

Alert

Three Provocative Business Bankruptcy Decisions of 2018

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The appellate courts are usually the last stop for parties in business bankruptcy cases. The courts issued at least three provocative, if not questionable, decisions in the past six months. Their decisions have not only created uncertainty, but will also generate further litigation over reorganization plan manipulation, arbitration of routine bankruptcy disputes and the treatment of trademark licenses in reorganization cases. Each decision apparently disposes of routine issues in business cases. A closer look at each case, though, reveals the sad truth: they are anything but routine.

Insiders

The U.S. Supreme Court tops the list with *In re The Village at Lakeridge LLC*, 138 S.Ct. 960 (March 5, 2018). On its surface, the Court merely held that “a clear-error standard should apply” to the narrow question of whether a “non-statutory insider” finding by a bankruptcy court is subject to *de novo* or clear error review on appeal. *Id.* at 963. But four justices stressed in two concurrences that the Court’s opinion was limited to “whether the [Ninth Circuit] applied the correct standard of review,” not whether “the test for non-statutory insider status as formulated [by] the Ninth Circuit is sufficient” *Id.* at 969 (Kennedy, J). Justice Sotomayor, joined by three Justices, wrote “separately . . . because [she was] concerned that our holding eludes the more fundamental question whether the Ninth Circuit’s underlying test [for insider status] is correct.” *Id.*, at 970. As the four Justices agreed, the “Court’s discussion of the standard of review . . . begs the question of what the appropriate test for determining non-statutory insider status is,” noting that “the Court expressly declined to grant certiorari on it.” *Id.*

The Court’s disappointing limited review in *Lakeridge* warrants a review of the record below. *See In re The Village at Lakeridge LLC*, 814 F.3d 993, 996 (9th Cir. 2016) (2-1) (“a creditor does not become an insider simply by receiving a claim from a statutory insider”). According to the majority of the Ninth Circuit panel, “insiders are either statutory [per se] [e.g., officers; directors] or non-statutory [*de facto*].” For a person to be a *de facto* insider, said the Ninth Circuit, “the creditor must have a close relationship with the debtor and negotiate the relevant transaction at less than arm’s length.” The creditor in question here, R, did “not qualify as either a statutory or non-statutory insider” for voting on the debtor’s Chapter 11 cramdown plan. *Id.*

The debtor in *Lakeridge* proposed a Chapter 11 plan to deal with the claims of its two creditors, one of which was secured (a bank) and the other an insider. Because the bank rejected the plan, the debtor intended to cram down the bank’s secured claim. Shortly after filing its plan and disclosure statement, the debtor’s insider sold its unsecured claim to R, a close business and personal friend, for \$5,000, enabling the debtor to classify R’s claim as a “general unsecured claim.” Because R was found not to be a *de facto* insider, he “could vote to accept the [debtor’s plan] under [Code] § 1129(a)(10) [as] an impaired creditor who was not an insider.” *Id.* at 998. Affirming the lower courts, the Ninth Circuit held that an individual such as R did not become an insider solely by acquiring the claim from a statutory insider. In its view, insider status was a factual inquiry that had to be conducted on a case-by-case

basis — “a question of fact.” *Id.* at 998-1000. The Ninth Circuit rejected the bank’s argument that its holding would allow debtors to assign their claims to third parties in return for votes in favor of plan confirmation.

The powerfully persuasive dissent in the Ninth Circuit agreed with the majority’s legal analysis as to the elements of insider status, but, “on the facts of this case,” deemed R a *de facto* insider. In its view, “[w]ithout the sale of [the insider’s] claim to [R] and his anticipated vote to approve the [debtor’s cramdown] plan, that plan [was] dead in the water.” *Id.* at 1004. According to the dissent, the “savvy debtor” here formulated “a reorganization plan . . . that would provide a payout on [an] insider claim” and then sold “the claim to a friendly third party for a price lower than the payout . . . ensuring [an acceptance] and thereby allowing the debtor to effectively avoid the requirement under [Bankruptcy Code] § 1129(a)(10) that at least one non-insider approve the plan.” *Id.*, at 1007. The critical issue, therefore, was whether R, the sole unsecured creditor was an insider, for his acceptance of the debtor’s reorganization plan was essential to confirmation. Because there was no other accepting impaired creditor class, confirmation of the plan turned on R’s not being an insider.

