NEW VALUE

FEDERAL BAR ASSOCIATION—BANKRUPTCY SECTION NEWSLETTER

September, 2011

BANKRUPTCY SECTION STEERING COMMITTEE

IN THIS ISSUE

EDITOR'S NOTE

Benjamin M. White

I am honored to serve as editor of the Federal Bar Association, Bankruptcy Section Newsletter. For years the newsletter has served as an invaluable resource to our members, providing updates, observations, and analysis of local as well as national bankruptcy issues. Anybody who has practiced bankruptcy law in the Western District of Michigan knows we enjoy an extremely knowledgeable bench and bar. The newsletter will continue to provide a forum in which we can share that collective knowledge.

The newsletter has a new look and a new name: *New Value*. Not only is "new value" a bankruptcy term of art, but it is my hope that each issue will provide just that (in the colloquial sense) to its readers. FBA members are invited and encouraged to contact me if interested in publishing an article in the newsletter, bwhite@kalawgr.com. Ideas and comments are also welcomed.

But enough administrative mumbo-jumbo, let's get down to business. An action-packed quarter has given us lots to cover, including the FBA-Bankruptcy Section's annual seminar, the Supreme Court's decision in Stern v. Marshall, stirrings about potential changes to Chapter 11 venue rules, notable Circuit and BAP decisions, and more. In other words, it's a great time for the Fall 2011 edition of *New Value*.

This issue discusses the Supreme Court's decision in *Stern v. Marshall* in addition to Judge Hughes's and Judge Gregg's interpretation thereof, and also the rise and effects of the so-called "bad-boy guarantees."

UPCOMING EVENTS

- ABI Detroit Consumer Bankruptcy Conference November 11, 2011, MGM Grand, Detroit, Michigan
- FBA Holiday Party, December 8, 2011 at 4:30 p.m., Amway Grand Plaza, Grand Rapids, Michigan

New Value is published by the Federal Bar Association, Bankruptcy Section, for the Western District of Michigan.

LETTER FROM THE CHAIR

Norman C. Witte

Those of you who attended the cocktail reception at the FBA seminar this past July know that we announced a contest to rename the reception in honor of Denni Chamberlain, who recently passed away. As promised, the selection process was completely arbitrary, and the winning entry submitted by the Scott Chernich Family (and I think also suggested by Judge Hughes) is "The Denni Chamberlain 'Friending' Reception." There were many excellent entries, so thanks to everyone who participated.

I would like to thank everyone who worked to make our annual seminar a success. In particular, I would like to thank Fran Ferguson for all her hard work organizing the event, and Judge Dales, our educational chair for putting together what I thought was an excellent program. I would also express our sincere appreciation to our sponsors:

Judge Hughes announces the contest to name the seminar reception in honor of Denni Chamberlain.

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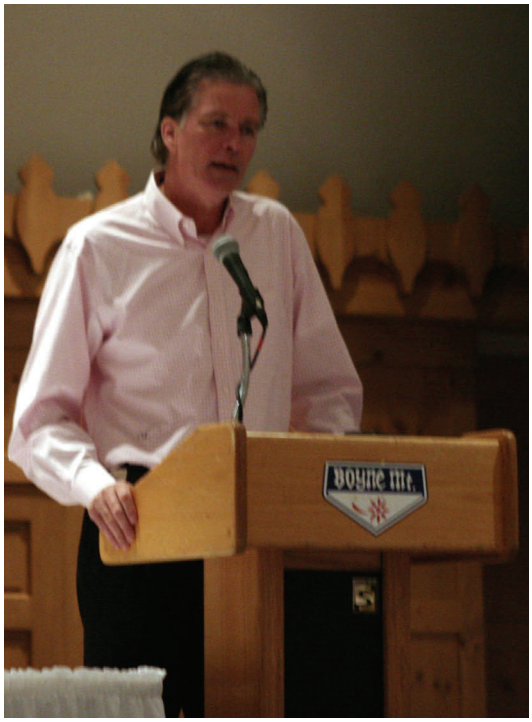
If you have comments, complaints, criticisms or complements regarding the seminar, feel free to email me at ncwitte@wittelaw.com.

