

INTERNATIONAL

Restructuring **NewsWire**

October 2011

**Has *Stern v. Marshall* Opened a Jurisdictional Dispute Floodgate?***By Douglas E. Deutsch, Robert Gayda and Eric Daucher*

On June 23, 2011, the Supreme Court of the United States issued the decision of *Stern v. Marshall*, debatably the most important case on bankruptcy court jurisdiction in the last 30 years. The 5-4 decision, written by Chief Justice Roberts, established limits on the power of bankruptcy courts to enter final judgments on certain state law created causes of action.

Although the Supreme Court stated that *Stern* concerned a “narrow” issue and found that bankruptcy courts had been granted excessive authority only “in one isolated respect,” we have identified scores of cases where these issues have been raised in the last two months. See sidebar titled “Cases Citing *Stern*,” at p. 5. While grappling with the parameters of a Supreme Court ruling always takes some time to work through, this preliminary evidence suggests that some parties may be using *Stern* as part of their litigation strategy and, whether the case or not, some additional burden may now be layered on case parties who are forced to grapple with the difficult issues raised by *Stern*. This article reviews *Stern* and its implications.

**Setting the Stage: A Tale of Dueling Courts**

*Stern v. Marshall* originated when Vickie Lynn Marshall, more famously known as Anna Nicole Smith, filed for bankruptcy. Vickie was married to octogenarian oil magnate J. Howard Marshall, one of the richest men in Texas. As J. Howard’s health declined, Vickie discovered that J. Howard’s living trust made no provision for her, even though — Vickie alleged — J. Howard intended to leave Vickie half his property. Accordingly, Vickie sued J. Howard’s son, Pierce Marshall, in Texas probate (state) court alleging that Pierce fraudulently induced his father to exclude Vickie from his estate. J. Howard died before Vickie’s Texas suit was resolved.

After J. Howard’s death, Vickie filed for bankruptcy in California bankruptcy (federal) court. Pierce filed a lawsuit within the bankruptcy case against Vickie where Pierce alleged that he

was defamed by Vickie and sought a declaration that the defamation damages he sought could not be excused as part of any bankruptcy discharge that Vickie might receive. Importantly, Pierce also filed a proof of claim in the bankruptcy case to recover damages on account of the defamation lawsuit. Vickie responded by filing a counterclaim against Pierce in bankruptcy court, alleging tortious interference with her expected testamentary gift from J. Howard. By counterclaiming while her / continued page 3

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# You are Invited

## **NEW PERILS IN CHAPTER 11: DISTRESSED INVESTING AFTER *WASHINGTON MUTUAL***

Please join us on Thursday, October 20, 2011

**Chadbourne & Parke LLP**  
30 Rockefeller Plaza  
(between 5th and 6th Avenues)  
36th Floor New York

On September 13, 2011, Judge Walrath of the United States Bankruptcy Court for the District of Delaware denied confirmation of a proposed Plan of Reorganization in the *In re Washington Mutual* chapter 11 cases. Although the decision covers a wide range of topics, its analysis and conclusions about the ability of distressed debt investors to conduct trading activities while participating in plan negotiations has caused particular concern and uncertainty among stakeholders in chapter 11.

Our panel discussion will cover the implications of Judge Walrath's decision for distressed debt investors, lenders, and other key participants, from both a business and legal perspective. The panel will also discuss the ongoing debate about disclosure of purchases, sales, and holdings in the chapter 11 context, including possible "spillover" effects from the *Washington Mutual* decision into the Rule 2019 disclosure scheme.

This program will offer practical insights that will be of interest to distressed debt investors, shareholders, creditors' committee members, and other participants in the chapter 11 plan negotiation process.

### **PROGRAM**

4:00 pm - 5:30 pm: Panel Presentation

5:30 pm - 6:30 pm: Cocktail Reception

### **MODERATOR**

**Howard Seife**, *Partner and Global Chair of the Bankruptcy and Restructuring Group, Chadbourne & Parke LLP*

### **PANEL**

**Thane Carlston**, *Managing Director, Moelis & Company*

**Karen Kirchen**, *Sr. Deputy General Counsel and Managing Director, Citigroup*

**Barry Kupferberg**, *Trilogy Capital LLC*

**David LeMay**, *Partner, Chadbourne & Parke LLP*

**Thomas McCormack**, *Partner, Chadbourne & Parke LLP*

*NY transitional/non-transitional CLE credit available*

For more information and forms for CLE credit, please contact Tracie Kiernan at [tkiernan@chadbourne.com](mailto:tkiernan@chadbourne.com)

### **REGISTRATION:**

To register and attend this event on-site, please visit: <http://www.chadbourne.com/events/2011/newperils/>

## Stern v. Marshall

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suit was still pending in probate court, Vickie set essentially identical lawsuits on parallel litigation tracks, one in bankruptcy (federal) court and one in probate (state) court.

