In This Issue

Programs Sponsored by the Business Bankruptcy Committee at the Business Law Section Annual Meeting

Featured Articles

Review of Supreme Court Opinions in Baker Botts (attorney fees), Bank of America v. Caulkett (lien stripping), Harris (disposition of funds held by Chapter 13 trustee upon conversion of case to Chapter 7) and Bullard (finality of order denying confirmation of a Chapter 13 plan)

The Supreme Court Affirms Bankruptcy Court Jurisdiction for "Stern" Claims Based Upon Implied Consent

Analysis of Third Circuit Approval of Structured Dismissals in Jevic Holding Corp.

Explanation of Indicative Rulings Under New Bankruptcy Rule 8008

Gaming Goodwill: Can Personal Goodwill be Used as an Asset Protection Tool?

Analysis of Wages Paid and Worker Turnover Where EmployersFiledawChapter11 Petition

In My Opinion: One Practitioner Weighs in on the ABI Commission’s Recommendation to Eliminate Roll-Ups in DIP Financing

Useful Links

Submit Articles for the Business Bankruptcy Newsletter

Get Business Bankruptcy Committee Materials From Programs At The Business

COMING UP AT THE ANNUAL BUSINESS LAW SECTION MEETING
SEPTEMBER 17-19, 2015, CHICAGO, IL

Thursday, September 17, 2015
Time: 2:30 p.m. - 4:30 p.m.

Program Title: Pro Bono Service On A Board Of A Not For Profit In Crisis: Fulfilling Your Not For Profit's Mission During Financial Distress

Sponsoring Committee: Business Bankruptcy

Co-sponsoring Committee(s): Pro Bono Services, Abuses Of Bankruptcy Process, Health & Non-Profit, Insurance, And Professional Ethics Subcommittees Of The Business Bankruptcy Committee

Program Chair: Andrew M. Troop

This program will cover:

1. Fiduciary Duties of Officers and Directors of Non-Profit Organizations
2. Officer and Director Insurance Issues for Non-Profits
3. How to Fulfill Your Responsibilities as a Non-Profit Director through real examples: Hull House (where claims against officers and directors were pursued); Religious organization (where claims have been considered and not pursued); and legal services corporations (where restructurings have occurred - NY Legal Aid - and are being considered - we’ve invited a legal services director to participate in the panel)

Friday, September 18, 2015
Time: 10:30 a.m. - 12:30 p.m.

Program Title: Mediation For Business Attorneys

Sponsoring Committee: Business Bankruptcy

Co-sponsoring Committee(s): TBD

Program Chair: Scott Y. Stuart

This program will cover:

1. Best Practices in Mediator Selection (Training; Mediation Bias; Gender and Cultural Sensitivities)
2. The use of Judge Mediators and the impact that has on resolution of business disputes
3. Use of presumptive Mediation in business cases and Ethical considerations in mediation considered

Friday, September 18, 2015
Time: 10:30 a.m.-12:30 p.m.

Program Title: Gotcha-Traps for the Unwary Presented by New and Emerging Legal Issues
This program will cover:

A survey of new or emerging legal issues that are relevant to a general business lawyer/transactional practitioner and that present traps for the unwary. It will focus on giving a "heads up" to non-specialists on issues they need to be able to spot that (a) could have a critical impact on a transaction, and (b) are not issues that might already be on their radar screen because the law has changed recently or is about to change. We want to alert practitioners that they need to consult a specialist in the appropriate circumstances.

Review of Supreme Court Opinions in Baker Botts (attorney fees), Bank of America v. Caulkett (lien stripping), Harris (disposition of funds held by Chapter 13 trustee upon conversion of case to Chapter 7) and Bullard (finality of order denying confirmation of a Chapter 13 plan)

By Danielle Spinelli

Bank of America, N.A. v. Caulkett, No. 13-1421 (June 1, 2015). Caulkett holds, based on the Supreme Court's precedent in Dewsnup v. Timm, 502 U.S. 410 (1992), that chapter 7 debtors may not strip off wholly unsecured junior liens on their property. In Dewsnup, the Court interpreted section 506(d) of the Bankruptcy Code, which provides that "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void." The debtors in Dewsnup argued that section 506(d) had to be read in conjunction with section 506(a), which provides that an undersecured claim is bifurcated into a "secured claim" for the value of the collateral and an "unsecured claim" for the remainder. The debtors contended that the portion of the lien exceeding the value of the collateral was thus "void" under section 506(d) and that they could "strip down" their partially underwater mortgage to the current value of their property. Dewsnup rejected that argument, holding instead that the phrase "allowed secured claim" in section 506(d) simply meant any valid claim secured by a lien, regardless of the bifurcation of the claim under section 506(a), and that debtors thus could not strip down their mortgage; rather, the mortgage lien rode through the chapter 7 proceeding unaffected.

After Dewsnup, most courts agreed that its reasoning also applied to "strip offs" - cases in which a junior mortgage lien was entirely underwater because a senior mortgage exceeded the value of the collateral. In this case, however, the Eleventh Circuit disagreed, and held that "strip offs" were distinguishable from "strip downs" and that the Eleventh Circuit thus remained bound by its pre-Dewsnup precedent holding that such strip-offs were permissible. Bank of America sought certiorari. Before the Court, it argued that strip-offs of wholly underwater mortgages were no different than strip-downs of partially underwater mortgages under Dewsnup's reasoning: in either case, the creditor's claim remained secured by a lien in the ordinary sense of the phrase, and the lien thus could not be voided under section 506(d). In a unanimous decision, the Supreme Court agreed, holding that Dewsnup resolved the question presented and that the debtor's arguments for distinguishing the case were unpersuasive and would lead to anomalous results. The Court included a footnote, which Justices Kennedy, Breyer, and Sotomayor declined to join, noting that Dewsnup had been criticized but also that the debtor in Caulkett had not asked that Dewsnup be overruled. The Court did not, however, suggest what it might do were that question to arise.

Read more...
for "Stern" Claims Based Upon Implied Consent

By Mark Felger and Keith Kleinman

In 2011, the U.S. Supreme Court issued its landmark *Stern v. Marshall* decision wherein it held that

> Article III [of the U.S. Constitution] prevents [Article I] bankruptcy courts from entering final judgment on claims that seek only to augment the bankruptcy estate and would otherwise exist without regard to any bankruptcy proceeding

Since the *Stern* decision was issued by the Supreme Court, it has been the subject of much scholarly debate and many court opinions addressing the scope and impact that it has on the jurisdiction of bankruptcy courts to enter final judgments. In particular, one question left open by the *Stern* decision was whether bankruptcy courts could enter final judgment on so-called *Stern* claims if the litigants consented to an adjudication by the bankruptcy court. In the recent *Wellness Int'l Network, Ltd. v. Sharif* decision, the Supreme Court ends the debate and explicitly affirmed that bankruptcy courts have jurisdiction to issue final judgments on *Stern* claims if the parties consent to the bankruptcy court adjudicating such claims.

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Analysis of Third Circuit Approval of Structured Dismissals in Jevic Holding Corp.

By Jonathan C. Lipson and Steven Walsh

How much "structure" may there be in a "structured" dismissal? The answer, according to a recent-and split-opinion of the U.S. Court of Appeals for the Third Circuit is "quite a bit." *In re Jevic Holding Corp., ___F.3d ___, No. 14-1465 (3d Cir. May 21, 2015).* Specifically, bankruptcy courts may, "in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme," provided that the dismissal is warranted by "specific and credible grounds." *Id.,* slip op. at 15, 23-24. While *Jevic* raises several important and novel questions, the most significant from the practitioner's perspective will be sorting out its reasoning, determining what made *Jevic* "rare," and therefore defining the class of future cases to which it applies.

Background.

Jevic, a trucking company headquartered in New Jersey, was acquired in a leveraged buyout (LBO) by Sun Capital that was financed by CIT. *Id. at 5.* When the company went into bankruptcy, its drivers sued Jevic and Sun for violating state and federal Worker Adjustment, Retraining and Notification (WARN) Acts (29 U.S.C. § 2102; N.J. Stat. Ann. § 34:21-2), and its creditors committee sued the LBO participants, claiming that the transaction was a fraudulent transfer. *Id.* at 6.

Read more...

Explanation of Indicative Rulings Under New Bankruptcy Rule 8008

By Henry C. Kevane

In April 2014, the Supreme Court adopted various amendments to the Federal Rules of Bankruptcy Procedure, which took effect on December 1, 2014, for all subsequently filed bankruptcy cases and, to the extent "just and practicable," for all pending cases. As with the other federal rules of procedure and evidence, the Supreme Court has the authority to promulgate general rules for practice and
procedure in cases under the Bankruptcy Code pursuant to 28 U.S.C. § 2075.¹
Among the comprehensive changes made to Part VIII of the rules governing bankruptcy appeals was the adoption of new Bankruptcy Rule 8008, titled Indicative Rulings.

The new rule addresses the effect of an appeal on the bankruptcy court's continuing jurisdiction over matters related to the appeal. Generally, an appeal from a final order confers exclusive jurisdiction in the appellate court over the issues that are the subject of the appeal. The bankruptcy court is thus deprived of any further authority to determine motions that would affect the status quo of the issues on appeal. See Griggs v. Provident Consumer Discount Co., 459 U.S. 56, 58 (1982) (per curiam) (“The filing of a notice of appeal is an event of jurisdictional significance—it confers jurisdiction on the court of appeals and divests the district court of its control over those aspects of the case involved in the appeal.”). This doctrine is designed to minimize the confusion that might arise if two courts simultaneously acted on the same matter.

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Gaming Goodwill: Can Personal Goodwill be Used as an Asset Protection Tool?

By Jeffrey M. Sklarz

When a business performs profitably, the whole firm is more valuable than the sum of the individual parts, such as physical assets, work force, and intellectual property. The value of a business in excess of physical assets and based on its ongoing operations is known as "goodwill." All businesses rely on key employees or owners to create revenue and, hence, goodwill. Companies of all sizes, but particularly closely held companies and service businesses, depend on the personal relationships and reputation of their owners and employees. Accordingly, over the years, the concept of goodwill has been further refined to distinguish between "enterprise goodwill" or "business goodwill," the going concern value of the business; and "personal goodwill" or "individual goodwill," the value of an owner's or employee's personal relationships and abilities, which are not considered an asset of the business. How to value personal goodwill has presented courts and practitioners with a complex and, often, controversial issue.

