

BANKRUPTCY LAW

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LEXISNEXIS

CHAPTER 2

INVOKING BANKRUPTCY RELIEF

(Insert the following on page 181, under “b. Coordinating the Chapter 13 Choice”, before the slides on pp. 182 & ff.):

d. Coordinating the Chapter 13 Choice

As the introductory text to this part explains, the rationale of the “abuse” test in § 707 is to drive supposed “can pay” debtors out of Chapter 7 and into Chapter 13 (assuming the debtor so elects), where the debtor would then have to make meaningful payments to her creditors under a Chapter 13 payment plan. That rationale only works, though, if the Chapter 13 plan confirmation rules and the Chapter 7 abuse test rules are coordinated. Otherwise a debtor could end up in a bizarre “never-never” land just like Peter Pan, where she can’t proceed under Chapter 7 because she flunks the abuse test but can’t confirm a Chapter 13 plan either. We know Congress wanted to stick it to consumer debtors in BAPCPA, but we’re pretty sure they didn’t want to stick it to debtors *that* bad. Indeed, doing so would actually undermine the “make debtors pay every last penny” imperative of BAPCPA — it’d be best (for fulfilling that policy) to make sure any Chapter 7 means test “flunkee” COULD proceed in Chapter 13, where she’d have to fork it all over.

We saw in the computation of the Chapter 7 means test some of these coordinating rules. Notably, any expenses the debtor would have to pay under a confirmed Chapter 13 plan (e.g., secured debts due over the next 60 months, priority claims, and Chapter 13 administrative expenses) may be deducted as expenses in the Chapter 7 means test computation.

In Chapter 13, the key coordinating provision is the “projected disposable income” test (also known as the “best efforts” test) of § 1325(b)(1). The Chapter 13 debtor must (if either the trustee or an unsecured creditor objects to her proposed plan) promise to commit all of her “projected disposable income” to plan payments. That test has 2 aspects: the “projected” part (which comes before the Court in *Lanning*) and the “disposable income” part (which the Court considers in both *Lanning* and *Ransom*). In those two cases, the Court has to figure out how to calculate this “projected disposable income” (PDI), and as one might suspect, doing so requires identifying the relevant income to be counted (the *Lanning* problem) and expense deductions to be allowed (the *Ransom* problem). Then, once THAT is figured out, one must “project” the “disposable income” over the life of the Chapter 13 plan. That projection problem was the real issue in *Lanning*.

Coordinating rules abound in figuring out the PDI. On the income side, the Code requires debtors to count their “current monthly income” (or “CMI”), which is a defined term used in the Chapter 7 means test. As we’ll discuss, the difficulty is that the CMI definition uses only the debtor’s *past* income. That might well be problematic if the debtor no longer is making the same income, which is where the “projection” part of the statutory test comes into play. Hello, *Lanning*. On the expense side, for those debtors whose income is at or above the state median for that family size, the allowed expense deductions are those authorized under the Chapter 7 means test itself, which utilizes IRS collection standards. Thus in *Ransom* we’ll see the Court

struggling to sort out whether to allow the Chapter 13 debtor an expense deduction (for car ownership) that the Chapter 7 means test at least possibly allows the debtor to take even if she doesn't have an actual car ownership expense.

Another important coordinating rule is how long a debtor has to make Chapter 13 plan payments (i.e., what is the "applicable commitment period"?). For debtors with income above the state median for their family size, the means test in Chapter 7 uses a 60-month "how much can she pay" calculation in deciding if said debtor is a presumptive abuser who should be given the heave-ho out of Chapter 7. Just so, if that above-median income debtor actually files (or, upon being given the heave ho, converts to) Chapter 13, she has to pay for 60 months. Below median debtors, though, only pay for 36 months.

In both *Ransom* and *Lanning*, the court struggles to make sense of the sometimes nonsensical BAPCPA. Broadly viewed, this is the problem: in BAPCPA, Congress sought to create a slew of very mechanical tests to determine what a debtor could pay and what to make them pay. Congress did so in large part because it worried that those darned bankruptcy judges were sneaky pro-debtor types who'd find any way to keep creditors from getting their just due, and a nice little mechanical test strips abusable discretion from those bankruptcy judges. BUT, since a Chapter 13 plan does actually require the debtor to cut the trustee a check each month to be distributed to the creditors, it is kind of important to take SOME cognizance of the debtor's *real* financial situation. So, ultimately, the interpretive choice in each case is between a strict formulaic determination that looks only to the mechanical means test or disposable income calculation, on the one hand, and an alternative interpretation that accounts for the reality of the specific situation, on the other. Of course, as noted, BAPCPA was designed in many ways to take considerable discretion *away* from bankruptcy judges, but at the end of the day the Supreme Court has nonetheless given significant discretion back to judges in both of these cases. Curiously, though, in the bulk of the likely real-world scenarios that might arise, doing so likely will hurt debtors and help their creditors.

Lanning

In *Lanning*, the Court dealt with (**Question 1**) the Chapter 13 issue of calculating the term "*projected disposable income*" in § 1325(b)(1)(B). If a trustee or unsecured creditor objects to a debtor's Chapter 13 plan, the Court can only approve the plan under one of two circumstances: (1) if the plan provides for full repayment to unsecured creditors (which typically isn't going to happen!); *or* (2) if the plan obligates the debtor to apply *all* "projected disposable income to be received" for the full duration of the plan. § 1325(b)(1). The term "projected disposable income" is undefined, but the calculation for "disposable income" is clearly outlined in § 1325(b)(2)(A)(i)-(ii). "Disposable income" is determined by subtracting the "amounts reasonably necessary to be expended" on qualifying maintenance and support expenses from the debtor's "current monthly income received." Finally, "*current monthly income*" is defined in § 101(10A)(A)(i) (and used in the Chapter 7 means test) as the debtor's average monthly income during the six months preceding the filing of the bankruptcy petition. Thus, a court in the situation of determining whether the debtor's proposed but objected-to plan complies with option (2) must look to the debtor's "projected disposable income to be received," and in doing so is forced to look at her "current monthly income." The issue the Court had to grapple with in this case was what to do in "projecting" a debtor's disposable income when the statutorily mandated calculation of income — which is based solely on *past* income — departed (and here, dramatically) from the debtor's *actual* future income.

As the Court noted, there are two possible approaches (**Question 2**) to this calculation — the “*mechanical approach*” and the “*forward-looking approach*.” The “mechanical approach” makes the calculation looking strictly at the debtor’s income from the prior six months and then multiplying by the number of months in the applicable commitment period. In other words, under the mechanical approach, the past DOES control plan-calculated income (via the use of the “current monthly income” definition). “Projected” is simply a *multiplier*. NO changes are made to account for the unpleasant reality that the debtor no longer HAS that kind of income any more. The “forward-looking approach,” by comparison, adopts a less mechanical view of the situation and, while it starts with the same mechanical computation, then allows for changes to the strict calculation if the income figure from the prior six months somehow over- or under- represents the debtor’s current income. Thus, if a debtor’s income picture does change, the forward-looking approach can account for that.

Much of the time, a debtor’s average income for the last six months will be an adequately accurate predictor of her average income in the future (or at least accurate enough, one might surmise, to satisfy a Congress that preferred rules over standards as a way to rein in debtor-favoring bankruptcy judges, and to escape an “absurd result” charge). If the debtor has consistent work and income to begin with, and if she keeps the same job after filing for bankruptcy, a calculation of disposable income based on the prior six months’ income will be a relatively good estimate of what she will actually receive during the course of her bankruptcy plan.

Of course, life is not always so predictable. That is the crux of the problem the Court had to deal with in *Lanning*. As Justice Alito notes for the majority, “In cases in which a debtor’s disposable income during the 6-month look-back period is either substantially lower or higher than the debtor’s disposable income during the plan period, the mechanical approach would produce senseless results.” For example, what if the debtor loses her job shortly before filing for bankruptcy? Or her employer cuts her hours? On the other hand, she may get promoted and have her salary double. Or she may be offered a job with a prestigious law firm, even though she didn’t make any money as an unemployed law school student during her 6-month pre-bankruptcy calculation period. In the interest of BAPCPA’s clear goal of making debtors pay creditors as much as possible, it does not seem that the recently employed lawyer — now making \$160,000/year — should have her law school debt discharged after just 60 low payments of basically nothing. Similarly, it seems, the debtor who loses her job shortly before filing for bankruptcy is probably even more in need of a workable bankruptcy option than she was before she filed. There is certainly no additional benefit to her creditors of denying her a feasible repayment plan based on her *current* monthly income (or possibly denying her any bankruptcy option at all, as we will discuss later).

Stephanie Lanning’s situation presented the Court with just such a problem. In the six-month period before filing for bankruptcy, Lanning received a one-time buyout payment from her former employer. This payment artificially inflated her average monthly income for the six months prior to filing for bankruptcy (the “current monthly income” formula under § 101(10A)(A)(i)) to \$5,343.70 — above the median income for a family of one in her state of Kansas. But Lanning’s *actual* monthly income at the time of filing, from her new job, was only \$1,922 — below the median income in Kansas. Calculated using the strict approach of § 707(b)(2) — which defines “current monthly income” by the backward-looking prior six months figure — Lanning had \$1,114.98 in monthly disposable income. (Note that this figure would have left her only \$807.02 for monthly living expenses, if we were to combine the real

and artificial worlds.) Lanning's *actual* disposable income (actual monthly income from new job minus monthly expenses) was only \$149.03 — leaving her almost \$1000 more per month (\$1772.97/month total) for living expenses.

As discussed in detail below, this change in income from the pre-bankruptcy period to the repayment period left Lanning potentially unable to confirm a bankruptcy plan under Chapter 13 (depending on how the Court interpreted “projected”), and presumptively subject to dismissal for abuse under the Chapter 7 means test. In short, Stephanie could have been a woman without a chapter.

Catch-22

The purpose of BAPCPA's Chapter 7 “means test” is to kick supposed “can pay” debtors out of Chapter 7 and into Chapter 13, where they will have to repay a significant portion of their debts. This rationale seems to presuppose that the “can pay” debtor denied Chapter 7 relief will, in fact, be permitted to confirm a Chapter 13 repayment plan. BAPCPA's coordinating mechanisms, however, contain one serious glitch that threatened to deny some debtors relief under either Chapter 7 *or* Chapter 13 — namely, those debtors whose income declined significantly during the six-month period before the bankruptcy filing. This circumstance is well illustrated by the facts of *Lanning* (and is the basis of **Question 4**).

As noted, Stephanie Lanning's calculated “disposable income” under Form B22C was **\$1,114.98** — making a Chapter 7 filing presumptively abusive (indeed, by about tenfold!) under the means test. Admittedly, she could try to rebut the abuse presumption by showing “special circumstances,” but that is no sure thing. So, at best, her potential for access to Chapter 7 would have been iffy. Stephanie, though, wasn't trying to file Chapter 7 and stiff her creditors; no, she wanted to repay them, as much as she could, in a Chapter 13. Good for her! But wait, there's a problem. Her *actual* repayment capacity (using the monthly income from her new job, which of course is the only money she will have available to make Chapter 13 plan payments, and calculated by comparing Schedules) was only **\$149.03**. In short, the mechanical calculation of her disposable income using the statute as written overstated the disposable income she actually had by almost a thousand dollars a month. Oops. Accordingly, residing in the real world rather than in a Congressionally-imagined fantasy world, Stephanie Lanning filed a Chapter 13 plan that proposed to devote \$144 per month to creditor repayment.

The Chapter 13 trustee objected to this plan, contending that the proposal failed the “best efforts” test of Code § 1325(b)(1). The trustee contended that Lanning was required to devote the full \$1,114.98 per month using the backward-looking projected disposable income calculation. (In fact, the trustee calculated that Lanning would “only” need to pay \$756 for 60 months to fully repay her creditors.) Of course, the teeny little problem was that Lanning was not making enough money in her new job to pay even close to that amount. Even the trustee frankly acknowledged “that Ms. Lanning did not have the means to fund such a plan.” (see **Question 4**). Under § 1325(a)(6), the court would have to deny confirmation of such a plan on feasibility grounds. Thus, Stephanie Lanning — and others whose income took a significant drop during the six-month period — would be left in a Catch-22 of presumptive abuse under Chapter 7, but unable to confirm a feasible plan under Chapter 13. The only option for a debtor in this situation would be to attempt to *rebut* the presumption of abuse under Chapter 7.

The culprit, of course, is the definition of “current monthly income,” which is solely *backward looking*, and thus inaccurate when the debtor's income picture changes. This provided a serious interpretive challenge for the Court in *Lanning*.

The Statutory Text

The challenge in interpreting Code § 1325(b) comes from the statutory contradiction embedded in the text. The statute refers to both the debtor's "current monthly income" and her "projected disposable income." "Current monthly income" is defined in the statute and is strictly *backward-looking*. "Projected disposable income," on the other hand, appears to suggest a *forward-looking* approach. Added fodder for that view in the text is that the "projected disposable income" that counts is that which is "*to be received*" during the plan period. How is it possible for *past* income to be *received* in the *future*? The statute appears, on its face, to command the impossible. (See **Questions 4, 8**)

The problem, then, is that in the circumstance that the debtor's income changes significantly between the pre-bankruptcy period and the plan payment period, the "current monthly income" and the "projected disposable income" don't match. The issue before the Court in *Lanning* (**Question 1**) was whether to adopt the "mechanical approach" (i.e. backward-looking approach) which strictly applies the "current monthly income" calculation, or the "forward-looking approach" which accounts for known or expected changes in income. According to the court, the critical statutory text was the phrase "projected disposable income." Specifically, what did the term "projected" add to the defined term "disposable income"?

The trustee, advocating the backward-looking approach, argued for an interpretation consisting of the "past average monthly disposable income multiplied by the number of months in a debtor's plan." *Lanning*, favoring the forward-looking approach, argued that "projected disposable income" gave the court discretion to adjust the calculation when significant income changes were "known or virtually certain." (**Question 2**)

(**Question 4**) The Court agreed with *Lanning's* interpretation and adopted the forward-looking approach. The precise holding of the Court was "that when a bankruptcy court calculates a debtor's projected disposable income, the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation." The operative test, then, is that the changes must be "known or virtually certain," judged at the time the plan is confirmed.

The Court gave five reasons for choosing this statutory interpretation, focusing on the definition of the term "projected." First, the Court pointed out that the ordinary meaning of "projected" is a prediction or forecasting of future occurrences which considers both past trends *and* other known factors. Ordinarily, the Court noted, "future occurrences are not 'projected' based on the assumption that the past will necessarily repeat itself."

Second, the Court looked to the definitions of "projected" given in other federal statutes — definitions which, not surprisingly, call for a modified prediction based on both historical data and known or anticipated future changes. They contrasted this with use of the term "multiplied" in other sections of the Bankruptcy Code (including § 1325(b)(3)) mandating simple multiplication of income by number of months. If Congress meant "multiplied," the majority argued, they knew how to say so.

Third, the Court noted that pre-BAPCPA, the language "projected disposable income" allowed judges discretion to adjust calculations for known or virtually certain changes in income. Because BAPCPA is only read to erode prior bankruptcy practice when there is an explicit statutory departure from past practice, and because BAPCPA does not define "projected disposable income," the Court concluded that Congress did not intend for "projected" to carry a different meaning than it did pre-BAPCPA.

This pre-Code practice argument, we would submit, is pretty ridiculous, or stupid (and if you are so inclined, you can be more critical). The nicest thing you can say is that it's disingenuous. Here Scalia surely is correct that pre-2005 practice simply can't be controlling given the radical revision of the Code's consumer provisions in 2005, including — for the first time — a definition of how to compute “disposable income,” *viz.*, by creating the new defined term “current monthly income,” which looks ONLY at pre-bankruptcy income.

Fourth, the Court tried to harmonize § 1325(b)(1) with the rest of the statute. They thought that the backward-looking approach clashed with the other parts of §1325. Importantly, “projected,” in the majority's view, serves the vital function of linking “disposable income” and “to be received in the applicable commitment period.” The term “projected,” given its typical usage, seems an odd word choice to describe a solely backward-looking approach to calculating disposable income. It is critical that the statute requires that the debtor pay “all of the debtor's projected disposable income *to be received* during the applicable commitment period.” § 1325(b)(1) (emphasis added). If “disposable income” is defined solely by reference to the *past* (as the mechanical approach directs, because of the use of the “current monthly income” definition in § 1325(b)(2)), then how, pray tell, is it possible for *past* income “*to be received*” in the *future*! (See **Question 8**) Here, Scalia did not really have a good answer. Indeed, his view largely reads the “to be received” language out of the statute. This language only makes sense if the past is, in fact, an accurate predictor of the future for a particular debtor, and if it were, then the language would be unnecessary anyway.

The Court also noted that § 1325(b)(1) “directs courts to determine projected disposable income ‘as of the effective date of the plan,’ *not* as of the filing date of the plan. This, the majority thought, was consistent with a forward-looking approach which “consider[s] postfiling information about the debtor's financial circumstances.” Why wait until the time of confirmation to make the determination if no new information post-filing would be considered anyway?

But Justice Scalia, in his dissent (**Questions 4, 6**), took his own crack at figuring out the textual issue in play here. In Scalia's view, the plan must simply “project” the purely historical Form B22C “disposable income” calculation over the applicable commitment period to determine the amount that will be “applied to make payments.” In other words, “projected disposable income” calls for multiplication of the backward-looking disposable income calculation across the number of months provided for in the plan. This is precisely the interpretation the majority argued against when it noted that Congress had used the term “multiplied” in other sections of the Code, when multiplication was what it intended.

Finally, the Court attempted to avoid an interpretation of § 1325(b) which led to surplusage — extraneous statutory language that did not add anything to the statute's meaning. While the full phrase “projected disposable income” is used in § 1325(b)(1)(B), only “disposable income” was used — without “projected” — in the very next subsection, § 1325(b)(2). The term “projected,” the Court argued, must add *something* to the “disposable income” definition to avoid surplusage.

But Scalia had a surplusage argument on his side as well. If courts are free to stray from the mechanical approach whenever it doesn't accurately predict future disposable income, he argues, the detailed definition of “disposable income,” which clearly calls for a calculation based on the past six months of income, would have been a pointless addition by Congress. This point also addresses the majority's argument that Congress did not amend the pre-BABCPA term “projected disposable income” in 2005. In fact, as Scalia points out, Congress *did* define the

“current monthly income” part of “disposable income” — *for the first time* in 2005 — as a strictly backward-looking calculation!

Scalia does some serious harm to the majority on their statutory view, and it's hard to argue with him. As he says, the majority can only get to the result it wants (effectively a rebuttable presumption approach, as will be discussed in a moment), by utterly rewriting the statute. Tellingly, he argues that “[n]othing in the text supports treating the definition of disposable income Congress supplied as a *suggestion*.”

However, in the end, the statutory arguments work both ways. Either the detailed, backward-looking definition of disposable income is read out of the statute by giving the court freedom to set that aside in circumstances when it doesn't seem to match actual disposable income (even without any real textual basis for doing so), *or* the “to be received” language is read out of § 1325(b)(1) in situations where the debtor's income has dramatically decreased.

In light of the dueling statutory arguments, if one is intellectually honest, one might well conclude that there is no way to make sense of the warring statutes. Congress just goofed. But what makes it more puzzling, and difficult to decide, is that Congress KNEW they were enacting a hopelessly intractable statute BEFORE THEY DID IT. (See **Question 7**.) Witnesses at the hearings prior to BAPCPA's enactment testified that precisely this sort of case could come up, and the statute was at war with itself. Undaunted, Congress sallied forth.

A Rebuttable Presumption

In effect, the *Lanning* Court crafted a rebuttable presumption (see **Question 5**), wherein the mechanical approach “should be determinative in most cases,” *but* nevertheless “the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation.” The court argued that this “rebuttable presumption” was textually based — simply carrying out the ordinary meaning of the term “projected,” which considers past data but adjusts for other expected factors. Because the rebuttable presumption requires courts to start with the mechanical approach, it does address Scalia's surplusage argument to the extent that courts still use the detailed “disposable income” definition.

Lower courts (such as the court in *In re Kagenveama*) who adopted the “mechanical” approach found it significant that Congress apparently “knew how to” craft a rebuttable presumption when it utilized the “current monthly income” construct, having done so quite explicitly in the Chapter 7 means test itself, see § 707(b)(2)(B), and yet did not enact a similar rebuttable presumption in the Chapter 13 setting involving application of the “best efforts” test of § 1325(b).

But the major issue with the Court's rebuttable presumption construction, as Scalia points out, is that even *if*, as the majority argues, there is a textual basis for reading in a rebuttable presumption (which of course there isn't — “projected” cannot fairly be said to create a rebuttable presumption), there really is *not* a textual basis for restricting this rebuttal to only those situations when future changes are “significant” *and* “known or virtually certain.”

Kagenveama/Pak Problem

In *Lanning*, the problem was that the debtor's projected income *dropped* substantially from what it had been prior to bankruptcy, producing a dramatic disparity in the payment capacity suggested by Form B22C, on the one hand (\$1,115), and by a comparison of Schedules I (income) and J (expenses) on the other (only \$149). The change, of course, could run the other way, as demonstrated by *Kagenveama* and *Pak*. (See **Question 9**.)

In *Kagenveama*, Form B22C showed that Laura Kagenveama had a negative repayment capacity (- \$4.04), but the comparison of Schedules I and J indicated an actual repayment capacity of \$1,524. Under the mechanical approach, Laura would not be required to pay anything to creditors, because her “projected disposable income” was negative. A forward-looking court, by contrast, would make Kagenveama pay up. In *In re Pak*, 378 B.R. 257 (B.A.P. 9th Cir. 2007), *abrogated*, *In re Kagenveama*, 541 F.3d 868 (9th Cir. 2008), the debtor was unemployed for four of the six months prior to bankruptcy, thus driving down his apparent repayment ability using the historically based “current monthly income” formula, but he then got a job paying \$104,000 annually, and in fact was able to pay creditors almost a thousand dollars a month in Chapter 13. After the court’s decision in *Lanning*, the “rebuttable presumption” can also be used *against* the debtors in these types of cases. Assuming that the debtor’s changed circumstances are “known or virtually certain at the time of confirmation,” (which they certainly would be if the information comes from the debtor’s own schedules!), courts can now account for the changes in determining whether to confirm a proposed Chapter 13 plan. Presumably, courts with this discretion will often see fit to require payment plans based on the debtors’ *actual* repayment ability rather than their historical earnings in cases where doing otherwise may seem to give debtors an unwarranted free pass.

Note that in these situations, where the debtor’s actual repayment capacity was *greater* than Form B22C reflected, there is not the same Catch-22 problem as in *Lanning*. The debtor of course still would be able to confirm a plan under the mechanical approach — it is certainly “feasible” to pay nothing when you have \$1,524 in actual disposable income every month!

In the “more actual income” cases such as *Pak*, does *Lanning*’s holding matter, or would the debtor be subject to an immediate post-confirmation *modification* of the plan under § 1329 anyway, to require the debtor to pay under the plan what he actually can pay? Should courts require proof of a *change in circumstances* before they will approve a modification of a confirmed plan? (**Question 9**)

The problem with simply modifying the plan is that nothing about the debtor’s situation has changed since the plan’s confirmation. Courts are understandably reluctant to modify a plan under those circumstances. Really it’s a bit of a sham to “confirm” a plan based on a mechanical application of the formula and then *immediately* “modify” the plan the court just confirmed. And there is a division in the courts as to whether changed circumstances are required for confirmation. At least under the Court’s approach in *Lanning*, courts can be more honest and confirm a plan based on reality.

Policy

The fifth and final basis for the Court’s holding in *Lanning* is *policy*. There are two distinct policy issues at play in *Lanning*. First is the BAPCPA intention of taking discretion away from bankruptcy judges. Second is the BAPCPA goal of making debtors who can pay do so.

The goal of limiting courts’ discretion favors the mechanical approach to the calculation in *Lanning*. While the hope when *giving* judges discretion is that they will be able to account for unanticipated or unusual circumstances precisely like those at work in *Lanning*, *losing* this flexibility is a known consequence of lessening courts’ discretion. In fact, as noted, Congress *knew* about the potential for absurd results when it adopted the projected disposable income test in § 1325(b). Lower courts who had used the mechanical approach pre-*Lanning* emphasized the point that prior to the enactment of BAPCPA, Chapter 13 trustees testified before Congress that the projected disposable income test as crafted in § 1325(b) in the pending legislation would lead

to absurd results in cases where the debtor's situation changed substantially from the pre-bankruptcy period to the Chapter 13 payment period. Undeterred, Congress passed the statute in that form anyway.

Nonetheless, the Court in *Lanning* declared that “the mechanical approach would produce senseless results that we do not think Congress intended.” How can a result be so “senseless” as to warrant judicial tampering with the statute if Congress *knew* about the senseless result beforehand and went ahead and passed the statute anyway? If Congress made an informed decision to chose a mechanical, discretion-limiting test for projected disposable income, over a more flexible approach with less potential for absurd results, should the Court nonetheless refuse to implement Congress' intended approach?

Conversely, the BAPCPA goal of making debtors pay favors the forward-looking approach. For debtors earning *more* actual income during the payment period than the pre-bankruptcy period, the forward-looking approach forces them to pay what they *can* pay. Applying only the mechanical test would let debtors pay much *less* than they can pay — effectively allowing these debtors to confirm a Chapter 13 plan in which they keep *substantial* amounts of their disposable income. Like *Kagenveama, Pak*, and the example of the law student above, this situation seems to run especially afoul of the goals of making debtors pay. For debtors earning *less* actual income during the payment period than the pre-bankruptcy period, the forward-looking approach solves the Catch-22 problem of the mechanical approach and allows debtors to confirm a *feasible* Chapter 13 plan for which they can realistically keep up with payments. In either situation, the forward-looking approach better supports a goal of ensuring that debtors pay what they can.

So what will happen now? Most of the time, it won't matter. If nothing has changed, courts will simply take the Form B22C number and multiply by the number of months. If it does matter, though, the outcome typically will be that creditors get more than they would have if the case had been decided the other way, as just explained.

Another possible worry for debtors post-*Lanning* is that the decision has increased uncertainty. The Court read “projected” in a way that returned much discretion to bankruptcy judges. As we are seeing in the bad faith cases, bankruptcy judges have much different ideas about how to exercise discretion. First, when is a change “known or virtually certain”? Second, taking a page from Scalia's playbook — *how much* of a change will be required? What if Stephanie Lanning's Form B22C said she had \$249 in disposable income whereas her Schedules I and J said the reality was \$149? Is that enough? What about \$199 versus \$149? Or \$159 versus \$149?

At the end of the day, though, any professor worth his or her salt should have a lot of fun teaching this case, since you can so easily make fun of Congress, and show what a put-up job BAPCPA really was. If you go around passing statutes verbatim that were written by generous lobbyists, some bad things may come home to roost.

Ransom

The issue in *Ransom* is the interpretation of that part of the means test (§ 707(b)(2)(A)(ii)(I)), as incorporated into Chapter 13 via § 1325(b)(3), which outlines what expenses a debtor may deduct. (**Question 1**) Specifically at issue was whether a debtor who owned one car free and clear (i.e., he did not have an actual car ownership expense) could nevertheless take the car ownership deduction under the Local Standard for transportation. The Supreme Court said “no.” In other words, if the debtor has no actual car ownership expense, he

can't take the car ownership deduction.

The means test is used in Chapter 7 to determine whether a Chapter 7 proceeding is presumptively abusive, and in Chapter 13 to calculate an above-median debtor's disposable income under § 1325(b)(2), (3). Specifically, § 707(b)(2)(A)(ii)(I) provides the following:

The debtor's monthly expenses shall be the *debtor's applicable monthly expense amounts specified under the National Standards and Local Standards*, and the debtor's actual monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service for the area in which the debtor resides

§ 707(b)(2)(A)(ii)(I) (emphasis added). In *Ransom*, the Court addressed in what circumstances “monthly expense amounts specified under the National Standards and Local Standards” can be considered “*applicable*” to the debtor.

When he filed for Chapter 13 bankruptcy relief, Jason Ransom owned outright a 2004 Toyota Camry, valued at \$14,000. In calculating his disposable income under § 1325(b), Ransom reported a monthly income of \$4,248.56 and monthly expenses of \$4,038.01, leaving \$210.55 per month of disposable income. Included in his monthly expenses, Ransom claimed both a car-ownership deduction of \$471 for the Camry (as specified in the IRS's “Ownership Costs” table) and a car-operating cost deduction of \$338 (also specified in the IRS Financial Collection Standards). FIA, an unsecured creditor, objected to confirmation of Ransom's proposed 60-month payment plan, arguing that he could not claim the car-ownership allowance because he did not make loan or lease payments on his car.

