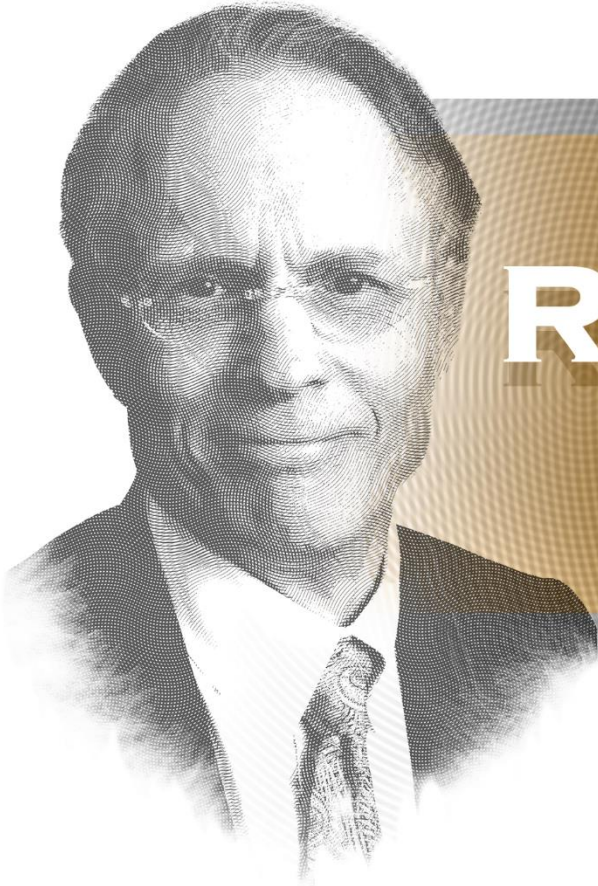




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ROCHELLE'S DAILY WIRE

The Top Ten RDWs for 2024

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Justice Gorsuch for the majority bans third-party releases for those who don't surrender all their assets to the court, and that would be broader than a discharge.

Supreme Court Reverses *Purdue*. No Nondebtor, Third-Party, Nonconsensual Releases

In a 5/4 decision, the Supreme Court reversed the Second Circuit's *Purdue* decision and declined an invitation to anoint chapter 11 as the remedy for deficiencies in the state and federal tort systems.

In his 20-page majority opinion June 27, Justice Neil M. Gorsuch defined the question before the Court as “whether a court in bankruptcy may effectively extend to nondebtors the benefits of a Chapter 11 discharge usually reserved for debtors.” He held “that the bankruptcy code does not authorize a release and injunction that, as part of a plan of reorganization under Chapter 11, effectively seeks to discharge claims against a nondebtor without the consent of affected claimants.”

Justice Gorsuch telegraphed the outcome when he said in the very first paragraph that the owners and executives of the opioid manufacturer were aiming for absolution from claims against them “without securing the consent of those affected or placing anything approaching their total assets on the table for their creditors.”

The Profit by the Owners from Opioids

Justice Gorsuch recited the facts and procedural history, focusing on the profits that the owners and managers of the Purdue opioid manufacturer had realized in the years leading up to the filing of the company's chapter 11 case in 2019. In the years before the opioid crisis grabbed national attention, the owners and managers received some 15% of company revenue, compared to about 70% each year after 2007. Ultimately, they received distributions of about \$11 billion.

In the original chapter 11 plan, the owners proposed to contribute \$4.325 billion, spread over 10 years, in exchange for nonconsensual “releases” of all claims, present and future, that might be brought against them. Justice Gorsuch noted that “thousands” of “opioid victims” voted against the plan. The U.S. Trustee, eight states and others opposed confirmation of the plan.

The bankruptcy court confirmed the plan over objections by the U.S. Trustee, eight states and others. On appeal, the district court reversed and vacated the decision confirming the plan. *In re Purdue Pharma, L.P.*, 635 14 B.R. 26 (S.D.N.Y. 2021). To read ABI's report, [click here](#).



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After reversal in district court, the owners contributed another \$1.675 billion to the plan to alleviate objections from states. Justice Gorsuch said that the owners' "proposed contribution still fell well short of the \$11 billion they received from the company between 2008 and 2016."

On the debtor's appeal, the Second Circuit reversed and reinstated the plan over a dissent. *Purdue Pharma LP v. City of Grand Prairie (In re Purdue Pharma LP)*, 69 F.4th (2d Cir. May 30, 2023). To read ABI's report, [click here](#).

The U.S. Trustee filed an application with the Supreme Court for a stay pending appeal. The Court treated the application as a petition for *certiorari* and granted the petition in August along with a stay. The Court heard argument on December 4.

The Merits and Section 1123(b)(6)

Before turning to Section 1123(b)(6) and the principal reason for reversing the Second Circuit, Justice Gorsuch noted that the owners "have not filed for bankruptcy and have not placed virtually all their assets on the table for distribution to creditors, yet they seek what essentially amounts to a discharge."

If there were any basis for a discharge in favor of nondebtors, Justice Gorsuch said it would be found in Section 1123(b)(6). It provides that a chapter 11 plan may include "any other appropriate provision not inconsistent with the applicable provisions of this title."

The plan proponents argued before the Court that the releases were permissible because they were nowhere prohibited in the Bankruptcy Code. As a so-called catchall subject to the *ejusdem generis* canon, Justice Gorsuch said that the subsection is "not necessarily" given the broadest possible construction but "must be interpreted in light of its surrounding context."

"Viewed with that much in mind," Justice Gorsuch said, "we do not think paragraph (6) affords a bankruptcy court the authority the plan proponents suppose." Rather, he said that "the catchall cannot be fairly read to endow a bankruptcy court with the 'radically different' power to discharge the debts of a nondebtor without the consent of affected nondebtor claimants." The other subsections in Section 1123(b), he said, authorize releases "without consent only to the extent such claims concern the debtor."

Justice Gorsuch said that "no one (save perhaps the dissent) thinks [that the catchall] provides a bankruptcy court with a roving commission to resolve all such problems that happen its way."

Other Grounds for Reversal



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In the Bankruptcy Code, Justice Gorsuch found three other grounds for reversal. First, the Code reserves discharges for the debtor. Second, the Code requires the debtor to submit all of the debtor's assets to the court. Furthermore, he said, a discharge is not "unbounded," because some claims are exempted from discharge. The Purdue plan, he said, "transgresses all these limits too."

Third, Justice Gorsuch pointed to Section 524(g)(4)(A)(ii) and said that the Code authorizes nondebtor releases "but does so in only one context," namely, plans dealing with asbestos.

Saying that "word games cannot obscure the underlying reality," Justice Gorsuch rejected the idea that the plan just gave releases to the owners, not discharges.

Prior Law

"History" offers a "third" ground for dismissal, Justice Gorsuch said, observing that "pre-code practice may sometimes inform our interpretation of the code's more 'ambiguous' provisions." From 1800 to 1978, he said,

No one has directed us to a statute or case suggesting American courts in the past enjoyed the power in bankruptcy to discharge claims brought by nondebtors against other nondebtors, all without the consent of those affected.

As far as policy is concerned, Justice Gorsuch noted arguments going both ways. If a policy decision were to be made, "it is for Congress to make," he said.

