STATE BAR *of* TEXAS

BANKRUPTCY LAW *Section Newsletter*

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IN THIS ISSUE

A MESSAGE FROM YOUR CHAIR

Dear Members of the Bankruptcy Law Section:

The section continues to grow in so many facets, including membership. The section recently crossed the 2,000 member threshold for the first time. Not bad for a specialty practice. Our dedicated and hard-working membership chair, Omar Alaniz, should be commended. Luckily, the section also continues to grow in the area of resources and volunteers, which translates into more benefits to our membership.

I wanted to take this opportunity to make sure every member is aware of the upcoming "10th Anniversary Bench/Bar Conference" sponsored by the section. It is scheduled for June 5-7, 2013, at the Westin La Cantera in San Antonio, Texas. The chairs of the conference are Charlie Beckham and the Honorable Brenda Rhoades. If you are interested in sponsorship opportunities, please reach out to our sponsorship chair and treasurer, Bill Wallander.

The bench/bar conference is the marquis event for the section and therefore a must attend event for the membership. It has it all — high quality speakers, CLE credit, networking opportunities with other attorneys and Bankruptcy Judges, golf, spa and other fun social events. Please be on the lookout for the registration notice. The conference only takes place every other year, so don't miss out!

Best,

Tom A. Howley
Chair, Bankruptcy Law Section

31ST ANNUAL WESTBROOK BANKRUPTCY CONFERENCE 2012

Recent Developments: Jay L. Westbrook; R. Bryn "Byrnie" Bass Jr.; Deborah B. Langehennig; William J. Rochelle; Deborah D. Williamson

These witty professionals called em like they saw 'em as they offered hot opinions on recent case law throughout the nation. Issues discussed included general topics such as counsel etiquette, lawyers' fees, and "wrongly" decided cases, as well as more specific issues such as the role of public interest in judicial decisions and Chapter 13 cases filed with the intention of paying only lawyers' fees through the plan.

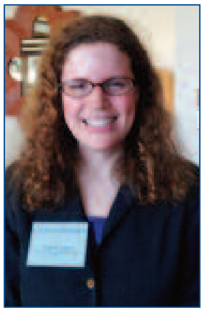
Debt as an Asset Acquisition Tool and Defenses to "Loan-to-Own" Strategies: Leon V. Komkov; Patricia Baron Tomasco

More and more, financial players are acquiring senior secured debt and using pre-bankruptcy forbearance and restructuring to enhance their ability to convert that debt to ownership of the debtor's assets. Although these financial opportunists may be viewed as sharks by some, current government policy actually encourages senior lenders to sell these "hopelessly" below water loans rather than foreclosing, and takeovers by debt purchasing can lead to an effective, viable turnaround plan by financial professionals.

Leon V. Komkov and Patricia Tomasco

Debt and Domestic Abuse: Angela Littwin

Professor Littwin of The University of Texas School of Law presented her fascinating research concerning "coercive debt," a new type of debt emerging from abusive relationships which can consist of the empowered spouse maintaining complete control over finances and listing all assets in his/her name, and all liabilities in the victim spouse's name. Professor Littwin's proposal for alleviating the situation includes substituting family courts that are familiar with domestic situations for the law enforcement entities that are currently in charge of overturning (or usually not overturning) coerced debt.



Prof. Angela Littwin

Current Employment Issues: Kevin Epstein; William A. "Trey" Wood III

This discussion tackled numerous employment issues including representing multiple debtors, representing a committee in a jointly-administered case, and a retainer paid by a non-debtor. Among the surprising recent holdings was that a "totality of circumstances" test is to be used in a situation where a retainer is paid by a third-party with a conflict, rather than a strict prohibition. Additionally, the use of conflicts counsel is becoming more and more popular—judges tend to look favorably upon disclosure in situations where they can become more involved.

Kevin Eptstein and William A. (Trey) Wood III

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UNITED STATES SUPREME COURT CONSIDERS DEGREE OF MISCONDUCT TO CONSTITUTE "DEFALCATION"

By: Jay A. Ferguson, SMU Dedman School of Law – May 2014,
Judicial Extern to the Honorable Judge Harlin D. Hale (jaferguson@smu.edu)

Introduction

On February 14, 2011, the Eleventh Circuit of the United States Court of Appeals held that "defalcation," as used in 11 U.S.C. § 523(a)(4), the discharge exception for fiduciary fraud or defalcation, requires a showing of recklessness by the fiduciary. *In re Bullock*, 670 F.3d 1160 (11th Cir. 2012) *cert. granted*, 133 S. Ct. 526 (2012). The Supreme Court granted certiorari and heard oral arguments on Monday, March 18, 2013.

Background

Bullock was named trustee of his father's trust and engaged in three transactions in opposition to the terms of the trust. An Illinois state court determined that Bullock breached his fiduciary duty by self-dealing while serving as trustee of his father's trust. The court assessed damages in the amount of $285,000. The Illinois court placed the property obtained with the self-dealt funds in a constructive trust with BankChampaign (Bank) as the trustee.

Bullock filed for Chapter 7 Bankruptcy. The Bank challenged the dischargeability of the judgment debt pursuant to 11 U.S.C. § 523(a)(4). The United States Bankruptcy Court for the Northern District of Alabama entered summary judgment for the Bank. Bullock appealed, and the district court affirmed. Bullock then appealed to the Eleventh Circuit arguing the bankruptcy court erred in concluding that the Illinois judgment was non-dischargeable, pursuant to § 523(a)(4).

Definition of Defalcation

To begin it's analysis, the court stated that it has previously held that "defalcation refers to a failure to produce funds entrusted to a fiduciary" and that "the precise meaning of 'defalcation' for purposes of § 523(a)(4) has never been entirely clear." *In re Bullock*, 670 F.3d at 1164 (quoting *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993)). Section 523(a)(4) states a discharge under this title does not discharge an individual debtor from any debt:

> (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.

11 U.S.C. § 523. The 11th Circuit referred to the Second Circuit's decision in Central Hanover Bank & Trust as containing "perhaps the best" analysis of the meaning of "defalcation" under § 523(a)(4). In re Bullock, 670 F.3d at 1164. The Hanover court stated, "Whatever was the original meaning of defalcation, it must here have covered other defaults than deliberate malversations, else it added nothing to the words, 'fraud or embezzlement.'" Cent. Hanover Bank & Trust Co. v. Herbst, 93 F.2d 510, 511 (2d Cir. 1937).

Split Among the Circuits

The Eleventh Circuit has previously held in *Quaif* that defalcation does not have to rise to the level of fraud, embezzlement, or misappropriation. *Quaif*, 4 F.3d at 955. The court also noted that there is a split among circuits regarding the meaning of defalcation under § 523(a)(4). *In re Bullock*, 60 F.3d at 1165. The First and Second Circuits have a narrow interpretation that requires a showing of extreme recklessness. *See In re Baylis*, 313 F.3d 9, 20 (1st Cir. 2002); *In re Hyman*, 502 F.3d 61, 68 (2d Cir. 2007). The Fifth, Sixth, and Seventh Circuits require a showing of recklessness by the fiduciary. *See In re Harwood*, 637 F.3d 615, 624 (5th Cir. 2011); *In re Patel*, 565 F.3d 963, 970 (6th Cir. 2009); *In re Berman*, 629 F.3d 761, 766 n.3 (7th Cir. 2011). The Fourth, Eighth, and Ninth Circuits have the broadest interpretation, having held that even an innocent act by a fiduciary can be a defalcation. *See In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997); *In re Sherman*, 658 F.3d 1009, 1017 (9th Cir. 2011). Finally, the Third Circuit has not addressed the issue, and the Tenth

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BETTER SAFE THAN SORRY? MAYBE NOT UNDER SECTION 328.