Norman C. Witte, Chairman

NEWS & ANNOUNCEMENTS

*Congratulations to **Tim Hillegonds**, the FBA Bankruptcy Section's 2011 Nims-Howard Civility Award Recipient.*

Treasurer Dillon gives his keynote address.



The FBA would like to thank the Hon. Andy Dillon, Treasurer, State of Michigan, who served as the keynote speaker at this year's Seminar, as well as the following Seminar panelists:

Hon. Scott W. Dales	Elizabeth T. Clark	Gregory M. Luyt
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ARTICLES

The "Anna Nicole Smith" Effect:

How the U.S. Supreme Court and the Bankruptcy Court for the Western District of Michigan are Interpreting Bankruptcy Judges' Authority to Enter Final Orders

By Laura J. Garlinghouse & Scott H. Hogan
Foster, Swift, Collins & Smith, P.C.

Many are familiar with Anna Nicole Smith, the late television personality who married an elderly oil tycoon shortly before his death and later became embroiled in a legal battle over his estate. Recently, the bankruptcy case of Vickie Lynn Marshall – Anna Nicole Smith's legal name – made its way to the U.S. Supreme Court and resulted in an opinion that limits the authority of bankruptcy courts to enter final orders in common law actions.

***Stern v Marshall*, U.S. Supreme Court, June 23, 2011 (No. 10-179).**

Vickie married J. Howard Marshall approximately a year before his death, and although he gave her many gifts, he did not leave her anything in his will. Before J. Howard passed away, Vickie sued his son, Pierce, in state court for tortious interference with J. Howard's will. Vickie then filed bankruptcy. Pierce filed a nondischargeability action and a proof of claim in Vickie's bankruptcy case, asserting that Vickie had defamed him. Vickie filed a counterclaim against Pierce, essentially restating the tort allegations from her state court action.

The bankruptcy court entered judgment in favor of Vickie and awarded her over $425 million in damages. Post-trial, Pierce argued that the bankruptcy court lacked authority to decide Vickie's counterclaim because it was not a core proceeding. The district court agreed and held that the bankruptcy court's judgment was merely a recommendation. On *de novo* review, the district court found in favor of Vickie but awarded just $44 million in damages. The Court of Appeals reversed, but on grounds that the U.S. Supreme Court later rejected. The case then returned to the Court of Appeals, which concluded that Vickie's counterclaim was *not* a core proceeding. By that time, the state court had ruled in favor of Pierce in Vickie's action, and so the Court of Appeals gave the state court judgment preclusive effect.

On appeal, the U.S. Supreme Court held that Vickie's counterclaim against Pierce, which was based on state tort law, was a core proceeding "under the plain text of § 157(b)(2)(C)" – which lists counterclaims by the estate against claimants as core proceedings. But the Court then held that although the Bankruptcy Code allowed the bankruptcy court to enter a final judgment, "Article III of the Constitution does not." *Id.* at 2608. That is, although the Bankruptcy Court had statutory authority to decide Vickie's counterclaim, it lacked constitutional authority.

The Court reasoned that final decisions on common law claims must be made by Article III judges, who have life tenure, to protect the integrity of the judicial system. Bankruptcy judges are not Article III judges and thus cannot decide common law claims unless the claims involve "public rights" that can be assigned to "legislative" courts – i.e., non-Article III courts – for determination. Cases may fall within the "public rights" exception if they arise between the government and individuals in connection with the government's constitutional functions.

Importantly, in its reasoning, the Court relied on *Granfinanciera, SA v. Nordberg,* 492 U.S. 33 (1989), in which the Court held that a fraudulent conveyance action in a bankruptcy case did not fall within the "public rights" exception because it more closely resembled a common law contract claim. Like the fraudulent conveyance action in *Granfinanciera*, the Court concluded that Vickie's counterclaim did not fall within the "public rights" exception because it was merely a private action between individuals. Because that exception did not apply, the bankruptcy court lacked constitutional authority to enter a final order as to Vickie's counterclaim.

