 11 business reorganizations. Unfortunately, *Till* did not so much smooth the road in Chapter 11 cases as much as create additional potholes and is a good example of how even the learned Justices of the Supreme Court can become confused by basic concepts of financial and economic reality.

Some argue, given that the cost of funds, coerced loan, and contract rate approaches were rejected in *Till*, each now has very limited, if any, application. But the real issue should be: "Did the secured creditor receive something worth \$100 for his \$100?," and not "What theoretical approach did the court take to get the result that the people in black robes wanted to get?" The pre-*Till* cases are useful as examples of when the judges did, or did not, consider the evidence and determine that the debtor was providing an adequate rate of return to meet the fair and equitable requirement of § 1129(b)(2) since even though the terminology used by the courts has changed, many courts still confirm plans that do not comport with the language of the statute, the evidence presented or economic reality.

### The Cost of Funds Approach Cases

The Cost of Funds approach sets the rate of return for the secured creditor at the secured creditor's cost of funds. See 8 *Collier on Bankruptcy* ¶ 1325.06[3][b] (Lawrence P. King ed.,

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<sup>57</sup> This concept confuses the concept of adequate protection with the statutory language of § 1129.

<sup>58</sup> See *In re Cellular Info. Sys., Inc.*, 171 B.R. 926 (Bankr. S.D.N.Y. 1994); *In re Deluca*, 1996 WL 910908 (Bankr. E.D. Va. 1996); *In re Birdneck Apartment Assocs., II, L.P.*, 156 B.R. 499 (Bankr. E.D. Va. 1993).

15th ed. revised 2004); *In re Breisch*, 118 B.R. 271 (Bankr. E.D. Pa. 1990); *Campbell v. Ford Motor Credit Co. (In re Campbell)*, 16 B.R. 496 (Bankr. N.D. Ill. 1982). The rationale for this approach is that the lender may obtain replacement funds for the loan in question at the rate which the lender pays to its funders and re-loan those funds to another borrower at market rates. The cost of funds approach has been criticized based on its underlying assumption that the secured creditor has an unlimited supply of credit. *United Carolina Bank v. Hall*, 993 F.2d 1126, 1130 (4th Cir. 1993) (Chapter 13 case). Since secured creditors have only a limited supply of funds, utilizing some borrowing capacity without providing the usual rate of return forces a loss on the creditor. *Id.* at 1130. The real problem is that this is an adequate protection concept and bears no relationship to the statutory language of §1129 which requires the debtor to give the secured creditor with a \$100 claim, property or a stream of cash payments worth \$100 as of the effective date of the plan. This is an evidentiary issue and not a judicially constructed “approach”.

According to advocates of the cost of funds approach, the lender is appropriately compensated by providing the lender with replacement funds to relend. But the cost of funds approach often leaves both the debtor and the secured creditor unsatisfied. From the debtor’s perspective, the cost of funds approach is flawed because it includes a profit component which some courts believe ought not to be included in the quest for “present value.” From the secured creditor’s point of view, the secured creditor might argue that this approach does not match the statutory language, which requires a present value equal to the claim. This requires a market rate of return. There is no correlation between the lender’s cost of funds, which is based on the lender’s risk profile and business, and the rate of return that the market requires to compensate the lender for its extension of credit to the debtor and provide the lender with the present value of its claim. The Second Circuit, in *In re Valenti*, expressed the view that the cost of funds method more appropriately reflects the present value of a creditor’s allowed claim, but still chose, as a standard rate for all cramdown cases, to fix the market rate of interest at the treasury rate, plus an additional risk premium of 1% to 3%, for the sake of efficiency and ease of administration. *Gen. Motors Acceptance Corp. v. Valenti (In re Valenti)*, 105 F.3d 55, 64 (2d Cir. 1997). This ruling, which was noted, but not endorsed, in *Till* is inconsistent with § 1129 and economic reality.

### **The Formula Approach Cases**

The Second, Eighth and Ninth Circuits applied the formula method to calculate rates.<sup>59</sup> Under this approach, “the court starts with a base rate, either the prime rate or the rate on treasury obligations, and adds a factor based on the risk of default and the nature of the security (the ‘risk factor’).”<sup>60</sup> Courts generally approved risk premiums of anywhere from 0% to 4%.<sup>61</sup>

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<sup>59</sup> *In re Valenti*, 105 F.3d at 63-64 (explicitly rejecting coerced loan theory in favor of formula approach); *United States v. Doud*, 869 F.2d 1144, 1145 (8th Cir. 1989) (approving risk premium of 2% over treasury bond rate); see also *In re Villa Diablo Assocs.*, 156 B.R. 650, 653-55 (Bankr. N.D. Cal. 1993) (applying the formula approach); *In re Computer Optics, Inc.*, 126 B.R. 664, 672-73 (Bankr. D.N.H. 1991) (approving risk premium of 2% over prime).

<sup>60</sup> *Farm Credit Bank of Spokane v. Fowler (In re Fowler)*, 903 F.2d 694, 697-98 (9th Cir. 1990) (holding that the bankruptcy court did not err in using the formula approach but remanding for lack of appropriate factual findings); see also *In re Gramercy Twins Assocs.*, 187 B.R. 112, 123-24 (Bankr. S.D.N.Y. 1995) (approving formula approach based on the agreement of the parties).

The formula approach theoretically does not ignore current market rates, which are relevant considerations.<sup>62</sup> However, several courts have adopted a fixed range of risk premium of 1% to 3%, independent of any requirement to provide evidence of a correlation of that range to the actual risk involved. After the Second Circuit decision in *Valenti*, some courts apparently have concluded that the risk premium cannot exceed 3% regardless of the evidence. This misconception appears to have arisen due to initial comments by courts to the effect that risk premiums are generally within that range (which may have been true in those cases) and has now morphed into an immutable doctrine. If appropriate evidence is presented to the court, the formula method should result in a rate that meets the statutory test, but the arbitrary caps that some courts have adopted do not comport with either the statute or the market reality.

The appropriate discount rate must be determined on the basis of the rate of return that is reasonable in light of the risks involved.<sup>63</sup> Thus, in determining the appropriate discount rate, the court must consider the prevailing market rate for a loan of a term equal to the payout period with due consideration for the quality of the security and the risk of subsequent default.<sup>64</sup> If the debtor and its business and the collateral are relocating from Boise to Baghdad the discount rate will increase considerably.<sup>65</sup>

In *In re Duval Manor Assocs.*,<sup>66</sup> the court confirmed a plan with a 7% rate for payments on a secured creditor's claim under § 1129(b)(2)(A)(i)(II). The rate was determined by starting with the then current risk-free market rate of approximately 6%, which was equivalent to the interest rate on government bonds which could come due on the same year as the secured creditor's indebtedness, which would mature under the plan, and adding a 1% risk premium. The debtor argued that the repayment risk on the loan balance had actually declined from that which existed prepetition due to a decreased vacancy rate at the debtor's apartment building and reduced expenses. The court determined that the debtor's figures were more reasonable than those submitted by the secured creditor who had attempted to construct a fictitious "comparable loan" pursuant to the coerced loan approach. Although the 7% rate coincidentally equaled the rate utilized in a prepetition workout arrangement between the debtor and the secured creditor,

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<sup>61</sup> Compare *In re Jordan*, 130 B.R. 185, 192 (Bankr. D.N.J. 1991) (holding that the most current and accurate market estimate of the present worth of a stream of payments is the prime rate and refusing to add risk premium) with *In re P.J. Keating Co.*, 168 B.R. 464, 473 (Bankr. D. Mass. 1994) (approving a rate of prime plus 4%).

<sup>62</sup> See *In re Fowler*, 903 F.2d at 698.

<sup>63</sup> See *In re Monnier Bros. Inc.*, 755 F.2d 1336 (8th Cir. 1985).

<sup>64</sup> See *In re Monnier Bros. Inc.*, 755 F.2d at 1338 - 1340. See also *In re 360 Inns, Ltd.*, 76 B.R. 573, 587-88 (Bankr. N.D. Tex. 1987); *In re Neff*, 60 B.R. 448, 457 (Bankr. N.D. Tex. 1985), *aff'd without opinion*, 785 F.2d 1033 (5th Cir. 1986); *In re Gene Dunavant & Son Dairy*, 75 B.R. 328 (Bankr. N.D. Tenn. 1987).

<sup>65</sup> See *In re Crosscreek Apartments, Ltd.*, 213 B.R. 521, 544 (Bank. E.D. Tenn. 1997) (holding that a 2% spread over the essentially risk-free T-bill rate would adequately compensate the secured creditor for the risk of non-payment and the expected decrease in the dollar over time); *In re 360 Inns, Ltd.*, 76 B.R. 573, 593-94 (Bankr. N.D. Tex. 1987) (finding that a discount rate of 2.5% above prime was appropriate considering the prevailing rates of a loan for equal term, the quality of the security and the risk of the proposed loan); *In re S.E.T. Income Props., III*, 83 B.R. 791, 794 (Bankr. N.D. Okla. 1988) (using the prime rate as the best evidence of the market rate and then added 1.5% in recognition of the additional risk factors); *In re Computer Optics, Inc.*, 126 B.R. 664 (Bankr. D.N.H. 1991) (holding the primary emphasis for determining an appropriate rate is to determine the appropriate riskless rate to reach the present value of the deferred stream of payments to the secured creditor and provide an upward adjustment for any general risk attributed to the facility of the plan).

<sup>66</sup> *In re Duval Manor Assocs.*, 191 B.R. 622, 631 (Bankr. E.D. Pa. 1996).



the rate was not per se unreasonable. “The observation that work-out loans are not analogous to cramdown plans certainly does not mandate adoption of the coerced loan [*i.e.*, determine the rate that an outside lender would charge if forced to accept the plan’s payment terms and collateralization] analysis.”

In *In re United Chemical Technologies, Inc.*,<sup>67</sup> the court confirmed a plan which provided for a cramdown rate of 1-1/2% above the prime rate for the portion of the debt which would not be amortized. Such a rate was reasonable in light of relatively low risk of repayment and was consistent with the contract rate, which the court believed should always be used as a guide. *United Chemical* adopted the approach utilizing “risk-free rate plus an additional premium for risk.” The *United Chemical* court rejected as unpersuasive the bank’s expert witness evidence that the appropriate risk premium was five or six percent.

Although a proper application of the formula method meets the statutory standard, courts have frequently either been presented with incomplete evidence of the true premium that would be required to provide a present value to the lender for a loan to the reorganized debtor or have ignored the evidence so as not to doom the debtor’s plan. It is certainly understandable that courts would not want to deprive a consumer debtor of his vehicle or allow a secured creditor to foreclose on a small business. However, the statutory language, in effect, requires a market rate of return on the stream of payments with a risk premium that matches the premium that the marketplace would require for that financing.

### Coerced Loan Theory Cases

Several courts employed the “coerced loan theory” to determine the appropriate market rate. The coerced loan theory assumes that the creditor is being forced to loan the debtor the amount of the secured claim and is being repaid pursuant to the terms of the plan. This approach treats the deferred payment structure as a forced loan and requires the debtor to provide a rate of return that corresponds to the rate which the creditor would charge a third-party borrower for a loan of similar terms, collateral and risk.<sup>68</sup> Theoretically, a proper application of the formula approach should arrive at the same rate as the rate determined by the coerced loan theory. In some cases, courts have actually applied the formula method, while paying lip service to the coerced loan theory.<sup>69</sup>

A number of courts, including those in the Third, Fourth, Sixth, Seventh, Tenth and Eleventh Circuit Courts, approved the coerced loan theory.<sup>70</sup> The Sixth Circuit was the first to

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<sup>67</sup> *In re United Chem. Techs., Inc.*, 196 B.R. 716 (Bankr. E.D. Pa. 1996), *rev’d on other grounds*, 202 B.R. 33 (E.D. Pa. 1996).

<sup>68</sup> See 7 COLLIER ON BANKRUPTCY ¶ 1129.06[1][c][ii] at 1129-148, 15th ed. rev. (2004).

<sup>69</sup> See, e.g., *Koopmans v. Farm Credit Servs. of Mid-Am., ACA*, 102 F.3d 874 (7th Cir. 1996) (requiring rate of prime plus 1.5%); *In re Eastland Partners Ltd. P’ship*, 149 B.R. 105, 106-07 (Bankr. E. D. Mich. 1992) (applying formula approach and requiring rate of 275-300 points above Treasury Bill Rate).

<sup>70</sup> See *In re Welco Inds., Inc.*, 60 B.R. 880 (Bankr. 9th Cir. 1986); *In re S. States Motor Inns, Inc.*, 709 F.2d 647 (11th Cir. 1983); *In re Bay Area Servs.*, 26 B.R. 811 (Bankr. M.D. Fla. 1982); *In re McMichen*, 23 B.R. 497 (Bankr. N.D. Cal. 1982); *In re Scovill*, 18 B.R. 633 (Bankr. D. Neb. 1982); *In re Benford*, 14 B.R. 157 (Bankr. W.D. Ky. 1981); *In re Cooper*, 11 B.R. 391 (Bankr. N.D. Ga. 1981); *In re Landmark at Plaza Park, Ltd.*, 7 B.R. 653 (Bankr. D.N.J. 1980). *Koopmans v. Farm Credit Servs. Of Mid-America, ACA*, 102 F.3d 874 (7th Cir. 1996) (nominally

adopt the coerced loan theory in a Chapter 13 context. *Memphis Bank & Trust Co. v. Whitman*, 692 F.2d 427 (6th Cir. 1982). The court held, that absent special circumstances, the proper cramdown rate was the current market rate of interest used for similar loans in the region.<sup>71</sup> In a later Sixth Circuit decision, *In re Kidd*,<sup>72</sup> the court concluded that because *Memphis Bank & Trust Co.* had concluded that bankruptcy courts are generally familiar with the conventional rate for vehicle loans, the debtor's individual risk factors were irrelevant and the appropriate rate for the lender to receive in connection with a Chapter 13 used truck loan would be the average rate for vehicle loans in the debtor's geographic area. The court rejected the lender's contention that the inquiry should be confined to sub prime used truck loans or even used truck loans.

The holding in *Kidd* was subsequently applied to the cram down of a \$250 million dollar syndicated loan to a publicly held national home health care company. In *American Homepatient*,<sup>73</sup> the court concluded that the rate of return to be provided to the secured lender on the \$250 million note contemplated by the plan of reorganization would be the rate for senior secured loans to home health care companies notwithstanding the secured creditor's argument that only approximately \$145 million was available at that rate. The court concluded that *Kidd* required that the specific risk factors of the reorganized debtor were to be ignored and that the conventional rate for loans for senior secured credit to home health care companies would be applied without regard to loan to value ratios, leverage, or other specific risk factors. The court specifically rejected the investment band approach discussed below.

