AMERICAN BANKRUPTCY INSTITUTE

2018 Bankruptcy Battleground West

Keynote Address

PLENARY SESSION

Dean Erwin Chemerinsky
UC Berkeley School of Law; Berkeley

2018

American Bankruptcy Institute
Los Angeles, California
March 6, 2018

Erwin Chemerinsky
Dean and Jesse H. Choper Distinguished Professor of Law,
University of California, Berkeley School of Law

I. Court procedure

Goodyear Tire & Rubber Co. v. Haeger, 137 S. Ct. 1178 (2017). When a federal court exercises its inherent authority to sanction bad-faith conduct by ordering a litigant to pay the other side's legal fees, the award is limited to the fees that the innocent party incurred solely because of the misconduct.

Bristol-Myers Squibb Co. v. Superior Court of California, 137 S. Ct. 1773 (2017). California courts lack specific jurisdiction to entertain the claims in this case brought by plaintiffs who are not California residents, because there is an insufficient connection between the forum and the claims at issue.

II. Constitutional rights

A. First Amendment

1. Speech

Matal v. Tam, 137 S.Ct. 1744 (2017). The disparagement provision of the Lanham Act, 15 U.S.C. 1052(a), which provides that no trademark shall be refused registration on account of its nature unless it "[c]onsists of . . . matter which may disparage . . . persons, living or dead, institutions, beliefs, or national symbols, or bring them into contempt, or disrepute" is facially invalid under the Free Speech Clause of the First Amendment.

Masterpiece Cakeshop Ltd. v. Colorado Civil Rights Commission, 370 P.3d 272 (Colo.App.2015), *cert. granted*, 137 S.Ct. 2290 (2017). Whether applying Colorado's public accommodations law to compel the petitioner to create expression that violates his sincerely held religious beliefs about marriage violates the free speech or free exercise clauses of the First Amendment.

Janus v. American Federation, 851 F.3d 746 (7th Cir. 2017), *cert. granted*, 138 S.Ct. 54 (2017). Whether *Abood v. Detroit Board of Education* should be overruled and public-sector "agency shop" arrangements invalidated under the First Amendment.

National Institute of Family and Life Advocates v. Bacerra, 839 F.3d 823 (9th Cir, 2017), *cert. granted*, 138 S.Ct. 446 (2017). Whether the disclosures required by the California Reproductive FACT Act violate the protections set forth in the free speech clause of the First Amendment, applicable to the states through the 14th Amendment.

2. Religion

Trinity Lutheran Church of Columbia, Inc. v. Comer, 137 S. Ct. 2012 (2017). The Free Exercise Clause prohibits a state from denying an otherwise qualified religious entity a public benefit (here, grants to help in the purchase of rubber playground surfaces made from recycled tires) solely because of its religious character. This case involves express discrimination based on religious identity with respect to playground resurfacing. The Court does not address religious uses of funding or other forms of discrimination.

B. Equal Protection—Gender Discrimination

Pavan v. Smith, 137 S. Ct. 2075 (2017). Having chosen to require the name of the male spouse of a new mother to appear on the child's birth certificate regardless of his biological relationship to the child, Arkansas may not, consistent with Obergefell v. Hodges, 135 S. Ct. 2584 (2015), refuse to issue birth certificates that include the female spouses of women who give birth in the state.

III. Statutory claims

Bank of American v. City of Miami, 137 S.Ct. 1296 (2017). (1) A city is an "aggrieved person," under the Fair Housing Act and has standing to sue based on its economic losses; and (2) proximate cause requires more than just the possibility that a defendant could have foreseen that the plaintiff might ultimately lose money.

Henson v. Santander Consumer USA, 137 S.Ct. 1718 (2017). A company that regularly attempts to collect debts it purchased after the debts had fallen into default is not a "debt collector" subject to the Fair Debt Collection Practices Act.

IV. Bankruptcy

Czyzewski v. Jevic Holding Co., 137 S.Ct. 973 (2017). Bankruptcy courts may not approve structured dismissals of Chapter 11 bankruptcy cases that provide for assert distributions that do not follow ordinary priority rules established by the Bankruptcy Code without the consent of the creditors.

Midland Funding v. Johnson, 137 S.Ct. 1407 (2017). The filing of a proof of claim that is obviously time barred is not a false, deceptive, misleading, unfair, or unconscionable debt-collection practice within the meaning of the Fair Debt Collection Practices Act.