In the course of subsequent litigation, Pierce argued that the bankruptcy court lacked jurisdiction to enter a final order on Vickie's tortious interference counterclaim because it was a "non-core matter" under the relevant Federal jurisdictional grant (28 U. S. C. §157). The bankruptcy court disagreed and, in December 2000, ruled in Vickie's favor and entered a judgment awarding her \$475 million in damages. However, and this is where the somewhat confusing jurisdiction issues first began, on appeal of the bankruptcy court's judgment, the district court found that the counterclaim was not within the jurisdiction of the bankruptcy court. As such, the district court concluded that it could not give the bankruptcy court's ruling preclusive effect but had to independently review the record. Ultimately, the district court ruled on the defamation claim and came to the same conclusion as the bankruptcy court; that is, the court found that Pierce interfered with Vickie's expectancy. Although ruling in Vickie's favor, the district court still reduced the damages to about 10% of the prior award. This was not, however, the end of the story.

On appeal to the Ninth Circuit Court of Appeals, the District Court's ruling was reversed. In turn, on further appeal, the Supreme Court reversed the Court of Appeals ruling and remanded the matter back to the Court of Appeals for further proceedings. This last Supreme Court ruling was made in 2006. The Court of Appeals subsequently ruled again, making a second review by the Supreme Court — which review is the subject of this article — possible.

Importantly, as of the entry of the bankruptcy court's final order and before the above-noted federal appeals had been heard, the Texas probate court had yet to resolve Vickie's identical state-court claim. Roughly one year later, in December 2007, the probate court entered a final judgment in Pierce's favor and denied Vickie any legal claim to J. Howard's estate. Because of the series of appeals taken from the bankruptcy court's order, the Texas probate court's ruling was the earliest final judgment entered in these disputes.

### The Supreme Court's View of Bankruptcy Court Jurisdiction

As summarized in a short "primer" on bankruptcy jurisdiction that has been included in this issue of *NewsWire*, see page 3, the fact that there are questions about the / *continued page 4*

## An Introduction to Bankruptcy Court Jurisdiction

While the Constitution allows Congress to "establish uniform laws on the subject of bankruptcy," Congress chose not to exercise the power to establish such laws for nearly 100 years of this Country's history. At such times, creditors and debtors were left to resolve insolvency-related disputes under applicable state laws. Starting during the second half of the 19th century, however, Congress took greater control of insolvency matters by enacting bankruptcy law in one form or another. For the most part, these laws established the federal district court (the trial-level court in the federal system) as the court that was to administer bankruptcy cases, but Congress allowed that court to refer such matters to "referees" or, subsequently, "bankruptcy judges" for administration. Bankruptcy referees and judges administered such cases as best they could but, without consent by case parties, could not address matters that fell outside their mandate; that is, if the matter did not involve a debtors' property (the bankruptcy "estate"), the matter could not be resolved without the involvement of the federal district court or a state court. This limitation was, at the very least, inconvenient.

The division between traditional bankruptcy matters and matters that were less closely related to a bankruptcy case was based on the above-cited Constitutional provision. That provision permitted Congress to administer bankruptcy matters in anyway Congress deemed appropriate, whether by a bankruptcy judge or by a referee or by whomever. In such cases, Congress was creating an "Article I" court; that is, a court created by Congress, the first of the three branches of government and the branch established under Article I of the Constitution. However, if a case involved non-bankruptcy matters, the judicial power of the United States was (at least debatably) being exercised. Consistent with other provisions of the Constitution, the judicial power of the United States can only be exercised by so-called "Article III" courts; that is, courts established by Article III of the Constitution as the third branch of government and imbued with certain attributes. These attributes ensure that Article III judges do not fall under the influence of either the legislature or executive branches, and can make independent decisions using the judicial power of the United States. Article III judges are appointed with life tenure and cannot have their salaries reduced. Bankruptcy courts, as Article I tribunals were not presided over by Article III judges.

In the 1970's, as part of the creation / *continued page 5*

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exact parameters of a bankruptcy court's jurisdiction under the Constitution was not a surprise to Congress or the Supreme Court. The most recent "fix," which divided what are purported to be traditional or "core" bankruptcy matters (over which bankruptcy courts should have complete control) from "non-core" matters (over which bankruptcy courts act essentially as assistants to the District Court) was, in fact, promulgated after the Supreme Court's last serious review of bankruptcy jurisdictional issues in the seminal case of *Northern Pipeline vs. Marathon Oil*, 458 U.S. 50 (1982). That "fix" was required because of an inherent Constitutional problem with the structure used to create bankruptcy court jurisdiction. The *Stern* decision provided some background on these issues.