What the Opinion Does Not Decide

Justice Gorsuch devoted the last page of his decision to noting what the opinion does not decide. First, he said,

Nothing in what we have said should be construed to call into question consensual third-party releases offered in connection with a bankruptcy reorganization plan; those sorts of releases pose different questions and may rest on different legal grounds than the nonconsensual release at issue here.

Likewise, he said that the decision does not say "what qualifies as a consensual release," nor does the decision "pass upon a plan that provides for the full satisfaction of claims against a third-party nondebtor." The statement appears to express no view on whether a consensual release must be "opt-in" rather than "opt-out."

Of significance with respect to plans already confirmed, Justice Gorsuch said, "because this case involves only a stayed reorganization plan, we do not address whether our reading of the bankruptcy code would justify unwinding reorganization plans that have already



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become effective and been substantially consummated.” The statement is pertinent to the confirmed Boy Scouts plan, where an appeal is pending in the Third Circuit. The statement is another way of saying that the opinion says nothing about the validity of the doctrine of equitable mootness.

Holding that “the bankruptcy code does not authorize a release and injunction that, as part of a plan of reorganization under Chapter 11, effectively seeks to discharge claims against a nondebtor without the consent of affected claimants,” Justice Gorsuch reversed and remanded.

The Lengthy Dissent

Joined by Chief Justice John G. Roberts, Jr., Sonia Sotomayor and Elena Kagan, Justice Brett Kavanaugh “respectfully” dissented in a 54-page opinion. However, he was dissenting “respectfully but emphatically,” which became evident with his choice of language, as the reader will see below.

Justice Kavanaugh said that the majority’s decision was “wrong on the law and devastating for more than 100,000 opioid victims and their families.” Chapter 11, he said, was designed to prevent a race to the courthouse by vesting “bankruptcy courts with broad discretion to approve ‘appropriate’ plan provisions. 11 U.S.C. § 1123(b)(6).”

In the case at hand, he said that “the Bankruptcy Court exercised that discretion appropriately — indeed, admirably.” It was, he said, a “shining example of the bankruptcy system at work.” In making a categorical preclusion of nondebtor releases for “no good reason,” he said that the majority “now throws out . . . a critical tool for bankruptcy courts to manage mass-tort bankruptcies like this one.”

Justice Kavanaugh said that mass torts “present the same collective-action problem that bankruptcy was designed to address,” by preventing “victims from litigating outside of the bankruptcy plan’s procedures.” He found authority for the releases in Section 1123(b)(6), saying that the word “appropriate” was broad and all-encompassing authority that “empowers a bankruptcy court to exercise reasonable discretion.” He said that the majority’s decision “flatly contradicts the Bankruptcy Code” and that the Code “does not remotely support that categorical prohibition.”

In terms of history, Justice Kavanaugh said that “courts have been approving such nondebtor releases almost as long as the current Bankruptcy Code has existed since its enactment in 1978.” He lauded the Second Circuit for having “developed a non-exhaustive list of factors for determining whether a non-debtor release is appropriately employed and appropriately tailored in a given case.”



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Judge Kavanaugh said that the majority's use of the *ejusdem generis* canon was "dead wrong" for two reasons. "First," he said, "its common thread is factually wrong. And second, its purported common thread disregards the evident purpose of § 1123(b)."

The majority should not have relied on Section 524(g), Justice Kavanaugh said, because the "very text of § 524(g) expressly precludes the Court's inference." He quoted the statute as follows: "Nothing in [§ 524(g)] shall be construed to modify, impair, or supersede any other authority the court has to issue injunctions in connection with an order confirming a plan of reorganization." 108 Stat. 4117, note following 11 U.S.C. § 524."

Justice Kavanaugh disagreed with the majority's belief that a release was the same as a discharge. He pointed out that the release only pertains to claims related to Purdue.

Concluding his dissent, Justice Kavanaugh said that the majority's opinion "makes little sense legally, practically, or economically." Pointing to Boy Scouts, the Catholic Church cases, breast implants, Dalkon Shield and others, he said that nondebtor releases "have been indispensable to solving that problem and ensuring fair and equitable victim recovery."

Justice Kavanaugh said that the "Court's decision will lead to too much harm for too many people for Congress to sit by idly without at least carefully studying the issue." If the majority believed that \$5.5 billion to \$6 billion from the owners was not enough, he said that the Court "at most" should have remanded for the lower courts to decide "whether the releases were 'appropriate' under 11 U.S.C. § 1123(b)(6) (if anyone had raised that argument here, which they have not)."

Note: Justice Kavanaugh said that the U.S. Trustee opposed the plan "for reasons that remain mystifying."

[The opinion is](#) *Harrington v. Purdue Pharma L.P.*, 23-124 (Sup. Ct. June 27, 2024)



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At oral argument, the justices were focused on whether the word “appropriate” in Section 1123(b)(6) allows chapter 11 plans to include nonconsensual, nondebtor third-party releases.

Supreme Court Seems Dubious About Purdue’s Nonconsensual, Nondebtor Releases

At the *Purdue* oral argument yesterday in the Supreme Court, the justices focused much of their attention on the word “appropriate” in Section 1123(b)(6) and whether it permits confirmation of a chapter 11 plan that includes nonconsensual releases of creditors’ direct claims against third parties who themselves are not in bankruptcy.

The justices were not unreceptive to the argument that creditors with claims related to opioid addiction may receive nothing if the Court reverses the Second Circuit and sets aside confirmation of Purdue’s chapter 11 plan. To read ABI’s report on the Second Circuit opinion, *Purdue Pharma LP v. City of Grand Prairie (In re Purdue Pharma LP)*, 69 F.4th (2d Cir. May 30, 2023), [click here](#).

Tough Sledding for the Government at First

Purdue was a manufacturer of opioids. The bankruptcy court confirmed a chapter 11 plan for Purdue that included nonconsensual releases of opioid claims against the company’s owners, officers and directors in return for the contribution of several billion dollars by members of the Sackler family. The district court reversed and set aside confirmation. Under longstanding authority in the circuit, the Second Circuit reversed the district court and reinstated confirmation.

On nondebtor releases, there is a split of circuits. The Fifth, Ninth and Tenth Circuits don’t permit them. Like the Second Circuit, others allow them.

The U.S. Trustee sought a stay pending appeal. The Second Circuit denied a stay, but the Supreme Court granted a stay. In fact, the Court took the government’s petition for a stay to be a petition for a writ of *certiorari* and granted review on August 10. To read ABI’s story, [click here](#).

As the petitioner in the Supreme Court, the U.S. Trustee argued first and was represented in the Court by the U.S. Solicitor General.

The Solicitor General received a tough but not brutal reception from the justices. The government’s oral argument was based largely on the idea that the word “appropriate” in Section 1123(b)(6) does not allow nonconsensual releases of this type. The section says that a chapter 11 plan “may . . . include any other appropriate provision not inconsistent with the applicable provisions of this title.”



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The government contended that the nonconsensual releases were the equivalent of a bankruptcy discharge that violated two fundamental concepts of bankruptcy law: (1) To receive a discharge, individuals, like members of the Sackler family, must submit all of their assets to the bankruptcy court; and (2) the Purdue plan gave releases to the Sacklers that would insulate them from claims that would be nondischargeable were they in bankruptcy themselves.