Ransom listed his total unsecured debt at over \$82,500, and his proposed five-year plan called for repayment of approximately 25% of this unsecured debt. The difference between Ransom's disposable income with and without taking the car-ownership deduction amounted to about \$28,000 over the 60-month plan period.

At the time this case reached the Supreme Court, there was a split of authority amongst the Courts of Appeals as to whether a debtor who did not make loan or lease payments on his car could still claim the deduction for vehicle-ownership costs. The Ninth Circuit, which heard *Ransom*, did not allow outright car owners to take this deduction; the Fifth, Seventh, and Eighth Circuits did allow outright owners the deduction. See *In re Washburn*, 579 F.3d 934 (8th Cir. 2009); *In re Tate*, 571 F.3d 423 (5th Cir. 2009); *In re Ross-Tousey*, 549 F.3d 1148 (7th Cir. 2008). The Ninth Circuit's holding against the debtor created a split at the circuit level for the first time, although bankruptcy courts had been divided. In the end, the Supreme Court agreed with the Ninth Circuit's interpretation and ruled against the debtor. (**Question 2, 3**)

Statutory Interpretation

The Court began its analysis, as it is wont to do, by looking at the text of 707(b)(2)(A)(ii)(I)—specifically, at the meaning of the term “*applicable*” in the phrase “debtor's applicable monthly expense amounts.” Essentially, the whole case turned on what it meant for a “monthly expense amount[] specified” to be “applicable” to the debtor. (**Question 1**) The question in *Ransom* was whether the car-ownership expense found in the IRS's Local Standards was “applicable” to Ransom, given that he owned his car outright and free of any debt.

“Applicable” can have two possible meanings here: (**Questions 2, 3**)

➔ First, that the expense amount specified is “applicable” to the debtor if the debtor owns a car

(whether or not he owes on the car). That is, the distinction wherein “applicable” would have content (and not be surplusage, always a dreaded statutory no-no) would be between a debtor who OWNS a car (“applicable”) and a debtor who does NOT OWN a car (and thus “not applicable”). Justice Scalia thought (and we agree) that this was the correct reading of the statute.

→ Or second, that the expense amount specified is “applicable” to the debtor if the debtor owns a car AND owes payments on the car. Now the force of “applicable” is to distinguish between a debtor who OWES money on the car (“applicable”) and a debtor who OWES NOTHING on a car (either because the debtor owns no car at all, or the debtor owns a car, but with no debt, i.e., free and clear—“not applicable”). This is the interpretation that the majority adopted in *Ransom*.

First, Justice Kagan, writing for the Court, employed that always-helpful source of law, the Webster’s Third New International Dictionary, to see how it defined “applicable.” This excursus apparently proved quite satisfactory to eight members of the Court, who found the insight in Webster’s that a particular expense is “applicable” to a debtor when it is “*appropriate, relevant, suitable, or fit*.” Ipe dixit, thus is the plain meaning of the Bankruptcy Code. In any case, given this definition, the Court concluded that the phrase “*the debtor’s* applicable monthly expense amounts” was meant as a “*filter*” (emphasis added) that allows a debtor to take a deduction if it is “appropriate for him.” And a deduction is appropriate “only if the debtor has costs corresponding to the category covered by the table—that is, only if the debtor will incur that kind of expense during the lifetime of the plan.”

It’s not clear to us how substituting “appropriate” for “applicable” makes the issue any clearer. (**Question 8**) It is question-begging. The key inquiry is whether the car ownership expense deduction specified should be allowed to a debtor who owns a car, but owes nothing on it. Whether you ask if it’s “applicable” or “appropriate” or “relevant” or anything else (and why not haul out Roget’s Thesaurus while you’re at it, and come up with a LOT of synonyms!), you STILL have the fundamental question: under the law that Congress passed, does the debtor actually have to owe money on the car to get the deduction, or is it enough to just own a car? Under EITHER view, a plausible case can be made that the textual requirement that the expense be “applicable” is triggered (in our not-so-humble opinion). Under Scalia’s view, it’s “applicable” to a debtor who owns a car, as contrasted with not owning one; under the Majority reading, it’s “applicable” to a debtor who owes on a car.

So what is going on here? Did Kagan think the word “appropriate” made it easier for her to just decide whatever she thought was best? We don’t think the Court was (intentionally) using the dictionary as a pretext (at least we hope not), but its use was just meaningless here. “Appropriate” is not any different from “applicable”! It doesn’t resolve the key question. Period. Indeed, if anything it is LESS clear, and in some connotations actually CHANGES the meaning of the statutory text. Perhaps it sounds a *little* better to declare something “inappropriate” (allows for more emotion, less rationality) than “inapplicable.” We suspect that the Court thought that it needed to do basic justice, and sought an “ordinary” meaning (thus the resort to the dictionary) to effectuate the meaning of the Congressionally enacted text. But doing so is flatly wrong here, where Congress passed an incredibly long, complex, detailed, term-of-art mechanical formula, with lots and lots of over-and under-inclusive tradeoffs. It may sound bizarre, on the face of it, to say that a car ownership expense deduction is “applicable” to a debtor who doesn’t have one, but the very nature of the National and Local Standards in the

ultimate deal Congress cut in 2005 in the means test was that the debtor was to be allowed to claim those “amounts specified” EVEN IF not identical to the debtor’s actual expenses.

Once that fact is established, the interpretive issue then becomes how divergent the debtor’s economic reality must be from the hypothesized allowance before it can be said not to be “applicable.” But “appropriate” has no more traction in answering that question than does “applicable.” We’d be comfortable saying that a debtor who simply KNEW someone who owned a car would not be a debtor as to whom the car ownership expense allowance was “applicable” — that is too remote — but a debtor who does own a car, but free and clear — it’s at least possible that it’s applicable to him, isn’t it? Note too that in other aspects of the means test tradeoff, the debtor gets hosed, rather than blessed. So, for example, the debtor whose actual expenses are higher than the IRS allowance is still capped by the Standards. That’s the way the means test was set up. In short, it’s not okay to use a dictionary to give a statutory term a “common meaning” when in the statutory context it has a *specialized* meaning.

In fact, the practice of using dictionary definitions in statutory interpretation — increasing in frequency according to at least one study — has been garnering recent attention, and disapproval. In a recent New York Times article on the subject, editor at large of the Oxford English Dictionary, Jesse Sheidlower, commented, “I think that it’s probably wrong, in almost all situations, to use a dictionary in the courtroom. . . . Dictionary definitions are written with a lot of things in mind, but rigorously circumscribing the exact meanings and connotations of terms is not usually one of them.” In fact, a common practice of dictionary editors is to consult the use of words in prominent press publications. The piece goes on to quote an article by Ellen P. Aprill, Professor at Loyola Law School in Las Angeles, who notes, “[i]t may also be a surprise to the Supreme Court justices who look to dictionaries as authorities in construing statutes that in good measure they are interpreting law according to The New York Times.”¹

So, allegedly based on the “ordinary meaning” (i.e. dictionary definition) of the term “applicable,” the Court determined that the car-ownership deduction is only “applicable” to the debtor if the debtor in fact has a car loan or lease expense. That’s conclusory; the Court assumes the answer and then hands it down as preordained. To us, the Court’s “plain language” argument is less than convincing (we’d go so far as to say it’s preposterous). The fact that two circuit courts (the Ninth in *Ransom* below and the Seventh in *Ross-Tousey*, 549 F.3d 1148) reached opposing results on this issue, each concluding that their interpretation was required by the “plain language” of the statute, suggests that the plain meaning of the statute is not as definite as the Court claimed. (**Questions 4, 8**) As a matter of judicial practice, too, it is really troubling, because it allows the Court to clothe what in reality is a purely policy-driven interpretation in the garb of “plain” statutory text. Yes, the Court did go on (many times, in fact) to talk about the policy of “make debtors pay more,” but did so simply to show that its dictionary-dictated reading of “applicable” made sense in context. It’s as if they had their finger (or, more “appropriately,” a hefty Webster’s dictionary) on the interpretive scales.

The Court also argued that any other statutory interpretation would render the term “applicable” superfluous. (**Question 8**) As we discussed before and also below, however, there is an alternative interpretation of “applicable” which does not, in our opinion, render the term superfluous. It’s “applicable” to a debtor who owns a car, payment or not. Now, that’s not so hard, is it?

¹ Adam Liptak, *Justices Turning More Frequently to Dictionary, and Not Just for Big Words*; N.Y. TIMES, June 13, 2011, <http://www.nytimes.com/2011/06/14/us/14bar.html>.

Statutory Context

The Court also invoked the statutory context, pointing to the definition of “disposable income” in § 1325(b)(2) as “current monthly income . . . less amounts *reasonably necessary to be expended.*” (emphasis added) (**Question 10**) These amounts are then determined according to the means test for debtors with incomes above the state median for their family size. The Court argues, then, that the means test calculation must require that the debtor has *actual* expenses in a particular category covered by the Standards, otherwise the allowance is not “reasonably necessary” as required by § 1325(b)(2). Thus, the Court held that the *only* debtors eligible for the car-ownership deduction are those who loan or lease a car.

The Court thought it anomalous that a Chapter 13 debtor with family income above the state median might be able to take a deduction that a below-median debtor could not take. (**Question 10**) But there are obviously other significant statutory differences for above- and below-median Chapter 13 debtors. For one, a Chapter 13 debtor with family income below the state median need only propose a 36-month Chapter 13 plan, whereas an above-median income debtor must propose a 60-month plan. Also, the below-median debtor might be able to deduct an actual “reasonably necessary” car ownership expense above the “amount specified” in the IRS Standards, while an above-median debtor is certainly capped by the Standard, regardless of actual expenses. The fact that for above-median debtors Congress chose to incorporate the Chapter 7 means test expenses, lock, stock, and barrel, means that whatever those expenses allow in Chapter 7 likewise **MUST** be allowed in Chapter 13. Now that IS plain from the statute! The issue— and the **ONLY** issue— then must be, what expenses are allowed **in the Chapter 7 means test**? Whatever *that* outcome is, it is then taken and inserted into Chapter 13. To use the Chapter **13** context to give content to a Chapter **7** term is not only nonsensical, it’s a tail-wagging-the-dog perversion of the statute. The only way it would not be is if the Court were to take the view that the expense deduction has a **DIFFERENT** meaning in Chapter 13 than in Chapter 7, but we don’t think the Court is saying that (and certainly absolutely nothing in the statute would support such an interpretation). In fact, we think that courts will apply *Ransom* without hesitation— indeed, will assume that doing so is mandated— in the Chapter 7 context as well. If so, though, then the Court’s whole “Chapter 13 context” argument becomes utterly meaningless (or should, at least).

The Court is probably right to consider whether its decision upholds the anti-abuse purpose of BAPCPA (more on that below), but we find little sense in its anti-abuse argument. Congress created the means test, making use of standard deductions for above-median debtors, to *remove* the discretion it thought had previously led to abuse. Of *course* these standard deductions will sometimes be greater than the deduction a below-median debtor could take, because they’re *standards* — *not* based on the debtor’s actual expenses. That fact is inherent in the reasoning Congress gave for implementing the means test, and the Court uses that exact reasoning later in its decision, when it dismisses some of the odder results that stem from *Ransom*’s holding as the inevitable products of enacting a “brighter-line test.” (See **Question 15**.)

Rather, the **REAL** “statutory context” issue is how to harmonize the distinction between “applicable . . . amounts specified” for National and Local Standards, on the one hand, and “actual . . . expenses” for Other Necessary Expenses, on the other. This clear distinction, used in the very same sentence of the means test, at least appears to require (or at worst, permit!), on its face, that the debtor be allowed to deduct an allowance under some National and Local Standard

categories that are NOT identical to the debtor's actual expenses. Otherwise, why on earth bother with such a convoluted framing of the test? Why not just say "actual expenses" in categories X, Y, and Z and be done with it? But, under the Court's reading, may a debtor only claim a deduction for his *actual* expenses under the means test? Or does the Court admit that the means test is a "standardized formula" that can be "by [its] nature over- and under-inclusive" — i.e., *not* necessarily mirroring exactly the "individual debtor's financial circumstances"? If exact correspondence to the debtor's actual expense is not required under the means test, how does the Court figure out which means test deductions must and which need not correspond to reality? **(Question 9)**

The Court equivocates in answering these questions, a point which will be elaborated more in answering the hypos posed in Questions 14 and following. Suffice it to say that there is language in the opinion running both ways. The Court does insist on a pretty close look at THIS debtor's *actual* financial circumstances. But, the opinion also could be read only to require that the debtor have an expense in the *category*, without having the exact expense amount.

As the dissent points out, there is another perfectly reasonable reading of "applicable" as regarding the use of the National Standards and Local Standards. **(Question 8)** This alternative reading is best understood by considering the Local Standards for Ownership Costs table, which looks something like the one below:

<i>Ownership Costs</i>		
National	First Car	Second Car
	\$471	\$322

Scalia read the language in § 707(b)(2)(A)(ii)(I) ("applicable monthly expense amounts specified under the National Standards and Local Standards") as meaning roughly the same thing as, "according to the applicable provisions of the attached table." Notably, the table has columns for both "First Car" and "Second Car," but does not include a column for "No Car." Thus, the term "applicable" directs the debtor to look to the designated ownership cost column in the Local Standards. For example, Jason Ransom's "applicable" expense under the Standards would be \$471, because he owns one car (and it would not be, for example, \$322).

In this way, Scalia argued, the use of the term "applicable" can be understood as adding *emphasis* rather than independent meaning. So he admitted the majority's point that the term "applicable" is not *necessary* to reach the result he argues for, but asserted (quite convincingly, we think) that "[t]he canon against superfluity is not a canon against verbosity."

Scalia also points out that elsewhere in the Bankruptcy Code, Congress expressly referred to "actual . . . expenses" and actual expenses "if applicable." (See, e.g., § 707(b)(2)(A)(ii)(II) discussing expenses for care of family members, and § 707(b)(2)(A)(ii)(I) discussing health and disability expenses.) These examples *clearly* express an intention to allow the deduction only if the debtor *actually* incurs the costs described. **(Question 9)** If Congress had meant for the Standards only to apply if there were related *actual* expenses, they could have said so—and did, in other places of the statute. If that is what they meant here, why not say so in similar language?

According to Justice Kagan, the majority's opinion still allows for a distinction between "applicable" and "actual." The debtor may only claim an allowance for car-ownership, the Court says, if he actually has car ownership expenses in the form of lease or loan payments. But the "applicable" deduction under the Local Standards does *not* account for the *amount* of the debtor's actual expense, just for the fact that he has some expense. If the debtor's actual lease

payments for his first car are greater than the \$471/month allowed under the Standards, he nonetheless cannot take a greater deduction. Thus, under the majority's interpretation, there is still a textual distinction in § 707(b)(2)(A)(ii)(I) between *applicable* monthly expense amounts (modifying the National and Local Standards), which apply one set deduction amount if the debtor has *any* actual expenses, and *actual* expenses (modifying Other Necessary Expenses), which deducts the amount actually spent. (**Question 9**)

This discussion brings up the interesting and significant conundrum of Justice Kagan's Footnote 8. In it, Kagan discusses the opposite situation to that described just above: What if the debtor's actual lease payments for his first car are *lower* than the \$471/month deduction under the Standards? Interestingly, pre-*Ransom*, just about every bankruptcy person in the known universe assumed that the debtor would have an "applicable" car-ownership payment in this scenario and, that being the case, the "amount specified" in the Local Standards (i.e. the \$471 per month) would then be allowed as a deduction, without worrying about the fact that the debtor's actual expense was less. Nevertheless, Kagan managed to confuse the law even *more* by declaring that the Court "decline[d] to resolve this issue"! What now? How close to \$471/month must the debtor's car loan or lease payments be in order for him to take the deduction? If his payments are under \$471, must he take only the amount of the actual expense?

After *Ransom*, the Court's opinion *could* be read to still give the debtor the full \$471 deduction, as before. For example, the Court said "a deduction is so appropriate only if the debtor has costs corresponding to the *category* covered by the table — that is, only if the debtor will incur *that kind* of expense during the life of the plan" (emphasis added). A couple of paragraphs later, the Court again made reference to the "category" and "kind" of expense. And here, the debtor with a car payment under \$471 per month *will* incur "that kind" or "category" of expense, even if the actual amount of the expense is less. But it's not a slam dunk. In the very same paragraphs, the Court noted that "[w]hat makes an expense amount 'applicable' . . . is most naturally understood to be its correspondence to an individual debtor's financial circumstances," and that "Congress intended the means test to approximate the debtor's reasonable expenditures on essential items." For a debtor with, for example, a \$100 monthly car payment, the \$471 per month Local Standards allowance doesn't "correspond" very closely to the debtor's "individual financial circumstances" of \$100 monthly payments, nor is it much of an "approximation." Plus, the Court's oft-stated policy of making the debtor pay all he can to creditors would seem to support only allowing the actual \$100 deduction. (That would free up an extra \$371 a month for 60 months, a cool \$22,260 total for creditors!) (See **Question 14d**)

Payments for Debts

The debtor in *Ransom* argued that under the means test, a debtor's monthly expenses "shall not include any payments for debts," § 707(b)(2)(A)(ii)(I), and thus under the Court's restrictive meaning, the transportation ownership standard essentially would never be triggered. (**Question 13**) A debtor who owns his car outright cannot take the deduction, and a debtor who has lease or loan payments cannot take the deduction because *his* ownership expenses are "payments for debts." Also, a separate part of the means test (§ 707(b)(2)(A)(iii)) allows a debtor to take a deduction for secured debt payments (without a cap, by the way). The Court essentially resolves this issue by *not* resolving the issue (see Footnote 11) and instead declares that it doesn't think Congress had the car-ownership deduction (or, apparently, any IRS Standards deductions) "in mind" when drafting the general provision against deducting debt payments as expenses.

The question for future cases will be whether a debtor with a monthly car payment can claim *both* the secured debt deduction under § 707(b)(2)(A)(iii), (which of course is incorporated into the Chapter 13 calculation via § 1325(b)(3) for the above-median debtor, and which the debtor indisputably *can* take), *and* the car ownership deduction of \$471 under the also-incorporated Local Standard of § 707(b)(92)(A)(ii)(I). Does the exclusion for “shall not include any payments for debts” apply here?

The *Ransom* Court, of course, declined to answer that question, and the lower courts are divided on the issue. The majority (and we think better) view is that the debtor cannot double-dip and claim both deductions, and thus would only get the secured debt deduction, with no Local Standard car-ownership deduction. Of course, if that is so, then the argument that *Ransom* made and which the Court rejected — that the car-ownership Local Standard would basically never apply — gains force. A minority of lower courts have held that a debtor can claim *both* the secured debt deduction *and* the Local Standard car-ownership deduction, reading the exclusion to apply only to “the monthly expenses of the debtor,” and understanding the Local Standard not to be an “expense” but rather an “amount[] specified.” We’d argue that the rationale of the Court in *Ransom* militates against the minority view, because the Court read the Local Standards as being linked to the debtor’s *actual* financial expenses, rather than as a statutory entitlement divorced from actual expenses. Although our prediction based on the Court’s reasoning in *Ransom* favors the majority view, the Court notably did *not* decide this issue, and the disagreement among the lower courts remains unresolved.

IRS Standards

The Court used the IRS Collection Financial Standards (the explanatory guidelines for IRS agents to the National and Local Standards) to bolster its argument — focusing on the guidelines’ distinction between the car-ownership deduction and the car-operating costs deduction. (**Question 12**) The Standards are based on average nationwide monthly loan and lease payments for new and used cars, and the guidelines instruct that individuals *without* car payments may only take the car-operating cost deduction, not the car-ownership deduction. The majority *said* they weren’t **incorporating** the IRS guidelines, but immediately thereafter said that courts could use them to interpret the National and Local Standards when they were not “at odds with the statutory language.” Justice Scalia responded by noting:

In the present context, the real-world difference between finding the guidelines incorporated and finding it appropriate to consult them escapes me, since I can imagine no basis for consulting them unless Congress meant them to be consulted, which would mean they are incorporated.

His bewilderment seems valid. The Court’s facial assurance that its decision does not incorporate the IRS guidelines is somewhat insulting, considering that lower courts are now required to follow the guidelines in determining whether debtors can take a car-ownership deduction.

Professor Lawless brought some insight to this issue, before the Court decided *Ransom*, on the blog *Credit Slips*, in a post titled “Can You Deduct an Expense for a Car You Own”²:

² Available at <http://www.creditslips.org/creditslips/2010/04/can-you-deduct-an-expense-for-a-car-you-own.html> (posted April 19, 2010)

“The problem stems from how Congress used the IRS Guidelines. The IRS . . . established the Guidelines as informal agency operating procedures to determine when to compromise a tax debt based on inability to pay. The IRS Guidelines were intended as a ceiling, used to determine when a taxpayer could afford to cut back on expenses and repay a tax debt. They also were intended as guidelines, not hard-and-fast rules. Congress, however, has used the IRS Guidelines as a hard-and-fast floor for the Bankruptcy Code. The Guidelines establish minimum amounts of expenses to which debtors are entitled to deduct in determining their eligibility for [c]hapter 7, and the Bankruptcy Code then allows debtors to deduct some expenses above those minimums. The Guidelines do not work well when applied to situations where debtors have hypothetical as opposed to actual expenses, but those are the rules that Congress chose.”

In fact, a *prior* version of the bankruptcy reform bill had limited the allowances under the National and Local Standards by adding qualifying language that *did* expressly incorporate the IRS standards, *viz.*, “as determined under the Internal Revenue Service financial analysis for expenses” (see H.R. 3150, 105th Cong. (1998)), but then chose to remove that language in the bill enacted as BAPCPA, leaving only the “amount . . . specified” text, sans express incorporation language.

Practical outcomes

So, was Jason Ransom stupid to pay off his car before filing bankruptcy? Yes. It’s not guaranteed, but there at least is a reasonable chance that if he still owed even a little on his car, he’d be able to take (at least some of) the car ownership deduction (for at least a little while). Would he have been better off to use that money to go on a European vacation? Yes — unless he got the boot out of Chapter 13 on a bad faith basis. But at least he’d have gotten to sip a little French wine, ski the Alps, and run with the bulls in Pamplona. To buy a new, expensive car on credit? Yes (again, subject to the bad faith caveat). There is NO doubt that if the debtor could survive the bad faith hurdle, he could deduct the entire secured debt owed. So Jason should have traded in his paid-off Toyota and incurred a big honkin’ secured debt, at the very least (and enhancing his good faith chances) on a similar, but new, Toyota. But wait, that is a crazy incentive! And if the Court had agreed with Scalia, the debtor would NOT have that incentive — he’d get the deduction either way, as long as he owned a car, and could be more frugal. He might have money stashed away for that sure-to-come rainy day when he’d need a replacement car for the trusty old Toyota. So, is the Court punishing frugality? Yes. (Detect a trend?)

(Question 6)

Justice Kagan apparently assumed (see page 19 of the Supplement) that the *only* two possible uses of Jason Ransom’s money pre-bankruptcy were (1) to pay the car debt or (2) to pay the credit card (or other) debt. Ipso facto, since he paid the car debt then, he did not pay the credit card debt. Now he has to tee it up and pay the credit card debt, using, in effect, the money he won’t need (under the means test formula) to pay the car debt. There are many, many things wrong with Kagan’s reasoning here. First, of course, it is factually absurd. All debtors (just about), and almost certainly all debtors who end up in bankruptcy, sometimes—sit down for this revelation — *fritter away* money improvidently. Maybe Jason was a Bulls fan and spent big bucks on StubHub to watch them play. Or Lagy Gaga. Or NASCAR (but probably not all three). In the interests of verisimilitude (really, I just wanted to show I knew that word), I looked it up, and if you want a ticket to see the iHeartRadio Music Festival with Lady Gaga, Jennifer

Lopez, and Kenny Chesney (an odd group?) on Saturday, Sep 24, 2011 at 7:30 p.m, you can do so for \$160 (those are the “so high they issue you an oxygen tank” tickets). Maybe Jason did that in his wild and crazy pre-bankruptcy days. And he wanted to pay on his car so it wouldn't get repossessed and he could drive to see Lady Gaga.

Second, the Court's “money-is-fungible” argument misses the point of how our consumer bankruptcy system is set up entirely. We COULD have a bankruptcy system where the “how much you pay” question depends in part on how good a steward you were with your \$ prior to your sad fall into bankruptcy. Many countries do. But we don't. All that the Chapter 13 payment rules look at, and all the Chapter 7 means test that is incorporated into Chapter 13 speaks to, is “what can you pay *going forward*?”

Even if Kagan WAS correct in that (amazing) assumption, given the Court's holding, Jason totally made the wrong choice. If he had paid down \$14,000 on the credit card debt instead of paying the car debt, he would have at *least* gotten to deduct his car loan payments (if he hadn't had it repossessed, which of course would have been possible — but then he could just borrow money for another car) plus, it seems, the \$471 car-ownership deduction (if we're allowing double-dipping) — and would've ended up with about \$28,000 more in disposable income over the 60 month plan period. Practically speaking, the Court's decision just leaves Jason Ransom with \$471 less per month in disposable income — even though debtors who were *less* responsible about paying off their assets would be eligible for this deduction. (**Question 7**) Well, that must have been a disappointment!

BABCPA Purpose

The Court argued (repeatedly) that its decision comported with the purpose of BABCPA “to ensure that debtors repay creditors the maximum they can afford.” H.R. Rep. 109-31(I) at 89. (**Question 11**) Accordingly, said the Court, it interpreted the means test in a way that best “reflect[ed] a debtor's ability to afford repayment.” But surely the Court didn't mean to say that *every* statutory issue involving consumer debtors under BAPCPA is to be decided with the court's thumb on the scales in favor of “*debtors repay creditors the maximum they can afford.*” After all, Congress legislates through the language of the statutes it enacts, not through *unenacted* legislative history. (**Question 11**)

If Congress intended for “*debtors repay creditors the maximum they can afford*” to effectively be the statutory test, they could have enacted that broad standard rather than a very long and very detailed means test formula. In fact, prior to 2005, the Chapter 13 test in § 1325(b) *did* simply use a “pay-all-you-reasonably-can” standard (and indeed continues to do so for debtors with income below the state median), but then in 2005 jettisoned that standard for a strict formula for above-median debtors. The Court did not even attempt to explain its reasoning in light of this statutory history. Also curious is the fact that Justice Kagan never mentioned the idea of a “fresh start” for individual debtors as a purpose of BAPCPA, but did find the time to reiterate the “make debtors pay the max” argument six times!

Lest you think that we are exaggerating in Chicken Little fashion the impact of the Court's “purposive” reading, consider the Sixth Circuit's decision in *Baud v. Carroll*, 634 F.3d 327, 356 (6th Cir. 2011), where that Court of Appeals read *Ransom* and *Lanning* in tandem to stand for the following canon of interpretation under BAPCPA:

We believe it is now clear that, where each competing interpretation of a Code provision amended by BAPCPA is consistent with the plain language of the

statute, we must, as the Supreme Court did in *Lanning* and *Ransom*, apply the interpretation that has the best chance of fulfilling BAPCPA's purpose of maximizing creditor recoveries.

The “purpose” point is stated more colorfully by one wise wag (who, while writing under the blog name “Buce” from “Palookaville,” happens also to be one of the leading bankruptcy scholars in the country), in “Justice Kagan’s Torture Memo: ‘It Can’t Possibly Mean That,’” at <http://underbelly-buce.blogspot.com/2011/01/justice-kagans-torture-memo-it-cant.html> (Jan. 12, 2011)(emphasis added):

“There's a back-story here that you'd never suss out of the opinion itself. Specifically, the language in question comes from the famous-all-over-town bankruptcy amendments of 2005, which made it much tougher for ordinary folks to get bankruptcy relief. Whether that's A Good Thing or not is the kind of issue on which, inevitably, tastes differ. But another issue, apart from substance, is quality of the statute as a piece of draftsmanship. Here there is much wider agreement: it's a mare's nest, a dog's breakfast, a can of worms, just about anything but the cat's meow. Cudgeling my brain, I can think of only one person who has ever gone on record as believing that the statute is carefully written.

No surprise, then, that a kind of cottage industry has developed in the lower courts since 2005 which you might call Saving Congress from Itself — more precisely, trying to read some sense into a statute which often doesn't make any sense. But this endeavor has not been purely technical. Rather, there seems to have developed a sense among the lower courts that *what Congress intended to do was jam it to the debtor good and hard, and that if Congress didn't get it right the first time, then we must help them*. Bankruptcy lawyers have fashioned a new canon of statutory interpretation: *if the statute seems to favor the creditor, apply the statute; if it seems to favor the debtor, assume it's a mistake and favor the creditor anyway*.