Under Article III of the Constitution, "[t]he judicial Power of the United States, shall be vested in one Supreme Court, and in

created of] 1789." *Stern*, 131 S. Ct. at 2609.

Bankruptcy courts are created by Congress under Article I of the Constitution. As such, bankruptcy courts are not Article III tribunals and bankruptcy judges do not enjoy the same protections as Article III judges. It is suggested that Congress is allowed to create such courts under what is called the "public rights exception." Such courts are allowed to administer, among other things, "cases in which the claim at issue derived from a federal regulatory scheme." The Supreme Court itself acknowledged, however, that its discussion of the public rights exception in prior cases has not been entirely consistent. *Stern*, 131 S. Ct. at 2611. What is clear to the Supreme Court, however, is that where administration of an issue in a bankruptcy case becomes too close to traditional state law rights that are wholly independent of the bankruptcy case, it may be entertaining "the stuff of Westminster" and must be specifically reserved for adjudication by Article III tribunals.

To allow bankruptcy courts to operate in as sensible a

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such inferior Courts as the Congress may from time to time ordain and establish." The same section provides that Article III judges "shall hold their Offices during good Behavior, and shall, at stated Times, receive for their Services a Compensation which shall not be diminished during their Continuance in Office." The Supreme Court noted that Article III is meant to ensure that the judiciary is independent from the other two branches of government. Accordingly, "Congress may not 'withdraw from judicial cognizance [by Article III courts] any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty.'" *Stern*, 131 S. Ct. at 2609. Such lawsuits are also described as "the stuff of the traditional actions at common law tried by the courts at Westminster [England] in [the year the Constitution was

fashion as possible despite their apparent inherent jurisdictional constraints, a division of labor was created in the new bankruptcy jurisdiction statute after *Northern Pipeline*. The relevant statute, 28 U.S.C. § 157(b)(2), lists sixteen types of matters that are defined as "core" proceedings, including claims and "counterclaims by [a debtor's] estate against persons filing claims against the estate." The bankruptcy court has been granted full and final statutory authority over such "core" matters because they are alleged to be traditional bankruptcy powers that are not included within "the stuff of Westminster."

### The Stern Ruling

After reviewing the historical background on bankruptcy court jurisdiction, the Supreme Court turned to the two issues at

hand: (1) whether bankruptcy courts were statutorily authorized to address the counterclaim at issue; and (2) even if statutorily authorized, was the statutory grant consistent with the Constitution. Turning to the first question, the Supreme Court rather quickly concluded that the bankruptcy court had statutory authority to enter a final judgment on Vickie's counterclaim. This was not incredibly surprising. The statute, 28 U.S.C. § 157(b)(2), explicitly says that. The court next turned to the more difficult question of whether the statute itself was constitutional.

Following completion of an exhaustive (and, at times, somewhat convoluted) analysis, the Supreme Court concluded that although 28 U.S.C. 157(b)(2)(C) purported to grant the bankruptcy court authority to enter a final decision on Vickie's counterclaim, the statute violated the Constitution by allowing an Article I court to improperly exercise powers reserved for Article III Courts. Citing several relatively recent cases, the Court noted that bankruptcy courts, as non-Article III courts, lacked authority to decide a state law contract claim and a fraudulent conveyance claim against an entity that was not "otherwise part of the bankruptcy proceedings." Similarly, the Court concluded that Vickie's right to relief did not flow from a federal (bankruptcy) statutory scheme and was based instead solely on a state law right. As such, the Court reasoned, the "experts" at resolving common law counterclaims such as Vickie's were Article III courts and such experts are required to resolve those matters in this case.

Vickie sought to distinguish prior cases on the grounds that Pierce, unlike the defendants in the prior cases, had filed a proof of claim, thereby making himself "part of the bankruptcy proceedings." Vickie, in fact, cited to several of the Supreme Court's decisions that held that creditors subject themselves to the bankruptcy court's equitable jurisdiction, including the claims allowance and disallowance process, by filing a proof of claim.<sup>1</sup> The *Stern* Court, however, suggests that such an interpretation of its prior case law was not correct.

