AMERICAN BANKRUPTCY INSTITUTE

Winter Leadership Conference

Supreme Court Review: Recent Decisions and Their Potential Implications for Bankruptcy Lawyers

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Implications for Bankruptcy Lawyers

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Supreme Court

On the Docket for This Term

The Supreme Court will hear two bankruptcy cases in the new term: nondebtor, nonconsensual releases, and refunds for overpayment of U.S. Trustee fees.

Supreme Court to Rule on Nondebtor Releases and Refunds for Overpayments

The U.S. Supreme Court granted the U.S. Solicitor General's petition for a writ of *certiorari* in *Office of the U.S. Trustee v. John Q. Hammons Fall 2006 LLC*, 22-1238 (Sup. Ct.), to decide whether chapter 11 debtors are entitled to refunds for overpayment of fees for the U.S. Trustee System.

In *Siegel v. Fitzgerald*, 142 S. Ct. 1770 (Sup. Ct. June 6, 2022), the Court unanimously held that the 2018 increase in fees paid by chapter 11 debtors to the U.S. Trustee System was unconstitutional because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees. To read ABI's report on *Siegel*, click here.

The Court in *Siegel* explicitly left open the question of remedy. The government had been contending that prospective relief was sufficient. In other words, the government believes it is enough for the Court to have ruled that fees must be uniform throughout the country in the future. Alternatively, the government wants courts to rule that someone should retroactively collect underpayments from debtors in Bankruptcy Administrator districts.

The grant of *certiorari* came as a surprise to this writer, because there was no split of circuits. Indeed, all four circuits to have considered the issue have ruled that chapter 11 debtors are entitled to refunds. However, the "grant" is less surprising when one realizes that the Court grants *certiorari* more than half the time when the government is the petitioner.

The Ninth Circuit most recently called for a refund in *USA Sales Inc. v. Office of the U.S. Trustee*, 76 F.4th (9th Cir. Aug. 10, 2023). To read ABI's report, click here. Similar decisions came from the Tenth Circuit in *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 20-3203, 2022 WL 3354682 (10th Cir. Aug. 15, 2022), reinstating 15 F.4th 1011, 1025-26 (10th Cir. Oct. 5, 2021) [to read the report, click here]; the Second Circuit in *Clinton Nurseries Inc. v. Harrington (In re Clinton Nurseries Inc.)*, 53 F.4th 15, 29 (2d Cir. 2022), amending and reinstating 998 F.3d 56, 69-70 (2d Cir. 2021) [to read the report, click here]; and the Eleventh Circuit in *U.S. Trustee Region 21 v. Bast Amron LLP (In re Mosaic Management Inc.)*, 71 F.4th 1341 (11th Cir. June 23, 2023) [to read the report, click here].

There will be practical significance to the Supreme Court's decision in *Hammons Fall*. A class action is pending in the Court of Federal Claims in Washington, D.C., seeking a refund for debtors nationwide. *See Acadiana Management Group LLC v. U.S.*, 19-496 (Ct. Cl.). Briefing on a motion for class certification will be completed this fall.

If the Supreme Court upholds the Tenth Circuit in *Hammons Fall*, the outcome in *Acadiana* might mean refunds for all debtors who overpaid, even those who have not sued for refunds on their own.

Already, there are two bankruptcy cases on the Supreme Court's calendar for the term that begins next week. In August, the Supreme Court granted *certiorari* in *Harrington v. Purdue Pharma LP*, 23-124 (Sup. Ct.), to decide whether chapter 11 plans can confer so-called nonconsensual, nondebtor, third-party releases. *Purdue* will be argued on December 4. No date has been set yet for argument in *Hammons Fall*.

Supreme Court to decide whether a creditor has standing to object to any provision in a chapter 11 plan, even provisions that don't affect the creditor.

Supreme Court to Hear a Third Bankruptcy Case this Term: Standing Under § 1109(b)

To resolve a split of circuits, the Supreme Court agreed on Friday to hear a third bankruptcy case in the term that began this month. The justices will decide whether any creditor may object to confirmation of a chapter 11 plan, even if the creditor has no financial stake underpinning the objection. In other words, may creditors object to provisions in plans that do not affect them?

The Supreme Court will expound on the meaning of Section 1109(b). The subsection provides that:

> *A party in interest, including* the debtor, the trustee, a creditors' committee, an equity security holders' committee, *a creditor*, an equity security holder, or any indenture trustee, *may raise and may appear and be heard on any issue in a case under this chapter*. [Emphasis added.]

The insurance company taking the appeal to the Supreme Court from the Fourth Circuit is aiming for the justices to rule that the "party in interest" standard in Section 1109(b) for conferring standing in bankruptcy cases is equivalent to Article III standing, also known as constitutional standing. Typically, a litigant establishes Article III standing by showing (1) an injury in fact that is concrete, particularized and actual or imminent; (2) an injury fairly traceable to the defendant's conduct; and (3) an injury that can be addressed by a favorable decision. Ordinarily, the pivotal requirement is injury in fact. In this case, however, the issue may be whether the alleged injury was due to the debtor's conduct.

In the Supreme Court, the insurance company-petitioner wants the justices to rule that anyone who is a creditor in any capacity has the statutory right under Section 1109(b) to object to any aspect of a chapter 11 plan. Some courts have adopted a so-called prudential standard limiting objections to creditors affected by an allegedly offending feature of a plan.

Conceivably, the justices might side with the Fourth Circuit by holding that the insurance company didn't have Article III standing. If the Court finds Article III standing, the justices presumably will decide whether Section 1109(b) has a different and higher standard blocking objections except from creditors who are directly affected.

Conversely, if the Supreme Court concludes there was no Article III standing, the justices presumably will decide whether Section 1109(b) permissibly announces a lower standard permitting any creditor to object to anything in a plan.

Another way of looking at the case is to say that the Supreme Court is being asked to decide whether a creditor, to have standing in a bankruptcy case, must also be a "party in interest" with respect to the substance of the objection.

The Asbestos Plan

Faced with 14,000 pending lawsuits, the corporate debtor proposed a chapter 11 plan under Section 524(g) to create a trust dealing with present and future asbestos claims. All asbestos claims were to be channeled to the trust.

The principal asset for the trust was the debtor's primary insurance policy, which had a $5,000 deductible per claim and a coverage limit of $500,000 per claim. The insurer was obliged by the policy to defend and indemnify the debtor, even if the claim was false or fraudulent. The policy had no maximum aggregate limit, and it was non-eroding, meaning that defense costs were not counted against the policy limit for each claim.

The plan divided asbestos claims into two classes: (1) those covered by the policy; and (2) those not covered by the policy. Uninsured claims were to be paid entirely by the trust. According to the insurance company, there were no uninsured claims.

Claims covered by insurance were to be litigated in the tort system, nominally against the debtor but subject to the coverage limit for each claim. The trust would pay the $5,000 deductible for each claim.

The claims covered by insurance remained subject to the insurer's prepetition coverage defenses.

The uninsured claims were subject to antifraud provisions under the plan to protect the trust by requiring the claimants to provide disclosures designed to avoid fraudulent and duplicate claims. The plan had no antifraud provisions for insured claims.

