"Debtor-Friendly" Bankruptcy Courts and The Secondary Loan Market: Will The Supreme Court Change The Dynamic?

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The bankruptcy courts are not always good places for creditors. That can be particularly true when the creditor holds distressed debt acquired on the secondary market—or, as one bankruptcy court recently put it, is "an activist distressed investor that purchased certain deeply discounted second lien debt of [the debtor] for pennies on the dollar." *In re Ion Media Networks, Inc.*, 419 B.R. 585, 588 (Bankr. S.D.N.Y. 2009).

Any guesses as to how *Ion Media* resolved the objections of the "activist distressed investor" to the debtor's plan of reorganization? That's right: The court held that the investor "lacks standing to object to the Plan and its objections to confirmation are overruled." *Id.* at 603.

The point is not that the *Ion Media* court was necessarily wrong on the facts of that case. Rather, the point is that bankruptcy courts can look unfavorably on creditors who acquire claims at a discount in the secondary markets, even when the way in which a creditor acquired its claim is irrelevant to the legal issue at hand. Where could such hostility come from? It's complicated.

In part, bankruptcy courts' attitude may stem from the age-old American aversion to "speculators," which is older than the Republic itself. During the Revolutionary War, when the colonies couldn't pay their soldiers in cash, they issued the soldiers promissory notes instead. Years later, with the colonies still cash-poor, many veterans sold those notes to investors who paid cash in return for a discount. How to treat those distressed-debt investors was a major issue in the first Congress, which had decided to assume the former colonies' debts. Alexander Hamilton (whose views ultimately prevailed) proposed paying all of the debt at par, reasoning that the buyers of the notes stood firmly in the shoes of the sellers and were fully entitled to payment on the obligation. But James Madison and many others opposed it, based on Madison's concern, as a leading historian describes it, that "patriot soldiers [were] being fleeced by an army of speculators whose only loyalty was to their own profit margins." Joseph J. Ellis, *Founding Brothers* 76 (2000).

Bankruptcy courts, it appears, have something of a Madisonian streak. Some have directly questioned whether a good faith buyer in a secondary market obtains "clean title" and is entitled to assert the acquired claim against the borrower. *See, e.g., Enron Corp. v. Avenue Special Situations Fund II*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006). Others, like the court in *Ion Media*, have been overtly skeptical when such holders, who acquired their positions for "pennies on the dollar," have raised objections to the manner in which a debtor's plan of reorganization proposed to treat their claims. Still others had adopted readings of the Bankruptcy Rules (which have since been amended—thanks in substantial part to LSTA's hard work) that would have required holders to disclose sensitive and proprietary information regarding their trading strategies. *See, e.g., In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

More broadly, bankruptcy courts may be friendly fora for corporate debtors, and less so for secured creditors, however their claims were acquired. One leading scholar has offered the controversial explanation that courts compete for interesting and important bankruptcy cases; because debtors have substantial flexibility in choosing the venue for a bankruptcy, "pro-debtor" rulings and precedent may well attract such cases. *See* Lynn M. LoPucki, *Courting Failure: How Competition For Big Cases Is Corrupting The Bankruptcy Courts* (2005). Less cynically—and, we believe, much more significantly—many bankruptcy courts view their primary job as facilitating the debtor's successful reorganization, thereby maximizing the value of the bankruptcy estate and the recovery of general unsecured creditors. Those

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are unquestionably key bankruptcy goals, and courts are right to keep them firmly in mind. But the Bankruptcy Code consciously balances those goals against the countervailing concern of providing appropriate protections for secured creditors. An overly narrow view of the bankruptcy court's task as furthering reorganization at all costs may too often trump the even-handed application of the law to all parties.

Indeed, the very notion of preferring "debtors" over "creditors" suffers from an obvious logical flaw. As a prominent court of appeals judge recently explained, being "friendly to debtors" can be successful "only in the short run; in the long run, the fewer rights that creditors have in the event of default, the higher interest rates will be to compensate creditors for the increased risk of loss." *In re River East Plaza LLC*, No. 11-3263, 2012 WL 169760, at *7 (7th Cir. Jan. 19, 2012) (Posner, J.). The Court of Appeals for the Second Circuit has explained that the same basic economic point applies to the courts' hostility to "speculators" who acquire claims for "pennies on the dollar." Just as Hamilton observed in response to Madison's objections to the assumption of colonial debt, the court explained that unless the buyer of debt—at whatever price—acquires all the seller's rights, the "holders of debt instruments would have substantial difficulty selling those instruments." *Elliott Assocs., L.P. v. Banco de la Nacion*, 194 F.3d 363, 380 (2d Cir. 1999). And that "additional risk would naturally be reflected in higher borrowing costs. . . . A well-developed market of secondary purchasers of defaulted . . . debt would thereby be disrupted and perhaps destroyed even though its existence provides incentives for primary lenders to continue to lend to high-risk [borrowers]." *Id.* Yet these economically rational points have not always prevailed in the face of some bankruptcy courts' "debtor-friendly" instincts.