Theories distinguishing between personal and enterprise goodwill first arose in the context of tax reduction strategies and divorce law valuation litigation. From a tax perspective, the question was whether, during the sale of a business, the transfer of personal goodwill could be valued and allocated separate and apart from the enterprise goodwill. If allowable the owner may be entitled to special tax treatment, rendering such allocations lucrative. In the divorce context, the issue was whether personal goodwill (in the form of future cash flow generated by an income stream connected to the individual) should be included in the value of a business for purposes of an equitable division of marital property.

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Analysis of Wages Paid and Worker Turnover Where Employers Filed a Chapter 11 Petition

By Ariadne Montare

When businesses fail, the most immediate impact that is visible to the affected community is the number of jobs that may be lost when a business is shuttered. Yet very little economic analysis has been done on the effects to the work force of companies who go through a Chapter 11 reorganization. One such study shows that the workers of companies that survive bankruptcy for at least five years are still profoundly and detrimentally affected.
In an effort to quantify the cost of human capital loss to financial distressed companies, a group of economists analyzed employee wage losses in connection with the bankruptcy of 138 publicly traded corporations that filed for Chapter 11 relief from 1992 to 2008, using data for 96,538 workers obtained from the US Census Bureau. Graham, et al.'s analysis found that employee wages began to deteriorate prior to bankruptcy by an average of 30%, and that almost half of the employees left the bankrupt firms within five years of the bankruptcy filings. Graham, et al. also concluded that "workers who stay with or leave the employer post-bankruptcy experience substantial earnings losses, suggesting that employer financial distress has negative effects on its employees beyond job displacements." Their analysis shows a huge cost of human capital to bankrupt firms, a cost that has not been sufficiently discussed by academicians studying the financial impact of bankruptcy on firms or society at large.

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In My Opinion: One Practitioner Weighs in on the ABI Commission's Recommendation to Eliminate Roll-Ups in DIP Financing

By Madeleine Kvalheim

Sidestepping the adage about declining to fix what is not broken, the ABI commission proposed in December of 2014 to restrict bankruptcy financing from specific lenders, likely shifting the reorganization burden to debtors and new lenders in unfamiliar territory. Entities currently have equal opportunity to provide financing to debtors in bankruptcy. Debtors generally need an influx of debtor-in-possession ("DIP") financing, at the beginning of the case to reorganize and address the issues requiring the debtor to file bankruptcy. Debtors have been able to turn to prepetition lenders, with which they are familiar and frequently have extensive relationships, to fund their reorganization efforts. In return for the investment in a decidedly risky business, lenders have received better treatment of their funds, via priority or security in the debtor's assets. To date, prepetition lenders have often provided desperate debtors an influx of post-petition funds, for which some or all of the prepetition debt is rolled into a higher priority post-petition claim, i.e., a "roll-up".

The commission, however, has found roll-ups problematic, and suggests that large secured creditors have become an "elephant in the room" which control the post-petition debtor's actions. In order to "reduce barriers to entry by providing debtors more flexibility in arranging debtor in possession financing," the commission proposes to prohibit post-petition financing to debtors if the financing includes such a "roll-up" provision that translates pre-petition debts into post-petition debts, or includes any attempt to pay down prepetition amounts.

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Submit Article for the Business Bankruptcy Newsletter

The Business Bankruptcy Committee invites you to submit articles for possible publication in future issues. The articles do not need to be long or in-depth, and it is a great way to get involved in the Business Bankruptcy Committee. Articles can survey the law nationally or locally, discuss particular business bankruptcy issues, or examine a specific case. If you are interested in submitting an article, please contact Newsletter Editors-in-Chief Brett Fallon at bfallon@morrisjames.com or Mariaelena Gayo-Guitian at mguitian@gjb-law.com.
The Kathryn R. Heidt Memorial Award

Please consider nominating a worthy candidate for this prestigious award of honor of a past chair of the Business Bankruptcy Committee. Nominations are due August 30, 2015.
chapter 13 case, and the trustee (after paying the debtor's counsel) distributed the funds in her possession to creditors pursuant to the plan. Debtors thus could not strip down their mortgage; rather, the mortgage lien rode through the chapter 7 proceeding unaffected.

After Dewsnup, most courts agreed that its reasoning also applied to “strip offs”—cases in which a junior mortgage lien was entirely underwater because a senior mortgage exceeded the value of the collateral. In this case, however, the Eleventh Circuit disagreed, and held that “strip offs” were distinguishable from “strip downs” and that the Eleventh Circuit thus remained bound by its pre-Dewsnup precedent holding that such strip-offs were permissible. Bank of America sought certiorari. Before the Court, it argued that strip-offs of wholly underwater mortgages were no different than strip-downs of partially underwater mortgages under Dewsnup’s reasoning: in either case, the creditor’s claim remained secured by a lien in the ordinary sense of the phrase, and the lien thus could not be voided under section 506(d). In a unanimous decision, the Supreme Court agreed, holding that Dewsnup resolved the question presented and that the debtor's arguments for distinguishing the case were unpersuasive and would lead to anomalous results. The Court included a footnote, which Justices Kennedy, Breyer, and Sotomayor declined to join, noting that Dewsnup had been criticized but also that the debtor in Caulkett had not asked that Dewsnup be overruled. The Court did not, however, suggest what it might do were that question to arise.

Baker Botts L.L.P. v. ASARCO LLC, No. 14-103 (June 15, 2015). Baker Botts holds that, under section 330(a) of the Bankruptcy Code, bankruptcy courts may not award fees to professionals for defending fee applications. This case stemmed from the ASARCO bankruptcy, in which the debtor retained Baker Botts as counsel. ASARCO successfully reorganized and paid all the claims against it in full. When Baker Botts filed its fee application, reorganized ASARCO contested it; Baker Botts prevailed and was awarded approximately $124 million in fees. The bankruptcy court also awarded Baker Botts about $5 million for time spent defending its fee application. The question before the Supreme Court was the propriety of that award.

Section 330(a)(1) of the Bankruptcy Code provides that bankruptcy courts may award professionals retained by a trustee or debtor-in-possession “reasonable compensation for actual, necessary services rendered.” The Supreme Court explained that it construed that statutory provision against the backdrop of the American Rule, under which parties presumptively bear their own litigation costs absent “explicit statutory authority” to the contrary. The Court did not read section 330(a)(1) to displace the American Rule with respect to fees for defending a fee application. It reasoned that defending a fee application was not a “service rendered” to the estate. Accordingly, the Court held, bankruptcy courts could not award fees for such work.

Harris v. Viegelaehn, No. 14-400 (May 18, 2015). Harris holds that when a chapter 13 debtor makes payments to a trustee under a plan and the trustee is holding those payments when the debtor converts the case to a chapter 7 case, the trustee must return the payments to the debtor. In many jurisdictions, chapter 13 debtors make payments to their creditors under a confirmed plan through a chapter 13 trustee; debtors make one payment per month to the chapter 13 trustee, whom then distributes it to creditors according to the terms of the plan. In this case, the debtor confirmed a chapter 13 plan under which he proposed to cure a default on his mortgage. The plan provided for the debtor to make the cure payments, along with payments to other creditors, to the chapter 13 trustee. The debtor also intended to make his regular mortgage payments going forward directly to his mortgage lender, Chase Manhattan. However, the debtor once again defaulted on his mortgage payments, and Chase obtained relief from the automatic stay to foreclose on the debtor's house. The debtor nonetheless continued to make the cure payments to the chapter 13 trustee for about a year; the trustee held the payments previously earmarked for Chase and those funds accumulated in the trustee's account, reaching about $5500. The debtor then converted his chapter 13 case to a chapter 7 case, and the trustee (after paying the debtor’s counsel) distributed the funds in her possession to creditors pursuant to the plan.

The Court granted certiorari to resolve a circuit split over whether, in that situation, the trustee should distribute the funds to creditors or return them to the debtor. Although the Bankruptcy Code does not directly address that question, the Court reasoned that section 348(e) of the Code provided guidance. Section 348(e) provides that when a chapter 13 case is converted to chapter 7, only property in the debtor’s possession on the date of filing of the chapter 13 case—and not property the debtor acquires later, such as post-petition wages—becomes part of the
chapter 7 estate available to creditors. Its purpose is to ensure that debtors are not “penalized” for attempting chapter 13 by losing assets that would not have gone to creditors if the debtor had filed for chapter 7 in the first place. The Court reasoned that “[a]llowing a terminated Chapter 13 trustee to disburse the very same [post-petition] earnings to the very same creditors is incompatible with that statutory design.” The Court also reasoned that because conversion to chapter 7 terminates the services of a chapter 13 trustee, the trustee was not authorized to distribute funds to creditors under the terms of the chapter 13 plan. Accordingly, the court held, upon conversion to chapter 7, a chapter 13 trustee must return all the funds in her possession to the debtor.

_Bullard v. Blue Hills Bank_, No. 14-116 (May 4, 2015). Bullard holds that a bankruptcy court’s order denying confirmation of a chapter 13 plan is not a final, appealable order. The Court granted certiorari to resolve a significant circuit split on this question, which grew out of the complexity inherent in applying the final judgment rule to bankruptcy cases. Unlike a traditional lawsuit, in which the final judgment is typically easy to identify, bankruptcy cases present “an aggregation of individual controversies” between multiple parties, and aren’t resolved by a single final judgment. Accordingly, as the Court explained, “orders in bankruptcy cases may be immediately appealed if they finally dispose of discrete disputes within the larger case.” Specifically, the bankruptcy appeals statute authorizes appeals as of right from “final judgments, orders, and decrees … in cases and proceedings.” 28 U.S.C. § 158(a).