Bankruptcy Court Decisions after *Stern v. Marshall*

Stern v. Marshall immediately cast a shadow of uncertainty on bankruptcy courts' ability to enter final orders. Some bankruptcy courts have interpreted *Stern* narrowly, concluding that its holding was limited to state court counterclaims. *See, e.g., In re Peacock*, -- B.R. --, 2011 WL 3874461 (Bankr. M.D. Fla. 2011). Other courts have held that *Stern*'s holding extends to claims other than counterclaims, such as fraudulent transfer actions. *See, e.g., In re Blixseth*, 2011 WL 3274042 (Bankr. D. Mont. 2011).

In the Western District of Michigan, only one written opinion regarding *Stern v. Marshall* has been issued as of this writing. In *Meoli v The Huntington Nat'l Bank (In re Teleservices Group, Inc.*), -- B.R. --, 2011 WL 3610050 (Bankr. W.D. Mich. 2011), the Hon. Jeffrey R. Hughes concluded that he lacked constitutional authority to enter a final order in the Chapter 7 trustee's fraudulent transfer action under §§ 548 and 544 of the Bankruptcy Code.

Among other things, Judge Hughes emphasized that according to *Stern*, the exercise of "judicial power" – which includes "traditional actions of common law" – is limited to Article III judges. *Id.* at *6. Judge Hughes reasoned that allowing non-Article III judges, such as bankruptcy judges, to exercise judicial power may result in the deprivation of due process rights guaranteed by the Fifth Amendment. *Id.* at *8-9. Consequently, Judge Hughes held that any money judgment against the defendant must be entered by an Article III judge and that the bankruptcy court's prior opinion and order would be submitted to the district court as a non-core matter on report and recommendation. *Id.* at *19.

Practicing in a Post-*Stern* World

Stern v. Marshall leaves plenty of questions unanswered. As Judge Hughes noted in *Teleservices*, *Stern* "offers virtually no insight as to how to recalibrate the core/non-core dichotomy" so that bankruptcy judges can understand their constitutional authority. Future decisions from the appellate courts will likely shed light on the boundaries of *Stern v. Marshall.*

Until then, practitioners should keep in mind that bankruptcy courts appear willing to enter a final order if all parties to the action consent to entry of a final order. Additionally, practitioners should be aware that in counterclaims and other types of actions, including fraudulent transfers in Judge Hughes' courtroom, the bankruptcy court may submit a report and recommendation to the district court.

Bad-Boy Guarantees

From Non-Recourse to Maximum Exposure

By: Robert D. Wolford and Matthew K. Bishop
Miller Johnson

This article originally appeared in
Michigan Lawyers Weekly on August 12, 2011

You just finished a phone conversation with a client, who called to tell you he secured a financing commitment for his new development. The lender agreed to provide your client with a non-recourse loan, secured only by a mortgage on the subject real property. According to your client, if the venture fails he will be shielded from personal liability, his only risk being the loss of the real property and his investment, for which he is prepared and understands.

Although your client believes this to be a deal where he has no personal exposure, this may not be entirely true if the loan documents contain a "bad-boy guarantee", which could result in a springing personal liability despite the non-recourse nature of the loan.

"Bad-boy guarantees" are a tool being utilized with increasing frequency by secured creditors. They have, with very few exceptions, been enforced by courts. These provisions are a form of creditor protection designed to turn a non-recourse loan into a recourse loan if the debtor violates certain covenants in the loan documents. Usually, these covenants are structured to compel debtors to act in the best interest of the lender and the collateral. Therefore, these covenants typically prohibit activities that may pose special risks to the secured creditor – for example, prohibition against placing additional liens on the collateral, making certain distributions, or from filing a petition for bankruptcy. While these prohibitions may seem reasonable to your client at the time of loan origination, debtors can often unintentionally breach them due to their broad wording and courts faced with these provisions have generally strictly interpreted their meaning absent any ambiguity, all of which can cause harsh results and substantial recourse liability to arise for principals of borrowers who believed they had no exposure unless they engaged in inappropriate activities.

For example, in *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, the plaintiff extended a seemingly non-recourse loan to the defendant memorialized by a promissory note and secured by a mortgage on the commercial property. However, the note provided that the plaintiff would have full recourse against the defendant and its members for repayment if the defendant failed "to obtain…prior written consent to any subordinate financing or other voluntary lien encumbering the mortgaged property." A few years later, the defendant took out a second mortgage on the property to secure short-term financing. The defendant repaid the holder of the second mortgage within a few months, and the mortgage was fully released.