The Court found that Pierce did not, by filing a proof of claim, automatically consent to bankruptcy court jurisdiction over all related matters, no matter how tangential. Indeed, the Supreme Court stated, in an apparent break with its prior decisions, that "it is hard to see why

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<sup>1</sup> This Hobson's choice should come as no surprise to those who operate frequently in the bankruptcy arena. Creditors often believe they must choose between (a) filing a proof of claim and obtaining the related chance of a case recovery but subjecting themselves to bankruptcy court jurisdiction, or (b) not filing a proof of claim and losing all chance for a bankruptcy case recovery but not subjecting themselves to bankruptcy court jurisdiction.

of the new bankruptcy law (what is referred to as the "Bankruptcy Code"), Congress recognized the Constitutional issue and, seeking to resolve the conflict and make bankruptcy case administration more sensible, contemplated making bankruptcy judges Article III judges. However, given objections by various parties including sitting Article III judges, a compromise solution was reached: bankruptcy courts were made "adjuncts" of the Federal District Court and the bankruptcy court was automatically referred all bankruptcy matters, including more "traditional" bankruptcy matters as well as matters only tangentially related to a bankruptcy case. Within a short time after the enactment of the new Bankruptcy Code and the new jurisdictional provisions, a Constitutional challenge arose. In the now seminal case of *Northern Pipeline Constr. Co. v. Marathon Pipe Line*, 458 U.S. 50 (1982), the Supreme Court found that a state law for contract lawsuit was not based on "traditional" bankruptcy law matters that required adjudication by an Article III court. Thus, the Supreme Court found that Congress's purported jurisdictional grant to bankruptcy courts was unconstitutional.

Following the imposition of a stop-gap measure to deal with the immediate operational problems of not having bankruptcy courts, Congress enacted a law in 1984 which, among other things, clearly granted jurisdiction over all bankruptcy cases and bankruptcy related matters to federal district courts but allowed the district courts to refer — but did not automatically refer — such matters to bankruptcy courts. (Following the enactment of the 1984 law, each of the 98 Federal Court Districts referred all bankruptcy matters to bankruptcy courts by a standing order.) To ensure that the Constitutional limits are otherwise satisfied, a relevant jurisdictional statute was also created to divide the allowed bankruptcy-related jurisdiction into two categories: "core" and "non-core" matters.

"Core matters" could be described as traditional bankruptcy matters in a bankruptcy case that could be fully administered by a bankruptcy judge under the Constitution. The statute, 28 U.S.C. § 157(b), lists sixteen types of matters that are considered core proceedings, including case administration, property of the estate issues, confirmation matters and, importantly, "counterclaims by [a debtor's] estate against persons filing claims against the estate." In contrast, "non-core" matters that are otherwise related to a bankruptcy case may also be heard by the bankruptcy judge but, in such instances, the bankruptcy judge cannot issue "final" orders but instead can only issue proposed

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Pierce's decision to file a claim should make any difference with respect to the characterization of [Vickie's] counterclaim." *Stern*, 131 S. Ct. at 2616. Having concluded that the mere submission of a proof of claim did not resolve the question at issue, the Supreme Court undertook a two-part analysis to determine whether resolution of Vickie's counterclaim nevertheless fell within the bankruptcy court's purview.

First, the court examined whether Vickie's counterclaim stemmed directly from her bankruptcy. After distinguishing certain prior cases on the grounds that they involved rights of recovery created by federal bankruptcy law, the Supreme Court found that Vickie's tortious interference counterclaim, which arose under Texas tort law, was "in no way derived from or dependent upon bankruptcy law . . ." *Stern*, 131 S. Ct. at 2618. Accordingly, the court concluded that the bankruptcy court

## The Impact of Stern

In the *Stern* case, Vickie also argued that ruling in Pierce's favor "will create significant delays and impose additional costs on the bankruptcy process." The *Stern* Court disagreed, stating that its "narrow" ruling will not "meaningfully change[] the division of labor in the current statute." *Stern*, 131 S. Ct. at 2620.<sup>2</sup> So far, the ruling appears to have had more substantial impact than the majority imagined. As can be seen in our sidebar on a sampling of recent cases citing *Stern*, see page 5, scores of courts are now in the middle of, as Justice Breyer predicted in his dissent, a game of "jurisdictional ping-pong." This is not always an easy game for the courts administering the cases to play. One court explained: "My frustration with *Stern* is that it offers virtually no insight as to how to recalibrate the core/non-core dichotomy so that I can again proceed with at least some assurance that I will not be making the same constitutional blunder with respect to some other aspect

Accordingly, parties should be considering *Stern* regardless of whether or not the other side has raised the jurisdictional issues.

could not exercise jurisdiction over the counterclaim as a matter "stemming from the bankruptcy itself."