By: Amelia L. Hurt, Paul M. Hebert Law Center, May 2014,
Extern to the Honorable Harlin "Cooter" Hale, U.S. Bankruptcy Judge, N.D. Texas (ahurt1@lsu.edu)

Overview

In *In re ASARCO, L.L.C.*, the Fifth Circuit determined that the bankruptcy court erred in granting a fee enhancement to professionals compensated pursuant to § 328(a), following a highly successful Chapter 11 bankruptcy. 702 F.3d 250 (5th Cir. 2012) ("*ASARCO III*"). In its opinion, the Court explained that because these professionals elected to enjoy the security of § 328(a), they must also accept the rigid standard for "incapable of anticipation" that accompanies it.

Facts

In August 2005, ASARCO, L.L.C. ("ASARCO") filed a voluntary Chapter 11 bankruptcy petition. *Id*. at 254. ASARCO initially retained Lehman Brothers ("Lehman") as financial advisors. *Id*. The bankruptcy court approved the terms of the engagement with Lehman ("Engagement Letter") that provided Lehman was to receive a $100,000 monthly advisory fee for the first 24 months of services and $75,000 per month thereafter. *Id*. at 255. However, following Lehman's own Chapter 11, Barclays Capital Inc. ("Barclays") acquired Lehman's contract with ASARCO. *Id*. The bankruptcy court approved the revised terms of Barclays's engagement ("Revised Engagement Letter") in accordance with §§ 327(a) and 328(a) that provided for an increased monthly advisory and transaction fee, as well as authorization for Barclays to seek a "discretionary fee based upon the successful outcome of the case." *Id*. at 256.

ASARCO's plan was confirmed, "resulting in one of the most successful bankruptcies in the United States history." *ASARCO L.L.C. v. Barclays Capital Inc.* (*In re ASARCO L.L.C.*), 457 B.R. 575, 580 (S.D. Tex. 2011) ("*ASARCO II*"). After confirmation, Barclays submitted a final fee application that requested "(1) $1,202,500 for 'unanticipated services'; (2) a $2 million success fee ('Success Fee') based on the overall outcome of ASARCO's reorganization; and (3) a $6 million auction fee ('Auction Fee') … ." *ASARCO III* at 256. The bankruptcy court ruled that Barclays could recover an additional $975,000 for "unanticipated services" pursuant to § 328(a), but it denied Barclays's "Success Fee" and "Auction Fee" requests. *ASARCO II* at 594. Thereafter, ASARCO challenged the $975,000 fee enhancement, and Barclays contested the denial of its request for a $2 million success fee. *ASARCO III* at 256–57.

On Appeal

Under § 328(a), "[a] professional may be retained on any reasonable terms; but, once [the terms] have been approved . . . the court may not stray from . . . them unless subsequent developments were incapable of being anticipated, rendering them improvident." *Id*. at 258. *See In re Coho Energy Inc.*, 395 F.3d 198, 204–05; *In re Barron*, 325 F.3d 690, 693 (5th Cir. 2003) ("*Barron II*"). This "high hurdle" is purposeful, as § 328(a) was "enacted to eliminate the previous uncertainty associated with professional compensation in bankruptcy proceedings, even at the risk of potentially underpaying, or conversely, providing a windfall to, professionals retained by the estate under § 328(a)." *Id*. However, this "high hurdle" may be avoided because the Bankruptcy Code allows professionals to seek compensation under either § 328(a) or § 330(a). *Id*. at 260. Professionals compensated under § 330(a) are provided with greater flexibility for adjustments in compensation, but also must bear the inherent uncertainty associated with court discretion, while those compensated under § 328(a) are insulated from the risk of discretion at the cost of flexibility. *Id*. at 260–61.

Disagreeing with the bankruptcy and district court, the Fifth Circuit found that Barclays was not entitled to a fee enhancement because each of the named subsequent developments were capable of anticipation, within the meaning of § 328(a). *Id*. at 263. The following subsequent developments are those that the Fifth Circuit rejected as being incapable of anticipation: (1) the protracted length of the proceeding; (2) the large volume of employee departure; and (3) the increased scope of services provided by Barclays. *Id*. at 261–63.

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THE FIFTH CIRCUIT CONSIDERS THE IMPACT OF *PERDUE* ON A BANKRUPTCY COURT'S AWARD OF FEE ENHANCEMENTS

By: Mason Parham, Judicial Extern to the Honorable Harlin D. Hale and third-year law student at SMU Dedman School of Law (dparham@smu.edu)

Introduction

In *Perdue v. Kenny A. ex rel Winn.*, 130 S. Ct. 1662 (2010), the Supreme Court held that fees calculated under the lodestar method could be enhanced in consideration of the quality of an attorney's performance in three circumstances: (1) the lodestar calculation does not represent the attorney's market value; (2) the attorney's expenses are unusually high and the litigation unusually protracted; or (3) there are exceptional delays in the payment of the attorney's fees. *Id*. at 1674-75.

In *CRG Partners Group, L.L.C. v. Neary*, the Fifth Circuit rejected a bankruptcy court's extension of the narrow fee-shifting standard set forth in *Perdue* on the ground that *Perdue* had not "unequivocally, *sub silentio* overrule[d]" Circuit precedent governing a bankruptcy court's award of fee-enhancements. By doing so, the court both reaffirmed the preexisting Circuit framework governing awards of fee-enhancements and also provided clear guidelines for lower courts to use in considering the effect of a Supreme Court decision on existing law.

Background

CRG Partners Group, LLC was retained by Pilgrim's Pride Company and six of its affiliates (the "Debtors") to assist the Debtors with their Chapter 11 restructuring. *CRG Partners Group, L.L.C. v. Neary* (*In re Pilgrim's Pride Corp.*), No. 11-10774, 2012 WL 3239955, at *1 (5th Cir. Aug. 14, 2012). Despite initially bleak prospects (i.e., a debt for equity swap for unsecured creditors and nothing for prepetition shareholders), CRG helped to pass a bankruptcy plan in just over a year which provided both a 100% return to both secured and unsecured creditors as well as $450 million in new equity interests to be distributed to prepetition shareholders. *Id*.

Using the lodestar method, CRG calculated fees of $5.98 million. *Id*. In consideration of the exceptional outcome, however, CRG also requested a $1 million fee-enhancement. *Id*. The U.S. Trustee objected, and the bankruptcy court denied the enhancement request, citing *Perdue. CRG Partners, LLC v. U.S. Tr.*, 445 BR 667, 672-73 (N.D. Tex. 2011).

On appeal, the district court reversed the bankruptcy court's decision, holding that *Perdue* did not apply in the context of a bankruptcy proceeding and, therefore, that established Circuit precedent continued to govern the award of fee-enhancements. Id. at 673. Applying the pre-*Perdue* analytical framework, the bankruptcy court approved CRG's request for a $1 million fee-enhancement. *CRG Partners Group, L.L.C.*, 2012 WL 3239955, at *1 (5th Cir. 2012).

Fifth Circuit

The appeals court first examined the current bankruptcy fee-shifting framework under 11 U.S.C. § 330(a). *Id*. at *7. Section 330(a) provides that a bankruptcy court may award professionals "reasonable compensation," which is to be determined by considering the nature, extent, and the value of the services provided. The provision also includes a list of factors for courts to consider in determining reasonableness, although "all relevant factors" should be considered. *See id*. at *8.

The court found that § 330's language was complimentary to fee-shifting precedent. *Id*. at *8, 21. Thus, under the § 330(a) framework, the analysis begins with a calculation of the lodestar amount. *Id*. This amount is then adjusted "up or down based on the factors contained in § 330." *Id*. Additionally, the court may also base adjustments on the factors traditionally used to evaluate the reasonableness of compensation in *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974). *Id*. at *13-14. In applying the *Johnson* factors, however, a court must recognize that four of the twelve factors are already accounted for by the lodestar method—"the novelty and complexity of the issues, the special skill and experience of counsel, the quality of the representation, and the results obtained from the litigation." *Id*. at *13. Ordinarily, these factors will only be considered

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FINAL JUDGMENT? PARTIES SAID YES, BUT SIXTH CIRCUIT SAID NO.