Unsecured creditors were to be paid in full.

The asbestos claimants, the only class impaired by the plan, voted unanimously in favor of the plan. The only confirmation objection came from the insurer.

The insurer contended that the plan was not proposed in good faith because the anti-fraud provisions didn't apply to insured claims. The insurer also objected, contending that the plan was

not insurance-neutral. The bankruptcy court wrote an opinion recommending that the district court approve the plan, finding that it was insurance-neutral and filed in good faith. Because the plan was insurance-neutral, the bankruptcy court concluded that the insurer was not a party in interest under Section 1109(b) and thus lacked standing to challenge the plan.

The district court confirmed the plan and adopted the bankruptcy court's findings *in toto* after *de novo* review.

The insurer appealed to the circuit.

The Fourth Circuit Affirmance

In February, the Fourth Circuit affirmed, in an opinion by Circuit Judge G. Steven Agee. *Truck Insurance Exchange v. Kaiser Gypsum Co. (In re Kaiser Gypsum Co.)*, 60 F.4th 73 (4th Cir. Feb. 14, 2023). To read ABI's report, click here.

Confusingly, the Fourth Circuit held that a creditor found by the bankruptcy court to have no standing *does* have standing to appeal the denial of standing to object to confirmation of the chapter 11 plan.

On the other hand, the Fourth Circuit found the plan to have been "insurance-neutral," thereby giving the insurance company no standing in the bankruptcy court or on appeal to object to the merits of the plan pertaining to any other aspects of the plan. In a footnote, the appeals court also said that the insurer had Article III, or constitutional, standing to challenge the finding of insurance neutrality.

The insurer argued that it also had standing on appeal to challenge other provisions of the plan, such as good faith, because it also was a creditor on account of unpaid deductibles. The Fourth Circuit held that the insurer, as a creditor, was subject to the strictures of Article III standing, also known as constitutional standing.

As a creditor, the insurer was unimpaired and had no objections to its treatment as a creditor. Thus, Judge Agee said, the insurer alleged no injury in fact as a creditor. Consequently, the insurer had no Article III standing "to object to aspects of a reorganization plan that in no way relate to its status *as a creditor* but instead implicate only the rights of third parties (who actually *support* the Plan)." [Emphasis in original.] *Id*., 60 F.4th at 88.

The Fourth Circuit affirmed the district court's judgment because (1) insurance neutrality left the insurer bereft of bankruptcy standing under Section 1109(b), and (2) the insurer had no Article III standing as a creditor to object to other aspects of the plan.

The 'Grant' of '*Cert*'

The insurer filed a petition for *certiorari* in early May. In July, the justices requested a response from the debtor. The Court granted *certiorari* on October 13, with Justice Alito taking no part in considering the petition and thus suggesting that he will not participate in the ruling on the merits.

The insurer urged the Court to grant *certiorari* to resolve a split of circuits. According to the insurer, "the Third Circuit has held that Section 1109(b), by its plain text, simply codifies the right of any party with Article III standing to appear and be heard in Chapter 11 proceedings."

On the other hand, the insurer says that the "Fourth and Seventh Circuits have taken the opposite view . . . . [T]he Seventh Circuit held that Section 1109(b) silently preserved certain 'other' pre-Code "imitations on standing, such as that the claimant be within the class of intended beneficiaries of the statute that he is relying on for his claim.'"

The Ninth Circuit, according to the insurer, "has a foot in each camp."

The insurer summed up the grounds for having Article III standing and status as a party in interest by alluding to its "responsibility to pay claims against the debtor [that] makes confirmation of the plan a concrete, traceable, and redressable injury."

The Other Bankruptcy Cases this Term

There are already two bankruptcy cases on the Supreme Court's calendar for the term that began this month. In August, the Supreme Court granted *certiorari* in *Harrington v. Purdue Pharma LP*, 23-124 (Sup. Ct.), to decide whether chapter 11 plans can confer so-called nonconsensual, nondebtor, third-party releases. *Purdue* will be argued on December 4.

On September 29, the U.S. Supreme Court granted the U.S. Solicitor General's petition for a writ of *certiorari* in *Office of the U.S. Trustee v. John Q. Hammons Fall 2006 LLC*, 22-1238 (Sup. Ct.), to decide whether chapter 11 debtors are entitled to refunds for overpayment of fees for the U.S. Trustee System.

In *Siegel v. Fitzgerald*, 142 S. Ct. 1770 (Sup. Ct. June 6, 2022), the Court unanimously held that the 2018 increase in fees paid by chapter 11 debtors to the U.S. Trustee System was unconstitutional because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees. The Court in *Siegel* explicitly left open the question of remedy. No date has been set yet for argument in *Hammons Fall*.

The appeal to the Supreme Court is *Truck Insurance Exchange v. Kaiser Gypsum Co. Inc.*, 22-1079 (Sup. Ct.).

The concurring opinion, which is really a dissent, urges the Supreme Court to grant certiorari and resolve the split of circuits on nondebtor releases.

The Second Circuit's *Purdue* Opinion on Review in the Supreme Court

Reversing the district court, the Second Circuit reinstated the bankruptcy court's confirmation of the chapter 11 plan of Purdue Pharma LP and its inclusion of nonconsensual releases of creditors' direct claims against nondebtors.

In the majority's 74-page opinion, Circuit Judge Eunice C. Lee found statutory authority for nondebtor, third-party releases in Sections 105(a) and 1123(b)(6) of the Bankruptcy Code and in "this Circuit's caselaw stating that a bankruptcy court has authority to impose such releases."

Circuit Judge Richard C. Wesley wrote a 14-page concurrence that reads like a dissent and urges the Supreme Court to grant *certiorari* to resolve the split of circuits. Judge Wesley concurred in the judgment because he saw the issue as having been resolved in *In re Drexel Burnham Lambert Grp., Inc.*, 960 F.2d 285, 293 (2d Cir. 1992), Second Circuit authority that "has not been overruled either by the Supreme Court or by this Court sitting *en banc*."

The third judge on the panel was Circuit Judge Jon O. Newman. Having served 44 years on the appeals court, he is the most senior judge on the Second Circuit.

The Opioid Claims, the Chapter 11 Case, and Reversal in District Court

Judge Lee devoted 30 pages of her opinion to laying out the facts, the deluge of opioid claims against Purdue and the controlling Sackler family, the chapter 11 case, the confirmation of the plan by now-retired Bankruptcy Judge Robert D. Drain and the reversal of confirmation by District Judge Colleen McMahon of Manhattan.

Foretelling the result, Judge Lee pointed out early in her opinion that the Sacklers were contributing $5.5 billion to $6 billion in return for receiving releases.

To deal with tens of thousands of lawsuits, the company filed a chapter 11 petition in September 2019, but the Sacklers did not file, nor did any company officers or directors. One month after filing, the bankruptcy court imposed an injunction halting all lawsuits against debtors and nondebtors alike.

After bankruptcy, the company resolved a criminal complaint by entering into a plea agreement that called for the company to pay $2 billion, which would come ahead of all creditor claims. However, the agreement would allow the company to pay most of the $2 billion into a trust for the benefit of claimants.