The question for the Court, therefore, was whether the denial of confirmation of a plan finally resolved a discrete proceeding. The Court held that it did not, and that denial of confirmation thus was not a “final” order appealable as of right. The Court reasoned that “[t]he relevant proceeding is the process of attempting to arrive at an approved plan that would allow the bankruptcy to move forward.” And it noted that an order confirming a plan—or dismissing a case—finally fixes the rights and obligations of the parties. By contrast, the Court reasoned, denial of confirmation does not: It does “rule out the specific arrangement of relief embodied in a particular plan. But that alone does not make the denial final.” The Court acknowledged that the debtor’s options for obtaining appellate review of the legal decisions embodied in an order denying a plan were “unappealing”: the debtor may either seek dismissal of the case and then appeal the dismissal—which would terminate the automatic stay—or propose a plan he does not want and then appeal from the confirmation of that plan. But the Court noted that the debtor could seek certification of an interlocutory appeal, and expressed its “expectation that lower courts will certify and accept interlocutory appeals from plan denials in appropriate cases.”
The Supreme Court Affirms Bankruptcy Court Jurisdiction for “Stern” Claims Based Upon Implied Consent

By Mark Felger and Keith Kleinman

In 2011, the U.S. Supreme Court issued its landmark *Stern v. Marshall* decision wherein it held that

Article III [of the U.S. Constitution] prevents [Article I] bankruptcy courts from entering final judgment on claims that seek only to augment the bankruptcy estate and would otherwise exist without regard to any bankruptcy proceeding.

Since the *Stern* decision was issued by the Supreme Court, it has been the subject of much scholarly debate and many court opinions addressing the scope and impact that it has on the jurisdiction of bankruptcy courts to enter final judgments. In particular, one question left open by the *Stern* decision was whether bankruptcy courts could enter final judgment on so-called *Stern* claims if the litigants consented to an adjudication by the bankruptcy court. In the recent *Wellness Int’l Network, Ltd. v. Sharif* decision, the Supreme Court ends the debate and explicitly affirmed that bankruptcy courts have jurisdiction to issue final judgments on *Stern* claims if the parties consent to the bankruptcy court adjudicating such claims.

Factual Background

In *Wellness*, the debtor, Richard Sharif, entered into a contract with Wellness International Network to distribute health and nutrition products for Wellness. Unfortunately, the relationship soured and Sharif sued Wellness in 2005 in a Texas district court. After Sharif repeatedly ignored discovery requests and other litigation obligations, the district court entered a default judgment in favor of Wellness, including $650,000 in attorney’s fees.

Before Wellness was able to collect on its judgment, in 2009, Sharif filed a Chapter 7 petition in the Northern District of Illinois. In Sharif’s bankruptcy case, Wellness commenced an adversary proceeding objecting to the discharge of Sharif’s debts and seeking a declaratory judgment that certain trust assets were property of the bankruptcy estate. In a familiar pattern, Sharif continued to evade discovery in the adversary proceeding. As a result, the bankruptcy court eventually entered a default judgment against Sharif, which included a declaration that the subject trust assets were property of the bankruptcy estate.

Sharif appealed the decision to the district court. Prior to the district court deciding the case, the Supreme Court issued its *Stern* decision. Although Sharif did not timely raise an objection to the bankruptcy court’s judgment based on *Stern*, he filed a motion for supplemental briefing wherein he argued that the bankruptcy court’s judgment should only be treated as a recommendation. However, the district court denied Sharif’s motion as untimely and affirmed the bankruptcy court’s judgment.

On appeal to the Seventh Circuit, the circuit court concluded that the bankruptcy court’s judgment with regards to the trust assets was a *Stern* claim and that Sharif could not have waived his *Stern* objection, because such objections concerned the underlying separation-of-powers between Article III district courts and Article I bankruptcy courts. Accordingly, the Seventh Circuit reversed the bankruptcy court’s decision on the *Stern* claim, finding that it lacked constitutional authority to enter a final judgment on the claim. The Supreme Court granted certiorari to address whether bankruptcy courts can obtain jurisdiction to enter a final judgment on so-called *Stern* claims based upon the consent of the parties.

The Supreme Court Affirms Jurisdiction of Bankruptcy Courts to Enter Final Judgment on “Stern Claims” Based on Consent of Parties

Justice Sotomayor delivered the opinion of the Court, in which Justices Kennedy, Ginsburg, Beyer and Kagan joined, and Alito concurred in part and concurred in the judgment. In reversing the Seventh Circuit, the majority opinion first discussed the long standing history of adjudication by consent in the federal judiciary. As the majority opinion stated, case law clearly shows that “[t]he entitlement to an Article III adjudicator is a personal right and thus ordinarily subject to waiver.”

The majority opinion then went on to explain that allowing bankruptcy courts to decide *Stern* claims by consent would not impermissibly threaten the institutional integrity of the judicial branch. Among other reasons, bankruptcy courts are appointed and subject to removal by Article III judges and serve as a unit of the district courts. Instead of substantially increasing the numbers of district courts, “Congress has supplemented the capacity of district courts through the able assistance of bankruptcy judges. So long as those judges are subject to control by the Article III courts, their work poses no threat to the separation of powers.” Hence, “allowing bankruptcy litigants to waive the right to Article III adjudication of *Stern* claims does not usurp the constitutional prerogative of Article III courts.”

The majority opinion then continued by distinguishing the Court’s *Stern* decision and other cases that have denied bankruptcy courts’ constitutional jurisdiction to decide certain claims by explaining that such decisions were...
premised on non-consent to adjudication. Furthermore, “[a]n expansive reading of Stern . . . would be inconsistent with the opinion’s own description of its holding,” which stated that it did not change much “about the division of labor between district courts and bankruptcy courts.”vii Therefore, the Court held that “Article III permits bankruptcy courts to decide Stern claims submitted to them by consent.”viii

Finally, the majority opinion explained that such consent need not be expressly given. Consent can be implied as long as it is knowingly and voluntarily given. “[T]he key inquiry is whether ‘the litigant or counsel was made aware of the need for consent and the right to refuse it, and still voluntarily appeared to try the case’ before” the non-Article III bankruptcy court judge.ix The Court then remanded the case to the Seventh Circuit to determine, based on the facts of the case, whether Sharif had sufficiently consented to the bankruptcy court entering a final judgment on the Stern claim.

Justice Alito’s Concurrence and Chief Justice Roberts’ Dissent Provide Insight for Future Stern Objections

Although Justice Alito agreed with the majority’s judgment, he wrote a concurring opinion to explain that he would not have decided the issue of whether consent to a bankruptcy court’s adjudication of Stern claims may be implied. Instead, he would have relied on the fact that Sharif forfeited any Stern objection by failing to present that argument properly in the lower courts. Accordingly, the majority’s opinion on implied consent only received a 5-4 majority.

In addition, Justice Roberts, who wrote the Court’s Stern decision, wrote a dissenting opinion wherein he specifically disagreed that the Stern decision was based on lack of consent. As Justice Roberts stated, “[p]ut simply, the litigant in Stern did not consent because he could not consent given the nature of bankruptcy.”x

Maybe more importantly, Justice Roberts also stated that he would have decided the Wellness case on a “narrower basis,” and found that the subject claim in Wellness was not a Stern claim at all. As Justice Roberts explained,

Wellness asked the Bankruptcy Court to declare that assets held by Sharif are part of [the] res [of the bankruptcy estate]. Defining what constitutes the estate is the necessary starting point of every bankruptcy; a court cannot divide up the estate without first knowing what’s in it.xi

Justice Roberts then went on to distinguish the claim in Wellness, which sought a determination that assets in the debtor’s possession were estate assets, from fraudulent conveyance actions that seek the return of assets in the hands of a non-debtor third party and/or claims like breach of contract and tort claims that do not stem from the bankruptcy itself and are based on an independent source of law.

Take Aways

The majority opinion in Wellness has definitively authorized bankruptcy courts to decide so-called Stern claims based on the consent of the litigants. Additionally, the majority opinion went so far as to hold that such consent may be implied, provided it is knowing and voluntary. While the issue of what qualifies as implied consent will be a new battleground for litigants, the Wellness decision provides greater certainty and stability for those that litigate in the bankruptcy courts.

3 Id. at 1939.
4 Id. at 1944 (quoting Commodity Futures Trading Comm’n v. Schor, 478 U.S. 833, 848 (1986)).
5 Id. at 1946.
6 Id. at 1944-45.
7 Id. at 1946-47 (citations omitted).
8 Id. at 1949.
9 Id. at 1952.
10 Id. at 1952.
11 Id. at 1957.
12 Id. at 1958.
13 Id. at 1959.
14 Id. at 1960.
15 Id. at 1961.
16 Id. at 1962.
17 Id. at 1963.
18 Id. at 1964.
19 Id. at 1965.
20 Id. at 1966.
21 Id. at 1967.
22 Id. at 1968.
23 Id. at 1969.
24 Id. at 1970.
25 Id. at 1971.
26 Id. at 1972.
27 Id. at 1973.
28 Id. at 1974.
29 Id. at 1975.
30 Id. at 1976.
31 Id. at 1977.
32 Id. at 1978.
33 Id. at 1979.
34 Id. at 1980.
35 Id. at 1981.
36 Id. at 1982.
37 Id. at 1983.
38 Id. at 1984.
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42 Id. at 1988.
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49 Id. at 1995.
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132 Id. at 2078.
133 Id. at 2079.
134 Id. at 2080.
135 Id. at 2081.
136 Id. at 2082.
137 Id. at 2083.
138 Id. at 2084.
139 Id. at 2085.
140 Id. at 2086.
141 Id. at 2087.
142 Id. at 2088.
143 Id. at 2089.
144 Id. at 2090.
145 Id. at 2091.
146 Id. at 2092.
147 Id. at 2093.
148 Id. at 2094.
149 Id. at 2095.
150 Id. at 2096.
151 Id. at 2097.
152 Id. at 2098.
153 Id. at 2099.
154 Id. at 2100.
155 Id. at 2101.
156 Id. at 2102.
How much “structure” may there be in a “structured” dismissal? The answer, according to a recent—and split—opinion of the U.S. Court of Appeals for the Third Circuit is “quite a bit.” In re Jevic Holding Corp., __F.3d __, No. 14-1465 (3d Cir. May 21, 2015). Specifically, bankruptcy courts may, “in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code’s priority scheme,” provided that the dismissal is warranted by “specific and credible grounds.” Id., slip. op. at 15, 23-24. While Jevic raises several important and novel questions, the most significant from the practitioner’s perspective will be sorting out its reasoning, determining what made Jevic “rare,” and therefore defining the class of future cases to which it applies.