A year later, the defendant defaulted on its loan from the plaintiff. The plaintiff foreclosed on the mortgage, but a substantial deficiency remained following its sale of the subject property. The plaintiff sued the defendant and its members personally to collect this deficiency, arguing that the defendant's actions in taking out the second mortgage without the plaintiff's consent triggered the bad-boy guarantee in the note. The defendant and its members argued for dismissal, on the basis that the loan was non-recourse and the foreclosure on the real property had discharged all obligations between the parties. The Court held that the defendant triggered the bad-boy guarantee when it took out the second mortgage, even though there was no evidence that doing so had actually harmed the plaintiff. The fact that the covenant in the note had been breached was sufficient reason to trigger the bad-boy guarantee and open the defendant's members to personal liability.

In *LaSalle Bank NA v. Mobile Hotel Props. LLC*, the borrower took out a non-recourse loan, secured only by a mortgage on real property. The loan documents contained a bad-boy guarantee, with certain covenants that, if violated by the debtor, would allow the lender to seek full recourse for repayment against the debtor and its members. One of these covenants prohibited the debtor from amending its articles of incorporation in any way that would result in its failing to maintain its status as a single-purpose entity. After the issuance of the loan, the debtor amended its articles of incorporation to add certain boilerplate language which was interpreted to allow the debtor to exist for more than a single-purpose. There was no evidence that the debtor actually began operating as anything other than a single-purpose entity. The court enforced the bad-boy guarantee, stating that the debtor's amendment had breached the loan covenant, therefore triggering the full recourse provisions of the loan documents.

With real property values continuing to decline and special assets groups struggling to maximize the return on their distressed credits, lenders continue to push the bounds on enforcement of these "bad-boy guarantees." In one pending Michigan case, a lender is seeking to enforce such a guaranty arguing that the failure to remain solvent breached the borrower's special-purpose entity designation. As lenders ratchet up the pressure to attempt to obtain recourse on these loans, it is critical to attempt to negotiate these provisions at loan origination to ensure that they are narrowly tailored, limited in applicability and require a material and continuing breach to be enforced.

1. CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC, 980 A.2d 1 (2009).

2. LaSalle Bank NA v. Mobile Hotel Props. LLC, 367 F.Supp.2d 1022 (E.D. La. 2004).

CASE SUMMARIES AND LEGAL UPDATES

*We do not include summaries of the Supreme Court's *Stern v. Marshall* opinion or the W.D. of Michigan Bankruptcy Court opinion *Meoli v. The Huntington Nat'l Bank (In re Teleservices Group, Inc.)* as those cases are discussed in the Article "The 'Anna Nicole Smith' Effect" on page 4 herein. Judge Gregg addresses *Stern v. Marshall* in *In re Hudson*, which is summarized below.

Thank you to Greg J. Ekdahl of Keller & Almassian, PLC for his assistance in preparing the following Case Summaries.

In re Dickson, -- F.3d --, 2011 WL 3768684 (6th Cir. 2011)

A chapter 13 debtor granted Countrywide a mortgage on the debtor's real estate, which at the time contained no improvements, to secure a loan of $79,000.00. The debtor used the loan proceeds to purchase a mobile home, and placed the mobile home on the real estate. Countrywide failed to note its lien on the title to the home. The debtor eventually defaulted on the loan, and on June 15, 2006, Countrywide filed a state-court action to foreclose, asserting that the debtor intended to grant Countrywide a lien on the mobile home as well as the real property, and pointed to a mortgage clause which included "all improvements now or hereafter erected on the property...." A month later, the debtor filed a chapter 13 proceeding. Countrywide filed a motion for relief from stay. The debtor and the chapter 13 trustee opposed the motion on the grounds that Countrywide failed to properly perfect its lien on the mobile home. The bankruptcy court issued an order granting the trustee thirty days to file an adversary proceeding, and if the trustee did not, the debtor would have an additional fifteen days to do so. The trustee did not file an adversary proceeding. The debtor, therefore, filed an adversary complaint pursuant to 11 U.S.C. §§ 544, 547, 550, and 551, in which she asserted that Countrywide did not properly perfect its lien on her mobile home. Countrywide filed a motion for summary judgment in which it asserted the debtor lacked standing to bring the proceeding.