The coerced loan method has been criticized because, in many instances, there is no comparable market for the forced loan created by the plan of reorganization.<sup>74</sup> In fact, the entire concept of "cramdown" is the antithesis of a market rate, which in and of itself, connotes a voluntary lending relationship. As one source recognizes, "in no reported case has a court concluded, based on evidence presented, that any actual market exists in which a lender makes loans to debtors under the circumstances which generally prevail in reorganization."<sup>75</sup> Judge Wedoff has espoused a similar sentiment: "Accordingly, a market-based, non recourse loan for

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applying coerced loan approach but approving calculation method more in line with formula approach); *Gen. Motors Acceptance Corp. v. Jones*, 999 F.2d 63 (3d Cir. 1993) (appropriate cramdown rate in Chapter 13 case was rate lender would charge a third party for a loan of similar character, amount and duration); *United Carolina Bank v. Hall*, 993 F.2d 1126 (4th Cir. 1993) (rate of return should be matched to "that which creditor would otherwise be able to obtain in its lending market"); *Hardzog v. Fed. Land Bank of Wichita (In re Hardzog)*, 901 F.2d 858 (10th Cir. 1990) (approving coerced loan theory in Chapter 12 case and rejecting formula approach on the basis that courts are "not well situated to craft and determine interest rates."); *United States v. S. States Motor Inns, Inc. (In re S. States Motor Inns, Inc.)*, 709 F.2d 647 (11th Cir. 1983) *cert. denied*, 465 U.S. 1022 (1984) (No. 83-790) (rejecting formula approach under 11 U.S.C. § 1129(a)(9)(c)). The Fifth Circuit has been somewhat non-committal, approving the use of the coerced loan theory in one Chapter 13 case, *Green Tree Fin. Servicing Corp. v. Smithwick (In re Smithwick)*, 121 F.3d 211, 214 (5th Cir. 1997) *cert. denied*, 523 U.S. 1074 (1998) (No. 97-1333), but refusing to adopt any particular approach in another. See *In re T-H New Orleans Ltd. P'ship*, 116 F.3d 790, 800 (5th Cir.1997).

<sup>71</sup> See also, *Gen. Motors Acceptance Corp. v. Jones*, 999 F.2d 63 (3d Cir. 1993) (appropriate cramdown rate in Chapter 13 case was rate lender would charge a third party for a loan of similar character, amount and duration).

<sup>72</sup> See *In re Kidd*, 315 F.3d 671, 676 (6th Cir. 2003).

<sup>73</sup> *In re Am. Homepatient, Inc.*, 298 B.R. 152 (Bankr. M.D. Tenn. 2003).

<sup>74</sup> See, e.g., *In re Oaks Partners, Ltd.*, 135 B.R. 440, 444-45 (Bankr. N.D. Ga. 1991); *In re Computer Optics, Inc.*, 126 B.R. 664, 672 (Bankr. D.N.H. 1991).

<sup>75</sup> Hon. John K. Pearson et al., *Ending the Judicial Snipe Hunt: the Search for the Cramdown Interest Rate*, 4 AM. BANKR. INST. L. REV. 35, 46 (1996).

the entire value of [the collateral] is the economic equivalent of a flying pig: it does not and cannot exist.”<sup>76</sup> When no similar market exists, some courts apply a formula-based approach.<sup>77</sup> While it can be argued that Judge Pearson and Judge Wedoff are correct that generally no conventional market exists for 100% loan to value consumer truck loans, such loans can often be obtained in particular market climates, or at high interest rates. In addition, 100% financing for businesses is available in the marketplace through a combination of senior financing, junior financing and equity financing.

Unfortunately, from the secured creditor’s perspective, proper evidence of the rate(s) resulting from a refinancing is not often presented to the courts. From the Chapter 11 debtor’s perspective, the rate(s) resulting from a total refinancing are irrelevant to the cramdown interest rate. Chapter 11 debtors argue that the fact “[t]hat the proposed loan is not similar to loans made in any market does not end the inquiry. Chapter 11 does not implode merely because there is no ‘market’ for loans of the sort that can be forced upon a secured claimholder under 1129(b).”<sup>78</sup> Instead, the Code strikes a balance among the interests of a debtor’s constituencies and allows the cramdown of secured creditors so value can be preserved for unsecured creditors and equity holders. Chapter 11 and Chapter 13 debtors are entitled, under §§ 1129(b) and 1325 of the Bankruptcy Code, respectively, to force their lenders to restructure their loan despite the 100% loan-to-value ratio; however, the secured creditor is entitled to the rate of return applicable to 100% financing.

### **Other Cramdown Calculations**

#### **Band of Investment Cases**

In response to the criticism that the coerced loan theory fails because there is no actual market for 100% loan-to-equity financing, some courts have employed a “Debt-Equity/Band of Investment Analysis.”<sup>79</sup> Under this framework, courts (through the testimony of expert witnesses) determine the rate of return that would be required by the marketplace to provide the financing presented to the secured creditor in the plan. This financing usually consists of a debt component in the maximum loan-to-equity or loan to EBITDA<sup>80</sup> percentage generally accepted by the market and a second priority debt and/or equity component for the remaining percentage. As an example of the investment band approach, in *In re Birdneck*, a secured lender to the single asset real estate debtor objected to a cramdown rate of 8.25%. The lender’s expert testified that although no market existed for a 100% loan to value ratio loan, he could construct a hypothetical financing for a 70% first priority debt portion and a 30% second priority equity portion. Accepting the expert’s testimony that the market rates for the first and second priority portion

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<sup>76</sup> *In re 203 N. LaSalle St. L.P.*, 190 B.R. 567, 580 (Bankr. N.D. Ill. 1995) *rev’d on other grounds* 182 F.3d 922 (7th Cir. 1999).

<sup>77</sup> See *In re River Village Assocs.*, 161 B.R. 127, 138-39 (Bankr. E.D. Pa. 1993).

<sup>78</sup> *In re Aztec Co.*, 107 B.R. 585, 588 (M.D. Tenn. 1989).

<sup>79</sup> See *In re Cellular Info. Sys., Inc.*, 171 B.R. 926 (Bankr. S.D.N.Y. 1994); *In re Deluca*, 1996 WL 910908 (Bankr. E.D. Va. 1996); *In re Birdneck Apartment Assocs., II, L.P.*, 156 B.R. 499 (Bankr. E.D. Va. 1993).

<sup>80</sup> An acronym for Earnings Before Interest, Taxes, Depreciation and Amortization.

were 8.66% and 14% respectively, the court denied confirmation, holding that a blended rate of over 10% would be required by § 1129(b).<sup>81</sup>

Recognizing that the differences between the formula and coerced loan approaches are somewhat superficial, Judge Lifland applied the investment band technique in *In re Cellular Info. Sys., Inc.*<sup>82</sup> Based on expert testimony, Judge Lifland bifurcated the note into a \$46 million senior band to be paid at LIBOR plus 2.8% and a subordinated band of \$48.5 million to be paid at LIBOR plus 4.8% for a blended rate of LIBOR plus 3.82%. Since this blended rate exceeded the debtors' proposed rate by 82 basis points, Judge Lifland denied confirmation. This investment band approach most closely complies with both the statutory language and market reality in the context of a business Chapter 11 case.

### **Contract Rate Cases**

In *In re Monnier Brothers*,<sup>83</sup> the debtor proposed a discount rate equal to the treasury bill rate, which was below the contract rate. The secured creditor failed to produce evidence to rebut the debtors' argument that the treasury bill rate should be used, and the debtor failed to produce evidence of the rate used in similar transactions in the market. Without any evidence, and based upon the facts that (i) the secured creditor was over secured; (ii) only twenty months had passed between the original date of the contract and confirmation; and (iii) the note proposed in the plan had similar terms as the original contract, the court held that the contract rate was an appropriate interest rate under § 1129(b)(2)(A)(i)(II). Prior to *Till*, the Fifth Circuit expressed approval for using the contract rate in some cases stating that “[o]ften the contract rate will be an appropriate rate.”<sup>84</sup>

Some other circuits put even more emphasis on the contract rate by making it the presumptive rate in determining the rate in a cramdown. In *Till*, the Seventh Circuit (which was later reversed) held that, in most cases, the contract rate would serve as the best “approximation of the proper rate.”<sup>85</sup> The Seventh Circuit cited the Third Circuit in *Gen. Motors Acceptance Corp.* as support for using the contract rate as the presumptive rate of interest in such cases.<sup>86</sup> The Fifth Circuit also adopted the contract rate as the presumptive rate, in Chapter 13 cramdowns only, by citing the same passage of *Gen. Motors Acceptance Corp.*, then proclaiming “[w]e are persuaded by the Third Circuit approach.” While the *Gen. Motors Acceptance Corp.* case claims that the contract rate should have some presumption in favor of its use, the court states that such a presumption should only be used if there can be no “stipulation regarding the creditor’s current rate for a loan of similar character, amount, and duration.” Furthermore, the Third Circuit was optimistic that if documents are “regularly maintained” by the creditor

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<sup>81</sup> See also *In re Deluca*, 1996 WL 910908 at \* 14 (concluding that 9% was an appropriate blended rate based on an 80% debt component at a market rate of 7.8% and a 20% equity component at a rate of 14%).

<sup>82</sup> *In re Cellular Info. Sys., Inc.*, 171 B.R. 926 (Bankr. S.D.N.Y. 1994).

<sup>83</sup> *In re Monnier Bros.*, 755 F.2d 1336 (8th Cir. 1985).

<sup>84</sup> See *In re Briscoe Enters.*, 994 F.2d 1160, 1169 (5th Cir. 1993) *cert. denied*, 510 U.S. 992 (U.S. Nov. 29, 1993) (No. 93-516).

<sup>85</sup> *Till*, 301 F.3d at 593. While acknowledging that courts still have “significant discretion in the application of the method described in this opinion,” the Seventh Circuit made the contract rate the presumptive rate. *Id.* at 593, 592.

<sup>86</sup> *Till*, 301 F.3d at 592-93 (quoting *Gen. Motors Acceptance Corp. v. Jones*, 999 F.2d at 70-71). *But see In re Yett*, 306 B.R. 287, 294 (B.A.P. 9th Cir. 2004) (refusing to adopt a presumption in a Chapter 12 case).

regarding the market rate of loans, then in “most instances” the debtor and creditor will stipulate to the interest rate.<sup>87</sup>

In some cases, like *Cardinal Federal Savings & Loan Ass’n v. Colegrove*,<sup>88</sup> courts used the contract rate as a maximum limit on the interest rate that can be derived from the interest on similar loans in that region.<sup>89</sup> However, more recently, in *Kidd*, the Sixth Circuit correctly held that the contract rate is not to be used in this way.<sup>90</sup>

Most circuits adopted the same standards with regard to the determination of rates in a cramdown regardless of whether the case is a chapter 11, chapter 12, or chapter 13 case.<sup>91</sup> However, the Fifth Circuit in *Smithwick* correctly argued that chapter 13 and chapter 11 cases ought to be treated differently.<sup>92</sup> In a previous case, *In re T-H New Orleans Ltd. P’ship*, the Fifth Circuit declined to adopt a specific “formula” to generate the relevant cramdown interest rate.<sup>93</sup> The *T-H New Orleans* court went on to assert that it “will not tie the hands of the lower courts as they make the factual determination involved in establishing an appropriate interest rate; they have the job of weighing the witness’ testimony, demeanor and credibility.”<sup>94</sup> Later in *Smithwick*, the Fifth Circuit held that this approach should be superseded by a presumption in favor of the contract rate in Chapter 13 cases because “[t]he type of expert testimony on valuation that is presented in complex Chapter 11 cases is not practical for the typical Chapter 13 case.”<sup>95</sup>

### **Workout Rate Cases**

A few courts compared the forced loan situation to a loan workout and have required a discount rate commensurate with the standard workout rate.<sup>96</sup> As few published opinions adopt this approach, most courts are unlikely to consider the workout rate, whatever that means, as the appropriate standard.

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<sup>87</sup> *Gen. Motors Acceptance Corp. v. Jones*, 999 F.2d at 70.

<sup>88</sup> *Cardinal Fed. Sav. & Loan Ass’n v. Colegrove (In re Colegrove)*, 771 F.2d 119 (6th Cir. 1985), superseded by statute as stated in *In re Howard*, 212 B.R. 864 (Bankr. E.D. Tenn. 1997).

<sup>89</sup> *Colegrove*, 771 F.2d at 123.

<sup>90</sup> *See In re Kidd*, 315 F.3d 671, 676 (6th Cir. 2003) (limiting the holding in *Colegrove* to its specific facts).

<sup>91</sup> *See In re Equip. Finders, Inc.*, No. 302-02211, slip op. at 11 (Bankr. M.D. Tenn. received for entry Apr. 9, 2003) (asserting that the 6th Circuit has adopted the same standard for cramdowns in chapter 11, 12, and 13 due to the similarities among these provisions).

<sup>92</sup> *In re Smithwick*, 121 F.3d at 214-15.

<sup>93</sup> *In re T-H New Orleans Ltd. P’ship*, 116 F.3d 790, 800 (5th Cir. 1997).

<sup>94</sup> *In re T-H New Orleans Ltd. P’ship*, 116 F.3d at 800.

<sup>95</sup> *Smithwick*, 121 F.3d at 215.

<sup>96</sup> *See In re Stratford Assocs. Ltd. P’ship*, 145 B.R. 689, 703 (Bankr. D. Kan. 1992); *In re Landing Assocs.*, 157 B.R. 791, 821 (Bankr. W.D. Tex. 1993).

***A Winding Road in Chapter 13: Straightforward  
Application of The Formula Approach***

*Till* holds that **in a Chapter 13 case** a cramdown interest rate must be calculated using a formula of the prime rate plus a risk adjustment based on “the circumstances of the estate, nature of the security, [and] duration and feasibility of the plan.” *Till*, 541 U.S. at 479.

In choosing the formula approach, the Plurality leveled three general criticisms at the coerced loan, presumptive contract rate, and cost of funds approaches: “each of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor’s payments have the required value.” *Till*, 124 S.Ct. at 1960. Additionally, the Plurality criticized the presumptive contract rate because, like the coerced loan approach, it “. . . improperly focuses on the creditor’s potential use of the proceeds of a foreclosure sale,” requires expensive fact-gathering by the debtor on lenders’ overhead, rewards inefficient, poorly-managed lenders, and creates vastly different and inconsistent cram down rates. *Id.* *Till* thus adopted the formula or “prime plus” approach in Chapter 13 cases to avoid what it viewed as the pitfalls of the other methods.

***Creating Problems in Chapter 11: Enter the Footnote  
and the “Efficient Market” Approach***

In what has become an oft-cited and much-debated footnote, *Till* makes the following observation: “when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce.” *Till*, 124 S. Ct. at 1960, n. 14. *Till* thus alluded to the argument that the inquiry in setting a cramdown interest rate in Chapter 11 may be something other than the simple formula approach. In Chapter 11, the footnote muses, it “might make sense” to perform a reality check, so to speak, on a proposed interest rate by reference to what an “efficient market” would produce. Whether the Supreme Court intended the footnote as an off-handed comment or as the articulation of a new rule of law remains unclear.

Thus, four of the justices rejected the cost of funds and coerced loan approaches and adopted the formula approach, which starts with a base rate and then adds percentage points to compensate for risk. The plurality noted that similar approaches should be taken in determining rates of return in both Chapter 13 and Chapter 11. The plurality also noted that the need for expensive evidentiary proceedings should be minimized (probably influenced by the small amounts at issue in Chapter 13 cases) and that in a Chapter 13, the individual debtor is under court supervision and the risk of default is “somewhat reduced.”