Originally, Purdue's plan had a $4.325 billion contribution to be made by the Sacklers over nine years. In return, the individuals were to receive releases that Judge Lee characterized as "extremely broad." With 95% in favor, she said that creditors "overwhelmingly" approved the plan.

During the course of the confirmation hearing, Bankruptcy Judge Drain required the debtors to narrow the scope of the third-party releases by providing that the debtor's conduct must be the legal cause or a relevant factor in the claims against released individuals.

As revised, Judge Drain confirmed the plan in September 2021 and delivered a lengthy, detailed opinion finding facts and stating the law as he saw it. He noted that while most circuits permit nondebtor releases, the Fifth, Ninth and Tenth Circuits don't.

Bankruptcy Judge Drain said the plan was the only reasonably conceivable means for resolving the case and satisfied the seven requirements demanded by *In re Iridium Operating LLC*, 478 F.3d 452, 464–66 (2d Cir. 2007). As authority for the nonconsensual releases, he found statutory power in Sections 105(a) and 1123(b)(6) and caselaw justification in *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005), and other Second Circuit authority.

The U.S. Trustee and several states appealed. District Judge McMahon set aside confirmation by reversing in December 2021. *In re Purdue Pharma, L.P.*, 635 14 B.R. 26 (S.D.N.Y. 2021). She found no statutory authority for the third-party releases. According to Judge Lee, the district judge "ejected the argument that the bankruptcy court possessed residual equitable authority to impose the Releases." To read ABI's report on the district court reversal, click here.

The Appeal to the Circuit

The company, the official creditors' committee, the Sacklers and others appealed. The appeals court heard oral argument on April 29, 2022.

While the appeal was pending, nine states dropped their opposition to the plan when the Sacklers agreed to contribute an additional $1.175 billion to $1.675 billion, raising their total payments to as much as $6 billion.

The U.S. Trustee was the remaining appellee, along with Canadian municipalities and indigenous tribes from Canada.

Addressing the merits, Judge Lee agreed with District Judge McMahon on one point: The bankruptcy court lacked constitutional power to enter a final judgment containing the third-party releases because they are the types of claims proscribed in *Stern v. Marshall*. In other words, the bankruptcy court could only issue proposed findings and conclusions for entry by the district court.

Judge Lee went on to say:

> [W]e agree with the district court that the practical import of the *Stern* issue is nonexistent given that only conclusions of law are at issue here, requiring our *de novo* review under any standard.

[Note: This writer respectfully disagrees. It's not nothing. If the bankruptcy court may only enter proposed findings and conclusions in similar circumstances, a chapter 11 plan may not be confirmed and consummated until the equivalent of an appeal has been completed in district court.]

Question One

Judge Lee tackled the first of two pivotal questions: "[W]hether the bankruptcy court had the authority to approve the nonconsensual release of direct third-party claims against the Sacklers, a non-debtor."

Judge Lee divided the releases into two categories: direct claims and derivative claims. Citing *Marshall v. Picard (In re Bernard L. Madoff Inv. Secs. LLC)*, 740 F.3d 81, 89 n.9 (2d Cir. 2014), she said it was "well settled" that the bankruptcy court may release derivative claims, which are those that arise from harm to the estate.

On the other hand, Judge Lee defined "direct claims [as] causes of action brought to redress a direct harm to a plaintiff caused by a non-debtor third party." Citing *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 91 (2d Cir. 1988), she said that a release of those claims would not be a discharge prohibited by Section 524(e), "because the releases neither offer umbrella protection against liability nor extinguish all claims."

Next, Judge Lee agreed "with both the bankruptcy court and the district court that the bankruptcy court had statutory jurisdiction to impose the Releases because it is conceivable, indeed likely, that the resolution of the released claims would directly impact [the estate]."

Statutory Authority

Judge Lee said that the bankruptcy court "correctly grounded its authority for approving the Releases in §§ 105(a) and 1123(b)(6)." Section 105(a) allows a bankruptcy court to issue "any order" that is "necessary or appropriate to carry out the provisions of" the Bankruptcy Code.

Section 1123(b)(6) permits a chapter 11 plan to "include any other appropriate provision not inconsistent with the applicable provisions of this title."

Judge Lee rejected the debtor's contention that Section 105(a) alone was up to the task. However, the combination of Section 105(a) with Section 1123(b)(6) made the magic elixir. She said that "§ 1123(b)(6) is limited only by what the Code expressly forbids, not what the Code explicitly allows." She cited the Seventh Circuit for having "convincingly" held that the section includes the power to release third parties.

If there were any doubt before, Judge Lee said, "we now explicitly agree with [the Sixth and Seventh Circuits] and conclude that § 1123(b)(6), with § 105(a), permit bankruptcy courts' imposition of third-party releases."

Second Circuit Caselaw

Having found statutory power, Judge Lee said that "this Court's precedents permit the imposition of nonconsensual third-party releases." She said that *Manville* and *Metromedia* "further confirm that such releases are neither discharges nor allowable only in the context of asbestos cases."

"More importantly," Judge Lee said, "this Court's opinion in *Metromedia* flatly rejects a restrictive interpretation of the Bankruptcy Code by stating that third-party releases can be valid outside of the asbestos context." She added, though, that "*Metromedia* nevertheless rests upon the premise that such releases may be permitted so long as bankruptcy courts make sufficient factual findings and satisfy certain equitable considerations."

Having found jurisdiction along with statutory and caselaw authority, Judge Lee analyzed the bankruptcy court's findings of fact and concluded that they satisfied the seven-part test imposed by *Metromedia*. Among other factors, the releases were necessary; the nondebtors made substantial contributions, and the affected creditors voted "overwhelmingly" in favor of the plan. She pointed to Section 524(g)(2)(B)(ii)(IV)(bb) for the concept that a 75% vote is the minimum.

Before ending her opinion, Judge Lee rejected the U.S. Trustee's argument that due process required that creditors be allowed to opt out.

Judge Lee reversed the district court, affirmed the bankruptcy court's approval of the plan and remanded for proceedings consistent with the opinion.

The Concurrence by Judge Wesley

Judge Wesley concurred in the judgment, because he read *Drexel* to mean that bankruptcy courts "have the power to release direct or particularized claims asserted by third parties against nondebtors without the third parties' consent."

Because *Drexel* had not been overruled by the Supreme Court or the Second Circuit sitting *en banc*, Judge Wesley said he "reluctantly" concurred. He said that neither *Drexel* nor *Metromedia* "tracks that power back to any provision of the Bankruptcy Code." Likewise, he saw nothing in Sections 105(a) or 1123(b)(6) about nondebtor releases. Indeed, he said that the Bankruptcy Code "is silent on the matter."

To buttress his views, Judge Wesley noted that claims for fraud cannot be discharged in bankruptcy but that the third-party releases had no carveouts for fraud. In other words, the releases, he said, were "broader than that which Congress decided was wise to make available to a debtor in bankruptcy."

Further, Judge Wesley said that creditors with direct claims receive nothing extra for those claims. Their recovery, he said, is identical to the recovery by a similar creditor with no direct claims against third parties.