Merit Management Group, L.P. v. FTI Consulting Group, Inc., 138 S.Ct. ___ (Feb. 27, 2018). The Bankruptcy Code allows trustees to set aside and recover certain transfers for the benefit of the bankruptcy estate, including certain fraudulent transfers "of an interest of the debtor in property"; the Bankruptcy Code also sets out a number of limits on the exercise of these avoiding powers, including the Section 546(e) safe harbor – which, inter alia, provides that a "trustee may not avoid a transfer that is a ... settlement payment ... made by or to (or for the benefit of) a ... financial institution .. or that is a transfer made by or to (or for the benefit of) a ... financial institution ... in connection with a securities contract." In the Chapter 11 bankruptcy filed by

Valley View Downs and its parent company, the only relevant transfer for purposes of the Section 546(e) safe harbor is the transfer that the trustee, FTI Consulting Inc., seeks to avoid, i.e., the transfer from Valley View to Merit Management Group for the sale of Bedford Downs Management's stock.

U.S. National Bank Association v. Village at Lakeridge, 814 F.3d 993 (9th Cir. 2016), *cert. granted*, 137 S.Ct. 1732 (2017). Whether the appropriate standard of review for determining non-statutory insider status is the de novo standard of review applied by the U.S. Courts of Appeals for the 3rd, 7th and 10th Circuits, or the clearly erroneous standard of review adopted for the first time by the U.S. Court of Appeals for the 9th Circuit in this action.

Lamar, Archer & Cofrin LLP v. Appling, 848 F.3d 953 (11th Cir. 2017), *cert. granted*, 138 S.Ct. 734 (2018). Whether (and, if so, when) a statement concerning a specific asset can be a "statement respecting the debtor's ... financial condition" within Section 523(a)(2) of the Bankruptcy Code.

Justices to rule on a narrow issue regarding the 'safe harbor' and leveraged buyouts.

Supreme Court to Decide Whether Using a 'Mere Conduit' Invokes the 546(e) 'Safe Harbor'

The Supreme Court granted *certiorari* today to resolve a split of circuits and decide whether the "safe harbor" for securities transactions applies under Section 546(e) when a financial institution acts only as a "mere conduit" with no beneficial interest in the stock being sold in a leveraged buyout.

The Court will review the Seventh Circuit's decision in *FTI Consulting Inc. v. Merit Management Group LP*, 830 F.3d 690 (7th Cir. July 28, 2016), where "mere conduit" is the only issue.

The justices are yet to act on the *certiorari* petition in *Deutsche Bank Trust Co. Americas v. Robert R. McCormick Foundation,* 16-317 (Sup. Ct.), which raises the "mere conduit" question along with several others under Section 546(e). Indeed, the Second Circuit gave the broadest possible interpretation of the safe harbor by holding that it supersedes state law and precludes creditors from bringing fraudulent transfer claims of their own against third parties when the selling corporation goes bankrupt.

Chief Circuit Judge Diane P. Wood wrote the decision for the Seventh Circuit in July 2016. Her opinion stands for the proposition that routing consideration for an LBO of a non-public company through a financial institution cannot preclude a fraudulent transfer attack if the seller was rendered insolvent. How her decision would apply to a leveraged buyout of a public company is not clear.

Judge Wood's decision was in the minority. Only the Eleventh Circuit has similarly held that using a financial institution as a conduit does not invoke the "safe harbor." The Second, Third, Sixth, Eighth and Tenth Circuits take the contrary view and apply the safe harbor when a financial institution is nothing more than a conduit.

The Seventh Circuit employed a powerful bench to decide the safe harbor question. With her on the panel were Circuit Judges Richard A. Posner and Ilana D. Rovner. The appeals court denied rehearing *en banc*.

With today's grant of *certiorari*, the Supreme Court already has two bankruptcy cases on the calendar for the term to begin in October 2017. In late March, the justices agreed to hear *U.S.*

Bank NA v. The Village at Lakeridge LLC, 15-1509 (Sup. Ct.), and decide whether the purchaser of a claim automatically takes on the seller's insider status.

To read ABI's discussion of Judge Wood's decision, click here.

The case is *Merit Management Group LP v. FTI Consulting Inc.*, 16-784 (Sup. Ct.).

High court won't decide whether a claim purchaser automatically takes seller's insider status.

Supreme Court Grants 'Cert' on Appellate Standards for Non-Statutory Insider Status

The Supreme Court granted *certiorari* today in *U.S. Bank NA v. The Village at Lakeridge LLC*, but the high court will *not* review the more important question for chapter 11 practice.

The justices will not decide whether the purchaser of a claim automatically takes on the seller's insider status, perhaps because the justices perceive no conflict among the circuits. Rather, the court will decide whether the standard of review for non-statutory insider status is *de novo* or clearly erroneous, or a combination of both.