I wouldn't put Kagan in quite that camp. Her reading seems more rooted in the “Congress couldn't have said anything that stupid” school. And she obviously has a lot of company: the whole crew is on board. The whole crew, that is, with one exception: Antonin Scalia who weighs in with a typical blunt assertion of a kind of plain-meaning rule (whatever Scalia may be willing to torture, you'd have to say that statutes are not on the list). . . . From early in his career Scalia has made it clear that (at least on non-political, technical, issues) if Congress is determined to muck things up, he will let them muck away.”

As noted above, at least some lower courts now have formally adopted as a canon of interpretation under BAPCPA the “jam it to the debtor good and hard” principle.

What is really, really troubling here, in addition to the point made above that the “make ‘em pay, grrr” policy surely can't ALWAYS trump, is the question — whatever happened to the “fresh start” as a major policy goal? Back in the “good old days” (to some — to others, of course, the time of evil incarnate) the Court usually interpreted the Bankruptcy Code with its thumb strongly on the scales of the fresh start. The truly amazing fact is that there is nary a single word in the entire, way-too-long opinion by Kagan that speaks to the fresh start. Honestly, this is a very, very bad sign for consumer debtors. It might sound like “Buce” was

being hyperbolic, but as *Baud v. Carroll* and other cases show, lower courts at least are taking the Court at its word. So, good bye fresh start, and hello “jam it good and hard.” Ouch.

Extending Ransom

So, how far does *Ransom* go? Of course, the majority in *Ransom* held that a debtor must have an actual car loan or lease expense in order for the car-ownership deduction to be “applicable” to him. But in his dissent, Scalia noted that a debtor is not required to prove that he *actually* operates his car or *actually* uses public transportation in order to deduct the “applicable” amounts for those costs provided by the Local Standards. At least, that was how cases were decided *before* the Court’s decision in *Ransom*, but what now?

What is really worrisome about *Ransom* is that it has breached the “doesn’t have to be an actual expense” barrier, so we have to (switch metaphors and) ponder where on the slope the slipping stops. Or (switching metaphors again), now that the might-need-to-be-actual-expense camel has its nose under the means test tent, where, if at all, can we stop it?

Will *Ransom*’s reasoning extend to **housing** ownership expenses? (**Question 17**) Assume, for example, that a debtor pays off the mortgage on his house before filing Chapter 13. Does *Ransom* require a conclusion that the housing ownership standard is not “applicable” to that debtor, and thus cannot be counted as a deduction? Does it matter whether the debtor files Chapter 13 or Chapter 7?

Taking the last question first, it shouldn’t matter, given how the statute is structured, whether the debtor files under 7 or 13. The means test is in 7, and is incorporated in all its glory into 13. But of course the Court’s mushy “context” discussion, hashed out above, could possibly be ground for some hand-wringing on this point. We haven’t heard anyone talk about this home ownership case, but for the life of us we can’t see how one could distinguish this case from *Ransom*. Here, the debtor would not have an ownership expense for a home in the “category” or “kind” dealt with in the Local Standards for housing. Thus, the apparent result would be no home ownership deduction, since the debtor has no “applicable” home ownership expense.

What about food? (**Question 18**) The National Standard allows a single debtor to deduct \$300 per month for food, but what if the U.S. Trustee can prove beyond a reasonable doubt that the debtor never, ever, ever spends more than \$200 per month? Does the debtor get to deduct \$300 or \$200? What if the debtor has begun a hunger fast? Or the debtor is incarcerated in the county jail, with the county generously picking up the debtor’s food tab for him? Should the court deny the jailed debtor’s food expense deduction entirely for the time of his incarceration?

As you can see, at this point it’s just fun to make light of the ridiculous nature of this decision. As for the \$200 v. \$300 case, I think the likely outcome — even for the wise Justices who joined the *Ransom* majority — is that the debtor does have *some* expenses in that “category” and thus could claim the “amount specified” under the National Standard. A court could point not only to the “category” and “kind” language to justify this conclusion, but also to the court’s statement that “[a]lthough the expense amounts in the Standards apply only if the debtor incurs the relevant expense, the debtor’s out-of-pocket cost may well not control the amount of the deduction” and similarly to the Court’s point that “[s]uch formulas are by their nature over- and under-inclusive.” Those statements must mean, if they mean anything, that some allowances are permitted even when not supported by actual expenses.

The hypo where the debtor provably has *no* food expense of course raises the question whether that unlucky (on many counts) debtor now falls within the *Ransom* no-such-category

exclusion. It sounds crazy and stupid and bizarre, but as a matter of strict logic and consistency (assuming we care about these things, and don't cater to Emerson's plaint that "a foolish consistency is the hobgoblin of little minds") — the trustee should be able to argue no food expense for the debtor who demonstrably has ZERO expense in that "category." What is different from *Ransom*? Anything? This is only different from *Ransom* in the extent to which food is "reasonably necessary" — but there is no consideration for this for above-median debtors. We're pretty much certain that a court won't deny a food deduction to even a "free food" incarcerated debtor, just because that sounds wacky, but as we said, logic could support it.

As for the future of the car-ownership deduction, the following hypotheticals bring out some of the more absurd and unclear possibilities resulting from *Ransom*. (**Question 14**) In each of the following scenarios, decide how much (if any) a debtor with family income above the state median may deduct as a transportation ownership expense under the post-*Ransom* Chapter 13 means test of § 1325(b). For simplicity, assume a \$471 one-car transportation ownership standard, as in *Ransom*. Alternatively, how would each case come out under Justice Scalia's view? What would be the outcome for a below-median debtor?

It's worth noting that the means test (both in Chapter 13 and in Chapter 7) is not the last chance, but rather just the first cut, to weed out supposedly "abusive" debtors. That is, in Chapter 13 a debtor still must clear the "good faith" hurdle (§ 1325(a)(3), (7)), and in Chapter 7 a debtor's petition may be dismissed even if the debtor passes the means test, if the court finds that the debtor filed the petition in bad faith or that the "totality of the circumstances" demonstrates abuse. § 707(b)(3). The "good faith" requirement is especially important to keep in mind when considering the Court's reaction to some of these hypotheticals.

a. Debtor owns no cars.

- Post-*Ransom*: No deduction. The car-ownership deduction is not "applicable" because the debtor owns no cars.
- Scalia: Still no deduction, for the same reasons. This is the situation where Scalia (correctly, in our opinion) would give meaning to the statutory text "debtor's *applicable* monthly expense." (See 2nd full paragraph of page 20 of the Supplement.)
- Below-median: No deduction. The car ownership expense would not be an "amount[] reasonably necessary to be expended."

b. Debtor owns one car free and clear.

(1) The car is a 2004 Toyota valued at \$14,000.

*Hopefully your clever students will notice that these are exactly the facts in *Ransom*. You can be fairly disappointed in them if they get this one wrong.

- Post-*Ransom*: No deduction. The car-ownership deduction is not "applicable" to the debtor because he does not have any *actual* car ownership expense.
- Scalia: Deduction is \$471 per month for 60 months. The deduction *is* "applicable" to the debtor because he owns a car.
- Below-median debtors: No deduction. A car ownership expense would not be a "reasonably necessary" expense, because the debtor did not actually have any such expense. See Footnote 5 in the majority opinion where Justice Kagan gave some weight

to the otherwise “anomalous” result of treating an above-median debtor better than a below-median debtor if the Court had held otherwise.

(2) The car is a “junkyard” car sitting on cinder blocks, is worth “a song,” and was acquired by the debtor on the eve of bankruptcy.

*Of course we are just making fun of the majority here (see page 18 of the Supplement).

- Post-Ransom: No deduction. The debtor has no actual car ownership expense.
- Scalia: Deduction is \$471 per month for 60 months. The deduction is “applicable” to the debtor because the debtor owns a car. Of course, a Chapter 13 plan still must be proposed in “good faith” (§ 1325(a)(3)), which could well lead to denial of confirmation in a case, like this, where the gaming of the system was so obvious.
- Below-median debtors: No deduction. The debtor has no actual car ownership expense.

(3) The car has been owned by the debtor for 15 years and has 300,000 miles on it; unlike for Mark Twain, reports of the car’s (imminent) death are not exaggerated.

- Post-Ransom: No deduction. The debtor has no actual car ownership expense. See **Question 15** for the possibility of plan modification if the debtor needs to purchase a new car.
- Scalia: Deduction is \$471 per month for 60 months. The deduction is “applicable” to the debtor because the debtor owns a car.
- Below-median debtors: No deduction. The debtor has no actual car ownership expense.

c. Debtor owns one car, and has 60 remaining payments of \$700 per month.

*This is the same question as Problem 2.9 a., and nothing in *Ransom* would change that analysis.

- Post-Ransom: Deduction is \$471 per month for 60 months. Now the debtor *does* have a car-ownership expense, so the Local Standard is “applicable” to him even under the majority’s view. Note, though, that the debtor’s deduction would be *capped* under the Local Standard at \$471 per month, even though his payments are significantly higher than that.

The real question here, as discussed above, is whether the debtor can claim *both* the secured debt deduction of \$700 per month under § 707(b)(2)(A)(iii) (which he indisputably *can* take) *and* the car-ownership deduction of \$471 under § 707(b)(2)(A)(ii)(I). The Court in *Ransom* declined to answer the question of whether the exclusion for “shall not include any payments for debts” applies here.

- Scalia: Again, the deduction would be \$471 per month for 60 months. However, we have no idea how Scalia would hold on the dual-deduction issue. One could probably argue a bit more persuasively that the minority view in the lower courts (allowing both deductions) would have more traction with Scalia because he does not see the Local Standards for car-ownership as necessarily linked to any actual “expenses” of debtor.

- Below-median debtors: The debtor would not get any additional deduction beyond the \$700 per month, because no other expense exists and thus is not a “reasonably necessary” amount. Indeed, it is not 100% certain that a court would be happy about letting the debtor keep such an expensive car, and might hold that the \$700 monthly payment is not “reasonably necessary.” Get a cheaper car, debtor!

d. Debtor owns one car, and has 60 remaining payments of \$100 per month.

- Post-Ransom: Of course, this is the situation we discussed above, and which the Court declined to resolve in Footnote 8. The Court’s opinion *could* be read to allow a full \$471 deduction, but this is far from definite.
- Scalia: The deduction is still \$471 per month for 60 months. The deduction is “applicable” to the debtor because the debtor owns a car.
- Below-median debtors: The deduction is \$100 per month, because that is the “reasonably necessary” amount.

e. Debtor owns a 2004 Toyota valued at \$14,000, with one remaining payment of \$471.

*The “one payment left” problem is discussed by the Court at the bottom of page 18 of the Supplement.

- Post-Ransom: In dicta, the Court appears to say that while the debtor would get the \$471 deduction for month #1 under the plan, at that juncture the creditors could move to modify the plan under § 1329. Kagan apparently assumes that the way the plan would be structured is to pay the secured car lender \$471 that first month, and thus come month #2 under the plan, the debtor would have the happy circumstance of an extra \$471 to play with. Not necessarily so. Under § 1325(a)(5)(B), the debtor’s plan might pay off the final \$471 *over the entire 60 months*. And thus, come month #2, there would be NO CHANGE in the debtor’s financial circumstances and thus no basis for modification under § 1329.

Even if the debtor did pay the full amount of \$471 to the secured lender in month #1, that would only serve to reduce the amount that would be payable to *other* creditors in that first month (see § 1326(a)(1)(C)), and thereafter the full amount owing by the debtor would be paid to her other creditors (remember, the “best efforts” test of § 1325(b) requires the debtor to pay ALL of her disposable income unless and until all creditors are paid in full). Where on earth does Kagan think this extra money is going to come from? Indeed, this little excursus by the Court is one of the more shocking displays of abject ignorance about how Chapter 13 actually works, and makes it pretty darned scary that the Court has the last say in how our bankruptcy law will be applied to the million plus new debtors filing every year.

Not only that, one might wonder—even if the bankruptcy world worked as Kagan thinks it does (and it doesn’t)—why this would not be dealt with up front in the structure of the plan itself that the court confirmed, given the admonition in *Lanning* to take account, at the time of confirmation, of changes that are “known or virtually certain.” The court can look out a month and say, “Hey, cool, that \$471 car payment is ending. Nice!” But then the court would say, “Yep, so that needs to be factored into how payments are made under the plan, from the start to the finish.” And again, then,

NOTHING WOULD CHANGE in Month #2, so no modification. (This also addresses **Question 15.**)

- **Scalia:** Again, we have no idea what Scalia would do here. He doesn't speak to the § 1329 modification issue.
- **Below-median debtors:** We assume that the bankruptcy court would confirm a plan that deals with the remaining total secured debt of \$471 in accordance with the dictates of § 1325(a)(3). In keeping with the discussion of why modification is absurd, we can't see why anything would change in Month #2.

f. Debtor owns one car, and has 60 remaining payments of \$471 per month, but he does not "reasonably need" the car.

- **Post-Ransom:** The deduction would be \$471 per month for 60 months. The car-ownership expense is "applicable" because the debtor actually has this expense, and in that exact amount. In the Local Standards, there is no limitation of what a debtor "reasonably needs." Of course, there is still the double-dipping problem as discussed above under c., so it may be that the debtor would only get the \$471 secured debt deduction and no car-ownership allowance because of the exclusion for debt payments. But even under the majority view of *Ransom*, there's no dispute that the Local Standards is "applicable."
- **Scalia:** Same result as the majority.
- **Below-median debtors:** Here, a court might apply the "reasonably necessary" limit in § 1325(b) and tell the debtor to get a cheaper car. As a below-median debtor, there is no incorporation of the Local Standards under § 707, so there's no way the debtor can argue that he has an entitlement to that amount.

In Question 14.b.(3), (*the 15-year-old car with 300,000 miles*) the debtor will be able to modify his plan and buy a new car, per § 1329(a), once the old car gives up the ghost, which it surely soon will. (**Question 16**) Here there actually *is* a change of circumstances that would qualify for modification. The debtor will, of course, have to reduce payments to other creditors to be able to make the new car payments. Could the debtor argue by invoking *Lanning* that the prospect of this change is so "known or virtually certain" that it should be dealt with up front in the plan itself? Perhaps that makes logical sense, but it seems plainly foreclosed by the strict holding of *Ransom*. So, it's modification or nothing.

The Court's decision in *Ransom* is consistent with *Lanning* in that it brings discretion back to bankruptcy judges to consider a debtor's *actual* circumstances rather than relying strictly on a mechanical test. (**Question 5**) But the majority in *Lanning* had significantly more textual support for their chosen interpretation of the statutory term "projected" than the majority in *Ransom* had for their interpretation of "applicable." Nevertheless, the critical point is that "actual matters."

Finally, as an irrelevant but interesting (at least to us) side note, the credit card company in *Ransom* (now FIA but formerly MBNA) gave more money to former President George W. Bush than any other entity, even surpassing Enron in its generosity to our 43rd President. (**Question 19**) It is surprising in some respect (if not surprising from a statutory interpretation standpoint) that in *Ransom*, Justice Kagan held for the credit card company against an individual consumer debtor, while Justice Scalia sided with the little guy. Those are the kinds of points that make teaching law fun.

CHAPTER 11 EXEMPTIONS

(Insert the following on page 610 under Part C., "Procedure")

Schwab

The issue facing the Supreme Court in *Schwab* was under what circumstances an interested party is required to object to a Chapter 7 debtor's claimed exemptions in order to keep the property in the bankruptcy estate. (**Question 1**)

Because (1): § 522(l) provides that "[u]nless a party in interest objects, the property claimed as exempt on such list is exempt," and because

(2): no one objected to the debtor's exemption in *Schwab*, and because

(3): the Supreme Court in *Taylor* (503 U.S. 638 (1992)) apparently had concluded that 522(l) really meant what it said about the necessity of an objection, it became critical in *Schwab* to figure out exactly what property the debtor had "claimed as exempt."

Ergo: whatever it was that debtor Nadjeda Reilly had claimed as exempt WAS exempt.

But what was that property?

More specifically, when a debtor's Schedule C form lists an identical value for the claimed exemption in the property *and* the market value of the property itself — with the claimed exemption value within the limits allowed under the Code — does she effectively exempt:

(1) the *asset itself*, and thus the full value of that asset (no matter what the value turns out to be in reality, even if in excess of allowed exemption limits), or

(2) only the \$ *value* of her interest in that asset up to the allowed exemption limits?

The answer to this question controls whether an interested party needs to object to the debtor's proposed exemption in order to prevent the debtor from taking the entire asset out of the estate as exempt, or whether — without any objection — the value of the asset *above* what is allowed under the Code will remain in the bankruptcy estate.

This issue becomes clearer when viewed in light of the facts in *Schwab*. On April 21, 2005, Nadejda Reilly filed for Chapter 7 bankruptcy after the failure of her small catering business. In filing her bankruptcy petition, Reilly included two forms relevant to this case:

First, Schedule B listed Reilly's assets, including a list of "business equipment" with a total estimated market value of \$10,718.

Second, Schedule C, which is reproduced below, listed the property Reilly wished to claim as exempt, ALSO, not coincidentally, with a total estimated value of \$10,718.

Schedule C-Property Claimed as Exempt

Description of Property	Specify Law Providing Each Exemption	Value of Claimed Exemption	Current Market Value of Property Without Deducting Exemptions
Schedule B Personal Property			
...
See attached list of business equipment.	11 U.S.C. § 522(d)(6)	1,850	10,718
	11 U.S.C. § 522(d)(5)	8,868	

The two exemption provisions Reilly claimed were the “tool[s] of the trade” exemption, permitting exemption of “[t]he debtor’s aggregate interest, not to exceed \$1,850 in value, in any implements, professional books, or tools, of [her] trade” (§ 522(d)(6)); and the “wildcard” exemption for the “debtor’s aggregate interest in any property, not to exceed” \$10,225 (§ 522(d)(5)). The total value of Reilly’s claimed exemptions, then, was \$10,718 — exactly the same amount she listed as the property’s current market value.

Under the Federal Rules of Bankruptcy Procedure, the interested parties in Reilly’s bankruptcy proceeding were required to object to her claimed exemptions within 30 days after the end of the creditors’ meeting or, under Code § 522(l), forfeit a right to the property. Fed. R. Bankr. P. 4003(b).

Before the creditors’ meeting, Reilly’s catering equipment was appraised at around \$17,200 — well *above* the allowed limit under the Code (combining the tools of the trade and the wild card exemptions, Reilly had a legitimate capped claim of \$1,850 (tools) + \$10,225 (wild) = \$12,075). Knowing this, Schwab, the trustee, informed Reilly on June 22, 2005 at the creditors’ meeting that he planned to sell all of her business equipment, and only remit back to her the net amount she had claimed as exempt on Schedule C. Nonetheless, the trustee did not object to her claimed exemptions of her business equipment and the Rule 4003(b) 30-day objection period lapsed (on July 22, 2005).

On August 10, 2005, after the objection period was over, Schwab moved the bankruptcy court for permission to sell the business equipment and pay Reilly the value of her claimed exemptions from the sale proceeds (\$10,718), with the sale proceeds above that amount to be retained by the estate for distribution to creditors. Reilly opposed the motion, arguing that her Schedule C, read in conjunction with her Schedule B, had served as notice to interested parties that she intended to exempt the *full value* of the equipment, and thus the equipment itself, even if the actual value ended up being more than the \$10,718 she had listed, *and* more than allowed under the Code sections she cited. Given this notice, she argued, Schwab (and the bankruptcy estate) had lost any right to the exempted property by failing to object within the 30-day period specified by Rule 4003(b). Schwab argued that a trustee is not required to object to a claimed exemption when “the amount the debtor declares as the value of [the] claimed exemption in certain property is an amount within the limits the Code prescribes.” Indeed, he argued that for

him to have objected to a facially valid exemption claim would have been sanctionable under Rule 9011 (see 2005 WL 3785193 (Trial Motion, Memorandum and Affidavit) Trustee's Brief in Support of Appeal (2005)).

The issue for the court to resolve, then, was what *exactly* Reilly had exempted in her Schedule C — the full value, whatever it turned out to be, of the specified equipment, and thus the equipment itself; or only the listed dollar amount of \$10,718 of value in that equipment. The Supreme Court took the latter view.

Statutory Interpretation

The statutory text at issue was § 522(l), which requires the debtor to file “a list of property” she “claims as exempt under subsection (b)” and notes that without an objection “the property claimed as exempt on [Schedule C] is exempt.” As the Court noted, subsection (b) refers to the categories of property a debtor may claim as exempt under § 522(d) — most of which, (including the two at issue here, § 522(d)(5)–(6)) specifically refer to the “debtor’s aggregate *interest*” in the property (emphasis added). These provisions, in conjunction with procedural rule 4003(b), which requires an interested party to object to proposed exemptions above the statutory limits within 30 days of the creditors’ meeting, led to the issue facing the Court in *Schwab*. (**Question 2**)

So how did the opposing parties interpret this critical language? (**Question 3**) The trustee’s interpretation of the exemption provisions focused on the “*interest*” language—arguing that all Reilly could exempt under these provisions was an *interest* in the listed property, up to the dollar amount stated on Schedule C, and NOT the property itself. Under that interpretation, Schwab would have no reason to object to the claimed exemptions because they were facially valid under the Code, no matter the appraised market value of the equipment. In short, under the trustee’s view, Reilly exempted \$10,718 worth of interest in her business equipment, not the actual equipment itself. That exemption claim was within the amounts permitted by the stated exemption provisions, and thus, the trustee claimed that it was entirely unobjectionable. Ergo, when the 30-day objection period expired on July 22, 2005, Nadjeda Reilly became entitled to receive \$10,718 of the business equipment, either in kind OR in cash, if the trustee were to choose to sell the property, as he did here.

Debtor Nadjeda Reilly, on the other hand, argued that because she equated the “Value of Claimed Exemption” column with her estimate in the “Current Market Value of Property” column, she was exempting the full value of the listed assets, no matter what that value turned out to be. Therefore, Reilly asserted that her Schedule C put Schwab and other interested parties on notice that she intended to exempt the full value of the “business equipment.” Reilly also pointed to the language of § 522(l) — “property claimed as exempt is exempt” — to counter the argument that a debtor can only exempt an interest in property instead of the property itself.

The Court took the position of the trustee, finding that Reilly’s listed exemptions under § 522(d)(5) and (6) only allowed an *interest* in her claimed property up to the amount she listed on her Schedule C (\$10,718). The Court focused on the language of § 522(l), which refers to the property the debtor claims as exempt *under subsection (b)*. Looking at subsection (b), in turn, led to an examination of subsection (d) (because Reilly claimed the federal exemptions), and under the operative subparts of (d), a debtor may only claim as exempt “the debtor’s aggregate interest in value” in described items up to a stated dollar maximum. Subsequent to the trustee’s failure to object, then, “the property claimed as exempt” under § 522(l) was only the value of the property up to \$10,718. By extension, of course, that means the *actual property* (including the ovens, refrigerators, mixer, and other equipment listed on Reilly’s Schedule B), and any value of

that property above \$10,718, was not rendered exempt by the trustee's failure to object. (Question 4)

Under the Court's interpretation, the language "debtor's aggregate interest" found in most exemption provisions under § 522(d) does a huge amount of work. Nadejda Reilly no longer had the right to exempt specific items, in kind (i.e. her particular refrigerated pastry case, dough mixer, and so forth) — only an entitlement to a claimed exempt dollar amount. Note that this conclusion would hold EVEN IF the total value of those items was below the exemption cap for the particular item. The Court placed great weight on the language in the relevant exemption provisions (§ 522(d)(5) for tools of the trade and § 522(d)(6) for "wild card" items), which only provide for an exemption of the "debtor's interest" in the property, up to stated dollar caps, not the property itself.

We have two thoughts (criticisms?) about this line of argument, though. First, the Court may have ascribed too much weight to the quoted statutory language, possibly not grasping that the noted statutory text has important functions even if a debtor can claim as exempt the item itself, in kind. For one, and most relevant to this case, of course, is that a debtor might only attempt to claim *part* of the value of the item as exempt. So, for example, what if Reilly had listed the total market value of the kitchen equipment on Schedule B as \$20,000, then in Schedule C claimed an exemption for the maximums allowed under (d)(5) & (6), viz., \$12,075? Pretty plainly, on the face of the schedules themselves, in that scenario, she is not claiming that she has a right to exempt all of the kitchen equipment; rather, she is claiming an "aggregate interest" of only \$12,075 of the \$20,000 total. The Court in *Schwab* treats that hypothetical and the facts of this case as the SAME scenario, but of course there is the important distinction that in the actual case she listed the Schedule B value as being the same (\$10,718) as the exemption value.

Furthermore, the statutory exemption provision MUST use the verbal construct "debtor's interest" to account for the fact that SOMEBODY ELSE might also have an "interest" in the property itself. So, for example, could Nadejda Reilly have exempted a dough mixer that belonged to her sister, or, more pertinently and less absurdly, to her sister's "interest" in the mixer if the two of them owned it jointly? The answer, obviously, is "of course not." Here, the usage "debtor's interest" distinguishes between the property interest claimed by Nadejda and that of her cotenant sibling.

Even more commonly, a debtor may share a property interest in "the thing itself" with a secured creditor, and the construct "debtor's interest" accounts for (and subtracts out) the lien value. So, for example, what if Reilly's kitchen equipment had been worth \$17,000 total, BUT was subject to a lien securing a debt of \$6,282? In that instance, the bundle of property sticks in the kitchen equipment would be divided with the first \$6,282 in value going to the secured creditor, and the balance of \$10,718 going to the debtor.

So, what if the debtor wants *that* dough mixer because it was brought over from Prussia by great-great-grandfather Alphonse in 1888? Unfortunately for sentimental debtors, the Court seems to have said "tough luck" to debtors who hold an attachment to the *actual property* they wish to exempt. Of course, realistically speaking, a trustee should have no reason to auction this property unless its full value is over the allowed exemption amount, and, in the case of secured property, unless the projected sale price exceeds both the exemption amount and the secured debt — i.e., unless there will be a net value recovered for the benefit of the general creditors of the estate.

The situation *would* be different if Nadejda had claimed as exempt a hearing aid, for

example. Under § 522(d)(9), a debtor may claim as exempt any “[p]rofessionally prescribed health aids for the debtor or a dependent of the debtor.” In *this* provision there is no mention of an “interest in” the property — the debtor is capable of exempting *the property itself*. (**Question 4**) Indeed the Court in *Schwab* gave weight to the difference in the statutory exemption scheme, inferring that “debtor interest”-dollar-capped exemptions such as those at issue in the actual case should be treated differently from obvious “in kind” exemptions such as that for hearing aids. Yet, that is of course not a necessary reading of the statutory language. While a hearing aid *itself* is to be given to the debtor (hard to help your hearing with greenbacks), that does not require a construction that the “debtor interest”-dollar-capped exemptions would NEVER permit a debtor to be entitled to claim the item itself. All that necessarily follows is that the dollar-capped types do not ALWAYS give the debtor the right to the whole item itself, such as in the hypo mentioned above, where the debtor lists a total value for the item on Schedule B in excess of the exemption claimed amount. This reading would not dictate precluding the Nadjeda Reillys of the world from claiming the item in itself when the Schedule C exemption claim equals the Schedule B property valuation.

We think it should matter that the trustee *knew* the “business equipment” was worth more than the amount scheduled as exempt *before* the 30-day objection period expired, but nevertheless did not bother to object in timely fashion. As the Court had explained in *Taylor*:

In this case, despite what respondents repeatedly told him, Taylor did not object to the claimed exemption. If Taylor did not know the value of the potential proceeds of the lawsuit, he could have sought a hearing on the issue, see Rule 4003(c), or he could have asked the Bankruptcy Court for an extension of time to object, see Rule 4003(b). Having done neither, Taylor cannot now seek to deprive Davis and respondents of the exemption.

One could make, one would think, exactly the same argument in *Schwab*, but alas, no. Rule 4003(b) seems to be hardly worth the paper it is printed on now, at least with regard to **valuation questions** (which, as the dissent points out, have been the most common type of objections against exemption claims until this decision). (**Question 6**) The Court’s decision in *Schwab* seems to mean that an interested party’s *only* obligation is to determine whether the property is of a type that can be exempted and whether the exempted values listed in the debtor’s Schedule C comply with the listed exemption provisions of the Code. Even if the party in interest *knows*, as Schwab did, that the values listed in the debtor’s Schedule C are far below the actual value of the property, the interested party is not required to object to the debtor’s claim of **value** in order to prevent the property’s exemption from the bankruptcy estate — so long as the *listed* (but known to be inaccurate) values are within the limits of the exemption provisions. The *actual* valuation of the property apparently plays no role in whether the interested party is required to object in order to retain the property for the estate.

The Court noted that it did not think — despite all appearances — that this interpretation rendered the column for estimated market value on Schedule C superfluous. That information, they argued, could still “aid[] the trustee in administering the estate by helping him identify assets that may have value beyond the dollar amount the debtor claims as exempt.” That is true, of course, but that is not *THIS* case. How an incorrect estimate of market value could help a trustee decide that the actual value is greater is wholly unclear to us.