By: Mason Parham, Judicial Extern to the Honorable Harlin D. Hale
and law student at SMU Dedman School of Law (dparham@smu.edu)[1]

Overview

In *Waldman v. Stone*, the Sixth Circuit considered whether a bankruptcy court exceeded its authority under the U.S. Constitution by entering a final judgment on claims brought by a debtor. The court analyzed and decided the issue differently, depending on whether the claims were disallowance claims or affirmative claims. Ultimately, the court determined that the bankruptcy court had authority to enter final judgment disallowing claims, but lacked constitutional authority to enter final judgment on the affirmative claims. And, it instructed the bankruptcy court to recast the final judgment as proposed findings of fact and conclusions of law as to the affirmative claims. Arguably, *Waldman* could have great impact on bankruptcy proceedings across the country, as it is the first circuit level decision construing *Stern v. Marshall*, 131 S. Ct. 2594 (2011).

Background

Bruce Atherton ("Atherton"), an attorney, was struggling to repay debts owed to Randall Waldman ("Waldman"). Apparently desperate to meet his obligations, Atherton devised a scheme where he and Waldman would defraud one of his client's, Ron Stone ("Stone"). Stone owned Stone Tool and Machine, Inc. ("STM"), and both owed more than $1,000,000 to First Third Bank ("FTB") for debt that was secured by mortgages and liens on STM's assets and Stone's house. Together, Atherton and Waldman took advantage of Stone, causing Waldman to own STM's assets and to become Stone's principal creditor, taking the place of FTB. Their scheme caused Stone to file a Chapter 11 bankruptcy petition followed by an adversarial proceeding, in which he asserted claims of fraud against Waldman.

In the adversary proceeding, Stone sought discharge of the debts owed to Waldman ("disallowance claims"), as well as enforcement of certain promises made by Waldman ("affirmative claims"). He also asked for damages. Both Waldman and Stone consented to the bankruptcy court's adjudication to final judgment of Stone's claims, as their pleadings described the claims as core. The bankruptcy court discharged the debts owed to Waldman and awarded Stone $1,191,374 in compensatory damages and $2,000,000 in punitive damages. After an unsuccessful appeal to the district court, Waldman appealed to the Sixth Circuit, arguing that (1) Stone's state law fraud claims were beyond the jurisdiction of federal courts; (2) the bankruptcy court acted beyond its statutory authority; and (3) the judgment was beyond the bankruptcy court's power pursuant to Article III of the United States Constitution.

Analysis

On appeal, Waldman raised several objections to the bankruptcy court's judgment, and the Sixth Circuit dismissed two of them rather quickly. First, the Court rejected Waldman's contention that no federal court had jurisdiction over Stone's state law fraud claims, describing it as "meritless" because it is well established that federal courts have jurisdiction to adjudicate state law claims that relate to a petition for reorganization. *Waldman v. Stone*, No. 10-6497, 2012 WL 5275241, at *3 (6th Cir. Oct. 26, 2012) (citing *N. Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 72 n. 26 (1982)). Next, the Court disagreed with Waldman's position that the bankruptcy court had exceeded its statutory authority by entering final judgment on Stone's claims. *Id*. at *4. Although it acknowledged that a bankruptcy court's statutory authority depends on whether the proceeding at issue is a "core proceeding" pursuant to 28 U.S.C. § 157, the Court determined that it did not need to analyze the core versus non-core status of Stone's claims. *Id*. This determination was made based on facts particular to the instant case. Specifically, Waldman described the claims as core in his pleadings, thereby forfeiting any right to object to the core status of such claims. *Id*.

The Court then turned to Waldman's argument regarding the bankruptcy court's constitutional authority to enter final judgment on Stone's claims. Specifically, Waldman argued that the bankruptcy court exercised Article III "judicial power" when

1. This article was edited by Trinitee G. Green, law clerk to the Honorable Harlin D. Hale.

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The Ninth Circuit Addresses the Trifecta of *Stern* Issues in Bellingham Insurance

By Omar Alaniz of Baker Botts, LLP (Dallas) (Omar.alaniz@bakerbotts.com)

If you're a *Stern v. Marshall* nerd like me (you know who you are), you were anxiously anticipating the Ninth Circuit's decision in *Executive Benefits Insurance Agency v. Arkison* (*In re Bellingham Insurance Agency, Inc.*). In *Bellingham Insurance*, the Ninth Circuit addressed the three issues that have garnered the most discussion since the Supreme Court's decision in *Stern v. Marshall*: (1) does a bankruptcy court have the constitutional authority to decide fraudulent transfer proceedings when the defendant did not file a proof of claim, (2) can a bankruptcy court submit proposed findings of fact and conclusions of law to the district court in matters that are statutorily core, (3) does *Stern* alter a bankruptcy court's ability to rule on matters with the parties' consent under 28 U.S.C. § 157(c)(2), and can such consent be implied from conduct in litigation.

Fraudulent Transfer Issue

The Ninth Circuit determined that a bankruptcy court does not have the constitutional authority to enter a final order in a fraudulent transfer adversary proceeding when the defendant has not filed a proof of claim. It is the first circuit court to address this issue since *Stern v. Marshall*[1]. Bankruptcy and district courts have split into a "Narrow" or "Expansive" view of *Stern* with respect to the fraudulent transfer issue.[2]

In *Bellingham Insurance*, the Ninth Circuit followed fairly closely the arguments supporting the Expansive view of *Stern*. The Expansive view relies on *Granfinanciera* just as much (if not more) than *Stern*. The issue in *Granfinanciera* was whether the defendant was entitled to a jury in a fraudulent transfer action, but in reaching its holding, the Supreme Court determined that fraudulent transfer actions involve private (not public) rights. *See Exec. Benefits Ins. Agency v. Arkison* (*In re Bellingham Ins. Agency, Inc.*), 702 F.3d 553, 561–62 (9th Cir. 2012) (citing *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 55 (1989)). The Ninth Circuit reasoned that because *Stern* held that non-Article III courts cannot adjudicate cases involving private rights, the inevitable conclusion is that bankruptcy courts may not enter a final order in fraudulent transfer actions when the defendant has not filed a proof of claim. *See id*. at 561. But as the Ninth Circuit cautioned, its decision was "no reprieve" for the defendant because it impliedly consented to the bankruptcy court's authority to rule on the matter.

Consent

28 U.S.C. § 157(c)(2) provides that the bankruptcy court may hear and determine matters "related to" a bankruptcy case "with the consent of all the parties to the proceeding." In the early *Stern* aftermath, some commentators questioned whether *Stern* affects a party's ability to consent to bankruptcy court adjudication under section 157(c)(2). But courts have overwhelmingly agreed that *Stern* does not do so.[3] The most significant departure from this almost monolithic case law is the Sixth Circuit's decision in *Machine & Fabrication, LLC v. Stone* (*In re Waldman*)—though the Sixth Circuit did not even mention section 157(c)(2) while apparently opining that it was unconstitutional. The more debated question is whether consent can be implied from conduct in litigation. On that topic, courts vary.[4]

The Ninth Circuit in *Bellingham Insurance* held that consent under section 157(c)(2) may be implied from conduct in litigation. *See* 702 F.3d at 568. The Ninth Circuit reasoned that the Supreme Court has already ruled on the issue of whether consent can

1 The Sixth Circuit's case of *Onkyo Europe Electronics GMBH v. Global Technovations Inc*. (*In re Global Technovations Inc.*) involved a fraudulent transfer action where the defendant had filed a proof of claim. Therefore, the Sixth Circuit's decision in *Global Technovations* was not nearly as groundbreaking as the Ninth Circuit's decision in *Bellingham Insurance*. A bankruptcy court has the power to rule in fraudulent transfer matters where the defendant has filed a proof of claim under the Supreme Court's precedent in *Katchen v. Landy*, 382 U.S. 323 (1966) and *Langenkamp v. Culp*, 498 U.S. 42 (1990). For further discussion, see pages 10 and 11 of: Navigating Through the Post-*Stern* World: A Comprehensive Survey of All Cases Meaningfully Discussing *Stern v. Marshall*," 31st Annual Jay L. Westbrook Bankruptcy Conference, UT CLE, Austin, November 2012 ("Westbrook Paper").