"At bottom," Judge Wesley said, "if Congress intended so extraordinary a grant of authority, it should say so," like it did in 1994 when amending the Code to allow nondebtor releases in asbestos cases.

Given that nondebtor releases are "an extraordinarily powerful tool," Judge Wesley said that the question "would benefit from nationwide resolution by the Supreme Court" of "a weighty issue that, for too long, has split the courts of appeals."

The opinion is *Purdue Pharma LP v. City of Grand Prairie (In re Purdue Pharma LP)*, 22-110 (2d Cir. May 30, 2023).

Grist for the Supreme Court

The Fourth Circuit says that bankruptcy courts have broader jurisdiction than other federal courts and that some of their decisions are unreviewable by Article III courts.

4th Circuit: Bankruptcy Courts Aren't Bound by Case or Controversy Requirements

The Fourth Circuit ruled that bankruptcy courts "can constitutionally adjudicate cases that would be moot if heard in an Article III court." More generally, the appeals court said that bankruptcy courts "are essentially unencumbered by Article III's case-or-controversy requirement." The extraordinary statements by the appeals court may or may not be *dicta*.

The September 14 decision by Circuit Judge Julius N. Richardson could be read to mean that the judicial power of bankruptcy and magistrate judges extends beyond constraints in the constitution limiting federal courts to the adjudication of "cases" or "controversies." If followed elsewhere, the decision also means that decisions by bankruptcy courts in some circumstances may be unreviewable on appeal.

In a footnote, Judge Richardson suggested that the delegation of bankruptcy powers to non-Article III courts may in itself be unconstitutional. If it were so, the same would be true of magistrate judges.

Following discussion of the opinion, we offer commentary by Kenneth N. Klee and Richard B. Levin, both of whom believe the decision was wrongly decided.

The Dischargeability Complaint

A husband and wife hired a contractor to renovate their home. Dissatisfied with results of the work, the couple learned that the contractor was not licensed. They sued in a Superior Court in Washington, D.C., to recover almost $60,000 they had paid the contractor.

While the suit was pending, the contractor filed a chapter 7 petition in Alexandria, Va. The couple filed a proof of claim for the $60,000 and, separately, a two-count complaint. One count sought a declaration regarding the validity of the alleged $60,000 debt, and the second sought a declaration that the debt was nondischargeable.

Without ruling on the validity of the debt, the bankruptcy court held that the debt was dischargeable and dismissed the count on dischargeability. The count regarding validity of the debt

remained for later adjudication, meaning that the ruling on dischargeability was not a final order subject to appeal.

Judge Richardson said that the debtor and the couple wanted appellate courts to rule on dischargeability "before deciding whether they should expend the resources to litigate the [validity of the] debt."

"So," Judge Richardson said, they "struck a deal" where the couple voluntarily dismissed the count regarding validity of the debt *without prejudice*, aiming to create a final, appealable order regarding dischargeability. On appeal, the district court upheld the bankruptcy court on dischargeability. The couple appealed to the Fourth Circuit.

Manufactured Finality

Judge Richardson cited Fourth Circuit authority for the proposition that "parties cannot collude to create finality after the fact through a voluntary dismissal without prejudice." *Waugh Chapel S. v. United Food and Com. Workers Union Local 47*, 728 F.3d 354, 359 (4th Cir. 2013). He then proceeded to analyze whether the order was indeed final and said that the "appropriate procedural unit for determining finality here is the adversary proceeding."

Judge Richardson said that the "bankruptcy court's order [before dismissal of the count on validity of the debt] was thus not final when entered" because "an order dismissing only one claim in a multi-claim adversary proceeding does not amount to a final order."

Quoting the Fourth Circuit, Judge Richardson said that the parties "cannot 'use voluntary dismissals as a subterfuge to manufacture jurisdiction for reviewing otherwise non-appealable, interlocutory orders.'" *Waugh, supra,* 728 F.3d at 359.

If the circuit were to allow an appeal on dischargeability, Judge Richardson said "there would be nothing to stop them from reinstating — and then separately appealing — [the count regarding validity of the claim] down the line." He therefore held that "the voluntary dismissal did not make the bankruptcy court's earlier, partial dismissal final," because the count related to validity of the debt "was still very much alive."

The Adversary Proceeding Wasn't Moot

The couple characterized the complaint as seeking authority to pursue collection of the debt outside of bankruptcy. Once the bankruptcy court decided that the debt was dischargeable even if valid, the couple contended that the count in the adversary proceeding regarding validity of the debt became moot because they could not win "any effectual relief" to pursue the debt outside of bankruptcy. Mootness of the validity count, according to the couple, meant that the order on the remaining count about dischargeability was final.

Evidently, Judge Richardson believes there's no such thing as mootness in bankruptcy court.

"Mootness is an Article III doctrine, and bankruptcy courts are not Article III courts," Judge Richardson said. Because bankruptcy courts are not Article III courts, he cited *Stern v. Marshall* for the idea that "they do not wield the United States's judicial Power." Therefore, he said, bankruptcy courts "can constitutionally adjudicate cases that would be moot if heard in an Article III court."

While a bankruptcy case must satisfy Article III standards when referred by district courts to bankruptcy courts, Judge Richardson said that Article III must again be satisfied when the case returns to district court. However, "that limit on the district court's authority does not constrain the bankruptcy court. *Once a case is validly referred to the bankruptcy court, the Constitution does not require it be an Article III case or controversy for the bankruptcy court to act.*" [Emphasis added.]

Having ruled that Article III does not constrain bankruptcy courts, Judge Richardson next considered whether statutes preclude bankruptcy courts from deciding matters that are moot.

Judge Richardson cited Section 157(b)(1) for saying that bankruptcy courts may hear and determine "all" bankruptcy cases and "all" core proceedings, "[n]ot just those that could be fully adjudicated in district court."

Article III constraints, such as mootness, "do not apply to [bankruptcy courts] as a matter of constitutional law," Judge Richardson said. "They only apply," he said, "if Congress said so in a statute." Finding no statute, he held that the "bankruptcy court could still adjudicate it."

Judge Richardson held that voluntary dismissal of count for validity of the debt "did not create a final order under § 158(a)" because dismissal was without prejudice, making the claim "legally viable." He vacated and remanded the order of the district court, because it had "reviewed a non-final order."

In the last paragraph of his decision, Judge Richardson said that bankruptcy courts "are essentially unencumbered by Article III's case-or-controversy requirement."

Commentary

The opinion presents essentially two holdings: (1) Parties may not manufacture finality, and (2) Article I tribunals are not encumbered by the limitations on justiciability imposed by Article III.

The first holding is a reiteration of *Waugh*. Notably, however, the Fourth Circuit in *Waugh* cited the black letter law but proceeded to follow the Eighth Circuit which held that the appeals court could "deem ambiguous voluntary dismissal . . . to be with prejudice" and consider the merits of the appeal. *Waugh*, *supra*., 728 F.3d at 359.