The *Till* court noted that while there is no readily apparent Chapter 13 “cram down market rate of interest,” debtor-in-possession loans are readily available in Chapter 11 and that when choosing a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. This ignores the distinction between DIP financing (theoretically voluntary new loans in which lenders are granted extensive statutory protections but often just a rollover of prepetition loans with little additional new money provided) and an involuntary cramdown loan created under a plan of reorganization. A more appropriate analogy would be to look to the rate of return required for exit financing for the reorganized debtor that

matches the stream of payments provided for by the plan, an approach rejected in the *Momentive* case.<sup>97</sup>

The plurality also rejected the coerced loan approach, concluding that the coerced loan approach overcompensated creditors because the market lending rate to non-debtors covers factors like transaction costs and overall profits that are not relevant in the context of court administered and supervised cramdown loans. But the plurality was addressing Chapter 13 cases where the court still supervises the post confirmation debtor. This is not true in Chapter 11. A bankruptcy court misapplies the coerced loan theory and effectively under-compensates the debtors' lenders if it concludes that the appropriate rate should not contain a risk adjustment consistent with a debtor's plan. The plurality also rejected the "presumptive contract rate" approach, which starts with a presumption that the pre-bankruptcy contract rate is appropriate, and the cost of funds approach, which pegs the rate to the cost to the lender of obtaining replacement funds to loan to another borrower because both approaches require inquiry into the financial status of the creditor, not the debtor and his plan.

The plurality adopted the formula approach, which starts with the prime rate and adds a risk adjustment to reflect the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan. The plurality concluded that a hearing must be held at which the debtor and creditors may present evidence about the appropriate risk adjustment and, since lenders have greater access to evidentiary resources than consumer debtors, the evidentiary burden should be placed on the creditor. The plurality specifically did not decide the proper amount of the risk adjustment, but noted that other courts have "generally approved adjustments of 1% to 3%," citing the *Valenti* case from the Second Circuit that several courts have interpreted as placing a 3% cap on risk adjustments. The plurality did not specifically adopt the arbitrary 3% cap and to do so would have been inconsistent with the ruling of the plurality that the rate should reflect the risk of the debtor's plan. The plurality, however, also noted that there is a dispute about the scale of the risk in Chapter 13 and that it did not need to resolve that dispute in its opinion. The plurality stated that the trial court must determine that the debtor would be able to make the payments under the plan and that the court should select a rate high enough to compensate the creditor for its risk, but not so high as to "doom the plan."<sup>98</sup> If the likelihood of default is so high as to necessitate an "eye-popping" interest rate, the plan probably should not be confirmed. "Perhaps bankruptcy judges currently confirm too many risky plans, but the solution is to confirm fewer such plans, not to set the default cram down rates at absurdly high levels, thereby increasing the risk of default." *Till*, 541 U.S. at 482-83 (2004).

The four dissenting justices (opinion authored by Justice Scalia) agreed with the plurality on most issues except where to start the calculation. The dissent, however, concluded that the contract rate, rather than the prime rate, was closer to reality in most cases and that the contract rate should be presumptive, subject to adjustment based on the evidence presented by either

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<sup>97</sup> *In re MPM Silicones, LLC*, 14-22503-RDD, 2014 WL 4436335, at \*24 (Bankr. S.D.N.Y. Sept. 9, 2014), aff'd, 531 B.R. 321 (S.D.N.Y. 2015) aff'd 531 B.R. 321 (S.D.N.Y.), currently on appeal to the Second Circuit.

<sup>98</sup> See *In re Pokrzywinski*, 311 B.R. 846, 850 (Bankr. E.D. Wis. 2004) (holding that, in light of the *Till* decision, an add-on interest rate of 11.25% is excessive).

party. The dissent view confirmed Chapter 13 plans as much more risky than the view of the plurality, and noted that in the *Till* case, where the lower court confirmed a plan with a 1.5% premium, it was apparent that the risk factor was wrong -- not by a couple of percentage points, but “probably by roughly an order of magnitude.” The dissent indicated that the 1% to 3% cap suggested by *Valenti* and other courts is not appropriate and concluded that the *Valenti* holding does not provide fair compensation to the lender and is the result of bankruptcy judges succumbing to the entirely understandable desire to not require that an “unfortunate debtor pay triple the prime rate as a condition of keeping his sole means of transportation.”

Justice Thomas concurred with the plurality in a separate opinion, but held that no risk premium was necessary because he made a distinction between plans that just promise a cash payout in a Chapter 13 case and plans that distribute a note or other form of property. He came to this conclusion by reading the statute to simply require a valuation of the property (the cash in the case of a Chapter 13 plan), not the promise to pay the cash as set forth in the plan. The other justices rejected this distinction. But even Justice Thomas appears to conclude that a risk adjustment would be appropriate where a note (non-cash property) is involved.

As for the footnote, it illustrates the problems with focusing on the case law instead of the statutory language. Case language can be taken out of context, manipulated, stretched, quoted and re-quoted so that it gains a whole new meaning. One court’s dicta become another court’s holding.

### ***The Post-Till Road***

Post-*Till*, it may be argued that judges believe that there are only two available methods for calculating a cramdown rate of interest in Chapter 11 - the “efficient market” approach or the formula approach. In applying *Till*, the several courts have held that, in the Chapter 11 context, courts must first evaluate whether an “efficient market” exists. If so, the rate of interest produced by that market is the rate that should be applied when the secured creditor’s claim is crammed down. If no efficient market exists, default to the formula approach-produced rate is appropriate. Other courts have rejected the market entirely.<sup>99</sup>

Although this sounds simple enough, the reality of identifying and implementing the rate the “efficient market” produces has proven to be anything but simple. As discussed below and as aptly illustrated by the divergent arguments in recent cases, the “efficient market” rate inquiry rises and falls on how one defines “the market” – and that is anything but simple.

### ***In re Prussia Assocs. 322 B.R. 572 (Bankr. E.D. Pa. 2005)***

The Prussia court was one of the first to address *Till* in a Chapter 11 context. The court therefore engaged in a detailed analysis of *Till* and the extent to which *Till* was “controlling” or even “relevant” in the Chapter 11 context, ultimately concluding that *Till* was “instructive” but not controlling and that a complex Chapter 11 case such as *Prussia* was indeed the “object instance for consideration of the exception which the Supreme Court discusses in the ... footnote,” i.e.: the efficient market analysis. This conclusion of the *Prussia* court was important

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<sup>99</sup> In re MPM Silicones, LLC, *supra*.



when made as it was the first of many courts to so conclude. However, the noteworthy holding of *Prussia* is not the conclusion that an “efficient market” analysis is necessary in Chapter 11.

The more interesting part of *Prussia* is that court’s conclusion that all of the evidence that the debtor and creditor presented in that case was deemed insufficient to allow the court to gauge an “efficient market” rate. Both the debtor and the secured creditor offered testimony from experts about the strength of the present transactional market, the availability of financing therein, and those experts’ opinions of the rate(s) available to the debtor. However, despite this testimony, the court found that the experts were “to a degree off-setting.” The court found that since the experts’ testimony was based on “pure judgment calls,” “anecdotal stories” about other transactions and “their visceral instincts about the state of the marketplace,” it was ultimately not helpful. The *Prussia* court found that “this case demonstrates that the mere existence of an efficient market does not guarantee that the shortcomings of the coerced loan approach to rate setting, as described in *Till*, will automatically be overcome.” The court thus fell back on the formula approach. The *Prussia* court’s ruling serves to highlight the importance of not only proving the existence of an efficient market, but also of being adept at presenting convincing evidence thereof.

***In re Sylvan I-30 Enter.*, 2006 WL 2539718 (Bankr. N.D. Tex. 2006)**

The *Sylvan* case is interesting for, among other things, its interpretation of the teachings of *Till*. The *Sylvan* court expresses its view that while the Supreme Court expressly rejected the “presumption” that the contract rate is the appropriate interest rate, nonetheless selection of an interest rate that recognizes the realities of the various transactions entered into by the Debtor is consistent with such approach. Given that there was apparently “no evidence that the risk of non-payment or non-performance is any greater now than it was when the loan was made” presented to the *Sylvan* court, that court ultimately held that “[t]he interest rate required of the Debtor prepetition is a fair measure of the market’s assessment of the risk associated with dealing with the Debtor.”

***In re Seaspán Dev. Corp.*, 2006 WL 2672298 (E.D. Tenn. 2006)**

This case is notable not for its recitation or adaptation of *Till* (which is largely consistent with other cases), but for its warning, as it were, of what can happen to a secured creditor (or debtor) unprepared to fight the cramdown interest rate battle. The *Seaspán* court adopted the approach that, in the Chapter 11 context, it should apply the market rate as the cramdown rate if an efficient market existed. The court went on to hold that, pursuant to *Till*, the secured creditor bore the burden of proof to provide evidence of the market rate. When the secured creditor failed to meet that burden and provide any such evidence, the court found no error in the bankruptcy court’s holding simply applying the prepetition contract rate, which rate, a disaster relief rate, was less than half that requested by the creditor.

***In re Milford Conn. Assoc., L.P.*, 2006 WL 2933895 (D. Conn. 2006)**

The *Milford* case is another instance where a court seemingly wanted to apply the “efficient market” approach but found it was unable to do so given the dearth of evidence about the market presented by the parties. Specifically, the *Milford* court held that testimony by the

debtor's president about the availability of financing and the prepetition contract rate was insufficient to demonstrate market rates. On remand, the court thus instructed the bankruptcy court to consider: "(1) does an efficient market rate exist for the type of loan [the creditor] is forced to give the debtor under the competing plans; (2) if there is no efficient market rate and it is thus appropriate to apply the *Till* formula, what was the national prime rate on the relevant date; (3) is it appropriate to use the national prime rate or some other rate; and (4) to what extent is it appropriate to deviate from the applicable rate to account for risk."

***In re Cantwell*, 336 B.R. 688 (Bankr. D.N.J. 2006)**

The *Cantwell* case is notable for its extended thoughtful analysis of *Till*, its expressed view that the key considerations that shaped the Supreme Court's opinion in *Till* are "equally relevant in Chapter 11," and its expression of the view that departure from the formula approach may well be appropriate in the Chapter 11 context where an efficient market exists. However, the *Cantwell* court, like the majority of courts to address the issue, stopped short of setting forth its view of the scope of what comprised the relevant "market," stating only that in that case "no evidence [was] produced to establish that an 'efficient market' exists to refinance the mortgages on the debtor's property immediately, as the debtors are emerging from their Chapter 11 case."

***In re Mirant Corp.*, 334 B.R. 800 (Bankr. N.D. Tex. 2005).**

In determining the enterprise value of the debtor-corporations for Chapter 11 plan confirmation purposes, Judge Lynn distinguished between present value and market value. In *Mirant*, the Debtor and Committees argued that *Till* should not apply and that it provided no guidance for determining the going-concern value of a multi-billion dollar business. Relying on note 14, the Debtors contended "that *Till* recognized that, in a chapter 11 case, it is appropriate to look to the market in determining a cram down interest rate and, hence, in valuing a business for cramdown purposes." *Id.* at 820. The opposing shareholder argued that *Till* was dispositive of the valuation issue in that *Till* established a sliding scale of return payable to creditors to satisfy cram down requirements, from prime interest rate to prime plus three. The court held that both parties were wrong.

First, *Till* is clearly relevant to a determination of value, not solely in a case in which an interest rate is determined. Because *Till* instructs what return a secured creditor is entitled to for cram down purposes, *Till* effectively determines what cash flow is necessary to satisfy that creditor. Put another way, *Till* addresses, independently of the value of the underlying collateral, the economic characteristics of the obligation that the secured creditor is entitled to receive in a cram down context. Under the plurality opinion in *Till*, the value of the obligation, naturally dependent on the interest it bears, is not determined by the market. What the market would pay to purchase a debtor's loan from creditors is not the proper measure of whether a given plan treatment meets the requirements for cram down. Rather, value of what is offered to satisfy a claim for cram down purposes is determined through the bankruptcy court's objective inquiry. . . .

Second, *Till* instructs how to derive that required return. While *Till* adopts a formula suitable to calculating the interest rate for secured claims in consumer

cases, the formula approach remains valid in determining required return for cram down purposes on other obligations. Thus, the formula for determining the present value of unsecured debt or equity securities issued under a plan will be a risk-free rate plus an adjustment for risk; the numbers plugged into the formula and the manner of their selection will vary depending on the character (secured or un-secured, debt or equity) of the underlying obligation.

Third, *Till* makes clear that the market in fact does not properly measure the value of an obligation undertaken in a plan. As noted in *Till*, the advantages of bankruptcy, such as the requirement of a court determination of feasibility, the benefits of court supervision, disclosure requirements and limits on debt are not given sufficient recognition by the market.

*Id.* at 821-22 (citing *Till*, 541 U.S. at 475-77). The court determined that a debtor's value, credit-worthiness and attractiveness as an investment be objectively assessed as of the prospective effective date of the plan by "taking a market-accepted risk-free interest rate or rate of return and adding to that a risk premium determined by the court based on the specific risks shown by the evidence." *Id.* at 822 (emphasis in original). The market is "at most" an item of evidence. *Id.* at 823. This is another example of a court nominally recognizing market evidence but ignoring that it is the market that determines value. Contrary to this ruling, what the market would pay to purchase the loan from the creditor is precisely what is required to meet the terms of §1129.

### **How Do You Define the "Market"?**

One of the real questions practitioners and courts must ask and answer in this post-*Till* world is: What is "the market?" Is it the market for senior secured debt? Or is "the market" the global financial markets which could recapitalize the debtor-company with senior debt, mezzanine financing and equity? Two cases, *American Homepatient* and *Northwest Timberline*, present an interesting study of contrasting views.

#### ***In re Am. Homepatient*, 420 F.3d 559 (6th Cir. 2005) (cert denied)**

In *American Homepatient* (AHP), the bankruptcy court purported to determine the interest rate based on an analysis of the actual market consistent with the *Till* footnote. Specifically, market analysis (via expert testimony) revealed an interest rate for senior secured debt in the home healthcare industry for comparable companies of approximately 6.8%. Since the AHP plan called for the secured lenders to provide what the plan termed "senior secured debt," the bankruptcy court determined, based on the "efficient market," that a cramdown interest rate of 6.785% provided present value to those secured lenders. The Sixth Circuit held that the AHP bankruptcy court's ruling was sound and did not conflict with *Till* because the interest rate determined by the bankruptcy court was indeed calculated based on an actual analysis of interest rates within the actual market in which AHP operated. The Court of Appeals noted that the bankruptcy court "in fact sought to determine what an efficient market would have produced for the loan that the lenders provided" and reached its conclusion on the appropriate rate "only after carefully evaluating the testimony of various expert witnesses."

From the debtor's perspective, AHP is a classic example of the trap of the "efficient market" approach for Chapter 11 debtors facing opposition by secured creditors arguing for a higher interest rate. The interest rate analysis rises and falls on how to define "the market."

