Secured Creditors Lunch & CLE Program:

Practical Effects of the Supreme Court’s Decision Relating to Secured Creditors

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Presented by:
ABA Business Bankruptcy Committee

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The Impact of *Stern* on Secured Creditors

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Effective December 1, 2016, amendments to the Federal Rules of Bankruptcy Procedure ensured that litigant consent would be resolved early in any action, and provided for use of the proposed findings and conclusions procedure in non-consent proceedings. *See Bankruptcy Rules 7008* (pleader to state if it does or does not consent to final determination by the bankruptcy court; 7012 (responsive pleading to state if respondent does or does not so consent); 7016 (three options for the bankruptcy court on consent or non-consent of the parties); 9027 (consent or non-consent to be stated in removal pleadings); 9033 (service of proposed findings of fact and conclusions of law applicable in non-core and core/*Stern* proceedings.

Permissibility of consent to jurisdiction and rule amendments resolved most *Stern* litigation, as a practical matter. Some disputes over the applicability of *Stern* to issues affecting secured creditors have continued to percolate through the bankruptcy judicial system, however.

I. Determining Claim Allowance, Lien Priority, Equitable Subordination and Counterclaims

Claim allowance and determining whether a lien is valid and the priority accorded to it in the bankruptcy case are quintessential bankruptcy issues where *Stern* does not affect bankruptcy court jurisdiction. Whether a bankruptcy court has jurisdiction over a debtor’s counterclaims depends on the nature of the counterclaim.

A. Secured Claim Allowance, and Counterclaims

In *In re Sundale, Ltd.*, 499 Fed.Appx. 887, 892–93 (11th Cir. 2012), a secured creditor sought a declaratory judgment regarding the extent, validity, and priority of claims stemming from

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² Note that a litigant’s actions must be consistent with any non-waiver. In *In re Carter*, 506 B.R. 83 (Bankr. D. Ariz. 2014), Barclays objected to the constitutional authority of the court to enter final judgment but also filed a motion for summary judgment requesting the court to enter final judgment in its favor. Its objection was waived.
secured loans it had made to the debtor. *Id.* at 889. The debtor filed counterclaims including causes of action for a declaratory judgment and for recoupment of more than $3 million it had paid to the creditor. *Id.* Critically, both the affirmative defenses and counterclaims relied upon the same factual and legal bases, namely that the funds advanced were only disguised as a loan, but were in fact intended as an initial payment of monies wrongfully diverted. *Id.* at 890-91. The court cited state law for the point that recoupment is a purely defensive matter springing from the same transaction. *Id.* at 892. A determination of whether the advance was a loan or a repayment would resolve both the complaint and the recoupment and declaratory judgment counterclaims. *Id.*. Because resolving the proof of claim issue would necessarily resolve the recoupment and declaratory-judgment counterclaims, the bankruptcy court had jurisdiction to enter a final judgment. *Id.*

In a different dispute over the nature of a secured loan, the Sixth Circuit concluded that the bankruptcy court could resolve the debtor’s objections to secured claims but could not resolve claims seeking affirmative relief. *Waldman v. Stone*, 698 F.3d 910, 921 (6th Cir. 2012). The debtor alleged that the creditor acquired the debts and security interests through fraud. *Id.* at 914-15. The debtor sought to discharge the creditor’s judgment, judgment lien, and mortgage without payment. *Id.* In addition, the debtor made affirmative claims for specific performance and damages. *Id.* at 915.

The *Waldman* court, pre-*Wellness*, held that the creditor had forfeited his *Stern* objection that the debtor’s fraud claims were not core proceedings and the bankruptcy court acted beyond its statutory authority by stating in the creditor’s own pleadings that the claims were core. *Id.* at 917. But the court held that it nevertheless had to analyze the bankruptcy court’s authority to enter judgment under the Constitution. It noted that to the extent that Congress can shift judicial power to judges without Article III tenure and salary protections, the judicial branch is weaker and less independent than it is supposed to be.