Second, the Court examined whether Vickie's claim required findings of fact that would necessarily be resolved in the course of deciding whether to allow or disallow Pierce's claim. After reviewing the record, the Court concluded that while Vickie's counterclaim for tortious interference would share some underlying facts with Pierce's claim for defamation, Vickie's "counterclaim raise[d] issues of law entirely different from those raise[d] on [Pierce's] defamation claim." *Stern*, 131 S. Ct. at 2617. Accordingly, the court found that Vickie's claim was not necessarily resolved as part of the claim's allowance process.

of authority [under] section 157(b)(2)." *Meoli v. Huntington Nat'l Bank (In re Teleservices Group, Inc.)*, 2011 WL 3610050, at \*3 (Bankr. W.D. Mich. Aug. 17, 2011). Not surprisingly, litigants are using such uncertainty to their advantage. As explained in a recent decision from a New York bankruptcy judge, "*Stern v. Marshall* has become the mantra of every litigant who, for strategic reasons, would rather litigate somewhere other than the bankruptcy court." See *In re Ambac Financial Group, Inc.*, 2011 WL 4436126 at \*6 (Bankr. S.D.N.Y. Sept. 23, 2011).

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<sup>2</sup> However, even if they were to agree with the argument, the Supreme Court concluded that efficiency, convenience and usefulness will not save a law that "is contrary to the Constitution." *Id.* at 2619.

While it is difficult to see what lessons will ultimately be learned from *Stern*, especially as circuit courts of appeal have, at least so far<sup>3</sup>, declined to interpret *Stern* and thus provide guidance to the district and bankruptcy courts on these issues, a few themes and approaches are worthy of note.

First, ignoring a jurisdictional issue in the hope that it will go away is not a safe approach. In fact, some courts have been considering the impact of *Stern* “*sua sponte*” (that is, on their own motion) because it is a well-settled doctrine of law that the question of a court’s jurisdiction may be raised at any time, including on appeal. Accordingly, parties should be considering *Stern* regardless of whether or not the other side has raised the jurisdictional issues.

Second, when bankruptcy courts do hold that they have authority to issue final judgments on matters, many courts are nevertheless couching their decisions with the express reservation that should a district court disagree with the bankruptcy court’s jurisdictional decision under *Stern*, the bankruptcy court’s opinion should be treated as a report and recommendation to the district court. This approach suggests a simplified alternative to a bankruptcy court completely removing itself from hearing a contested matter and referring it to the district court. To the extent possible, parties may want to encourage a court to take this approach.

It is too soon to tell whether this flood of disputes regarding jurisdiction will continue. However, it is evident that, if the cases logically progress and litigants continue to do what they do (litigate in their best interests), *Stern*’s impact on bankruptcy court jurisdiction could easily be more significant than the Supreme Court majority contemplated when it issued its “narrow” decision on Vickie Lynn Marshall’s state law counterclaim. Stay tuned. ☺

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<sup>3</sup> See e.g., *Sigillito v. Hollander (In re Hollander)*, No. 10-30696, 2011 U.S. App. LEXIS 17057, at \*12 n.1 (5th Cir. Aug. 16, 2011) (circuit court of appeals leaving the question of whether *Stern* is applicable to further proceedings to the district court); *Matrix Iv v. Am. Nat’l Bank and Trust Co. of Chicago*, No. 08-3917 (DSS), 2011 WL 3211500 (7th Cir. July 28, 2011) (circuit court of appeals declining to apply *Stern* and ruling on claim preclusion issue on narrower grounds).

findings of fact and conclusions of law that are reviewed in their entirety by the district court (and thus do not become fully binding until the District Court judge approves them). See 28 U.S.C. § 157(c).

For the most part, until the *Stern* decision was issued, the division of labor between the District Court and the bankruptcy court was not seriously disputed. ☺

## A Sampling of Cases Citing *Stern*

By Young Yoo

In the last several months, *Stern* has been raised in scores of bankruptcy cases. A sampling of those cases follows:

- *Buffets, Inc. v. California Franchise Tax Board (In re Buffets Holdings, Inc.)*, No. 09-50894, 2011 WL 3607825 (Bankr. D. Del. Aug. 15, 2011) (bankruptcy court held that it had jurisdiction over debtors’ state tax claims under *Stern* because they “essentially involve[d] the allowance of the [Franchise Tax Board’s proof of claim for unpaid franchise taxes]”).
- *In re Fairfield Sentry Ltd*, No. 11-MC-224, 2011 WL 4359937 (S.D.N.Y. Sept. 19, 2011) (district court held that bankruptcy court did not have jurisdiction over a foreign representatives’ state and foreign law avoidance claims because they more closely “resemble state law contract claims brought by a bankrupt corporation to augment the bankruptcy estate,” similar to those at issue in *Stern* and *Granfinanciera*).
- *Miller v. Greenwich Capital Fin. Prods., Inc. (In re American Business Financial Services, Inc.)*, No. 06-50826, 2011 WL 3240596 (Bankr. D. Del. July 28, 2011) (bankruptcy court held that it had jurisdiction over chapter 7 trustee’s avoidance and state law tort claims because they were integrally related to a section 363 sale, and thus, the bankruptcy itself under *Stern*).
- *In re Salander O’Reilly Galleries*, No. 07-30005, 2011 WL 2837494 (Bankr. S.D.N.Y. July 18, 2011) (bankruptcy court held that it had jurisdiction over liquidating trustee’s avoidance claim under *Stern* because, despite questions of state law being involved, action implicated the determination of a proof of claim).
- *In re Bearingpoint, Inc.*, No. 09-10691, 2011 WL 2709295 (Bankr. S.D.N.Y. July 11, 2011) (bankruptcy court granted trustee’s motion seeking relief from a plan and confirmation order which required certain / continued page 9

