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Last in Line

By Deborah L. Thorne and Timothy S. McFadden

A Circuit Split Unfolds on Unstayed Judgments Pending Appeal

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Involuntary bankruptcy petitions are a useful tool for creditors when collecting on debts and judgments or when mystery shrouds the alleged debtor's activities. One of the key threshold issues that creditors must consider prior to filing an involuntary petition is whether their claims are "not contingent as to liability or the subject of a bona fide dispute as to liability or amount."[1] In *Marciano v. Chapnick (In re Marciano)*,[2] the U.S. Court of Appeals for the Ninth Circuit held that the holder of an unstayed judgment could qualify as a petitioning creditor under § 303(b)(1) despite the fact that it was being appealed.

The *Marciano* decision is contrary to the Fourth Circuit's holding on the same issue in *Platinum Financial Services Corp. v. Byrd (In re Byrd)*.[3] This new circuit split underscores the importance for creditors of assessing whether they qualify as petitioning creditors under § 303(b) (1). This article reviews the statutory provisions relevant to any such analysis and discusses the various positions that courts have taken on the particular issue that was decided in *Marciano* regarding whether a holder of an unstayed judgment subject to an ongoing appeal can qualify as a petitioning creditor.

Statutory Provisions

Section 303(b) (1) provides that an involuntary payment can be commenced

> by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount, or an indenture trustee representing such a holder, if such noncontingent, undisputed claims aggregate at least $14,425 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims.[4]

The phrase "the subject of bona fide dispute" was added by Congress in the Bankruptcy Amendments and Federal Judgeship Act of 1984 but was left undefined. This ambiguity has led to the question of whether holding an unstayed judgment subject to an appeal qualifies as a valid claim to support the filing of an involuntary petition.

1 11 U.S.C. § 303(b)(1).
2 708 F.3d 1123 (9th Cir. 2013).
3 357 F.3d 433 (4th Cir. 2004).
4 11 U.S.C. § 303(b)(1).

In re Byrd

Prior to the Ninth Circuit's decision in *Marciano*, only one circuit court—the Fourth Circuit—had issued a published opinion regarding whether an unstayed judgment on appeal could be subject to a bona fide dispute.[5] In *Byrd*, the Fourth Circuit reversed and remanded to the district court the question of whether the petitioning creditors holding unstayed judgments in which appeals were pending had claims that were "not subject to bona fide disputes."

The court held that once petitioning creditors demonstrated that they held unstayed state court judgments, the burden shifted to the potential debtor to demonstrate the existence of a bona fide dispute.[6] The Fourth Circuit explained that § 303(b) should allow the bankruptcy court to inquire into "the genuineness of Byrd's appeals." This would not, in effect, be "relitigating [his] liability in violation of settled rules of *res judicata* because it was not actually resolving any disputed question of fact or law."[7] The *Byrd* petitioning creditor was able to file its petition against Byrd not just because it held a judgment but because Byrd did not raise any "substantial factual or legal questions about the continued viability of those judgments."[8] Had Byrd raised a substantial factual or legal question, however, and not simply maintained the same arguments that the state court and the bankruptcy court found were not supported by documentation or relevant facts, the involuntary petition would have been supported by claims that were "subject to bona fide dispute." Under the Fourth Circuit's holding, an unstayed judgment while on appeal is not sufficient to support an involuntary petition if there are questions of law or fact that are not determined.

The *Marciano* Decision

In *Marciano*, Georges Marciano sued five of his former employees, alleging theft. Three of the employees filed counterclaims against Marciano, alleging intentional infliction of emotional distress and defamation. Following a jury trial on damages,

5 *Platinum Fin. Servs. Corp. v. Byrd (In re Byrd)*, 357 F.3d 433 (4th Cir. 2004). In an unpublished decision that is not precedent, the Fifth Circuit held that an unstayed final judgment was not subject to a bona fide dispute for purposes of 11 U.S.C. § 303(b)(1). *See Norris v. Johnson (In re Norris)*, 114 F.3d 1182, 1997 WL 256808 (5th Cir. 1997) (unpublished) (holding that unstayed final judgment entered in Louisiana state following trial was not subject to bona fide dispute).
6 *Platinum Fin. Servs. Corp.*, 357 F.3d at 439.
7 *Id.* at 440-41 (citation omitted).
8 *Id.* at 441.

the court entered judgments against Marciano totaling more than $100 million. Marciano appealed the judgments to the California Court of Appeals, but did not post bond to stay the judgments during the appeal.