The Sixth Circuit concluded in *Waldman* that even though the debtor’s claims to discharge the liens and judgment were based upon a state law fraud cause of action, seeking disallowance was “part and parcel of the claims-allowance process in bankruptcy,” arising under the Bankruptcy Code. 11 U.S.C. § 502(b). The creditor had not filed a proof of claim, but was the “principal creditor and surely would have filed a proof of claim if [the debtor] had not beat him to the courthouse with an adversarial proceeding.” *Id.* at 920. The creditor appeared in the bankruptcy proceeding and counterclaimed, as well as seeking stay relief to enforce his security and take possession of estate property. *Id.* And as a secured creditor, he was not required to file a proof of claim to preserve his right to recover from the estate. *Id.*

*Waldman* held that the bankruptcy court could enter a final judgment on the debtor’s disallowance claims. *Id.* at 920-21. But the bankruptcy court did not have core jurisdiction over the affirmative claims, “which required [the debtor] to prove facts beyond those necessary to his disallowance claims.” *Id.* at 921. Therefore, the bankruptcy court’s judgment on the affirmative claims violated Article III. *Id.*

The Sixth Circuit directed the bankruptcy court on remand to submit proposed findings of fact and conclusions of law with respect to the affirmative causes of action to the district court. *Id.* at 922. But the court still proceeded to rule on the creditor’s procedural and substantive arguments. The district court was given a roadmap that would obviate another appeal.
A useful opinion summarizing scholarly articles and case law in the wake of Stern, and providing practical guidance in the context of litigation over a secured claim, is In re Pulaski, 475 B.R. 681 (Bankr. W.D. Wis. 2012). The creditor’s proof of claim asserted that the claim was secured by a mortgage on the debtors’ home; the debtors denied it. Id. at 686. Without asking for monetary relief, they sought an order declaring the mortgage to be invalid for the state-law reasons raised in their objection to the claim and adversary complaint. Id. As the court explained:

The essence of the claims allowance process is the determination of the claim's validity—i.e., its conformity to the requirements of applicable law. Whether a secured claim is defective because it fails to satisfy the state's statute of frauds, the recording statute, or rules regarding unconscionability, fair dealing, or mistake, it is all the same on a fundamental level. The claim itself is being attacked, not offset. Any augmentation of the estate arises not by addition (i.e., through a separate state law claim that increases the estate irrespective of the resolution of the creditor's claim) but rather through negation—or modification—of the creditor's claim itself.

Id. at 687 (court’s emphasis). While the litigation could have been brought in state court, it was integral to the structuring of the debtor-creditor relationship, with the claim to be paid under the debtor’s chapter 13 plan. Id. at 688.

As a guiding principle, Pulaski cited another court’s observation that “if the debtor’s claim can be resolved without considering the creditor’s claim, then the bankruptcy court lacks the constitutional authority to hear the debtor's claim.” Id. at 688, citing In re Black, Davis and Shue Agency, Inc., 471 B.R. 381, 402 (Bankr. M.D. Pa. 2012)). By contrast, “when the debtor’s claim and the validity of the creditor’s claim are sufficiently tied together, the bankruptcy court is authorized under Stern to enter a final judgment.” Id.

Other bankruptcy courts have agreed that they can enter final judgments on whether a lien is valid and provides a creditor with secured status, because that is an issue that is resolved in the claims allowance process. E.g., GMAC Mortg., LLC v. Orcutt, 506 B.R. 52, 63 (D. Vt. 2014) (“Consistent with Stern, the issue of whether the 2007 Mortgage was a valid lien and provided GMAC with secured creditor status would have been resolved in the claims allowance process.”); Fleury v. Specialized Loan Servicing, LLC, 11-26987-E-13, 2011 WL 4851141, at *2 (Bankr. E.D. Cal. Oct. 6, 2011) (reasoning that court had statutory and constitutional authority because “the validity of the deed of trust, which creates the secured claim, is an issue that would plainly be resolved in the claims allowance process”).