The dissent rejected the majority’s application of the law to the facts of the case, stressing the following undisputed facts:

- R paid \$5,000 for a nominal claim of \$2.76 million held by the insider;
- The selling insider creditor did not offer the claim to any other party;
- R did not solicit the claim;
- The insider proposed to R that he buy the claim;
- Neither the insider nor R negotiated over the price for the claim;
- R knew nothing or little about the debtor before buying the claim;
- R made no investigation regarding the value of the claim before or after his purchase;
- R knew nothing regarding the debtor apart from its proposed treatment of the claim under its plan prior to his later deposition by the bank;
- After learning of a \$30,000 distribution on the claim during his deposition, R still rejected the bank’s offer to purchase the claim for \$60,000;
- The insider needed R’s acceptance of the plan, which could not “be approved unless there was a class of creditors willing to vote to approve it.” *Id.* at 1004;
- The debtor’s insiders were “primarily motivated to place the unsecured claim in the hands of a friendly creditor who could be counted on to vote in favor of the reorganization plan, opening the door to . . . approval of the proposed plan” *Id.*; and
- R had a close business and personal relationship with the selling insider, the person who proposed the sale of the claim to him.

Id., at 1002-05.

The dissent’s characterization of R as a *de facto* insider turned on the premise that the sale of the claim was not negotiated at arm’s length. Although the bankruptcy court found that R and the insider were

“separate financial entities,” it did not and could not find that the transaction “was conducted as if they were strangers.” *Id.* at 1005. According to the dissent, “even if the clear error standard [of appellate review] applies, the finding that [R] was not a [*de facto*] insider cannot survive scrutiny.” *Id.* at 1006. In its view, no reviewing court “could reasonably conclude that this transaction was conducted as if [R] and [the insider] were strangers.”

The Ninth Circuit’s holding, now affirmed by the Supreme Court, may have a long-term negative effect on the formulation of reorganization plans in other cases. It will, at least in the Ninth Circuit, facilitate creative plan manipulation by “savvy” debtors.

The Sixth Circuit, in contrast to *Lakeridge*, held that a Chapter 11 plan’s contrived impairment of two unsecured claims held by the debtor’s former lawyer and accountant “was transparently an artifice to circumvent the purposes of” the Bankruptcy Code. *In re Village Green I GP*, 811 F.3d 816 (6th Cir. 2016). Affirming the reversal of the bankruptcy court’s finding that the debtor had “proposed its plan in good faith” under § 1129(a)(3), the Sixth Circuit rejected the debtor’s “assertion that it could not safely pay off the [two] minor [friendly] claims (total value: less than \$2,400) up front rather than in over 60 days.” Had the bank in *Lakeridge* raised the debtor’s lack of good faith in proposing its plan, as evidenced by the apparently collusive sale of the insider claim to R, the result might have been different. See *In re KB Toys Inc.*, 736 F.3d 247, 255 (3d Cir. 2013) (“Claim purchasers are entities who knowingly and voluntarily enter the bankruptcy process [A] purchaser should know that it is taking on the risks . . . attendant to the bankruptcy process [A] claim purchaser’s opportunity to profit is partly created by the risks inherent in bankruptcy. Disallowance of a claim . . . is among these risks”; transferred claim disallowed because transferor had received preference); *In re Metiom Inc.*, 301 B.R. 634, 642 (Bankr. S.D.N.Y. 2003) (because Code “disallows the claim . . . [t]he claim and defense to the claim . . . cannot be altered by the claimant’s subsequent assignment of the claim to another entity . . .”).