After five other individuals holding judgment against Marciano totaling almost $200 million began collection efforts against Marciano, the three former employees filed an involuntary bankruptcy petition against Marciano in the U.S. Bankruptcy Court for the Central District of California. Marciano filed a motion to dismiss the petition on voluntary grounds, which both the bankruptcy court and the U.S. Bankruptcy Appellate Panel for the Ninth Circuit denied. Following those decisions, Marciano appealed to the Ninth Circuit.

In its analysis, the Ninth Circuit considered the two approaches to determining whether unstayed nondefault judgments are claims not in a bona fide dispute as to liability. The majority view, referred to as the "*Drexler*" rule,[9] provides a *per se* rule that an unstayed nondefault statement judgment on appeal is not subject to a bona fide dispute for purposes of § 303(b)(1).[10]

The Ninth Circuit discussed the *Byrd* minority approach[11] and rejected it, adopting the *Drexler* rule as correct based on a matter of statutory interpretation and federalism. The court noted that the Bankruptcy Code's definition of "claim" under § 101(5)(A) is a "right to payment, *whether or not such right is reduced to judgment*."[12] Thus, a right to payment includes a judgment. The "claims" relied on by the petitioning creditors were the unstayed judgments rather than the underlying claims for defamation and slander.[13] The court noted that since the petitioning creditors were entitled to immediate payment of their claims in the amounts set forth in the state court judgments, they had fully vested property interests in the claims under California state law.

The court stated that its ruling provided an objective basis for evaluating claims under § 303(b)(1) in that "it is difficult to imagine a more 'objective' measure of the validity of a claim than an unstayed judgment entered by a court of competent jurisdiction."[14] Moreover, the Ninth Circuit stated that its ruling was consistent with the principles of federalism since a *per se* rule would give "full faith and credit" to the judicial proceedings of state courts as required under 28 U.S.C. § 1738.[15] The court stated that "[s]uch 'full faith and credit' would be of little consequence if a federal court treated a nondefault unstayed state judgment differently than it would be treated in its state of origin."[16]

The Ninth Circuit's ruling, however, was not unanimous, and a dissenting opinion written by Hon. Sandra Segal Ikuta provides a reminder that the *Byrd* ruling may remain a persuasive precedent when other courts address this issue in the future. The dissent opined that the court's holding was a "shortcut" approach that failed to provide the necessary safeguards for debtors subject to involuntary petitions as contemplated in § 303(b)(1). Instead, the court should have employed the objective test used in *Byrd* and in fact used by the Ninth Circuit in a previous case.[17] This test essentially required a factual determination as to whether there was an objective basis for either a factual or legal dispute as to the validity of the debt.

> **[A]lleged debtors who are able to assert the existence of undecided issues of law or fact may again be able to sway a court that is on the fence to steer clear of a *per se* rule in order to achieve a more equitable result and safeguard against the potential abuses of involuntary bankruptcy.**

As noted in the dissent, the possibility that there could be legitimate questions regarding Marciano's liability proved to be true when the California state appellate court reduced the amount of each judgment against Marciano to $10 million.[18] The dissent stated that a "claim" as defined under § 101(5) is a "right to payment" rather than a judgment, and it is irrelevant that a right to payment has been reduced to a judgment.[19] The immediate enforceability of the unstayed judgment need not be considered so long as the right to payment was subject to a bona fide dispute.

As for the argument that a *per se* rule was necessary to give state court judgments "full faith and credit" in accordance with the Full Faith and Credit Act, the dissent stated that the *Byrd* ruling does not require federal courts to reassess liability or the amount of a state court judgment. Rather, the dissent acknowledged that "the question [of] whether a determination is *subject to* a genuine dispute is separate from determining the merits of that dispute."[20]

The dissent concluded by stating that the Ninth Circuit's ruling ignored existing precedent in favor of a per se rule advanced in the name of judicial efficiency. According to the dissent, however, the preference for judicial efficiency should not have carried the day over the greater interest in safeguarding against abuses of involuntary bankruptcy.[21]