The decision reached in AHP was not in accordance with either the statutory language or reality. In AHP, both the bankruptcy court and the district court interpreted the coerced loan theory and the *Kidd* decision to eliminate specific risk as a factor in determining a cramdown discount rate. The *Till* decision rejected that interpretation and adopted the reasoning of Judge Simpson in his dissent in *Kidd* that the individual risk profile of the reorganized debtor dictates the discount rate. This was ignored by the Sixth Circuit in AHP.

Section 1129(b)(2)(a) requires that to cramdown a secured creditor the debtor has to give the creditor a stream of payments with a present value equal to the claim.<sup>100</sup> In AHP, the court concluded that the entire value of the debtors, and the secured claim of the lenders, was \$250 million. The secured lenders disagreed with both the court's determination of the debtors' value and the appropriate discount rate that would provide the lenders with the present value of their claim.

AHP is an example of a case where the real issue should have been "Did the secured creditor receive something worth \$100 for his \$100?", and not "What theoretical approach did the court take to get the result that the people in black robes wanted to get?" The analysis of whether the secured creditor received something worth \$100 for his \$100 is one of FACT.

The facts showed that the debtors' own experts had said in their engagement letter that they could not testify that the package of securities, the \$250 million note, had a market value equal to \$250 million, for a very simple reason -- risk. The debtors' projections, and the testimony of its experts, were that the projected EBITDA for the debtors was approximately \$45 million. The debtors' experts further testified that the appropriate leverage for a company like the debtors' was 2.5 to 3 times EBITDA, *i.e.* about \$135 million. Leverage is different than loan-to value. Leverage is the ratio of debt to EBITDA and is an important measure of risk. That means that a company like AHP could get a senior secured loan of approximately \$135 million, not \$250 million, at senior secured lending rates of 6.8%. (In contrast, \$250 million is closer to 6 times EBITDA – twice the safe range for a senior secured loan. Also, the loan-to value ratio is 1 to 1 – \$250 million loan to \$250 million value.) According to AHP's own experts, the loan-to value ratio should be \$135 million loan to \$250 million value.

The debtors' experts further testified that the debtors could only borrow \$135 million at senior secured rates of 6.785% – not \$250 million. For a loan of \$250 million the debtors would have to pay a blended rate of about 12.5% of which \$135 million would be loaned at 6.785% and \$45 million would be loaned at 10-12% and \$70 million at equity rates of 15-16% because providing \$135 million of financing for a company worth \$250 million with EBITDA of \$45 million is a lot less risky than providing the entire \$250 million. Therefore, the facts – the

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<sup>100</sup> In *Lamie*, the Supreme Court said to read the statute and to enforce its plain meaning even if it leads to a "harsh outcome." *Lamie v. United States Trustee*, 540 U.S. 526, 538 (2004).

debtors' own numbers and the testimony of its experts – showed that the Class 2 note of \$250 million to the lenders was a very risky loan.

After confirmation, the reorganized debtor was insolvent. The leverage – EBITDA – to debt was twice the industry average. So how did the bankruptcy judge decide to confirm the plan? He misapplied the *Kidd* case and concluded that the rate of return for the stream of payments to the secured lenders did not have to take into account the risk of the reorganized debtor and that the rate of return that would apply to a \$135 million loan to a home health care company worth \$250 million should apply to the entire \$250 million Class 2 note to the secured lenders despite the fact that a \$250 million loan is much more risky. The debtor's expert was instructed by counsel for the debtors, specifically not to consider leverage and loan to value – two of the most important risk factors. The Court concluded that *Kidd* allowed the debtor to completely disregard the risk profile of the reorganized debtor.

That conclusion is inconsistent with the holding of the Supreme Court in *Till*. In *Till*, nine of the nine justices said that, when the lender gets a note, to comply with the cramdown provisions of the Bankruptcy Code, the court must consider the risk factors of the specific debtor. The rate has to be a rate with the same risk profile as the reorganized debtor. The rate must be what would be required to assure that a stream of payments of \$250 million, from a company with twice the industry leverage and twice the industry loan to value ratio and that is insolvent after it exits Chapter 11, is worth \$250 million at confirmation. If the debtor gives the creditor a note for \$250 million the statute requires that it must have a present value of \$250 million. In determining the discount rate the individual risk of the reorganized debtor must be considered.

***In re Nw. Timberline Enters., Inc.*, 348 B.R. 412 (N.D. Tex. 2006)**

The opinion in *Northwest Timberline* provides some insight into how another court views the critical question of how to define “the market” when faced with an “efficient market” analysis of a proposed cramdown interest rate. Interestingly, the conclusions in *Northwest Timberline* are markedly different than those in *American Homepatient*.

In assessing the proposed cramdown rate under the debtor's Chapter 11 plan in *Northwest Timberline*, the court began its analysis with *Till*, recognizing its questionable applicability to Chapter 11 cases given the (in)famous footnote. The *Northwest Timberline* court declined to “mechanically apply” the formula approach in the Chapter 11 context, opting instead to determine what rate an “efficient market” might produce. Reflecting on the expert testimony and the record before it, the *Northwest Timberline* court endeavored to frame the parameters of “the market” available to the debtor. The court focused its analysis on what type of lender, if any, would do “*exactly* what the Current Joint Plan is proposing with regard to [the secured lender],” (emphasis added) and paid particular attention to the fact that the debtor had in fact obtained a loan offer on the eve of bankruptcy at a rate five points higher (13%) than that proposed under the plan (8%) – thus effectively defining its own available “market” and, ultimately, in Judge Jernigan's words, hoisting itself on its own petard. The *Northwest Timberline* court further found persuasive expert testimony that the loan to the debtor (and any loan for that matter), even at 13%, would carry the additional requirements of a substantial, credible guarantee and a substantial equity infusion (10% to 20%).

Ultimately, the *Northwest Timberline* court concluded that the “efficient market” approach of the *Till* footnote could not be applied in the case before it because “there really proved, without question, to be no efficient market for this risky of a loan[.]” Therefore, the court concluded that its only option was to “fall back to the *Till* formula approach as being the controlling test, since there appears to be no ‘efficient market’ of lenders willing to provide an exit loan *identical to* what is being offered to [the secured creditor] here” (emphasis added). Thus, the *Northwest Timberline* court determined that the interest rate proposed under the plan of 8% (which was the prime rate) was insufficient and that, under the formula approach, a risk adjustment factor of +5.75% was necessary. Given that the plan did not so provide, and that an interest rate of 13.75% rendered the plan infeasible, the *Northwest Timberline* court properly denied confirmation.

Had the *Northwest Timberline* court stopped there, this case would merely stand for the following rather logical propositions: (1) courts should not “mechanically apply” the formula approach to determining cramdown interest rates in Chapter 11; (2) courts should look to the existence of an “efficient market” to guide the interest rate determination in Chapter 11; and (3) debtor beware the terms of your DIP or other proposed financing as they may come back to haunt you at confirmation. However, the court did not end its analysis there. Instead, the court went on to elaborate further on its opinion of how to define “the market” -- the critical inquiry in the rate analysis discussed above.

The *Northwest Timberline* court stated: “[t]his court believes that the correct discount rate for purposes of § 1129(b)(2) should fairly consider the rate that the market would require debtors to pay *for financing* the amount of the secured creditor’s claim, and the market rate would necessarily take into account loan-specific and debtor-specific criteria (e.g., the amount financed, the ratio of the amount financed to the debtor’s assets, the debtor’s leverage, the debtor’s performance history, the industry, et cetera)” (emphasis added). In the *Northwest Timberline* court’s opinion, the focus is whether the market will provide the “exact” or “identical” loan (see quoted portions of opinion above) as proposed in a cramdown plan which, at 100% loan to value, practically does not exist. Since the market does not contemplate *financing* at 100% loan to value as the *Northwest Timberline* court’s logic goes, the market should be defined more broadly to include “loan-specific characteristics” which inevitably will require consideration of the rates of mezzanine and equity pieces and will result in a higher rate of return for secured lenders.

***In re Village at Camp Bowie In re Village at Camp Bowie I, L.P., 454 B.R. 702, 713 (Bankr. N.D. Tex. 2011), aff’d, 710 F.3d 239 (5th Cir. 2013)***

Village at Camp Bowie was a single asset shopping center case where the secured creditor, Western, acquired the secured claim at a discount in order to foreclose and own the property. The court found that the property was worth \$34,000,000 and that the Western secured claim was \$33,000,000. Unsecured creditors were owed \$60,000. The plan proposed an equity infusion of \$1,500,000 and the issuance of a cramdown note to Western payable interest only for three years and then principal and interest for two years based on a 30-year amortization with a balloon payment of the remainder at the end of the five years. Western objected. To determine the appropriate rate of return, in this case an interest rate, the court looked to *Till*. Both the debtor’s expert and Western’s expert testified that no efficient market provided for loans of the

type proposed so the court used the formula approach of *Till*. Western's expert used a three level investment band approach of senior debt for 65%, mezzanine debt and equity arriving at a blended rate. The principal adjustment made by the court was the elimination of profit as an element of the interest rate noting that the profit element wasn't mentioned in the *Till* plurality opinion, ultimately dropping the rate by approximately one percent to 6.4%.

In effect, application of an investment band analysis does use market data since that is how financing is determined for assets such as a shopping center. Profit is a factor in any determination of present value of a stream of payments since no one will pay full value for a stream of payments unless they foresee making a profit. The *Village* court got it right to use an investment band but should not have deducted the profit element.

***In re Texas Grand Prairie Hotel Realty, L.L.C., 710 F.3d 324, 332 (5th Cir. 2013)***

In *Texas Grand Prairie* the debtor owned hotels and proposed a cramdown plan on the secured lender, Wells Fargo issuing a ten year note with an interest rate of 5%, 1.75% above the prime rate. Both parties stipulated that the *Till* formula should be used. The 5<sup>th</sup> Circuit, however determined that the *Till* formula was not binding precedent in a Chapter 11 case and that courts could be more flexible in determining an appropriate rate. While the debtor's expert followed *Till's* observation that a rate 1% to 3% over prime was appropriate, concluding that the rate should be 5%, the expert for Wells, conceding that no market existed for a single secured loan as contemplated, used an investment band approach and arrived at a blended rate of 8.8%. The 5<sup>th</sup> Circuit rejected the Wells analysis as market based and inconsistent with *Till* stating "[w]hile Wells Fargo is undoubtedly correct that no willing lender would have extended credit on the terms it was forced to accept under the § 1129(b) cramdown plan, this "absurd result" is the natural consequence of the prime-plus method, which sacrifices market realities in favor of simple and feasible bankruptcy reorganizations." In discussing the testimony of the Wells expert witness, Ferrell, the court reasoned "While Ferrell concluded that exit financing could be cobbled together through a combination of senior debt, mezzanine debt, and equity financing, courts including the Sixth Circuit have rejected the argument that the existence of such tiered financing establishes "efficient markets," observing that it bears no resemblance to the single, secured loan contemplated under a cramdown plan.<sup>101</sup>" The court affirmed the 5% rate but noted that the prime plus formula was not always the appropriate method for determining the cram down rate.

Again, a court rejected reality and the fact that value is determined by the market.

***In re MPM Silicones, LLC, 531 B.R. 321, 325 (S.D.N.Y. 2015)***

The *MPM* (Momentive) decision involved a debtor with multiple layers of secured debt which had actually obtained exit and bridge financing in connection with its Chapter 11 case and plan of reorganization. Two classes of secured lenders objected to cramdown rates of the plan consisting of the Treasury rate plus 1.5% in the case of the first lien creditors (total 3.60%) and

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<sup>101</sup> *Am. HomePatient*, 420 F.3d at 568–69; *20 Bayard Views*, 445 B.R. at 110–11; *SW Boston Hotel*, 460 B.R. at 55–58; see also *Marsh & Weiss*, *supra* note 51, at 221 ("[C]ourts have generally been unreceptive to the use of tiered financing as a basis for establishing a market interest rate.").

the Treasury rate plus 2% in the case of the 1.5 lien holders (total 4.09%). The bankruptcy court noted that it was “not writing on a blank slate” citing *Till* and *Valenti* and concluding that those cases rejected a market based approach to determining an appropriate cramdown rate and that *Valenti* held that the rate should not include an element of profit. The bankruptcy judge (Robert Drain) determined that both *Till* and *Valenti* had held that, generally speaking, the risk adjustment should be between 1 and 3 percent above the risk free base rate and that application of the formula approach cannot be a back door to applying a market rate. Market based evidence should not be considered except secondarily when setting a proper premium in the formula approach. Since, according to Judge Drain, profit, fees and costs should not be considered in determining rate, market evidence isn’t relevant and the existence of a backup exit loan facility at a higher rate isn’t determinative. Judge Drain did add .5% to the first lien rate and .75% to the 1.5 lien rate to account for the difference between the prime rate and the Treasury rate. The District Court affirmed Judge Drain’s ruling and the case is on appeal to the 2d Circuit.

### **The Courts Have Really Screwed This Up**

Section 1129 says that a secured creditor is to receive deferred cash payments with a present value equal to the value of the collateral. That seems simple enough but the courts have totally ignored the statute and created an Alice in Wonderland construction that defies reality to the point where the 5th Circuit in the *Texas Grand Prairie* case and the court in *MPM* admitted that market reality had been thrown out the window. The statute says that if my collateral is a gold bar worth \$1 million then I’m entitled to a stream of payments with a value today of \$1 million. The stream of payments doesn’t have to be in the form of a note. It can be payments from a trademark license or royalties from an oil and gas lease. Each of those streams of payment has value.

The dictionary defines “value” as the monetary worth of something. That means what the market will pay for it on a given day under a given set of circumstances -- the old willing buyer and willing seller concept. This is the same concept that is used for valuing collateral in 506(a). By definition, a valuation of deferred payments requires a market rate of return or nobody will pay full value. If my gold bar is worth \$1 million then the deferred payments you give me must be worth \$1 million. The value of a Picasso is what I can sell it for today, not tomorrow or yesterday. That’s simply an evidentiary question whether it’s a Picasso or a stream of payments—what rate of return is required for someone to give me \$1 million for those deferred payments. Notice, I didn’t say “interest”. The statute doesn’t say interest. It says value and there is always a market for deferred payments. It may be Luigi the loan shark—or a Goldman Sachs debt trader or a combination of lenders. And the rate of return to give it value may be higher than a court and a debtor would like. But there is always a way to value a stream of deferred payments.

Just because the debtor calls part of the payments interest doesn’t mean it is interest -- it’s really a rate of return for financing. And a rate of return isn’t a legal principle -- that’s where the courts have gotten off the rails. The value of that Picasso isn’t determined by legal principles. The value of an oil and gas royalty or a trademark license isn’t determined by common law. If the market rate of return to give a stream of payments value on a given day is determined by what Vladimir Putin says about Ukraine, or whether the Greeks default on a bond, or what Janet Yellin



says to CNN, or how many Toyotas are sold this month in China then that's what determines value -- not some "approach" that some judge in a black robe who majored in Medieval Music says it is. It's a fact that changes every day -- not an approach. And the cases that say as a matter of law the risk premium is 1-3% over prime are just out of touch with reality.