# Valid Foreclosure Sale May Still be Subject to Preference Attack

By Michael Distefano

In the recent case of *Whittle Development, Inc. v. Branch Banking & Trust Co.* (*In re Whittle Development, Inc.*), No. 10-37084, 2011 WL 3268398 (N.D. Tex. July 27, 2011), a bankruptcy court was asked whether a preference action could be sustained against a creditor who purchased real property in a properly conducted state law foreclosure sale. Recognizing a split of authority and some contrary principles enunciated by the Supreme Court in its prior decision, *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), the bankruptcy court found that a preference claim could be asserted. The case demonstrated that in certain instances, even a properly conducted state foreclosure does not provide finality of all issues.

## Factual Background

On December 31, 2007, Whittle Development Inc. entered into a development loan agreement with an entity that later became Branch Banking and Trust Company. The agreement provided Whittle with a \$2,700,000 loan secured by real property.

In early 2010, Branch Banking declared the loan in default and accelerated payments owed by Whittle. On September 7, 2010, Branch Banking foreclosed on Whittle's property securing the loan. The foreclosure sale complied with all relevant state law requirements. Ultimately, the foreclosed property was sold to a subsidiary of Branch Banking for approximately \$1,200,000. On October 4, 2010, Whittle filed a chapter 11 petition in the bankruptcy court. Branch Banking subsequently filed a proof of claim in Whittle's bankruptcy case for the difference between the sale amount and the outstanding loan amount, approximately \$2,850,000.

Thereafter, Whittle brought an action to avoid, as a preferential transfer, the foreclosure sale. As the basis of its claim, Whittle argued that the approximate value of the property sold at foreclosure was \$3,300,000, but that Branch Banking's claim on the property at the time of foreclosure was only \$2,200,000. Thus, Whittle alleged, Branch Banking had received approximately \$1,100,000 more than it should have.

## Preference Lawsuits

A "preference" is a pre-bankruptcy transfer of a debtor's interest in property to a creditor that enables the creditor to receive more than she would have received had the transfer not taken place. Section 547 gives the trustee or a debtor in possession the power to "avoid" preferences. If a transfer is avoided, section 550 enables the trustee or debtor in possession to seek the return of the transferred property to the debtor's estate. This furthers the basic bankruptcy policy of securing equal distribution of the debtor's assets among similarly situated creditors. A successful preference action requires a trustee to prove six elements:

1. a transfer of the debtor's interest in property;
2. to or for the benefit of a creditor;
3. on account of antecedent debt;
4. made while the debtor was insolvent;
5. made within ninety days before the petition date (or one year for insiders); and
6. such transfer enabled the creditor to receive more than such creditor would have received under a hypothetical chapter 7 liquidation.

There is a presumption that the debtor was insolvent during the ninety days immediately preceding the bankruptcy filing. In *In re Whittle*, the only dispute was to the final element—whether the proceeds from the foreclosure sale enabled Branch Banking to receive more than it would have in a chapter 7 liquidation.

## BFP and the "Reasonably Equivalent Value" Defense

The key issue for the *In re Whittle* court was whether a creditor should be subject to attack for purchasing real estate at (so it was alleged) a discount in a validly performed state foreclosure sale. Branch Banking argued that such an action was proscribed by the Supreme Court's decision in *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994). Accordingly, the *In re Whittle* court's analysis turned first to a review of the of BFP case.

In *BFP*, a partnership formed for the purpose of buying a home in Newport Beach, California, defaulted on its mortgage payments, resulting in a foreclosure by the bank. A third-party purchased the home for \$433,000 at a properly-noticed foreclosure sale shortly before the partnership filed for bankruptcy. Acting as a debtor in possession, the partnership sued to avoid the transfer as a fraudulent conveyance, alleging that the property had an actual value of \$725,000.

Unlike a preference, a constructive fraudulent conveyance requires only two elements: (a) a transfer of a debtor's property for less than reasonably equivalent value and (b) insolvency of the transferor. In *BFP*, the Supreme Court was ultimately asked whether the \$433,000 received at the foreclosure sale was a transfer for "reasonably equivalent value." The Supreme Court held that a "fair and proper price, or a 'reasonably equivalent value,' for foreclosed property, is the price in fact received at the foreclosure sale, so long as all the requirements of the state's foreclosure law have been complied with." To hold otherwise, the Supreme Court stated, would interfere with the essential state interest in ensuring the security of titles to real property.