Conclusion

The *Marciano* decision creates a circuit split regarding the issue of whether § 303(b)(1) mandates a *per se* rule regarding whether unstayed state court judgments may be the subject of a bona fide dispute. As a result, petitioning creditors and alleged debtors must be aware of this dispute

9 The *Drexler* holding has been followed by a number of other courts, including—but not limited to—*In re AMC Investors LLC*, 406 B.R. 478, 487 (Bankr. D. Del. 2009); *Norris v. Johnson (In re Norris)*, 114 F.3d 1182 (5th Cir. 1997); *In re Euro-Am. Lodging Corp.*, 357 B.R. 700, 712 (Bankr. S.D.N.Y. 2007) (*per curiam*) (unpublished); *In re Amanat*, 321 B.R. 30, 37 (Bankr. S.D.N.Y. 2005); and *In re Caucus Distribs. Inc.*, 83 B.R. 921, 929 (Bankr. E.D. Va. 1988).
10 *Marciano*, 708 F.3d at 1126 (citing *In re Drexler*, 56 B.R. 960, 967 (Bankr. S.D.N.Y. 1986)).
11 *Platinum Fin. Servs. Corp. v. Byrd (In re Byrd)*, 357 F.3d 433 (4th Cir. 2004).
12 11 U.S.C. § 101(5)(A).
13 *Marciano*, 708 F.3d at 1127.
14 *Id.*
15 *Id.* at 1128.
16 *Id.*
17 *Id.* at 1127 (citing *Liberty Tool & Mfg. v. Vortex Fishing Sys. Inc. (In re Vortex Fishing Sys. Inc.)*, 277 F.3d 1057 (9th Cir. 2001)).
18 *Id.* at 1131.
19 *Id.*
20 *Id.* at 1133.
21 *Id.* at 1134-35.

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and be prepared to litigate the issue when new involuntary bankruptcy petitions are filed.

One of the factors that litigants should consider is whether the underlying judgment at issue was based on a trial or evidentiary hearing versus a default judgment or confession of judgment. If a claim is based on an unstayed default judgment or a confession of judgment that did not involve a debtor's active participation or presentation of evidence or arguments, some courts may consider rejecting a *per se* approach, as in *Norris*.[22] While courts strictly following *Marciano* and *Drexler* will be unswayed by such an argument, this equitable argument may persuade a court that is undecided on the issue.

Likewise, other courts may be more willing to adopt the *Byrd* rule if an alleged debtor can identify questions of law or fact that have not been determined. In *Byrd*, the alleged debtor failed to defeat the involuntary petition in bankruptcy court because he simply reiterated the same arguments that he raised in the state court cases. Although this effectively doomed Byrd's attempt to have the case dismissed, alleged debtors who are able to assert the existence of undecided issues of law or fact may again be able to sway a court that is on the fence to steer clear of a *per se* rule in order to achieve a more equitable result and safeguard against the potential abuses of involuntary bankruptcy. Thus, alleged debtors should carefully review the underlying judgment and, to the extent possible, argue that undecided factual and legal issues remain. Counsel advising creditors considering the use of an involuntary petition to place a debtor in bankruptcy should carefully consider whether the supporting claims are truly free of any bona fide dispute that could be the basis of litigation over the eligibility of the claims. abi

22 *Norris*, 114 F.3d at *5.

Feature

By Jeremy R. Fischer and Julia G. Pitney

Involuntary Judgment Creditors Beware

1st Cir. Peeks Behind State Court Judgment for Bona Fide Dispute

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Trade creditors often find themselves overextended with a debtor who cannot or will not agree to satisfactory repayment arrangements. Frustrated, the creditor decides to initiate state court lawsuits to collect on the debts. The debtor may or may not defend such lawsuits, but because the claims sound in contract and few viable defenses exist, judgments are ultimately entered. Judgment liens begin accumulating in public registries for the world to see, and a group of creditors begin talking about joint, post-judgment collection strategies. Inevitably, these discussions lead the creditors to a choice: Should they band together to force an involuntary bankruptcy, or should they race one another to the auction block to liquidate the debtor's assets?

Section 303(b)(1) of the Bankruptcy Code embodies a fundamental creditor right: Three or more creditors whose claims are "not contingent as to liability or the subject of a bona fide dispute as to liability or amount" may force a debtor into involuntary bankruptcy, provided that their aggregate claims exceed $14,425. Creditors holding state court judgments generally assume that they hold claims that are unassailable and cannot be subject to bona fide dispute.