**Background.**

Jevic, a trucking company headquartered in New Jersey, was acquired in a leveraged buyout (LBO) by Sun Capital that was financed by CIT. Id. at 5. When the company went into bankruptcy, its drivers sued Jevic and Sun for violating state and federal Worker Adjustment, Retraining and Notification (WARN) Acts (29 U.S.C. § 2102; N.J. Stat. Ann. § 34:21-2), and its creditors committee sued the LBO participants, claiming that the transaction was a fraudulent transfer. Id. at 6.

After three years of litigation, the Bankruptcy Court for the District of Delaware (Judge Shannon) granted in part and denied in part CIT’s motion to dismiss the fraudulent transfer suit, holding that the committee had adequately pleaded claims under Bankruptcy Code section 548 and was permitted to replead claims under section 544. Id. at 6-7 (citing In re Jevic Holding Corp, 492 B.R. 416, 433 (Bankr. D. Del. 2011)).

Thereafter, the major parties met to discuss settlement of the fraudulent transfer suit. They agreed, in pertinent part, that (1) the committee, Jevic, CIT and Sun would release one another, and (2) CIT would fund a distribution of about 4% to general unsecured creditors, after paying the committee’s legal fees and other administrative expenses. Id. at 7-8 & n. 1. The parties thus contemplated a “structured dismissal,” “a disposition that winds up the bankruptcy with certain conditions attached instead of simply dismissing the case and restoring the status quo ante.” Id. at 8 (citation omitted).

As the court noted, there remained “just one problem with the settlement: it left out the [d]rivers, even though they had an uncontested WARN Act claim against Jevic,” which they estimated to be worth $12.4 million, and of which $8.3 million would have been entitled to priority over general unsecured claims as unpaid wages. Id. at 9 (citing In re Powermate Holding Corp., 394 B.R. 765, 773 (Bankr. D. Del. 2008) (“Courts have consistently held that WARN Act damages are within ‘the nature of wages’ for which § 507(a)(4) provides”)).

The drivers and the United States Trustee objected to the proposed settlement, “mainly because it distributed property of the estate to creditors of lower priority than the [d]rivers under § 507 of the Bankruptcy Code.” Id. at 10. Although the bankruptcy court recognized that no explicit provision of the Bankruptcy Code authorized the structured dismissal, “the dire circumstances that are present in this case warrant the relief requested by the Debtor, the Committee and the secured lenders.” Id. at 11 (quoting App. 31). These “dire circumstances” included the fact that there was “no realistic prospect” of a meaningful distribution to anyone but the secured creditors unless the settlement was approved because the traditional routes out of Chapter 11 bankruptcy were impracticable. Id. at 11.

Over the objection that the settlement violated “the [Bankruptcy] Code’s ‘absolute priority rule,’” the bankruptcy court approved the dismissal as a settlement governed by Federal Rule of Bankruptcy Procedure 9019 and In re Martin. Id. at 11-12 (citing In re Martin, 91 F.3d 389 (3d. Cir. 1996)).

After being affirmed by the United States District Court for the District of Delaware (id. at 12-13, citing In re Jevic Holding Corp., 2014 WL 268613 ) (D. Del. 2014)), the drivers appealed to the U.S. Court of Appeals for the Third Circuit, supported by the Office of the United States Trustee as amicus curiae. Id. at 13.

**The Third Circuit’s Analysis**

The Third Circuit analyzed two related issues: (1) whether the bankruptcy court had the power to approve this settlement, and (2) if so, whether the structured dismissal could permit this deviation from “absolute priority.”

Judge Hardiman, writing for himself and Judge Barry, had little trouble answering the first question affirmatively. Although the majority acknowledged that “the Code does not expressly authorize structured dismissals” (id. at 16), it viewed them as “simply dismissals that are preceded by other orders of the bankruptcy court.” Id. at 16-17. While section 349 of the Bankruptcy Code “contemplates that dismissal will typically reinstate the prepetition state of affairs by revesting property in the debtor and vacating orders and judgments of the bankruptcy court, it also explicitly authorizes the bankruptcy court to alter the effect of dismissal ‘for cause’”—in other words, the Code does not strictly require dismissal of a Chapter 11 case to be a hard reset.” Id. at 17 (citations omitted).
More important than authority per se was the second question: approval of this particular settlement, with its “priority skipping” distribution to general unsecured creditors. The majority concluded that while it was “a close call” (id. at 24), the deviation from “absolute priority” was permissible under these circumstances.

The court compared the two leading opinions on the priority of distributions in structured settlements, In re AWECO, Inc., 725 F.2d 293 (5th Cir. 1984), and In re Iridium Operating LLC, 478 F.3d 452 (2d Cir. 2007). In AWECO, the Court of Appeals for the Fifth Circuit rejected a settlement of a lawsuit against a chapter 11 debtor that would have transferred $5.3 million in estate assets to an unsecured creditor despite the existence of outstanding senior claims. AWECO, 725 F.2d at 295–96. The Fifth Circuit held that the “fair and equitable” standard applies to settlements, and “fair and equitable” means compliant with the priority system.” Id. at 298.

In Iridium, the Second Circuit also refused to approve a priority-skipping settlement, but announced a different test than the one used by AWECO. In Iridium, the unsecured creditors’ committee sought to settle a suit it had brought on the estate’s behalf against a group of secured lenders that would have split the estate’s cash between the lenders and a litigation trust set up to fund a suit against Motorola, a priority administrative creditor and the debtor’s former corporate parent. Iridium, 478 F.3d at 456, 459–60. Motorola objected to the settlement, arguing that the distribution violated priority by skipping Motorola and distributing funds to lower-priority creditors. Id. at 456.

Rejecting the approach taken by the Fifth Circuit in AWECO as “too rigid,” the Second Circuit held in Iridium that the absolute priority rule “is not necessarily implicated” when “a settlement is presented for court approval apart from a reorganization plan.” Id. at 463–64. The Second Circuit Court of Appeals instead held that “whether a particular settlement’s distribution scheme complies with the Code’s priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is ‘fair and equitable’ under Rule 9019,” but a noncompliant settlement could be approved when “the remaining factors weigh heavily in favor of approving a settlement[,]” Id. at 464. Although the deviation from priority was problematic, the Second Circuit remanded the settlement to the bankruptcy court for further determinations.

In Jevic, Judge Hardiman agreed with the Second Circuit’s approach in Iridium because, “as in other areas of the law, settlements are favored in bankruptcy.” Jevic, slip op. at 22. The majority acknowledged that “compliance with the Code’s priorities will usually be dispositive of whether a settlement is fair and equitable” because “[s]ettlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals.” Id. at 23 (citing Iridium, 478 F.3d at 464). Although the court concluded that the absolute priority rules “do[es] not extend to . . . settlements in bankruptcy, we think that the policy underlying the rule—ensuring the evenhanded and predictable treatment of creditors—applies in the settlement context.” Id. at 23.

Judge Scirica concurred in part and dissented in part. He construed the facts of the case differently than the majority, questioning whether “this appeal presents an extraordinary case where departure from the general rule is warranted.” Id. at 1 (Scirica, J., dissenting). In part, this was because he was not persuaded that a Chapter 7 liquidation was the only alternative to this particular settlement. More fundamentally, he reasoned, the settlement failed to advance one of the Bankruptcy Code’s “core goals[,] to maximize the value of the bankruptcy estate.” Id. at 2 (citing Toibb v. Radloff, 501 U.S. 157, 163 (1991)). “Here,” he observed, “it is difficult to see how the settlement is directed at estate-value maximization. Rather, the settlement deviates from the Code’s priority scheme so as to maximize the recovery that certain creditors receive, some of whom (the unsecured creditors) would not have been entitled to recover anything in advance of [the drivers].” Id. at 3.

Judge Scirica also observed that the structured dismissal implicated the “sub rosa” plan doctrine. Under this doctrine, sales of assets (or other actions) that have “the practical effect of dictating some of the terms of any future reorganization plan” are impermissible because they “short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan sub rosa in connection with a sale of assets.” Id. at 4 (quoting In re Braniff Airways, Inc., 700 F.2d 935 (5th Cir. 1983)). Although Judge Scirica recognized that this settlement did not dictate the terms of a reorganization plan, “the broader concerns underlying the sub rosa doctrine are at play” because the settlement “reallocated assets of the estate in a way that would not have been possible without the authority conferred upon the creditors’ committee by Chapter 11.” Id. at 5. Yet, the settlement here “failed to observe Chapter 11’s ‘safeguards of disclosure, voting, acceptance and confirmation.’” Id. at 5 (quoting In re Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1982)).

Judge Scirica also focused on the “[c]ritical . . . fact that the money paid by the secured creditors in the settlement was property of the estate” as proceeds of the fraudulent transfer cause of action. Id. at 5-6 (citations omitted). Thus, he reasoned, this was not like a “gift plan” where senior claimants “give” their property (not estate property) to junior claimants in order to procure a vote for a proposed reorganization plan. Id. at 6 (citations omitted). Rather, he reasoned that this case was closer to a section 363 asset sale “where the proceeds from the debtor’s assets are distributed directly to certain creditors, rather than the bankruptcy estate.” Id. at 6 (citation omitted). “It is,” he concluded, “doubtful that such an arrangement would be permissible.” Id. at 7.
Discussion

The Jevic majority opinion presents at least three questions. First, it is not clear whether (or to what extent) priority rules under the Bankruptcy Code should apply in structured settlements. On one hand, the Jevic majority stated that the absolute priority rule “does not extend to . . . settlements in bankruptcy.” Id. at 23. This, of course, may be true in the sense that Federal Rule of Bankruptcy Procedure 9019 says nothing about priority at all, and the “absolute priority rule” applies under the Code to cramdown plans—not dismissals. 11 U.S.C. § 1129(b). On the other hand, it relies on Iridium to support its conclusion that this deviation from the Bankruptcy Code’s priority structure was permissible. Id. at 22-23. Yet, Iridium viewed deviations from “absolute priority” with far greater concern than Judge Hardiman. Because the majority did not dispute that section 507 applied in this case (via section 103), the authority for “priority skipping” is simply unclear. Id. at 18.