Notably, an amendment to Bankruptcy Rules 3002(a) effective December 1, 2017, mandated that secured creditors file proofs of claim, provided that non-filing does not void the creditor’s lien, and Code § 1111(a) continues to make a proof of claim unnecessary if the claim is not scheduled as disputed, contingent or liquidated. Bankruptcy Rule 3012 was concurrently amended to provide that on request of a party in interest and after notice and a hearing, the court may determine the amount of a secured claim and also the amount of a claim entitled to priority, via a motion or claim objection (or a chapter 12 or 13 plan). Bankruptcy Rule 3015(g) was also amended to provide that a chapter 12 or 13 plan determination is binding on the claim holder, even if the scheduled amount or a proof of claim amount is different and regardless of whether a claim objection has been filed. These amended provisions will help to avoid any arguments that might be made about the necessity to file a proof of claim to avoid the impact of Stern.
B. Priority of Liens

As with claim allowance, courts have held that Stern does not prevent bankruptcy courts from determining the priority of liens. In In re Frazer, 466 B.R. 107, 113-14 (Bankr. S.D. Tex. 2012), the court reasoned that it could enter a final judgment in an adversary proceeding where the debtor alleged his homeowners association’s lien was subordinate to a bank’s lien and therefore was unsecured. Unlike in Stern, resolution of the dispute would determine the extent of the bank and association’s claims. Id. Further, unlike in Stern, a bankruptcy statute (§ 506) undergirded the claim and would determine whether the association’s claim was secured or unsecured. Id. at 114. Finally, the court noted that resolution of the issue would also enable the other creditors to determine how the Chapter 13 plan would treat their claims. Id. Therefore, Stern did not apply to the adversary proceeding. Id. Even if Stern applied, the court determined it could enter a final order under Stern’s “public rights” exception because the Bankruptcy Code is a public scheme for restructuring debtor-creditor relations, and the Code establishes the right to determine priority of claims. Id.

Another court observed that resolution of a lien priority dispute is “part and parcel of the claims resolution process and thus ‘integral to the restructuring of the debtor-creditor relationship.’” In re Washington Coast I, L.L.C., 485 B.R. 393, 405 (B.A.P. 9th Cir. 2012) (quoting Stern v. Marshall, 564 U.S. 462, 497 (2011)). Unlike the resolution of the counterclaim in Stern, resolution of a lien priority dispute is necessary to adjudicating the claim of a creditor. Id.; see also In re Salander O’Reilly Galleries, 453 B.R. 106 (Bankr. S.D.N.Y. 2011) (Stern does not bar determination of consignment rights and consequences of failure to file a UCC financing statement).

C. Equitable Subordination

Consistent with its 2011 holding in Direct Response Media, discussed below, the bankruptcy court in Delaware in In re USDigital, Inc., 461 B.R. 276 (Bankr. D. Del. 2011) applied a “narrow interpretation” of Stern in an equitable subordination suit. USDigital held that equitable subordination is a substantive right in Bankruptcy Code § 510(c), a unique creature of bankruptcy law determining inter-creditor treatment of claims against the estate. Id. at 284-85. It is a core proceeding, even though not listed in § 157(b), rendering Stern non-applicable. Id. at 292. The amendments to Bankruptcy Rules 3002 and 3012 will help to ensure that most creditors file proofs of claim, submitting themselves to bankruptcy court jurisdiction.

II. Avoidance Actions: A “Broad” or “Narrow” Interpretation of Stern

The effect of Stern on avoidance actions, including against secured creditors, is an open question. Is Stern to be read narrowly and restricted to its facts, as the Court stated was its expectation? See Wellness, 135 S. Ct. at 1946-47 (reading Stern narrowly because the Court “took pains to note that the question before it was ‘a ‘narrow’ one,’ and that its answer did ‘not change all that much’ about the division of labor between district courts and bankruptcy courts”) quoting Stern, 131 S. Ct. at 2620. Or more broadly, does it mean that bankruptcy judges cannot enter final adjudications on avoidance actions and other common law suits, and they must be decided by an Article III judge?
A. Delaware Courts Employ a Narrow Approach

The court in *In re Direct Response Media, Inc.*, 466 B.R. 626, 644 (Bankr. D. Del. 2012) described the “broad interpretation” of *Stern* employed by some courts in the aftermath of the decision: that because fraudulent transfer actions would “augment the estate” by seeking to take the defendant’s property through a money judgment, instead of just seeking a pro rata share of the bankruptcy *res*, such actions must be adjudicated through an Article III court. *Id.* at 641. Disagreeing with the “broad interpretation,” the *Direct Response Media* court reasoned that the broad interpretation “is based on a holding that the Supreme Court has never made, namely, that restructuring of the debtor-creditor relationship is not a public right, nor falls within any other exception that would permit a non-Article III court to finally adjudicate those matters.” *Id.* at 644. The *Stern* opinion emphasized the narrow and limited nature of the decision. *Id.* at 642-43. Further, “because Justice Scalia disagreed with the Chief Justice’s rationale and underpinnings, but only partially concurred in the judgment, the decision is a 4–4–1 plurality that must be ‘narrowly’ interpreted.” *Id.* at 643-44.