However, a recent decision from the First Circuit Court of Appeals should give such creditors (and putative debtors) pause. In *Fustolo v. 50 Thomas Patton Drive LLC*,[1] the First Circuit held that bankruptcy courts may "peek behind the curtain" of state court judgments, at least if such judgments are stayed from execution by a court order or by operation of law.

Background[2]

The claims from the creditor, 50 Thomas Patton Drive LLC (hereinafter, "Patton Drive"), against Steven Fustolo arose from four promissory notes issued to Patton Drive by Fustolo's affiliate companies. Fustolo personally guaranteed two of the notes, which totaled $1.25 million, but did not guarantee the other two, which totaled $1.5 million. The principal obligors on each of the notes defaulted, and Patton Drive sued Fustolo in Massachusetts state court on the guaranties. Ultimately, judgment was entered against Fustolo in the amount of $6.76 million. He filed a timely appeal, arguing that the judgment overstated his liability by approximately $4 million because the trial court erroneously determined that Fustolo had guaranteed all four notes.

While the appeal was pending, three of Fustolo's creditors, including Patton Drive, filed an involuntary chapter 7 petition pursuant to § 303(b)(1) of the Bankruptcy Code. Challenging the petition, Fustolo argued that Patton Drive's claim was subject to a "bona fide dispute as to liability or amount."[3] The bankruptcy court disagreed and entered an order for relief.

Merits-Based Approach

In making its determination that Patton Drive's state court judgment constituted a qualifying claim despite the pending appeal, the bankruptcy court relied on the Fourth Circuit's so-called "merits-based" approach set forth in *In re Byrd*.[4] Following this approach, the court began with the rebuttable presumption that the state court judgment foreclosed any bona fide dispute, but then proceeded to assess the merits of Fustolo's pending appeal to determine whether it constituted the "rare circumstance where the amount of the judgment is in bona fide dispute."[5] Upon review, the bankruptcy court found that no bona fide dispute existed with respect to the claims on the guaranteed notes, and thus Patton Drive qualified as a petitioning creditor.

Categorical Rule

Fustolo then appealed to the district court and, as the First Circuit observed, "found himself jumping from the frying pan into the fire."[6] The district court arrived at the same conclusion as the bankruptcy court, but took a different route. The district court adopted the so-called "categorical" rule originally articulated by the U.S. Bankruptcy Court for the Southern District of New York in *In re Drexler*[7] and later followed by the Ninth Circuit in *In re Marciano*.[8]

In *Drexler*, the bankruptcy court determined that an unstayed state court judgment, regardless of whether an appeal was taken, *per se* constitutes a claim that is not subject to a bona fide dispute.[9]

1 No. 15-1340, 2016 WL 732207 (1st Cir. Feb. 24, 2016).
2 Additional details about the case can be found in both the bankruptcy court's decision, *In re Fustolo*, 503 B.R. 206, 207 (Bankr. D. Mass. 2013), and the district court's decision, *Fustolo v. 50 Thomas Patton Drive LLC*, No. CV 14-10248-RWZ, 2015 WL 4876075 (D. Mass. Feb. 17, 2015).
3 *Fustolo*, 2016 WL 732207, at *2 (citing 11 U.S.C. § 303(b)(1)).
4 357 F.3d 433 (4th Cir. 2004).
5 *Fustolo*, 2016 WL 732207, at *2.
6 *Id.*
7 56 B.R. 960, 966 (Bankr. S.D.N.Y. 1986).
8 708 F.3d 1123, 1124 (9th Cir. 2013).
9 *In re Drexler*, 56. B.R. at 967.

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Under this rule, the court need not, and cannot, "look behind the state court judgment to assess its merits."[10] Applying the categorical rule and affirming the bankruptcy court's decision, the district court found that regardless of how meritorious Fustolo's appeal in state court might have been, there was no bona fide dispute with Patton Drive's claim.