Holding and reasoning in Taylor: distinguishable or not?

An even more fundamental problem with the Court's holding, though, is that it flies directly in the face of the Court's 1992 decision in *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992). (**Question 5**) Indeed, as we will explain, we believe that exactly the same sort of statutory argument could have been made (indeed, *was* made — see Petitioner's Brief, 1992 WL 511874, and see Justice Stevens' dissent in that case) in *Taylor*, and was rejected by the Court in that case. The Court of Appeals in *Schwab* believed — correctly, we think — that a holding in favor of the debtor was required by *Taylor*. Mind you, we're not necessarily saying that *Taylor* got it right, and perhaps the *Schwab* Court rectified a wrong by (largely) doing away with "exemption by declaration." But if so, the Court should have been honest enough to "fess up" and admit it was overruling *Taylor*. Now, post-*Schwab*, we have a truly bizarre sort of "centaur" scheme of half-*Taylor*, half-*Schwab*, where sometimes exemption by declaration works and sometimes it doesn't, depending on EXACTLY what the debtor says in Schedule C. Hmmm, kind of embarrassing.

The *Schwab* Court took issue with the contention that its decision in *Taylor v. Freeland & Kronz* dictated a holding in favor of Reilly. So let's look more closely at *Taylor*. In *Taylor*, the debtor filed the Schedule B-4 reproduced below.

Schedule B-4 — Property Claimed Exempt

Type of Property	Location, Description, and, So Far As Relevant to the Claim of Exemption, Present Use of Property	Specify the Statute Creating the Exemption	Value Claimed Exempt
Proceeds from lawsuit	<i>Winn v. TWA</i> Claim for lost wages	11 U.S.C. § 522(b)(d)	\$ <i>unknown</i>

As you can see, the debtor in *Taylor* entered "*unknown*" as the value of his claimed exemption — proceeds from a pending lawsuit. This claimed exemption was "objectionable on its face" because the applicable provision for lawsuit proceeds does not allow a debtor to exempt proceeds beyond a certain amount. The only even colorable basis for an exemption in *Taylor* was the wild card provision in § 522(d)(5), and at that time and in that case, the unused amount of the exemption available to debtor Emily Davis was a mere \$3,950. Davis's attorneys had stated at the creditors' meeting that they thought Davis might win as much as \$90,000 in the lawsuit. Turned out, she won \$110,000 in a settlement (okay, most of it went to her lawyers, which is why the named party in the caption of the case that trustee Taylor was suing was "Freeland & Kronz"). However, the trustee inadvisably assumed that Davis and her attorneys were just blowing smoke and decided not to object to the exemption claim. When the \$110,000 windfall gushed forth, the trustee said "hand it over" and Davis and her attorneys said "in your dreams, it's exempt because you didn't object, ha ha."

The Supreme Court held against the trustee and concluded that the trustee's failure to object rendered the full amount of the "claim for lost wages" to be exempt under the command of Rule 4003(b) and Code § 522(l). The Court in *Taylor* determined that the trustee *was* required to object within the 30-day period as required by Rule 4003 or let the full amount be exempted, "whether or not Davis had a colorable statutory basis for claiming it." 503 U.S. at 644. The

Court assumed that by the force of the schedule entry above, “Davis in fact claimed the full amount as exempt.” *Id.* at 642. Note, by the way, that such was not an inexorable reading of the exemption claim; the Court could have read the Schedule to mean that Davis simply did not know the actual worth of the lawsuit, since it had not yet been resolved, but was claiming as exempt whatever amount she recovered in the claimed lawsuit, *up to the legal exemption limit* of \$3,950 (as opposed to the somewhat larger and indeed absurd amount of \$110,000!). This, indeed, would have been supportable by reference to the same statutory language in § 522(l) given weight by the *Schwab* Court, *viz.*, “claims as exempt *under subsection (b)*” (emphasis added). Subsection (b) refers to subsection (d) for federal exemptions, and under subsection (d), the only claim of exemption that even possibly could have been made was \$3,950 under the wild card of (d)(5). Indeed, Justice Stevens in dissent in *Taylor* made the argument that Emily Davis had not really validly made an exemption claim under subsection (b) for \$110,000, because that was an impossibility, given that nothing in subsection (b) (and by reference, subsection (d)), so provided. The *Schwab* Court made just this argument, which is certainly not a frivolous argument at all.

One small problem, though: the majority of the *Taylor* Court didn’t buy it. Their focus was not on the hyper-technicality of what exactly the debtor legally *could* have claimed as exempt under subsection (b),” but on a realistic and fair reading of what the debtor *actually* intended to exempt, assuming it was done so in a way that should have caught the trustee’s attention. Sure, one could have read Emily Davis’ exemption claim as limited. But that was bogus, and the Court knew it. Emily wanted it all. She and her attorneys told the trustee they thought the claim was worth a lot. The trustee did not bother to object, simply because he thought they were full of it. Emily (and her attorneys) therefore got to keep all of the property, even though the only possible exemption category (522(d)(5)) was a dollar-capped category limited to the “debtor’s interest,” just like in *Schwab*, with a cap about 30 times less than what Emily and her attorneys effectively got through the unobjected-to exemption claim.

Just so, the only fair reading of Nadjeda Reilly’s exemption claim was that she — like Emily Davis before her — intended to exempt ALL of her restaurant equipment, and she did so in a way that only the densest of trustees could have missed. Thus, an honest reading of *Taylor* should have dictated holding for Reilly. Unless, of course, the Court was willing to admit that almost a score of years ago, Justice Stevens was right and the other eight Justices were wrong, and thus *Taylor*’s time for the precedential chopping block had come. As Justice Ginsburg said in dissent in *Schwab* (joined by the rather unlikely bedfellows Chief Justice Roberts and Justice Breyer):

I would hold that Reilly, by her precise identification of the exempt property, and her specification of \$10,718 as both the current market value of her kitchen equipment and the value of the claimed exemptions, had made her position plain: She claimed as exempt the listed property itself — not the dollar amount, up to \$10,718, that sale of the property by *Schwab* might yield. Because neither *Schwab* nor any creditor lodged a timely objection, the listed property became exempt, reclaimed as property of the debtor, and therefore outside the bankruptcy estate the trustee is charged to administer. . . .

In this case, by specifying \$10,718 as both the current market value of her kitchen equipment and the value of her claimed exemptions, Reilly gave notice that she had reclaimed the listed property in full. To borrow the Court’s

terminology, Reilly waved a “warning flag” that should have prompted Schwab to object if he believed the equipment could not be reclaimed in its entirety because its value exceeded the statutory cap.

But the Court in *Schwab* was not so easily deterred. Eschewing reading Reilly’s exemption claim for what it so obviously intended, as Justice Ginsburg so cogently explained, the Court instead distinguished the case from *Taylor* by focusing on whether the claimed Schedule B exemptions were “*not* plainly within the limits the Code allows.” That is, is the claimed exemption “facially within the limits the Code prescribes”? If so, then such claim would “raise no warning flags that warranted an objection.” In *Taylor*, according to the Court, an exemption plainly outside the allowed limits put the trustee on notice that he needed to object; “\$ unknown” was a facially objectionable warning flag. In *Schwab*, an exemption plainly and facially within the allowed exemption limits (based only on the Schedule C, of course, not on the trustee’s knowledge about the property’s value that was also “plainly” gleaned from Schedule B!) did not put the trustee on notice and did not require him to object. (**Question 5**)

But, as explained above, it wasn’t clear after *Taylor* that the reasoning was based on whether the exemptions were plainly within the allowed limits. Instead, the debtor in *Taylor* had listed “unknown” for both the value of the property and the “value claimed exempt.” The Third Circuit in *Schwab* thought it was important that Reilly had, likewise, listed the same value for the business equipment as the “value claimed exempt.” The critical point in both, one could argue, was that the debtor intended to exempt the entire asset, and the trustee knew it — and knew it from the face of the schedules — and yet did not object. But the *Schwab* Court gave the trustee a pass and allowed him to ignore with impunity a warning sign requiring looking at both Schedule B and C together. ONLY if the claim is facially objectionable, based SOLELY on Schedule C itself, does the *Taylor* mandate still hold. More on that in a moment below.

So, as it turns out, *Taylor* may not be so fairly distinguishable from *Schwab* — and it might be more honest to say that the Court realized it had erred in *Taylor* by allowing brazen “exemption by declaration,” and decided to narrow the rule to exemptions “not plainly within the allowed limits.” (**Question 5**)

Practical Implications

What the Court’s decision means for debtors is that for any exemption which technically gives the debtor only an “interest” in the property up to a specific dollar amount, that property is *always* at risk of being seized and sold by the trustee if the trustee believes he could sell the property for more than the dollar value assigned as “value of claimed exemption” on Schedule C — whether the trustee objected to the exemption claim or not. Indeed, *Schwab* totally excuses trustees from ever objecting to claimed valuations, as long as the *listed* valuation is within the statutory limits.

So, after *Schwab*, is there ANY way a debtor can pull an old-style *Taylor* exemption-by-declaration and slip a full exemption in the property itself past a trustee who sleeps on his objection rights? (**Question 8**) That is, earlier we said the post-*Schwab* world creates a “centaur” of half-*Taylor*, half-*Schwab* when it comes to the workability of exemption-by-declaration. So, what is the still-living *Taylor* half (and more frivolously, before this metaphor totally runs out of steam, is that the man or beast half)? The Court made plain in dicta how a debtor could still get the whole asset. (**Question 7**) If Reilly had listed the “Value of Claimed Exemption” on Schedule C as “100% of fair market value” (the Court’s suggestion for this

gambit, along with “full fair market value”) or “*the whole shebang*” or “*all my restaurant S**,” rather than as a specific dollar amount (totaling \$10,718), and the trustee had still failed to object within the 30-day period, Reilly would have been able to keep all of her exempted property — because the trustee was on notice on the face of Schedule C itself that the debtor intended to exempt the full value of the property, no matter its value, and no matter whether within an allowed exemption limit. This, the Court posited, would be a sufficient “warning flag.”

Similarly, if Reilly had listed “\$500,000” as the “Value of Claimed Exemption” (even though that would have been kind of weird because she thought the equipment was only worth \$10,718), then her claim would have been objectionable on its face (because in excess of the dollar caps) and the trustee would have been required to object within the 30-day period or surrender the property to Reilly. Of course, that also would have been a bankruptcy crime and also possible grounds for denial of the discharge.

However, the specific dollar amount that Reilly did claim as exempt (\$10,718) in fact did equal her Schedule C estimate of the “Current Market Value of Property Without Deducting Exemptions” (i.e., also \$10,718) thus indicating that she obviously was intending to exempt the property in its entirety. How is this different from the previous examples? Only that in this case, the value Reilly (perhaps arbitrarily) placed on her claimed exemption fits obviously within the allowed exemption limits. *Should* this difference change the outcome of the case? We don’t see any reasonable grounds for allowing what the debtor lists as an asset’s value to have so much control over the trustee’s responsibility to object to these claimed exemptions.

Indeed, as the dissent pointed out, this rule may often serve as a trap for the unwary (or unrepresented). A debtor (often without counsel) would never think to put “100% of FMV” in the “Value of Claimed Exemption” category, especially when the form’s instructions specifically tell the debtor to list a *dollar value*. (**Question 7**)

In light of *Schwab*, whenever a debtor specifies a dollar value for an exempt interest, and a trustee believes that property may sell for more than the applicable exemption provision, the trustee will have an incentive to sell the property. (**Questions 9, 11**) There is also *no* apparent impetus for the trustee to object in a timely fashion to the amount of a claimed exemption. (**Question 10**) So, not only are there no apparent consequences for the trustee if his belief is incorrect, but his power also extends until the closing of the case.

But can a trustee *always* force a sale of property claimed as exempt, even if the full market value of the property is clearly less than the allowable exemption amount for that type of property? (**Question 9**) Say, for example, that the trustee took the property Reilly had claimed as exempt for \$10,718 (well below the allowable exemption amount of just over \$12,000) and sold it for \$8,000. Because Reilly’s exemption is only an “interest” in the property sold, that “interest” would seem to be limited by the property itself. This means Reilly would only receive the \$8,000, despite her uncontested claim to more than that on her Schedule C. Finally, what if the trustee sold the property for \$12,000? This is below the allowable exemption entitlement of sections 522(d)(5) and (6), but above the value Reilly claimed as exempt on her Schedule C. Now Reilly would only be entitled to the \$10,718 she claimed — but her unfettered right to amend her schedules “as a matter of course at any time before the case is closed” (Fed. R. Bankr. P. 1009(a)) should enable her to claim and capture the full proceeds up to the exemption provision limit. (**Question 9**)

This has a serious impact on the debtor’s supposed “fresh start” — which, now, does not begin until his entire case has ended, even when no objections are made to the debtor’s claimed exemptions. Finality is a chimera. The *Taylor* Court, and the dissent in *Schwab*, appreciated this

reality. After *Schwab*, a “cloud of uncertainty” hangs over a debtor’s ability to fully retain and use assets that she has valued at less than the full statutory exemptible amount. And the majority realized this — but seemed to be saying that this uncertainty is the price debtors must pay to ensure that they cannot “convert a fresh start into a free pass.” (**Question 12**) Here, at any time until Reilly’s bankruptcy case closed, the trustee could have come in and taken her kitchen equipment and sold it, hoping to generate some money for the estate. The 30-day finality intended by Rule 4003(b) is meaningless for the all-important issues of valuation.

In the future, for any property the debtor wishes to retain in kind — and expects to retain, because its value is less than the exemption provision — the debtor can only bring finality to the status of that property by putting its value only in the “current market value” column of Schedule C, and not assigning a dollar amount to the “value of claimed exemption.” When the debtor intends to claim as exempt the entire value of an asset, she should indicate this intention by entering something along the lines of “full value,” “entire value,” or “100%” as the “value of claimed exemption.” (As noted above, the Court suggests listing “full fair market value (FMV)” or “100% FMV.”) (**Question 8**) This “trick” for getting around *Schwab*’s broad grant of power to trustees, however, is not intuitive nor instructed by the Code and clearly disadvantages—we’d go so far as to say *traps*—pro se debtors. Not only that, the trustee could object to the form of the exemption and force the debtor to list an actual value. Mostly, though, it’s a ridiculous distinction to draw. If the Court had wanted to be straight-up, they could have simply overruled *Taylor*, and done away with all exemption-by-declaration.

We have no problem concluding that as a matter of policy, a debtor should be able to exempt no more than what the Code allows. We also would have no problem agreeing with Stevens’ dissent in *Taylor* and concluding that an attempt to exempt what the Code does not allow is simply a non-starter, a nullity. But instead we have a half-baked regime which will serve only to confuse the issue, and for good measure encourage debtors to be sneaky and trustees to be lax, with any notion of finality regarding valuations completely gone. Well done.

CHAPTER 12

REORGANIZATION

(Add the following on page 677 before Part E)

In re DBSD North America, Inc.

The Chapter 11 bar is a wondrously talented collection of lawyers who sustain a corporate reorganization machine that is the envy of the world. One very telling indicator of the sophistication of the Chapter 11 bar is the extent to which they manage to continually resurrect practices that are manifestly inconsistent with positive law, sometimes even in the face of outright prohibitions of said practices by Congress and the Supreme Court. What's more, they succeed in these endeavors with little more, at bottom, than self-serving appeals to the expediency interests of those whom the dubious practices favor. Case in point: inter-class give-ups in Chapter 11 or what now apparently travels under the banner of the "gifting doctrine."

For a time, not too long ago, it seemed to be a widely held view in the Chapter 11 bar that "give ups" — pursuant to which a creditor or creditor class gives up or "carves out" part of a distribution that they would seemingly otherwise be entitled to receive, and "gifts" it to or "shares" it with some other party or (more usually) some other class, typically a junior class — were perfectly appropriate, entirely unproblematic, and essentially an exception to the absolute priority rule and other distribution strictures such as the cram-down protection against "unfair discrimination." Thus the inter-class "gift" could permissibly cut out intermediate classes or cause widely disparate distributions among those of the same priority rank, and dissenting classes had no right to complain.

Such give-ups are not a new practice, by any means. Indeed, give-ups were precisely *the* objectionable practice that first gave rise to the absolute priority rule now codified in Code § 1129(b)(2)(B)(ii). This Code provision descends from equitable receivership practice elucidated in a line of Supreme Court decisions that the famous *Case* case (even more fun to say than (b)(2)(B)(ii)) "firmly embedded" within the statutory requirement that a cram-down plan be "fair and equitable" to dissenting creditors.

The Second Circuit, however, in its *DBSD* decision, reversed a plan confirmation premised upon the so-called "gifting doctrine" and issued the most forceful holding to date that there is no "give up" or "gifting" exception to the "fair and equitable" cram-down standards codified in Code § 1129(b), including the absolute priority rule and the prohibition against unfair discrimination. Indeed, after *DBSD* one might be tempted to declare inter-class give-ups dead (or at least mortally wounded). That, however, would clearly be premature and would vastly underestimate the resourcefulness of the Chapter 11 bar (after all, the Supreme Court has prohibited inter-class "gifting" repeatedly since 1868!). The Chapter 11 bar is most adept at exploiting potential porousness in Chapter 11's distributional norms, and means for evading *DBSD* are readily available. And we'll revisit *DBSD* and its prohibition of "gifting" plans in the next Part of this chapter when we talk about the *Chrysler* and *GM* cases.

DBSD North America was formed in 2004 by ICO Global Communications, a publicly traded satellite communications company, to develop a next-generation mobile communications network using both satellites and land-based transmission towers. When *DBSD* filed Chapter 11 in 2009, it was still a development-phase company (i.e., without any revenue sources). The debt *DBSD* was seeking to restructure was principally of three distinct classes: (1) First Lien Debt of

approximately \$51 million secured by liens on substantially all DBSD assets, (2) Second Lien Debt of approximately \$752 million with second-priority liens on substantially all DBSD assets, and (3) general unsecured claims dominated by a \$211 million claim of Sprint for reimbursement of DBSD's share of certain spectrum relocation expenses under an FCC order. Prior to the Chapter 11 filing, ICO Global (as DBSD's 99.8% parent corporation and essentially sole shareholder), DBSD, and certain holders of the Second Lien Debt executed a plan support agreement under which DBSD agreed to file a plan providing for a prearranged division of new common stock in a reorganized DBSD among holders of Second Lien Debt and ICO Global (as the existing DBSD shareholder).

The plan proposed by the Debtors would issue secured replacement debt to the holders of First Lien Debt and would issue equity in reorganized DBSD to all remaining classes. The Second Lien Debt would receive nearly 95% of the new common stock, and ICO Global (as the existing shareholder) would receive warrants and virtually all of the remaining 5% of new common stock — only a token sum (0.15%) of the new common stock was to be issued to general unsecured creditors.

Sprint voted to reject DBSD's proposed plan, which was sufficient (in and of itself) to cause the general unsecured creditor class to reject the plan under Code § 1126(c). Given this class rejection and the existing shareholder's receipt of equity in the reorganized DBSD (which a unanimous *Ahlers* court held is receipt of "property" for purposes of the absolute priority rule), Sprint objected to confirmation on the basis that the plan contravened the absolute priority rule of Code § 1129(b)(2)(B)(ii). Bankruptcy Judge Gerber confirmed the plan nonetheless, though, by relying upon the so-called "gifting doctrine," which he explained as follows:

The Gifting Doctrine has been applied in two distinct, but related, contexts in cramdown usage. It has been applied to provide a gloss on the requirements under section 1129(b)(1) of the Bankruptcy Code that a plan not "discriminate unfairly" [against] and also that it be "fair and equitable" [to a dissenting class]. In both contexts, the Gifting Doctrine cases share the attribute of a consensual give-up of entitlements by the more senior class.³

* * * *

The Gifting Doctrine permits creditors, if they wish, to "gift" part of the distributions to which they'd otherwise be entitled to junior classes or interests, even if that gift results in unequal distributions to classes that would otherwise be *pari passu*, or if the gift makes distributions to a class when a more senior class has not been paid in full. . . .

. . . .

. . . [U]nderlying the Gift Doctrine, as it has evolved, is the concept that if the creditor class is entitled to property from the estate — as particularly is the case when a class of secured creditors holds a perfected security interest in the property — it may generally do whatever it wishes with such property, including transferring it to other holders of claims or interests — at least so long as the property clearly belongs to the senior creditor gift-giving class and, in the views

³In re DBSD North America, Inc., 419 B.R. 179, 212 (Bankr. S.D.N.Y. 2009).

of some, there are good business reasons for the gift.⁴

Since the “property” that was being “gifted” by the Second Lien Debt to the existing shareholder was equity in the reorganized entity, the propriety of the “gift” under the so-called “gifting doctrine” was entirely a function of the value of the reorganized entity. After receiving a wide range of valuation evidence, Judge Gerber valued reorganized DBSD “in the range of \$492 million to \$692 million.”⁵ Since the petition-date debts owing to the First Lien Debt and Second Lien Debt aggregated over \$800 million (and the First Lien Debt was receiving replacement debt of reorganized DBSD), giving the entire value of reorganized DBSD to the Second Lien Debt would not fully satisfy the Second Lien Debt.

Thus the entirety of the equity in reorganized DBSD “belonged” to the Second Lien Debt, according to “gifting doctrine” dogma, and the Second Lien Debt was, therefore, free to “gift” some of that equity to ICO Global (notwithstanding the dissent of the general unsecured creditor class) without regard for the absolute priority rule of § 1129(b)(2)(B)(ii). Moreover, Judge Gerber specifically found that “there were good business reasons for the Second Lien Debt’s gifts to . . . the Existing Shareholder” in that “the donees’ continued cooperation and assistance would be valuable to the reorganized Debtors.”⁶ Sprint appealed Judge Gerber’s confirmation order, though, and while the District Court affirmed, the Second Circuit reversed, holding that there is no “gifting” exception to the absolute priority rule.

The Text of Code § 1129(b)(2)(B)(ii)

The initial difficulty that a “gifting” exception to the absolute priority rule must confront is the text of Code § 1129(b)(2)(B). The Second Circuit in *DBSD* ultimately concluded that the statutory text is straightforward and dispositive and simply does not admit of any distribution-sharing exception to the absolute priority rule, in this very succinct paragraph:

Under the plan in this case, Sprint does not receive “property of a value . . . equal to the allowed amount” of its claim. Sprint gets less than half the value of its claim. The plan may be confirmed, therefore, only if the existing shareholder, whose interest is junior to Sprint’s, does “not receive or retain” “any property” “under the plan on account of such junior . . . interest.” We hold that the existing shareholder did receive property under the plan on account of its interest, and that the bankruptcy court therefore should not have confirmed the plan.

Code § 1129(b)(2)(B)(ii) Only Prohibits Distribution of Property “Under the Plan”

At least one court has attempted to reconcile a putative “gifting” exception with the text of § 1129(b)(2)(B)(ii), contending that any distribution resulting from a so-called distribution-sharing agreement “is not the result of the Debtors’ distribution of estate property” but rather is a product of the inter-creditor sharing agreement and, thus, is not a treatment “*under the plan*,”

⁴DBSD, 419 B.R. at 210-11.

⁵DBSD, 419 B.R. at 200.

⁶DBSD, 419 B.R. at 212 n.140.

within the meaning of § 1129(b)(2)(B)(ii)'s prohibition.⁷ When it is the plan of reorganization, however, that contains the terms of the so-called "agreement" and enforceability of the "agreement" is dependent upon entry of a court order confirming the plan (which is invariably the case), it is somewhat disingenuous to suggest that the resulting distribution is not "under the plan."

Moreover, in most instances, the distribution to the junior classes is not really pursuant to any independent "agreement" or "consent" of the senior class at all. Thus the DBSA plan provided as follows:

Class 9 — Existing Stockholder Interests

. . . . In full and final satisfaction, settlement, release, and discharge of each Existing Stockholder Interest, and on account of all valuable consideration provided by the Existing Stockholder [ICO Global], including without limitation, certain consideration provided in the Support Agreement, . . . *the Holder of such Class 9 Existing Stockholder Interest shall receive the Existing Stockholder Shares and the Warrants.*

However, this "gift" by the Second Lien Debt did not contemplate actual "consent" to the "gift" by all of the holders of Second Lien Debt. Indeed, only some (but not all) of the Second Lien Debt holders were parties to the prepetition plan support agreement with DBSD and ICO Global, and some of the Second Lien Debt holders voted to reject the proposed plan. Second Lien Debt holders who neither were party to the plan support agreement nor voted to accept the plan were not actually "gifting" anything to ICO Global; rather, the DBSD plan contemplated imposition of this "gift" on even dissenting Second Lien Debt holders through judicial confirmation of the plan of reorganization. Class consent binding on dissenters is, of course, the means by which "consent" is achieved in the plan confirmation context, but it is fallacious to pretend that such "consent" to "contributions of Plan recoveries made by certain creditors to other creditors" is somehow independent of, and thus not "under," the plan.

So, while it may be true, in the abstract, that "[c]reditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors,"⁸ which is a commonly repeated platitude of the "gifting" doctrine, that is certainly not what happens when a plan of reorganization essentially tells a creditor: "Under no circumstances will you ever receive this particular distribution because you will be deemed to have 'waived' your 'right' to receive this particular distribution and to have 'gifted' it to other creditors or shareholders, even if you vote against this plan and object to its confirmation!"

The Second Circuit in *DBSD*, therefore, had little difficulty concluding that the distribution of warrants and new common stock in reorganized DBSD to ICO Global obviously constituted a distribution "under the plan."

Code § 1129(b)(2)(B)(ii) Only Prohibits Distribution of Property "on Account of" the Recipient's Junior Interest

⁷In re Worldcom, Inc., 2003 WL 23 861928, at *61, *60 (Bankr. S.D. N.Y. 2003) (emphasis added).

⁸WorldCom, 2003 WL 23861928 at *61.

The *DBSD* plan proponents attempted to square the equity distribution to ICO Global with the absolute priority rule by arguing that this distribution was not “on account of” ICO Global’s junior shareholder interest in *DBSD* within the meaning of Code § 1129(b)(2)(B)(ii). Rather, consistent with the inter-class “gift” theory, they argued that the distribution to ICO Global was (1) “on account of” ICO Global’s execution of the plan support agreement, as recited in the plan’s disclosure statement, and ICO Global’s consequent consensual support of the plan, and (2) as the bankruptcy court found, ICO Global’s “continued cooperation and assistance” to reorganized *DBSD*, which the continuing equity stake in *DBSD* would presumably entice and ensure.

The Second Circuit, however, rejected this contention as fundamentally inconsistent with the Supreme Court’s interpretation of the phrase “on account of” in § 1129(b)(2)(B)(ii). In its *203 North LaSalle* decision, the Supreme Court read “‘on account of’ to mean ‘because of,’ which recognizes that a causal relationship between holding the prior claim or interest and receiving or retaining property is what activates the absolute priority rule.” Of course, old equity’s receipt of property under a plan can be “on account of” or “because of” multiple reasons. If one of those reasons, though, is the old equity interest (e.g., a desire to buy old equity’s support of the plan, as the *DBSD* plan proponents essentially conceded was the case through the plan support agreement with ICO Global), then that distribution is “on account of” the junior equity interest within the meaning of the absolute priority rule. As the Second Circuit recognized in *DBSD* then:

This conclusion is not undermined by the fact that the disclosure statement recites, and the [bankruptcy] court found, additional reasons why the existing shareholder merited receiving the shares and warrants. First a transfer *partly* on account of factors other than the prior [junior] interest is still partly “on account of” that interest. “If Congress had intended to modify [‘on account of’] with the addition of the words ‘only,’ ‘solely,’ or even ‘primarily,’ it would have done so.” *In re Coltex Loop*, 138 F.3d [39,] 43 [(2d Cir. 1988)]. . . . [R]eceipt of property partly on account of the existing [junior] interest [i]s enough for the absolute priority rule to bar confirmation of the plan.

Indeed, the *DBSD* plan provided that the proposed distribution of new equity to ICO Global was “in full and final satisfaction, settlement, release, and discharge of each Existing Shareholder Interest.” As the Second Circuit pointed out, this indicates that the proposed distribution to ICO Global would satisfy the even more narrow interpretation of “on account of” as meaning “in exchange for” or “in satisfaction of” (which was rejected by the Supreme Court in *203 North LaSalle* in favor of the more inclusive “because of” meaning).

Moreover, the Supreme Court in *Ahlers* flatly rejected (as insufficient to escape the absolute priority rule) precisely the kinds of future benefits to be provided by old equity that the *DBSD* plan proponents were proffering: “continued cooperation and assistance” to reorganized *DBSD*. As the Second Circuit astutely recognized, this “sounds like the sort of ‘future labor, management, or expertise’ that the Supreme Court [in *Ahlers*] has held insufficient to avoid falling under the prohibition of the absolute priority rule.” The Second Circuit, therefore, had little difficulty concluding that under the *DBSD* plan confirmed by the bankruptcy court, ICO Global “received ‘property,’ that it did so ‘under the plan,’ and that it did so ‘on account of’ its prior, junior interest.”