Second, this lack of clarity makes it difficult to know what made the deviation permissible in this case, and thus what characteristics will permit it in future cases. The majority sought to limit the scope of the ruling, stating that such deviations are permissible only “in rare instances like this one,” where warranted by “specific and credible grounds.” Id. at 15, 23-24. Yet, it is not clear what cases will be “like” Jevic, or when they will be “rare.” Many cases involve failed leveraged buyouts, followed by fraudulent transfer suits that are then settled. Jonathan C. Lipson & Jennifer L. Vandermeuse, Stern, Seriously: The Article I Judicial Power, Fraudulent Transfers, and Leveraged Buyouts, 2013 Wis. L. Rev. 1161. Many cases involve prepetition lenders (here, CIT) that “roll up” their prepetition loan into post-petition debtor-in-possession financing, which may have the effect of giving the prepetition lender super-priority liens. See, e.g., Resolution Trust Corp. v. Official Unsecured Creditors Comm. (In re Defender Drug Stores), 145 B.R. 312, 316 (B.A.P. 9th Cir. 1992) (“Bankruptcy courts...have regularly authorized postpetition financing arrangements containing lender incentives beyond the explicit priorities and liens specified in section 364.”). Is the deviation from priority justified in any case with such facts? The court characterized the debtor’s situation as “dire” (In re Jevic Holding Corp., slip op. at 11), yet negotiations had gone on for at least two years. How “dire” was the situation? While the majority may wish to limit Jevic’s reach, it offered little guidance on how to do so. Given the fairly common facts of the case, it is not clear how or why its form of dismissal should be "rare."

Third, the majority ignored the effect that the structured dismissal had on the fraudulent transfer claim the drivers would otherwise have had. Although not discussed in the opinion, the order of dismissal in fact would apparently prevent the drivers from pursuing the fraudulent transfer claim outside bankruptcy. This is because the dismissal barred any prosecution of the fraudulent transfer suit—even outside bankruptcy—by dismissing the complaint with prejudice and providing that all orders entered in the bankruptcy case would remain "in full force and effect," “specifically preserved for purposes of finality of judgments and res judicata.” Order Granting Joint Motion at 7, In re Jevic Holding Corp., 492 B.R. 416 (Bankr. D. Del. Dec. 4, 2012). This overrides that portion of section 349 which provides that dismissal “revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case under this title.” 11 U.S.C. § 349(b)(3).

Here, the “entity” in which the fraudulent transfer claim should have revested would have been dissenting creditors—the truckers. While the Bankruptcy Code permits an order of dismissal to deviate from revesting "for cause," the Jevic opinion fails to tell us what the "cause" was to deprive the drivers of a right to recovery they may have had outside of bankruptcy under applicable fraudulent transfer law. Judge Shannon initially seems to have thought the suit had some merit, denying motions to dismiss the fraudulent transfer suit. Later, at the case-dismissal hearing, he seems to have changed his mind. Any lawyer that took that suit on contingency, he said, “should have his head examined.” Transcript of Record at 13-14, In re Jevic Holding Corp., 492 B.R. 416 (Bankr. D. Del. Nov. 28, 2012). Is the bankruptcy judge’s ambivalence about the merits of a suit—prior to discovery—"cause" to grant a third-party discharge of liability, as the Jevic dismissal does?

The Third Circuit majority emphasized that Sun refused to settle in a way that would have funded litigation by the drivers against Sun for violating the WARN Act. In re Jevic Holding Corp., slip op. at 8. Yet, the bankruptcy court ultimately ruled that Sun had no WARN Act exposure to the drivers. While it is certainly understandable that parties may not wish to fund adversaries’ litigations, this is a common problem in bankruptcy and is often present when there is a “carve out” of collateral to fund estate investigations and litigations. Is every desire to avoid funding adverse litigation “cause” to deprive creditors of causes of action they would have outside of bankruptcy? The Jevic majority does not say. Of course, it is not clear whether the drivers could win a fraudulent transfer suit today for a

Conclusion

Jevic is likely to be a controversial opinion, as it appears to have the effect of expanding the use of structured dismissals over the objections of dissenting priority creditors without clearly setting limiting principles. While it purports to be narrow, it would seem to invite further litigation to test its boundaries.
Strictly speaking, this is not quite correct, as section 349 is not limited to revesting property in the debtor. Rather, as discussed further below, section 349 provides in pertinent part: “Unless the court, for cause, orders otherwise, a dismissal of a case . . . (3) revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case under this title.” 11 U.S.C. § 349 (emphasis supplied). The fraudulent transfer claim would have been property of Jevic’s creditors—not Jevic.

The rule provides in pertinent part: “On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement. Notice shall be given to creditors, the United States trustee, the debtor, and indenture trustees as provided in Rule 2002 and to any other entity as the court may direct.” Fed. R. Bankr. P. 9019(a).
The pendency of the appeal. The court may not, however, alter, expand or supplement a final ruling that is on appeal. The court retains authority to stay or enforce a final order until leave to appeal has been granted. Other attributes of the appealed order, such as the authority to stay or enforce a final order and, naturally, retains authority over all aspects of the case that are not matters related to the appeal. Generally, an appeal from a final order confers exclusive jurisdiction in the appellate court over the issues that are the subject of the appeal. The bankruptcy court is thus deprived of any further authority to determine motions that would affect the status quo of the issues on appeal. See Griggs v. Provident Consumer Discount Co., 459 U.S. 56, 58 (1982) (per curiam) ("The filing of a notice of appeal is an event of jurisdictional significance—it confers jurisdiction on the court of appeals and divests the district court of its control over those aspects of the case involved in the appeal."). This doctrine is designed to minimize the confusion that might arise if two courts simultaneously acted on the same matter.

Bankruptcy Rule 8008 now permits the bankruptcy court, under certain circumstances, to entertain a motion that the court would otherwise lack authority to determine because it has been divested of jurisdiction due to an appeal. The new rule is patterned on existing procedures applicable in the civil context. See Fed. R. Civ. Proc. 62.1 (adopted in 2009); Crateo, Inc. v. Intermark Inc., 536 F.2d 862 (9th Cir. 1976). Essentially, the rule permits the bankruptcy court and the appellate court to share jurisdiction over the matters subject to appeal. This shared jurisdiction may enable the bankruptcy court to dispose of an appeal despite the shift of jurisdiction to the appellate forum, thereby promoting the "just, speedy and inexpensive determination of every case and proceeding." See Fed. R. Bankr. Proc. 1001.

Under the new rule, the bankruptcy court retains the authority to address a timely motion for relief, that the court might otherwise be unable to consider because of a pending appeal, in one of three ways: (a) defer consideration of the motion, (b) deny the motion, or (c) indicate either that it would grant the motion if the appellate court remanded for that purpose, or that the motion "raises a substantial issue." Bankruptcy Rule 8008(a). If the bankruptcy court issues an indicative ruling under the third option, it must promptly notify the clerk of the court where the appeal is pending (i.e., the district court, the bankruptcy appellate panel—BAP—or the court of appeals). Bankruptcy Rule 8008(b). The "substantial issue" indication, while not elaborated upon by the Advisory Committee notes to the new rule, is modeled on existing Civil Rule 62.1. There, the committee notes reveal that a "motion may present complex issues that require extensive litigation.... In such circumstances, the district court may prefer to state that the motion raises a substantial issue, and to state the reasons why it prefers to decide only if the court of appeal agrees that it would be useful to decide the motion before decision of the pending appeal." But the court is not bound to grant the motion if it indicates that the motion raises a substantial issue, rather, "further proceedings on remand may show that the motion ought not to be granted."

Once notified of the bankruptcy court's indicative ruling, the district court or the BAP has the ability to partially remand the appeal for further proceedings in the bankruptcy court yet retain continuing jurisdiction over the appeal. (If the indicative ruling affects an appeal pending before the court of appeals then Federal Rules of Appellate Procedure 6 and 12.1 govern the procedure following notification of an indicative ruling.) Alternatively, the appellate court may determine to effectively remand all proceedings by expressly dismissing the appeal. The Advisory Committee notes to the new rule suggest, however, that the appellate court should only dismiss the appeal "when the appellant has clearly stated its intention to abandon the appeal" (perhaps, for instance, if a post-appeal settlement among the parties has been reached). If the appeal is partially remanded, the parties must notify the clerk of the appellate court once the bankruptcy court has decided the underlying motion for relief that triggered the indicative ruling. Bankruptcy Rule 8008(c).

The Advisory Committee notes clarify that the new rule is not intended to "define the circumstances in which an appeal limits or defeats the bankruptcy court's authority to act in the face of a pending appeal." Indeed, the ouster of the bankruptcy court's jurisdiction following an appeal is not all-encompassing. A bankruptcy court retains the authority to stay or enforce a final order and, naturally, retains authority over all aspects of the case that are not related to the appeal. Appeals from interlocutory orders, moreover, do not deprive the bankruptcy court from modifying the order until leave to appeal has been granted. Other attributes of the appealed order, such as the correction of clerical mistakes or the award of costs or sanctions, may also proceed in the bankruptcy court despite the pendency of the appeal. The court may not, however, alter, expand or supplement a final ruling that is on appeal.
Moreover, existing Bankruptcy Rule 8002(c) already identifies various motions that, if timely filed, “suspend the effect of a notice of appeal filed before the last such motion is resolved.” In these instances, the bankruptcy court has the ability to resolve such motions “without resorting to the indicative ruling procedure.” Thus, for example, if a party files a Civil Rule 60(b) motion for relief from a final judgment (due to mistake or newly discovered evidence), within 14 days after the judgment is entered (the same deadline for filing a notice of appeal), Bankruptcy Rule 8002(b)(2) preserves jurisdiction in the bankruptcy court to determine the motion despite the timely docketing of an appeal. The appeal only becomes effective, and jurisdiction is divested, when the order disposing of such Civil Rule 60(b) motion is entered. But if a Civil Rule 60(b) motion is filed after the 14-day deadline under Bankruptcy Rule 8002(b)(1)(D), which is possible under the separate, longer deadlines for a Civil Rule 60(b) motion, the indicative ruling procedure may nonetheless permit the bankruptcy court to entertain the motion. In fact, a 2014 amendment to Bankruptcy Rule 9024, which incorporates Civil Rule 60 in cases under the Bankruptcy Code, states that in “some circumstances, Rule 8008 governs post-judgment motion practice after an appeal has been docketed and is pending.”