The second holding has broad implications. If adopted in other circuits, bankruptcy courts could rule on disputes that have become moot, and the rulings would be immune from appellate review. Question: Would rulings of the sort be entitled to *res judicata* or collateral estoppel effect in state or federal courts?

The second holding would also seem to mean that bankruptcy court may issue advisory opinions.

To this writer, it's a close call on whether the second holding is *dicta*.

Although not constrained by the Constitution to avoid ruling on moot questions or advisory opinions, may bankruptcy courts in the Fourth Circuit nonetheless abstain?

In the Fourth Circuit, magistrate judges similarly would not be constrained by Article III justiciability standards. One assumes that magistrate and bankruptcy judges would both abstain from exercising jurisdiction beyond the limits of Article III, if authorized to do so.

Constitutionality of the Bankruptcy System

After ruling that bankruptcy courts may constitutionally adjudicate cases that would be moot in Article III courts, Judge Richardson wrote a footnote saying:

> The harder question may be whether [bankruptcy courts] can constitutionally adjudicate cases that are within the judicial power and so could be heard in Article III courts.

To the writer, the quotation seems to suggest that the reference of bankruptcy power to bankruptcy courts may be unconstitutional. However, Judge Richardson said in the footnote that "we need not dive into this question."

Scholarly Commentary

Kenneth N. Klee provided ABI with the following commentary:

> Because the bankruptcy court is not actually a court at all but is a unit of the United States District Court, it is inconceivable to me that the jurisdiction of a non-tenured judge could be greater than that of a tenured judge.

> The jurisdiction is derivative. That's what the concept of withdrawal of the reference is all about. I understand that to a small, uninformed mind, one could reason that the constraints of Article III don't apply to a non-Article III judge, but the notion that by referring matters to non-tenured judges, you can expand jurisdiction is somewhat absurd. Even more so in the criminal context with magistrate judges.

Richard B. Levin provided ABI with the following commentary:

> In my view, the dischargeability determination mooted [the count regarding validity of the debt], even though it did not moot the proof of claim. The proof of claim seeks to share in the estate; the adverse party is the trustee, not the debtor.
>
> [The count on validity of the debt] seeks to collect from the post-discharge debtor, which becomes a moot case once the debt is declared dischargeable. But the [proof of claim] is still live, unless perhaps it's a no-asset case, but that does not affect the mootness (or not) of the count I claim against the debtor [seeking a declaration regarding validity of the debt].
>
> Therefore, the dismissal of [the count regarding validity of the debt] rendered the order final, as in the *Affinity Living Group* case the court cites, and the district court and the court of appeals should have had jurisdiction over that final order.
>
> The only way the Article III courts did not have finality jurisdiction was if the case was not moot in the bankruptcy court or, as the court of appeals puts it, if the bankruptcy court could still adjudicate the case even though it became moot. (Of course, why would anyone want to adjudicate a moot case? That was the parties' point in their stipulation.)
>
> Therefore, the Article III language in the court of appeals opinion is not *dicta*; it is holding. It was necessary to the decision, which makes it even more troubling than if it were *dicta*. In short, I think the court did not really understand the court and jurisdictional system that Congress set up after *Marathon*.
>
> Another troubling part of this decision, even though not so troubling as the Article III point, which would give the bankruptcy courts unreviewable authority over a whole range of moot and advisory issues, is that the decision effectively requires parties to keep fighting over something that doesn't matter so they can appeal something that does matter.

Messrs. Klee and Levin were counsel for committees in the House and Senate and were among the principal draftsmen of the Bankruptcy Code and the Bankruptcy Reform Act of 1978. Mr. Klee is partner emeritus at KTBS Law LLP in Los Angeles, and Mr. Levin is a partner with Jenner & Block LLP in New York City.

Further Commentary

This writer believes that the Fourth Circuit may have reached the right result for the wrong reason.

Was it a subterfuge to dismiss the count in the complaint on validity of the debt while leaving proof of claim alive in the claims register? Doesn't survival of the proof of claim mean that the creditors had not in reality dismissed the count based on the alleged debt?

This writer submits that the appeal court could have and perhaps should have ruled that survival of the proof of claim in itself kept disposition of the adversary proceeding from becoming a final order. Focusing on the implications arising from the proof of claim would have obviated the need to discuss the bankruptcy court's lack of constraints under Article III.

This writer hopes that someone files a petition for rehearing *en banc*, permitting scholars to submit *amicus* briefs regarding Article III constraints on bankruptcy and magistrate judges.

The opinion is *Kiviti v. Bhatt*, 22-1216 (4th Cir. Sept. 14, 2023).

Last Term

The opinion by Justice Barrett largely bases the outcome on the use of the passive voice in Section 523(a)(2)(A).

Debts for a Partner's Fraud Are Still Nondischargeable, the Supreme Court Says

Based on the "natural breadth of the passive voice" used in Section 523(a)(2)(A), the Supreme Court held yesterday in a unanimous opinion by Justice Amy Coney Barrett that a partner who herself was innocent of fraud is nonetheless saddled with a nondischargeable debt resulting from the fraud of her partner.

The opinion is a reaffirmation of the Court's holding in *Strang v. Bradner*, 114 U.S. 555 (1885).

In a concurring opinion, Justices Sonia Sotomayor and Ketanji Brown Jackson endeavored to limit the scope of the holding by saying that they understood the outcome to be based on the existence of a partnership under state law.

The Partner's Fraud

Before marrying, a couple formed a partnership to buy, refurbish and sell a home. Judge Barrett said the woman was "largely uninvolved" in the remodel and sale.

Alleging that the disclosure statement failed to list defects in the home, the buyer filed suit after purchasing the home. A jury found the man and woman liable for $200,000 in damages for breach of contract, negligence and nondisclosure of material facts.

The couple filed a chapter 7 petition. The buyer filed an adversary proceeding contending that the judgment was nondischargeable under Section 523(a)(2)(A) as a debt resulting from "false pretenses, a false representation, or actual fraud." After a bench trial, the bankruptcy court ruled that the debt was nondischargeable as to both.

The Bankruptcy Appellate Panel for the Ninth Circuit reversed as to the woman, saying she had no reason to know of the man's fraudulent intent. Relying on *Strang*, the Ninth Circuit reversed the BAP, reinstating the nondischargeability judgment with respect to the woman. According to Justice Barrett, the Court of Appeals reasoned that "a debtor who is liable for her partner's fraud cannot discharge that debt in bankruptcy, regardless of her own culpability."

The woman filed a petition for *certiorari*, which the Court granted to resolve a split among the circuits. The Second, Fourth, Seventh and Eighth Circuits require scienter before the debt is deemed nondischargeable, while the Fifth, Sixth, Ninth and Eleventh Circuits don't.

An Opinion Based on Grammar

Judge Barrett held that the "text" of Section 523(a)(2)(A) barred the woman from discharging the debt "[b]y its terms." Based on the "basic tenets of grammar," she said that the statute's use of the "[p]assive voice pulls the actor off the stage."

Although the debt must result from fraud, Justice Barrett said that "Congress was 'agnosti[c]' about who committed it. *Watson v. United States*, 552 U.S. 74, 81 (2007)." The "context" of the statute, she said, "does not single out the wrongdoer as the relevant actor."