The Fair and Equitable Standard “Includes” Certain “Requirements”

Attempts to sidestep the absolute priority rule of § 1129(b)(2)(B)(ii) often point to the fact that Congress did not attempt to comprehensively codify all aspects of the “fair and equitable” standard for confirmation of a cram-down plan.⁹ In an innovation brought about by the Bankruptcy Code in 1978, § 1129(b)(2) elaborates on the meaning of “fair and equitable” and does so in a nonlimiting manner by using the term “includes.” Moreover, legislative history explains that “[p]aragraph (2) provides guidelines for a court to determine whether a plan is fair and equitable with respect to a dissenting class,”¹⁰ and “[a]lthough many of the factors interpreting ‘fair and equitable’ are specified in paragraph (2), others . . . were omitted . . . to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental to ‘fair and equitable’ treatment of a dissenting class.”¹¹

The nonlimiting nature of § 1129(b)(2), though, cannot be used to contradict the terms of the absolute priority rule of § 1129(b)(2)(B)(ii). What § 1129(b)(2) “includes” are “requirements” necessary to satisfy the “condition” that a plan be fair and equitable. Confirmation of a cram-down plan, then, is conditioned on satisfaction of the requirements of the absolute priority rule specified in § 1129(b)(2)(B)(ii). There may well be other uncodified “requirements” that are “included” in the “condition” that a plan be fair and equitable. “For example, a dissenting class should be assured that no senior class receives more than 100 percent of the amount of its claims.”¹² The existence of additional included requirements for a fair and equitable plan, however, is not a statutory authorization for an uncodified “gifting” exception that would contravene the codified and statutorily mandated “requirement” of § 1129(b)(2)(B)(ii). To thereby excuse compliance with the absolute priority rule of § 1129(b)(2)(B)(ii) would simply ignore the confirmation “requirements” that Congress has expressly enacted.

So the Second Circuit ultimately concluded, “[m]ost fatally, this [Gifting Doctrine] does not square with the text of the Bankruptcy Code.”

The Code extends the absolute priority rule to “any property,” not “any property not covered by a senior creditor’s lien.” The Code focuses entirely on who “receive[s]” or “retain[s]” the property “under the plan,” not on who *would* receive it under a liquidation plan. And it applies the rule to any distribution “under the plan on account of” a junior interest, regardless of whether the distribution could have been made outside the plan, and regardless of whether other reasons might support the distribution in addition to the junior interest.

A distribution-sharing, give-up, or “gifting” exception to the absolute priority rule of § 1129(b)(2)(B)(ii) is not only inconsistent with the statutory text of the Code, it is also

⁹See generally Kenneth N. Klee, *Cram Down II*, 64 Am. Bankr. L.J. 229 (1990).

¹⁰124 Cong. Rec. 32,407 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. 34,006 (Oct. 5, 1978) (statement of Sen. DeConcini).

¹¹124 Cong. Rec. 32,407 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. 34,006 (Oct. 5, 1978) (statement of Sen. DeConcini).

¹²124 Cong. Rec. 32,407 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. 34,006 (Oct. 5, 1978) (statement of Sen. DeConcini).

fundamentally at odds with the entire concept of a “fair and equitable” plan, a confirmation requirement derived from a venerable body of equitable receivership jurisprudence that unequivocally rejected any such distribution-sharing escape from absolute priority.

The Common Law Origins of the Absolute Priority Rule

When Congress legislates against the backdrop of existing common law, federal courts are to presume the continuing validity of the common law unless the statute “speaks directly” to abrogation of the common law principle.¹³ Consistent with that principle, with respect to attempts to undermine the force of § 1129(b)(2)(B)(ii)’s absolute priority rule with uncodified exceptions, the Supreme Court in *Ahlers* noted the particular salience of pre-Code law: “We think the statutory language and the legislative history of § 1129(b) clearly bar any expansion of any exception to the absolute priority rule beyond that recognized in our cases at the time Congress enacted the 1978 Bankruptcy Code.”

While statutory specification of the contours of an absolute priority rule in § 1129(b)(2)(B)(ii) is new with the enactment of the Bankruptcy Code in 1978, the more general statutory standard (of which the absolute priority rule became part and parcel) that a plan of reorganization be “fair and equitable” to dissenting creditors is derived from the requirement of § 77B (and its successor, Chapter X) of the 1898 Act, that any reorganization plan be “fair and equitable.” The seminal decision equating the statutory “fair and equitable” standard with a rule of absolute priority was *Case v. Los Angeles Lumber Prods. Co.*, construing the original statutory corporate reorganization provisions in § 77B of the 1898 Act:

The words “fair and equitable” as used in § 77B, sub. f are words of art which prior to the advent of § 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations. . . .

In equity reorganization law the term “fair and equitable” included, inter alia, the rules of law enunciated by this Court in the familiar cases of *Railroad Co. v. Howard*; *Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co.*; [and] *Northern Pacific Ry. Co. v. Boyd*. These cases dealt with the precedence to be accorded creditors over stockholders in reorganization plans.¹⁴

Moreover, that trio of equity receivership cases not only established what Justice Douglas in *Case* called a “rule of full or absolute priority,”¹⁵ but as the Second Circuit points out, each of them also expressly repudiated any distribution-sharing, give-up, or “gifting” exception to absolute priority, specifically rejecting precisely the sorts of “gifting” rationales that underlay the modern incarnation of the “Gifting Doctrine.”

Those cases dealt with facts much like the facts of this one: an over-leveraged corporation whose undersecured senior lenders agree to give shares to prior shareholders while intermediate lenders receive less than the value of their claims. And it was on the basis of those facts that the Supreme Court developed the

¹³U.S. v. Texas, 507 U.S. 529, 534, 113 S. Ct. 1631, 123 L. Ed. 2d 245 (1993).

¹⁴308 U.S. 106, 115-16 (1939) (citations omitted).

¹⁵308 U.S. at 117.

absolute priority rule, with the aim of stopping the very sort of transaction the appellees propose here. . . . [I]f courts will not infer statutory abrogation of the common law without evidence that Congress intended such abrogation, it would be even less appropriate to conclude that Congress abrogated the more-than-a-century-old core of the absolute priority rule by passing a statute whose language explicitly adopts it.

Lessons Learned

A secured-creditor “gifting” exception to the absolute priority rule is manifestly inconsistent, therefore, with both the text of Code § 1129(b)(2)(B)(ii) and the common law origins of the absolute priority rule. What’s more, the Code’s legislative history confirms the drafters’ intention that § 1129(b)(2)(B)(ii) was, indeed, codifying the Court’s equitable receivership case law flatly rejecting any “gifting” exception to absolute priority:

The condition contained in section 1129(b)(2)(B)([ii]) provides another basis for confirming the plan with respect to a class of unsecured claims. It will be of greatest use when an impaired class that has not accepted the plan is to receive less than full value under the plan. The plan may be confirmed . . . in those circumstances if the class is not unfairly discriminated against with respect to equal classes and if junior classes will receive nothing under the plan. The second criterion is easier to understand. It is designed to prevent a senior class from giving up consideration to a junior class unless every intermediate class consents, is paid in full, or is unimpaired. This gives intermediate creditors a great deal of leverage in negotiating with senior or secured creditors who wish to have a plan that gives value to equity.¹⁶

Rejection of any “gifting” exception to absolute priority is grounded in two interrelated concerns — both of which are recurring themes in absolute priority jurisprudence.

Valuation Uncertainty

One concern is valuation difficulties. Indeed, valuation uncertainty is perhaps the central challenge confronting the efficacy of the entire corporate reorganization process. When plan distributions consist of securities in the reorganized debtor, such as in *DBSD*, the value of those securities is dependent upon the (often contested and extremely uncertain) value of the reorganized entity. And in that regard, it’s useful to keep in mind the very frank (and extremely wary) attitude toward judicial valuations (quoted in Question 6) in the Code’s legislative history: “Though valuation is theoretically a precise method of determining the creditors’ and stockholders’ rights in a business, more often the uncertainty of predicting the future, required in any valuation, is a method of fudging a result that will support the plan that has been proposed.”¹⁷

If ever there were a case in which enterprise valuation was (as Professor Coogan reputedly characterized it) “an estimate compounded by a guess,”¹⁸ it was *DBSD* — a

¹⁶H.R. Rep. No. 95-595, at 416.

¹⁷H.R. Rep. No. 95-595, at 222.

¹⁸H.R. Rep. No. 95-595, at 225.

development-phase company generating no revenues that, indeed, was not anticipated to generate any revenues for at least several years after plan confirmation. In such a case, if the reorganized entity is undervalued, then plan distributions to senior creditors will likewise be undervalued, and “less than full” payment to senior creditors may (in truth) be payment in full, in which case senior creditors are not forgoing further distributions to which they are otherwise entitled as a “gift” to equity holders. Rather, excess value to which senior creditors have no entitlement is simply being distributed to equity holders rather than unsecured creditors. Indeed, Sprint made precisely that contention in *DBSD*,¹⁹ and among the wide range of enterprise valuation evidence proffered in that case, there were valuation estimates indicating that the Second Lien Debt was over- (rather than under-)secured.²⁰

As the Supreme Court itself indicated in the *Boyd* case, the virtue in the absolute priority rule (without any “gifting” exception) is that it obviates any judicial assessment of the value of the reorganized enterprise for purposes of resolving the unsecured creditors’ contention that enterprise value is being improperly funneled to old equity holders. As with so many aspects of the absolute priority rule, then, rejection of a “gifting” exception provides an important procedural check on the vagaries of judicial valuations.

Bargaining in the Shadow of the Absolute Priority Rule

The second and related procedural protection that the absolute priority rule (without any “gifting” exception) provides to unsecured creditors is that mentioned in the just-quoted legislative history — a bargaining equalizer. The “best interests” test of § 1129(a)(7), by assuring that a plan of reorganization must provide *each individual creditor* at least as much as that creditor would receive in a Chapter 7 liquidation, recognizes that the value in reorganization (in lieu of liquidation) is in the “reorganization surplus” — value over and above liquidation value for one or more claimant constituencies. Because the cram-down rules of § 1129(b) protect only dissenting *classes*, they permit “consensual” redistribution of this reorganization surplus among classes through class acceptances, notwithstanding the dissent of minority class members. Correlatively, the cram-down rules also provide the ground rules for negotiations regarding distribution of the reorganization surplus. Creditors’ ability to block, by class vote, distributions that depart from their baseline priority rights provide a fundamental protection against what they regard as an improper apportionment of the debtor’s reorganization surplus.

The facts of *DBSD* also provide a wonderful illustration of reorganization surplus. One would expect any substantial enterprise value in a development-phase company with no present revenues to consist primarily of its so-called “good will” or surplus of going-concern value over liquidation value. Indeed, while the bankruptcy court found that the enterprise value of *DBSD* was \$492 to \$692 million (with proffered evidence placing the value as high as \$3.1 billion), the court found the liquidation value of *DBSD* to be only \$113 to \$153 million — far less than the aggregate secured amount owed the First and Second Lien Debt of \$810 million.

The Code’s design for distribution of reorganization surplus reveals the utter fallacy in the “gifting” rationale in the Chapter 11 plan confirmation context. To the extent that a plan give-up is a give-up of reorganization surplus and not liquidation value (which was indisputably the case with the purported “gift” in *DBSD*), this is not surplus that in any sense “belongs” to

¹⁹See *In re DBSD North America, Inc.*, 2010 WL 1223109, at *4 (S.D. N.Y. 2010).

²⁰*DBSD*, 419 B.R. at 196-97 (enterprise valuations as high as \$900 million and even \$3.1 billion compared to aggregate secured debt of \$810 million).

senior creditors, and senior creditors have no unfettered “right” to this surplus with which they “are generally free to do whatever they wish” — the all-purpose “gifting” argument. Each and every creditor does have an inviolable “right” to their share of the debtor’s liquidation value (a right enshrined in the “best interests” test of § 1129(a)(7)), but creditors have no intrinsic “rights” in a debtor’s reorganization surplus (preserved and in a very real sense created by the reorganization process itself). Creditors’ relative “rights” in the debtor’s reorganization surplus can be determined only by reference to the Code’s cram-down rules, and the entire object of those rules (including the absolute priority rule) is to regulate inter-class sharing of the reorganization surplus. One can divine a “gifting” exception to absolute priority, then, only by a bootstrap appeal to a (nonexistent) “right” to ignore absolute priority. The absolute priority rule permits junior-most classes to participate in the reorganization surplus only with the consent (by class acceptance) of all senior classes; this is the only plan “gift” to junior classes that is sanctioned by the Code.

Indulging a “gifting” exception to the absolute priority rule dramatically reworks the prevailing bargaining equilibrium and returns it to the pre-Code, pre-*Boyd/Louisville Trust/Howard* state of affairs. Thus the basic contention of the plan proponents (accepted by the bankruptcy court) in *DBSD* was that they should be able to throw ICO Global a “gift” (from the debtor’s reorganization surplus, not liquidation value) in order to obtain “the donees’ continued cooperation and assistance” to reorganized *DBSD*. As we have pointed out in a related context, though (to which we will return in the next Part of this chapter, when we discuss *Chrysler* and *GM*):

The fundamental and profoundly disturbing problem with this notion is that it is precisely the same argument that was proffered during the development of “fair and equitable” jurisprudence a century ago, in an attempt to give value in the reorganized entity (nominal “purchaser”) to the debtor’s shareholders (while squeezing out unsecured creditors) in order to retain shareholders’ supposed expertise in running the railroad. The Supreme Court, though, in a series of foundational cases [*Howard*, *Louisville Trust*, and *Boyd*], repeatedly rejected this argument.²¹

Moreover, the Second Circuit hit the nail on the head as to why the Court (and then the Code drafters) would choose to reject this gambit as an unreliable and even somewhat illicit basis for departures from absolute priority. It is virtually impossible to penetrate the real reasons for the “gift” to old equity: Is it really because they will provide substantial value to the reorganized entity, or is it simply because they have substantial control over the reorganization process, and a “gift” to them is necessary to grease the reorganization skids? Indeed, the plan support agreement in *DBSD* seems to indicate there was a healthy dose of the latter in play. The Second Circuit accurately assessed the value of the absolute priority rule (without any “gifting” exception) as a bulwark against unseemly “kickbacks” to old equity:

It deserves noting... that there are substantial policy arguments in favor of the [absolute priority] rule. Shareholders retain substantial control over the Chapter

²¹Ralph Brubaker and Charles Jordan Tabb, Bankruptcy Reorganizations and the Troubling Legacy of *Chrysler* and *GM*, 2010 U. Ill. L. Rev. 1375, 1402.

11 process, and with that control comes significant opportunity for self-enrichment at the expense of creditors. This case provides a nice example. Although no one alleges any untoward conduct here, it is noticeable how much larger a distribution the existing shareholder will receive under this plan (4.99% of all equity in the reorganized entity) than the general unsecured creditors put together (0.15% of all equity), despite the latter's technical seniority. Indeed, based on the debtor's estimate that the reorganized entity would be worth approximately \$572 million, the existing shareholder will receive approximately \$28.5 million worth of equity under the plan while the unsecured creditors must share only \$850,000. And if the parties here were less scrupulous or the bankruptcy court less vigilant, a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders.

What happened back in the bankruptcy court after the Second Circuit junked the original plan and remanded provides a resounding vindication of the absolute priority rule (without any "gifting" exception) and vividly illustrates the dangers of ignoring the absolute priority rule in order to effectuate cozy "side deals" such as that struck in the original DBSD plan support agreement. As this is being written, the parties are soliciting votes on a new proposed plan by which Dish Network would purchase DBSD for over \$1.4 billion, paying all creditors in full (including Sprint's disputed \$211 million claim whenever the dispute is resolved) and paying the existing shareholder (ICO Global) nearly \$325 million in cash. This proposed plan is (surprise, surprise) expected to sail through the confirmation process relatively uncontested.

So now that we have an actual sale on the table setting a price that a party is willing to shell out in cold hard cash, let's use that \$1.4 billion valuation to assess the terms of the original plan facilitated by the highly-touted (by many) "gifting" doctrine, which would have given effect to the side deal struck by ICO Global, some (but not all) of the Second Lien Debt, and DBSD management. Under this \$1.4 billion sale valuation, the first thing to note is that Sprint was correct, the bankruptcy court vastly undervalued the reorganized enterprise, which means that the Second Lien Debt was *not* under-secured; the Second Lien Debt was greatly *over*-secured. So using the \$1.4 billion sale valuation (minus the approximately \$50 million of First Lien Debt that would have stayed in place), how much value was the original plan proposing to pay to the Second Lien Debt (owed about \$750 million) in proposing to give them 95% of the new equity shares? $\$1.35 \text{ billion} \times .95 = \mathbf{\$1.28 \text{ billion!}}$, more than 1-1/2 times more than what they were owed. ("Gifts" flow freely when it's a "gift" of someone else's money!)

The second thing to note is that ICO Global nearly sold themselves short by trying to do a cozy side deal with the Second Lien Debt. They will get nearly \$325 million in cash under the Dish Network sale. So using the \$1.4 billion sale valuation (minus the approximately \$50 million of First Lien Debt that would have stayed in place), how much value was the original plan proposing to pay to ICO Global in proposing to give them 5% of the new equity shares? $\$1.35 \text{ billion} \times .05 = \mathbf{\$67.5 \text{ million!}}$, almost 5 times less than what they'll get under a plan negotiated in the shadow of the absolute priority rule.

The Future of Inter-Class Gifting in Chapter 11

Plan Support Agreements

Those who like (and benefit from) cozy side deals will go right on liking (and benefitting from) them, though, and one of the inevitable consequences of *DBSD* is that the Chapter 11 bar will now simply look for other means to effectuate a desired inter-class “gift.” The Second Circuit alluded to one possibility in *DBSD* itself: “We need not decide whether the Code would allow the existing shareholder and Senior Noteholders to agree to transfer shares outside the plan, for, on the present record, the existing shareholder clearly receives these shares and warrants ‘under the plan.’” Could, for example, the Second Lien Debt in *DBSD*, as part of its plan support agreement with *DBSD* and *ICO Global*, agree that in exchange for *DBSD* proposing and *ICO Global* supporting a plan of reorganization containing certain specified terms, then if such a plan is confirmed, Second Lien Debt will “gift” a specified portion of the distributions it receives under that plan to *ICO Global*? This stratagem has at least a couple of potential difficulties.

Initially, the enforceability of such a plan support agreement is highly questionable. Indeed, a recent bankruptcy court decision from the Southern District of New York refused to permit a Chapter 11 debtor to assume a plan support agreement.²² Moreover, if a court is affirmatively prohibited by law from entering a plan confirmation order directly and specifically enforcing the terms of such a distribution-sharing agreement (see *DBSD*), it seems that a court in a collateral damages or specific performance action asked to enforce those same terms nonetheless might view such a request with understandable suspicion and might consider the agreement unenforceable on grounds of public policy. This is particularly likely if the collateral court views the absolute priority rule prohibition on inter-class “gifting” of plan distributions as a prophylactic counter to illicit “mischief,” which is precisely the policy perspective highlighted by the Second Circuit in *DBSD*. At a minimum, any fiduciary party to such a plan support agreement (such as the DIP or an official committee) would seem duty-bound to disclose the existence of the plan support agreement and perhaps even to seek the bankruptcy court’s approval of the fiduciary’s execution of the agreement.

Of course, even if the plan support agreement is unenforceable, if the parties themselves voluntarily choose to comply with the terms of their plan support agreement, then (as the Supreme Court specifically noted in its *Louisville Trust* opinion) they are certainly free to do so (to the extent consistent with any applicable fiduciary obligations). Therefore, if the parties are content to simply rely upon their counterparties’ good faith compliance with the agreed terms, then such a plan support agreement will do the trick. If the efficacy of the deal is at all dependent upon a court enforcing the terms of the agreement, though, then plan support agreements may not work so well.

The other major drawback of relying upon such a plan support agreement to effectuate an inter-class “gift” is illustrated by the *DBSD* case itself. Contractual agreements are only binding on parties to the contract, and of course, one of the principal reasons to reorganize in Chapter 11 (rather than through a purely contractual out-of-court workout) is the ability to bind everyone to “the deal” in Chapter 11, whether they have agreed to “the deal” or not. That is precisely why the parties’ first best choice for implementing an inter-class “gift” is through a confirmed plan of reorganization. For example, in *DBSD*, not all holders of Second Lien Debt were parties to the plan support agreement, and some even voted against the proposed plan, but they would nonetheless be compelled to participate in the Second Lien Debt’s “gift” to *ICO Global* if the

²²See *In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D. N.Y. 2010).

“gift” is properly included in the terms of a confirmed plan of reorganization. If the efficacy of the inter-class “gift” from the Second Lien Debt to ICO Global rests solely upon a contractual agreement, though, dissenting Second Lien Debt holders cannot be compelled to participate in the “gift.” Thus to the extent that the viability of inter-class “gifting” depends upon unanimous (or even high levels of) participation amongst the affected class members, contractual plan support agreements will be sub-optimal, even if they are fully enforceable.

Non-Plan (Sub Rosa?) “Reorganizations”

The holdout problem attendant to any contractual work-around of *DBSD* places a premium on finding a way to obtain a bankruptcy court order approving the inter-class “gift” (and thus binding dissenters to the “gift”). This is the potential *DBSD* loop-hole that holds the most promise for the Chapter 11 bar. The absolute priority rule and other Chapter 11 distribution rules, by their terms, only constrain the terms of a confirmed plan of reorganization, which obviously suggests the possibility that the parties may obtain court approval of the inter-class “gift” outside of the plan process.

Inter-class “gifts” can be incorporated into pre-plan settlement agreements approved by the bankruptcy court.²³ Moreover, as we’ll see in the next Part of this chapter (when we discuss *Chrysler* and *GM*), parties can also try to effectuate an inter-class “gift” by structuring the reorganization as a “sale” transaction rather than using a traditional plan structure. In fact, as we’ll see, that was exactly what the parties did in the *General Motors* case, which essentially involved a secured creditor “gift” from the government to UAW retirees. Indeed, “[w]hat *Chrysler* and *GM* vividly illustrate is that there actually is no clean, clear distinction between reorganization by ‘plan’ and reorganization by ‘sale’ — through the wonders of sophisticated transaction engineering, each can be the precise functional equivalent of the other.”²⁴

When the inter-class “gift” is effectuated outside the context of a plan of reorganization, the extent to which the absolute priority rule and other plan distribution constraints are applicable, if at all, is highly uncertain. We believe that, given the realities of modern-day Chapter 11 practice, resolving that very issue is the central challenge confronting reorganization courts today, and at stake is nothing less than preserving (or abandoning) the very core and essence of bankruptcy reorganization law. There is no way to consistently and coherently enforce Chapter 11’s distributional rules and norms unless and until the courts have a clear sense of what is and is not a sub rosa plan of reorganization that is subject to Chapter 11’s distributional rules. The Second Circuit did not bring clarity to that inquiry as applied to pre-plan settlements in its *Iridium* decision,²⁵ and (as we’ll see) the Second Circuit’s *Chrysler* decision (although formally vacated by the Supreme Court) essentially gutted sub rosa plan doctrine of any meaning at all in the context of 363 sales.

In re Pacific Lumber Co. and In re Philadelphia Newspapers, LLC

The next two cases address cram-down of an undersecured creditor’s secured claim by sale of the creditor’s collateral. Both the Fifth Circuit and then the Third Circuit adopted a fairly

²³See Christopher W. Frost, Settlements, Absolute Priority, and Another Look at Inter-Class Give-Ups, 27 Bankr. L. Letter No. 6, at 1 (June 2007).

²⁴Brubaker & Tabb, 2010 U. Ill. L. Rev. at 1375.

²⁵See *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007); Frost, 27 Bankr. L. Letter No. 6, at 6-8.

novel and alarming interpretation of § 1129(b)(2)(A). And as Judge Ambro's very lengthy dissent in *Philly News* reveals, there are lots of reasons to doubt the soundness of that interpretation, and other courts have already said they will follow Ambro's interpretation (including the Seventh Circuit in the *River Road* decision cited in Question 2). It's an important issue because it goes to the heart of the baseline entitlements of an undersecured creditor in Chapter 11. So it's worth spending some time on these cases. And the facts of both *Pacific Lumber* and *Philly News* nicely illustrate what's at stake.

But first let's do a little primer on credit bidding. Code § 363(k) says that in any 363(b) sale of a secured creditor's collateral, the secured creditor can bid at the sale, and if the secured creditor is the successful purchaser, the secured creditor "may offset [the secured creditor's allowed] claim against the purchase price of such property," up to the full amount of the creditor's allowed claim without any cash outlay by the secured creditor. That's credit bidding. And since it's the sale itself that establishes the value of the secured creditor's collateral (and thus the amount of the creditor's "secured" claim), the secured creditor has at its disposal, for credit bidding purposes, the full amount of the debt owed (including post-petition interest), such that if the sale fetches less than the amount of the debt, the secured creditor can, if it wants, acquire the collateral with no cash outlay whatsoever, by just bidding an offset against its claim.

Well, many of us assumed for a very long time (over 30 years, at least for Tabb; Brubaker was in high school when Klee wrote his "Cram Down" article) that secured creditors had the same credit bidding rights when a plan of reorganization proposed to sell the secured creditor's collateral free and clear of the secured creditor's lien via the cram-down protections for secured creditors in § 1129(b)(2)(A). Subsection (ii) of (b)(2)(A), by its terms, applies specifically to a free-and-clear sale of a secured creditor's collateral pursuant to the terms of a plan, and requires two things for that plan to be confirmed over the objection of the secured creditor: (1) that the sale be "subject to section 363(k)," which is the credit-bidding provision that also specifically gives the secured creditor the right to bid in the sale, and (2) that the secured creditor capture all of the proceeds of the sale up to the full amount of the debt (including post-petition interest) by virtue of the provision for the secured creditors' "liens to attach to the proceeds of such sale."

Well, in both *Pacific Lumber* and *Philly News*, we had plans that proposed sale of the secured creditor's collateral free and clear of the liens, but they denied to the secured creditor the ability to credit bid to try to buy the property through a competing bid. (Indeed, in *Pacific Lumber*, the secured creditor had no right to bid at all.) And both the Fifth Circuit and the Third Circuit said that's perfectly OK; you don't have to give the secured creditor the opportunity to credit bid, even though the plan is proposing a free-and-clear sale of the secured creditor's collateral.

OK, so let's look a little more closely at each of those cases.

Pacific Lumber: "Plan" Cash-Out or "Sale" Cash-Out?

Analysis of the *Pacific Lumber* case is confounded somewhat by the complex nature of the "sale" at issue in that case, which was not nominally structured as a sale. Some background in the details of the plan of reorganization in *Pacific Lumber*, therefore, is necessary.

The affiliated debtors at issue in *Pacific Lumber* were Pacific Lumber Company and Scotia Pacific LLC, engaged in growing, harvesting, and processing redwood timber in Humboldt County in northwest California. Pacific Lumber owned and operated a sawmill, a power plant, and the company town of Scotia, California. Pacific Lumber's assets were

estimated to be worth about \$110 million, and Marathon Structured Finance (“MSF”) had liens on all of Pacific Lumber’s assets securing pre- and post-petition debt of about \$160 million.

Scotia Pacific was a special-purpose financing entity wholly owned by Pacific Lumber. In 1998, Pacific Lumber transferred ownership of more than 200,000 acres of prime redwood timberland to Scotia Pacific (in exchange for 100% ownership of Scotia Pacific) to facilitate the sale of nearly \$900 million of notes secured by liens on all of Scotia Pacific’s assets (the “Secured Notes”). Pacific Lumber had an exclusive right to purchase and harvest Scotia Pacific’s timberland, and Scotia Pacific used the payments from Pacific Lumber for the Scotia Pacific timber to service its principal and interest payment obligations on the Secured Notes. When the debtors filed Chapter 11 in January of 2007, Scotia Pacific owed the holders of the Secured Notes (the “Secured Noteholders”) approximately \$740 million.

A year into the debtors’ Chapter 11 case, the bankruptcy court terminated the debtors’ exclusivity, permitting the filing of multiple competing plans. Ultimately, all but two plans were withdrawn. The Indenture Trustee for the Secured Notes filed a plan solely with respect to Scotia Pacific that contemplated a sale by auction of all of Scotia Pacific’s assets, consisting primarily of its timberlands. The bankruptcy court denied confirmation of the Indenture Trustee’s Scotia Pacific plan, though, opting instead to confirm the plan proposed by MSF (Pacific Lumber’s undersecured creditor) and Mendocino Redwood Company (“MRC”), a competitor of Pacific Lumber in the lumber business.