A similar change was made to Bankruptcy Rule 9023, which incorporates Civil Rule 59, addressing a motion for a new trial or to alter or amend a judgment. But, Bankruptcy Rule 9023 expressly requires that a Civil Rule 59 motion be filed within 14 days after entry of judgment (the same deadline for filing the notice of appeal). If timely filed, thus, the bankruptcy court would not need to use the indicative procedure in order to consider the Civil Rule 59 motion. This is because, as noted above, Bankruptcy Rule 8002(b)(2) tolls the effectiveness of the appeal until such Civil Rule 59 motion is disposed of. Oddly, thus—despite the 2014 change to Bankruptcy Rule 9023—there would seem to be no circumstances under which the Bankruptcy Rule 8008 indicative ruling procedure could ever be used to address a Civil Rule 59 motion because it would be untimely if filed more than 14 days after entry of judgment. Bankruptcy Rule 8008(a) only permits the indicative ruling procedure to be used if the underlying motion is “timely.” By contrast, Civil Rule 60(b) has much longer deadlines—a “reasonable time” or, for grounds such as mistake or fraud, within one year after entry of judgment.

The use of Bankruptcy Rule 8008 may also gain traction in the context of motions to reconsider orders allowing or disallowing claims under Bankruptcy Rule 3008. The reconsideration of claims requires an underlying motion made pursuant to Civil Rules 59 and 60. Recently, Bankruptcy Judge Dennis Montali of the Northern District of California followed the new Bankruptcy Rule 8008 procedure to address a motion to reconsider the disallowance of claims in the Heller Ehrman chapter 11 case. See Order Denying Request for Indicative Ruling, In re Heller Ehrman, LLP, Case No. 08-32514, Docket No. 368, Bankr. N.D. Cal. (May 13, 2015). As noted, under Bankruptcy Rule 8008 the bankruptcy court now retains jurisdiction in order to, among other options, “deny” a timely motion for relief from the order on appeal. Here, Judge Montali determined that certain “newly discovered” evidence did not meet the standard for relief under Civil Rule 60(b)(2).

Aside from the bankruptcy court’s ability to deal with these types of post-judgment motions, new Bankruptcy Rule 8008 may also clarify the procedure to be followed when the parties reach a settlement that requires approval under Bankruptcy Rule 9019. Although this question is open to debate, some bankruptcy courts have expressed reservations about their authority to hear and determine the merits of a settlement when the dispute is subject to a pending appeal. Bankruptcy Rule 8008 now permits the settling appellant to request an indicative ruling that would allow the appellate forum to remand the appeal to permit consideration of a settlement that, if approved, would entail a dismissal. Other bankruptcy courts have not felt constrained from acting on settlement motions despite the absence of a limited remand from the appellate forum. After all, if the appellant is prepared to dismiss the appeal under the compromise, the proposed settlement might be viewed as a matter “in aid of” the disposition of the appeal (another category of actions that many trial courts recognize they retain jurisdiction to decide notwithstanding an appeal).

The clear procedures set forth in new Bankruptcy Rule 8008 will undoubtedly assist the coordination of proceedings in the bankruptcy court and the appellate court. The rule will also help dispel doubts over the scope of the bankruptcy court’s continuing jurisdiction to decide certain post-appeal matters. It will be very interesting to follow the myriad factual patterns that may invoke this new indicative ruling procedure.

1 The Bankruptcy Rules also include forms prescribed by the Judicial Conference of the United States, known as the Official Bankruptcy Forms, whose use is required pursuant to Bankruptcy Rule 9009. The Bankruptcy Rules also incorporate and adopt, at various rules, selected Federal Rules of Civil Procedure. See Fed. R. Bankr. Proc. 9032. Moreover, pursuant to Bankruptcy Rule 9029, each district court may make and amend (or authorize the bankruptcy judges of the district to make or amend) additional local rules governing practice and procedure in all cases and proceedings within the district court’s bankruptcy jurisdiction.
Gaming Goodwill: Can Personal Goodwill be Used as an Asset Protection Tool?
By Jeffrey M. Sklarz, Esq.

When a business performs profitably, the whole firm is more valuable than the sum of the individual parts, such as physical assets, work force, and intellectual property. The value of a business in excess of physical assets and based on its ongoing operations is known as “goodwill.” All businesses rely on key employees or owners to create revenue and, hence, goodwill. Companies of all sizes, but particularly closely held companies and service businesses, depend on the personal relationships and reputation of their owners and employees. Accordingly, over the years, the concept of goodwill has been further refined to distinguish between “enterprise goodwill” or “business goodwill,” the going concern value of the business; and “personal goodwill” or “individual goodwill,” the value of an owner’s or employee’s personal relationships and abilities, which are not considered an asset of the business. How to value personal goodwill has presented courts and practitioners with a complex and, often, controversial issue.

Theories distinguishing between personal and enterprise goodwill first arose in the context of tax reduction strategies and divorce law valuation litigation. From a tax perspective, the question was whether, during the sale of a business, the transfer of personal goodwill could be valued and allocated separate and apart from the enterprise goodwill. If allowable the owner may be entitled to special tax treatment, rendering such allocations lucrative. In the divorce context, the issue was whether personal goodwill (in the form of future cash flow generated by an income stream connected to the individual) should be included in the value of a business for purposes of an equitable division of marital property.

More recently, the concept of personal goodwill has permeated into the creditor-debtor world. Two broad sets of issues arise when personal goodwill and creditor-debtor law mix: (1) if a distressed business is sold, can personal goodwill be transferred outside of the asset purchase agreement, thereby permitting equity holders (or even employees) to receive payments on account of personal goodwill ahead of creditors and (2) is personal goodwill an asset of a bankruptcy estate under § 541 of the Bankruptcy Code? To answer these questions, one must first understand the nature of personal goodwill.

A Primer on Personal Goodwill

While personal goodwill received some recognition prior to 1986, particularly with the transfer of professional practices, its treatment as an asset class in commercial businesses gained prominence in the Tax Court case of *Martin Ice Cream v. Commissioner*, 110 T.C. 189 (1998). In *Martin Ice Cream*, the Internal Revenue Service sought to assess additional taxes on a business sale by recharacterizing a payment allocation as enterprise goodwill instead of personal goodwill.

There, the Tax Court held that, because a corporation (Martin Ice Cream) had no employment contract or covenant not to compete with an employee-owner (Arnold Strassberg, sole owner of Martin Ice Cream), the employee's personal relationships are not corporate assets: “[t]his Court has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill.” *Id.* at 207.

Thus, when the owner sold his interest, the Tax Court held that the intangible assets embodied by the seller’s personal relationships were owned at all times by Arnold. The decision recites its rationale in great detail, but most significant was that Arnold built the distribution business based on years of personal relationships. The success of the business depended entirely on Arnold, and ownership of the intangible asset could not be attributed to the corporation because Arnold never entered into a covenant not to compete or other agreement to transfer the asset to the corporation. The Tax Court stated it has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of enterprise goodwill. On the sale of his company, the value of the seller’s personal goodwill was not included in the purchase price for tax purposes, and the Tax Court rejected the IRS’ position that the “true seller” of the asset (personal goodwill) was the business.

In contrast, *Muskat v. U.S.*, 554 F.3d 183 (1st Cir. 2009) illustrates when personal goodwill does not exist, other than as a contrivance for tax avoidance purposes. *Muskat* involved the sale of a family owned business. At the time of the sale, the owner/founder was the CEO, owned 37% of the shares of stock, and for 30 years had developed valuable relationships with customers. In negotiating the sale, the owner/founder received payments in addition to payment for corporate assets. The owner/founder filed a tax return characterizing a payment on a non-competitive agreement as ordinary income but then filed an amended return claiming a refund on the basis that the payment was compensation for personal goodwill and should have been characterized as capital gain. The District Court disallowed the refund claim and the First Circuit affirmed. The First Circuit held the owner/founder’s attempt to alter the allocation agreed upon by the parties required “strong proof,” and the taxpayer did not satisfy that requirement. It noted the asset purchase agreement allocated almost $16,000,000 to the corporation’s goodwill and during the
reached on the value of the practice under the Chapter 11 plan and the court held a valuation hearing. A letter of intent to sell his practice to another dentist for between $450,000 and $500,000. No agreement could be
corporation. There was no covenant not to compete. The bankruptcy plan provided that to retain the dental practice,
time of the filing Dr. Prince (the husband) was the sole owner of his dental practice, organized as a professional
Matter of Prince

Several cases illustrate the struggle parties and courts have when determining how to assign value to
relationships as between the business and owner should be indistinguishable. (personal goodwill) or the phone number and location (enterprise goodwill)?

A key to distinguishing personal goodwill from enterprise goodwill involves the incidents of ownership and
the degree of control the individual possesses over business relationships. In Martin Ice Cream, the owner did not
have an employment contract, restriction on alienation of ownership, or covenant not to compete. Prior to the sale
there was a negotiated arm's-length transaction and a valuation of the personal goodwill as part of the deal structure.
Moreover, Martin Ice Cream is a particularly important case because it demonstrates that personal goodwill can exist
outside of professional service businesses (law, accounting, medicine, dentistry, etc.). In contrast, in Muskat,
personal goodwill was an afterthought, contrived to reduce taxes. The question, of course, is how far can the ruling in
Martin Ice Cream be extended?

The concept of personal goodwill also developed within the family law context. There, one spouse sought to
avoid (or obtain) a property settlement based on the argument that personal goodwill is not (or is) subject to equitable
division or community property laws. Thus, unlike the tax arena, valuations of personal goodwill arise forensically
rather than as part of the structure of a deal.

In Eslami v. Eslami, 591 A.2d 411 (Conn. 1991), in a divorce action, the Connecticut Supreme Court
determined that a future income stream that is based on “personal goodwill” has no value: “[t]o the extent that the
goodwill of the practice cannot be detached from the personal reputation and ability of the practitioner through a sale,
it cannot be said to have any significant market value, even though it may enhance the earning power of the
practitioner so long as he continues to work in the same community.” The Connecticut Supreme Court continued, “if
goodwill depends on the continued presence of a particular individual, such goodwill, by definition, is not a
marketable asset distinct from the individual.” Accordingly, if a business does not have any value without its current
owner at the helm, all value is attributed to personal goodwill.