Other courts have gotten it right. If the lender is undersecured, and is providing the entire capitalization of the reorganized debtor, then the market uses a blended rate to determine the value of that stream of expected payments. Part of the payments carry a senior credit risk -- the rest have a higher risk. You combine those risks to get the overall rate of return that will give the payments a present value. That's what the market does -- that's reality -- basic finance and econ 101. That isn't inconsistent with the basic concept of *Till* that you take a base rate and add a risk premium. But it's obvious that the Supreme Court in *Till* -- some of the justices more so than others -- didn't really understand basic finance and were flopping around. The risk premium covers dozens of considerations that change day to day -- sometimes minute to minute.

If the collateral is in Kansas City that's different than if the collateral is in Kabul or Damascus. If the management of the debtor has brains, it's different than if the management is comprised of idiots. Does the business deliver a basic necessity, like doors, or is it dependent on the whim of 13 year old girls, like dresses? Are there strong covenants or is it covenant lite. And yes -- profit is part of the rate of return in the real world that determines value. The market builds profit into its rate of return. Nobody is going to provide capital unless they anticipate a profit. The "risk" premium is a combination of the probability of you getting your money back and your profit and is a component of value.

The courts can say that you have to wear stripes and plaid and that may be the law but that doesn't make it look good. And they can say that a rate of return is interest when it isn't, and that it's 1% to 3% over prime when it isn't, and that profit doesn't count -- which it really does, but they're operating in a made up universe devoid of reality. So to fix it in Chapter 11 -- my world -- amend section 1129(b)(2)(A)(i)(II) to state that the lender will receive deferred payments of a present fair saleable market value of the value of the collateral so that it's clear that a market rate of return is required.

For Chapter 13 the statutory fix should be the same -- market value. But in Chapter 13 there may be additional considerations. You have thousands of cases and consumer debtors. You can't have valuation hearings on the deferred payments as a practical matter. Often, the parties agree on a rate. If necessary, by statute, or rule, or standing order the U.S. Trustee could periodically -- perhaps once a month -- survey the published rates for auto and home loans and determine an average rate for borrowers in that district. Those rates would be the presumed rates for auto and home cramdown plans. A debtor or lender could always challenge the rate and have a hearing. But those presumed rates would be a lot closer to reality than 1 to 3% over prime.

This issue is a good example of a weakness in our common law system. One court gets it wrong and then it gets incrementally worse with each subsequent decision. You can't fix that but at least fix this issue to clarify that reality is the standard.

## **Recent Developments: Bankruptcy Safe Harbor and Federal Pre-emption**<sup>102</sup>

This section discusses the current case law interpreting the safe harbor provisions in the Bankruptcy Code with a particular focus on safe harbor provisions that are applicable to financial transactions. These transactions involve securities contracts, commodity contracts, forward contracts, repurchase agreements, swaps, derivatives, and master netting agreements. This section will also discuss federal pre-emption and recent case law involving attempts to create a successful work around of § 546(e).

### **Statutory Progression of the Safe Harbor Provisions**<sup>103</sup>

The Bankruptcy Code provides preferential treatment called “safe harbors” for certain types of transactions by exempting those transactions from the effects of certain provisions of the Bankruptcy Code. While the wisdom of these safe harbors is often debated, they began in 1978 and are now more prevalent and far-reaching than ever. As Professor Charles Mooney so eloquently explained recently:

The Bankruptcy Code safe harbors began modestly in 1978. Section 362(b)(6) of the original 1978 Code exempted from the automatic stay setoff with respect to various sorts of commodity-related contracts and § 764(c) prevented the trustee from avoiding certain types of transfers involving commodity contracts.<sup>104</sup> Interestingly, neither the Senate Report nor the House Report discusses § 362(b)(6). With respect to § 764(c), the Senate report, without citing to the section specifically, noted that one of the main objectives of the commodity broker liquidation subchapter, of which § 764 was a part, “is the protection of commodity market stability.”<sup>105</sup> This objective, to achieve “commodity market stability,” or, more broadly, “market stability,” is one that is repeatedly invoked as a justification for expanding the scope and number of the safe harbor provisions.

The 1982 amendments were intended in part to rectify the conspicuous omission in the 1978 Code of special treatment for securities contracts in view of the special treatment for commodity contracts.<sup>106</sup> Congress applied the same policy rationale of the 1978 commodity safe harbors to these amendments: “Several of the amendments are intended to minimize the displacement caused in the commodities and securities

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<sup>102</sup> This section is based on a paper by Stephen Manz and Robin E. Phelan titled “*Grede*” is Good: *Wall Street Welcomes Recent Bankruptcy Safe Harbor Developments*.

<sup>103</sup> The legislative history and the background on the rationales for the safe harbor provisions is borrowed with permission from a paper by Professor Charles W. Mooney, Jr. titled *The Bankruptcy Code’s Safe Harbors for Qualified Financial Contracts: Too Safe to Fail*. Professor Mooney is a really smart dude.

<sup>104</sup> 11 U.S.C. §§ 362(b)(6) & 764(c) (1978).

<sup>105</sup> S. Rep. No. 95-989, at 8 (1978).

<sup>106</sup> See *Bankr. of Commodity and Sec. Brokers: Hearings before the Subcomm. on Monopolies & Commercial Law of the H. Comm. on the Judiciary*, 97th Cong. 239 (1981) (testimony of Bevis Longstreth, Commissioner, Securities and Exchange Commission) (“The resulting discrimination in treatment [between commodities and securities] appears to have been inadvertent. It plainly is not supportable on policy grounds. It is further the Commission’s view that the amendments now under consideration present an effective solution to these problems by assuring equality of treatment as between the securities and commodities industries.”).

markets in the event of a major bankruptcy affecting those industries.”<sup>107</sup> While Congress did not use the term “systemic risk,” that was its concern: “[C]ertain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possible [sic] threatening the collapse of the affected market.”<sup>108</sup>

The 1982 amendments also added § 546(e) (then 546(d)) and 555 to the Code. Section 546(e) replaced 764(c) and expanded the language of 764(c) to cover securities contracts. As a result, except in cases of intentional fraudulent transfer, the trustee could not avoid margin or settlement payments “made by or to a commodity broker, forward contract merchant, stockbroker, or securities clearing agency.”<sup>109</sup> Section 555 allowed stockbrokers and securities clearing agencies to liquidate securities contracts if the contracts in question allow for liquidation upon a counterparty insolvency or bankruptcy. Ordinarily, the use of such clauses, so-called *ipso facto* clauses, would be rendered ineffective by § 365(e)(1).<sup>110</sup>

Two years later, in 1984, Congress altered §§ 546(e) and 555 to broaden their applicability. Congress also introduced § 559. As enacted in 1982, § 546(e) prevented a trustee from avoiding a margin or settlement payment “made by or to a commodity broker, forward contract merchant, stockbroker, or securities clearing agency.”<sup>111</sup> Section 555 originally only protected the use of *ipso facto* clauses by stockbrokers and securities clearing agencies.<sup>112</sup> In 1984, Congress added “financial institution” to the list of protected counterparties in §§ 546(e) and 555. The Code defined “financial institution” as “a person that is a commercial or savings bank, industrial savings bank, savings and loan association, or trust company and, when any such person is acting as agent or custodian for a customer in connection with a securities contract, . . . such customer.”<sup>113</sup> Section 559 mimics § 555 but applies to repo participants.<sup>114</sup>

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<sup>107</sup> H.R. Rep. No. 97-420, at 1 (1982).

<sup>108</sup> *Id.*

<sup>109</sup> 11 U.S.C. § 546(d) (1982). Again, the changes was made to ensure equal treatment for commodities and securities contracts: “An additional conforming amendment is made to [§ 546(e)] in order to include stockbrokers and securities clearing agencies, thereby avoiding an unintended potential disparity in treatment [as between securities and commodities contracts].” *Bankr. Of Commodity and Sec. Brokers: Hearings before the Subcomm. On Monopolies and Commercial Law of the H. Comm. on the Judiciary*, 97th Cong. 371 (1981).

<sup>110</sup> Section 555, in combination with the exemption from the automatic stay, was specifically meant to address the following situation: if open trades of a bankrupt customer could not be liquidated immediately, then the broker could have to wait days or weeks to obtain bankruptcy court approval to do so, if such permission were granted at all. During that time, the market would continue to move, and if the market moved in the wrong direction, the broker’s losses would increase. *See Bankr. of Commodity and Sec. Brokers: Hearings before the Subcomm. on Monopolies & Commercial Law of the H. Comm. on the Judiciary*, 97th Cong. 3 (1981) (testimony of Philip F. Johnson, Chairman, Commodity Futures Trading Commission). And, “[s]ince the bankrupt is unlikely to be able to pay these losses, other carrying brokers must pay them. This is unfair . . . and it could even be dangerous, by placing the other carrying brokers and the clearing organizations in financial jeopardy.” *Id.*

<sup>111</sup> 11 U.S.C. § 546(e) (1982).

<sup>112</sup> 11 U.S.C. § 555 (1982).

<sup>113</sup> 11 U.S.C. § 101(a)(19) (1984).

The next major revisions came in 1990 and were focused on swap agreements. These revisions were meant to bring the treatment of swaps under the Bankruptcy Code in line with the Code's treatment of security contracts, commodity contracts, and repos.<sup>115</sup> The main users of swaps, financial institutions, had three central concerns: the possibility of a bankruptcy trustee assuming favorable swap transactions and rejecting unfavorable ones, loss from market exposure if a swap contract could not be terminated immediately upon bankruptcy of a counterparty, and the enforceability of netting.<sup>116</sup> If these concerns were not addressed, the International Swap Dealers Association (ISDA) contended, "the potential exposure for all swap counterparties is materially increased, and this could undermine the basic foundation of the swap market," which, even at that time, had a notional value near \$2 trillion.<sup>117</sup>

All three of ISDA's concerns were addressed. Section 362(b)(17) (then § 362(b)(14)) prevented the automatic stay from applying to swap agreements, and § 546(g) prevented a trustee in bankruptcy from "avoid[ing] a transfer under a swap agreement."<sup>118</sup> Finally, § 560 extended the §§ 555 and 559 protections to swap participants; that is, swap participants could now make use of ipso facto clauses without fear that a bankruptcy trustee would declare them unenforceable. If the automatic stay does not apply to swap agreements, if the trustee cannot avoid transfers made pursuant to swap agreements, and if swap participants can liquidate pursuant to the contract, then the trustee cannot "cherry-pick" which agreements to keep and which to discard. Additionally, these provisions ensured that netting would not be avoidable as a transfer.

Major change would not come again until 2005 with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). Though focused on consumer and small business bankruptcies, BAPCPA contained a number of significant changes to the safe harbors, changes that once again were declared to be designed to thwart systemic risk.<sup>119</sup> These amendments were a response to the near failure in 1998 of the hedge fund Long-Term Capital Management (LTCM).<sup>120</sup>

In the wake of LTCM's near-collapse, the President's Working Group on Financial Markets (PWG), which consisted of members of the Department of the Treasury, the Board of Governors of the Federal Reserve, the SEC and the CFTC, issued a report exploring the causes of LTCM's failure and recommending policy changes based on

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<sup>114</sup> 11 U.S.C. § 559 (1984). Section 559 and changes to § 362(b) and other parts of the Code were meant to bring the same protection to repurchase agreements that had already been afforded to commodity and securities contracts. S. REP. NO. 98-65, at 45 (1983).

<sup>115</sup> See *Bankr. Treatment of Swap Agreements and Forward Contracts: Hearing on H.R. 2057 and H.R. 1754 Before the Subcomm. on Econ. and Commercial Law of the H. Comm. on the Judiciary*, 101st Cong. 14 (1990) (statement of Mark C. Brickell, Chairman, International Swap Dealers Association).

<sup>116</sup> *Id.* at 16.

<sup>117</sup> *Id.* at 14, 16.

<sup>118</sup> 11 U.S.C. §§ 362(b)(14) & 546(g) (1990).

<sup>119</sup> H.R. Rep. No. 109-31, at 3 (2005) ("In addition, [BAPCPA] contains provisions designed to reduce systemic risk in the financial marketplace.").

<sup>120</sup> See e.g., Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697, 698 (2005).

their findings.<sup>121</sup> The PWG specifically recommended “expanding and clarifying the definitions of the financial contracts eligible for netting and . . . allowing eligible counterparties to net across different types of contracts” in order to “reduce the likelihood that the procedure for resolving a single insolvency will trigger other insolvencies due to the creditors’ inability to control their market risk.”<sup>122</sup>

Congress not only heeded the PWG report in enacting BAPCPA but went even further.<sup>123</sup> BAPCPA “expand[s] and clarify[ies] the definitions of the financial contracts eligible for netting” by altering the Bankruptcy Code definitions for forward contracts,<sup>124</sup> repurchase agreements,<sup>125</sup> securities contracts<sup>126</sup> and swap agreements.<sup>127</sup> Significantly, the definition of repurchase agreement was expanded to include repos on mortgage-related securities and mortgage loans. Congress addressed the issue of cross-product netting by defining a new type of agreement, a “master netting agreement (MNA).”<sup>128</sup> An MNA is an agreement that can provide for the exercise of netting, setoff, liquidation, termination, acceleration, or close out rights with respect to securities contracts, commodity contracts, forward contracts, repos and swap agreements.<sup>129</sup> That is, rather than rely on a different agreement for each separate type of financial instrument, a master netting agreement specifies a counterparty’s rights with respect to all these different types of financial instruments within one document. Consequently, it can provide for netting among all the financial instruments that arise between counterparties.

MNAs receive the same protections as other derivatives contracts and repurchase agreements. Section 362(b)(27) exempts the operation of MNAs from the automatic stay while § 546(j) prevents a trustee from avoiding transfers “made by or to a master netting agreement participant under or in connection with a master netting agreement.” Section 561 allows for the effective use of ipso facto clauses in MNAs.<sup>130</sup>

BAPCPA also defines a new type of counterparty, a “financial participant.”<sup>131</sup> A financial participant is an entity with at least \$1 billion in notional or principal amount outstanding or \$100 million in mark-to-market securities contracts, commodities contracts, swap agreements, repurchase agreements or forward contracts, with the debtor at the time of filing or on any day during the 15 month

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<sup>121</sup> The President’s Working Group On Financial Markets, Hedge Funds, Leverage, And The Lessons Of Long-Term Capital Management, available at <http://www.treasury.gov/resourcecenter/fin-mkts/Documents/hedgfund.pdf>.

<sup>122</sup> *Id.* at 26, 40.

<sup>123</sup> H.R. REP. NO. 109-31, at 20 (2005) (citing to the PWG as a source of the enacted provisions).

<sup>124</sup> 11 U.S.C. § 101(25) (2005).

<sup>125</sup> 11 U.S.C. § 101(47) (2005).

<sup>126</sup> 11 U.S.C. § 741(7) (2005).

<sup>127</sup> 11 U.S.C. § 101(53B) (2005). For a discussion of the changes to these definitions, see Campbell, *supra* n. 17 at 701-05.

<sup>128</sup> 11 U.S.C. § 101(38A) (2005).