The MRC/MSF plan formed two new reorganized entities, initially denominated Newco and Townco. Newco was vested with all of Scotia Pacific’s assets (consisting principally of its timberlands) and Pacific Lumber’s sawmill assets. Townco was vested with the remainder of Pacific Lumber’s assets, including the town of Scotia, California and the power plant. MSF and MRC together contributed \$580 million in cash to Newco, in exchange for their ownership interests in Newco. MSF received 100% ownership of Townco and 15% ownership of Newco in exchange for (i) full satisfaction of its \$160 million undersecured claim against Pacific Lumber and (ii) its portion (amount undisclosed) of the \$580 million cash contribution to Newco. MRC received 85% ownership of Newco in exchange for its portion (amount undisclosed) of the \$580 million cash contribution to Newco.

A Litigation Trust was formed to take ownership of certain litigation claims and to pay unsecured creditors their pro rata portion (by class) of an additional \$10.6 million (subdivided by class) paid into the Litigation Trust by Newco. The Secured Noteholders did not elect § 1111(b)(2) treatment of their \$740 million undersecured claims. Thus the Secured Noteholders’ claims were bifurcated into a secured claim for the value of the collateral and an unsecured deficiency claim for the balance pursuant to Code § 506(a). With respect to the secured portion of the Secured Noteholders’ claims against Scotia Pacific, the MRC/MSF plan paid the Secured Noteholders \$513.6 million, which is the value placed on the Secured Noteholders’ collateral by the bankruptcy court after receiving extensive valuation evidence.

The Secured Noteholder class, constructed to treat the secured portion of the Secured Noteholders’ claims as just described, voted against confirmation of the MRC/MSF plan. Thus the plan could be confirmed only if “crammed down” the throats of the Secured Noteholders on the basis that the plan was nonetheless “fair and equitable” in its treatment of their secured claims, according to the cram-down requirements of Code § 1129(b)(2)(A) applicable to a dissenting class of secured claims.

Cash-Out as Indubitable Equivalence and the Role of the § 1111(b)(2) Election

The plan proponents, MRC and MSF, relied upon subdivision (iii) in their attempt to cram-down the Secured Noteholders' secured claims — “realization by [the Secured Noteholders] of the indubitable equivalent of such [secured] claims.” An immediate cash payment in full of a creditor's entire “allowed secured claim” would, indeed, seem to provide for full “realization of the indubitable equivalent of such claim[.]”²⁶ Indeed, legislative history explaining the cryptic phrase “indubitable equivalent” (discussed by Judge Ambro in his dissent in *Philly News*) states that “present cash payments less than the secured claim would not satisfy the standard,”²⁷ clearly implying that present cash payments in the full amount of the secured claim would satisfy the “indubitable equivalent” standard.

Of course, the rub with respect to undersecured creditors is quantifying the amount of the creditor's “allowed secured claim,” which is entirely a function of the value of the creditor's collateral. The Code drafters obviously were not content to leave creditors' ultimate distribution rights in Chapter 11 entirely at the mercy of inherently uncertain judicial valuations, and (as we've seen repeatedly) cram-down protections, in particular, provide numerous procedural checks on the vagaries of judicial valuations. This is especially the case with respect to cram-down of secured claims.

One important procedural protection the Code provides undersecured creditors is the ability to elect treatment under Code § 1111(b)(2), which provides that “[i]f such an election is made, then notwithstanding section 506(a) . . . , such claim [a claim secured by a lien on property of the estate] is a secured claim to the extent that such claim is allowed.” Therefore, “under § 1111(b)(2), an undersecured creditor may elect to have its *entire* claim treated as an allowed secured claim, with the *quid pro quo* for making the election being that the undersecured creditor must give up its unsecured deficiency claim. Thus, in the *Pacific Lumber* case, had the Secured Noteholder class elected § 1111(b)(2) treatment, the “allowed secured claim” subject to “fair and equitable” cram-down treatment would have been a \$740 million secured claim, rather than the \$513.6 million value that the bankruptcy court placed on the Secured Noteholders' collateral. Consequently, the real importance of the § 1111(b)(2) election is to protect a secured creditor against the risk that a debtor will cram-down the secured claim at a low value determined by the bankruptcy court.

One might think, then, that had the Secured Noteholders made the § 1111(b)(2) election in *Pacific Lumber*, this would have required a \$740 million immediate cash payment to the Secured Noteholders in order to confirm the MSF/MRC plan over the Secured Noteholders'

²⁶Indeed, as originally enacted, Code § 1124(3)(A) provided that a class of claims (including secured claims) was not impaired (and, thus, was not entitled to even vote on the plan — entirely mooted any need to consider cram-down of the class) if the plan “provide[d] that, on the effective date of the plan, the holder of such claim . . . receive[], on account of such claim . . . cash equal to . . . the allowed amount of such claim.” The 1994 amendment that removed § 1124(3) from the Code was motivated by the extremely anomalous, infrequent situation of a solvent debtor using § 1124(3) to deny unsecured creditors post-petition interest with a resulting windfall to equity holders. Repeal of § 1124(3), therefore, does not call into question the Code drafters' apparent belief that (in the more frequent case of an insolvent debtor) a cash payment in full of an undersecured creditor's entire “allowed secured claim” is all that undersecured creditor is entitled to as regards the secured portion of its claim.

²⁷124 Cong. Rec. S17, 421 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 Cong. Rec. H11,104 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

objection. So why didn't the Indenture Trustee for the Secured Noteholders elect § 1111(b)(2) treatment? Because plan proponents like MRC and MSF have a ready escape from an 1111(b)(2) cash-out: draft a plan that proposes alternative treatments of the secured creditor's claim — one if the secured creditor does *not* elect § 1111(b)(2) treatment (e.g., cash-out of the secured portion of the claim at the judicially-determined value of the collateral) and a different treatment if the secured creditor *does* elect § 1111(b)(2) treatment (e.g., deferred cash payments). The first treatment alternative (if there is *no* § 1111(b)(2) election) relies upon the subdivision (iii) “indubitable equivalent” route to cram-down of the secured creditor, while the second treatment alternative (if there *is* a § 1111(b)(2) election) relies upon the subdivision (i) route to cram-down. And notice that under subdivision (i) of § 1129(b)(2)(A), only the *face amount* of deferred cash payments must total the full allowed amount of the secured creditor's claim (\$740 million in the case of the Secured Noteholders in *Pacific Lumber*); the *present value* of those deferred cash payments “as of the effective date of the plan” need only equal the value of the secured creditor's collateral as determined by the bankruptcy court (\$513.6 million in the case of the Secured Noteholders in *Pacific Lumber*).

The prospect of a § 1111(b)(2) election, therefore, becomes nothing more than a math problem for plan proponents like MSF and MRC. MSF and MRC simply had to come up with a payment schedule that ensures they would pay the Secured Noteholders no more than the amount of their full allowed claim in total deferred payments (\$740 million) over a sufficiently long number of years that the present value of those payments is no greater than the judicially-determined value of the Secured Noteholders' collateral (\$513.6 million), and propose that as the treatment of the Secured Noteholders in the event they elected § 1111(b)(2) treatment.

Since the present value of both proposed alternative treatments (immediate cash-out if there's no § 1111(b)(2) election or deferred cash payments if § 1111(b)(2) is elected) theoretically is exactly the same (the judicially-determined value of the collateral), it is not surprising that a secured creditor presented with this option might well opt *not* to elect § 1111(b)(2) treatment and, instead, take the immediate cash-out, even if the secured creditor thinks the bankruptcy court undervalued (even vastly undervalued) the secured creditor's collateral. The immediate cash payment is a certain amount, whereas the present value of deferred cash payments is also a judicially determined valuation, which the bankruptcy court may well have overvalued (which, of course, is what adverse plan proponents will systematically advocate). The “true” present value of the deferred cash payments is a function of choosing the “right” discount rate that appropriately reflects the risk inherent in the deferred cash payments; if the bankruptcy court uses too low a discount rate, its present value estimate will be too high. Moreover, opting for the immediate cash payment (and *not* electing § 1111(b)(2)) means that the secured creditor retains its § 506(a) unsecured deficiency claim and may well receive additional plan distributions on account of this unsecured claim.

The § 1111(b)(2) election, therefore, is not by any means a foolproof check against systematic undervaluation of a secured creditor's collateral, and when presented with an analogous choice under the proposed MRC/MSF plan in *Pacific Lumber*, the Secured Noteholders in *Pacific Lumber* decided not to elect § 1111(b)(2) treatment and take the proposed cash-out at the judicially determined value of their collateral. The Secured Noteholders, however, contended that they were being denied another procedural protection against judicial undervaluation of their collateral embedded in the secured-creditor cram-down provisions.

Cash-Out Through “Sale” of the Creditor's Collateral: A *Sub Rosa* Sale Doctrine

The Secured Noteholders argued that the MRC/MSF plan (a) effectuated a “sale” of the assets of Pacific Lumber and Scotia Pacific to MRC and MSF free and clear of liens, including the Secured Noteholders’ liens on all Scotia Pacific assets, and (b) as such, the plan was not “fair and equitable” in its treatment of the Secured Noteholders’ secured claims as the Secured Noteholders were not permitted to submit a competing credit bid for purchase of their collateral as required by Code § 1129(b)(2)(A)(ii).

The bankruptcy court disagreed with part (a) of the Secured Noteholders’ argument, which mooted part (b). The MRC/MSF plan was not nominally structured as a “sale” of assets to MSF and MRC. The MRC/MSF plan depicted the means of its effectuation as a mere “transfer” of the assets of Pacific Lumber and Scotia Pacific to two newly formed reorganized entities, Newco and Townco, as authorized by Code § 1125(a)(5)(B), in the same manner that a newly formed reorganized entity is employed in a purely internal reorganization to transfer ownership of the debtor’s assets to the debtor’s creditors and shareholders: The newly formed reorganized entity takes ownership of the debtor’s assets and the value of the new reorganized entity is distributed amongst the debtor’s creditors and shareholders as provided in the plan of reorganization.

The bankruptcy court in *Pacific Lumber* was unwilling to look behind the conventional “internal reorganization” structure employed in the MRC/MSF plan to re-characterize the “transfer” of assets as, in substance and effect, a “sale” of those assets to MSF and MRC. It is easy enough, though, to conceptualize the “sale” embedded in the MRC/MSF plan. MSF had liens on all of Pacific Lumber’s assets securing debts that exceeded the value of those assets, and the MRC/MSF plan provided for acquisition of all of Pacific Lumber’s assets through what was essentially a credit bid by MSF — surrender of its claims against Pacific Lumber. Scotia Pacific’s assets were acquired in exchange for the \$580 million cash put up by MRC and MSF. Two new acquisition entities were formed to effectuate the purchase of the Pacific Lumber and Scotia Pacific assets, and the ownership of each entity was established (as between MRC and MSF) to reflect their relative contributions toward the purchase price of the assets of each new entity.

All this illustrates, of course, is the other side of the truism that not only can any particular “plan” be structured as a “sale” (a point to which we will return when we talk about the *General Motors* case on p.732), but any “sale” can also be effectuated through a “plan” structure (*Pacific Lumber* being a case in point). Indeed, a wholly internal bootstrap reorganization is “basically a method by which the sale of a firm as a going concern may be made to the claimants themselves.”²⁸ Nonetheless, the Code contains a different set of distributional norms and protections for creditors in the event of a “sale” than it does for an internal bootstrap reorganization effectuated through a “plan.” To the extent it makes sense to have a “sub rosa plan” doctrine to prevent evasion of the distributional norms and protections surrounding confirmation of a plan of reorganization (which we will explore further when we talk about the *Chrysler* and *GM* cases, beginning on p.719), then we may likewise need a “sub rosa sale” doctrine to prevent evasion of the distributional norms and protections of the Code’s “sale” rules.

The effort to distinguish between what is, in substance, an internal reorganization and what is, in substance, a sale, seems to proceed from the insight that “[t]he key conceptual difference between a reorganization and a liquidation [by sale] is that in a reorganization the

²⁸Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* 211 (1986).

firm's assets . . . are sold to the creditors themselves rather than to third parties.”²⁹ By that measure, then, the MRC/MSF plan was dominated by the cash purchase of Scotia Pacific's assets for \$580 million, which of course is precisely the aspect of the transaction for which the Secured Noteholders were insisting upon compliance with the Code's “sale” rules — the “sale” of its collateral. And the intuitions of the Fifth Circuit panel in *Pacific Lumber* led it to the same conclusion — the MRC/MSF plan, in substance, effectuated a “sale” of the Secured Noteholders' collateral:

In this case, the bankruptcy court held that Clause (ii) [of § 1129(b)(2)(A)], governing sales free and clear, is inapplicable because the reorganization plan constitutes a “transfer” rather than a “sale” of assets. See 11 U.S.C. § 1123(a)(5)(B) and (D). We agree with the Noteholders that this ruling was wrong. MRC, a competitor of [Pacific Lumber], joined with [Pacific Lumber]'s creditor [MSF] to offer cash and convert debt into equity in return for taking over both [Pacific Lumber] and [Scotia Pacific]. New entities wholly owned by MRC and [MSF] received title to the assets in exchange for this purchase. That the transaction is complex does not fundamentally alter that it involved a “sale” of the Noteholders' collateral.

Once we conclude that the MRC/MSF plan proposed a “sale” of the Secured Noteholders' collateral, we must scrutinize that sale transaction for compliance with the Code's “sale” rules. At this point, the analysis in *Pacific Lumber* joins issue with that of *Philly News*, which involved a more straightforward sale of a secured creditor's collateral pursuant to a plan of reorganization. So let's also look at *Philly News* now.

Pacific Lumber and Philly News: Cash-Out Through Sale of a Secured Creditor's Collateral Without Credit Bidding

The debtors in *Philadelphia Newspapers* owned and operated a number of print and online publications in and around Philadelphia, including the *Philadelphia Inquirer*, the *Philadelphia Daily News*, and *philly.com*. The debtors' secured debt arose from a 2006 acquisition of the debtors' businesses by an investor group led by Philadelphia PR magnate, Brian Tierny. The acquisition debt was financed by a consortium of lenders (the “Senior Lenders”) who took first priority liens on substantially all of the debtors' assets, which liens secured debts that exceeded \$300 million. Financial difficulties prompted efforts at a consensual restructuring of the Senior Lenders' debt, and the breakdown of those negotiations led to a Chapter 11 filing.

In the Chapter 11 case, the debtors filed a proposed plan of reorganization contemplating a sale of substantially all of the debtors' assets and, on the same date, executed a purchase and sale agreement (subject to higher and better offers at public auction) with a stalking horse bidder. Based upon the stalking horse bid, the plan contemplated a cash distribution to the Senior Lenders of \$37 million and surrender to the Senior Lenders of the debtors' headquarters building in Philadelphia, in full satisfaction of the Senior Lenders' secured claim, and also contemplated

²⁹*Id.*

that any topping bid would result in a dollar-for-dollar increase in the cash distribution on the Senior Lenders' secured claim. The plan also established a \$750,000 to \$1.2 million liquidating trust fund in favor of general unsecured trade creditors.

Shortly after filing the proposed plan, the debtors filed a motion to approve bidding procedures for the public auction of the debtors' assets contemplated by the proposed plan. In that motion, the debtors insisted that any qualified bidder fund its purchase offer with cash. The Senior Lenders, who had long made known their intention to submit a competing bid for the debtors' assets, objected to this provision, insisting that they had a right to credit bid up to the full amount owed the Senior Lenders, in excess of \$300 million.

The *Philly News* debtors' argument that the Senior Lenders had no right to credit bid paralleled the same argument by MSF and MRC in *Pacific Lumber*. The quote from the *Philly News* debtors' bidding procedures motion sums it up quite succinctly:

The Plan sale is being conducted under sections 1123(a) and (b) and 1129 of the Bankruptcy Code, and not section 363 of the Bankruptcy Code. As such, no holder of a lien on any assets of the Debtors shall be permitted to credit bid pursuant to section 363(k) of the Bankruptcy Code.

This argument also returns us to our earlier consideration of Code § 1129(b)(2)(A)(iii), its provision for cramdown of a secured claim by providing the creditor with the "indubitable equivalent" of its allowed secured claim, and the indubitable equivalence of an immediate cash payment to the secured creditor in the full amount of the creditor's secured claim. Thus the argument is that, credit bid or no, as long as the secured creditor receives on the effective date of the plan, in cash, the full amount of its allowed secured claim, it is receiving the "indubitable equivalent" of its secured claim and has no right to anything else.

The secured creditors' counter is subdivision (ii), which provides that "the condition that a plan be fair and equitable with respect to a class [of secured claims] includes the . . . requirement" that "the plan provides . . . for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale." Thus the secured creditors argued that for any plan proposing a free-and-clear sale of a secured creditor's collateral, the plan can be confirmed over the secured creditor's objection only if (1) the secured creditor is allowed to credit bid at the sale of its collateral as prescribed in § 363(k), and (2) the secured creditor captures all proceeds of the sale (by virtue of its lien attaching to the proceeds) up to the full amount of its allowed claim. Bankruptcy Judge Raslavich agreed with the secured creditors in *Philly News*, but the district court and Third Circuit panel majority disagreed, as did the Fifth Circuit in *Pacific Lumber*.

Until the Fifth Circuit's decision in *Pacific Lumber*, the clear weight of authority supported the Lenders' position on the issue. Indeed, one of the principal draftsmen of the Code, now-Professor Kenneth Klee, contemporaneously described the import of the enactment of the secured creditor cramdown provisions in precisely the manner that the secured creditors contended: "A sale of collateral must be made under 11 U.S.C. § 363(k) which permits the lien holders to bid for the collateral and offset their allowed claims that are secured by the collateral against the purchase price. 11 U.S.C. § 1129(b)(2)(A)(ii)."³⁰ Moreover, it seems that until

³⁰Kenneth N. Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 Am. Bankr. L.J. 133, 155 n.143 (1979).

Pacific Lumber, there were no other decisions where § 1129(b)(2)(A)(iii) and the indubitable equivalence alternative were permitted to enable a debtor to cash out a secured creditor via the type of free-and-clear sale specifically contemplated under § 1129(b)(2)(A)(ii).³¹ Indeed, the Fifth Circuit itself acknowledged that “[t]he nature of this cramdown and the refusal to apply § 1129(b)(2)(A)(ii) to authorize a credit bid are unusual, perhaps unprecedented decisions.” The surprise “discovery” of this unprecedented cramdown power, over 30 years after enactment of § 1129(b), thus warrants careful scrutiny (which, unsurprisingly, this “discovery” cannot withstand).

The Plain-Meaning Canard

Initially (and unfortunately), we must spend some time dispensing with the notion that a “plain meaning” reading of § 1129(b)(2)(A) (that had evidently escaped everyone for over 30 years) compels acceptance of this newly discovered cramdown power. The *Philly News* majority, though, was particularly enthralled with the immense power of its purportedly unambiguous plain-meaning reading of § 1129(b)(2)(A). If you find any ambiguity in (b)(2)(A), though, and thus proceed to thoughtful consideration of (i) common-sense canons of statutory interpretation/construction, (ii) the structure and context of the statute as a whole and the relationship between interconnected statutory provisions, (iii) relevant legislative history directly speaking to the meaning of the provisions at issue, and (iv) the meaning attributed to (b)(2)(A) by the person who drafted it, ALL of these other cues as to the meaning of the statutory language contradict the purported “plain meaning” divined by the *Philly News* majority—[**SOUND ALARM BELLS, ACTIVATE WARNING LIGHTS, NOW!!**].

So, we are all now dying to know, just what is the unambiguous plain-meaning reading of § 1129(b)(2)(A) that opens the door to this newly discovered cramdown power (that has evidently been there all along, right under our literal noses — if only we had had the, uh, “plainness” of mind, I guess, to grasp it)? Well, according to the *Philly News* majority, the plain meaning of (b)(2)(A) is: “Section 1129(b)(2)(A) provides three circumstances under which a plan is “fair and equitable” to secured creditors § 1129(b)(2)(A) is phrased in the disjunctive. The use of the word “or” in this provision operates to provide alternatives — a debtor may proceed under subsection (i), (ii), *or* (iii), and need not satisfy more than one subsection. . . .” So the debtors did not have to attempt cramdown under subdivision (ii), where they’d clearly have to give the secured creditor a right to credit bid. They could, in the alternative, attempt cram-down under subdivision (iii) by giving the secured creditor the “indubitable equivalent” of its allowed “secured claim.” And, of course, most significantly, indubitable equivalence is indubitably provided by cashing out the secured creditor, with an immediate cash payment in the full amount of the secured creditor’s “allowed secured claim.” So as long as the plan proposes a full cash-out of the s.c.’s “allowed secured claim,” then that’s all the secured creditor is entitled to; that fulfills the cram-down requirement of subdivision (iii),

³¹One case had held that a plan sale of collateral that denied the secured creditor the right to credit bid at the sale was not unconfirmable as a matter of law and that the debtor could attempt to demonstrate that the plan nonetheless provided the secured creditor the “indubitable equivalent” of its secured claim. The court, though, emphasized that to do so, the debtor “faces a formidable task,” as “[s]omething is ‘dubitable’ if it is ‘open to doubt or question,’” and therefore can only be “‘indubitable’ if it is without question, or doubt.” In re CRIIMI MAE, Inc., 251 B.R. 796, 808 n.12 (Bankr. D. Md. 2000).

and the secured creditor does not have to be given the right to credit bid in the proposed plan sale of the secured creditors's collateral. Moreover, the majority said that the text of (b)(2)(A) is unambiguous in permitting free-and-clear plan sales to be confirmed without credit bidding under subdivision (iii), as an alternative to free-and-clear plan sales with credit bidding under subdivision (ii).

However, we agree with Ambro (who agreed with one of us) that this is too simplistic. The obvious disjunctive phrasing of the three subdivisions of § 1129(b)(2)(A) — (i) the Deferred Payment Requirement, (ii) the Sale Requirement, (iii) the Indubitable Equivalent Requirement — does not unambiguously establish that which the court assumed it must: that the Indubitable Equivalent Requirement does not require credit bidding rights when the plan proposes a free-and-clear sale of a secured creditor's collateral. I.e., there is no unambiguous language in the statute telling us which of the three alternatives applies in any given case. Use of an “or” simply cannot and does not do that.

Initially, it is worth noting that what those three subdivisions are disjunctively but collectively specifying is what the statute refers to as a “requirement” necessary to satisfy “the condition that a plan be fair and equitable with respect to a” dissenting “class of secured claims.” Use of the word “requirement,” therefore, invokes the “necessity” of an “essential requisite” (see dictionary on your desk) with which the plan cannot dispense.

Yes, the statute delineates three disjunctive means of satisfying this “requirement,” but use of the disjunctive does not resolve the question of which of these disjunctive means specifies the “requirement” in any particular case. Both the Fifth Circuit in *Pacific Lumber* and the *Philly News* district court assumed that the plan proponent can simply choose which of the three disjunctive specifications of the requirement it wishes to try to satisfy. A perfectly (and perhaps even more) plausible alternative reading of the disjunctive specification of three means of satisfying the requirement, though, is that the plan's proposed treatment of the secured claim determines which of the three alternative specifications of the requirement must be satisfied: (i) if the plan proposes deferred cash payments, then the Deferred Payment Requirement must be satisfied; (ii) if the plan proposes a free-and-clear sale of the secured creditor's collateral, then the Sale Requirement must be satisfied; or (iii) if the plan proposes some other treatment of the secured claim, then the Indubitable Equivalent Requirement must be satisfied. In fact, this is precisely how Professor Klee contemporaneously described the operation of the three disjunctive cramdown “requirements” of newly enacted Code § 1129(b)(2)(A):

[addressing clause (ii)] Second, the plan may propose to sell collateral free and clear of the lien held by members of the dissenting class as long as the class has a chance to bid in their claims and the lien attaches to the proceeds.³²

* * * *

Under 11 U.S.C. § 1129(b)(2)(A)(i)(I) [the Deferred Payment Requirement] the lien must be retained whether the collateral is retained by the debtor or a successor to the debtor or is sold subject to the lien. If the collateral is sold free and clear of the lien, then 11 U.S.C. § 1129(b)(2)(A)(ii) [the Sale Requirement] is the controlling provision.³³

³²Klee, 53 Am. Bankr. L.J. at 155 (footnote omitted).

³³Klee, 53 Am. Bankr. L.J. at 155 n.136.

That the plan's proposed treatment of the secured claims determines the cramdown "requirement" that must be satisfied is also indicated by the dynamic specification of the "requirement" in the text of subdivision (ii). Note that subdivision (ii) not only specifies the requisites of the Sale Requirement in the event of a proposed free-and-clear sale of a secured creditor's collateral (i.e., credit bidding rights and lien attaching to sale proceeds), but also provides that the proceeds generated by the sale trigger an additional fair-and-equitable "requirement" with respect to the secured creditor's lien on the proceeds themselves — "treatment of such liens on proceeds under clause (i) or (iii)," with the applicable "requirement" at issue in treatment of the proceeds, again, seemingly determined by the plan's proposed disposition of the proceeds. If the plan proposes to simply surrender the proceeds to the secured creditor (which is not addressed by (i)), the Indubitable Equivalent Requirement of (iii) would be controlling, and as we discussed earlier, such an immediate cash-out for the full value of the allowed secured claim (i.e., the value of the collateral) would indeed satisfy the Indubitable Equivalent Requirement. Alternatively, if the plan does not propose surrender of the sale proceeds to the secured creditor, then the Deferred Payment Requirement of (i) would be controlling.

Contrary to the oversimplified assumption of both the Fifth Circuit in *Pacific Lumber* and the Third Circuit majority in *Philly News*, then, the obvious disjunctive specification of the minimum fair-and-equitable "requirement" as applied to secured claims is not necessarily drafted as a plan proponent's veritable smorgasbord of three "alternative paths to meeting the fair and equitable test of § 1129(b)(2)(A)" (from *Philly News* majority opinion). Rather, the disjunctive specification of the "requirement" seems to be a much more nuanced, dynamic, and even interactive provision for which the controlling requirement at issue is a function of the plan's proposed treatment of the secured claims.

Under this entirely reasonable, natural, ordinary reading of the disjunctive specification of the statutory requirement, the fact that the plans in both *Pacific Lumber* and *Philly News* proposed a free-and-clear sale of a secured creditor's collateral would mean that the Sale Requirement of subdivision (ii) must be satisfied. And as the *Philly News* majority fully acknowledged in footnote 6, "[t]he right to credit bid . . . found in § 363(k) [is] explicitly incorporated into subsection (ii)."

The obvious disjunctive specification of alternative requirements, therefore, does not unambiguously permit the plan proponent to simply choose the requirement that it wishes to satisfy and bypass a requirement that specifically addresses, on its face, the treatment that the plan proposes. Even if that were the best reading of the disjunctive specification, though, the disjunctive specification still does not overcome an even more glaring ambiguity in the disjunctive requirement the plan proponents sought to satisfy in both *Pacific Lumber* and *Philly News* — the Indubitable Equivalent Requirement. Indeed, it is worth keeping in mind the "plain meaning" assertion (or, more accurately, assumption) of the *Philly News* majority: the Indubitable Equivalent Requirement plainly does *not* require credit bidding rights when the plan proposes a free-and-clear sale of a dissenting secured creditor's collateral. Any assertion, though, that the requirement "for the realization by [the secured creditor] of the indubitable equivalent of [its secured] claim[]" has no ambiguity or vagueness as to what it does or does not require is laughable. One can hardly imagine a more hopelessly vague (and also ambiguous, for those who are careful to distinguish the two concepts) requirement than the somewhat stilted and incredibly inscrutable phrase "indubitable equivalent."

Indubitable Equivalent of What?

The Indubitable Equivalent Requirement of § 1129 is satisfied if a plan will provide the holder of an allowed secured claim with “the realization by such holder of the indubitable equivalent of such claim.” The inherent ambiguity of this requirement follows from the complex nature of a secured claim. A secured claim embodies not only the § 101(5) “right to payment” on which any “claim” is premised, but in addition that right to payment is “secured by a lien on property” of the estate (§ 506(a)(1)), which is an “interest in property to secure payment” of the claim (§ 101(37)). It is the secured creditor’s “right to payment” coupled with its “property interest” securing that right to payment that is the source of unavoidable ambiguity in the statutory concept of providing the secured creditor the “indubitable equivalent” of its secured claim. And even if the linguistic meaning of that phrase is not ambiguous, it is indubitably vague in its application.