2 For a list of cases supporting the Narrow and Expansive view, see pages 4 through 10 of the Westbrook Paper.

3 *See* Westbrook Paper, 20–24.

4 *See id*. at 24–26.

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Retirement Party for the Honorable Leif M. Clark

Review and Photographs By Anabel King, Hughes Waters Askanase, LLP (Houston)

On January 8, 2013, the Bankruptcy Section of the State Bar of Texas hosted a retirement party in Houston for the Honorable Leif M. Clark (Bankr. W.D. Tex. – San Antonio). Judges, lawyers and bankruptcy professionals from across the state and country gathered to celebrate Judge Clark's twenty-five years of judicial service. Speakers included the Honorable Richard S. Schmidt (Bankr. S.D. Tex. – Corpus Christi), Russell Munsch (Munsch Hardt), Harry Perrin (Vinson & Elkins), Deborah Williamson (Cox Smith), Tom Howley (Jones Day), Eric Van Horn (Wick Phillips) and Berry Spears (Fulbright & Jaworski), who also read remarks prepared by Professor Jay Westbrook. The speakers enlightened the audience with thoughtful speeches and anecdotes of Judge Clark as a law school classmate, colleague, mentor, and judge.

The event was sponsored by many generous law firms and financial advisory firms. As a result of the outpouring of support by the sponsors, the Bankruptcy Law Section will be making a generous donation to Rio Grande Legal Aid on behalf of Judge Clark.

Thanks to all who attended and sponsored. Congratulations and many thanks to Judge Clark for his distinguished judicial service.

Judge Clark and Dr. Billie Pennings (Judge Clark's Mother)

Harry Perrin

Russ Munsch

Eric Van Horn, Tony Davis, Chris Adams, Deborah Williamson, & Barry Spears

Barry Spears, Judge Leif Clark, & Tom Howley

Eric Van Horn & Tom Howley

Tim Million and Eric Van Horn

Barry Spears

Ruth Rodriguez, Judge Clark, & Oxcar Gonzalez

ASSESSING THE RISK OF A MUNICIPALITY'S REORGANIZING UNDER CHAPTER 9 OF THE BANKRUPTCY CODE

By: John E. Mitchell, Barker & McKenzie, LLP (Dallas) (john.mitchell@bakermckenzie.com)
and Angela B. Degeyter, Vinson & Elkins L.L.P. (Dallas) (adegeyter@velaw.com)

Chapter 9 of the Bankruptcy Code provides the exclusive bankruptcy option for a municipality,[1] permitting it to restructure its liabilities through a plan of adjustment approved by creditors and confirmed by the bankruptcy court. When assessing a municipality's risk of filing a petition under chapter 9, it is important for creditors to understand that it is relatively difficult for a municipality to qualify as a debtor under chapter 9, and, almost always, significant creditors will have some advance notice that a municipality intends to file under chapter 9. However, if the municipality meets its hurdles and is successful in invoking the protections of chapter 9, creditors of the municipality are left with few remedies when compared to the creditors of debtors filing under other chapters of the Bankruptcy Code.

I. Eligibility to File Chapter 9

Unlike other provisions of the Bankruptcy Code, a municipality must first "qualify" to be a debtor under chapter 9. To begin the qualification process, the municipality will file a chapter 9 petition, notice of which must be sent to known creditors and published for three weeks in a local newspaper and in a national publication.[2] If the bankruptcy court finds the petition was filed in good faith and meets the chapter 9 eligibility guidelines, the court will enter an order for relief, which officially commences the chapter 9 case.[3]

The eligibility guidelines are enumerated in Bankruptcy Code § 109(c), which provides:

> An entity may be a debtor under chapter 9 of this title if and only if such entity—
>
> (1) is a municipality;
>
> (2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;
>
> (3) is insolvent;
>
> (4) desires to effect a plan to adjust such debts; and
>
> (5) (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
>
> (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
>
> (C) is unable to negotiate with creditors because such negotiations is impracticable; or
>
> (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

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1 *See* 11 U.S.C. §§ 109(b), (c), 101(41) (a governmental unit is not a "person" eligible to file a petition under chapter 7).

2 11 U.S.C. § 923; *see also Public Finance Challenges and Opportunities for Resolution*, at 28, Paul Maco, Jane Vris, William Wallander, Municipal Finance Journal, Volume 31, No. 2, 2010 (hereinafter, "Public Finance Challenges").

3 Public Finance Challenges, at 29. Unlike chapter 7 and chapter 11 cases, which are randomly assigned to bankruptcy judges in the federal district where the case is filed, the chief judge of the court of appeals over the municipality's district designates the bankruptcy judge who will preside over the chapter 9 case. 11 U.S.C. § 921(b).

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Troop Movement

John Mitchell (formerly of Vincent & Elkins, Dallas) joined Backer McKenzie, LLP (Dallas) as a partner.

Brian Kilmer (formerly of Okin & Adams, LLP, Dallas) joined Chamberlain Hrdlicka (Houston) as a Shareholder.

Dan Winikka, **Craig Simon** and **Matt Ray** (formerly of Jones Day, Dallas) have formed Simon, Ray & Winikka LLP in Dallas.

Judith Ross (formerly of Baker Botts, LLP) has opened The Law Offices of Judith Ross in Dallas.

Merritt Crosby (formerly of Okin Adams & Kilmer, LLP – Dallas) has co-founded Crosby Wood & Walker PLLC in Dallas.

Calendar of Upcoming Events

April 9-11, 2013	**7th Annual TMA Cross Border Regional Conference: Energy Beyond Borders** Weston La Cantera Resort, San Antonio, Texas
April 18-21, 2013	**ABI – 31st Annual Spring Meeting** Gaylord Resort & Conference Center, National Harbor, Maryland
May 21-24, 2013	**ABI – Litigation Skills Symposium** – SMU Dedman School of Law, Dallas, Texas
June 5-7, 2013	**10th Anniversary (of the Bankruptcy Section) Bench/Bar Conference** Weston La Cantera Resort, San Antonio, Texas
June 6, 2013	**Bankruptcy Section Annual Meeting** (held during lunch at the Bench/Bar Conference)
June 20-21, 2013	**State Bar Annual Meeting** – Anatole Hotel, Dallas, Texas

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Call for Articles and Announcements

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31st Annual Westbrook Bankruptcy Conference 2012
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Student Loans: Separate Classification in Chapter 13, Hardship Discharge, Special Circumstances and Alternative Repayment Plans: Reese W. Baker; Michael V. Baumer

Reese Baker and Michael Baumer

Mr. Baker and Mr. Baumer led an educational conversation about the difficulty of paying student loans through a Chapter 13 plan, even if a debtor has leftover income after accounting for the payment of all other debts, because such a plan violates the "unfair discrimination" provision of Chapter 13. Discharging student loans in bankruptcy is even more challenging and complicated, and this situation is in dire need of attention because of the rising numbers of students exiting college with large amounts of debt.

