July 2011: Bankruptcy Litigation Update

Supreme Court Limits Bankruptcy Court Authority to Render Final Orders on State Law Counterclaims: The Supreme Court recently issued a decision resolving "two issues: (1) whether the Bankruptcy Court had the statutory authority under 28 U.S.C. § 157(b) to issue a final judgment on [a debtor's counterclaim against a creditor]; and (2) if so, whether conferring such authority on the Bankruptcy Court is constitutional." *Stern v. Marshall*, 131 S.C. 2594, 2600. *Stern* involves a dispute between Vickie Marshall (professionally known as Anna Nicole Smith) and Pierce Marshall regarding the disposition of the assets of J. Howard Marshall, Vickie's husband and Pierce's father.

During the pendency of this dispute, Vickie filed for chapter 11 bankruptcy protection. Pierce filed a proof of claim in Vickie's chapter 11 case in respect of a pending litigation over defamation of character. Vickie responded by asserting a counterclaim for tortious interference with a gift she expected from J. Marshall. The Bankruptcy Court for the Central District of California subsequently entered judgment in Vickie's favor. The District Court held that the Bankruptcy Court lacked authority to enter a final order, but ultimately affirmed the Bankruptcy Court's holding. However, by the time the California District Court entered its order on appeal, a jury paneled in Texas State Court found for Pierce on his defamation claim. The Ninth Circuit ultimately held that because the Bankruptcy Court lacked authority to enter a final order, the Texas State Court judgment, as the first final judgment entered by a court of competent jurisdiction, controlled.

In discussing the Bankruptcy Court's authority to enter a final order on the state law counterclaim, the Supreme Court first construed the scope of 28 U.S.C. § 157(b)(2)(c). The Supreme Court held that Congress had clearly provided that counterclaims against the debtor were "core" matters under section 157(b)(2)(c) and that such section evidenced Congress's clear intent to provide the bankruptcy courts with authority to hear and enter final orders on such counterclaims. However, the Supreme Court held that while section 157(b)(2)(c) provided bankruptcy courts with statutory authority to enter final orders on such counterclaims, such authority violated Article III of the Constitution which vests the "judicial power of the United States" solely in judges with life tenure and salary protection.

The Supreme Court held that Article III of the Constitution limited the Article I bankruptcy courts' authority to enter final judgments to those situations where: "the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process." *Id.* at 2618 Ultimately, the Supreme Court held that the state common law tortious interference claim did not stem from the bankruptcy, as it was a claim arising under state common law, and was not integral to determining the allowance or disallowance of Pierce's claims against Vickie's estate. As such, the Court held that Article III of the Constitution prevented the bankruptcy court from entering a final order on the state law counterclaims.

Stern has sparked significant debate among litigants over its scope or whether it should be limited to its facts. The extent to which courts and litigants will use this opinion as a means to move adjudication of bankruptcy matters to final judgment from the United States Bankruptcy Courts to United States District Courts also remains to be seen.

Bankruptcy Court Holds That Transaction Regarding Closely Held Corporation Is Subject to Challenge as a Constructive Fraudulent Transfer Notwithstanding Safe Harbor Provisions: On April 21, 2011, the United States Bankruptcy Court for the Southern District of New York held that section 546(e) of the Bankruptcy Code, which protects certain transfers (in particular margin and settlement payments and transfers made under a securities contract between the debtor and a qualifying financial participant) from avoidance absent actual fraud, did not apply to transfers connected with a transaction regarding a closely-owned corporation.

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In *MacNenamin's Grill*, the debtor was a closely-held corporation owned by three equal shareholders. In 2007, the debtor entered into a stock purchase agreement with the shareholders to repurchase all outstanding stock. The stock sale was financed by a bank loan secured by the debtor's assets. The debtor was unable to service the acquisition loan and filed for chapter 11 protection. The chapter 11 trustee subsequently commenced an action to avoid both the cash transfers to the shareholders and the bank loan and security interest as constructive fraudulent transfers. The shareholders and lender each argued that the transaction was protected by the section 546(e) safe harbors.