First Circuit's Decision

Next, Fustolo appealed to the First Circuit and urged the panel to reject the district court's adoption of the categorical rule and instead to "peek behind the curtain" of the state court judgment like the bankruptcy court. However, Fustolo also argued that the bankruptcy court's application of the more debtor-friendly merits-based approach was flawed because, among other things, Patton Drive's underlying claims had merged into the judgment and the amount of its claims remained subject to bona fide dispute under state law.[11] The First Circuit ultimately affirmed the lower courts' decisions to allow Patton Drive to serve as a petitioning creditor, but adopted the bankruptcy court's merits-based approach rather than the district court's categorical rule.

The First Circuit began by noting that the categorical rule has much to commend it from a policy perspective. It is simple to apply, reduces the waste of assets that are inherent in relitigating the merits of issues that had been previously adjudicated in state court, and accords the state court decision with the sort of respect and finality reflected in the Full Faith and Credit Clause.[12] However, the panel also noted that the common-sense purpose of the bona fide dispute requirement is to prevent creditors from using involuntary bankruptcy to coerce a debtor to satisfy a judgment, even when substantial questions may remain concerning liability.[13] When the creditor already holds a state court judgment upon which execution is possible, allowing the creditor to join in and force a bankruptcy proceeding does little to increase the creditor's ability to coerce payment of the debt.[14]

The issue the First Circuit confronted in Fustolo's case was that the state court judgment was automatically stayed under Massachusetts law in some important ways pending appeal (*e.g.*, the judgment creditor could not execute on the debtor's assets), but not in others (*e.g.*, the judgment credit could not obtain post-judgment discovery and attachment).[15] The First Circuit determined that a judgment is unstayed for bankruptcy purposes — and thus free from bona fide dispute under § 303(b)(1) — only where the judgment creditor is entitled to immediately execute on the debtor's assets.[16] The panel reasoned that because the ability to execute on a state court judgment provides the "crucial link in the rationale that justifies the bright line, automatic nature of the Drexler rule," the rule was inapplicable when, as in this case, execution on the judgment was stayed.[17] Thus, the First Circuit concluded that the categorical rule applies, if at all, *only* to unstayed state court judgments that entitle a creditor to immediately execute on the debtor's assets.[18]

Having rejected the categorical rule, the First Circuit then proceeded to "peek behind the curtain" of Patton Drive's judgment to assess the merits of its underlying claims.[19] The panel first addressed Fustolo's argument that Patton Drive's underlying contract claims based on the guaranties no longer existed because they had been merged into the state court judgment.[20] The panel reasoned that it was inequitable for Fustolo to argue, "on the one hand, that the judgment is not final for purposes of establishing that Patton Drive's claim on the judgment is subject to bona fide dispute, yet argue, on the other hand, that we should treat the judgment as final for purposes of displacing the underlying contract claims."[21] The panel rejected the merger argument.

The panel then analyzed whether Patton Drive's claims were subject to bona fide dispute as to liability or amount. The panel found that Fustolo had "conceded that he owes the principal due" under the guaranteed notes, and thus his only viable challenge was to the amount of that liability.[22] Fustolo argued that the amount of the liability remained in dispute because "Patton Drive is not entitled to the Guaranteed Notes' full default interest rate of 35 [percent] because Patton Drive failed to timely submit a required 'usury notification form' to the state attorney general before levying interest rates in excess of 20 [percent]."[23] The First Circuit reviewed the Massachusetts usury statute and the state court's application thereof, and determined that there was no bona fide dispute as to the amount of Patton Drive's claims under the guaranteed notes:

> "[D]etermining what relief is appropriate, if any," is a matter up to "the [trial] judge's discretion, under equitable principles." *Clean Harbors*, 383 N.E.2d at 626[24] (emphasis supplied) (noting that "the *de minimis* nature of the delay in filing the [statutorily required usury] notices" may be a factor in determining remedy). Given the discretion that state law affords trial courts in this matter, and given the state trial court's cogent explanation for its determination that Patton Drive was entitled to the full default interest rate on the Guaranteed Notes despite its technical violation of

10 *Fustolo*, 2016 WL 732207, at *3.
11 *Id.* at *4, 6.
12 *Id.* at *3 (citing 28 U.S.C. § 1738, which requires that federal courts give state court judgments the same full faith and credit as they have by law or usage in the courts of the state from which they are taken).
13 *Id.*
14 *Id.* at *4.
15 *Id.*
16 *Id.*
17 Id.
18 *Id.* Notably, the First Circuit left open the question of whether the "categorical" rule would apply in a situation where the judgment is wholly unstayed in all respects pending appeal. *Id.* at *4, n.5.
19 *Id.* at *5.
20 *Id.*
21 *Id.* at *7.
22 *Id.* at *8.
23 *Id.* at *7-8.
24 *Clean Harbors Inc. v. John Hancock Life Ins. Co.*, 833 N.E.2d 611 (Mass. App. Ct. 2005).