Justice Barrett said that "the common law of fraud . . . has long maintained that fraud liability is not limited to the wrongdoer." Citing a commentator from 1841 and state supreme court decisions from the nineteenth century, she listed courts that "have traditionally held principals liable for the frauds of their agents."

The debtor contended that the interpretation of Section 523(a)(2)(A) should be informed by subsections (B) and (C), which require a culpable act by the debtor. Justice Barrett rejected the argument, saying that the "more likely inference is that (A) excludes debtor culpability from consideration given that (B) and (C) expressly hinge on it."

The Court's Precedent

"Our precedent," Justice Barrett said, "eliminates any possible doubt about our textual analysis."

At the time of *Strang*, the statute required fraud "of the bankrupt." Nonetheless, the Court held in *Strang* that the "fraud of one partner . . . is the fraud of all because '[e]ach partner was the agent and representative of the firm with reference to all business within the scope of the partnership.'" *Strang*, *supra*, 114 U.S. at 561.

Thirteen years after *Strang*, Justice Barrett said that Congress "overhauled the bankruptcy law," this time deleting "'of the bankrupt' from the discharge exception for fraud, which is the predecessor to the modern § 523(a)(2)(A)."

"The unmistakable implication," Justice Barrett said, "is that Congress embraced *Strang*'s holding — so we do too."

Justice Barrett ended her opinion for the Court by saying she was "sensitive to the hardship that the debtor faces," but she went on to say that "innocent people are sometimes held liable for fraud they did not personally commit, and, if they declare bankruptcy, § 523(a)(2)(A) bars discharge of that debt."

The Court affirmed the Ninth Circuit's judgment that the debt was nondischargeable.

The Concurrence

Joined by Justice Jackson, Justice Sotomayor concurred, saying that the "Court correctly holds that 11 U.S.C. § 523(a)(2)(A) bars debtors from discharging a debt obtained by fraud of the debtor's agent or partner." Citing *Strang*, she said that the "Court long ago confirmed that reading when it held that fraudulent debts obtained by partners are not dischargeable."

Justice Sotomayor noted that the woman and her husband incurred the debt after forming a partnership. She said that the "Court here does not confront a situation involving fraud by a person bearing no agency or partnership relationship to the debtor."

She joined the Court's opinion with the "understanding" that it concerns fraud only by "agents" and "partners within the scope of the partnership."

Application to Section 523(a)(19)

Justice Sotomayor's understanding of the opinion, if adopted by other courts, may affect the application of Section 523(a)(19). That subsection bars the discharge of judgments by state or federal courts for violation of state or federal securities laws, but it too is in the passive voice and does not in its language demand a violation committed by the debtor.

Presumably, a court influenced by Justice Sotomayor's concurrence would make a debt nondischargeable as to an innocent debtor only if there were an agency or partnership.

Observations

Justice Barrett rejected the debtor's reliance on *Bullock* v. *BankChampaign, N. A.*, 569 U.S. 267 (2013). There, the Court held that under Section 523(a)(4) the term "defalcation"

> includes a culpable state of mind requirement akin to that which accompanies application of the other terms in the same statutory phrase. We describe that state of mind as one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior.

Id. at 269.

Bullock means that defalcation cannot be derivative, but the Court yesterday held that a fraudulent representation or actual fraud can be derivative.

Curiously, *Strang* cited and discussed *Neal v. Clark*, 95 U.S. 709 (1877). The *Strang* court paraphrased *Neal* as saying that

> the term "fraud," in the clause defining the debts from which a bankrupt is not relieved by a discharge under the bankrupt act, should be construed to mean positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, and not implied fraud or fraud in law, which may exist without the imputation of bad faith or immorality.

Neal required "positive fraud, or fraud in fact," but the Court yesterday imposed nondischargeability when the debt was derived from someone else's fraud.

With respect, this writer sees the Court as being selective in citing nineteenth century precedent for the idea that innocent individuals can be saddled with nondischargeable debts.

True, common law for centuries has held that one partner is liable for another partner's fraud, but nondischargeability and derivative liability for fraud are different questions under a different statute.

However, Congress adopted Section 523(a)(2)(A), presumably knowing what *Strang* says. Still, this writer is troubled by the notion that contemporary courts are so bound by nineteenth century precedent.

The opinion is *Bartenwerfer v. Buckley*, 143 S. Ct. 665, 214 L. Ed. 2d 434 (Sup. Ct. Feb. 22, 2023).

The Supreme Court's MOAC decision contains language casting doubt on the validity of the doctrine of equitable mootness.

Supreme Court Holds: § 363(m) Isn't Jurisdictional; It's a Limitation on Appellate Relief

Reversing the Second Circuit, the Supreme Court handed down a unanimous opinion today in *MOAC Mall Holdings LLC*, deciding that Section 363(m) is not jurisdictional. It's a limitation on the remedy available to an appellate court on an appeal from an order approving a sale.

Section 363(m) says that the reversal or modification "of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease [to a purchaser in good faith] . . . unless such authorization and such sale or lease were stayed pending appeal."

The Second and Fifth Circuits have held that Section 363(m) is jurisdictional. The Third, Sixth, Seventh, Ninth, Tenth and Eleventh Circuits have held that it is not. The opinion for the Court by Justice Ketanji Brown Jackson was her first since her elevation in June 2022.

The Sale of a Sears Lease

The petitioner in the Supreme Court was the landlord of a Sears store in the giant Mall of America. The landlord objected to the assignment of a lease but lost in bankruptcy court.

Initially, the district court reversed the bankruptcy court, holding that a provision in a lease cannot supplant the requirement in Section 365(b)(3)(A) mandating that the financial condition of an assignee of a lease must be "similar to the financial condition . . . of the debtor . . . as of the time the debtor became the lessee under the lease . . . ." *MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.)*, 613 B.R. 51 (S.D.N.Y. May 11, 2020). ("*MOAC I*"). To read ABI's report on *MOAC I*, click here.

Two weeks later, the purchaser of the lease filed a motion for rehearing. Although having taken contrary positions throughout, the purchaser contended for the first time on rehearing that the appeal should be dismissed under Section 363(m) because the landlord had not obtained a stay pending appeal. Previously, the purchaser had consistently contended that the transaction was not a sale and that Section 363 did not apply.

Ruling on the motion for rehearing, the district judge said that the buyer now "seeks to benefit from a complete reversal of that representation." *MOAC II*, 616 B.R. at 626. Citing *In re WestPoint Stevens Inc.*, 600 F.3d 231, 248 (2d Cir. 2010), and *In re Gucci*, 105 F.3d 837, 838–840 (2d Cir. 1997), the district judge said that the Second Circuit had twice held that Section 363(m) is "a jurisdiction-depriving statute." *Id*. at 624.

In *MOAC II*, the district judge granted rehearing, concluded that she lacked appellate jurisdiction, vacated her earlier opinion, and dismissed the appeal. The Second Circuit affirmed in a nonprecedential opinion. *MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.)*, 20-1846, 2021 BL 481940, 2021 US App Lexis 37358, 2021 WL 5986997 (2d Cir. Dec. 17, 2021). To read ABI's report on the Second Circuit opinion, click here.