The Bankruptcy Court held that section 546(e) was inapplicable cash transfers to shareholders involving a small, private transaction, notwithstanding that they were settlement payments were made through a financial intermediary (*i.e.*, a bank). The court noted that the policies underlying the statutory safe harbor provisions (*i.e.*, the reduction of systemic risk and preservation of the financial markets) were not served by protecting the sale of three shareholders' interests in a small business when the funds simply passed through a financial institution. The court adopted a five-part test to determine whether a transaction qualified for protection under the Bankruptcy Code safe harbor provisions:

(1) whether the transactions were long settled through actual transfers of consideration, so that a subsequent reversal of the trade could disrupt the securities industry, potentially creating a chain reaction that could cause the affected market to collapse;
(2) whether consideration was paid for the securities or property interest as part of the settlement of the transaction;
(3) whether the transfer of cash or securities effected contemplated the consummation of a securities transaction;
(4) whether the transfers were made to financial intermediaries involved in the national clearance and settlement system; and
(5) whether the transaction affected participants in the system of intermediaries and guaranties involved in the clearing and settlement process of public markets, thus creating the potential for adverse impact on the securities market if any of the guaranties were invoked.

The Bankruptcy Court found that the shareholders did not provide "any evidence that the avoidance of the transaction at issue involved any entity in its capacity as a participant in any securities market, or that the avoidance of the transactions at issue poses any danger to the functioning of the securities market." As such, the court found that the section 546(e) safe harbor provisions did not apply.

The court further held that the Section 546(e) protections did not apply to the trustee's action to avoid the underlying loan obligations. It noted that the reasons for holding the safe harbors inapplicable applied equally to the shareholders and lenders. It further held that Section 546(e) applies only to actions to avoid a "transfer of property of the debtor" and not to actions to avoid incurring an obligation of the debtor. Because the loan agreement constituted the incurrence of an obligation by the debtor, it was not protected by the statutory safe harbor. The case is *Geltzer v. Mooney* (*In re MacNenamin's Grill LTD*), 09-8266 (Bankr. S.D.N.Y. April 21, 2011).

Second Circuit Rules that Chapter 11 "Gifting" Plan Violates Absolute Priority Rule: The Second Circuit recently held that a chapter 11 plan allowing a secured creditor to "gift" property to a junior class of stake holders, notwithstanding that a more senior class of unsecured creditors had not been paid in full, violated the Absolute Priority Rule of Bankruptcy Code section 1129. *In re DBSD North America, Inc.*, 634 F.3d 79, 100 (2d Cir. 2011). In DBSD, the debtor sought confirmation of a chapter 11 plan to refinance the first lien debt, equitize the second lien debt (at less than par recovery), distribute new equity to holders of unsecured claims (providing a recovery estimated at less than 50%), and distribute new shares and warrants to the existing equity holder. Sprint Nextel objected that the plan violated the Absolute Priority Rule, which provides that absent the agreement of all senior classes, junior creditors classes and interest holders may not receive distributions under a reorganization plan unless all senior classes are paid in full.

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The Second Circuit reversed the bankruptcy court, holding that the distribution to existing equity holders, though labeled a "gift," was nonetheless a distribution that failed to comply with Bankruptcy Code section 1129(b)(2)(B). In doing so, the Court distinguished the leading gifting case, *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993), on the basis that SPM involved a chapter 7 case in which a secured creditor had already obtained relief from the automatic stay. It was therefore free to dispose of its recouped collateral as it saw fit because distribution was not made pursuant to a chapter 11 plan.

DBSD might make it more difficult to achieve consensus in complex chapter 11 cases by creating obstacles to allocating value to junior stakeholders. *DBSD* is also noteworthy in that it upheld a bankruptcy court ruling designating (i.e. disregarding) DISH Network's vote on the basis that DISH voted against the plan not as a creditor seeking to maximize its return but as a competitor seeking to gain control of the debtor. Prior rulings had established that Bankruptcy Code section 1126(e) (authorizing the designation of votes) should be invoked sparingly, but the facts supported the designation of DISH's vote.

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