This ruling effectively insulated regularly conducted foreclosure sales from avoidance under fraudulent conveyance law. In *In re Whittle*, Branch Banking requested that this result be extended to preference actions. In deciding this question, the bankruptcy court turned to an analysis of the competing interpretations of *BFP*.

### Bankruptcy Court's Analysis

Despite the differences in the applicable statutes, the *In re Whittle* court noted that some courts have simply held that the test for preferences—a transfer which enables a creditor to receive more than in a chapter 7 liquidation—is essentially the same as the Supreme Court's test for "reasonably equivalent value" in the fraudulent conveyance context. That is, a court performing this analysis should simply look at the exchanged value and see if it was reasonable at that time and in that context. The courts that take this position (and apply *BFP* to a preference scenario) base their reasoning on the policy underlying the Supreme Court's ruling in *BFP*; namely, they recognize that states' have very important interest in enacting laws governing foreclosure of real property. See *Chase Manhattan Bank v. Pulcini* (*In re Pulcini*), 261 B.R. 836 (Bankr. W.D. Pa. 2001); *Glaser v. Chelec, Inc.* (*In re Glaser*), No. 01-10220-SSM, 2002 WL 32375007 (Bankr. E.D. Va. 2002). These courts conclude that, despite the language difference between the two statutes, a bankruptcy court's ability to avoid state foreclosure sales under either section would undermine the states' sovereign interest in the security and stability of title to land. While Article I, Section 8 of the Constitution gives Congress the authority to displace state law in the bankruptcy context, federal courts will not do so absent Congress' "clear and manifest" intent. Looking to the preference statute, these courts have found no "clear and manifest" congressional intent to interfere with state foreclosure laws. / continued page 10

non-core litigation to be brought exclusively in the bankruptcy court because, in a post-*Stern* environment, case efficiency motivations were nullified where the bankruptcy court judge could not render a final judgment.

- *Samson v. Blixseth* (*In re Blixseth*), No. 10-00088, 2011 WL 3274042 (Bankr. D. Mont. Aug. 1, 2011) (bankruptcy court reviewed its jurisdiction sua sponte and held that, under *Stern*, it did have jurisdiction over trustee's preference, related tort and equitable subordination claims but it did not have jurisdiction over the fraudulent transfer claims; court provided the parties time to file motion to withdraw the reference before it dismissed the fraudulent transfer claims).
- *Springel v. Prosser* (*In re Innovative Commc'n Corp.*), No. 08-3004, 2011 Bankr. LEXIS 3040 (Bankr. D. V. I. Aug. 5, 2011) (bankruptcy court held that it had jurisdiction over trustee's fraudulent conveyance claims to recover post-petition transfers under *Stern* but, should the district court disagree, the bankruptcy court's opinion would constitute its report and recommendation to the district court).
- *In re Okwonna-Felix*, No. 10-31663, 2011 WL 3421561 (Bankr. S.D. Tex. Aug. 3, 2011) (bankruptcy court reviewed its jurisdiction sua sponte and held that it had authority to approve a settlement of breach of insurance contract claims under *Stern* because the contested matter involved Bankruptcy Rule 9019 which has no equivalent in state law).
- *Kurz v. EMAK Worldwide, Inc.*, No. 11-CV-375, 2011 WL 4048966 (D. Del. Sept. 9, 2011) (district court held that the bankruptcy court must adjudicate plaintiff's state law contract claims under *Stern* because plaintiff also filed a proof of claim in defendant's bankruptcy which "contain[s] the same legal question, whether the [a]greement entitles Plaintiff to fees and expenses").
- *In re Ambac Financial Group, Inc.*, No. 10-15973, 2011 WL 4436126 (Bankr. S.D.N.Y. Sept. 23, 2011) (bankruptcy court held that it had jurisdiction to approve a settlement affecting plaintiff's securities litigation claims pending in state and district court because those claims became property of the debtor's estate upon filing for bankruptcy and approving a settlement under Bankruptcy Rule 9019 does not implicate *Stern*).

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## Foreclosure Sale

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In contrast, other courts analyzing the preference test simply highlight the plain language of the statute and point out that the test for whether a transfer is a preference is fundamentally different than that used in the fraudulent conveyance statute. In addition, such courts note that preferences are much more likely to exist because the defendants are from a much smaller universe than fraudulent conveyance claims (preference defendants must be prepetition creditors of the debtor).