Several justices challenged the government's opposition to the plan by alluding to how 97% of voting creditors were in favor of the plan. How or why could the government substitute its judgment for the wishes of creditors who stand to make recoveries under the plan but may never receive any compensation if confirmation is set aside?

The government received several "friendly" questions from the bench. For example, Justice Neil M. Gorsuch asked whether the releases might offend the Due Process Clause of the Fifth Amendment or the Seventh Amendment's right to a jury trial. Justice Amy Coney Barrett wondered whether it would be preferable for Congress rather than the courts to craft global solutions for mass tort cases.

Justice Ketanji Brown Jackson asked the government whether there was any precedent under the former Bankruptcy Act to permit nonconsensual releases. The Solicitor General cited *Callaway v. Benton*, 336 U.S. 132 (1949), and said that the "courts were not doing this" under the Act.

Tough Sledding for Purdue

As respondents, counsel for Purdue and the official creditors' committee argued second and third. They said that nonconsensual releases have been used successfully for 30 years and that the Court should not "disrupt longstanding practice."

Questions from the bench to the debtor and the committee were more probing.

Justice Sonia Sotomayor said that one of the government's "stronger arguments" was based on the idea that discharges are dispensed only when all of the "assets are on the table" and that affirming the Second Circuit might "subvert" one of the fundamental principles of bankruptcy law.

Much of the questioning by the justices focused on the word "appropriate" in Section 1123(b)(6). One justice said that a broad word like "appropriate" has "some limits" and should be read in the "statutory context" of the more narrow subsections (b)(1) through (b)(5).

Constitutionally speaking, a justice said that the releases raise "serious" due process and Seventh Amendment concerns and "defy" what the Court does with class actions.



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The so-called major questions doctrine was also on the minds of some justices. Justice Brett M. Kavanaugh said that the Court has been “cautious” in giving broad authority to agencies on major questions. He also cited the Court’s reluctance to conclude that Congress put “elephants in mouse holes.”

Justice Barrett asked why Congress enacted Section 524(g) to permit nonconsensual releases in asbestos cases if the power already resided in Section 1123(b)(6).

Standing and Consensual Releases

The debtor and the committee challenged the U.S. Trustee’s standing. Indeed, finding that the U.S. Trustee lacked standing might be the debtor’s best hope of success.

The government said that the U.S. Trustee is the congressionally created “watchdog” over bankruptcy. In addition, the Solicitor General noted that an opioid creditor had been objecting in bankruptcy court throughout and was a petitioner in the Supreme Court.

Justice Clarence Thomas on several occasions asked why the government conceded that releases under a plan could be consensual. The questions suggested that Justice Thomas may be of the opinion that a plan may contain neither consensual nor nonconsensual releases.

Justice Sotomayor noted that a petition for *certiorari* is pending in the Supreme Court from the Fifth Circuit’s decision in *In re Highland Cap. Mgmt., L.P.*, 48 F.4th 419 (5th Cir. July 28, 2023). She asked how the Court could craft an opinion disallowing nonconsensual releases without also wiping out exculpations. To read ABI’s report on *Highland Capital*, [click here](#).

Curtis E. Gannon, the Deputy Solicitor General, argued on behalf of the U.S. Trustee as petitioner. Gregory G. Garre from the Washington, D.C., office of Latham & Watkins LLP argued for the debtor, while Pratik A. Shah from the Washington, D.C., office of Akin Gump Strauss Hauer & Feld LLP argued for the creditors’ committee. All are veteran appellate advocates in the Supreme Court.

[The case is](#) *Harrington v. Purdue Pharma L.P.*, No. 23-124 (Sup. Ct.).



The fraudulent intent of an individual who controls a corporation can be imputed to the corporation itself, even if the board is unaware of fraud.

Judge Goldblatt on the Imputation of Fraudulent Intent to a Delaware Corporation

With apologies to our readers, we are once again obliged to report on a decision by Bankruptcy Judge Craig T. Goldblatt of Delaware, this time because he has written an important decision about the imputation of actual fraud to a corporation.

On a motion for summary judgment, Judge Goldblatt imputed fraudulent intent to the corporation, even though a majority of the board were unaware of the fraud and indeed were themselves victims of the fraud.

Judge Goldblatt based his reading of Delaware law in part on a recent decision from the Delaware Chancery Court, where the chancellor said that “the actual fraudulent intent of an entity exercising control over a transferor may be imputed to the transferor.” *Cleveland-Cliffs Burns Harbor LLC v. Boomerang Tube, LLC*, No. 2022-0378-LWW, 2023 WL 5688392 at *12 (Del. Ch. Sept. 5, 2023).

Thoroughgoing Fraud from Inception

The debtor corporation was founded in 2016 and controlled by an individual who had exclusive access to the company’s bank accounts and exclusive control over financial statements issued by the debtor.

In the four years of the debtor’s existence, Judge Goldblatt said in his October 19 opinion that the revenues generated by the debtor were “only trivial.” In one year, for instance, the debtor reported \$270,000 in revenue, when actual revenue was less than \$25,000. In the four years before bankruptcy, total revenues were less than \$500,000, while operating expenses were \$13 million.

Using altogether fictional financial statements, the founder was successful in raising \$143 million from sophisticated investors in several financings. As part of the later financings, the hoodwinked investors were given three seats on the board of five. The founder occupied one of the non-investor seats.

The lawsuit before Judge Goldblatt involved a tender offer just a few months before the fraud blew up.



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To enable the tender offer, the debtor completed a \$73 million preferred stock financing. The financing permitted but did not require that proceeds from the financing be used in a tender offer for outstanding stock.

The independent board members knew that the Securities and Exchange Commission had been sniffing around. The board engaged an accounting firm, a forensic investigator and a law firm to investigate claims by the whistleblower.

Judge Goldblatt said that the outside professionals were “apparently all deceived by [the founder’s] fabrications [and] reported no instances of fraud or wrongdoing.” The board then approved the oversubscribed tender offer where the debtor paid \$72 million to repurchase stock.

The founder received \$17 million from selling some of his stock in the tender offer.

After the tender offer, the fraud unraveled when the company’s new president obtained access to bank accounts. Three months after the tender offer, the founder was arrested. Four months after the tender offer, the debtor was in chapter 11. The founder pled guilty and is now in prison.

The debtor confirmed a liquidating plan that created a litigation trust to pursue lawsuits.

The Lawsuit

The litigation trust sued some of the shareholders who sold stock in the tender offer. The complaint alleged actual and constructive fraudulent transfers along with unjust enrichment. The defendants conceded that the stock they sold was worthless.

The trust and the defendants filed cross motions for summary judgment. Primarily, the defendants raised an earmarking defense and contended that the innocence of the board majority meant there was no fraudulent intent by the corporation to underpin an actually fraudulent transfer.

The defendants had all filed proofs of claim, allowing Judge Goldblatt to issue final orders.

Earmarking

The defendants contended there was no fraudulent transfer claim because the money paid out in the tender offer was not the debtor’s property, but rather was property of hoodwinked investors.

For earmarking to apply, Judge Goldblatt said that the “debtor must have been *legally obligated* to use the funds in [the tender offer], rather than having the discretion to use them for other purposes.” [Emphasis in original.] “If the debtor retains discretion to use the funds however it sees fit, then the funds are not earmarked.”