Court found that the valuation methodology used properly distinguished between personal and enterprise goodwill
and found that it was possible to “distinguish[ ] between the goodwill of the dental practice that, according to
comparable sales, constitutes a marketable asset, and that portion of the prestige or expectation of continued public
patronage of Wife’s practice that is not marketable because [it is] dependent on her continued presence."

However, in Kowalesky v. Kowalesky, 384 N.W.2d 112, 116 (Mich. App. 1986), the Michigan Court of
Appeals did not allow for a reduction of value of a business on account of personal goodwill because: “there is
nothing in the record to support the assumption that the plaintiff would discontinue his practice or that the staff would
not stay on. Since it appears that plaintiff would continue the dental practice, the valuation of the practice should be
the value of the practice to plaintiff as a going concern.” In other words, if the owner-employee will not really
abandon his business, there is no personal goodwill. Stated differently, what is worth more: the owner’s reputation
(personal goodwill) or the phone number and location (enterprise goodwill)?

While courts may look to different factors when considering whether an income stream is attributable to personal or
enterprise goodwill, there can be no doubt that personal goodwill is a valid asset class. Thus, personal goodwill must
be considered during the structuring of any business sale transaction or valuation.

Distressed Transfers of Personal Goodwill

Personal goodwill, if it exists, can constitute a very powerful asset planning tool for distressed privately held
businesses. If value can be attributed to personal goodwill, a business owner can recognize proceeds for his
personal association with the business, even though creditors of the business itself may not receive any payment.
Such treatment is both easily justifiable and, at the same time, nearly indefensible. On one hand, since the asset
(relationships and reputation) is owned by the individual, it was never part of the business; hence, creditors of the
business never had a claim to the asset. On the other hand, the business permitted the owner to build her reputation
and relationships and acted as a conduit through which the owner conducted her enterprise; therefore, the
relationships as between the business and owner should be indistinguishable.

Several cases illustrate the struggle parties and courts have when determining how to assign value to
personal goodwill in the creditor-debtor context. In In re Prince, 127 B.R. 187, 188 (N.D. Ill. 1991), aff'd sub nom,
Matter of Prince, 85 F.3d 314 (7th Cir. 1996), a dentist and his wife filed a joint individual Chapter 11 petition. At the
time of the filing Dr. Prince (the husband) was the sole owner of his dental practice, organized as a professional
corporation. There was no covenant not to compete. The bankruptcy plan provided that to retain the dental practice,
“Dr. Prince agreed to pay its value to his bankruptcy estate.” Shortly after the confirmation, Dr. Prince entered into a
letter of intent to sell his practice to another dentist for between $450,000 and $500,000. No agreement could be
reached on the value of the practice under the Chapter 11 plan and the court held a valuation hearing.
The creditor’s committee submitted evidence, based on a discounted cash flow analysis that the practice was worth $650,000. Dr. Prince argued that the practice was worth only $7,500: “[t]he debenture’s expert opined that the professional corporation’s stock had only nominal value, based on a liquidation analysis that concededly excluded Dr. Prince’s personal goodwill.” Both experts agreed that if Dr. Prince was free to compete, the practice had only nominal value. Analyzing the nature of the practice, the bankruptcy court concluded that the “value of the stock resided primarily in the personal goodwill of [Dr. Prince’s] practice.” Thus, the bankruptcy court excluded the value of personal goodwill from what Dr. Prince owed to the estate.

On appeal, the district court vacated and remanded the case for further consideration. The district court did not overturn the logic of exclusion of personal goodwill. Rather, the district court appears to have believed that no one properly contemplated its role in the valuation process under the plan. Thus, the Seventh Circuit Court of Appeals, affirming the district court, reasoned that the simple existence of personal goodwill does not strip a business of its value: “the mere possibility that he might leave to compete with the corporation does not render the stock worthless any more than the possibility of fire destroying an uninsured house strips that house of every cent of its present value. What is important for calculating present value is the probability of a particular future event occurring.” 85 F.3d at 321 (emphasis in the original). Thus, the bankruptcy court properly considered factors other than the value of the hard assets of the business when valuing it, including what, if any, discount factor should have been made were Dr. Prince to leave and compete with his practice.

In one of the earliest cases to address the issue of personal goodwill within the bankruptcy context, In re Cooley, 87 B.R. 432 (Bankr. S.D. Tex. 1988), a world renowned heart surgeon filed an individual Chapter 11. The court was “asked to separate, if necessary, the postpetition income stream of an individual debtor into profits generated from property of the estate and earnings from the debtor’s services.” Id. at 434. Thus, Cooley considered whether personal goodwill was property of the estate under § 541 of the Bankruptcy Code.

Because the business was a sole-proprietorship, the court had to determine whether personal goodwill was property of the estate or excluded from the estate under the earnings exception embodied in § 541(a)(6). In other words, what amount of the doctor’s income was derived from his reputation even if he was not actually performing the surgery? The court held that “his personal goodwill is inextricably bound up with his personal services and is not by operation of the earnings exception property of the estate. Dr. Cooley’s personal goodwill is of the same nature as his medical degree and license to practice medicine which although arguably property under state law, are nonetheless inextricably bound up with his postpetition services.” Id. at 443. It is interesting that the court looked to the earnings exception to § 541 of the Bankruptcy Code rather than state law and the nature of personal goodwill. However, the court was likely required to frame its reasoning as it did because the business was a sole-proprietorship, meaning it had no separate existence from its owner, unlike a corporation or LLC. However, personal goodwill is more than an income stream and the use of the earnings exception to remove personal goodwill from the estate is an imperfect justification.

In finding that personal goodwill is protected by the earnings exception, the court held that the creditor, which had objected to the debtor’s exemption, “failed to distinguish in any fashion between personal as opposed to business goodwill. Instead, it calculated the overall goodwill of the medical practice as a residual after the other three income generating components were projected.” Id. at 434. Thus, the debtor was able to retain the vast majority of his income stream because it was the debtor’s “reputation, referral network, services and experience,” that generated the revenue, not the business itself. Id.

Of course, since Cooley the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”), modified § 541 and chapter 11 to make postpetition earnings property of the estate. 11 U.S.C. § 1115(a)(2). Viewing personal goodwill as in Cooley would mean that the debtor’s personal goodwill would be property of the estate. The most important take away from Cooley, however, is the importance of ensuring that one has a proper valuation to support the position taken. There, the creditor bore the burden of proof given the procedural posture (objection to exemption) and did nothing to distinguish between business and personal goodwill. Whether arguing in favor of, or against, the existence of personal goodwill, a well-founded valuation and litigation strategy is essential.

Structuring and Defeating Allocation of Personal Goodwill in Distressed Transactions

In most closely held businesses, the owner or key employee’s skills, reputation and connections are essential to the enterprise’s success or failure. Even during down times, an individual’s relationships, ability and reputation can be valuable. When structuring an asset sale that will pay an owner on account of personal goodwill but not all business creditors, having a proper valuation and process to assess the existence of personal goodwill is fundamental. The teachings of Martin Ice Cream should be followed carefully. Further, counsel must obtain the valuation opinion early, and the concept of personal goodwill should be discussed from the start. Further, legal and financial advisors must consider incidents of ownership that may constitute a transfer of personal goodwill, such as a covenant not to compete, employment agreement, or buy-sell agreement between a business and the holder of the personal goodwill.
The same process should be followed when attacking allocations of personal goodwill. The affected creditor should begin by identifying whether personal goodwill was considered early on in a transaction, or whether it was a contrivance used as a creditor avoidance tactic. Funds paid to a business owner instead of creditors can be recovered as a fraudulent transfer if not properly attributed to personal goodwill.

This analysis does not change within the bankruptcy context. When a bankruptcy filing is contemplated and a personal goodwill issue presents, the bankruptcy lawyer should obtain a valuation so that any exemption can be defended. The expert opinion is essential to exemption planning or other proceeding in which the allocation of personal goodwill may be challenged.

When business assets are sold (either through a § 363 sale or plan), and the former owner is receiving compensation attributed to personal goodwill, counsel must consider potential disclosure, conflict and abuse issues. For example, as the owner is also an estate fiduciary with a duty to both the debtor and creditors, is the owner required to forfeit payments to her for personal goodwill, which is not property of the estate? Another tension is whether the personal goodwill aspects of a deal need to be disclosed. In any asset sale involving personal goodwill, the DIP’s owner will be acting in two capacities: negotiating the best outcome for the DIP and for herself. Again, careful attention on the front-end of a sale is critical in navigating this problem. Careful attention to documentation and valuation will mean that a court is more likely to approve a sale involving payments to the DIP’s owner(s) on account of their personal goodwill, or that the allocations will be less susceptible to avoidance in subsequent litigation.

Conclusion

Where it exists, personal goodwill can be a powerful asset preservation tool. However, the limitations and complexities of personal goodwill must be understood. Far too often, business owners fail to prepare their case before it is necessary to support the validity of the existence of personal goodwill. From a practical perspective, the optics of any deal that compensates owners but not creditors will appear improper and care must be taken to avoid a negative result. Business advisors and counsel are well advised to heed Martin Ice Cream and plan a distressed personal goodwill transaction carefully.