The circuit panel said that the landlord's argument "is foreclosed by our binding precedent in *In re WestPoint Stevens Inc.*, under which § 363(m) deprived the District Court of appellate jurisdiction." In another nonprecedential opinion citing *WestPoint Stevens*, a Second Circuit panel indeed had said that Section 363(m) is jurisdictional because it "creates a rule of statutory mootness." *Pursuit Holdings (NY) LLC v. Piazza (In re Pursuit Holdings (NY) LLC),* 845 Fed. App'x 60, 62 (2d Cir. 2021).

The landlord filed a petition for *certiorari* in March 2022, raising the circuit split. The Court granted the petition at the end of the last term in June 2022.

Jurisdiction Must Be 'Clearly Stated'

Addressing the merits, Justice Jackson rejected the buyer's "creative arguments" and mirrored comments from the district court when she referred to the buyer's conduct as "egregious" in waiting until rehearing in district court to raise the question of jurisdiction.

Justice Jackson's opinion is another stab at repairing the Court's precedents on jurisdiction versus power. She referred to "our past sometimes loose use of the word 'jurisdiction.'" More recently, she said, "We have clarified that jurisdictional rules pertain to 'the power of the court rather than to the rights or obligations of the parties.'"

Today, Justice Jackson said, "we only treat a provision as jurisdictional if Congress 'clearly states' as much," citing *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493, 1494 (2022). On the other hand, Congress isn't required to use "magic words," she said.

To be jurisdictional, Justice Jackson said that "the statement must indeed be clear; it is insufficient that a jurisdictional reading is 'plausible,' or even 'better,' than nonjurisdictional alternatives," again citing *Boechler*.

Applying precedent, Justice Jackson saw "nothing" in Section 363(m) "that purports to 'gover[n] a court's adjudicatory capacity,'" quoting *Henderson v. Shinseki*, 562 U.S. 428, 435 (2011). To the contrary, she said that "§ 363(m) takes as a given the exercise of judicial power over any authorization under § 363(b) or § 363(c)."

The section, Justice Jackson said, "consists of a caveated constraint on the effect of a reversal or modification" and "is not the stuff of which clear statements are made."

Noting that Section 363(m) is not located in 28 U.S.C. § 1334(a)-(b), (e) and § 157, Justice Jackson said, "Statutory context leads to the same conclusion" that Section 363(m) is not jurisdictional. She said that the buyer "does not (because it cannot) deny the paucity of textual or contextual clues indicating a clear statement of jurisdictional intent."

Justice Jackson said that Section 363(m) is "a mere restriction on the effects of a valid exercise of [appellate] power when a party successfully appeals a covered authorization."

Commentary on Equitable Mootness?

The buyer argued in the Supreme Court that the appeal was moot even without regard to Section 363(m). Justice Jackson rejected the argument using words that might be read as undercutting the validity of the doctrine of equitable mootness, which is the topic of a pending petition for *certiorari*. *See U.S. Bank N.A. v. Windstream Holdings Inc.*, 22-926 (Sup. Ct.).

Without relying on Section 363(m), the buyer argued that the appeal was moot because the transfer of the lease could not now be avoided as a post-petition transaction under Section 549 since the debtor alone had standing to raise Section 549 and the debtor had waived any rights under that section.

In short, the buyer was saying that the appeal was moot because no relief could be granted.

Justice Jackson said that a "'case becomes moot only when it is impossible for a court to grant any effectual relief whatever to the prevailing party,'" quoting *Chafin v. Chafin*, 568 U.S. 165, 172 (2013). "The case remains live," she said, "'[a]s long as the parties have a concrete interest, however small, in the outcome of the litigation.'" *Id.*

In the MOAC appeal, Justice Jackson said, "[W]e cannot say that the parties have 'no "concrete interest,'" *id.* at 176, in whether [the buyer] obtains that relief."

As a court of "first review," Justice Jackson rejected the mootness contention, saying, "[W]e decline to act as a court of 'first view,' plumbing the Code's complex depths in 'the first instance' to assure ourselves that [the buyer] is correct about its contention that no relief remains legally available."

The Court remanded the case to the Second Circuit for "further proceedings consistent with this opinion."

Observations

Today's opinion casts doubt on the doctrine of equitable mootness, where courts routinely dismiss appeals from confirmation orders where the plans have been consummated. *MOAC* could be read to mean that appellate courts should not in the first instance decide that no relief is available following reversal.

MOAC could be read to mean that an appellate court should hear an appeal from a confirmed plan as long as there is constitutional or Article III jurisdiction. More often than not, the appellate court will uphold confirmation and never reach the question of whether there would have been available relief had there been a reversal.

On remand from reversal of confirmation, the bankruptcy court might locate a sliver of relief for the appellant that would not upset the apple cart and undo the plan altogether. Perhaps the bankruptcy court could award attorneys' fees to the creditor who appealed confirmation and established an important principle about chapter 11 plans.

The opinion is *MOAC Mall Holdings LLC v. Transform Holdco LLC*, 22-1270 (Sup. Ct. April 19, 2023).

The high court's ruling on the Takings Clause also seems to mean that real estate tax foreclosures can be avoided as constructively fraudulent transfers.

Supreme Court Holds that Real Estate Tax Foreclosures Can Violate the Takings Clause

Barely one month after oral argument, the Supreme Court unanimously resolved a split of circuits by reversing the Eighth Circuit and holding that a real estate tax foreclosure can violate the Takings Clause of the Fifth Amendment when the municipality takes title but doesn't give the owner the difference between the unpaid taxes and the value of the property.

For the Court, the opinion by Chief Justice John G. Roberts, Jr. said that "[h]istory and precedent" do not permit the state to take away a property interest protected by the Takings Clause.

$40,000 Property Taken for $15,000 in Taxes

A 94-year-old woman had owned a condominium. She went to live in a senior community but did not continue paying real estate taxes on the condominium. When some $2,300 in unpaid real estate taxes accrued along with $13,000 in interest and penalties, the municipality seized the property and sold it for $40,000. The county kept the $25,000 surplus and paid none to the former homeowner.

Conceding the validity of the foreclosure, the homeowner filed a class action under the Takings Clause, challenging the county's retention of the $25,000 surplus. The district court dismissed the suit for failure to state a claim and was affirmed last year in the Eighth Circuit. *Tyler v. Hennepin County*, 26 F.4th 789 (8th Cir. 2022).

The appeals court found no unconstitutional taking because state law recognized no property interest in the owner after the property was seized. The homeowner filed a petition for *certiorari* in May 2022.

While the *certiorari* petition was pending, the Sixth Circuit created a circuit split by holding that a real estate tax foreclosure violated the Takings Clause. *Hall v. Meisner*, 51 F.4th 185 (6th Cir. Oct. 13, 2022). The municipality in *Hall* had taken a $300,000 home in satisfaction of $22,250 in real estate taxes but refused to turn over the surplus. The Sixth Circuit denied a motion for rehearing *en banc* in January. To read ABI's report on *Hall*, click here.