<sup>129</sup> *Id.*

<sup>130</sup> 11 U.S.C. §§ 362(b)(27), 546(j) & 561 (2005).

<sup>131</sup> 11 U.S.C. § 101(22A) (2005).

period preceding filing.<sup>132</sup> Sections 362(b)(17), 546(e) and (g), 555, 559 and 560 extend their protection to financial participants. By doing so, Congress sought to reduce systemic risk by allowing entities that meet the financial participant dollar requirements, but would not otherwise qualify as a protected counterparty (e.g., because the entity is not a commodity broker or stockbroker), to close out and net derivatives contracts and repurchase agreements.<sup>133</sup> Congress also sought to reduce systemic risk by including “clearing organizations” in the definition of “financial participants,” which means they too can take advantage of the Bankruptcy Code’s safe harbors.<sup>134</sup> Congress felt this would “further the goal of promoting the clearing of derivatives . . . as a way to reduce systemic risk.”<sup>135</sup>

Finally, BAPCPA altered § 553. Section 553 states when creditors can offset mutual debts owing between the creditor and debtor. The automatic stay, avoidance and liquidation exceptions for derivatives and repurchase agreements are designed, in part, to ensure that creditors can offset their debts with the debtor without interference from the bankruptcy court. BAPCPA made changes to § 553 to reflect this result.<sup>136</sup>

One year later, Congress enacted the Financial Netting Improvements Act of 2006. Section 362(b)(17) was substantially reworded to conform it to the parallel provisions in the Federal Deposit Insurance Act and Federal Credit Union Act.<sup>137</sup> Section 362(b)(27) was also changed to resemble the phrasing of the newly reworded § 362(b)(17). Sections 546(e) and (j) were expanded in scope to shield from the trustee’s avoidance power not only transfers made by or to one of the listed types of entities but also transfers made for the benefit of such protected entities. In addition, § 546(e) was further expanded so that it not only protects from avoidance margin payments and settlement payments but also protects all types of transfers made “in connection with a securities contract . . . commodity contract . . . or forward contract.”<sup>138</sup>

Charles W. Mooney, Jr., *The Bankruptcy Code’s Safe Harbors for Qualified Financial Contracts: Too Safe to Fail*.

### **The Current Language of § 546(e) and Selected Case Law**

Given its recently expanded breadth, § 546(e) has become a highly utilized safe harbor provision and is the focus of a great deal of case law. While it has changed over the years, the current version of § 546(e) states:

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<sup>132</sup> *Id.*

<sup>133</sup> H.R. Rep. No. 109-31, at 130-31 (2005).

<sup>134</sup> *Id.* at 131.

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at 134.

<sup>137</sup> H.R. Rep. No. 109-648, at 7 (2006).

<sup>138</sup> 11 U.S.C. § 546(e) (2006).

Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

Accordingly, § 546(e) now immunizes from avoidance **both** (a) any margin payment or settlement payment made by or to a commodity broker, a forward contract merchant, a stockbroker, a financial institution, a financial participant, or a securities clearing agency; **and** (b) any transfer in connection with a securities contract, a commodity contract, or a forward contract made by or to a commodity broker, a forward contract merchant, a stockbroker, a financial institution, a financial participant, or a securities clearing agency.

While each of the terms used in § 546(e) appears fairly targeted to address a specific type of financial transaction, certain of the definitions are defined broadly and therefore grant broad applicability to the safe harbor. The term “settlement payment,” for instance, means “a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade.”<sup>139</sup> While the definition is somewhat circular, the formulation of this definition has led to widespread acknowledgment by courts that the definition of “settlement payments” is extremely broad.<sup>140</sup>

In addition, the term “securities contract” includes “a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing . . . .”<sup>141</sup> That subsection of the definition of a securities contract continues on, and

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<sup>139</sup> 11 U.S.C. § 741(8). There is also a definition of “settlement payment” in § 101(51A).

<sup>140</sup> See, e.g., *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 336-38 (2d Cir. 2011) (construing the term “settlement payment” broadly and holding that it does not require a purchase or a sale); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 985-86 (8th Cir. 2009) (noting that the definition of “settlement payment” is “extremely broad” and “intended to encompass most payments that can be considered settlement payments”); *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 548-50 (6th Cir. 2009) (holding that the term “settlement payment” includes an exchange of stock for cash in a leveraged buy-out); *Lowenschuss v. Resorts Int’l, Inc. (In re Resorts Int’l, Inc.)*, 181 F.3d 505, 515 (3d Cir. 1999) (noting that the “extremely broad” definition of “settlement payment” “includes almost all securities transactions”); *Jonas v. Resolution Trust Corp. (In re Comark)*, 971 F.2d 322, 325 (9th Cir. 1992) (“We follow our sister circuits in adopting a broad definition of settlement payment . . . .”); *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 850 (10th Cir. 1990) (The definition in section 741(8), while somewhat circular, is ‘extremely broad.’”).

<sup>141</sup> 11 U.S.C. § 741(7)(A)(i).

there are ten additional subsections specifying even more agreements that qualify as a securities contract.<sup>142</sup>

Certain parties have attempted to impose limitations through an appeal to legislative history or public policy arguments, but these efforts have generally failed in light of the perceived plain meaning of the broad statutory language. *See, e.g., Kaiser Steel Corp. v. Charles Schwab & Co., Inc.*, 913 F.2d 846, 849 (10th Cir. 1990) (“Kaiser’s position that section 546(e) was only intended to insulate from avoidance routine securities transactions is not without merit. Neither leveraged buyouts (“LBOs”) nor other exceptional transactions were even mentioned in any of the discussions of the securities industry in the reports, debates, and hearings on the bill. *See Bankruptcy of Commodity and Securities Brokers: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 97th Cong., 1st Sess. 238-349 (1981). However, because of the variety and scope of different securities transactions, and the absence of any restrictions in sections 546(e) and 741(8), it would be an act of judicial legislation to establish such a limitation.”).

The fact that Congress has repeatedly amended § 546(e)—to broaden it rather than to narrow it—is particularly difficult for parties to explain when they argue that it is not being construed properly based on the legislative intent. *See Picard v. Katz*, 462 B.R. 447, 452 n.3 (S.D.N.Y. 2011) (“In any event, there is no reason to ignore the breadth of the statutory language. Section 546(e) has been revisited by Congress on numerous occasions, as recently as 2006, when it was amended to its present wording. . . . If Congress did not mean it to be taken literally, Congress had ample opportunity to narrow or alter the wording, but Congress chose not to.”).

Nevertheless, there are still points of disagreement between jurisdictions on certain sub-issues implicated by § 546(e). However, even with respect to these disagreements on sub-issues regarding the reach of the § 546(e) safe harbor, such as whether a financial institution must actually be a beneficial party-in-interest to a transaction or whether it may simply be a conduit for funds transferred<sup>143</sup> and whether the § 546(e) safe harbor applies to private transactions,<sup>144</sup> the majority of courts favor broad interpretations of the applicability of the safe harbor.

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<sup>142</sup> 11 U.S.C. § 741(7)(A)(ii-xi).

<sup>143</sup> *See, e.g., QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 551 (6th Cir. 2009) (“[T]he plain language of § 546(e) simply does not require a ‘financial institution’ to have a ‘beneficial interest’ in the transferred funds.”); *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 338 (2d Cir. 2011) (same); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 986-87 (8th Cir. 2009) (same); *Lowenschuss v. Resorts Int’l, Inc. (In re Resorts Int’l, Inc.)*, 181 F.3d 505, 516 (3d Cir. 1999) (same); *but see In re Munford, Inc.*, 98 F.3d 604, 610 (11th Cir. 1996) (concluding that a bank “was not a transferee” in an LBO transaction because the bank never obtained a beneficial interest in the funds and was therefore ineligible for § 546(e) protection).

<sup>144</sup> *See Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 986 (8th Cir. 2009) (“Nothing in the relevant statutory language suggests Congress intended to exclude these payments from the statutory definition of ‘settlement payment’ simply because the stock at issue was privately held.”); *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 550 (6th Cir. 2009) (“[W]e hold that nothing in the text of § 546(e) precludes its application to settlement payments involving privately held securities.”); *but see Official Comm. of Unsecured Creditors v. Lattman (In re Norstan Apparel Shops, Inc.)*, 367 B.R. 68, 76-77 (Bankr. E.D.N.Y. 2007) (holding, based on an old version of § 546(e), that the safe harbor could only apply to publicly traded securities); *Official Comm. of Unsecured Creditors v. Asea Brown Boveri, Inc. (In re Grand Eagle Co.)*, 288 B.R. 484, 494 (Bankr. N.D. Ohio 2003) (same);



The following cases are useful in understanding the current interpretation of the safe harbor in § 546(e). The first and second cases display the remarkable reach of the safe harbor provision and the third case shows a very recent attempt by one court to push back on the ever-expanding scope of the § 546(e) safe harbor.

***In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.***<sup>145</sup>

The *Enron* case was decided based on the version of § 546(e) effective prior to the 2006 amendment. That version prohibited the avoidance of “settlement payments” made by, to, or on behalf of a number of participants in the financial markets.

On June 28, 2011, the Second Circuit Court of Appeals held that Enron’s redemption of its commercial paper prior to maturity fell within the definition of a “settlement payment” and was protected from avoidance under § 546(e)’s safe harbor provision.

***Factual Background***

In 2001, Enron collapsed and petitioned for Chapter 11 bankruptcy. In 2003, the reorganized entity sought to avoid and recover redemption payments from approximately two hundred financial institutions, including Alfa and ING. Prior to filing its bankruptcy petition, Enron had redeemed its commercial paper at a price considerably higher than the paper’s market value. Enron alleged the payments were recoverable as preferential transfers under § 547(b), because they were made on account of antecedent debt within ninety days prior to bankruptcy, and as constructively fraudulent transfers under § 548(a)(1)(B), since the redemption price for the commercial paper exceeded the market value.

***Procedural Background***

Alfa and ING moved to dismiss Enron’s complaint because they alleged that the redemption payments were “settlement payments” protected by § 546(e). The bankruptcy court denied the motion to dismiss, and Alfa and ING then moved for summary judgment. The bankruptcy court held that “settlement payments” include only payments to buy or sell securities, not payments made to retire debt. Therefore, the safe harbor in § 546(e) did not protect Enron’s payments from avoidance, and summary judgment was denied.<sup>146</sup> Alfa and ING were then granted interlocutory review of the bankruptcy court’s ruling. The district court reversed and remanded the bankruptcy court’s decision, with instructions to enter summary judgment in favor of Alfa and ING.<sup>147</sup> The district court held that the definition of “settlement payment” in 11 U.S.C. § 741(8) is not restricted to payments that are “commonly used” in the securities trade, and therefore the circumstances of a specific payment do not bear on whether that payment fits within the definition of a settlement payment. The district court also held that a “settlement payment is any transfer that concludes or consummates a securities transaction.”

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*Kipperman v. Circle Trust F.B.O. (In re Grafton Partners, L.P.)*, 321 B.R. 527, 539-40 (B.A.P. 9th Cir. 2005) (same).

<sup>145</sup> 651 F.3d 329 (2d Cir. 2011).

<sup>146</sup> *In re Enron Creditors Recovery Corp.*, 407 B.R. 17, 45 (Bankr. S.D.N.Y. 2009).

<sup>147</sup> *In re Enron Creditors Recovery Corp.*, 422 B.R. 423, 442 (Bankr. S.D.N.Y. 2009).

### The Issue

In a case of first impression in the courts of appeals, the Second Circuit had to determine “[w]hether the § 546(e) safe harbor applie[d] to an issuer’s redemption of commercial paper prior to maturity, effected through the customary mechanism of transacting in commercial paper through the Depository Trust Company, without regard to extrinsic facts, such as the motives and circumstances of redemption.”

### The Majority’s Analysis

In analyzing whether the redemption of commercial paper prior to maturity qualified as a “settlement payment,” the court rejected each of Enron’s three contentions: (1) the definition of “settlement payment” excludes all payments that are not common in the securities trade, (2) the definition of “settlement payment” includes only transactions where title to the securities changes hands, and (3) a “settlement payment” requires that a financial intermediary take title to the transacted securities.

Enron’s first argument addressed the definition of a “settlement payment.”<sup>148</sup> The court acknowledged that the Second Circuit had not yet addressed the scope of § 741(8)’s definition of a “settlement payment,” but that other circuits have held it to be “extremely broad.” Enron alleged that the phrase “commonly used in the securities trade” modifies all the preceding terms and thereby excludes from the definition all uncommon payments. This reading of the phrase would have limited the definition of a “settlement payment.” The Court disagreed with Enron’s interpretation of the definition and concluded that the phrase “commonly used in the securities trade” modifies only the term “any other similar payment.” Therefore, the Court read the phrase as a “catchall phrase intended to underscore the breadth of the § 546(e) exemption.”

In Enron’s second argument, it alleged that the redemption payments were not settlement payments because they involved the retirement of debt, not the acquisition of title to the commercial paper. The Court concluded that there was no basis in the Bankruptcy Code or case law to interpret § 741(8) as excluding the redemption of debt securities and that because Enron’s redemption payments completed a transaction in securities, they were settlement payments. Additionally, the Court stated that § 741(8) does not have a purchase or sale requirement.

Enron’s third argument was that the redemption of debt was not a protected “settlement payment” because there was not a financial intermediary that took a beneficial interest in the securities during the course of the transaction. The Court concluded that the absence of a financial intermediary that takes title to the transacted securities during the transaction is not a reason to deny safe harbor protection.

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<sup>148</sup> 11 U.S.C. § 741(8):

“settlement payment” means a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade.

Ultimately, the Court declined to adopt any of Enron's arguments. The Court affirmed the district court's holding and classified Enron's redemption of commercial paper prior to maturity as a "settlement payment," falling within the § 546(e) safe harbor.

### The Dissent

The dissent preferred a narrow interpretation of the definition of a "settlement payment." The dissent concluded that the text of § 741(8) is ambiguous and provides virtually no guidance as to the types of transfers that should be identified as "settlement payments," so a plain meaning interpretation would not be instructive. The dissent determined that a settlement payment required a purchase or a sale and cited various cases and Judge Friendly's explanation that "in common speech a maker's paying a note prior to maturity in accordance with its terms would not be regarded as a 'purchase.'" According to the dissent, the majority failed to point to a case that held there was not a purchase or sale requirement for a securities transaction, and they did not demonstrate the existence of a common industry understanding that the redemption of commercial paper is a securities transaction.

The dissent feared that the majority's definition of a "settlement payment" would "bring virtually every transaction involving a debt instrument within the safe harbor of Section 546(e), thus allowing the settlement payment exception to swallow up the Section 547(b) avoidance provision." Additionally, the dissent stated that the majority's approach imperils the ordinary repayment of loans.

### Takeaways

The majority takes an expansive view of the definition of "settlement payment" and of the § 546(e) safe harbor provision. This expansive interpretation of § 546(e) has also appeared in many other cases, and it suggests a national trend toward a broad interpretation of the § 546(e) safe harbor provision.