The majority never really directly confronted the indisputable vagueness of the “indubitable equivalent” requirement in subdivision (iii) and what it takes to satisfy indubitable equivalence under sub(iii), which is not self-evident. (The district court, however, actually acknowledged that “indubitable equivalent” is indeed vague as to what it requires.) The majority said that phrase isn’t ambiguous because the statute, by its terms, requires giving the secured creditor the “indubitable equivalence” of its secured claim. And a secured claim is defined in § 506(a) for an undersecured creditor as the value of the secured creditor’s collateral, so indubitable equivalence under subdivision (iii) just requires giving the secured creditor value equal to its collateral. That, of course, just begs the question as to how the value of the secured creditor’s collateral is to be determined, which is even more question-begging in the context of a proposed sale of the secured creditor’s collateral because we usually presume that the sale itself establishes the value of the collateral. And the whole credit bidding issue goes to the conducting the sale that determines the value of the collateral, and whether credit bidding is or is not permitted at that sale can obviously affect the sale price and thus the ultimate value of the secured creditor’s collateral for which the secured creditor must receive the “indubitable equivalent.” So even if subdivision (iii) is not ambiguous as to its meaning, it’s clearly vague in its application to this particular context — giving the secured creditor the indubitable equivalent of the value of its collateral when the plan proposes a free-and-clear sale — does indubitable equivalence require permitting the secured creditor to credit bid or not?

That question cannot be answered solely by reference to the textual standard of “indubitable equivalence.” That text alone is hopelessly vague in its application to this particular issue. And, of course, interpretive aids like rules of construction and statutory structure and context and legislative history are also helpful in resolving vagueness.

The Code also employs Judge Hand’s “indubitable equivalent” formulation in § 361(3) with respect to providing a secured creditor so-called “adequate protection” of the property interest securing its right to payment (i.e., its secured claim). Congress explained that the objective of these provisions is that “[s]ecured creditors should not be deprived of the benefit of their bargain,”³⁴ and courts have generally imputed the same standard to “indubitable equivalence” in the cramdown context. That which the secured creditor bargained for is (as described in the the quotation to Justice Brandeis’s *Radford* opinion) that when the debtor defaults, a secured creditor typically has the right to have the collateral seized and sold at

³⁴ S. Rep. No. 95-989, at 53 (1978); H.R. Rep. No. 95-595, at 339 (1977).

foreclosure, and to apply the net proceeds of the foreclosure sale against the outstanding debt. Since the Code denies the secured creditor the unfettered right to do this when the debtor files bankruptcy, obviously the benefit-of-the-bargain statement from the legislative history is not literally true, and Congress obviously did not intend that the secured creditor should receive the benefit of the literal and exact bargain which it could have enforced under non-bankruptcy law.” The critical focus, therefore, as Judge Hand himself put it (in the quotation from *Murel Holding*), is upon providing the secured creditor “a substitute of the most indubitable equivalence.”

Is There an Indubitably Equivalent Substitute for Credit Bidding Rights?

How, then, should we apply this standard — providing the secured creditor “a substitute of the most indubitable equivalence” — in the context of a proposed free-and-clear sale of a secured creditor’s collateral? The Sale Requirement of Code § 1129(b)(2)(A)(ii) seems to indicate that a free-and-clear sale of a secured creditor’s collateral can be considered an indubitably equivalent substitute for the creditor’s lien rights if (1) the secured creditor will capture all proceeds of the sale (by virtue of its lien attaching to the proceeds) up to the full amount of its allowed claim, or alternatively (2) the secured creditor will acquire the collateral itself through credit bidding up to the full amount of its allowed claim. As Judge Hand himself stated (in that same quote from *Murel Holding*), the secured creditor “wishes to get his money or at least the property,” and there is “no reason to suppose that the statute was intended to deprive him of that.”

The disjunctive specification of the minimum fair-and-equitable requirement in subdivisions (i), (ii), and (iii), therefore, seems to be structured as two specific applications (in (i) and (ii)) of the more general, overarching “indubitable equivalent” standard contained in (iii). To provide a secured creditor *less* than that which is specified in either (i) or (ii) would, therefore, essentially *by definition* fail to provide the secured creditor the indubitable equivalent of its secured claim. Thus, for example, if the plan proposes deferred cash payments to the secured creditor, the Deferred Payment Requirement of subdivision (i) requires that the secured creditor “retain the liens securing such claims.” Consequently, and as the legislative history confirms, “[u]nsecured notes as to the secured claim . . . would not be the indubitable equivalent,”³⁵ as that treatment provides the secured creditor *less* than the indubitably equivalent substitute already specified in subdivision (i). If the secured creditor will not retain the liens securing its claim, the plan must provide the secured creditor some other substitute that “would clearly satisfy indubitable equivalence,” such as (the legislative history further explains) “a lien on similar collateral.”³⁶

The Fifth Circuit in *Pacific Lumber* actually employed similar reasoning, but apparently without recognizing its full and proper import. The court said that “indubitable equivalence does not require more protection than is afforded by the preceding clauses in § 1129(b)(2)(A). . . . Just as the Noteholders would have no statutory complaint against . . . treatment [that satisfies (i) or (ii)], so they cannot support a statutory argument that they are entitled to better treatment under Clause (iii).” The Fifth Circuit, though, seems to have lost sight of which party (plan proponent or secured creditor) § 1129(b)(2)(A) is protecting and, consequently, reversed the

³⁵124 Cong. Rec. S17,421 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 Cong. Rec. H11,104 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

³⁶124 Cong. Rec. S17,421 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 Cong. Rec. H11,104 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

relevant burden. This is where we must remind ourselves that what § 1129(b)(2)(A) is specifying is a minimum “requirement” that a plan must meet in order to be considered “fair and equitable” to dissenting secured creditors. It is not, therefore, specifying the absolute *maximum* treatment to which secured creditors are entitled (as the Fifth Circuit’s reasoning assumed), but rather, is specifying the absolute *minimum* treatment secured creditors must receive in order for the plan to be considered “fair and equitable” to them. Using the converse of the Fifth Circuit’s reasoning, then, we can properly rephrase the preceding quote as follows: Indubitable equivalence cannot require less protection than is afforded by the preceding clauses in § 1129(b)(2)(A). Indeed, the Fifth Circuit actually acknowledged that elsewhere in its opinion: “Indubitable equivalent is therefore no less demanding a standard than its companions.”

That insight — that the Deferred Payment Requirement and the Sale Requirement are simply specific applications of the more general, overarching Indubitable Equivalent Requirement — fully explains and justifies the Code drafters’ assumption that a “plan may propose to sell collateral free and clear of the lien held by members of the dissenting class as long as the class has a chance to bid in their claims” because the “sale of collateral must be made under 11 U.S.C. § 363(k) which permits the lien holders to bid for the collateral and to offset their allowed claims that are secured by the collateral against the purchase price. 11 U.S.C. § 1129(b)(2)(A)(ii).”³⁷ One can come to this conclusion quite naturally by simply employing common-sense canons of statutory construction, such as that which dictates that a generic provision of a statute — the Indubitable Equivalent Requirement of subdivision (iii) — should not be used to achieve a result not contemplated by a more specific provision — the Sale Requirement of subdivision (ii). Moreover, to the extent possible, subdivision (iii) should not be read in a manner that render’s subdivision (ii)’s requirement of credit-bidding rights in free-and-clear plan sales to be a nullity or mere surplusage. Essentially, though, that is a determination that there is no indubitably equivalent substitute for the secured creditor’s right to credit bid at the sale. Indeed, there are indications that Congress included this credit-bidding right as part-and-parcel of interrelated plan protections for secured creditors that also includes the § 1111(b)(2) election.

The Alternative, Interrelated Protections of § 1111(b)(2) and Credit Bidding Rights

Recall from our earlier discussion that undersecured creditors are afforded the opportunity to elect § 1111(b)(2) treatment as a protection against the risk that a debtor will cram down the secured claim at a low value determined by the bankruptcy court.” A recourse secured creditor, however, is denied the ability to elect § 1111(b)(2) treatment, and have its entire allowed claim treated as secured, if the secured creditor’s collateral “is to be sold under the plan.” § 1111(b)(1)(B)(ii).

To understand why the § 1111(b)(2) election is denied the secured creditor in this instance, consider, for example, the case of a secured creditor with a claim of \$100, whose collateral sells for \$75. If that creditor could elect § 1111(b)(2) treatment of its secured claim, such that the creditor had an allowed secured claim of \$100, upon sale of the creditor’s collateral, the only way to cash-out the secured creditor and provide the secured creditor the “indubitable equivalent” of its “allowed secured claim” would be to pay the secured creditor \$100 in cash — \$25 more than sale of the collateral itself produced. The most that secured creditor should be able to insist on, though, is the full value of its collateral, whatever that value is; and in the case

³⁷ Klee, 53 Am. Bankr. L.J. at 155 & n.143.

of an actual sale of the collateral, as legislative history put it, “the bid at the sale would be determinative of value.”³⁸ So when there’s an actual sale of the secured creditor’s collateral, we can take away the § 1111(b) check on judicial undervaluation of the collateral because we don’t have to rely on a judicial valuation of the collateral in the case of an actual sale: the sale itself establishes the value of the collateral, and an undersecured creditor will get *all* of the proceeds of the sale as the “indubitable equivalent” of its secured claim (an assumption we will revisit in a bit). Moreover, any concern that the lienholder might have that the sale might not bring a fair price for the collateral is fully redressed by credit bidding rights — the ability of the lienholder to bid at the sale itself, and to offset its claim against the purchase price.

Thus, the protection against being cashed out at an unfairly low valuation that the § 1111(b)(2) election provides is, in the event of a sale of the collateral, provided instead by the right to credit bid at the sale. Indeed, this is exactly how the Code’s legislative history explains the interrelated operation of the § 1111(b)(2) election and the secured creditor cramdown provisions:

Section 1111(b)(2) provides that an allowed claim is a secured claim to the full extent the claim is allowed rather [than] to the extent of the collateral as under 506(a). A class may elect application of paragraph (2) only . . . if the creditor is a recourse creditor, the collateral is not . . . to be sold under the plan. Sale of property . . . under the plan is excluded from treatment under section 1111(b) because of the secured party’s right to bid in the full amount of his allowed claim at any sale of collateral under section 363(k). . . .³⁹

Once again, then, the Code drafters assumed a fixed right for dissenting secured creditors to credit bid at any plan sale of its collateral, which right was fixed by enactment of Code § 1129(b)(2)(A)(ii): “[A] class of claims is ineligible to make the election if the holders have recourse against the debtor and the collateral is sold. The recourse creditor will be able to bid in its claim when the collateral is sold” because if the “collateral will be sold . . . under the plan . . . the recourse lender has a right to bid at the sale and to offset his full allowed claim against the purchase price. *See* 11 U.S.C. § 1129(b)(2)(A)(ii).”⁴⁰ Given that this meaning does, indeed, flow naturally from the text of § 1129(b)(2)(A), the most reasonable interpretation of that provision would seem to be the one that gives dissenting secured creditors the right to credit bid, as specified in § 363(k), at any sale of their collateral under a proposed plan of reorganization.

The Code’s Presumption in Favor of Credit Bidding Rights

The holding in *Philly News* seemed designed to indulge the argument of the debtors that structuring the auction without credit bidding would spur competitive bidding.” Thus, the court essentially left it to “the process” to determine whether the absence of credit bidding will, indeed, spur competitive bidding:

This rule, which proceeds from the plain language of the statute, is not akin to

³⁸ S. Rep. No. 95-989, at 55 (1978).

³⁹ 124 Cong. Rec. S17,420 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini); 124 Cong. Rec. H11,103 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

⁴⁰ Klee, 53 Am. Bankr. L.J. at 153 & n.127.

guaranteeing plan confirmation. We are asked here not to determine whether the “indubitable equivalent” would necessarily be satisfied by the sale; rather, we are asked to interpret the requirements of § 1129(b)(2)(A) as a matter of law. This distinction is critical. The auction of the Debtors’ assets has not yet occurred. Other public bidders may choose to submit a cash bid for the assets. The value of the real property that the Lenders will receive, in addition to cash, under the terms of the proposed plan has not yet been established. And the secured claim itself has not yet been judicially valued under § 506(a). We are simply not in a position at this stage to conclude, as a matter of law, that this auction cannot generate the indubitable equivalent of the Lenders’ secured interest in the Debtors’ assets. We approve the proposed bid procedures with full confidence that such analysis will be carefully and thoroughly conducted by the Bankruptcy Court during plan confirmation, when the appropriate information is available.

The “loan to own” phenomenon has caused some to question the advisability of credit bidding. The basic concern seems to be that a “loan to own” lender’s primary incentive is, unlike a traditional lender, acquiring the debtor’s assets as cheaply as possible, rather than maximizing the recovery on its secured loan. A traditional lender has every incentive to maximize the sale price of its collateral through vigorous competitive bidding, sincerely hoping that bid prices will exceed the amount it could credit bid with its existing secured loan, as this would mean a full recovery on that loan. A “loan to own” lender, though, has every incentive to inhibit competitive bidding in order to ensure that bid prices will not exceed the amount it can credit bid with its existing secured loan, as this would mean that the “loan to own” lender can acquire the debtor’s assets solely through a credit bid of its existing secured loan and with no additional investment.

While the “loan to own” phenomenon should cause us to closely scrutinize all aspects of the sale process, to ensure that sale procedures are designed to elicit the highest sale price possible, the secured creditors in both *Pacific Lumber* and *Philly News* appeared to be traditional lenders, not “loan to own.” Moreover, it is unclear that credit bidding, even by “loan to own” lenders, inhibits competitive bidding in any nefarious way. Rather, credit bidding is simply economic reality. If the secured lender is entitled to capture all proceeds from the sale up to the full amount of its allowed claim (more on that in a bit), any amount the secured lender bids, up to and including the full amount of its allowed claim, is money that will simply immediately flow back into the pocket of the secured lender. What legitimate reason is there to require the lender to essentially write a check to itself?

That question points up, of course, that there may be illegitimate reasons, such as seizing upon coordination difficulties inherent in the administration of a large syndicated loan that might actually prevent the multiple secured lenders from writing a check to themselves. And, of course, the secured creditor is *not* actually writing a check to itself; it’s writing a check to the estate to be administered and paid out under a plan of reorganization, which means actually being *without* the cash for some period of time, even if the secured creditor *will* get it all back (an assumption we’ll re-examine in a bit). And if you have a large syndicated loan with lots of participating lenders, particular lenders may or may not have ready access to the necessary capital. And, of course, those are all reasons the debtor would want to exclude credit bidding they want someone else to acquire the debtor’s assets on the cheap by preventing the secured lenders from credit bidding. If they think making the secured creditor/s pay cash to buy, as a

practical matter, will simply exclude the secured creditor/s from bidding at all, fewer viable bidders means it's easier to get the assets to the debtor's favored bidder at a lower price, which seems to be what was going on in *Philly News*, where the stalking horse bidder was an insider management group.

If a secured lender is owed an amount that vastly exceeds the fair value of the collateral, competitive bidding may be inhibited by credit bidding, particularly in a "loan to own" scenario, but only by virtue of the economic reality that the sale price is extremely unlikely to exceed the amount owed the secured lender (i.e., the secured lender is, indeed, entitled to the full value of the collateral). If the secured lender primarily desires ownership of the collateral, then the secured lender will be prepared to readily bid up to the full amount of its claim, which may well inhibit competitive bidding, but only because potential bidders believe that the fair value of the assets does *not* exceed the amount owed the secured lender (i.e., the secured lender is, indeed, entitled to the full value of the assets). Even if the secured lender would rather have cash (which, of course, shouldn't scare away competitive bidding), the secured lender may still bid if it believes the other bid prices do not reflect fair value and, thus, the lender can resell the collateral at a higher price. In either case, though, the secured lender acquires the assets simply by virtue of the economic reality of its first-priority claim against all proceeds of the sale up to the full amount of its allowed claim. Unless we are prepared to take away that first-priority claim to any and all sale proceeds up to the full amount of its allowed claim (which would raise serious constitutional concerns), credit bidding is not nefarious, but rather is simply recognition of the reality of that first-priority claim to the proceeds.

Even if one could construct a convincing argument that credit bidding is nefarious and should be restricted, the Code already fully and explicitly accommodates this possibility in the credit bidding provision of § 363(k) itself, which is fully incorporated by reference into the cramdown Sale Requirement of § 1129(b)(2)(A)(ii). Section 363(k) provides:

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

The problem with the holding in *Philly News*, therefore, is not so much that it indulges the possibility that credit bidding might be inappropriate; the problem is that it reverses the Code's presumptions and allocation of burdens for overcoming those presumptions. First, the Code presumes that credit bidding rights should accompany *any* sale of a secured creditor's collateral and places the burden on a sale proponent to demonstrate cause to restrict credit bidding. *Philly News*, though, quite explicitly turned this presumption on its head by putting the secured lenders in that case to the burden of establishing "that the restriction on credit bidding failed to generate fair market value at the Auction."

Second, the burden of demonstrating compliance with all requisites to confirmation of a plan of reorganization lies with the plan proponent, and particularly in a cramdown context, the plan proponent has the burden of proving that the plan is "fair and equitable" to a dissenting secured creditor class. *Philly News*, though, improperly placed the burden on the secured lenders to show "that the restriction on credit bidding failed to generate fair market value at the Auction, thereby preventing them from receiving the indubitable equivalent of their claim."

Lastly, the Code not only adopts the presumption that credit bidding will be a feature of

any sale of a secured creditor's collateral, but also that any cause for restriction of credit bidding must be established *before* the sale is conducted. The *Philly News* majority, however, was content to let a sale without credit bidding go forward, without any advance demonstration of cause to restrict credit bidding, and then try to somehow unscramble the egg after the fact at a subsequent plan confirmation hearing. Setting aside the utter improbability of accurately discerning the impact of potential credit bidding by observing the outcome of one isolated sale at which credit bidding was not permitted, the process the *Philly News* majority contemplated is entirely self-defeating. If the sale does not garner finality at the auction itself and must await subsequent plan confirmation proceedings, this feature will run counter to the desire to spur competitive bidding. And if the sale does garner finality at the auction itself (in which case it would not seem to be a "plan" sale at all and should be characterized as a § 363(b) sale that's fully subject to § 363(k) credit bidding rights), then immediate closing of the sale will likely moot any ability to try to unscramble the egg after the fact. Only a moment's thought, therefore, is necessary to recognize the wisdom and superiority of the process codified in Code § 363(k), incorporated by reference in § 1129(b)(2)(A)(ii).

Protecting a Secured Creditor's Right to Proceeds from a Sale of Its Collateral

While the principal issue at stake in both *Pacific Lumber* and *Philly News* was the credit bidding rights of secured creditors, lurking not far beneath the surface of the credit bidding issue is an arguably even more important (perhaps constitutional) right of secured creditors — the right to capture all proceeds of a sale of collateral up to the full amount of the claim secured thereby. As discussed above, this right is embedded within the cramdown Sale Requirement of § 1129(b)(2)(A)(ii) by virtue of the provision for dissenting secured creditors' "liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii)." In both *Pacific Lumber* and *Philly News*, the plan proponents purported to be effectuating a clause (iii) cash-out with sale proceeds — providing the dissenting secured creditors the indubitable equivalent of their secured claims by paying them the full value of their allowed secured claims. The disconnect, though, is that in neither case did the plan proponent seem to propose paying to the vastly-undersecured creditors all of the proceeds of the sale of their collateral.

Indeed, that may well be an even more significant reason that debtors and unsecured creditors want to deny secured creditors the right to credit bid. It's not so much about credit bidding, *per se*, and is *more* about the second requirement in subdivision (ii) — that an undersecured creditor must capture *all* of the proceeds of a free-and-clear sale through the secured creditor's lien attaching to the proceeds of the sale. A lot of people's preconceived assumptions and analyses of the credit-bidding issue sort of take that as a given: "Well, of course, the undersecured creditor is entitled to receive all of the proceeds from the sale of its collateral because it's the sale itself that establishes the value of the collateral and thus the amount of the creditor's "allowed secured claim." But that assumption no longer holds true in a *Pacific Lumber/Philly News* world. *Pacific Lumber* and *Philly News* absolutely destroy that assumption. You can see that most clearly in *Pacific Lumber*.

Pacific Lumber: A §506(a) Valuation Bifurcation in a "Sale" Case. Really?!!

The Fifth Circuit summed up its ultimate conclusion that the MRC/MSF plan satisfied the Indubitable Equivalent Requirement of § 1129(b)(2)(A)(iii) vis-à-vis the Secured Noteholders like this: "Whatever uncertainties exist about indubitable equivalent, paying off secured

creditors in cash can hardly be improper *if the plan accurately reflected the value of the Noteholders' collateral.*" Of course, that "IF" is a humongous one, and is the entire raison d'être for protections such as the 1111(b)(2) election and credit bidding rights.

The Fifth Circuit sanguinely reviewed the bankruptcy court's § 506(a) valuation findings, in light of the evidence presented, and concluded that the bankruptcy court's valuation of the Secured Noteholders' collateral at \$513.6 million was (surprise, surprise) *not* clearly erroneous (given that trial court factual findings are virtually NEVER found to be clearly erroneous on appeal). Thus, cash-out of the Secured Noteholders with this sum supposedly gave them all they were entitled to with respect to their secured claims. The Fifth Circuit's holding, however, denied the Secured Noteholders any ability to invoke the Code's systemic procedural protections against a judicial undervaluation. Finding that the MRC/MSF plan effectuated a "sale" of the Secured Noteholders' collateral denied the Secured Noteholders any ability to elect 1111(b)(2) treatment, and without the corollary Sale Requirement of credit bidding rights. And that's why the Noteholders sought to invoke the 203 *N. LaSalle* preference for market valuations over judicial valuations, whenever possible.

More fundamentally, though, the Fifth Circuit's holding exposes an even more troublesome incongruity: If there *is* an actual sale of the secured creditor's collateral, why do we even need a § 506(a) collateral valuation? Doesn't the sale price itself establish the value of the collateral? Indeed, the Code drafters assumed that in the case of an actual sale of the secured creditor's collateral, "the bid at the sale would be determinative of value."⁴¹ (See also the *Philly News* majority's discussion about the need for a judicial valuation of the Lenders' collateral before confirmation of the plan in footnote 10 and accompanying text, as if the sale itself would not establish the value of the collateral.)

The same analysis above by which we teased out the "sale" of the Secured Noteholders' collateral (Scotia Pacific assets) embedded in the MRC/MSF plan also seems to indicate that the "sale price" of those assets was \$580 million. Even after deducting prior payment of a senior secured line of credit in the amount of \$36.2 million owed Bank of America, there was substantial leakage of sale proceeds that never found their way into the Secured Noteholders' pockets, \$10.6 million of which was evidently used to fund payments to general unsecured creditors. Thus the Secured Noteholders rightly objected that the MRC/MSF plan was not "fair and equitable" because it was "directing some of the capital injected by MRC and [MSF] to pay claims junior to the Noteholders' secured claim."

Plan proponents' desire to avoid application of the cramdown Sale Requirement of § 1129(b)(2)(A)(ii), therefore, is about more than simply denying secured creditors the right to credit bid at the sale; it is also about denying undersecured creditors their entitlement to fully capture all sale proceeds. As Professor Klee put it in his classic cramdown exegesis: "A *secured creditor's collateral may be sold but the proceeds must be protected.*"⁴²

Philly News: Where Do All of the Proceeds Go?

The same phenomenon seemed to be occurring in the *Philly News* case, although the complex structure of the stalking horse bid (with cash and non-cash consideration) makes it somewhat difficult (at least from a reading the court opinions) to fully trace disposition of the sale proceeds. As in *Pacific Lumber*, though, the debtors' plan established a cash fund to pay

⁴¹ S. Rep. No. 95-989, at 55 (1978).

⁴² Klee, 53 Am. Bankr. L.J. at 159.

general unsecured creditors, presumably through “leakage” from the cash portion of the sale price.

The ability of plan proponents to essentially obscure the value and/or disposition of the purchase price being paid for sold collateral through complexity of the sale and plan structures points up yet another protective function of § 1129(b)(2)(A)(ii)'s preservation of credit bidding rights to secured creditors, particularly vastly-undersecured creditors: Not only can the undersecured creditor bid in its claim to acquire the assets when it believes the otherwise prevailing sale price is too low, but the undersecured creditor can also bid in its claim to acquire the assets when it believes that the proposed plan would not return to the secured creditor the full value of the proceeds generated by sale of its collateral. The two components of the cramdown Sale Requirement of § 1129(b)(2)(A)(ii) — credit bidding and proceeds capture — are, therefore, mutually reinforcing assurances that secured creditors will receive the indubitable equivalent of their secured claim in any plan sale of the secured creditor's collateral. To blithely deny either of these sale protections to secured creditors in the guise of otherwise “indubitable equivalence” fundamentally misconstrues the essential nature of that concept.

Note, that this helps explain why the judges in *Pacific Lumber* and the majority in *Philly News* were so unconcerned about taking away the secured creditor's right to credit bid. It's because, in their minds, the sale is *not* necessarily what establishes the value the secured creditor is ultimately entitled to receive. The assumption they were operating on is all the undersecured creditor is ultimately entitled to under (b)(2)(A)(iii) is the value of its collateral as determined by a judicial valuation and *not* necessarily by the ultimate price paid for the collateral (which can be hard to tease out sometimes, given deal complexity). In the *Pacific Lumber/Philly News* world, the only baseline distribution value protection that undersecured creditors are guaranteed is the value of their collateral as determined in a judicial valuation. And that view corresponds with those courts' interpretation of 1129(b)(2)(A). If subdivision (ii) is *not* controlling in a free-and-clear plan sale, not only does the credit-bidding requirement *not* apply, but *neither* does the requirement that the undersecured creditor must capture all sale proceeds by its lien attaching to the sale proceeds. You can cram down the undersecured creditor by cash-out at a judicially determined value under subdivision (iii). And the debtor and the estate get to keep any extra value the sale brings.

The Times They Are a-Changin'

Much about the Chapter 11 process has changed since enactment of the Bankruptcy Code in 1978. Such changes, many of which alter basic assumptions around which the entire Chapter 11 process was conceived and designed, may cause us to reconsider the advisability of allowing a vastly-undersecured creditor with first-priority liens on all of a debtor's assets to capture all of the going-concern value implicit in the debtor's business, particularly if the Chapter 11 process is the only means by which the secured creditor could ever hope to realistically realize going-concern value. Indeed, the decisions in *Pacific Lumber* and *Philly News* district court decision seem to be a manifestation of precisely that sort of rethinking. As enacted, though, Chapter 11 goes to great lengths to protect a secured creditor's right to insist upon capturing the full value of its collateral, including its going-concern value. Those not content to patiently await a legislative recalibration of secured creditors' rights in bankruptcy reorganizations, however, will find considerable solace in *Pacific Lumber* and *Philly News*.

To some extent, *Pacific Lumber* and *Philly News* (and their reset of our basic assumptions regarding secured creditors' baseline entitlements) may well be a reaction against

the control that secured creditors have been able to wield in Chapter 11 cases. In the brave new world of Chapter 11, (1) secured creditors routinely have blanket liens on all assets, such that you commonly have one big undersecured creditor or creditor-group whose collateral is the whole company, and (2) going-concern sales of the entire company are the dominant reorganization vehicle (as we'll see in the next Part of this chapter). Well, liens attaching to sale proceeds and credit-bidding rights essentially give the entire value of the company to the secured creditor, including any going concern value. As a theoretical matter, you could question whether the secured creditor should be entitled to receive all of the going concern value, especially if the only way they can really capture all of that going-concern value (or a larger going-concern value) is in Chapter 11 (i.e., they'd get a smaller recovery if they had to enforce their lien rights outside bankruptcy). If you buy into that view, then you don't really regard it as unfair to the secured creditor that they're forced to take less than the full going-concern value of the company under a § 506(a) valuation. So denying credit bidding is a way to try to force secured creditors to share some of the going concern value with the unsecureds.

Of course, that gambit only works if you go the traditional plan route because if you do a 363 sale, the secured creditor clearly has credit-bidding rights under 363(k). So *Pacific Lumber* and *Philly News* create a dynamic that runs counter to the increasing dominance of 363 sales. Debtors and insiders and unsecured creditors have an incentive to do any sale via a plan because that's how they try to force secured creditors to share more of the going-concern surplus with them (through the threat of limiting their return to a 506(a) valuation amount).

Pacific Lumber and *Philly News* also up the stakes on forum choice as between Delaware and New York City. Secured creditors will want to stay away from Delaware now (all else being equal), and debtors and unsecureds will favor the S.D.N.Y, where *Pacific Lumber* and *Philly News* are not controlling precedent.

CHAPTER 13

JURISDICTION AND PROCEDURE

(insert the following at the end of the first full paragraph on page 702)

(As we'll see, though, subsequent developments have called into doubt this aspect of *Marathon*, a topic to which we will return when we talk about *Stern v. Marshall* and the *Granfinanciera* case.)