1 “Goodwill is the sum total of those imponderable qualities which attract the custom of a business – what brings patronage to the business.” Howard v. United States, 448 Fed.Appx. 752, 753 (9th Cir.2011) (internal punctuation omitted) (quoting Grace Brothers v. Comm’r, 173 F.2d 170, 175–76 (9th Cir.1949)). “Goodwill may be personal, adhering to an individual, or ‘enterprise,’ adhering to a business.” Jones v. Tauber & Balsier, P.C., 503 B.R. 162, 182 (N.D. Ga.) modified, 503 B.R. 510 (N.D. Ga. 2013).
2 Kennedy v. C.I.R., 100 T.C.M. (CCH) 268 (T.C. 2010) ("Martin Ice Cream Co. held that a corporation (Martin Ice Cream Co.) was not taxable on payments that were made to Strassberg, the corporation’s controlling shareholder, for his customer relationships.
3 See Bross Trucking, Inc. v. C.I.R., 107 T.C.M. (CCH) 1528 (T.C. 2014) ("A key employee who develops relationships for his or her employer may transfer goodwill to the employer through employment contracts or noncompete agreements. The transfer is evidenced by the employee’s covenant to not use his or her goodwill to compete against the employer.")
4 Interestingly, in Moll v. Moll, 187 Misc. 2d 770, 775, 722 N.Y.S.2d 732, 735 (NY Sup. Ct. 2001), the New York Supreme Court recognized the concept of personal goodwill, but held under state law that it was subject to equitable division anyhow.
5 Nail v. Nail, 486 S.W.2d 761, 761 (Tex. 1972) ("The controlling question here is whether in this divorce proceeding the accrued good will of the medical practice of the husband, a doctor of medicine specializing in ophthalmology, based as it is on his personal skill, experience and reputation, as well as upon his continuing in the practice, constitutes property that is subject to division as part of the estate of the parties. The trial court and a divided court of civil appeals considered that it was. 477 S.W.2d 395. We hold that it was not.")
6 Thompson v. Thompson, 576 So. 2d 267, 270 (Fla. 1991) ("If a law practice has monetary value over and above its tangible assets and cases in progress which is separate and distinct from the presence and reputation of the individual attorney, then a court should consider the goodwill accumulated during the marriage as a marital asset.")
7 "[T]his court finds that the plan does not reveal any mutual intention to exclude personal goodwill as an element of value. But it does seem possible that there was no thought given to the matter, at least by the Committee. This apparent failure of the parties mutually to contemplate, or, in any event, to provide for what later happened—a sale of the practice by Prince—raises the question of whether the plan can be interpreted to cover valuation in the event of a sale. ... The value of Prince's personal goodwill should be included, unless additional evidence on remand supports the conclusion that Prince and the Creditors' Committee mutually intended to exclude it.")
8 Cooley raises several other substantial and interesting issues that are not germane to this article.
The Impact of Human Capital Loss on Chapter 11 Reorganizations
By Ariadne Montare

When businesses fail, the most immediate impact that is visible to the affected community is the number of jobs that may be lost when a business is shuttered. Yet very little economic analysis has been done on the effects to the work force of companies who go through a Chapter 11 reorganization. One such study shows that the workers of companies that survive bankruptcy for at least five years are still profoundly and detrimentally affected.

In an effort to quantify the cost of human capital loss to financial distressed companies, a group of economists analyzed employee wage losses in connection with the bankruptcy of 138 publicly traded corporations that filed for Chapter 11 relief from 1992 to 2008, using data for 96,538 workers obtained from the US Census Bureau. Graham, et al. ’s analysis found that employee wages began to deteriorate prior to bankruptcy by an average of 30%, and that almost half of the employees left the bankrupt firms within five years of the bankruptcy filings. Graham, et al. also concluded that “workers who stay with or leave the employer post-bankruptcy experience substantial earnings losses, suggesting that employer financial distress has negative effects on its employees beyond job displacements.” Their analysis shows a huge cost of human capital to bankrupt firms, a cost that has not been sufficiently discussed by academicians studying the financial impact of bankruptcy on firms or society at large.

The data for the firms was obtained from the UCLA-LoPucki Bankruptcy Research Database, which tracks bankruptcy filings of publicly traded firms with assets over $100 million (measured in 1980 dollars, the first full year of data in the database). Graham, et al., then obtained corresponding worker-level information for these firms from the US Census Bureau’s Longitudinal Employer-Household Dynamics program (LEHD) and the Longitudinal Business Database (LBD) and firm-level information from the Compustat and CRSP databases. Graham, et al. narrowed their analysis to workers for which they could identify data on age, education, and gender, and excluded workers older than 55 and younger than 22 to avoid complications associated with early retirement and legal ages for employment.

By comparing the firms’ workers to a control group matched by age, gender and education, Graham, et al. were able to conclude that the average wage of the employees in the bankruptcy firms was about $5,000 less than that of the control group. While there is much debate surrounding retention bonuses and incentives for executive-level workers, Graham, et al.’s research suggests that more attention should be paid to the impact on distressed firms of depressed wages across the board – on retention, productivity, and high employee turnover.

By showing that workers displaced from bankrupt firms suffer significant wage loss, Graham, et al. ’s research suggests a ripple effect of personal financial distress to the employees, which may very well result in corresponding individual bankruptcy filings resulting from the loss of wages. Graham, et al. ’s regression analysis shows that “employees who ultimately leave the bankrupt firms experience a significantly larger wage loss than those who remain in the firms.” The wage loss for departing workers is even greater for those who end up switching industries. Given that almost 50% of workers eventually left the bankrupt firms, and those remaining also suffered wage loss, the true economic impact of these firms’ bankruptcies went well beyond loss of capital, transaction costs, and costs related to the bankruptcy process itself. This study begins to show that over the long term, the greater economic cost may well have been to the individual workers.

It also follows that firms looking to successfully reorganize after bankruptcy must have access to sufficient capital to pay their workers market wages or risk having their reorganization jeopardized by the inability to attract and retain quality workers. While retention at the executive level has been the subject of both judicial and statutory changes to Chapter 11 practice, the retention of middle management and line workers must also be considered in the ongoing debate over Chapter 11 reform and in measuring the societal costs of financially distressed firms.

The corporate finance community should be encouraged to continue research on human capital costs related to financially distressed companies. One angle not explored in Graham, et al. was whether the wage losses were the product of necessary workforce reduction to improve these firms’ competitive postures within their industries, or the result of mismanagement or other subjective factors within the individual firm’s control. An industry-by-industry breakdown would help illuminate whether such contractions were an evitable response to market forces, or the result of a firm’s inability to access sufficient capital to maintain its workforce at pre-bankruptcy levels. Further research in this area would contribute to the ongoing debate over how to balance the protections given to secured creditors in the Bankruptcy Code over a debtor’s need to access its cash collateral and take other steps to retain and attract the manpower necessary to successfully reorganize.

2 Id. at 2.
4 Graham, et al.’s analysis focused only on firms that survived for five years post-petition, and therefore does not account for the human capital loss suffered by firms that are liquidated post-bankruptcy.
The LEHD database is accessible to the public at http://lehd.ces.census.gov and covers data from 30 states. The LBD, which is only accessible to qualified researchers, tracks data on over 5 million establishments each year. See Graham, et al. at 7.

Compustat is a private database that contains financial information on over 99,000 publicly traded companies, both active and inactive, worldwide. See https://en.wikipedia.org/wiki/Compustat. CRSP is the Center for Research in Security Prices, which provides data for academic research. See http://www.crsp.com/about-crsp.

Graham, et al. at 6-7.

Id. at 9, Table 2.

Id. at 13, Table 5.

Id.
Sidestepping the adage about declining to fix what is not broken, the ABI commission proposed in December of 2014 to restrict bankruptcy financing from specific lenders, likely shifting the reorganization burden to debtors and new lenders in unfamiliar territory. Entities currently have equal opportunity to provide financing to debtors in bankruptcy. Debtors generally need an influx of debtor-in-possession (“DIP”) financing, at the beginning of the case to reorganize and address the issues requiring the debtor to file bankruptcy. Debtors have been able to turn to prepetition lenders, with which they are familiar and frequently have extensive relationships, to fund their reorganization efforts. In return for the investment in a decidedly risky business, lenders have received better treatment of their funds, via priority or security in the debtor's assets. To date, prepetition lenders have often provided desperate debtors an influx of post-petition funds, for which some or all of the prepetition debt is rolled into a higher priority post-petition claim, i.e., a "roll-up".

The commission, however, has found roll-ups problematic, and suggests that large secured creditors have become an "elephant in the room" which control the post-petition debtor's actions. In order to "reduce barriers to entry by providing debtors more flexibility in arranging debtor in possession financing," the commission proposes to prohibit post-petition financing to debtors if the financing includes such a "roll-up" provision that translates pre-petition debts into post-petition debts, or includes any attempt to pay down prepetition amounts.

The commission notes that the proposal should not apply to a lender which repays the entire prepetition debts in cash and extends new credit to the debtor, on better terms than any alternative offers. The commission makes an exception for financing options that are in the best interests of the estate, a vague term which would seem to punt the aforementioned principles. Additionally, the commission proposes to put a 60-day moratorium on affirmative actions negotiated with DIP financing, as accessibility to funds can be premised on sales of assets, termination of employees, or recessions of contracts, and restricts liens and interests in estate proceeds in bankruptcy recovery actions.

In the dry credit climate of recent, debtors facing inevitable liquidation have limited options: generally, their essential post-petition financing is only obtainable from prepetition lenders. With the Commission’s recommendations, however, this already-limited option may now be in jeopardy by creating rigid, inflexible requirements to what likely is not a problem. While the commission asserts DIP lending to be profitable, they acknowledge the contradictory argument, that a lender with no knowledge of or history with a business is unlikely to extend itself financially to support a fragile reorganization. Professionals would tell you with risk comes reward, enough to entice an investment in a struggling company. The ABI report, however, does not provide statistics on how often this happens. Instead, the commission came to almost the opposite conclusion, recommending that prepetition lenders be subjected to strict rules in the realm of DIP financing, almost prohibiting them from extending financing to a post-petition debtor for whom they hold a prepetition debt.

What does this mean for lenders, and business generally, and why should you care? Because in the risky business of distressed business lending, relationships with borrowers are key. A lenders' involvement in a business can be a fulcrum on which the business balances, with the lender providing access to funds based on business decisions regarding future governance and actions. The commission proposes to disrupt these relationships by plausibly removing the lenders’ ability to finance and effectively participate in the management of the post-petition debtor. This means lending becomes riskier. Not only could post-petition lenders lose their rights to provide for debtor rehabilitation and advise how their funds are used, they would turnover that control to a third-party which may have little knowledge of the debtor. Or worse – without prepetition lenders willing to hedge their bets on a return, the destitute debtors' hopes of rehabilitation are dashed in favor of fire-sale liquidation and/or no bankruptcy filing at all. Indeed, the commission's report notes that 69% of debtors with DIP financing reorganize, as opposed to 52% without. In the face of statistics which would support an opposite conclusion, the commission suggests an overhaul of DIP financing without any reference to facts and figures which suggest roll-ups are detrimental to chapter 11 debtors or to the bankruptcy process. While these are merely proposals, this is one suggestion that Congress should reject.