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> the usury statute, Fustolo has failed to overcome our strong presumption that state court findings, even when not categorically binding, are free of bona fide dispute.[25]

Thus, after rejecting the categorical rule and applying the merits-based approach, the First Circuit determined that the underlying claims were not subject to bona fide dispute as to liability or amount, and Patton Drive was qualified to serve as a petitioning creditor.

Practice Pointers

When a creditor holds a valid state court judgment, putative debtors and petitioning creditors generally assume that the claims are beyond bona fide dispute for purposes of § 303(b)(1) of the Bankruptcy Code. The First Circuit's recent decision in *Fustolo* should make both sides think again. There are only three reported circuit-level decisions on this topic, and each one provides useful signposts for practitioners.

In courts following the merits-based approach (including courts in the Fourth Circuit), bankruptcy judges are entitled to "peek behind the curtain" of state court judgments to assess the merits of the underlying claims in determining whether a bona fide dispute exists. Conversely, in courts applying the categorical rule (including courts in the Ninth Circuit), bankruptcy judges are prohibited from doing so if the state court judgments are unstayed. The First Circuit's recent decision may further limit application of the categorical rule.

Under the First Circuit's analysis, petitioning creditors, putative debtors and bankruptcy judges must now ask, "When is a state court judgment really final and beyond bona fide dispute?" The answer to this important question will turn on the law of each state. In many states — including Massachusetts — a judgment is automatically stayed for purposes of execution upon the filing of a timely notice of appeal. Under the First Circuit's analysis, a stay of the judgment creditor's right to execute is dispositive. Practitioners should be aware of this recent decision and its potential impact in contested proceedings on involuntary petitions. abi

25 *Fustolo*, 2016 WL 732207, at *8.

Arbitration Agreements Held Unenforceable in WARN Act Litigation

"Delaware's Judge Shannon protects workers' rights, disagreeing with some circuit courts."

Bankruptcy Judge Brendan L. Shannon wrote a decision on the cutting edge of issues where courts are split on the ability of wo sue collectively for improper early termination under the National Labor Relations Act, or NLRA.

The Oct. 11 opinion also explores the so-called *Chevron* deference doctrine in a difficult case where the NLRA seemingly conflicts with the Federal Arbitration Act, or FAA.

The Arbitration Agreement

Two years before a retailer filed a chapter 11 petition in Delaware, an employee signed an agreement requiring arbitration of any employment disputes. The agreement also barred the employee from bringing class claims in arbitration.

The arbitration agreement gave the employee a 30-day window to opt out of the arbitration agreement. The employee did not opt out.

The employee was among those who were fired when the retailer terminated all operations in chapter 11, before selling the assets. On behalf of a class of workers, the employee initiated an adversary proceeding in bankruptcy court, alleging that the debtor violated the federal Worker Adjustment and Retraining Notification Act and a comparable California law requiring employers to give 60 days' notice of mass firings.

The debtor filed a motion asking Judge Shannon to compel arbitration and provide that the arbitrator could only rule on the named plaintiff's individual claim.

The motion to compel arbitration raised complex issues given the seeming conflict between two federal statutes. On one hand, there is the FAA, with its strong federal policy favoring arbitration. On the other, the NLRA arguably bars employers from requiring workers to arbitrate and waive their right to file class actions.

Issue One: 'Concerted Activities' Protected

For Judge Shannon, the first question was deciding whether the NLRA protects workers' rights to file class suits. He interpreted Section 7 of the NLRA, which protects workers' ability to "engage in other concerted activities" for their "mutual aid or protection."

He followed courts that have held that the statutory reference to "concerted activities" gives workers the right to "collective adjudications," or class suits. He went on to say that allowing class suits "furthers the policies underlying the NLRA."