Accordingly, *Direct Response Media* determined that *Stern* does not prevent bankruptcy courts from entering final judgments in preference and fraudulent conveyance actions. *Id.* at 644. The court concluded that “*Stern* only removed a non-Article III court’s authority to finally adjudicate one type of core matter, a debtor’s state law counterclaim asserted under § 157(b)(2)(C).” By contrast, “*Stern* does not remove the bankruptcy courts’ authority to enter final judgments on other core matters, including the authority to finally adjudicate preference and fraudulent conveyance actions like those at issue before this Court.” *Id.*

This narrow approach was utilized again in *In re DBSI, Inc.*, 467 B.R. 767, 772-73 (Bankr. D. Del. 2012). The court held that it could enter final judgment disposing of core preference, unauthorized postpetition transfer, fraudulent transfer and unjust enrichment claims. More recently, an Illinois bankruptcy court analyzed the competing lines of authority for the broad and narrow approaches to the impact of *Stern* on avoidance actions, and adopted the narrow approach. *In re Peregrine Financial Group, Inc.*, 2018 WL 3410065 (Bankr. N.D. Ill. July 11, 2018). The *Peregrine Financial* court concluded that it could enter final judgment in a fraudulent transfer case even though the defendant refused to consent to its jurisdiction to do so.

There may be a difference between preference and fraudulent transfer avoidance actions, however. Preference actions exist only in bankruptcy, statutory creations of the Bankruptcy Code, and an integral part of the bankruptcy process dating back to the 1898 Act, while fraudulent transfer claims have long-standing common law roots.

B. Preference Litigation

In *In re Apex Long Term Acute Care – Katy, LP*, 465 B.R. 452 (Bankr. S.D. Tex. 2011), the court undertook an extensive analysis of *Stern* in the context of preference litigation. The court held that *Central Va. Cmt. College v. Katz*, 546 U.S. 356 (2006) supports the view that a preference claim is within the bankruptcy court’s *in rem* jurisdiction, and thus its constitutional power, even when defendants do not file proofs of claim. *Apex Long Term*, 465 B.R. at 455-65. The court discussed Supreme Court cases concerning jurisdiction preference litigation against defendants who had not filed proofs of claim, and held that they were effectively overruled by *Katz*, which
held that preferences actions are resolved through in rem jurisdiction and orders “ancillary to and in furtherance of the court’s in rem jurisdiction. Id. at 467, quoting Katz, 546 U.S. at 378.

C. Fraudulent Transfer Litigation

Different treatment of preference and fraudulent conveyance litigation under the 1898 Bankruptcy Act may be important. The dissent in Wellness written by Chief Justice Roberts and joined by Justices Thomas and Scalia harkened back to summary and plenary jurisdiction law under the Bankruptcy Act. The dissent reasoned that it is not a Stern claim for the court to determine that property in the actual or constructive possession of the debtor comes within the estate so long as no third party asserts more than a “merely colorable” claim, citing the Act concept of summary jurisdiction over substantive consolidation, alter ego and equitable subordination issues, with plenary jurisdiction required for fraudulent conveyance suits. Wellness, at 1953-54. The majority noted that summary jurisdiction was permissible with consent. Id. at 1939. While not always noticing this history, lower courts have interpreted Stern more restrictively in fraudulent transfer cases.

The district court for the Southern District of New York held that a fraudulent transfer suit is restricted by Stern when the defendant has not filed a proof of claim. In In re Lyondell Chem. Co., 467 B.R. 712 (S.D.N.Y. 2012), the court held that such a lawsuit did not fall within the public rights exception, and the fraudulent transfer claims in that case would not necessarily be determined in ruling on a proof of claim. Id. at 720. The court pointed to the analogy drawn by the Court in Stern to fraudulent conveyance claims at issue in Grandfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989), and found the claims were matters of private right, over which the bankruptcy court lacked final adjudicative authority. Lyondell, 467 B.R. at 720, citing Stern, 131 S. Ct. at 2616.