Consumer Track: Litigation of Federal Tax Liens in Bankruptcy: David G. Adams

Mr. Adams gave an overview of federal tax lien issues related to tax lien litigation. Tax liens attach to all property the taxpayer has an interest in under state law, but courts differ on whether the IRS can perfect liens on debtors' real and personal assets by the same filing. Additionally, property rights with concern to trusts are often complicated with regards to whether tax liens attach or not; generally, discretionary dividends paid by a trustee are not determined to be subject to a tax lien on the beneficiary's assets.

Michael P Cooley and Jay Ong

Business Track: Involuntary Petitions: A Weapon in the Right or Wrong Hands: Michael P. Cooley; Joachim H. "Jay" Ong

Despite their relative rarity, an involuntary Chapter 11 filing raises interesting strategic implications for both debtor and creditor, especially as it concerns "bankruptcy remote" entities, timing, choice of venue (the creditors, as the actual filers of the petition, are entitled to this choice) and the use of cash. Another intriguing issue involves a debtor "winking and nodding" as a creditor puts it into bankruptcy—although this hints of collusion, some judges have said it's acceptable, as long as the debtor has not violated any other statutes.

Business Track: *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*: Honorable Leif M. Clark, Demetra L. Liggins

Demetra Liggins and Judge Leif Clark (retired)

The Supreme Court's opinion in *RadLAX*—holding that sale procedures in the context of an 1129(b) "cramdown" plan could not forbid the undersecured lender from credit bidding—has potential effects which could go far beyond simply the enforcement of lenders' right to credit bid. Namely, there is some thought that now under the statutory scheme for cramdown on secured lenders, the 1129(b)(2)(A)(iii) "indubitable equivalent" option is wholly distinct and inoperable with the (i) lien retain; and (ii) sale of asset sections of the statute.

Clash of the Titans: A *Stern v. Marshall* Debate:
Honorable Cecelia G. Morris, Honorable Robert D. Drain, and Omar Alaniz

Judge Cecelia G. Morris, Omar Alaniz, and Judge Robert D. Drain

Omar Alaniz (Dallas) refereed a spirited and entertaining a *Stern v. Marshall* debate between the Hon. Robert D. Drain (Bankr. S.D.N.Y.) and the Hon. Cecelia G. Morris (Bankr. S.D.N.Y.) as to whether the decision has broad or narrow implications for bankruptcy courts. The panel also discussed recent cases and trends from lower court rulings.

Prof. Michael Brandl

Judge Robert Drain, Omar Alaniz, and Judge Cecelia Morris

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Business Track: Top 10 Impediments to Reorganizing in Chapter 11:
Honorable Stacey G. C. Jernigan, Clifton R. Jessup Jr., Michael R. "Buzz" Rochelle.

These top bankruptcy experts discussed the current reality of the decline in Chapter 11 reorganization: volume is down, section 363 sales are far more typical, and there are many repeat filings. Among the top reasons for this debacle are the notion that the § 363 sale *is* the Chapter 11, the shift in the balance of power towards secured lenders, and the increasing costs of filing a Chapter 11 (both due to rising attorney fees and pressure to file in New York or Delaware). All is not lost for Chapter 11 reorganizations, however, as there are strategies to increase the probability of a successful journey through bankruptcy for the debtor, including communicating with the other side, keeping control of your client, and telling the court clearly where you want to go.

Clifton R. Jessup Jr., Judge Stacey G. C. Jernigan, and Buzz Rochelle

Judges Panel:

The conference concluded with the Judges Panel featuring the Hon. Stacey Jernigan (Bankr. N.D. Tex.), the Hon. Bill Parker (Bankr. E.D. Tex.), the Hon. Chris Mott (Bankr. W.D. Tex.) and the Hon. Marvin Isgur (Bankr. S.D. Tex.). The judges discussed current cases and procedural issues, and addressed questions raised by the audience.

Judges Jernigan, Parker, Mott and Isgur

Young Lawyers Committee Reception Attendees

United States Supreme Court to Consider Degree of Misconduct to Constitute "Defalcation"
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Circuit has made a brief statement in an unpublished opinion that defalcation requires some portion of misconduct. *See In re Millikan*, 188 Fed. Appx. 699, 702 (10th Cir. 2006).

Decision Regarding 11 U.S.C. § 523(A)(4)

The Eleventh Circuit decided to align itself with the Fifth, Sixth, and Seventh Circuits, in holding that defalcation under § 523(a)(4) requires a showing of recklessness by the fiduciary. *In re Bullock*, 670 F.3d at 1166. The court concluded that the bankruptcy court was correct in determining that Bullock committed a defalcation. *Id*. Bullock was the trustee of his father's estate, and as such, should have known that he was engaging in self-dealing, given that he knowingly benefitted from the loans. *Id*. His conduct can thus be characterized as objectively reckless, and therefore falls under the definition of defalcation pursuant to § 523 (a)(4). *Id*.

Conclusion

The Eleventh Circuit joins the Fifth, Sixth, and Seventh Circuits by holding that defalcation under § 523(a)(4) requires a showing of recklessness by the fiduciary. Bullock argues that the Eleventh Circuit's definition of defalcation is not strict enough to be listed among the likes of fraud, embezzlement, and larceny in § 523(a)(4), which all require findings of wrongful intent. The Eleventh Circuit settled into the middle ground in the split among courts as to how defalcation should be defined under the bankruptcy code. If the Supreme Court affirms the lower appellate court, this decision likely will have limited impact on Texas lawyers, as the case is in accord with the Fifth Circuit rule. However, stay tuned!

Better Safe Than Sorry? Maybe Not Under Section 328.
Continued from page 4.

Barclays asserted that because ASARCO was "a non-public subsidiary of a foreign company" it lacked awareness as to the extent of ASARCO's internal disarray, and it was therefore reasonable to expect the bankruptcy to proceed much quicker than it did. *Id*. at 263–64. Although the bankruptcy court agreed with Barclays, the Fifth Circuit pointed out that the terms of the Engagement Letter contemplated a lengthy proceeding, providing monthly fee terms for the first 24 months and a different monthly fee thereafter until the end of the engagement. *Id*. at 264–65. Additionally, when Barclays agreed to be compensated under the rigid standards of § 328(a) in the Revised Engagement Letter, Barclays knew it lacked complete information as to ASARCO's "internal disarray." *Id*. at 265. Because Barclays knew it lacked this information when it agreed to the terms, "it cannot now seek additional compensation simply because the previously undisclosed information reduced Barclays's projected bottom-line." *Id*. at 265–66. Most significantly, the Fifth Circuit noted that regardless of Barclays's actual knowledge as to the extent of ASARCO's "internal disarray," "it could have and should have anticipated … that [a Chapter 11 Debtor] . . . might have latent problems." *Id*. at 264.

Additionally, the Fifth Circuit found that the next two developments relied upon by Barclays were capable of anticipation. With respect to the second development Barclays named in its fee enhancement request, the Court reasoned that Barclays could have anticipated that executives, board members, and salaried employees would leave after a Chapter 11 filing. *Id*. at 266. "The fact the number of personnel departures was above average, or even extraordinary, does not transform a foreseeable development into one that is incapable of anticipation." *Id. See In re Nucentrix Broadband Networks, Inc.*, 314 B.R. 574, 580 (Bankr. N.D. Tex. 2004). Finally, the Court found that because the bankruptcy court failed to explain explicitly why Barclays was incapable of anticipating an increased scope of services, the bankruptcy court erred in granting a fee enhancement based upon additional services. *Id. See Barron II*, 325 F.3d at 693.

The Court remanded Barclays's appeal of the denial of the $2 million Success Fee to the district court, instructing it to remand to the bankruptcy court for consideration of whether a Success Fee is appropriate in light of this Court's opinion that the $975,000 fee enhancement was made in error." *Id*. at 267.