Throughout the majority's opinion, the Court appeared to be balancing the sometimes conflicting concerns of systemic risk to the securities market with a literal reading of the statute. For example, private transactions do not create any sort of substantial systemic risk in the securities market, but they were held to be covered in *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*.<sup>149</sup>

During a hypothetical discussing the purchase or sale requirement, the Court made a statement about loans that are repaid prematurely, which could have significant consequences for the financial community. In the hypothetical, the terms of an ordinary promissory note prohibited voluntary early redemption. According to the Court, if the borrower decided to buy back the promissory note at a negotiated price, it would be "difficult to characterize this transaction as a redemption rather than a repurchase in order to exclude it from the safe harbor." This suggests that if a borrower pays off a note in less than the full amount, that § 546(e) might apply. The majority's hypothetical highlights the dissent's fear that the "Court's approach imperils the ordinary repayment of loans." The Court seemed to say that even in a workout

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<sup>149</sup> 571 F.3d 545, 550 (6th Cir. 2009).

context, a payment or settlement prior to maturity could be protected from avoidance by § 546(e). The expansive application of § 546(e) to transactions neither commonly understood to involve settlement payments, nor involving systemic risk to the financial markets, is creating an interesting interpretation of § 546(e) in which courts protect from avoidance large numbers of transactions that were apparently not within the contemplation of Congress when § 546(e) was enacted.

### *In re Quebecor World (USA) Inc.*<sup>150</sup>

The Second Circuit followed its reasoning in *Enron* when *Quebecor* was decided two years later. In *Quebecor*, the court continued its expansive view of the type of transactions that apply to § 546.

#### *General Background Facts*

The unsecured creditors “sought to avoid and recover certain payments made by debtor, Quebecor World (USA) Inc. (“QWUSA”) to the appellee noteholders in exchange for private placement notes that had been issued by one of QWUSA’s affiliates, Quebecor World Capital Corporation (“QWCC).”<sup>151</sup> QWUSA and QWCC were subsidiaries of Quebecor World Inc. (QWI) and QWCC had raised \$371 million for the Quebecor entities by issuing private placement notes (the “Notes”) to the noteholders pursuant to two Note Purchase Agreements (the “NPAs”). The Notes were guaranteed by QWI and QWUSA and these funds were eventually transferred, at least in part, to QWUSA. The NPAs allowed for prepayment if QWCC paid the principal, interest, and paid a “Make-Whole Amount.” Quebecor affiliates were barred from purchasing the notes, unless the affiliate complied with the prepayment provisions.

In September of 2007, QWI approved prepayment of the Notes and QWCC issued a redemption notice. However, due to Canadian tax implications, the prepayment was restructured with QWUSA purchasing the notes for cash and then QWCC would redeem the notes from QWUSA. Because of this arrangement, QWUSA issued new notice to the noteholders, which stated that it would pay the “redemption price” pursuant to the NPAs, resulting in purchase of the notes by QWUSA. Subsequently, QWUSA transferred \$376 million to CIBC Mellon, the trustee for the noteholders, for the notes and the money was eventually distributed to various noteholders.

#### *Preference Action*

In January of 2008, QWUSA filed for bankruptcy, less than 90 days after the payment was made for the Notes. Subsequently, the unsecured creditors committee commenced an adversary proceeding against the noteholders, which sought to avoid the earlier transfer as a preference. Procedurally, while this case was before the bankruptcy court, the Second Circuit decided the *Enron* case. In following *Enron*, the bankruptcy court held that QWUSA’s payment qualified as a “settlement payment” and a transfer made “in connection with a securities

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<sup>150</sup> 719 F.3d 94 (2d Cir. 2013).

<sup>151</sup> *Id.* at 96.

contract.”<sup>152</sup> The district court also affirmed that the payment was a “settlement payment” but disagreed with the bankruptcy court’s finding that the payment qualified as a transfer “made in connection with a securities contract.”<sup>153</sup>

### Issue

The issue before the Second Circuit was what role a financial institution must undertake in order for the transaction to be considered protected under § 546(e).

### Analysis

Following its earlier decision in *Enron*, and keeping with a number of other circuit courts, the Second Circuit determined that the payment was entitled to protection under § 546(e). The court reviewed its earlier language in *Enron* where it held that “the absence of a financial intermediary that takes title to the transacted securities during the course of the transaction is [not] a proper basis on which to deny safe-harbor protection.”<sup>154</sup> Consequently, the payment by QWUSA to the trustee for the noteholders was a payment to a financial institution (the trustee).<sup>155</sup>

The court based its decision on three factors. First, the court determined that the transfer was indeed a purchase and not redemption because QWUSA made the transfer in order to purchase the QWCC notes, not to redeem obligations of QWUSA. Second, the NPAs qualified as securities contracts. “The NPAs were clearly ‘securities contracts’ because they provided for both the original purchase and the ‘repurchase’ of the Notes. Accordingly, this was a transfer made to a financial institution in connection with a securities contract that is exempt from avoidance.”<sup>156</sup> Finally, the court determined that QWUSA transferred the payment to the trustee, which qualifies as a financial institution. The court also noted “[a] clear safe harbor for transactions made through these financial intermediaries promotes stability in their respective markets and ensures that otherwise avoidable transfers are made out in the open, reducing the risk that they were made to defraud creditors.”<sup>157</sup> As such, the Second Circuit affirmed the lower courts’ rulings that the payment and transfer was exempted from avoidance.

### Takeaways

In this opinion, the Second Circuit essentially double downed on its expansive view of § 546(e) through a broad interpretation of the types of transactions that are covered under this code section. From a policy standpoint, the circuit continued to view the stability of the securities market as an overriding concern when deciding cases under § 546(e).

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<sup>152</sup> 11 U.S.C. § 546(e) (2006).

<sup>153</sup> *Id.*

<sup>154</sup> *Quebecor*, 719 F.3d, at 98 (quoting *In re Enron*, 651 F.3d at 338).

<sup>155</sup> 11 U.S.C. § 546(e) (2006).

<sup>156</sup> *Quebecor*, 651 F.3d at 98-99 (citation omitted).

<sup>157</sup> *Id.* at 100.

### *FTI Consulting, Inc. v. Merit Management Group, LP*<sup>158</sup>

In contrast to *Enron*, *Quebecor*, and the majority of cases analyzing the § 546(e) safe harbor provision, the Seventh Circuit recently held in *FTI Consulting, Inc. v. Merit Management Group, LP*, that transfers conducted through financial institutions in which the entity is merely a conduit, and not the debtor or the beneficial transferee, does not fall under § 546(e) safe harbor protections. It is, however, important to note that this case has been appealed to the United States Supreme Court; however, certiorari has not yet been granted as of the date of this paper.

#### *General Background Facts*

Valley View Downs, LP (“Valley View”) acquired shares of a competing entity, Bedford Downs (“Bedford”) for the express purpose of avoiding a fight over the last available harness-racing license in Pennsylvania. In a combine and conquer tactic, Valley View paid Bedford \$55 million to acquire all of Bedford’s shares. The exchange took place through an escrow agent, Citizens Bank of Pennsylvania. Valley View obtained the harness-racing license, but was unsuccessful in securing the gambling license and subsequently filed for Chapter 11 bankruptcy.

#### *Preference Action*

FTI Consulting, Inc. (“FTI”), served as trustee for the litigation trust, which brought suit against Merit Management Group (“Merit”) which held a 30% interest in Bedford Downs. FTI filed the action to recover payments made by Valley View as fraudulent transfers under § 548(a)(1)(b). Merit, however, argued that the transfer was protected under the § 546(e) safe harbors provision as a “settlement payment” due to the use of Citizens Bank as an escrow agent.

#### *Issue*

The court identified the issue as follows: “whether the section 546(e) safe harbor protects transfers that are simply conducted through financial institutions (or the other entities named in section 546(e)), where the entity is neither the debtor nor the beneficial transferee but only the conduit.”<sup>159</sup>

#### *Analysis*

The court first analyzed the breadth of the safe harbor provision and determined that a conduit transfer is simply not included within the scope of § 546(e). Section 546(e) appears in Chapter 5 of the Bankruptcy Code which covers what property is included in the estate. The court analyzed that while § 546 limits the trustee’s avoidance powers, other sections in Chapter 5, such as § 544, § 547, and § 548, encompass the trustee’s avoidance power. The court opined that “[t]he trustee’s avoidance powers serve the broad purpose of ensuring the equitable distribution of a debtor’s assets.”<sup>160</sup> FTI argued that, because other Chapter 5 sections clearly establish that only transfers made prior to the bankruptcy petition by the debtor are avoidable,

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<sup>158</sup> 830 F.3d 690 (7th Cir. 2016).

<sup>159</sup> *Id.* at 691.

<sup>160</sup> *Id.* at 693.

transfers that are made by a listed entity in section 546(e) should also refer to a transfer by the debtor. Furthermore, FTI argued that “because sections 544, 547, and 548 refer to avoidance of transfers to or for the benefit of entities subject to fraudulent-transfer liability, section 546(e)'s safe harbor must refer only to transfers made to a named entity that is a creditor.”<sup>161</sup> The court agreed and found that Chapter 5 of the Bankruptcy Code creates a system both for avoiding transfers and allowing transfers due to the safe harbor provision of § 546(e). Therefore, it is logical to understand that the safe harbor only applies to transfers that are avoidable in the first place.

The court went on to recognize that although § 546(e) is to be given a wide latitude, there are still limits to its reach. “While Valley View's settlement with Bedford resembled a leveraged buyout, and in that way touched on the securities market, neither Valley View nor Merit were ‘parties in the securities industry.’”<sup>162</sup> Put simply, the Seventh Circuit was unwilling to expansively interpret the safe harbor provision as covering any securities transaction that uses a financial institution as a conduit for funds.

### Takeaways

In addressing policy implications, the Seventh Circuit found that it was not concerned over a potential ripple effect in financial markets over its decision. “Valley View's bankruptcy will not trigger bankruptcies of any commodity or securities firms. Even if Valley View's bankruptcy were to ‘spread’ to Merit after avoidance of the transfer, there is no evidence that it would have any impact on Credit Suisse, Citizens Bank, or any other bank or entity named in section 546(e).”<sup>163</sup>

The court also addressed that its holding split with several other circuits. “We recognize that we are taking a different position from the one adopted by five of our sister circuits, which have interpreted section 546(e) to include the conduit situation.”<sup>164</sup> The Eleventh Circuit, however, has agreed with the Seventh Circuit in *Matter of Munford, Inc.* In that case, the court found that payments made by Munford to shareholders were inapplicable to § 546(e) because the financial institutions involved were only conduits. The Supreme Court recently granted certiorari to give final guidance on this issue.<sup>165</sup>

### **Who Can Bring this Action? Analyzing Federal Pre-emption**

As noted in the previous section, a number of defendants have successfully utilized the safe harbor defense in § 546(e). In response, creditors have sought out a “work around” to this defense by bringing actions under state fraudulent transfer laws or the doctrine of unjust enrichment. In response, defendants have argued that these claims are barred by the doctrine of “federal pre-emption.” This section will address the definition of federal pre-emption and the current case law examining these creditor work-arounds for § 546(e).

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<sup>161</sup> *Id.* at 693-94.

<sup>162</sup> *Id.* at 696.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* at 697.

<sup>165</sup> *Merit Management Group LP v. FTI Consulting Inc.*, 16-784 (Sup. Ct.).

## **Federal Pre-emption**<sup>166</sup>

Although American government is based on dual-sovereignty at both the state and federal level, the laws of the federal government occasionally conflict with the laws of the state government(s). This conflict is resolved by Article VI clause 2 of the U.S. Constitution which holds that when a conflict arises, federal laws pre-empt state laws. Preemption cases arise in three situations: (1) the trustee, debtor in possession, or creditor's committee is the plaintiff; (2) A post-confirmation litigation trust is the plaintiff; and (3) the creditors bring a suit in a non-bankruptcy forum. The following cases explore preemption in the context of § 546(e).

### **Whyte v. Barclays Bank PLC**<sup>167</sup> **and In re Tribune Company Fraudulent Conveyance Litigation**<sup>168</sup>

On March 24, 2016, the Second Circuit reached a decision in the *Tribune* case, holding that the Bankruptcy Code's safe harbor provision disallows a suit brought by a trustee or creditor seeking to assert certain state law claims through § 544. The Court, in a separate summary order of non-precedential<sup>169</sup> value, also reached a similar conclusion in *Whyte* regarding the relationship between § 546(e) and swap agreements. Both cases have been appealed to the United States Supreme Court, however certiorari has not yet been granted at the time of this paper.

#### **In re Tribune Company Fraudulent Conveyance Litigation**

The facts of the Tribune case involved the bankruptcy of the Tribune Company ("Tribune") following an LBO. During the bankruptcy, the Official Committee of Unsecured Creditors filed a complaint against Tribune's officers and directors, its cashed-out shareholders, and any other beneficiaries of the LBO.<sup>170</sup> The complaint asserted "actual" fraudulent conveyance claims under § 548(a)(1)(A). After the automatic stay of § 362, which prevented creditors from filing fraudulent transfer actions, was lifted a number of individual creditors ("Tribune Individual Creditors") filed separate state law claims in order to unwind the transfers under the LBO and to recover damages based on state law "constructive" fraudulent conveyance theories. The cases were then consolidated before the district court.

Defendants made two arguments in response to the claims asserted by the Tribune Individual Creditors: (1) although § 546(e) precludes claims by the trustee, its protection also extends to claims that a trustee in bankruptcy could pursue even if the trustee chooses not to pursue such claims; and (2) the Tribune Individual Creditors lacked the necessary standing to bring fraudulent conveyance claims outside of bankruptcy while the Official Committee of

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<sup>166</sup> This section is based on a paper by Ronald R. Peterson and Landon Raiford titled, *Can the Trustee Bring that Lawsuit? Exploring Standing and In Pari Delicto Issues in Chapter 11 Cases*.

<sup>167</sup> 644 Fed. Appx. 60 (2d Cir. 2016). The summary of this case is based on a Memorandum published by Cleary Gottlieb Steen & Hamilton LLP titled, *Second Circuit Holds Bankruptcy Code Safe Harbors Bar State Law Fraudulent Conveyance Claims Brought by Individual Creditors*.

<sup>168</sup> 818 F.3d 98 (2d Cir. 2016).

<sup>169</sup> While the summary order is non-precedential, it is clear that the Second Circuit applies a similar analysis under both § 546(g) and (e).

<sup>170</sup> This cause of action was transferred to a litigation trust by the plan of reorganization.



Unsecured Creditors pursued the same claims as actual fraudulent transfers within the bankruptcy proceeding. The district Court dismissed the Tribune Individual Creditors' claims because they had no standing to pursue the suit while the Official Committee of Unsecured Creditors pursued the same action.

On appeal, the Second Circuit affirmed the dismissal of the Tribune Individual Creditors' state law constructive fraudulent conveyance claims. The court, however, did not invalidate the claims based on standing, deciding instead that the safe harbor provision of § 546(e) prevented the claims from moving forward. The Second Circuit held that "under both the bankruptcy court's orders and the confirmed reorganization plan, if appellants had actionable state law, constructive fraudulent conveyance claims, assertion of those claims was no longer subject to Section 362's automatic stay."<sup>171</sup> Particularly, Tribune's plan expressly allowed LBO-related Causes of Action authorized under state fraudulent conveyance law, and further stated that nothing in the plan would impair the rights of the Tribune Individual Creditors to pursue their claims.