Lyondell rejected prior opinions that interpreted Stern in a narrower manner that would allow bankruptcy court jurisdiction over fraudulent conveyance litigation. Lyondell, 467 B.R. at 721, rejecting, e.g. In re Refco, Inc., 461 B.R. 181, 184-94 (Bankr. S.D.N.Y. 2011). The district court nonetheless did not withdraw the reference, desiring to “benefit from exposure to the bankruptcy court’s knowledge and expertise when it rules on the outstanding motions.” Lyondell, 467 B.R. at 723. The bankruptcy court could make proposed findings and conclusions, and the district court noted that its ruling was without prejudice to refiling a withdrawal request when the case was ready for trial, allowing the bankruptcy court to issue opinions on pending motions to dismiss and for summary judgment. Id. at 723-26. See also In re Madison Bentley Assoc., LLC, 474 B.R. 430, 439 (S.D.N.Y. 2012) (bankruptcy court lacked authority to finally adjudicate fraudulent conveyance and alter ego claims); In re Heller Ehrman, LLP, 464 B.R. 348 (N.D. Cal. 2011) (fraudulent transfer counterclaims are not “public rights” and cannot be finally adjudicated by the bankruptcy court, but withdrawal of the reference is not required because the bankruptcy court may enter a report and recommendation).

In re Bernard L. Madoff Inv. Securities LLC, 740 F.3d 81, 94-95 (2d Cir. 2014), held that the bankruptcy court is empowered to enter final judgment on a fraudulent transfer claim against a party that filed a proof of claim because the avoidance action must be resolved to also resolve the proof of claim. Similarly, in U.S. Bank, N.A. v. Verizon Communications, Inc., 761 F.3d 409,

3 Katchen v. Landy, 382 U.S. 323 (1966) held that bankruptcy courts also have summary jurisdiction to decide preference actions when the defendant has filed a proof of claim.
424 (5th Cir. 2014), the court concluded that fraudulent transfer claims can be part of restructuring the debtor-creditor relationship, when a proof of claim has been filed and an avoidance action resolution is needed under Bankruptcy Code § 502(d), Id. at 424-25, citing Lagenkamp v. Culp. 498 U.S. 42, 44 (1990).

But in In re Lehman Bros. Holdings, Inc., 480 B.R. 179, 192 (S.D.N.Y. 2012), the district court held that the bankruptcy court lacked authority to enter final judgment on a fraudulent transfer claim (along with common law claims for conversion, unjust enrichment and constructive trust) against a defendant that had filed a proof of claim, where Code § 502(d) did not apply. The creditor and debtors had executed an agreement approved by the court that deferred resolution of the creditor’s payment on any avoidance claims until all claims in the complaint were resolved. Id. at 192. By definition, the avoidance actions would not be resolved within the process of allowing or disallowing the creditor’s proof of claim. Id.

III. Plan Provisions Affecting Secured Creditors

A. Third Party Releases and Injunctions

The bankruptcy court in Delaware recently continued to interpret Stern narrowly, holding that the court has jurisdiction to order a non-consensual release of third parties (the senior secured lenders, sued in a RICO lawsuit) in a plan confirmation order. In re Millennium Lab Holdings II, LLC, 575 B.R. 252 (Bankr. D. Del. 2017), on remand from In re Millennium Lab Holdings II, LLC, 242 F.Supp.3d 322 (D.Del.2017). The court noted that the Second Circuit upheld the bankruptcy court’s jurisdiction to grant such relief in AOV Industries, 792 F.2d 1140 (D.C. Cir. 1986). Id. at 263-64. And two previous bankruptcy courts had held post-Stern that they had constitutional authority to confirm plans containing releases. Charles Street African Methodist Episcopal Church of Boston, 499 B.R. 66 (Bankr. D. Mass. 2013); MPM Silicones, LLC, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), aff’d on other grounds, 531 B.R. 321 (S.D.N.Y. 2015), aff’d and rev’d in part on other grounds, 874 F.3d 787 (2d Cir. 2017).