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Perusing the tender offer documents, Judge Goldblatt determined that the debtor could use the proceeds “however it wanted.” He therefore dismissed the earmarking defense.

Fraudulent Intent

On a fraudulent transfer claim, Judge Goldblatt said that “[t]he intent that matters for fraudulent conveyance law is that of the transferor.” When a corporation is the transferor, it’s the intent of the corporation that matters.

For a corporation, it’s ordinarily the intent of the board that matters, and a majority of the debtor’s board were not only ignorant of the fraud but had been defrauded by purchasing some of the preferred stock in the financing.

When deciding whether to impute the intent of an individual to a corporation, Judge Goldblatt said that courts in the Third Circuit “should look to the law of imputation of the state under whose laws the entity is organized.”

In the case at hand, Judge Goldblatt said that the outside professionals who had ok’d the tender offer “had themselves been tricked by [the founder’s] fraud.” For guidance, he studied an opinion by retired Bankruptcy Judge Robert E. Gerber, *In re Lyondell Chem. Co.*, 541 B.R. 172, 177-178 (Bankr. S.D.N.Y. 2015).

In *Lyondell*, Judge Gerber interpreted Delaware law to mean that the intent of an individual may be imputed to the board if the individual can “control” the board. *Id.* at 177-178. Judge Goldblatt noted that the Third Circuit had “adopted” *Lyondell*’s “reading of Third Circuit law.”

Similarly, Judge Goldblatt paraphrased the holding in the Delaware Chancery Court’s recent *Boomerang* opinion to mean “that one party’s control over another may provide a basis for imputing the intent of the controlling party to the one who was controlled.”

“In this case,” Judge Goldblatt said, “the argument for control by means of deception, and thus imputation, is exceptionally strong.” He said it was “undisputed” that the board was “controlled” by the founder “in the sense that he deceived them into believing, by virtue of his fraud, that the transaction was fair to the debtor.”

Judge Goldblatt granted summary judgment for the litigation trust on the claim for actual fraudulent transfer. It was therefore unnecessary for him to rule on the additional claims for constructive fraudulent transfer and unjust enrichment.



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The opinion is [Drivetrain LLC v. DDE Partners LLC \(In re Cyber Litigation Inc.\)](#), 22-50439 (Bankr. D. Del. Oct. 19, 2023).



Seemingly in conflict with Section 329, a district court decided that a chapter 7 debtor's attorneys could sue for post-petition fees, even though the firm never disclosed the fee arrangement as required by Section 329 and Rule 2016.

District Court Disregards the Bankruptcy Court's Authority over Post-Petition Fees

A troubling decision from a district court in New Jersey seems to have disregarded the power of a bankruptcy court under Section 329 to rule on the adequacy of disclosures and the amount of compensation paid to an attorney by a chapter 7 debtor for post-petition services.

As described in a March 30 opinion by District Judge Karen S. Williams of Camden, N.J., a couple hired a law firm to file what they said would be a simple, no-asset chapter 7 case in New Jersey. The firm charged the couple \$6,500 plus the filing fee, she said.

Fee Litigation in Two Courts

According to Judge Williams, the firm “claims that it explicitly and repeatedly informed the [debtors] that they would be charged additional legal fees if their bankruptcy required any post-petition work.” The case turned out to be difficult and turbulent as a consequence of what the firm claimed to be the debtors’ lack of cooperation and concealment of assets.

Before the firm won permission to withdraw more than two years after filing, the firm ran up almost \$230,000 in fees. Along the way, Judge Williams said that the debtors signed an agreement to pay the firm’s fees from the sale of real property that was not an estate asset. According to the judge, the debtors sold the property but didn’t pay the attorneys.

The opinion by Judge Williams does not describe any fee disclosures that the firm filed with the bankruptcy court under Rule 2016(b).

After withdrawal, the firm sued the debtors for fees in federal district court in Pennsylvania based on diversity of citizenship. The district judge in Pennsylvania denied the debtors’ motion to dismiss for improper venue or to transfer the suit to New Jersey.

The debtors then filed a motion in the New Jersey bankruptcy court, asking the judge under Section 329 and Rule 2016 to determine the reasonableness of the firm’s fees and whether or not there had been a proper fee agreement. The debtors also filed a motion in the Pennsylvania court



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seeking a stay pending the outcome of the proceedings in bankruptcy court. The Pennsylvania district judge declined to stay the suit, saying that the firm was entitled to a jury trial.

Judge Williams described how the New Jersey bankruptcy judge did not pass on the reasonableness of the firm's fees but did decide "that the firm had failed to timely and accurately update its fee disclosure statements, thereby violating 11 U.S.C. § 329 and Federal Rule of Bankruptcy Procedure 2016." She also said that the bankruptcy court did not rule on the firm's Seventh Amendment right to a jury trial.

As a sanction, Judge Williams said that the New Jersey bankruptcy court prohibited the firm from pursuing the suit in Pennsylvania and directed the firm to disgorge fees it had been paid by the debtors. The bankruptcy court granted a stay pending appeal, and the Pennsylvania court stayed the collection suit pending the outcome of the New Jersey appeal.

The Right to a Jury Trial Prevails

On appeal in New Jersey, the firm harped on the deprivation of its right to a jury trial.

Judge Williams said that a creditor loses the right to a jury trial by filing a proof of claim and that professionals forfeit jury trials by filing fee applications. However, she noted that the firm had filed neither a claim nor a fee application. She also said that lawyers "do not automatically forfeit their Seventh Amendment rights solely because they represented a debtor in a bankruptcy proceeding . . . particularly [when they] seek only to be compensated for post-petition legal services from outside of the bankruptcy estate."

Correctly, but incompletely, Judge Williams cited Rule 2016(a), which requires professionals to file fee applications when seeking compensation "from the estate."

Because the firm had filed neither a fee application nor a claim, Judge Williams said that the debtors could "take issue with the reasonableness of [the firm's] fees or the adequacy of its disclosures . . . in the Collection Action" in Pennsylvania. She reversed the bankruptcy court, holding that "the Seventh Amendment entitles [the firm] to have its claims heard and decided in the U.S. District Court for the Eastern District of Pennsylvania."

Observations

The decision by Judge Williams does not recite some of the findings and holdings by the bankruptcy court. For example, the bankruptcy court found that the firm failed to disclose under Rule 2016 that post-petition services were not covered by the fees that the debtors paid before filing. Indeed, the bankruptcy court found that the fees paid before filing included representing the debtors in "adversary proceedings and other contested matters."



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Accordingly, the bankruptcy court found that the firm “failed to make the required disclosure under section 329 and Rule 2016. [The firm] did not disclose that any services in connection with the bankruptcy case were excluded from \$3,500 paid.”

The bankruptcy court held that the firm “violated the disclosure requirements of section 329 and Rule 2016(b).” As a sanction, the bankruptcy court ordered the disgorgement of the \$3,500 fee listed on the Rule 2016(b) statement and said that the firm could only sue in Pennsylvania for fees “not incurred in connection with this bankruptcy case.” To read the bankruptcy court’s opinion, [click here](#).