Finding the debtor did have standing to bring the adversary proceeding, the Court held that "a Chapter 13 debtor has standing to avoid a transfer under § 522(h) if five conditions are met: (1) the transfer was not voluntary; (2) the transfer was not concealed; (3) the trustee did not attempt to avoid the transfer; (4) the debtor seeks the avoidance pursuant to §§ 544, 545, 547, 548, 549, or 724(a) of the Bankruptcy Code; and (5) the transferred property is of a kind that the debtor would have been able to exempt from the estate if the trustee had avoided the transfer under one of the provisions in § 522(g)."

Rankin v. Brian Lavan and Associates, P.C. (In re Rankin), 2011 WL 3701441 (6th Cir. 2011) (Unpublished)

The debtors purchased a home under land contract with the Woods. The debtors defaulted on the land contract in 1999, but thereafter negotiated a purchase of the home from the Woods. The parties attempted to close in February 2002, but the debtors were unable to fund the closing and the sale never occurred. The debtors filed a chapter 7 proceeding shortly thereafter, but did not disclose any interest in the home nor any claims against the Woods. In January of 2004, the debtors filed a state-court action against the title insurance company and closing agent ("Title Action"), which the trustee removed to the bankruptcy court, and concluded in summary judgment in favor of the defendants. The debtors then filed a state-court action against the Woods ("Woods Action"). Once the trustee learned of the lawsuit, the trustee settled the action with bankruptcy-court approval pursuant to Rule 9019. In 2006, the bankruptcy court issued an injunction prohibiting the debtors from further filings without the court's approval. The debtors violated the injunction and the bankruptcy court awarded more than $9,000.00 in sanctions under Bankruptcy Rule 9011 ("Sanctions Award"). The debtors appealed the bankruptcy court rulings in the Title Action, the Woods Action, and the Sanctions Award.

The Court affirmed all three bankruptcy-court rulings. The Court held that the debtors had no standing to bring the Title Action because the trustee had that exclusive right under Section 323. The Court further held that the Woods Action was property of the estate under Section 541, and that the bankruptcy court had the facts it needed to evaluate the settlement under Rule 9019 and there was no clear error. And finally, the Court held that the bankruptcy court's award of sanctions was not an abuse of discretion and was in an amount intended to deter repetitive violations of Rule 9011.

Cupps & Garrison, LLC v. Rhiel (In re Two Gales, Inc.), -- B.R. --, 2011 WL 2714869 (B.A.P. 6th Cir. July 14, 2011)

On September 3, 2009, Two Gales, Inc. filed a chapter 11 proceeding with the assistance of Cupps & Garrison ("C&G"). On October 22, 2009, C&G filed an application seeking court approval of its employment as counsel for the Debtor. The application disclosed that C&G had received a $10,000.00 retainer pre-petition. The bankruptcy court approved C&G's employment and authorized C&G to draw on the retainer for 80% of its documented fees and 100% of its documented expenses prior to approval of any fee application. The order further stated that any such funds would be subject to repayment and final approval by the court. C&G filed its first fee application on January 18, 2010 asking for approval of fees in the amount of $19,504.50, expenses of $1,224.32, and for approval of the $10,000.00 provisionally applied by C&G against the retainer. Before the court ruled on the fee application, the case was converted to a chapter 7 proceeding. Because the debtor was administratively insolvent, the bankruptcy court denied the application in full, finding that, under Section 726(b), chapter 7 administrative expenses and outstanding U.S. Trustee fees are entitled to priority over debtor's counsel's fees, and ordered disgorgement of the prepetition retainer. The court declined to consider the relevance or existence of a security retainer.

The Court found that the "holder of a valid 'security retainer' under state law may not be subject to the distribution scheme in 11 U.S.C. § 726(b)." Therefore, the Court held, it was inappropriate for the bankruptcy court to deny counsel's fee application based on priority of distribution after conversion of the debtor's case without first determining whether counsel held a valid lien against the retainer under state law.

In re Hudson, --- B.R. ----, 2011 WL 3583278 (Bankr. W.D. Mich.)