Curiously, the Acting Solicitor General recommended denial of *certiorari*, believing that in reality there are no circuit splits and that the Ninth Circuit made the correct holdings. To the contrary, the petitioner contends that the Third, Seventh and Tenth Circuits employ the *de novo* standard while the Ninth Circuit "for the first time" employed the clearly erroneous standard.

The Ninth Circuit Opinion

In the chapter 11 case that came to the Ninth Circuit, there were only two creditors. One was a bank with a $10 million secured claim. The other was the debtor's general partner, with a $2.8 million unsecured claim. As an insider, the general partner's vote in favor of the plan could not be counted under Section 1129(a)(10). For lack of an accepting class, the plan could not have been confirmed and crammed down, because the bank opposed the plan.

Hoping to confirm using cramdown, the general partner sold his claim for $5,000 to a close friend of one of the owners of the general partner. The plan called for a $30,000 distribution on the unsecured claim.

The bankruptcy judge ruled that the buyer automatically became an insider upon purchasing the claim and thus could not be the accepting class. The Bankruptcy Appellate Panel reversed and was upheld in a 2-1 opinion in February 2016, with Circuit Judge N. Randy Smith writing for the majority.

The case turned on the definition of "insider" contained in Section 101(31), which names several types of people, known as statutory insiders, who are automatically insiders. By the definition's use of the word "including," Judge Smith said that others become "non-statutory

insiders" if they have "a sufficiently close relationship with the debtor to fall within the definition."

In the principal holding of the case, all three judges, including the dissenter, agreed that a "person does not become a statutory insider solely by acquiring a claim from a statutory insider." Judge Smith said that the Code distinguishes between the status of a claim and the status of a creditor. Insider status, he said, pertains only to the claimant.

Consequently, Judge Smith said that status as an insider entails a "factual inquiry that must be conducted on a case-by-case basis." To become an insider, a claim buyer "must have a close relationship with the debtor and negotiate the relevant transaction at less than arm's length," he said.

The bankruptcy judge had determined that the buyer was not an insider based on his conduct and relationship with the debtor and its owners. Since the buyer as a matter of law did not become an insider by purchasing the insider's claim, the majority on the circuit court upheld the appellate panel because the bankruptcy judge's findings of fact on insider status were not clearly erroneous.

Circuit Judge Richard R. Clifton dissented in part. It was "clear" to him that the buyer should have been deemed an insider. In his view of the facts, the sale was not negotiated at arm's length.

The *Certiorari* Petition

The lender filed a petition for *certiorari* in June 2016, raising three issues: (1) whether the purchaser of an insider's claim automatically acquires the seller's insider status under Sections 1129(a)(10) and 101(31); (2) whether the standard of review on non-statutory insider status is *de novo* or clear error; and (3) whether the test for non-statutory insider status is an "arms' length" analysis or a "functional equivalent" test.

In October, the justices invited the Acting Solicitor General to file a brief "expressing the views of the United States."

In a brief filed in February, the Acting Solicitor General recommended that the Court deny the *certiorari* petition, saying that the circuit court properly articulated and applied the standards for appellate review. The government also could not discern any conflict among the circuits on the issues presented in the petition.

According to the government, the Ninth Circuit correctly applied the appellate standards: The bankruptcy court's conclusions of law are reviewed *de novo*, and its findings of fact are reviewed for clear error. Concluding that "[f]urther review is not warranted," the government said that the

Ninth Circuit's "application of the governing legal standard in conducting clear error review of the bankruptcy court's factual findings raises no issue of general importance."

The Supreme Court Cogitates

The justices were originally scheduled to pass on the *certiorari* petition at a conference on March 17. On March 20, the Court rescheduled the conference for March 24. Rescheduling consideration of a petition is sometimes an indication that the justices may be inclined to review the case.

In an order on March 27, the Court granted the petition, but "limited [review] to Question 2 presented in the petition," regarding the standard of review. Not granting review of the first issue may be an indication that the justices see no conflict of circuits on the holding that the purchaser of a claim does not automatically assume the seller's insider status.

The petition was granted too late for the Court to hold argument in time for a decision to be made before the current term ends in late June. Argument likely will be scheduled not long after the new term begins in October, assuming there are no delays in the parties' submissions of briefs on the merits.

To read ABI's discussion of the Ninth Circuit opinion, click here. For discussion of the Acting Solicitor General's views, click here.

To read the Ninth Circuit opinion, click here. The opinion is officially reported at *U.S. Bank NA v. The Village at Lakeridge LLC (In re The Village at Lakeridge LLC)*, 814 F.3d 993 (9th Cir. 2016).

The case in the Supreme Court is *U.S. Bank NA v. The Village at Lakeridge LLC,* 15-1509 (Sup. Ct.).