With respect, the district court seems not to have given effect to the authority of a bankruptcy court under Section 329(a). It provides:

Any attorney representing a debtor in a case under this title, . . . whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

The authority of a bankruptcy court with regard to the fees paid by a chapter 7 debtor does not end with the disclosures required by Section 329(a) and Rule 2016(b). Section 329(b) gives the bankruptcy court control over fees paid by a chapter 7 debtor for post-petition services. The subsection reads:

If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to — . . . (2) the entity that made such payment.

In the case at hand, the bankruptcy court found violations of Rule 2016 and Section 329 in that the firm did not disclose that it would bill the client for post-petition services. The firm also did not disclose post-petition fee agreements with the debtors.

Unless Section 329 violates the Seventh Amendment, this writer believes that the bankruptcy court had the authority under Section 329 to rule on the “reasonable value” of the firm’s fees, whether or not the firm filed a fee application.

To this writer, a professional who agrees to represent a chapter 7 debtor in view of the requirement of disclosure and the power of the bankruptcy court to determine the value of services under Section 329 has waived Seventh Amendment rights.

The foregoing opinions are those of this writer, not ABI.



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The opinion is *Spector Gadon Rosen Vinci PC v. Aquilino (In re Aquilino)*, 23-01099 (D.N.J. March 30, 2024).



Whether a creditor violated the automatic stay is not arbitrable in bankruptcy.

Bankruptcy Code Overrides Contrary Delaware Corporate Law, Judge Lopez Says

Contrary to holdings by the Delaware Chancery Court, Bankruptcy Judge Christopher M. Lopez of Houston held that Delaware law cannot strip away a member's managerial and voting rights in a limited liability corporation when the member files a chapter 11 petition.

The chapter 11 debtor was a corporation that held a 25% interest in an LLC. Under the management agreement, the debtor held two of five board seats. The management agreement provided that the board could not take certain actions without the consent of at least one of the debtor's board members.

After the debtor filed a chapter 11 petition, the other two members of the LLC invoked Section 18-304 of the Delaware Limited Liability Company Act. It provides that "a person" ceases to be a member of an LLC when that person files bankruptcy voluntarily. "Person" under Delaware law includes a corporation like the debtor.

Using Section 18-304, the other two members changed the management agreement to say that the debtor no longer held a voting or managerial interest in the LLC. They acted without consent from either of the debtor's board members.

The debtor responded by filing a motion in bankruptcy court seeking a declaration that the action violated the automatic stay. The other two members opposed, contending that the action was permissible under Delaware law and that the dispute was subject to an arbitration clause contained in the management agreement.

Arbitration

In his December 12 opinion, Judge Lopez first dealt with arbitration, observing that "the existence of an arbitration clause in an agreement doesn't mean it is automatic." He cited the Fifth Circuit for the proposition that a bankruptcy court may decline to enforce an arbitration agreement involving a proceeding that "derives exclusively" from the Bankruptcy Code.

Judge Lopez admitted that the LLC management agreement contained a valid arbitration clause, but, he said, "this is not a contract dispute that should be arbitrated. There is nothing in the



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LLC Agreement to interpret.” Rather, he said that the other members were relying on Delaware corporate law for the idea that the debtor lost its voting and managerial interests.

As a result, Judge Lopez said there is a “direct conflict between § 541 of the Bankruptcy Code and Delaware law,” making it “as core of a proceeding as it gets in bankruptcy.” He denied the motion to compel arbitration because the stay violation motion was a core proceeding and permitting arbitration would be “inconsistent with the purpose of the Bankruptcy Code.”

The Conflict with State Law

The other members of the LLC claimed there was no stay violation because the debtor’s loss of voting and managerial rights resulted from state law. Indeed, Judge Lopez cited decisions from the Delaware Chancery court holding that Section 18-304 is not preempted by the Bankruptcy Code and that a debtor retains its economic interest but automatically loses voting and managerial rights.

Judge Lopez observed that the Delaware courts had not dealt with the language in Section 541(a)(1), which creates an estate on filing that retains “all legal or equitable interests of the debtor in property as of the commencement of the case.” Finding a direct conflict between Section 541(a) and Section 18-304 of the Delaware Limited Liability Company Act, he said that “parties cannot contract around what becomes estate property, and states cannot legislate estate property away.”

Judge Lopez also found a direct conflict with Section 541(c)(1)(B), which includes property in a bankruptcy estate “notwithstanding any provision in an agreement . . . or applicable nonbankruptcy law . . . (B) that is conditioned on the insolvency . . . of the debtor [or] on the commencement of a case under this title.”

Judge Lopez said that his decision “clarifies that a member of a Delaware LLC who starts a bankruptcy case keeps *all* legal and equitable interests in the LLC that it held as of the commencement of the case.” [Emphasis in original.] He went on to say that “[m]anagerial and voting rights are legal and equitable interests that [the debtor] held as of the petition date, so they are included as property of its estate.”

Judge Lopez cited decisions from a district court in New York and bankruptcy courts in West Virginia and Oregon for reaching the same conclusion about similar state laws.

Finding a direct conflict, Judge Lopez held that Section 18-304 must “give way” to Section 541. He found a violation of the automatic stay and voided the amendment to the management agreement that had been made by the other two members.

[The opinion is](#) *In re Envision Healthcare Corp.*, 23-90342 (Bankr. S.D. Tex. Dec. 12, 2023).



The 'new value' offered by old equity in a chapter 11 plan was insufficient because it was only a small fraction of claims and because the dividend to creditors was also small.

Judge Harner Gives Contours to the Amorphous Notion of 'New Value'

A “new value contribution” is a nonstatutory construct developed by courts as a counterweight to the so-called absolute priority rule in chapter 11, which precludes owners from retaining equity following confirmation if creditors object and are not paid in full.

A December 15 opinion by Bankruptcy Judge Michelle M. Harner of Baltimore gives definition to the amorphous notion of new value.

The corporate debtor began an attempted reorganization under Subchapter V of chapter 11. The debtor elected to proceed under “ordinary” chapter 11 after the Fourth Circuit held that debts of a corporate debtor in Subchapter V can be nondischargeable under Section 523(a). *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022). To read ABI’s report, [click here](#).

Had the debtor remained in Subchapter V, the absolute priority rule would not have applied even if a class of creditors had voted against the plan, but in “ordinary” chapter 11, the absolute priority rule came back to life.

The corporate debtor had sought chapter 11 relief to deal with a \$4.7 million state court judgment against the debtor and its owner. Now under “ordinary” chapter 11, the debtor proposed a plan where the owner would retain ownership after confirmation.

The class of unsecured creditors voted overwhelmingly in favor of the plan, but the creditor with the \$4.7 million judgment was in a class of its own and voted against the plan.

To overcome the absolute priority rule and retain ownership after confirmation, the owner offered new value described by Judge Harner as:

- (i) his sweat equity; (ii) the payment on his prepetition claim against the Debtor (arguably approximately \$2,000 in wages and \$47,000 in commissions); (iii) his \$35,000 postpetition (and preconfirmation) loan to the Debtor; and (iv) \$25,000 (presumably in cash) from his retirement account.



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Analyzing the adequacy of the new value, Judge Harner explained that the absolute priority rule came into play under Section 1129(b), the so-called cramdown provisions in the Bankruptcy Code. It became applicable because a class voted against the plan. Section 1129(b)(1) says that “[t]he court . . . shall confirm the plan notwithstanding [a dissenting class] if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims and interests that is impaired under, and has not accepted, the plan.”