Arbitration

A bankruptcy court properly denied a bank’s motion to compel arbitration of a debtor’s asserted violation of the court’s discharge injunction, held the Second Circuit on March 7, 2018. *In re Anderson*, 884 F.3d 382, 392 (2d Cir. 2018). The debtor’s breached credit card agreement with the defendant bank had mandated arbitration of any dispute, including a claim for injunctive relief, and precluded the debtor’s right to participate in a class action. Two years after getting his bankruptcy discharge, the former Chapter 7 debtor asked the creditor bank to change its accurate credit report that showed his default, but the bank refused. The debtor then reopened his bankruptcy case and started a class action, alleging that the bank was seeking to collect on its discharged claim, although the bank had previously sold the claim to a third party.

Finding a purported “inherent conflict between arbitration of [the debtor’s] claim and the Bankruptcy Code,” the Second Circuit reasoned that the bankruptcy court “properly considered the conflicting policies [of the Arbitration Act and the Bankruptcy Code] in accordance with law.” *Id.*, quoting *In re United States Lines Inc.*, 197 F.3d 631, 641 (2d Cir. 1999). To reach its extraordinary result, the court strained to distinguish *Anderson* from its earlier decision in *MBNA America Bank v. Hill*, 436 F.3d 104, 111 (2d Cir. 2006) (*held*, arbitration of debtor’s “automatic stay claim would not necessarily jeopardize or inherently conflict with the Bankruptcy Code”). The Second Circuit also ignored Supreme Court precedent as well as the text of the Bankruptcy Code, the Judiciary Code and relevant legislative history.

The Supreme Court, on May 21, 2018, later held in another case that “employees and employers [were] allowed to agree that any disputes between them will be resolved through one-on-one arbitration,” and preclude “class or collective actions . . .” *Epic Systems Corp. v. Lewis*, 2018 WL 2292444, *3 (2018) (5-4). Finding no conflict between the Arbitration Act and the National Labor Relations Act, the Court stressed that it “has heard and rejected efforts to conjure conflicts between the Arbitration Act and other federal statutes. In fact, this Court has rejected *every* such effort to date (save one temporary exception since overruled), with statutes ranging from the Sherman Clayton Act to the Age Discrimination Employment Act, the Credit Repair Organizations Act, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Racketeer Influenced Corrupt Organizations Act.” *Id.* at *11 (emphasis in original). It is hardly surprising, therefore, that the creditor bank in *Anderson* filed a petition for certiorari in the Supreme Court on June 8, 2018.

The Second Circuit’s *Anderson* decision is problematic in at least two respects. First, it failed to cite a significant contrary district court decision. *Belton v. GE Capital Consumer Lending Bank*, 2015 WL 6163083, *6-8 (S.D.N.Y. Oct. 15, 2015) (Congress never “intended to preclude arbitration of [§] 524 [discharge violation] claims”; Congress gave federal district courts non-exclusive jurisdiction over [such] claims; no “inherent conflict” between arbitrating such claims and underlying purpose of Bankruptcy Code; debtor’s rights could be vindicated in arbitration; discharge injunction a “national form”; nothing suggested that “bankruptcy court . . . more qualified than an arbitrator to adjudicate [discharge violation] claim[s].”). *Belton* is currently on appeal to the Second Circuit.

Second, nothing in the text or the legislative history of the Bankruptcy Code even suggests that Congress intended bankruptcy courts to have exclusive jurisdiction over discharge violation claims. In its earlier *Hill* decision, the Second Circuit conceded that when “arbitration would not interfere with or affect the distribution of the estate” or “affect an ongoing reorganization,” a bankruptcy court lacks discretion to deny arbitration. 463 F.3d at 109-110, citing *Bigelow v. Green Tree Financial Servicing Corp.*, 2000 WL 33596476, *6 (E.D. Cal. Nov. 3, 2000) (compelled arbitration of discharge violation claim). In *Anderson*, the Chapter 7 bankruptcy case was closed and the debtor had already received his discharge. Arbitration, therefore, would have had no effect on a reorganization or on distributions to creditors.