Few Chapter 11 cases ever reach the Supreme Court. But a pair of recent cases have—in quite different ways—offered the Court the opportunity to influence the dynamic described above and played out in bankruptcy court every day. Last Term's decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011)—well-known because one of the parties to the litigation was Anna Nicole Smith, but interesting for quite another reason—stands for the seemingly obscure proposition that bankruptcy courts cannot constitutionally enter final judgment on a counterclaim by a debtor against a creditor who filed a proof of claim against the bankruptcy estate unless the counterclaim will necessarily be resolved as part of resolving the creditor's claim. *RadLAX Gateway Hotel, LLC v. Amalgated Bank*, No. 11-166, which will be argued April 23, 2012, presents the question whether a debtor may auction collateral under a Chapter 11 plan without permitting the creditor holding the lien on that collateral to "credit bid" its claim in the auction. Both cases have significant implications for secured creditors who may feel unwelcome in bankruptcy court.

In *Stern*, the Supreme Court issued its most important decision in decades on the proper role of bankruptcy courts and the limitations on their powers under the Constitution. Briefly, the 1978 Bankruptcy Code gave bankruptcy courts authority to "hear and determine" all proceedings within the bankruptcy jurisdiction—not only those at the heart of federal bankruptcy law, but also common-law tort and contract actions that were merely "related to" a bankruptcy case because they might increase the estate's assets. But bankruptcy judges lack life tenure and undiminished compensation, as the Constitution requires for those who exercise the "judicial Power of the United States." U.S. Const. art. III, § 1. In *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the Supreme Court held the 1978 scheme to be unconstitutional insofar as it permitted bankruptcy courts to adjudicate matters of "private right," such as a traditional common-law claim for breach of contract, without consent. *Id.* at 69-72 (plurality); *id.* at 90-91 (Rehnquist, J., concurring in the judgment). *Marathon* noted, however, that certain matters of "public right" could be finally adjudicated by a non-Article III tribunal. The plurality commented that "the restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power, must be distinguished from the adjudication of state-created private rights .... The former may well be a 'public right,' but the latter obviously is not." *Id.* at 71.

In 1984, Congress amended the bankruptcy jurisdictional provisions in an attempt to cure the constitutional defect identified in *Marathon*. The amended statute distinguished between proceedings that "arise under" the Bankruptcy Code or "arise in" a bankruptcy case, which it described as "core" proceedings, and proceedings that are merely "related to" a bankruptcy case, which it described as "non-core." Congress treated "core" proceedings as matters of "public right" under *Marathon*, giving the bankruptcy courts the power to "hear and determine" such matters. 28 U.S.C. § 157(b)(1). As to non-core proceedings, the statute gave bankruptcy courts a role similar to that of federal magistrate judges. Bankruptcy courts may "hear" such proceedings, but, absent consent, may not "determine" them; instead, they "shall submit proposed findings of fact and conclusions of law to the district court," which enters final judgment after *de novo* review. *Id.* § 157(c)(1).

The 1984 amendments went on to offer examples of the sort of matters Congress considered "core" proceedings, including "counterclaims by the estate against persons filing claims against the estate." 28 U.S.C. § 157(b)(2)(C). *Stern* struck down this provision, reasoning that when a debtor's counterclaim is a matter of "private right" and need not be resolved as part of the allowance or disallowance of the defendant's claim, it cannot constitutionally be "heard and determined" by the bankruptcy court absent the parties' consent. 131 S. Ct. at 2614-2615.

While *Stern's* holding may seem narrow, it has caused great consternation in the bankruptcy bench and bar, which had proceeded for nearly 30 years on the assumption that the 1984 statute had fixed the *Marathon* problem. A decision further constraining bankruptcy courts' powers was not much to the liking either of courts or of debtors. Moreover, *Stern* called into question provisions of the statute beyond the one it specifically addressed. Perhaps the issue of greatest significance to the loan markets is *Stern's* effect on § 157(b)(2)(H) of the Bankruptcy Code, which purports to give bankruptcy courts the authority to enter final judgments in fraudulent conveyance cases.