High court to decide whether a false oral statement about one asset results in nondischargeability.

Supreme Court Grants *Certiorari* in a Third Bankruptcy Case This Term

On Jan. 12 the Supreme Court granted *certiorari* and will review *Lamar, Archer & Cofrin LLP v. Appling*, 16-1215 (Sup. Ct.), to resolve a split of circuits and decide whether a false oral statement about one asset is a statement of "financial condition" that must be in writing to result in denial of discharge of a debt under Section 523(a)(2).

The case will be argued, with a decision handed down before the Court's term ends in late June. With *Appling*, the high court will decide three bankruptcy cases this term.

On Nov. 6, the justices heard oral argument in *Merit Management Group LP v. FTI Consulting Inc.*, 16-784 (Sup. Ct.), dealing with the safe harbor in Section 546(e). In *U.S. Bank NA v. The Village at Lakeridge LLC,* 15-1509 (Sup. Ct.), argued on Oct. 31, the Supreme Court will prescribe the standard of appellate review for non-statutory insider status. Decisions in those cases could come down in the next few weeks.

On the issue in *Appling*, the courts of appeals are evenly split. The Eleventh and Fourth Circuits hold that a false oral statement about one asset is a statement of "financial condition" that must be in writing to result in denial of discharge of a debt under Section 523(a)(2). The Fifth and Tenth Circuits ruled to the contrary, holding that misrepresenting one asset can result in nondischargeability of the debt owing to the creditor to whom the misrepresentation was made.

Among the lower courts, a majority follow the Eleventh and Fourth Circuits.

In the Eleventh Circuit case that the justices will review, a client told his lawyers that he expected a large tax refund that would enable him to pay his legal bills. Based on that representation, the lawyers continued working.

Although the refund was smaller than represented, the client spent it on his business, falsely telling his lawyers that he had not received the refund. The lawyers continued working. Later, they obtained a judgment they could not collect when the client filed bankruptcy.

The bankruptcy judge held that the claim for legal fees was not discharged. The ruling in bankruptcy court was upheld in district court, but the Eleventh Circuit reversed in a Feb. 15

opinion authored by Circuit Judge William Pryor. *Appling v. Lamar, Archer Cofrin LLP (In re Appling)*, 848 F.3d 953 (11th Cir. Feb. 15, 2017).

The high court will be interpreting Sections 523(a)(2)(A) and 523(a)(2)(B). Under (a)(2)(B), a debt will not be discharged if it resulted from a materially false written statement "respecting the debtor's . . . financial condition."

Under (a)(2)(A), a debt will not be discharged if it resulted from "a false representation or actual fraud, other than a statement respecting the debtor's . . . financial condition."

The creditor who lost in the Eleventh Circuit filed a petition for *certiorari* in April. In June, the justices invited the Solicitor General "to file a brief in this case expressing the views of the United States."

In a brief on Nov. 9, the Solicitor General recommended that the high court hear the case because there is a deepening circuit split over an "important and recurring" question. The government also took the position that the Eleventh Circuit was correct in holding that a false oral statement about one asset should not result in nondischargeability of a debt.

If the justices reverse the Eleventh Circuit, bankruptcy law will mean that someone who utters a big lie can win a discharge of debt when making a small lie can mean a nondischargeable debt.

Here are the examples. If the debtor says orally, "I have a $10 million net worth," that statement will not make a debt nondischargeable because all circuits would agree it's a statement about "financial condition" that must be in writing before resulting in nondischargeability.

By way of contrast, assume the debtor owns many properties and says orally, "One property I own is worth $10 million." In the Fifth and Tenth Circuits, the statement could make the debt nondischargeable if it were false because those courts of appeals believe that the representation would not concern "financial condition" because it says nothing about the debtor's overall net worth.

In the Fifth and Tenth Circuits, a debtor could safely misrepresent his or her net worth without the risk of dischargeability, but the same debtor in those circuits would end up with a nondischargeable debt for misrepresenting only one asset. In other words, the Supreme Court will decide whether a smaller lie is more dangerous to dischargeability than a big lie.

Like *Merit Management*, *Appling* gives the Supreme Court another opportunity to decide a bankruptcy case by focusing more on the perceived purpose as opposed to the language of the statute. Like the Eleventh Circuit, perhaps the justices will recognize that human beings are prone to puffery and that creditors should take oral statements about financial condition with a

grain of salt, regardless of whether the statement concerns one asset or overall financial condition.

To read ABI's discussions of the *Merit Management* and *Lakeridge* oral arguments, click here and here, respectively.

The *Appling* case in the Supreme Court is *Lamar, Archer & Cofrin LLP v. Appling*, 16-1215 (Sup. Ct.).