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Court decisions impact core bankruptcy law principles

VIEWPOINT
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Several high court decisions have implicated core bankruptcy law principles and shaped the rights of debtors and creditors in bankruptcy this year.

Let's take a look at four key issues affected by recent rulings of the U.S. Supreme Court (and one district court, which expanded a principle set by a prior Supreme Court decision) and analyze their practical implications.

■ **Lien stripping in bankruptcy:** In bankruptcy cases under Chapters 11 and 13 of the Bankruptcy Code, courts generally agree that a debtor may void the lien of a junior lien creditor to the extent that such creditor's lien is undersecured by equity in the debtor's property. The wiping away of the creditor's lien is commonly known as lien stripping.

Before June, there was a split among the U.S. Circuit Courts as to whether lien stripping applied in bankruptcy cases under Chapter 7, which is the chapter of the Bankruptcy Code that provides for a liquidation of a debtor's assets.

On June 1, the Supreme Court issued an opinion (*Bank of Am. N.A. v. Caulkett*) holding that a Chapter 7 debtor could not strip off a junior mortgage lien even if the lien was completely underwater. The majority opinion expressed the view that allowing a wholly underwater lien to be stripped off when the Bankruptcy Code does not permit a partially underwater lien to be stripped down would lead to arbitrary results, especially in light of the fact that real estate values fluctuate frequently.

After the Supreme Court decision in *Caulkett*, undersecured or "out of the money" junior lien creditors in a Chapter 7 case will be comforted to know that they will retain their liens and may realize any appreciation in collateral value after the bankruptcy case begins.

■ **"Cram down" of senior secured lenders**

In 2004, the Supreme Court issued a decision (*Till v. SCS Credit Corp.*), holding that an individual debtor who filed a Chapter 13 bankruptcy could confirm a bankruptcy plan that contemplates paying a secured lender's claim at an interest rate lower than the applicable contract rate. In bankruptcy parlance, this is called a "cram down" interest rate.

In May, the U.S. District Court for the Southern District of New York affirmed a bankruptcy court decision that expanded the *Till* cram down interest rate to cases under Chapter 11, the chapter under which most large corporate debtors file.

In *U.S. Bank Nat'l Ass'n v. Momentive Performance Materials Inc.*, the court addressed the issue of whether a senior secured lender can be crammed down at a below-market interest rate in a Chapter 11 case. The court held that a Chapter 11 plan providing a cram down interest rate for senior secured lenders does not violate the fair and equitable requirement of the Bankruptcy Code. That ruling applies if such interest rate set in the plan puts the secured creditor in the same economic position that it would have been in had it received the value of its claim immediately. The court proceeded to hold that the bankruptcy court's use of the seven-year Treasury rate, as opposed to the national prime rate, as the risk-free base rate was appropriate.

Finally, the court rejected an argument by the senior lender that it was entitled to a make-whole (or pre-payment) premium pursuant to the loan indenture. This is when the indenture provided for the automatic acceleration of the debt in the event of a voluntary bankruptcy filing, but did not expressly and unambiguously provide for a make-whole payment in the event of acceleration of the debt resulting from such a filing.

As this article is being written, the *MPM Silicones* decision is on appeal before the Second Circuit. If the decision stands, it emphasizes to a secured lender the importance of including express language in its loan documentation that in the event of acceleration of the loan, irrespective of the reason for such acceleration, the borrower is responsible to pay a pre-payment premium.

Additionally, in the bankruptcy context, a secured lender that votes against confirmation of a Chapter 11 reorganization plan should be cognizant of the potential of cram down of the secured creditor's claim and repayment of the loan at an interest rate below the applicable market rate. For debtors, this ruling provides significant leverage in negotiating a consensual plan where there is a secured creditor class of "holdouts."

■ **Entitlement to post-petition funds**

Unlike Chapter 7 cases where the debtor's non-exempt assets are transferred into the bankruptcy estate to be distributed to creditors, in Chapter 13 cases, the debtor is permitted to retain assets during the bankruptcy case subject to a court-approved plan for repayment of debts. Occasionally, for a variety of reasons—including the inability of the debtor to demonstrate regular income—a Chapter 13 case is converted into one under Chapter 7.

In May, the Supreme Court grappled with the issue of who is entitled to a debtor's post-petition wages held by the Chapter 13 trustee, but not yet distributed pursuant to a confirmed Chapter 13 plan, upon conversion of the debtor's case to one under Chapter 7.

The Supreme Court held in *Harris v. Viegelahn* that undistributed plan payments made by a debtor from wages and held by the Chapter 13 trustee, at the time of the conversion, must be returned to the debtor and may not be distributed to creditors. The Supreme Court reasoned that once a case is converted, the Chapter 13 trustee is stripped of powers to distribute funds to creditors as the provisions governing Chapter 13 cases cease to apply upon conversion.

As the Supreme Court noted in *Harris*, creditors of a Chapter 13 debtor should monitor the Chapter 13 plan process and ensure it provides a schedule for disbursements of funds collected by the trustee to avoid any distribution delays, which may result in unavailability of funds to pay off claims if the Chapter 13 case is converted to Chapter 7.

■ **Appeals of orders denying confirmation**

Also in May, the Supreme Court settled another key bankruptcy issue of whether a bankruptcy court's order denying confirmation of a debtor's proposed plan is immediately appealable. In *Bullard v. Blue Hills Bank*, the Supreme Court's answer was no, a bankruptcy court's denial of confirmation of a Chapter 13 debtor's proposed plan was not a final order that could be immediately appealed.

The Supreme Court reasoned that because a bankruptcy case involves "an aggregation of individual controversies," many of which would exist as stand-alone lawsuits, orders in bankruptcy cases are immediately appealable only if they dispose of the discrete disputes within the larger bankruptcy case on a final basis.

The Supreme Court elaborated on finality in bankruptcy cases by reasoning that denial of confirmation changes very little in a Chapter 13 case because, among other things, the automatic stay remains in place. The trustee continues to collect funds to distribute to creditors and the possibility of the debtor receiving a discharge survives.

From a policy perspective, the Supreme Court expressed concern over the potential for delays and inefficiencies caused by numerous appeals of confirmation denials while expressing confidence that bankruptcy courts rule correctly most of the time, and most errors committed are not egregious enough to justify a system of universal immediate appeals.

The *Bullard* case means that debtors with little or no prospect of reorganization will not have the leverage of prolonging bankruptcy cases by immediately appealing orders denying confirmation. From a creditor's perspective, the *Bullard* decision will shorten the timeline of a case and result in quicker distributions on account of their claims or quicker relief from the automatic stay, in the event the case is ultimately dismissed.

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