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United States Supreme Court to Consider Degree of Misconduct to Constitute "Defalcation"
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Conclusion: Section 328(a) has Rigid Standards for Qualifying as Incapable of Anticipation

In articulating § 328(a)'s strict requirement for subsequent developments that would qualify as "incapable of anticipation," the Fifth Circuit's decision in *ASARCO* confirms that when professionals elect to be compensated pursuant to § 328(a), they enjoy the insulation from court discretion at the expense of the flexibility to adjust compensation at the end of the proceeding. This case should provide guidance to professionals in bankruptcy cases in this Circuit as to the provision under which to seek employment.

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in calculating the lodestar amount, but may be "double count[ed] . . . in rare and exceptional cases supported by both specific evidence on the record and detailed findings by the lower courts." *Id*. at *14 (quoting *In re Fender*, 12 F.3d 480, 488 (5th Cir. 1994). Though a bankruptcy court has broad discretion to adjust a lodestar figure, upward adjustments should only occur in "rare and exceptional circumstances . . . where the applicants had provided superior services that produced outstanding results." *Id*. at 15.

Because the Fifth Circuit adheres to the rule of orderliness, the court noted that it—a three judge panel—was prohibited from ignoring Circuit precedent unless there had been "an intervening change in the law." *Id*. at 19-20. A Supreme Court decision will suffice in that regard, but to do so it "must be more than merely illuminating with respect to the case before the court and must unequivocally overrule prior precedent." *Id*. at 20 (quoting *Technical Automation Servs. Corp. v. Liberty Surplus Ins. Corp.*, 673 F.3d 399, 405 (5t Cir. 2012)). The question the court then considered was whether the preexisting framework governing fee-adjustments by a bankruptcy court had been unequivocally, *sub silentio* overruled by *Perdue. Id*. at *22.

Perdue, the court determined, had been "founded primarily upon justifications that are unique to cases governed by [42 U.S.C.A.] § 1988 or other fee-shifting statutes," and had not been intended to address similar issues in a bankruptcy context. *Id*. at *10, 23. As support, the court noted that the Bankruptcy Code already addressed three of the "rare and exceptional circumstances" allowing for a fee enhancement under *Perdue*, thus rendering them effectively meaningless in a bankruptcy proceeding. *Id*. at *23 n.16. Further, while the statute at issue in *Perdue* left "reasonable fee" undefined, thereby implicitly deferring to the lodestar method, §330(a) provides six factors to be considered in addition to the lodestar method and makes further allowance for consideration of "all relevant factors." *Id*. at 23. Finally, the policy justifications underlying *Perdue* would be inapplicable in a bankruptcy context where taxpayers are not asked to foot the bill, and where a more relaxed approach to fee enhancements would do little to discourage settlements, particularly when, as in the instance case, everyone is a winner. *Id*. at *24-25.

Based on the foregoing, the court held that *Perdue* was inapplicable, and that the Fifth Circuit's preexisting framework under § 330(a) continued to govern fee-adjustments in bankruptcy proceedings.

Impact

The *CRG* decision affirms that bankruptcy courts are not constrained by the limitations on fee-shifting set forth in *Perdue*, but rather may resort to the more flexible body of fee-shifting law which has developed within the Fifth Circuit. The effect is that bankruptcy courts will retain broad discretion in determining whether to enhance an attorney's fees for exceptional service. In addition, *CRG* provides a valuable guide for lower courts that are required to determine the impact of a Supreme Court decision on existing law.

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it entered final judgment on Stone's claims; therefore, the judgment was entered in violation of the U.S. Constitution. *Id*. In response, Stone and the United States, as *amicus curiae*, took the position that Waldman had forfeited his right to raise this objection because he failed to raise it before the appeal. *Id*. at *5. The Court decided to reach the merits of this issue, explaining that the argument made by Stone and the United States took "too narrow a view of the interests preserved by Article III." *Id*. Although Waldman's Article III objection may have involved personal rights, which are waivable, Article III promotes a non-waivable structural principle. Therefore, his Article III objection necessarily involved non-waivable rights. *Id*.

First, the Court had to determine whether Stone's claims addressed private rights or public-rights, and the Supreme Court's opinion in *Stern v. Marshall* seems to have been particularly instructive. Because "bankruptcy courts . . . cannot enter final judgments as to claims involving liability between individuals, unless the claim falls within the so-called 'public rights' exception to Article III," the Court began its analysis by asking whether Stone's claims involved "public rights." *Id*. (quoting *Stern v. Marshall*, 131 S. Ct. 2594, 2610 (2011)). To answer this question, the Court considered a line of cases, all discussed in *Stern*, as well as the "public rights" definition provided in *Stern. Id*. at *5-*7. According to *Stern*, "[a] public-rights claim is one that 'derives from a federal regulatory scheme, or in which resolution of the claim by an expert governmental agency is essential to a limited regulatory objective within the agency's authority.'" *Id*. at *5 (quoting *Stern*, 131 S. Ct. at 2613). Also, in *Stern*, the Supreme Court held that a debtor's counterclaim against one of her creditors concerned a private right because resolution of the creditor's claim would not resolve the "entirely different" legal issues presented by the debtor's counterclaim. *Id*. at *6 (citing *Stern*, 131 S. Ct. at 2617). Therefore, the bankruptcy court was constitutionally precluded from entering final judgment on the counterclaim. *Id*. From this, the Court in *Waldman* derived the following rule:

> When a debtor pleads an action under federal bankruptcy law and seeks disallowance of a creditor's proof of claim against the estate . . . the bankruptcy court's authority is at its constitutional maximum. But when a debtor pleads an action arising only under state-law . . . or when the debtor pleads an action that would augment the bankrupt estate, but not "necessarily be resolved in the claims allowance process," then the bankruptcy court is constitutionally prohibited from entering final judgment.

Id. at *7 (internal citations omitted) (quoting *Stern*, 131 S. Ct. at 2617).

Next, the Court applied the foregoing rule to determine whether the bankruptcy court was constitutionally precluded from entering final judgment. Though Stone's disallowance claims were predicated on the existence of fraud, they "arose under the bankruptcy statute." *Id*. (citing 11 U.S.C. § 502(b)). While acknowledging that the Supreme Court has never "squarely decided" whether bankruptcy courts can enter final judgment on a debtor's objections to a creditor's proof of claim, the Court recognized that doing so is a fundamental part of administering the bankruptcy estate. *Id*. at *8. Noting that bankruptcy courts have exercised this power "for more than two centuries," the Court held that the bankruptcy court in this case "was authorized to enter final judgment on the disallowance claims." *Id*. Stone's affirmative claims, on the other hand, "arose exclusively under state law and existed without regard to any bankruptcy proceeding" and "sought only money damages to augment the bankruptcy estate." *Id*. (citing *Stern*, 131 S. Ct. at 2618 (comparing Stone's affirmative claims to the debtor's counterclaim in *Stern*); citing *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 56 (1989) (comparing Stone's claims to the claim in *Granfinanciera* where the debtor sued for affirmative relief, based on fraudulent conveyances grounds, and the Supreme Court found that only an Article III court was authorized to enter final judgment the claim)). Further, the "affirmative claims required [Stone] to prove facts beyond those necessary to his disallowance claims," and thus would not be necessarily resolved in the claims-disallowance process. *Id*. These claims, therefore, did not involve public rights. Because Article III reserves adjudication of private rights claims to Article III courts, the Court found that the bankruptcy court exceeded its constitutional authority by entering final judgment on the affirmative claims. *Id*.