Consequently, Judge Shannon held that Congress has "spoken directly" in the NLRA and created a "substantive right" for employees to "proceed collectively" to vindicate their rights under Section 7.

Issue Two: *Chevron* Deference

Recently, the National Labor Relations Board, or NLRB, interpreted Section 7 to mean that workers have a substantive right to bring class or collective suits. The debtor argued that the NLRB's interpretation was not entitled to *Chevron* deference because the FAA was beyond the labor board's purview.

Judge Shannon disagreed, finding that *Chevron* requires the court to give the Board's interpretation "considerable deference." To reach his conclusion, Judge Shannon saw the NLRB as interpreting only the NLRA, not also the FAA, contrary to the holding of some courts, including the Fifth Circuit.

Even if he were wrong in having previously held that NLRA Section 7 on its face ensures workers' rights to bring collective suits, Judge Shannon said that invocation of the *Chevron* deference doctrine requires the same result, because the NLRB's decisions were "rational and consistent" with Section 7. He therefore declined to follow courts holding that collective suits are not protected by Section 7.

Issue Three: Substantive Rights

The debtor contended that protection of a class suit is merely procedural and thus not protected by Section 7.

Although the ability to mount a class action is usually a procedural right, Judge Shannon followed the Seventh Circuit, holding that the right to collective action is an "independent substantive right" granted by NLRA Section 7.

Issue Four: Class Waiver Unenforceable

The debtor argued that the waiver of the right to mount a class arbitration is unenforceable because the FAA mandates enforcement of arbitration agreements as written.

Again, Judge Shannon disagreed, citing Section 2 of the FAA, which provides that arbitration agreements are enforceable except "upon such grounds as exist at law or in equity."

Although the Fifth Circuit found conflict between the FAA and the NLRB, Judge Shannon followed the Seventh Circuit, finding no conflict because, he said, FAA Section 2 does not require enforcement of class waivers. He said the "FAA's savings clause prevents a conflict between the statutes."

Judge Shannon therefore concluded that the class wavier was unenforceable because Section 7 of the NLRB is a law falling within the exception contained in Section 2 of the FAA.

Issue Five: No Waiver Via 'Opt Out'

The debtor relied on a 2014 Ninth Circuit decision holding that an arbitration agreement is enforceable if the employee could have opted out. Judge Shannon said that the appeals court did not refer to any NRLB decisions nor did it discuss *Chevron* deference.

While no other circuits have directly addressed the issue, Judge Shannon concluded that the ability to opt out does not eradicate rights under NLRA Section 7. In that regard, he interpreted the Seventh Circuit's *Lewis* decision as intimating disagreement with the Fifth Circuit.

To bolster his conclusion, Judge Shannon cited a recent decision by the NLRB holding that requiring an employee to opt out of an arbitration agreement interferes with workers' rights under the NLRA.

Even though the Fifth Circuit summarily reversed the NLRB, Judge Shannon felt compelled by *Chevron* deference to follow th

Judge Shannon did not reach the question of certifying a class or rule on the validity or invalidity of WARN Act claims. In a footnote, Judge Shannon said that the issues were "core." If an appellate court decides that the issues were non-core, he said that that his opinion should be taken as proposed findings and conclusions.

By concluding that the NLRA renders the arbitration agreement unenforceable, Judge Shannon was not called upon to utilize judge-made law for overriding an arbitration agreement in the bankruptcy context. In a *Lehman* case decided on Oct. 6 by the Second Circuit, the appeals court reiterated the two-part test that Judge Shannon would have been obliged to employ were it not for Section 7 of the NLRA.

The two-part test first requires that the dispute be "core." Second, the court must conclude that arbitration "would severely conflict" with a purpose of the Bankruptcy Code. Courts have tended to enforce arbitration agreements in the non-NLRA context when debtors attempt to mount class actions in bankruptcy.

To read ABI's discussion of the *Lehman* decision, click here. For an example of a non-employment case where arbitration was enforced in bankruptcy, click here.

Opinion Link: Opinion Link

Judge Name: Brendan L. Shannon

Case Citation: Chan v. Fresh & Easy LLC (In re Fresh & Easy LLC), 15-51897 (Bankr. D. Del. Oct. 11, 2016)

Case Name: In re Fresh & Easy LLC

Case Type: Business

Court: 3rd Circuit

Delaware

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