In summary, the debate between these two lines of authority is essentially whether a court should defer to federalism concerns and find that valid state foreclosure sales should be

The court stated that it was not concerned about intruding on the states' interest in the stability of title to real property because "[i]f an otherwise valid foreclosure sale is found to enable a creditor to obtain more than he would in a chapter 7 liquidation, then the additional amount of benefit conferred to the creditor is simply brought back into the estate." Because a preference action may only be brought against a creditor of the estate, title to the real property would only be disturbed in those instances where the creditor was also the purchaser of the property. Additionally, the fact that preference reach back period is only ninety days from the bankruptcy filing (for non-insiders) versus the two-year reach back period for fraudulent conveyances, means that the "cloud on title" created by a potential preference claim is substantially more limited than that created by a potential fraudulent conveyance claim.

**Unlike a preference, a constructive fraudulent conveyance requires only two elements: (a) a transfer of a debtor's property for less than reasonably equivalent value and (b) insolvency of the transferor.**

unassailable in the preference context, or whether the plain language of the statute should be followed and thus make foreclosure sales subject to attack as preferences.

### The Bankruptcy Court's Decision

The *In re Whittle* court sided with the second group of cases, holding that *BFP* was inapplicable in the preference context based on the clear language of the statute. "[L]ooking at the unambiguous language of the statute, it would seem that the only thing that must be shown is that the creditor did, in fact, receive more from the pre-petition transfer than it would have under a Chapter 7 liquidation . . ." The court found *BFP's* assessment of "reasonable equivalent value" wholly inapplicable to the preference context.

Based on this ruling and others like it, secured creditors and purchasers of foreclosed property who are also creditors of the estate should be cautious. These parties should view this case as a clear warning that, depending on the jurisdiction, the ability to resolve each and every case issue in a lawful foreclosure sale could potentially be threatened by a subsequent bankruptcy filing. ☹

- *Retired Partners of Coudert Brothers Trust v. Baker & Mackenzie LLP (In re Coudert Brothers LLP)*, No. 11-2785, 2011 U.S. Dist. LEXIS 110425 (S.D.N.Y. Sept. 23, 2011) (district court held that bankruptcy court did not have authority to render final judgment over fraudulent transfer and state law tort claims under *Stern* and *Granfinanciera* but treated the bankruptcy court's final judgment as a report and recommendation that would be subject to its de novo review).
- *In re Washington Mutual, Inc.*, No. 08-12229, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011) (bankruptcy court held that it had jurisdiction to approve a global settlement of the estate's fraudulent conveyance, federal intellectual property and state law tort claims because approving a settlement under Bankruptcy Rule 9019 is a "firmly established historical practice" of bankruptcy courts and "a court does not have to have jurisdiction over underlying claims in order to approve a compromise of them"). ☺

## IN OTHER NEWS

### Speeches, Publications, Events and Announcements

**Ted Zink** and **Douglas Deutsch** spoke at a webinar sponsored by ExecSense titled "Writing Legal Opinion Letters for Bankruptcy Lawyers" (June 17, 2011).

**Douglas Deutsch** and **Eric Daucher** authored "Dodd-Frank's Liquidation Scheme: Basics for Bankruptcy Practitioners," *American Bankruptcy Institute Journal* (July/August 2011).

**Seven Rivera** spoke with litigation partner **Thomas Hall** at a webinar sponsored by Stafford Publications titled "The Far Reaching Impact of *Stern v. Marshall*" (October 13, 2011).

**Howard Seife**, **David LeMay** and Litigation Partner **Thomas McCormack** will be, respectively, moderator and speakers at a Chadbourne & Parke client program titled "New Perils in Chapter 11: Distressed Investing After *Washington Mutual*" (October 20, 2011).

**David LeMay** will be speaking at American Bankruptcy Institute's Mid-Level Professional Development Seminar in New York City in a program titled "Tribune: A Case Study" (October 28, 2011).

**Douglas Deutsch** will be co-chairing the American Bankruptcy Institute's Mid-Level Professional Development Program, a one-day seminar held in New York City (October 28, 2011).

**Frank Vazquez** will be speaking at St. John's University 2011 CLE Program in New York City on a panel titled "Bankruptcy Fundamentals: The Importance to General Practitioners" (November 5, 2011).

**Howard Seife** will be co-chairing INSOL International's one day seminar in Buenos Aires (November 10, 2011).

**David LeMay** will be a panelist in the Delaware State Bar/American Bankruptcy Institute's jointly sponsored "Views from the Bench" seminar in Wilmington, Delaware in a program titled "Claims Trading and Bankruptcy Rule 2019" (November 21, 2011).

**Frank Vazquez** spoke at a New York State Bar Association seminar in New York City at a program titled "Practical Skills—The Basics of Bankruptcy" (June 16, 2011). ☺

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