More important, Congress provided exclusive federal-court jurisdiction over specific bankruptcy-related claims (e.g., § 327), but not § 524 discharge violation claims. 28 U.S.C. §§ 1334(a) & (e). Congress, in fact, gave bankruptcy courts non-exclusive jurisdiction over such claims. 28 U.S.C. § 1334(b) (“ . . . original but not exclusive jurisdiction . . .”). Resolution of a discharge violation claim hardly requires unique bankruptcy expertise, for the issue is only whether the alleged act sought “to collect” a discharged debt. In *Anderson*, the arbitrator was required to be either a lawyer or a former judge.

Rejection of Trademark License

A Chapter 11 debtor-licensor’s rejection of a trademark license “left [the non-debtor licensee] with only a pre-petition damages claim in lieu of any obligation by Debtor to further perform under . . . the trademark license,” held the First Circuit on Jan. 12, 2018. *In re Temptnology LLC*, 879 F.3d 389, 392 (1st Cir. 2018) (2-1). Reversing the Bankruptcy Appellate Panel (“BAP”) and affirming the bankruptcy court, the First Circuit explained that “we favor the categorical approach of leaving trademark licenses unprotected from [bankruptcy] court approved rejection.” *Id.* at 404. Thus, the licensee’s “right to use Debtor’s trademarks did not otherwise survive rejection of the” license. *Id.* at 396.

The key trademark issue, said the First Circuit “poses for this circuit an issue of first impression concerning which other circuits are split.” *Id.* at 392. It expressly noted the Seventh Circuit’s contrary view in *Sunbeam Products Inc. v. Chicago American Mfg. LLC*, 686 F.3d 372, 377 (7th Cir. 2012) (right to use debtor’s trademark continues post-rejection), a view shared by an important judge on the Third Circuit. *In re Exide Techs.*, 607 F.3d 957, 964-68 (3d Cir. 2002) (Ambro, J., concurring). The First Circuit, though, followed the approach taken by the Fourth Circuit in *Lubrizol Enters. Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985) (effect of rejection was to terminate intellectual property license). The licensee, of course, filed a petition for certiorari with the Supreme Court on June 12, 2018.

The First Circuit distinguished between a “statutory breach” and a “common law breach.” 879 F.3d at 396, citing *Lubrizol*. It then argued that Congress only partially overturned *Lubrizol* in 1988 when it defined intellectual property in Code § 101(35A) and had specifically excluded trademarks from any new statutory protection from contract rejection. 879 F.3d at 401.

Disagreeing with the Seventh Circuit’s *Sunbeam* decision, the court reasoned that the goal of Code § 365(a) is to release the debtor “from burdensome obligations.” *Id.* at *402. According to the First Circuit, a debtor should not be forced to choose between performing its obligations under the license agreement or risking the loss of its trademarks under applicable federal law. Any such “restriction on Debtor’s ability to free itself from its executory obligations, even if limited to trademark licenses alone, would depart from the manner in which section 365(a) operates.” *Id.*, at 403. “In sum, . . . *Sunbeam* entirely ignores the residual enforcement burden it would impose on the debtor just as the Code otherwise allows the debtor to free itself from executory burdens. [It] also rests on a logic that invites further degradation of the debtor’s fresh start options.” *Id.* at 404.

The majority opinion in *Temptnology* relied on the premise that federal bankruptcy law preempts federal trademark law, taking a “categorical approach” that values reorganization over other business concerns. The case is now ripe for U.S. Supreme Court review, given the circuit split.

The Seventh Circuit’s *Sunbeam* decision is more persuasive. Merely because trademarks are not covered by the protection of § 365(n) means nothing: “an omission is just an omission.” 686 F.3d at 375. “According to the Senate committee report on the bill that included § 365(n), the omission was designed to allow more time for study, not to approve [the Fourth Circuit’s] *Lubrizol* [decision].” *Id.* Also, “[o]utside of bankruptcy, a licensor’s breach does not terminate a licensee’s right to use intellectual property [N]othing about [the rejection] process implies that any rights of the other contracting party have been vaporized [R]ejection is not the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed.” *Id.* 376-77.

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