(replace Problem 13.1(d)-(f) on pages 706-10 with the following)

Problem 13.1(d)-(g) (pp.761-62)

These problems roughly approximate the facts of *Katchen v. Landy*, 382 U.S. 323 (1966), and are designed to explore the issues raised by that case and the more recent *Stern v. Marshall* decision excerpted after Problem 13.1.

d. Let's put aside the trustee's counterclaim for the moment, and let's say the trustee only objected to LL's claims on the merits. He says that Debtor already paid that rent in cash (under the table, so to speak). So they're going to have to litigate whether LL's claim should be allowed or disallowed. Do you think those claims allowance proceedings are core? Well, it's a generic state law dispute. LL says Debtor owes me \$ under my state law causes of action; trustee says, "no way." You can't really say that anything in that controversy is founded on a federal bankruptcy cause of action such that the dispute "arises under" the Bankruptcy Code.

But is it a proceeding "arising in" the bankruptcy case? Sure. And what is it about this proceeding on a state-law dispute that makes it somehow unique to the bankruptcy process? Well, it's back to the idea we talked about earlier that claims allowance proceedings have always been considered so integral to administration of the bankruptcy estate that they were within the summary *in rem* jurisdiction of a referee.

Well, outside of bankruptcy, would LL's claim against Debtor be considered *in personam* or *in rem*? *In personam*. It's just a claim to establish liability for money damages, without claiming a right of recourse to any particular assets of Debtor to satisfy that liability. So it would be just a plain old *in personam* claim. So what is it about the bankruptcy filing that suddenly turns that *in personam* claim into an *in rem* claim? In making a claim against the bankruptcy estate, a creditor isn't just seeking to establish the debtor's personal liability. The creditor is now seeking payment from specific assets of the debtor. The bankruptcy is all about gathering up all of the debtor's property and distributing it to creditors. And even an unsecured creditor, in filing a proof of claim, is essentially saying, "I want my share of whatever's left over after taking out exempt property and satisfying liens and priority claims. I have a right to my share of that property — the property of the estate. And because of the bankruptcy discharge of Debtor's *in personam* liability, that's really *all* the bankruptcy claim is going to do — establish LL's rights in the property of Debtor's bankruptcy estate.

So a bankruptcy filing really does convert what would otherwise be strictly an *in personam* claim against the debtor into an *in rem* claim against the debtor's property (the

bankruptcy estate). And that's what the quote from *Katchen v. Landy* on p.760 is talking about: "The whole process of proof, allowance, and distribution is, shortly speaking, an adjudication of interests claimed in a *res*,' and thus falls within the principle . . . that bankruptcy courts have summary jurisdiction to adjudicate controversies relating to property within their possession."

So claims allowance proceedings are the perfect example of a core proceeding "arising in" the bankruptcy case. Nothing in your run-of-the-mill disputed claim is founded on a cause of action that "arises under" the Bankruptcy Code, but because of the different context and different consequences of making a claim against a bankruptcy estate, a claims allowance proceeding is distinct from a non-bankruptcy adjudication of the same claim. Under the 1898 Act, that distinctiveness was marked by the summary *in rem* nature of claims allowance proceedings, and under the Code, they're core proceedings that can be adjudicated by a bankruptcy judge. And nobody seriously questions that. The Supreme Court, in the recent *Stern v. Marshall* decision, took as a given that it is indeed constitutional for a non-Article III bankruptcy judge to enter a final judgment allowing or disallowing a creditor's proof of claim, and that is codified in 28 U.S.C. § 157(b)(2)(B), which expressly makes "allowance or disallowance of claims against the estate" core proceedings.

OK, now let's add in the trustee's counterclaim. Instead of just objecting to the validity of the rent claim, the trustee says, well, Debtor would owe you rent, except for the fact that you didn't properly maintain the premises by installing fire protection devices like you said you would in the lease. As a result, the building burned to the ground, destroying not only your building, but all of Debtor's inventory that was kept in the building. So Debtor's got a counterclaim against you for breach of lease, which claim Debtor's bankruptcy estate succeeded to on the petition date. And I'm asserting that counterclaim against you on behalf of the estate, and it not only wipes out your rent claim, but you also owe the estate \$1.2 million.

So notice what we've got now. The trustee is asserting a prepetition state-law breach of lease claim against a third party, which sounds a lot like the *Marathon* cause of action. Is that counterclaim a core proceeding or is it a *Marathon*-like noncore proceeding that's only "related to" the bankruptcy case? Well, note that the statute, in § 157(B)(2)(C), expressly includes as core proceedings *all* "counterclaims by the estate against persons filing claims against the estate." But in *Stern v. Marshall*, the Supreme Court said that provision, read literally to apply to all counterclaims, is unconstitutionally overbroad. Relying upon *Katchen v. Landy*, the Court said that final adjudication of a state-law counterclaim like this one, is properly within a non-Article III bankruptcy judge's core jurisdiction only to the extent that the bankruptcy judge has to address factual and legal issues involved in the counterclaim in order to fully and finally dispose of the creditor's claim against the estate. And, of course, any issues relevant to the counterclaim that are actually litigated and decided by a final order of the bankruptcy judge, in disposing of the creditor's claim, will thereafter bind the parties under the issue preclusion principles of collateral estoppel (and on direct appeal, will receive the same deference as any other final appealable order — most significantly, factual findings will only be reversed if clearly erroneous).

But with respect to any factual and legal issues that the bankruptcy judge does *not* have to address in order to fully and finally dispose of the creditor's claim against the estate must be treated as non-core "related to" matters on which the bankruptcy judge can only submit proposed findings and conclusions, for consideration and final judgment by the district court, after a *de novo* review (including, if the district judge wants, after rehearing or hearing more or new evidence).

OK, so how should we apply that framework to Problem 13.1(d)? A lot will depend upon the precise positions of the parties and the evidence presented. For example, if the trustee has some grounds to object to the rent claim other than the fire, and the bankruptcy judge agrees with the trustee, then it may be possible for the bankruptcy judge to completely dispose of the rent claim without ever addressing the trustee's counterclaim, which would render the counterclaim a non-core "related to" proceeding in its entirety. And note, that seems to be the situation the Supreme Court was presented with in *Stern v. Marshall*: the bankruptcy judge entered summary judgment entirely disallowing E. Pierce Marshall's defamation claim against Anna Nicole Smith's bankruptcy estate before addressing (through a subsequent full-blown trial) Anna Nicole's tortious interference counterclaim against E. Pierce. So in *Stern v. Marshall*, given the framework the Court adopted regarding counterclaims, it was easy to say that the bankruptcy judge in that case did not have core jurisdiction over the counterclaim. Once the bankruptcy judge had already disallowed E. Pierce's claim, thereafter, *everything* the bankruptcy judge was doing with respect to the counterclaim clearly was *not* necessary to dispose of the creditor's claim (which had already been fully disposed of) and thus was non-core.

Note, though, that that's not necessarily how resolution of claims and counterclaims play out. These things tend to be a little more messily intertwined in practice. For example, let's say that the only ground the trustee has to object to the rent claim is the fire. "Yeah, Debtor (and the estate as successor) would owe you \$15,000 rent money, but for the fact that you breached the lease and your breach caused Debtor (and the estate as successor) damages of \$1.2 million." Well, note, that in this instance, you can't really allow or disallow the creditor's claim until you determine the validity of the counterclaim, so it would seem that the bankruptcy judge would have core jurisdiction to enter a final order on the counterclaim under these circumstances, at least as to liability on the counterclaim. But this may well be a case in which the bankruptcy judge would have core jurisdiction over part but not all of the counterclaim. Given the very large damages at stake on the counterclaim, as compared to the creditor's claim, if the bankruptcy judge found that the creditor was indeed liable on the counterclaim, that's probably all it would take for the bankruptcy judge to be able to disallow the rent claim in its entirety. The bankruptcy judge probably wouldn't really need to go on and determine the full extent of the damages on the counterclaim and enter a money judgment against the creditor in that amount; that's not really necessary to dispose of the creditor's claim. So the bankruptcy judge likely would have to sever the counterclaim as between liability and damages. The bankruptcy judge would have core jurisdiction to enter a final order as to liability on the counterclaim, but as regards damages and a money judgment therefor, that would be a non-core "related to" matter on which the bankruptcy judge could only submit proposed findings and conclusions to the district court.

e. This problem further teases out the practicalities of applying the *Stern v. Marshall* framework to counterclaims. In this case, it looks like that in order to fully dispose of the rent claim the bankruptcy judge will probably have to adjudicate not only liability but also the extent of damages on the counterclaim. You can't fully adjudicate Lord Land's claim without adjudicating the trustee's counterclaim, and both *Katchen v. Landy* and *Stern v. Marshall* said that when that's the case, adjudicating the counterclaim becomes part of the *in rem* claims allowance process, appropriate for final resolution by a non-Article III bankruptcy arbiter.

Well, let's say the bankruptcy judge does that and agrees with the trustee that Debtor's computer servers were worth \$20,000, so that after netting the claim and counterclaim, Lord Land owes the estate \$5,000. Can the bankruptcy judge enter a \$5,000 final money judgment

against Lord Land on the state-law breach of lease claim? Doesn't that look a lot like what the DIP was after in the *Marathon* case — an affirmative monetary recovery on a prepetition state law cause of action? Does that make the counterclaim non-core? Nope. Why not? Well, *Katchen v. Landy* said the counterclaim is still part of the summary *in rem* claims allowance proceedings, even if the result could be a money judgment to pay the trustee on what would otherwise be a plenary *in personam* action. You still have to resolve all of those issues as to validity and amount of the counterclaim in order to allow or disallow the creditor's claim. And to the extent the claims allowance proceedings resolve all of the issues that would be raised in a separate plenary suit to recover on the counterclaim, then the claims allowance proceeding is binding on both parties in any other court through the preclusion principles of *res judicata*. So why not just let the referee enter the money judgment for the trustee on the counterclaim? And nothing in *Stern v. Marshall* seems to call that into doubt.

You can also think of that in terms of the 1898 Act concept of constructive possession. Once the referee has already determined that LL actually owes the trustee money on the counterclaim in the course of deciding the claims allowance proceedings, it's as if the trustee is, at that point, in constructive possession of that money. At that point, LL can no longer make a substantial adverse claim that LL doesn't owe the trustee the money (i.e., no longer has a substantial defense to payment) because LL is bound by *res judicata*, so it's within the referee's summary *in rem* jurisdiction to order LL to turnover the money.

f. Now, instead of countering the rent claim with a breach of lease claim, the trustee responds with a claim that's completely unrelated to the lease or the building. The T says Debtor may owe you rent, but you owe Debtor a lot more money because of these gambling debts that Debtor covered for you. That wipes out the rent claim, plus you owe the estate nearly \$350,000. Now is the trustee's counterclaim a core proceeding? Do you have to adjudicate that counterclaim in order to decide whether the rent claim against the estate is valid? Well, they're totally unrelated, and even if the rent claim is allowed, there's nothing to prevent the trustee from going out and suing LL on these unpaid loans.

Would the same be true with respect to the trustee's counterclaim for breach of lease in (d) or (e)? If the trustee just sat back and posed no objection to allowance of the LL's rent claim so that it was allowed, could the trustee then go into a state or federal district court and try to sue LL for breach of lease? Probably not.⁴³ Why not? What basic civil procedure concept am I driving at, here? Compulsory counterclaims. Remember, if a defendant has a counterclaim against a plaintiff that arises from the same transaction or occurrence, that's a compulsory counterclaim. And if the defendant doesn't assert it, once there's a judgment on the plaintiff's claim, the defendant's compulsory counterclaim disappears through the magic of *res judicata*. So for a compulsory counterclaim, you have to use it or lose it.

And note, that the trustee might be smart *not* to assert the loan claim as a counterclaim and just sue LL on it separately, because then LL collects the rent claim in little tiny pro rata

⁴³I say probably, because as we'll see later, it's not entirely clear that the compulsory counterclaim rule applies to claims objections, which are contested matters, to which Rule 7013 is not automatically applicable. Rule 7013 kicks in only if the trustee actually makes a counterclaim for affirmative relief. See Rule 9014. Even if the compulsory counterclaim rule, by its terms, doesn't apply to claims proceedings, it may still apply as a general matter of *res judicata* and claim preclusion.

bankruptcy dollars along with all other unsecured creditors, but T could collect from LL on the loan claim in big full-value nonbankruptcy real 100-cent dollars. If that loan claim is asserted as a counterclaim, though, LL may be able to more easily try to do a setoff or offset and use the entire amount of the rent claim to offset the much greater liability on the loan claim. And that's really the only thing that ties the two together if the loan claim is asserted as a counterclaim to the rent claim before the bankruptcy judge: can LL offset the rent claim against any liability on the loan claim? So it seems like this is another instance in which the bankruptcy judge might have to sever claims and issues? The bankruptcy judge would clearly have core jurisdiction to allow the rent claim of \$15,000, but would probably only have non-core "related to" jurisdiction to submit proposed findings and conclusions to the district court on the loan counterclaim. And if the district court is going to enter judgment against LL on the loan counterclaim and LL is arguing for an offset for the amount of the allowed rent claim, the district court could itself then rule on that issue in order to decide what the dollar amount of the judgment against LL should be. But if the district court wanted to remand that offset issue back to the bankruptcy judge, it looks like that offset issue would probably be a core matter that the bankruptcy judge could finally decide because that issue is really the equivalent of deciding whether LL is a secured or unsecured creditor with respect to the rent claim.

g. Now, the trustee counterclaims with an avoidance action, to recover a prepetition transfer of property from Debtor to LL as a fraudulent conveyance. And, remember, in (c) we said that the courts are split over whether that avoidance action, on its own, would or would not be considered a core proceeding. Now, it's posed as a counterclaim, and notice that it's a counterclaim that's totally unrelated to the factual basis for LL's claim against the estate, so it wouldn't be considered a compulsory counterclaim for purposes of *res judicata*.

Would that avoidance counterclaim have been within a referee's summary jurisdiction under the 1898 Act? Absolutely. And why is that? Because of 1898 Act § 57g. Section 57g gave the trustee grounds to object to allowance of a proof of claim on the basis that the creditor was the recipient of an avoidable transfer.

What's the purpose of doing that? It's to prevent setoff as against a trustee's avoidance actions. Remember what setoff is all about. If the trustee has a claim against a creditor, the creditor is generally entitled to setoff any claim that the creditor has against the estate so that the creditor only has to pay the net amount to the trustee (or, alternatively, the creditor only has a claim against the estate for the net amount). So a creditor's setoff rights are the equivalent of having a secured claim. E.g., C has a \$50 claim against the estate, and the trustee has a \$200 claim against C. If C can net those claims, or set them off against one another, C only owes the estate \$150. Well, what § 57g said was if the trustee's \$200 claim is an avoidance action, like a preference claim, then you can't setoff. Your claim against the estate is disallowed until you turnover the entire preference in full. So C has to pay the estate \$200, and only then can C receive a bankruptcy distribution on its \$50 claim (plus a claim for the \$200 recovered by the trustee), at whatever reduced pro-rata distribution is applicable. And that nearly always means C will be out more than the \$150 C would pay if setoff were allowed.

OK, so what's all that got to do with summary jurisdiction over the avoidance action counterclaim? Well, the Court in *Katchen v. Landy* said that § 57g made a preference counterclaim to a proof of claim part-and-parcel of the claims allowance process because § 57g explicitly made receipt of an avoidable transfer grounds to object to a creditor's claim. So adjudication of the avoidance action necessarily becomes part of the summary *in rem* claims

objection proceedings. Whether the avoidance action is factually related to the creditor's proof of claim or not, it doesn't matter because § 57g makes the avoidance counterclaim integral to the allowance proceedings. You cannot allow or disallow the creditor's claim until you determine whether the creditor received an avoidable transfer, and if so, the amount that the creditor must pay the estate before its claim can be allowed.

Section 57g from the 1898 Act is carried forward into the Code by § 502(d). So what that means is the unrelated avoidance counterclaim, in conjunction with a § 502(d) objection to LL's claim, should be considered a core proceeding under BAFJA, just like it was considered a summary *in rem* proceeding under 1898 Act and the holding of *Katchen v. Landy*. And the Court in *Stern v. Marshall* confirms the validity of this aspect of *Katchen v. Landy*, and in fact, uses it to construct its framework for deciding when a counterclaim is or is not within core jurisdiction: only to the extent it's necessary for the bankruptcy judge to address factual and legal issues governing the counterclaim in order to allow or disallow the creditor's claim against the estate.

Note, though, that § 502(d) may not add much now, though. Contrasted with old § 57g, § 502(d) is much less significant in converting what would otherwise be a non-core proceeding, standing alone, into a core counterclaim. Why that is? Because most avoidance actions, like preference suits, are core proceedings even standing alone, as we've already seen. They're usually considered "arising under" core proceedings.⁴⁴ And, recall, that's a departure from the 1898 Act, under which a trustee's avoidance actions, standing alone, were plenary actions, not summary.

But what's a good example of a case where a § 502(d) objection and counterclaim to a creditor's proof of claim *would* convert an otherwise non-core avoidance action into a core counterclaim? A § 544(b) avoidance counterclaim, just like this problem. Remember, there's a split in the courts over whether a § 544(b) action, standing alone, is core or non-core, but if the § 544(b) action is a counterclaim to a creditor's proof of claim, in conjunction with a § 502(d) objection, that should make the § 544(b) action core, even in courts that say a stand-alone § 544(b) action is non-core.

(change the heading labeled **Problem 13.1(g)** (p. 762) on page 714 to **Problem 13.1(h)** (page 762))

(add the following before Part C on page 717)

Stern v. Marshall (p. 762)

The most efficient way to explore the direct implications of the holding in *Stern v. Marshall* is through Problem 13.1(d)-(g). We've also included the case itself, though, because it provides the Supreme Court's most recent thinking on how to sort out the constitutional limits of non-Article III bankruptcy judges' adjudicatory authority. The Court's reasoning also speaks to

⁴⁴The only proviso being that, as we'll discuss later, *Stern v. Marshall* and *Granfinanciera* call this aspect of *Marathon* and BAFJA into doubt as a constitutional matter.

the constitutional right to a jury trial in bankruptcy proceedings that's explored in Part E of this Chapter.

The facts and procedural posture of the case are a bit complicated, but the background necessary to the Court's holding is pretty easy to grasp. Vickie Lynn Marshall, more famously known as *Playboy* Playmate Anna Nicole Smith, married the fabulously wealthy J. Howard Marshall II very late in J. Howard's life, and this set her at odds with J. Howard's principal heir, E. Pierce Marshall. The whole sordid saga that unfolded both before and thereafter is, indeed, the stuff of a Dickens novel, but we will focus on the legal niceties in the bankruptcy proceedings precipitated by Anna Nicole filing a Chapter 11 petition in California. E. Pierce filed a proof of claim against Anna Nicole's bankruptcy estate claiming that she defamed him prepetition (through her lawyers by telling the press that he improperly prevented J. Howard from gifting half of his property to her). She objected to allowance of that claim on the merits (she didn't authorize publication of the statements, truth as a defense, etc.), and also filed a counterclaim against E. Pierce claiming, yes, he did, through all kinds of wrongful machinations, affirmatively prevent J. Howard from effectuating an *inter vivos* gift that he intended and tried to make to Anna Nicole of half of all of his property. Easy enough: (1) a state-law claim by E. Pierce against Anna Nicole's bankruptcy estate for damages for defamation and (2) a state-law counterclaim by Anna Nicole against E. Pierce for damages for tortious interference.

The bankruptcy court granted Anna Nicole summary judgment on E. Pierce's defamation claim, disallowing the claim in its entirety, and then the bankruptcy court tried Anna Nicole's tortious interference counterclaim. After trial, the bankruptcy court entered judgment for Anna Nicole in the amount of \$425 million. On appeal, the district court affirmed liability but reduced the damages to only \$90 million.

The reason that the core/non-core issue became relevant is because there was parallel litigation proceeding in a Texas probate court that was administering J. Howard's estate, and after the bankruptcy court's judgment, but before the district court ruling, the Texas probate court (after a very lengthy jury trial) entered a judgment in Pierce's favor that he was *not* liable to Anna Nicole for tortious interference. With conflicting judgments from collateral courts, resolving those conflicting judgments was a matter of preclusions principles and which court had entered the first "final" judgment. If the bankruptcy court did not enter the first "final" judgment and it was the Texas probate court that entered the first final judgment, then the district court was required to give preclusive effect to the final judgment of the Texas probate court denying Anna Nicole any relief against E. Pierce on her tortious interference claim.⁴⁵ Whether the bankruptcy court had entered the first "final" judgment turned on whether Anna Nicole's counterclaim was a "core" proceeding in which it was constitutional for the non-Article III bankruptcy judge to enter a final judgment, subject to only appellate review by the district court. The Supreme Court held that it was unconstitutional for the non-Article III bankruptcy judge to purport to enter a final judgment on Anna Nicole's counterclaim. So the Texas probate court's judgment is given preclusive effect, denying Anna Nicole any relief on her tortious interference counterclaim against E. Pierce.

The first thing to notice is something we've emphasized all along — you can't take the illustrative list of core proceedings in 28 U.S.C. § 157(b)(2) too literally. By its terms,

⁴⁵If the bankruptcy court's decision was the first "final" judgment, sorting out the proper application of preclusion principles would have been very messy. The Court's decision, though, avoided all of that potential messiness.

157(b)(2)(C) expressly includes as core proceedings *all* “counterclaims by the estate against persons filing claims against the estate.” That provision has always been highly suspect. Under the 1898 Act, the lower courts had drawn the line at compulsory counterclaims (arising out to the same transaction or occurrence as the proof of claim), which were considered within referees’ summary jurisdiction, but most courts said that unrelated permissive counterclaims were not within referees’ summary jurisdiction. The Supreme Court, while citing the compulsory counterclaim cases approvingly in *Katchen v. Landy*, expressly refused to opine on their validity, which left some room for the Supreme Court to draw the line differently in *Stern v. Marshall*. But by holding that 157(b)(2)(C) is unconstitutionally overbroad if applied to all counterclaims, we’re back in this situation where you really have to construe the scope of core proceedings as co-extensive with the constitutional limits of non-Article III bankruptcy judges’ final adjudicatory authority (whatever that limit is), and for counterclaims that cannot be finally adjudicated by a bankruptcy judge (like the one at issue in *Stern v. Marshall*), in an omitted portion of the Court’s opinion, the Court signaled that the bankruptcy courts should treat those as the equivalent of non-core “related to” proceedings that they can hear and in which they can enter proposed findings and conclusions, but not final judgments (absent consent of the parties). And the Court holds that filing a proof of claim, in and of itself, cannot be considered consent to having a non-Article III bankruptcy judge finally adjudicate any counterclaim against the creditor because (as we’ve seen) the combined effect of the automatic stay and the discharge injunction *compel* a creditor to file a proof of claim if they want a distribution from property of the estate.⁴⁶

The second thing to note about the Supreme Court’s opinion is the Court’s continued perplexing preoccupation with the state-law nature of the claim at issue, which the *Marathon* plurality and concurrence both emphasized also (and we previously puzzled about in discussing *Marathon*). And the *Stern v. Marshall* Court goes so far as to expressly cite the *Butner* principle as if it somehow speaks to the issue at stake in the case. It’s not apparent, however, that the *Butner* principle has any relevance at all. That principle speaks directly to a federalism principle for choosing the applicable rule of decision, state or federal, to govern parties’ disputes in bankruptcy. It may well have some constitutional underpinnings in the constitutional dimension of the *Erie* decision, and *Erie*’s constitutional dimension may well implicate separation of powers principles — preventing the federal courts from encroaching upon Congress’s prerogative to prescribe substantive federal law by restraining the federal courts’ power to fashion federal common law. But that’s not the separation of powers concern at stake in *Stern v. Marshall*, which was not a choice-of-law issue at all; it was all about whether the litigants are entitled to an Article III judge to decide their dispute. And the principal separation-of-powers

⁴⁶In *CFTC v. Schor*, 478 U.S. 833 (1986), the Supreme Court OKed a non-Article III administrative adjudication of state-law counterclaims “arising out of the [same] transaction or occurrence or series of transactions or occurrences” as a reparations complaint before the CFTC. The holding was based on notions of waiver or consent and the need to adjudicate the counterclaims as a necessary incident to adjudication of the federal reparations complaint. In *Granfinanciera*, the Supreme Court distinguished *Schor* from bankruptcy, saying that the CFTC complaint was an optional forum, which makes it look more like consent. A creditor, though, has no other forum in which to file a proof of claim other than the bankruptcy court. So filing a proof of claim probably won’t support a notion of “consent” to adjudication by a bankruptcy judge.

danger from having non-Article III bankruptcy judges seems to be that they may be more subject to potential prejudicial influences on their decision-making (e.g., because they'll have to find another job after their time on the bench — perhaps from one of the big law firms whose lawyers have appeared regularly before the court) than would an Article III district judge. That danger, though, is not one that subsides in federal-law claims (think, e.g., about the priority issues at stake in *Chrysler* and *GM*). So it's not at all clear why the state-law nature of the claim at issue is relevant to this separation-of-powers issue.

The *Butner* principle does implicate procedural issues. Indeed, the different procedural forum necessitated by bankruptcy is one of our guideposts in determining the limits of the *Butner* principle. And we've talked about various "level playing field" provisions, that are largely procedural, and that might well be the intuition that explains the historical distinction between summary and plenary proceedings — efficient administration of a limited-fund bankruptcy estate necessitates summary processes in administering that estate, but that shouldn't extend to give the estate undue procedural advantages when it's suing people, particularly on claims that have nothing to do with the bankruptcy proceedings other than the fact that the debtor filed bankruptcy so that it's now a trustee or DIP who's doing the suing. But it's not clear that that is (or should be) a constitutional principle, and the other instances of it that we've explored are not a matter of constitutional mandate, but rather are statutory codifications as a matter of congressional policy. *Stern v. Marshall*, however, raises the specter that the *Butner* principle has a constitutional dimension.

Juxtaposing the state-law nature of the claim at issue with the practical separation-of-powers concern at stake is even more puzzling. It's the *Butner* principle itself that ensures that a lot of what's adjudicated in bankruptcy (like creditors' claims against the estate) are state-law claims, and note, that the Court doesn't even question (and indeed seems to expressly endorse) the constitutionality of bankruptcy judges adjudicating creditors' state-law claims against the estate. But the potential for prejudicial influences on bankruptcy judges' decision-making seems to apply just as (if not more) forcefully to those state-law matters that bankruptcy judges can unquestionably finally adjudicate as it does to state-law claims that they cannot finally adjudicate. Justice Scalia is probably correct; probably the only way that it makes sense to say that the Constitution *permits* a non-Article III bankruptcy judge to finally adjudicate Pierce's state-law claim against Anna Nicole's bankruptcy estate, but the Constitution *forbids* a non-Article III bankruptcy judge from finally adjudicating Anna Nicole's state-law counterclaim against Pierce, is in terms of established historical practice. And in bankruptcy, that established historical practice lies in the historical distinction between summary and plenary proceedings.

And that historical practice is, at the end of the day, the only thing that ties together all of the Court's decisions. And that brings us to the third most noteworthy thing about the Court's decision. Not only does the Court reason directly from the 1898 Act's summary-plenary dichotomy (in distinguishing *Katchen v. Landy*), but the Court also reasons directly from Seventh Amendment *jury trial* decisions that did not expressly present any Article III separation-of-powers issue (i.e., *Granfinanciera*, *Katchen v. Landy*, and *Langenkamp v. Culp*). We'll come back to this issue when we address *Granfinanciera*, but the reasoning of that decision implies a constitutionalization of the 1898 Act divide between summary and plenary proceedings, both for purposes of the Seventh Amendment and for Article III separation-of-powers purposes. And now that the Court is (in an Article III separation-of-powers case) reasoning directly from both an 1898 Act summary-plenary decision *and* Seventh Amendment decisions, that implication seems inescapable. And what that means is that for proceedings that the 1984 BAFJA

Amendments declare to be core proceedings but that were plenary matters under the 1898 Act (most visibly, actions to recover preferences and fraudulent conveyances and to avoid liens) are highly constitutionally suspect.

(Insert the following at the end of the second full paragraph)

Of course, it's very hard to restrict the implications of *Granfinanciera* in that way after *Stern v. Marshall*, which we looked at in Part B. Recall that *was* an Article III separation-of-powers case, *and* the Court reasoned directly from *Granfinanciera* as if *Granfinanciera* were *also* an Article III separation-of-powers case, making clear that a majority of the Court regards both the Article III and the Seventh Amendment inquiries as the same: If Congress can't take away the parties' right to a jury trial, they also can't take away the parties' right to an Article III judge. So the courts are probably going to have to now directly confront the constitutionality of 28 U.S.C. § 157(b)(2)(F) and (H), in light of *Granfinanciera* and *Stern v. Marshall*.