Fraudulent conveyance law, of course, serves an important purpose—protecting creditors when a debtor conveys its assets to a third party to hinder creditors' collection efforts, or otherwise diminishes the estate without receiving reasonably equivalent value in return. But in a number of recent cases, such as *TOUSA*, *Lyondell*, and *Tribune Co.*, debtors and creditors' trusts have made aggressive use of the fraudulent conveyance remedy in circumstances arguably outside the heart of what fraudulent transfer law was designed to address. And in some cases, bankruptcy courts (with their disposition towards maximizing the estate for the benefit of unsecured creditors) have been receptive to such efforts. *See, e.g.*, *In re TOUSA, Inc.*, Adv. Pro. No. 08-1435-JKO (Bankr. S.D. Fla. Oct. 13, 2009), *rev'd*, *In re TOUSA, Inc.*, Nos. 10-60017 et al. (S.D. Fla. Feb. 11, 2011).

In our view, *Stern's* rationale compels the invalidation of § 157 (b)(2)(H), as applied to suits against defendants who have not filed proofs of claim in the bankruptcy or consented to bankruptcy court adjudication. And although bankruptcy courts have divided on the question, *compare, e.g, Development Specialists, Inc. v. Orrick, Herrington & Sutcliffe, LLP*, 2011 WL 6780600 (S.D.N.Y. Dec. 23, 2011); *In re Heller Ehrman LLP*, 2011 WL 6179149 (N.D. Cal. Dec. 13, 2011), *with, e.g., In re Refco Inc.*, 2011 WL 5974532, (Bankr. S.D.N.Y. Nov. 30, 2011); *In re Direct Response Media, Inc.*, 2012 WL 112936 (Bankr. D. Del. Jan. 12, 2012), the United States has now conceded, in a brief filed in the Ninth Circuit, that bankruptcy courts may not constitutionally enter final judgment in such fraudulent conveyance disputes. See Brief for the United States as Amicus Curiae, *In re Bellingham Ins. Agency, Inc.*, No. 11-35162 (9th Cir. Jan. 19, 2012). Because the United States is obligated to defend the constitutionality of acts of Congress, that concession amounts to an admission that no reasonable contrary argument can be made. Assuming that the courts ultimately agree, fraudulent conveyance defendants—who are often also secured creditors—will be entitled to de novo review of legal conclusions and factual findings by the bankruptcy court in such suits, thus arguably evening the playing field in "debtor-friendly" courts.

The *RadLAX* case will affect secured creditors in bankruptcy in a different but equally important way. There, the question—which has divided the courts of appeals—is whether a debtor may confirm a Chapter 11 plan that provides for an auction of the debtor's property without permitting a creditor who holds a lien on that property to "credit bid"—that is, to bid the amount of its secured claim without being required to put up cash. In *RadLAX*, as in the other cases where this issue has arisen, a stalking-horse bidder with ties to existing management wants to bid for the property without being required to compete with the secured creditor. The debtor in *RadLAX* argues that it should be entitled to bar credit-bidding so long as the plan purports to provide that the lender will receive the "indubitable equivalent" of its claim under Chapter 11's cram-down provisions. The debtor contends that reorganizations will be easier under this interpretation. By contrast, the secured lender contends that the credit-bidding right is part of a carefully structured set of protections in the Bankruptcy Code that ensure that a secured creditor cannot be "cashed out" at a value lower than the value it deems its collateral to have, and that a sale without credit-bidding can never provide the creditor with the "indubitable equivalent" of its claim.

RadLAX thus features a direct confrontation between a debtor and a secured creditor battling over the interpretation of the Bankruptcy Code. If the Supreme Court rejects the "debtor-friendly" interpretation in favor of an interpretation that stresses the interdependent nature of the Code's protections for secured creditors, lenders will be able to breathe easier when their collateral is auctioned. But more broadly, such a ruling would also be a step toward a vision of Chapter 11 in which, while

reorganization remains the most significant goal, the interests of all constituencies are addressed in accordance with law that balances those interests carefully, rather than sacrificing them to reorganization at all costs.

Put another way, both *Stern* and *RadLAX* have the potential to mitigate the risk that bankruptcy courts may make use of what they regularly describe as their "broad equitable authority" to require "participants in commercial transactions not only to keep their contracts but also do 'more'—just how much more resting in the discretion of a bankruptcy judge assessing the situation years later." *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356 (7th Cir. 1990) (Easterbrook, J.) If so, commercial lenders—and even the "activist distressed investors" who buy those loans on the secondary market—can perhaps worry less that their right to repayment may be sacrificed to what a bankruptcy court views as the best interests of the bankruptcy estate.