This case examined whether a Chapter 7 Trustee could avoid an erroneously stated mortgage under 544(a)(3), and secondarily, whether a bankruptcy court judge is constitutionally authorized to enter a final order in a mortgage avoidance adversary proceeding following *Stern v. Marshall*. Regarding the first issue, Wells Fargo claimed to hold a valid mortgage on real property owned by Chapter 7 Debtor. The mortgage contained an incorrect legal description. Debtor owned "Lot 5," but Wells Fargo's mortgage covered "Lot 6" of the same plat. Despite the error, the Bank argued that the Trustee, as a bona fide purchaser ("BFP") would have, after inquiries were made, constructive notice that the Bank's mortgage was really on Lot 5 rather than Lot 6. The Court discarded this argument, noting that the Bank had "no one to blame but itself" and that when an instrument that is not recorded in accordance with Michigan recording acts, either because it was recorded improperly or because it was not entitled to be recorded, may not constitute constructive notice to anyone. Accordingly, the Bank's interest was preserved for the estate and the Trustee was able to administer the real property free and clear of any asserted lien by the Bank.

Judge Gregg also addressed the question of whether Stern v. Marshall prohibited the Court from entering a final order in certain types of core proceedings (beginning on page 14 of the decision). Judge Gregg held that except for the specific and isolated types of counterclaims addressed in Stern v. Marshall, a bankruptcy judge remains empowered to enter final orders in all core proceedings. He went on to hold that although the adversary proceeding required the Court to decide state law issues, the matter arose under 544(a)(3) of the Code and that the Court could not envision a core proceeding that is more "core" than lien avoidance. As a final matter, Judge Gregg indicated in a final footnote that the court anticipates it will continue to enter final orders in adversary proceedings that "arise under" the Bankruptcy Code, e.g., preferential transfers under 547.

In re XMH Corp., 647 F.3d 690 (7th Cir. 2011)

This is the first published court of appeals opinion answering whether trademark licenses are assignable in bankruptcy.

In the case, a chapter 11 debtor sought to sell the assets of its debtor-subsidiary, including an executory contract between the debtor-subsidiary and a trademark licensee. The licensee objected to the assignment of its contract, contending that the contract could not be assigned without the licensee's permission. The Bankruptcy Court approved the sale except as to assignment of the contract. Debtor appealed.

Judge Posner, writing for a panel of the Seventh Circuit, explained that Section 365(c)(1) of the Bankruptcy Code limits the ability of a debtor to assign an executory contract to the extent that "applicable law" permits the non-debtor party to the contract to refuse to accept performance from an assignee, regardless of whether the contract itself prohibits or restricts assignment. In *XMH Corp.*, the contract neither prohibited nor permitted assignment. The Court held that if the contract included a trademark sublicense when XMH attempted to assign the contract, it was not assignable. The Court found that this was true regardless of whether federal or any state's trademark law applied, because "as far as we've been able to determine, the universal rule is that trademark licenses are not assignable in the absence of a clause expressly authorizing assignment."

Legal Updates

New Rules for Garnishment of Accounts Containing Federal Benefit Payments

On May 1, 2011, a new federal rule went into effect establishing procedures for and restrictions on the garnishment of federal benefit payments, including Social Security benefits, Supplemental Security Income, VA Benefits, Federal Railroad Retirement Benefits, Federal Railroad Unemployment and Sickness Benefits, Civil Service Retirement System Benefits, and Federal Employee Retirement System Benefits.

The rule shifts the burden of enforcing the protection of such funds from the account holders to the financial institution. The rules does not apply to garnishments of the United States or State child support enforcement agencies. The rule requires that, within two days after receipt of a garnishment, a financial institution review the account transactions for the two-month period prior to the date of the garnishment, to determine whether federal benefits were *directly deposited* into the account. If such direct deposits occurred, the financial institution must ensure that the account holder has access to the amount of such direct deposits. Notably, the rule does not apply to federal benefits that were deposited by paper check.

Proposed Chapter 11 Venue Reform

House Bill 2533, if enacted, would reform Chapter 11 venue rules to require corporations to file in the district in which the corporation had its principal place of business, or principal assets in the United States, for the 1 year period prior to filing. No longer would there be Chrysler or GM of New York. The House Judiciary committee held hearings on the Bill on September 8, 2011.