The Millennium Lab court noted that plan confirmation is a core proceeding; in the Third Circuit, nonconsensual third party releases are permissible in plans if they meet specified standards of fairness and necessity to the reorganization. Millennium Lab, 575 B.R. at 271-72. An order confirming a plan with releases does not rule on the merits of the state law claims being released, and plan releases do not exist without regard to the bankruptcy proceeding. Id. at 272-73. And, the RICO claims were necessarily resolved in the claims allowance process insofar as the plan settlements resolved claims. Id. at 275.

In the similar context of an injunction to stay third party action, drawing down on insurance policies that were property of a bankruptcy estate, the court held in In re Quigley Company, Inc., 676 F.3d 45 (2d Cir. 2012), that a bankruptcy court has jurisdiction post-Stern to enjoin third-party non-debtor claims that directly affect the res of the bankruptcy estate. Id. at 53-54.

In In re Safety Harbor Resort and Spa, 456 B.R. 703 (Bankr. M.D. Fla. 2011), the debtor’s plan provided for a four-year restriction on creditor actions to pursue non-debtor guarantors instead of providing for third party releases. When the creditors sought to impose “lock up” restrictions to prevent the debtor and guarantors from disposing of their assets during this period, the debtor argued that Stern prevented such relief. The court held that the lock up provision was within its
jurisdiction as an integral part of its plan confirmation. And the guarantors, by virtue of their controlling interest in the debtor as plan proponent, had consented to final orders with respect to the lock up provisions of the confirmation order. *Id.* at 718-19.

**B. Plan Settlements**

In *In re Washington Mutual, Inc.*, 461 B.R. 200 (Bankr. D. Del. 2011), the bankruptcy court held that *Stern* did not restrict its power to approve settlements of state law causes of action in a global settlement central to the debtors’ plan of reorganization. After an in-depth discussion of *Stern*, the court concluded that courts can approve such settlements. *Id.* at 214-17. Code § 1123(b)(3)(A) expressly authorizes plan settlements, and there is a difference between approving a settlement and ruling on the merits of claims. Also, this settlement resolved certain claims regarding what was property of the estate. *Id.* at 216-17.

**C. Section 1111(b) and Attorneys’ Fees Awards**

Another court concluded that it could enter a final order on whether an undersecured creditor who elects the application of § 1111(b) is entitled to its post-petition attorneys’ fees as part of its secured claim. *In re Pioneer Carriers, LLC*, 581 B.R. 809, 811, 815 (Bankr. S.D. Tex. 2018). The *Pioneer* court noted that the *Stern* opinion “is replete with language emphasizing that the ruling is limited to the one specific type of core proceeding involved in that dispute,” 28 U.S.C. § 157(b)(2)(C). *Id.* at 815. Because “[c]ore proceedings under 28 U.S.C. §§ 157(b)(2)(A), (L), and (O) are entirely different than a core proceeding under 28 U.S.C. § 157(b)(2)(C),” which was at issue in *Stern*, it held that *Stern* did not preclude entering a final order. *Id.* Even if *Stern* were to apply to all core proceedings, the court reasoned, it could still enter an order because the claim was not governed solely by state law but rather primarily by express provisions of the Bankruptcy Code—§ 502(b) and § 1111(b)—and judicial interpretation of those provisions. *Id.* at 816. The court also concluded in the alternative that the parties implicitly consented to bankruptcy court adjudication by hearings on the plan and to determine the amount of post-petition attorneys’ fees and no one ever objected to bankruptcy court adjudication. *Id.* at 816.

**IV. Section 363 Sale Terms and Conditions**

The bankruptcy court was held to have authority to enter final judgment in an adversary proceeding by guarantors of a secured claim in *In re Spillman Dev. Group, Ltd.*, 710 F.3d 299 (5th Cir. 2013). The adversary complaint claimed that the lender’s credit bid at a § 363 sale fully paid the secured debt, and therefore discharged the guarantors’ liability, because the lender’s recovery form the guarantors could have reduced the deficiency claim against the debtor. The court held that the issue was “inextricably intertwined with the interpretation of a right created by federal bankruptcy law – the interpretation of the effect of [the lender’s] credit bid” pursuant to § 363(k). *Id.* at 306.