“In simple terms,” Judge Harner said that “the absolute priority rule requires that each class of impaired and unaccepting creditors be paid in full prior to any junior class of claims or interests receiving any distributions under the plan.” She said that the new value theory “emerged to address the dilemma posed to prepetition equity holders of a chapter 11 debtor.”

Judge Harner went on to say that the “general contours” of new value were “best described” by the Supreme Court in *Bank of America Nat’l Trust and Savings Ass’n. v. 203 North LaSalle Street P’ship*, 526 U.S. 434 (1999). There, the Court held that the provision of new value may not be offered only to existing equity holders “without consideration of alternatives.”

“Unfortunately,” Judge Harner said, “[l]ower courts have struggled to define appropriate ‘alternatives’ in the context of the new value exception.”

For definition, Judge Harner decided to follow the Ninth Circuit’s decision in *Bonner Mall P’ship v. U.S. Bancorp Mort. Co. (In re Bonner Mall P’ship)*, 2 F.3d 899 (9th Cir. 1993), cert. granted sub nom. *U.S. Bancorp Mortg. Co. v. Bonner Mall P’ship*, 510 U.S. 1039 (1994), motion to vacate denied and case dismissed, 513 U.S. 18 (1994). She characterized the five-factor test in *Bonner Mall* as requiring new value to be:

(i) new, (ii) substantial, (iii) in money or money’s worth, (iv) necessary for a successful reorganization, and (v) reasonably equivalent to the value of the stock being retained or received.

Id., 2 F.3d at 908.

The debtor attempted to short-circuit application of the test by contending that the equity after confirmation would be worthless. Judge Harner disagreed. She said that the debtor was “a profitable business, has the ability to continue profitable operations in the future, and has particularly significant value to the [owner].”

Applying the test, Judge Harner said that sweat equity and debt forgiveness “are not considered ‘new,’ ‘substantial,’ or ‘money or money’s worth’ under the case law,” citing *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988). She said:



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Courts place great emphasis on the proposed new value actually being “new” and in the nature of a fresh, outside capital infusion that will help pay creditors or otherwise aid the reorganization.

Similarly, Judge Harner said that repayment of the owner’s loan from the debtor was not “new or money or money’s worth” because “it must be repaid.”

Judge Harner did find that the contribution of \$25,000 from the owner’s retirement account was new value. However, she said it was not “adequate new value,” citing *In re Ambanc La Mesa Ltd. P’Ship*, 115 F.3d 650, 655 (9th Cir. 1997), where the Ninth Circuit compared the offered new value to the total unsecured claims, the claims being discharged and the dividend to unsecured creditors.

Judge Harner said that the \$25,000 was about 0.5% of total claims and some 1.8% of the proposed distribution to creditors. “[P]erhaps more importantly,” she said that the owner would retain all of the equity “while the Debtor pays creditors only 27% of their claims under a 60-month plan.”

Judge Harner denied confirmation of the plan, holding that “the Debtor’s plan fails the absolute priority rule of section 1129(b) of the Code.”

[The opinion is](#) *In re Cleary Packaging LLC*, 21-10765 (Bankr. D. Md. Dec. 15, 2023).



'National' rates higher than 'local' rates can be locked in by retention orders under Section 328(a).

U.S. Trustee Rebuffed in Objecting to Rates Higher than Local Rates

In this column in March 2018, we said:

In years past, a debate raged over “local vs. national rates.” The controversy subsided, because courts outside of New York and Delaware generally began allowing compensation to counsel at the rates ubiquitous in their home districts, even when the rates were higher than those prevailing in the venue where the case was located.

The debate also subsided because so many reorganizations are filed in Delaware or New York, where there is no observable cap on hourly rates.

Bankruptcy Judge Selene D. Maddox of Aberdeen, Miss., stifled a reinvigoration of the “local vs. national” debate in an opinion on December 21. In addition, she rejected the idea that compensation for all chapter 11 cases in her district was frozen at rates set by another bankruptcy judge in 2015.

For lawyers from out of town whose rates are higher than prevailing rates in the district where a case is pending, the 52-page opinion by Judge Maddox contains a helpful hint: Lock in your rates with a retention order approving higher rates under Section 328(a).

To read ABI reports about “local vs. national rates,” click [here](#), [here](#) and [here](#).

Out-of-Town Debtor's Counsel

The corporate debtor was a furniture manufacturer. For its primary bankruptcy advisors, the debtor selected its long-time outside counsel, a Philadelphia-based firm with 825 lawyers spread across 27 offices in the U.S. For local counsel, the debtor tapped a Houston-based firm with 325 lawyers in nine U.S. offices.

In their retention affidavits, both firms said that the debtor had agreed to pay their normal rates. For primary counsel, hourly rates for partners were shown to be \$640 to \$940 an hour. Local counsel's lead partner would charge \$650 per hour. There were no objections to the retention applications.



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The retention orders authorized the debtor to retain the firms under Sections 327(a) and 328(a). The retention orders did not explicitly approve the hourly rates contained in the retention affidavits. The retention orders did say that compensation was approved as set forth in the retention applications.

On the first interim fee application, general bankruptcy counsel sought less than \$110,000 in fees, while local counsel's request was for about \$30,000.

The U.S. Trustee objected, mainly because the hourly rates were higher than those for Mississippi counsel. The U.S. Trustee in substance wanted the court to impose what might be understood as a \$425 hourly cap espoused in 2015 by another bankruptcy judge in the district in *In re Sanderson Plumbing Prods., Inc.*, 13-14506, 2015 BL 345100 (Bankr. N.D. Miss. Oct. 20, 2015).

The U.S. Trustee said that the case was not complex and that fees should not be so high. The U.S. Trustee also claimed there were duplications of services because local counsel had appeared at hearings alongside primary counsel.

The Significance of Section 328(a) Retention

Both firms countered the objections by asserting that the court had preapproved their rates under Section 328(a). The section allows a debtor or trustee to engage a professional “on any reasonable terms and conditions of employment, including on a retainer, *on an hourly basis*, on a fixed or percentage fee basis, or on a contingent fee basis.” [Emphasis added.]

When allowing compensation for retentions approved under Section 328(a), the court may depart from the approved terms of engagement “if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.”

Approval of compensation is different for a professional person retained under Sections 327 or 1103. Section 330(a) permits a court to grant “reasonable compensation for actual, necessary services rendered.”

Judge Maddox said that professionals have the option of having their retentions approved under either Section 330(a) or Section 328(a). She began her analysis by deciding whether the retention orders had approved hourly rates under Section 328(a).

Citing the Fifth Circuit, Judge Maddox explained that “Section 328(a) applies when the court approves a fee as part of the employment application at the outset of the engagement, while § 330(a) applies when the court has yet to do so.”



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If retention was under Section 328(a), Judge Maddox said it's a "high hurdle" to revise the terms of compensation. However, she said that the Fifth Circuit had not clarified "how a court determines whether an applicant's hourly rate or contingency fee has been preapproved under § 328." There are "competing tests" in other circuits "governing preapproval," she said.

The Test for Section 328(a) Retention

Judge Maddox said that the Third and Ninth Circuits require that retention orders must have specifically approved hourly rates. The Second and Sixth Circuits, she said, take "a more relaxed approach" by employing "the totality of the circumstances" to decide whether compensation has been approved under Section 328(a).