Once the Court determined that the bankruptcy court violated Article III by entering final judgment on Stone's affirmative claims, it considered whether the judgment could be converted into proposed findings of fact and conclusions of law. Under 28 U.S.C. § 157(b)(1), a bankruptcy court is authorized to *enter* judgment in "core" proceedings. *Id*. at *9 (second emphasis added). Under 28 U.S.C. § 157(c)(1), a court may *propose* judgments in non-core proceedings that are "related to" the bankruptcy estate. *Id*. (second emphasis added). Thus, if the affirmative claims were treated as core, then the statute expressly allows final

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judgment that is constitutionally impermissible. *Id*. Although both Stone and Waldman described the claims as core, the Court found that the affirmative claims were not in fact core. Instead, the affirmative claims were based only on state law and were merely "related to" the bankruptcy estate. *Id*. Therefore, the bankruptcy court had authority to submit proposed findings of facts and conclusions of law pursuant to § 157(c)(1), and Waldman's pleadings could not diminish such authority. *Id*. Because Waldman's waiver of his own personal rights could not alter the bankruptcy court's authority, the Court instructed the bankruptcy court to recast its judgment as to Stone's affirmative claims as proposed findings of fact and conclusions of law. *Id*.

Conclusion

Both *Waldman* and *Stern* demonstrate that the grant of authority provided by 28 U.S.C. § 157 is limited by Article III of the Constitution and, in particular, the "public rights" exception carved therefrom. The cases also make it clear that bankruptcy courts are constitutionally prohibited from entering final judgment on debtors' claims, which arise only under state law and will not be necessarily resolved during the claims allowance process. *Waldman* appears to go further than *Stern* by suggesting that parties cannot waive the right to challenge the constitutional authority of a bankruptcy court, notwithstanding consent at the outset. Likewise, parties cannot enhance bankruptcy courts' authority to adjudicate claims by stipulating that claims are core when they are not.

Whether *Waldman* becomes the law in the Fifth Circuit is uncertain, but it is worthy of attention nevertheless. Courts at all levels, bankruptcy, district, and appeals are just now wrestling with the meaning of *Stern*. However, as *Waldman* is the first circuit level decision to apply *Stern*, it is an insightful one for judges and lawyers to consider.

The Ninth Circuit Addresses the Trifecta of Stern Issues in Bellingham Insurance
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be implied by conduct in litigation under a provision of the Federal Magistrate Act (28 U.S.C. § 636(c)) that is substantially similar to section 157(c)(2). *See Roell v. Withrow*, 538 U.S. 580 (2003) ("[t]he question is whether consent can be inferred from a party's conduct during litigation, and we hold that it can be"). The circuit court also observed that, unlike section 157(e), section 157(c)(2) does not require "express" consent. 702 F.3d at 569. The *Bellingham Insurance* court also noted that the defendant did not challenge the bankruptcy court's authority until the appeal stage. *See id*. at 568.

The Statutory Gap

The "statutory gap" theory is that *Stern* has left a third category of matters falling within the bankruptcy court's jurisdiction: "core but unconstitutional." The concern is that if a proceeding is "core" under section 157(b) and yet the bankruptcy court is somehow not constitutionally permitted to determine the matter (as in *Stern*), then section 157(c)(1) does not appear to supply the bankruptcy court with the authority to submit proposed findings of fact and conclusions of law because the statute refers only to non-core matters. This concern has been widely rejected among courts,[5] and the Ninth Circuit now joins that group.

As discussed above, the circuit court determined that bankruptcy courts do not have constitutional authority to determine fraudulent transfer actions when the defendant has not filed a proof of claim or consented to the bankruptcy court's authority. But even though fraudulent transfer matters are "core" under section 157(b)(1) and (b)(2)(H), the Ninth Circuit determined that the bankruptcy court could submit proposed findings of fact and conclusions of law despite the plain language of section 157(c)(1). *See* 702 F.3d at 568. The circuit court stated "[w]ith respect to any bankruptcy-related claim, then, the bankruptcy courts must be vested with as much adjudicatory power as the Constitution will bear." *Id*. at 565. The court reasoned that the power to "hear and determine" fraudulent transfer actions that Congress conferred on bankruptcy courts surely encompasses the power to submit proposed findings and conclusions. *Id*.

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5 *See id.* at 15–17.

Assessing The Risk Of A Municipality's Reorganizing Under Chapter 9 Of The Bankruptcy Code
Continued from page 9.

The debtor bears the burden of establishing that it satisfies each of the five statutory requirements of Bankruptcy Code Section § 109(c).[4] This burden is substantial. As one court explained "[t]he bankruptcy court's jurisdiction should not be exercised lightly in Chapter 9 cases . . . ."[5] If a municipality does not meet all of the requirements of Bankruptcy Code § 109(c), the bankruptcy court should dismiss the case. Many of the elements required for eligibility under chapter 9 are discussed below.

a. Insolvency

"Chapter 9 does not offer relief to a municipality simply because it is economically distressed."[6] A debtor must be insolvent, and the prospective debtor bears the burden of proving its insolvency.[7] Insolvency is established by showing as of the petition date, the municipality is either generally not paying its unconditionally owing, generally enforceable debts as they become due, or is prospectively unable to pay its debt obligations.[8] The first test involves current, general nonpayment of debts. The second test is prospective and requires the petitioner to prove as of the petition date an inability to pay its debts as they become due in its current fiscal year or, based on an adopted budget, in its next fiscal year.[9] Additionally, there is no requirement that a municipality "'do more' to raise money, but the ability to raise taxes, reduce spending, or possess adequate cash reserves to meet current obligations may result in a finding by the bankruptcy court that the municipality is not 'insolvent' and, thus, is ineligible for chapter 9."[10] Finally, the "debt" upon which insolvency is based cannot be contingent, unliquidated or in unknown amounts.[11]

b. Good-Faith Intent in Commencing the Chapter 9 Case

Bankruptcy Code § 109(c)(4) requires that the bankruptcy case be filed in good faith. Additionally, a corollary to this provision is Bankruptcy Code § 921(c) which permits the court to dismiss the petition if the debtor did not file the chapter 9 petition in good faith or if the petition otherwise fails to meet the requirements of the Bankruptcy Code. The inquiry regarding good faith includes determining whether the petition was filed for an improper purpose (such as resolving a contractual dispute with a single creditor) or in an attempt to abuse the bankruptcy process.[12] "Factors that may be relevant in determining whether a chapter 9 petition has been filed in good faith include: (a) the debtor's subjective beliefs; (b) whether the debtor's financial problems can be addressed by chapter 9; (c) whether the debtor's motivation for filing is consistent with the purposes of chapter 9; (d) the extent of the debtor's prepetition negotiations, if practical; (e) the extent to which the debtor considered alternatives to chapter 9; and (f) the scope and nature of the debtor's financial problems."[13]

c. Negotiation

Before a municipality can qualify as a chapter 9 debtor, it must also meet the prior "agreement/negotiation" requirement of Bankruptcy Code § 109(c)(5). A chapter 9 debtor must either (A) obtain the agreement of a majority of creditors in each class that will be impaired under a plan of adjustment, (B) negotiate in good faith with a majority of creditors in each class, (C) show it is unable to negotiate because negotiation is impractical, or (D) show it reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under Bankruptcy Code § 547.

"In the context of § 109(c)(5)(C), negotiation is impracticable where '(though possible) it would cause extreme and unreasonable difficulty.' A petitioner may demonstrate impracticability by the sheer number of its creditors or by its need to file a petition quickly to preserve assets. The need to act quickly to protect the public from harm may also show the impracticability of negotiation."[14]

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4 *In re Valley Health Sys.*, 383 B.R. 156, 161 (Bankr. C.D. Cal. 2008).

5 *In re Sullivan County Reg'l Refuse Disposal Dist.*, 165 B.R. 60, 82 (Bankr. D.N.H. 1994).