The Second Circuit addressed whether Tribune Individual Creditors' state law claims were revived by order of the court and the plan lifting the stay or by the expiration of the two-year bankruptcy statute of limitations. The court determined that § 546(e) served as a bar to the Tribune Individual Creditors' state law claims. The first step of the analysis was to determine if the Tribune Individual Creditors' claims had reverted to them after the Official Committee of Unsecured Creditors chose not to pursue the claims, or if the claims had somehow become property of the unsecured creditors. The court expressed doubt about support within the Bankruptcy Code, either expressly or impliedly, for the proposition that creditors can themselves bring claims outside of bankruptcy solely because the trustee did not bring the claims within the bankruptcy case. The court reasoned that the Bankruptcy Code itself prescribes a two-year statute of limitations for a trustee to bring claims, but does not expressly state or imply that claims not asserted by a bankruptcy trustee somehow revert to creditors who may have the ability to assert the actions outside of bankruptcy. "Equally important is the fact that the inference of a reversion of fraudulent conveyance claims to creditors drawn from Section 544's statute of limitations is not based on the language of the Code, which says nothing about the reversion of claims vested in the trustee et al. by Section 544."<sup>172</sup> Turning next to the idea that the claims were property of the unsecured creditors, the court examined whether or not avoidance claims become the property of the debtors' estates. "Use of the term 'property' as a short-hand way of suggesting exclusivity has merit, Henry E. Smith, *Property and Property Rules*, 79 N.Y.U. L. Rev. 1719, 1770-74 (2004), but Section 544(b)(1) does not expressly state whether the bundle of rights transferred can revert."<sup>173</sup> The court, however, determined that it need not resolve the property or reversion issues.

The answer to the issue was found in the second part of the court's analysis. The court, through interpretation of § 546(e), considered whether "a consensus would have existed among reasonable, contemporaneous readers" at the time that the safe harbor was enacted that § 546(e)

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<sup>171</sup> *Tribune*, 818 F.3d at 109.

<sup>172</sup> *Id.* at 114.

<sup>173</sup> *Id.* at 117.

barred only claims brought by a “trustee.”<sup>174</sup> Finding no consensus existed, the court moved to the legislative history and underlying context of § 546(e) to consider the question of whether this section impairs a creditor’s right to bring state law fraudulent conveyance claims after filing a Chapter 11 case. The court reasoned that safe harbors exist in order to protect the stability of the securities markets and to allow the unwinding of these types of transactions would seriously undermine the speed, certainty, and finality of the market. The court ran through a parade of horrors concluding that the threat of unwinding transactions would impede investment and distort markets. Ultimately, in finding preemption by the federal government, the court found that allowing the claims to proceed has no basis in the Bankruptcy Code and is simply not a

rational action. The idea of preventing a trustee from unwinding specified transactions while allowing creditors to do so, but only later, is a policy without logical rationale.

Separately the court affirmed the application of § 546(e) safe harbors provision to LBOs, such as the LBO at issue in the *Tribune* case.

### **Whyte v. Barclays Bank PLLC**

In *Whyte*, the district court was tasked with considering the ability of a trustee of a litigation trust (the “Litigation Trustee”) to pursue the state law claims of individual creditors involving swap transactions. In order to avoid the safe harbor provisions, a group of creditors, the SemGroup Individual Creditors, had previously transferred their state law fraudulent transfer claims into the litigation trust pursuant to the Chapter 11 reorganization plan. The Litigation Trustee, not a Bankruptcy Code “trustee”, sought to bring an action against Barclays under New York’s Debtor & Creditor Law in order to unwind an alleged fraudulent conveyance of SemGroup’s NYMEX swap portfolio to Barclays. “Accordingly, the Trustee seeks to here invoke, not her powers under the Bankruptcy Code, but her rights under state law as ‘holder and assignee of all claims and causes of action against Barclays.’”<sup>175</sup> Avoidance claims, in the Litigation Trustee’s opinion, remained the property of the creditors during bankruptcy. In response, defendants sought protection under the safe harbor provision. The Litigation Trustee countered by arguing that because § 546(g), which is similar to § 546(e) for swap transactions, applies to a “trustee” that is “exercising federal avoidance powers under [Section 544 of] the Bankruptcy Code,”<sup>176</sup> the safe harbor defense should not apply to creditor claims brought under state law.

The district court agreed with defendants, finding that § 546(g) safe harbor provision applied to the Litigation Trustee, thus preempting the state law claims. The court found that allowing the claims to proceed would go against the public policy initiative of Congress to protect such transfers from avoidance. Further, in “the Trustee’s view, § 546(g) could be thwarted in any bankruptcy by the simple device of conveying fraudulent conveyance claims into

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<sup>174</sup> *Id.*

<sup>175</sup> *Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013) (citation omitted).

<sup>176</sup> *Id.* at 199.

a litigation trust for later use, repackaged as creditors' state law fraudulent conveyance claims.<sup>177</sup>

The Second Circuit affirmed for the same reasons stated in *Tribune*.

*Significance of Tribune/White*

The Second Circuit's opinion considered and subsequently rejected individual creditor constructive fraudulent conveyance claims after confirmation of a plan in order to avoid the application of safe harbors to LBOs and other similar financial transactions. The Second Circuit continues to provide serious protections to section 546 safe harbor provision without dealing with the anomaly that had there been no bankruptcy case the causes of action of the creditors would have proceeded. Based on the guidance coming out of the circuit regarding this issue, these broad protections of the strength of safe harbors are likely to continue until and if guidance is provided by the United States Supreme Court.

*In re Physiotherapy, Incorporated*<sup>178</sup>

In *Physiotherapy*, the Chapter 11 debtor provided outpatient physical therapy services throughout the United States. The Litigation Trustee of the post confirmation litigation trust subsequently commenced multiple fraudulent transfer claims against multiple defendants, including the controlling shareholders and private equity funds, Water Street Healthcare Partners and Wind Point Partners IV (the "Controlling Shareholders"). The Trustee sought to recover \$248.6 million in payments made to the Controlling Shareholders and other selling shareholders (the "Selling Shareholders") in exchange for their equity in Physiotherapy Holdings, Inc. ("Physiotherapy" or the "Debtor").<sup>179</sup> In 2007, Water Street acquired Physiotherapy and thereafter, according to the Litigation Trustee, the Controlling Shareholders began engaging in various forms of accounting fraud in order to prop up the financial health of Physiotherapy and gain a substantial profit from the sale of Physiotherapy shares to the purchaser, Court Square. As a result of the sale, Physiotherapy assumed a significant amount of debt while the Controlling Shareholders were compensated \$248 million for their shares.

Physiotherapy subsequently defaulted on the debt and filed for bankruptcy. The senior noteholders of the Debtor assigned their fraudulent transfer claims to a litigation trust. The trustee of the litigation trust then sought to avoid the \$248 million payment to the Controlling Shareholders. At trial, the court granted in part and denied in part the defendants' motion to dismiss for failure to state a claim. The court held that the safe harbor did not bar the litigation trust from asserting the state law fraudulent transfer claims of the senior noteholders. The Court held that a litigation trustee can assert state law fraudulent transfer claims as a creditor-assignee when: "(1) the transaction sought to be avoided poses no threat of 'ripple effects' in the relevant securities markets; (2) the transferees received payment for non-public securities, and (3) the

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<sup>177</sup> *Id.* at 201.

<sup>178</sup> 62 Bankr. Ct. Dec. (CRR) 213, 2016 WL 3611831 (Bankr. D. Del. 2016).

<sup>179</sup> *Id.* at \*1.

transferees were corporate insiders that allegedly acted in bad faith. When these three factors are present, a finding of implied preemption is inappropriate.”<sup>180</sup>

Defendants relied on the *Whyte* case to argue that the litigation trust was barred from bringing fraudulent transfer claims for creditors of the debtor. Further, the defendants relied on the *Tribune* case for the proposition that Section 546(e) preempts state fraudulent transfer law.”<sup>181</sup>

Declining to follow the Second Circuit, the court instead followed the reasoning in *In re Lyondell Chem. Co.*<sup>182</sup> which held that the safe harbor provision did not apply to claims brought by a litigation trust pursuant to state fraudulent transfer law. In the *Lyondell* opinion, the court “correctly recognized that the States have traditionally occupied the field of fraudulent transfer law, and applying the presumption against preemption is therefore appropriate.”<sup>183</sup> The court was equally unmoved by policy arguments against its holding such as the potential destabilization on financial markets. Because no public shares or swap agreements were involved in the case at bar, the court found that such policy arguments were not warranted and thus a finding of preemption was inappropriate.<sup>184</sup>

The court further reasoned that the plain language of Section 546(e) promoted its holding. The court reasoned that the statute limits the trustee’s ability to bring a fraudulent conveyance claim, but is silent as to a creditor’s ability to bring the claim. “The absence of this phrase in section 546(e) constitutes strong evidence ‘that Congress did not intend that section to preempt state-law avoidance claims.’”<sup>185</sup> The court did, however, reject the idea that the safe harbor provision did not apply as a result of alleged participation in the fraud by the transferees.

### **Significance of These Cases**

Although courts of the Second Circuit continue to expand the scope of the safe harbor provisions we are now seeing some pushback from courts in other circuits to limit the scope of the safe harbor provisions to situations which more closely resemble the apparent intent of Congress to avoid systemic risk. When the financial institution involved has no economic stake in the transaction or where only private securities are involved the applicability of the safe harbor protections is questionable.

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<sup>180</sup> *Id.* at \*10.

<sup>181</sup> *Id.* at \*7.

<sup>182</sup> 503 B.R. 348 (Bankr. S.D.N.Y. 2014). It is important to note that *Lyondell* was abrogated by the *Tribune* decision, however as *Tribune* is not mandatory precedent for the Southern District of New York, the court was free to follow the reasoning in *Lyondell*.

<sup>183</sup> *Id.* at \*7.

<sup>184</sup> The court also noted that unlike *Whyte and Barclays*, the trustee had alleged that the defendants had acted in bad faith. “Permitting a defendant to evade liability in this scenario vis-à-vis the safe harbor would run counter to Congress’ policy of providing remedies for creditors who have been defrauded by corporate insiders.”

<sup>185</sup> *Id.* at \*9 (citation omitted).

**SCHULTE ROTH**  
88 F.3d 311 (5<sup>th</sup> Cir.1996)

The *Schulte Roth* case involved a proxy fight where the Parks Group of shareholders wanted to put some people on the board. Their lawyers were Shulte, Roth and Zable. At first the Parks Group disseminated solicitation materials stating their demands and indicating that they would seek reimbursement for their legal fees, to the extent legally permissible. The Parks Group then filed suit and included a request for attorney fees. Subsequently, there was a settlement agreed to and Southmark made a payment of \$3.3 million into a Schulte Roth escrow to cover the fees and expenses of the Parks Group. A formal settlement agreement was then signed and Schulte Roth received \$1 million of the \$3.3 million. Within 90 days of the payment, Southmark filed Chapter 11 and sued Schulte Roth for a preference.

Schulte Roth admitted that a claim may have existed prior to the payment because of the broad definition of “claim” in the Bankruptcy Code but contended that no debt existed until the settlement was reached since there was no liability on the claim until there was either a settlement or a judicial determination.

The bankruptcy code defined the term "debt" as "liability on a claim."<sup>186</sup> The term "claim" is broadly defined in § 101(5) as a:

- (A) Right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured; or
- (B) Right to an equitable remedy for breach of performance if such breach gives rise to a right to payment whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

Schulte Roth also argued that to constitute a preference § 547(b)(2) requires that a transfer must be "for or on account of an antecedent debt ‘owed’ by the debtor before such transfer was made.” The bankruptcy and district courts agreed that there was no debt owed prior to the settlement.

The 5th Circuit reversed, noting that the Supreme Court said in the *Davenport* case that claim and debt were “coextensive”.<sup>187</sup> The court also noted the same language in the legislative history and concluded that claim and debt is the same thing. Since Schulte Roth had a contingent, unliquidated claim prior to the settlement there was a debt.

What about the requirement that a debt must be owed? The 5th Cir blew by that because Schulte Roth didn’t cite any cases in support of that proposition stating that the argument was

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<sup>186</sup> 11 U.S.C. § 101(12).

<sup>187</sup> *Pennsylvania Dep't of Public Welfare v. Davenport*, 495 U.S. 552, 558, 110 S.Ct. 2126, 2130, 109 L.Ed.2d 588 (1990).

“contrary to established law” and “spurious”. The court did not discuss the fact that in every prior case the facts established that there actually was a debt owed. In fact, a sampling of prior and subsequent cases citing *Davenport* failed to show another situation where a claim existed but no debt was owed.<sup>188</sup>

This case is an example of judicial misapplication of precedent. If I have a contract to sell you 10 bowling balls every month for 12 months I have a contingent claim but there is no liability on that claim until I deliver the bowling balls or you breach the contract. In addition, no debt is owed until I either deliver the bowling balls or you breach the contract. *Davenport* involved a determination of whether a criminal restitution obligation constituted a dischargeable debt and the Supreme Court concluded that the restitution obligation constituted a debt. In doing so the court noted the legislative history regarding claim and debt being coextensive, as it was in that case and in the vast majority of cases that address the issue.<sup>189</sup> However, if claim and debt are always the same there would be no need for separate definitions in the Bankruptcy Code, and certainly, there would be no need to elaborate and require an antecedent debt owed for a recoverable preference. If the contract for the delivery of bowling balls is cancelled prior to the delivery of any bowling balls there never was any money owed although a potential claim existed during the life of the contract. Sometimes it’s best for a court to step back from slavish adherence to statements made in prior cases that made sense in the context of those cases and determine if those statements are consistent with the statutes and facts that are then in question.

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<sup>188</sup>See, e.g.: *In re St. Laurent*, 991 F.2d 672, 676 (11th Cir.1993); *In re Huelbig*, 313 B.R. 540, 542, 543 (D. R. I. 2004); *In re Lewin*, No. CC-12-1238, 2013 WL 3369306, at \*7 (B.A.P. 9th Cir. 2013); *In re Mazzeo*, 131 F.3d 295, 302 (2d Cir. 1997); *In re Davis*, 778 F.3d 809, 812 (9th Cir. 2015); *Hessinger & Assoc. v. Voglio (In re Voglio)*, 191 B.R. 420, 422 (D. Ariz. 1996); *In re McCarther-Morgan*, No. 07-90654, 2009 WL 7810817, at \*8 (B.A.P. 9th Cir. 2009); *Francis v. Scorpion Group, LLC (In re Francis)*, 489 B.R. 262, 267 (Bankr. N.D. Ga. 2013); *In re Gainey*, 447 B.R. 807, 815 (Bankr. W.D. Mich. 2011); *Lewis v. Lewis (In re Lewis)*, 423 B.R. 742, 747 (Bankr. W.D. Mich. 2010).

<sup>189</sup> The dissent in *Davenport* disagreed, mainly on policy grounds.