For herself, Judge Maddox adopted "a totality of the circumstances test . . . to determine whether an applicant's fee arrangement was preapproved under § 328."

Applying the test, Judge Maddox noted that the retention orders "explicitly" approved employment under Section 328 and that there was sufficient information regarding the firms' hourly rates.

After considering the "totality of the circumstances," Judge Maddox concluded that she had approved hourly rates under Section 328. The "thoroughness" of the retention applications, she said, gave "more than sufficient information to put all parties on notice of the agreement between [the debtor] and the Applicants concerning their agreed upon hourly rates."

Judge Maddox then turned to the question of whether the rates should be reduced as "improvident." She noted how the U.S. Trustee had not claimed that the terms of engagement were improvident. Rather, the U.S. Trustee contended that the case was not sufficiently complex to justify counsel's higher rates.

A case that's not so complex does not "meet the improvident standard," Judge Maddox said. In those circumstances, she said that "a professional whose compensation has been fixed under § 328 should have their expectations protected."

Duplication of Services

The U.S. Trustee claimed there were duplications of services because local counsel attended hearings alongside general bankruptcy counsel. Judge Maddox countered by quoting a local rule that requires local counsel to "participate in all trials . . . and other proceedings conducted in open court."



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Judge Maddox overruled the duplication objection, saying that local counsel's "attendance at these hearings was neither unnecessary nor duplicative."

Sanderson Plumbing

Although she had decided that fees could not be reduced under Section 328(a), Judge Maddox said she was

concerned by the UST's reliance on *Sanderson Plumbing* and § 330 not only in this bankruptcy case where § 328 is applicable, but also in other cases where a professional's hourly rate would be subject to review at the compensation stage under § 330's reasonableness factors and the *Johnson* factors.

Judge Maddox went on to say that she "continues" to see the U.S. Trustee invoking *Sanderson Plumbing* whenever hourly rates are more than \$425 to \$450 per hour. However, she noted that "the prevailing hourly rate in *Sanderson Plumbing* was only applicable under the facts as known to the court in that bankruptcy case at that time." She said it was "not proper to simply point to that case in an objection to an applicant's fees."

"In other words," Judge Maddox said,

a fee award in other cases is just one of the many factors this Court utilizes in a § 330 analysis, and it certainly should not be the only metric the UST uses in responding or objecting to fee applications.

Next, Judge Maddox analyzed the fee requests under the so-called *Johnson* factors, noting the U.S. Trustee's objection that the requested rates were higher than what firms charge in Mississippi.

If the rates of \$425 to \$450 per hour as allowed in *Sanderson Plumbing* were adjusted for inflation, Judge Maddox said that range today would be \$567 to \$640 an hour.

Although there was no evidence that the debtor could not have obtained lead counsel from Mississippi, Judge Maddox agreed "that debtors should be able to choose their own representation." Still, she said that "the appropriate prevailing rates in this community would be in the range of \$550.00 to \$600.00 per hour for partners or counsel and \$350.00 to \$400.00 per hour for associates."

If prevailing local rates were applied to the fee applications, Judge Maddox said that counsel would have been granted allowances lower than they requested. Because there were no grounds under Section 328(a) for reducing hourly rates, Judge Maddox said she would not lower the awards.



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Using “hindsight,” Judge Maddox said, is “a tool not available when hourly rates are preapproved under § 328.”

Judge Maddox allowed the fees as requested but required counsel to apply their remaining retainers to the awards before receiving compensation from the debtor.

[The opinion is](#) *In re Feilitech LLC*, 23-10599 (Bankr. N.D. Miss. Dec. 21, 2023).



*The Fourth Circuit says that
bankruptcy courts have broader
jurisdiction than other federal courts and
that some of their decisions are
unreviewable by Article III courts.*

4th Circuit: Bankruptcy Courts Aren't Bound by Case or Controversy Requirements

The Fourth Circuit ruled that bankruptcy courts “can constitutionally adjudicate cases that would be moot if heard in an Article III court.” More generally, the appeals court said that bankruptcy courts “are essentially unencumbered by Article III’s case-or-controversy requirement.” The extraordinary statements by the appeals court may or may not be *dicta*.

The September 14 decision by Circuit Judge Julius N. Richardson could be read to mean that the judicial power of bankruptcy and magistrate judges extends beyond constraints in the constitution limiting federal courts to the adjudication of “cases” or “controversies.” If followed elsewhere, the decision also means that decisions by bankruptcy courts in some circumstances may be unreviewable on appeal.

In a footnote, Judge Richardson suggested that the delegation of bankruptcy powers to non-Article III courts may in itself be unconstitutional. If it were so, the same would be true of magistrate judges.

Following discussion of the opinion, we offer commentary by Kenneth N. Klee and Richard B. Levin, both of whom believe the decision was wrongly decided.

The Dischargeability Complaint

A husband and wife hired a contractor to renovate their home. Dissatisfied with results of the work, the couple learned that the contractor was not licensed. They sued in a Superior Court in Washington, D.C., to recover almost \$60,000 they had paid the contractor.

While the suit was pending, the contractor filed a chapter 7 petition in Alexandria, Va. The couple filed a proof of claim for the \$60,000 and, separately, a two-count complaint. One count sought a declaration regarding the validity of the alleged \$60,000 debt, and the second sought a declaration that the debt was nondischargeable.

Without ruling on the validity of the debt, the bankruptcy court held that the debt was dischargeable and dismissed the count on dischargeability. The count regarding validity of the debt



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remained for later adjudication, meaning that the ruling on dischargeability was not a final order subject to appeal.

Judge Richardson said that the debtor and the couple wanted appellate courts to rule on dischargeability “before deciding whether they should expend the resources to litigate the [validity of the] debt.”

“So,” Judge Richardson said, they “struck a deal” where the couple voluntarily dismissed the count regarding validity of the debt *without prejudice*, aiming to create a final, appealable order regarding dischargeability. On appeal, the district court upheld the bankruptcy court on dischargeability. The couple appealed to the Fourth Circuit.

Manufactured Finality

Judge Richardson cited Fourth Circuit authority for the proposition that “parties cannot collude to create finality after the fact through a voluntary dismissal without prejudice.” *Waugh Chapel S. v. United Food and Com. Workers Union Local 47*, 728 F.3d 354, 359 (4th Cir. 2013). He then proceeded to analyze whether the order was indeed final and said that the “appropriate procedural unit for determining finality here is the adversary proceeding.”

Judge Richardson said that the “bankruptcy court’s order [before dismissal of the count on validity of the debt] was thus not final when entered” because “an order dismissing only one claim in a multi-claim adversary proceeding does not amount to a final order.”

Quoting the Fourth Circuit, Judge Richardson said that the parties “cannot ‘use voluntary dismissals as a subterfuge to manufacture jurisdiction for reviewing otherwise non-appealable, interlocutory orders.’” *Waugh, supra*, 728 F.3d at 359.

If the circuit were to allow an appeal on dischargeability, Judge Richardson said “there would be nothing to stop them from reinstating — and then separately appealing — [the count regarding validity of the claim] down the line.” He therefore held that “the voluntary dismissal did not make the bankruptcy court’s earlier, partial dismissal final,” because the count related to validity of the debt “was still very much alive.”