6 *See In re Hamilton Creek Metropolitan District*, 143 F.3d 1381, 1386 (10th Cir. 1998).

7 *In re Hamilton Creek*, 143 F.3d at 1385.

8 11 U.S.C. § 101(32)(C); *see also* Public Finance Challenges, at 26.

9 *See In re Hamilton Creek*, 143 F.3d at1384.

10 *In re Boise County*, 465 B.R. 156, 172 (Bankr. D. Idaho, 2011).

11 *In re Town of Westlake, Tex*, 211 B.R. 860 (Bankr. N.D. Tex. 1997) (stating "there must be an inescapable quality of the obligation and the certainty that it cannot be met. Mere possibility or even speculative probability is not enough.").

12 Public Finance Challenges, at 29.

13 *See An Overview of Chapter 9 of the Bankruptcy Code: Municipal Debt Adjustments*, Jones Day, at 6, August 2010.

14 *Boise County*, 465 B.R. at 169 (citing *In re Valley Health Sys.*, 383 B.R. at 163).

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II. Operating in Chapter 9

Once eligible to remain a chapter 9 debtor, the bankruptcy court has limited power to regulate the debtor's affairs,[15] and, by extension, there is limited relief a disgruntled creditor may attempt to seek in the bankruptcy court. The constrictions upon the bankruptcy court are derived from the Tenth Amendment's limitations on federal government interference in the states' affairs.[16] For example, the filing of a chapter 9 petition does not create a "bankruptcy estate" that is subject to bankruptcy court oversight and control.[17] Furthermore, absent consent of the municipality, a bankruptcy court cannot interfere with the day-to-day operations and activities of the municipality.[18]

Because the Bankruptcy Code protects municipalities' operations and property rights, the bankruptcy court is simply unable to take certain actions in a chapter 9 case that it would be able to take in cases under other chapters. Such actions include, for example, conversion to chapter 7, appointing an examiner or a trustee, or allowing a secured creditor to compel the sale of assets to satisfy a lien. Without these traditional creditor remedies at their disposal, to include even the ability to object to a proposed use or sale of property during a case, a creditor's degree of influence in a chapter 9 case is significantly curtailed. As a result, moving for dismissal of the chapter 9 case and voting against a municipality's proposed plan of adjustment are often a dissatisfied creditor's only substantive legal remedies.[19]

Another important difference between chapter 9 and chapter 11 of the Bankruptcy Code is that bankruptcy court approval is not needed for the municipal debtor to retain legal counsel or other professionals.[20] Further, specific approval of the fees incurred by the debtor's professionals is not required; however, one requirement for confirmation of a plan of adjustment under chapter 9 does require that all amounts paid by a debtor for services rendered in connection with the case or the plan must be fully disclosed and found by the bankruptcy court to be reasonable.[21]

III. The Plan of Adjustment

The chapter 9 case culminates with the filing of the municipality's plan of adjustment, a process that implements the restructuring and binds creditors.[22] Only the municipality may propose a plan of adjustment and unless the bankruptcy court affirmatively sets a deadline, there is no statutory deadline to propose a plan.[23] In other words, while the aggrieved creditor of a chapter 11 debtor may seek to terminate, or await the expiration of, the Bankruptcy Code's "exclusivity" period for a debtor to file a plan,[24] and propose its own plan to reorganize or liquidate the debtor, creditors in chapter 9 proceedings remain at the mercy of the municipal debtor with respect to the timing and content of the plan of adjustment.

Similar to chapter 11, a disclosure statement detailing information about the plan is filed with every plan of adjustment under chapter 9, and the plan is sent out to all creditors for review and voting.[25] The voting requirements under chapter 9 remain the same as in chapter 11.[26] As in other chapters of the Bankruptcy Code, "cramdown" of the plan on a dissenting class is available in chapter 9.[27] The municipality may cramdown the plan over the objection of a dissenting class of creditors if it can show that

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15 Gregory M. Gordon & Michael E. Imber, *The Other Chapters: Chapter 9 and Chapter 15*, State Bar of Texas: Advanced Business Bankruptcy, at 5 (2012).

16 *Id.*

17 Bankruptcy Code § 541, which defines what constitutes property of a debtor's bankruptcy estate, is not incorporated into chapter 9; *see* 11 U.S.C. § 901 (enumerating sections of the Bankruptcy Code that are applicable to chapter 9).

18 11 U.S.C. § 904.

19 11 U.S.C. § 930 provides that the court shall dismiss the case if, *inter alia*, a plan of adjustment is not accepted within any time frame fixed by the court or if confirmation under the plan is refused.

20 11 U.S.C. §§ 327, 328 and 330, which govern the payment of professional fees, are not applicable to a chapter 9 case; *see also* 11 U.S.C. § 901.

21 11 U.S.C. § 943(b)(3).

22 *See* Public Finance Challenges, at 32.

23 *See* 11 U.S.C. § 901 (exclusivity provisions of § 1121 not applicable in chapter 9); *see also* 11 U.S.C. § 941 ("The debtor shall file a plan for the adjustment of the debtor's debts. If such plan is not filed with the petition, the debtor shall file such a plan at such later time as the court fixes.").

24 *See* 11 U.S.C. § 1121.

25 *See* 11 U.S.C. § 901 (disclosure provisions of § 1125 applicable in chapter 9); Fed. R. Bankr. P. 3016(b) ("in a chapter 9 or chapter 11 case, a disclosure statement under § 1125 of the Code or evidence showing compliance with § 1126(b) shall be filed with the plan or within a time fixed by the court.").

26 *See* 11 U.S.C. § 901 (voting provisions of § 1126 applicable in chapter 9).

27 *See* 11 U.S.C. § 901 ("cramdown" provisions of § 1129 applicable in chapter 9).

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at least one impaired class has accepted the plan, the plan is fair and equitable, and the plan does not discriminate unfairly among creditors.[28] A chapter 9 plan of adjustment is considered fair and equitable if the amount received by the dissenting class is all it can reasonably expect to receive under the circumstances. Given this minimal threshold to establish what is "fair and equitable," impairment of claims may be substantial under a chapter 9 case. For example, payment plans for litigation claims or judgments may be greatly reduced and payment extended many years in to the future, without interest.[29]

IV. Conclusion

Creditors dealing with potentially troubled municipalities should understand that chapter 9 differs in many ways from the other chapters under the Bankruptcy Code. Chapter 9 can provide a municipality with an effective means for adjusting its debts and alleviating the demands of its creditors *if* that municipality can satisfy certain statutory prerequisites to gain access to the protections of chapter 9, which, as discussed herein are substantial hurdles. Further, in determining whether to commence a proceeding under chapter 9, a municipality has significant non-bankruptcy ramifications to consider, including (1) the cost of running a chapter 9 process, including the costs to retain counsel and negotiate with creditors, and (2) any adverse credit market reaction and possible decrease in a municipality's bond rating that may occur as a result.[30] However, if the municipality is able to establish its burden to remain as a debtor, it will have significant autonomy in its day-to-day operations and in the bankruptcy case itself, subject to limited interference by the bankruptcy court and aggrieved creditors.

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28 *Id.; see also An Overview of Chapter 9 of the Bankruptcy Code: Municipal Debt Adjustments*, Jones Day, at 6, August 2010.

29 *See, e.g., In re Westfall Township*, Case No. 09-02736 (Bankr. M.D. Penn., March 2, 2010) (confirming a plan of adjustment that reduced a $20 million judgment to $6 million and paid such judgment via quarterly payments over the course of 20 years, without interest); *In re Village of Alorton*, Case No. 05-30055 (Bankr. S.D. Ill. Dec. 11, 2006) (approving plan of adjustment that paid judgment through monthly payments over the course of 20 years, with payments beginning after 5 years).

30 Public Finance Challenges, at 16.