The Adversary Proceeding Wasn’t Moot

The couple characterized the complaint as seeking authority to pursue collection of the debt outside of bankruptcy. Once the bankruptcy court decided that the debt was dischargeable even if valid, the couple contended that the count in the adversary proceeding regarding validity of the debt became moot because they could not win “any effectual relief” to pursue the debt outside of bankruptcy. Mootness of the validity count, according to the couple, meant that the order on the remaining count about dischargeability was final.



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Evidently, Judge Richardson believes there's no such thing as mootness in bankruptcy court.

"Mootness is an Article III doctrine, and bankruptcy courts are not Article III courts," Judge Richardson said. Because bankruptcy courts are not Article III courts, he cited *Stern v. Marshall* for the idea that "they do not wield the United States's judicial Power." Therefore, he said, bankruptcy courts "can constitutionally adjudicate cases that would be moot if heard in an Article III court."

While a bankruptcy case must satisfy Article III standards when referred by district courts to bankruptcy courts, Judge Richardson said that Article III must again be satisfied when the case returns to district court. However, "that limit on the district court's authority does not constrain the bankruptcy court. *Once a case is validly referred to the bankruptcy court, the Constitution does not require it be an Article III case or controversy for the bankruptcy court to act.*" [Emphasis added.]

Having ruled that Article III does not constrain bankruptcy courts, Judge Richardson next considered whether statutes preclude bankruptcy courts from deciding matters that are moot.

Judge Richardson cited Section 157(b)(1) for saying that bankruptcy courts may hear and determine "all" bankruptcy cases and "all" core proceedings, "[n]ot just those that could be fully adjudicated in district court."

Article III constraints, such as mootness, "do not apply to [bankruptcy courts] as a matter of constitutional law," Judge Richardson said. "They only apply," he said, "if Congress said so in a statute." Finding no statute, he held that the "bankruptcy court could still adjudicate it."

Judge Richardson held that voluntary dismissal of count for validity of the debt "did not create a final order under § 158(a)" because dismissal was without prejudice, making the claim "legally viable." He vacated and remanded the order of the district court, because it had "reviewed a non-final order."

In the last paragraph of his decision, Judge Richardson said that bankruptcy courts "are essentially unencumbered by Article III's case-or-controversy requirement."

Commentary

The opinion presents essentially two holdings: (1) Parties may not manufacture finality, and (2) Article I tribunals are not encumbered by the limitations on justiciability imposed by Article III.



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The first holding is a reiteration of *Waugh*. Notably, however, the Fourth Circuit in *Waugh* cited the black letter law but proceeded to follow the Eighth Circuit which held that the appeals court could “deem ambiguous voluntary dismissal . . . to be with prejudice” and consider the merits of the appeal. *Waugh, supra.*, 728 F.3d at 359.

The second holding has broad implications. If adopted in other circuits, bankruptcy courts could rule on disputes that have become moot, and the rulings would be immune from appellate review. Question: Would rulings of the sort be entitled to *res judicata* or collateral estoppel effect in state or federal courts?

The second holding would also seem to mean that bankruptcy court may issue advisory opinions.

To this writer, it's a close call on whether the second holding is *dicta*.

Although not constrained by the Constitution to avoid ruling on moot questions or advisory opinions, may bankruptcy courts in the Fourth Circuit nonetheless abstain?

In the Fourth Circuit, magistrate judges similarly would not be constrained by Article III justiciability standards. One assumes that magistrate and bankruptcy judges would both abstain from exercising jurisdiction beyond the limits of Article III, if authorized to do so.

Constitutionality of the Bankruptcy System

After ruling that bankruptcy courts may constitutionally adjudicate cases that would be moot in Article III courts, Judge Richardson wrote a footnote saying:

The harder question may be whether [bankruptcy courts] can constitutionally adjudicate cases that are within the judicial power and so could be heard in Article III courts.

To the writer, the quotation seems to suggest that the reference of bankruptcy power to bankruptcy courts may be unconstitutional. However, Judge Richardson said in the footnote that “we need not dive into this question.”

Scholarly Commentary

Kenneth N. Klee provided ABI with the following commentary:

Because the bankruptcy court is not actually a court at all but is a unit of the United States District Court, it is inconceivable to me that the jurisdiction of a non-tenured judge could be greater than that of a tenured judge.



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The jurisdiction is derivative. That's what the concept of withdrawal of the reference is all about. I understand that to a small, uninformed mind, one could reason that the constraints of Article III don't apply to a non-Article III judge, but the notion that by referring matters to non-tenured judges, you can expand jurisdiction is somewhat absurd. Even more so in the criminal context with magistrate judges.

Richard B. Levin provided ABI with the following commentary:

In my view, the dischargeability determination mooted [the count regarding validity of the debt], even though it did not moot the proof of claim. The proof of claim seeks to share in the estate; the adverse party is the trustee, not the debtor.

[The count on validity of the debt] seeks to collect from the post-discharge debtor, which becomes a moot case once the debt is declared dischargeable. But the [proof of claim] is still live, unless perhaps it's a no-asset case, but that does not affect the mootness (or not) of the count I claim against the debtor [seeking a declaration regarding validity of the debt].

Therefore, the dismissal of [the count regarding validity of the debt] rendered the order final, as in the *Affinity Living Group* case the court cites, and the district court and the court of appeals should have had jurisdiction over that final order.

The only way the Article III courts did not have finality jurisdiction was if the case was not moot in the bankruptcy court or, as the court of appeals puts it, if the bankruptcy court could still adjudicate the case even though it became moot. (Of course, why would anyone want to adjudicate a moot case? That was the parties' point in their stipulation.)

Therefore, the Article III language in the court of appeals opinion is not *dicta*; it is holding. It was necessary to the decision, which makes it even more troubling than if it were *dicta*. In short, I think the court did not really understand the court and jurisdictional system that Congress set up after *Marathon*.

Another troubling part of this decision, even though not so troubling as the Article III point, which would give the bankruptcy courts unreviewable authority over a whole range of moot and advisory issues, is that the decision effectively requires parties to keep fighting over something that doesn't matter so they can appeal something that does matter.



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Messrs. Klee and Levin were counsel for committees in the House and Senate and were among the principal draftsmen of the Bankruptcy Code and the Bankruptcy Reform Act of 1978. Mr. Klee is partner emeritus at KTBS Law LLP in Los Angeles, and Mr. Levin is a partner with Jenner & Block LLP in New York City.

Further Commentary

This writer believes that the Fourth Circuit may have reached the right result for the wrong reason.

Was it a subterfuge to dismiss the count in the complaint on validity of the debt while leaving proof of claim alive in the claims register? Doesn't survival of the proof of claim mean that the creditors had not in reality dismissed the count based on the alleged debt?

This writer submits that the appeal court could have and perhaps should have ruled that survival of the proof of claim in itself kept disposition of the adversary proceeding from becoming a final order. Focusing on the implications arising from the proof of claim would have obviated the need to discuss the bankruptcy court's lack of constraints under Article III.

This writer hopes that someone files a petition for rehearing *en banc*, permitting scholars to submit *amicus* briefs regarding Article III constraints on bankruptcy and magistrate judges.

[The opinion is](#) *Kiviti v. Bhatt*, 22-1216 (4th Cir. Sept. 14, 2023).