The Supreme Court granted *certiorari* in January and held oral argument on April 26. To read ABI's report on argument, click here.

History and Precedent Rule the Day

The Chief Justice recited the history of real estate tax foreclosure in Minnesota. "Historically," he said, the state recognized an owner's property interest in the excess value in a home sold to satisfy delinquent property taxes. In 1935, he said that "the State purported to extinguish that property interest by enacting a law providing that an owner forfeits her interest in her home when she falls behind on her property taxes."

Against the backdrop of state law, the Chief Justice explored precedent regarding the Takings Clause. Contained in the Fifth Amendment, the clause provides that "private property [shall not] be taken for public use, without just compensation."

The Chief Justice noted that the clause itself "does not define property." He stated the question as "whether that remaining value is property under the Takings Clause, protected from uncompensated appropriation by the State."

The Chief Justice said that state law "is one important source" for defining property rights "but cannot be the only source." Otherwise, he said, the state could "sidestep" the Takings Clause by disavowing traditional property interests. He therefore looked at traditional property law principles "plus historical practice and this Court's precedents."

History

For the "principle that a government may not take more from a taxpayer than she owes," the Chief Justice went back to "Runnymeade in 1215" and found that the principle "became rooted in English law" by acts of Parliament and common law. Then, he said, the principle "made its way across the Atlantic."

Today, the Chief Justice said that the county identified only three states that deem property "entirely forfeited" for delinquent taxes. In contrast, he said that 36 states and the federal government "require that the excess value be returned to the taxpayer."

High Court Precedent

Citing decisions by the Court in 1881 and 1884, the Chief Justice said that "[o]ur precedents have also recognized the principle that a taxpayer is entitled to the surplus in excess of the debt owed." The county, in response, relied on *Nelson* v. *City of New York*, 352 U.S. 103 (1956), where the Court upheld the foreclosure of property for unpaid water bills.

The Chief Justice distinguished *Nelson* by noting how the taxpayer had waived a statutory right to recover the surplus. There was no Takings Clause violation, because the city had not absolutely precluded the owner from recovering the surplus.

The Chief Justice said that Minnesota "itself recognizes that in other contexts a property owner is entitled to the surplus in excess of her debt." For example, he mentioned real estate mortgage foreclosures, where a homeowner is entitled to the surplus after foreclosure.

The Chief Justice reversed the Eighth Circuit, saying that the homeowner "has plausibly alleged a taking under the Fifth Amendment," because the state made "an exception only for itself, and only for taxes on real property." Minnesota, he said, "may not extinguish a property interest that it recognizes everywhere else to avoid paying just compensation when it is the one doing the taking."

The Concurring Opinion

Agreeing there was a "plausibly alleged" violation of the Takings Clause, Justice Neil M. Gorsuch wrote a concurring opinion, joined by Justice Ketanji Brown Jackson. They wrote separately to deal with the Excessive Fines Clause in the Eighth Amendment.

In addition to the Takings Clause, the Eighth Circuit had found no violation of the Excessive Fines Clause. The Chief Justice did not address the Eighth Amendment, because the homeowner said that the finding of a Takings Clause violation would fully remedy her harm.

Justices Gorsuch and Jackson concurred because, they said, "even a cursory review" of the circuit's decision "reveals that it too contains mistakes future lower courts should not be quick to emulate."

The Eighth Circuit saw no Eighth Amendment violation, because they believed the statute to be remedial. Justice Gorsuch said, "It matters not whether the scheme has a remedial purpose, even a predominantly remedial purpose." The Excessive Fines Clause does not apply only when the statute is solely remedial.

According to Justice Gorsuch, the district also found no Eighth Amendment violation because the statute was not punitive, since it did not turn on culpability. He said that a statute may still be punitive if it uses punishment as a deterrent.

Justice Gorsuch ended his concurrence by saying:

> Economic penalties imposed to deter willful noncompliance with the law are fines by any other name. And the Constitution has something to say about them: They cannot be excessive.

Observations

The finding of a constitutional right to the surplus in a tax foreclosure may put a related issue to rest: Can a tax foreclosure be attacked in bankruptcy as a fraudulent transfer?

In *BFP v. Resolution Trust*, 511 U.S. 531 (1994), the Supreme Court held that regularly conducted real estate mortgage foreclosures cannot be fraudulent transfers, no matter how much equity the debtor loses above the mortgage debt.

The Fifth, Ninth and Tenth Circuits expanded *BFP* by holding that real estate tax foreclosures cannot be avoided as fraudulent transfers. The most recent of those decisions came from the Ninth Circuit. *See Tracht Gut, LLC v. Los Angeles County Treasurer*, 836 F.3d 1146 (9th Cir. 2016). To read ABI's report on *Tracht Gut*, click here.

The Second, Third, Sixth and Seventh Circuits have held that real estate tax foreclosures can be attacked as fraudulent transfers. To read ABI's reports, click here, here, here and here.

Since a tax foreclosure can violate the Constitution, it stands to reason that a tax foreclosure can be avoided as a fraudulent transfer.

Granted, the standards for finding a constitutional violation and a constructively fraudulent transfer are different. Given that courts will not rule on constitutional questions when the same result can be reached by other means, this writer believes that courts in the future will examine real estate tax forecloses to find fraudulent transfers before turning to the Constitution.

This writer bases his belief on the holding by the Chief Justice that a homeowner has a constitutionally protected property interest in the surplus arising from a tax foreclosure.

Indeed, one could ask whether *BFP* can be reconciled with *Tyler*. If the surplus in foreclosure is constitutionally protected property, how can a real estate tax foreclosure pass muster no matter how much equity the owner loses in foreclosure?

The opinion is *Tyler v. Hennepin County*, 22-166 (Sup. Ct. May 25, 2023).

The Supreme Court resolved a split of circuits in an opinion that could give support to the notion that arbitration agreements are not enforceable in bankruptcy.

Supreme Court: The Bankruptcy Code Waived Tribes' Sovereign Immunity

Over a dissent by Justice Neil M. Gorsuch, Justice Ketanji Brown Jackson held for herself and six other justices that Section 106(a) of the Bankruptcy Code waives sovereign immunity as to tribes of Native Americans.

Justice Clarence Thomas concurred in the judgment, believing that tribes never had sovereign immunity to begin with.

Compelling Facts for the Debtor

The debtor borrowed $1,100 from a corporate payday lender before filing bankruptcy. The lender was owned by a federally recognized tribe. By the time the debtor filed a chapter 13 petition, the debt had grown to almost $1,600 as an unsecured, nonpriority claim.

Despite the automatic stay and despite being told about the bankruptcy, the tribal lender continually called the debtor demanding payment. Two months after bankruptcy, the debtor attempted suicide, blaming his action on the incessant calls.

In bankruptcy court, the debtor sought an injunction to halt collections attempts, along with damages and attorneys' fees. The bankruptcy court granted the tribe's motion to dismiss, based on sovereign immunity. The First Circuit accepted a direct appeal and reversed over a vigorous dissent.

For the majority, First Circuit Judge Sandra L. Lynch took sides with the Ninth Circuit, which had held in 2004 that Section 106(a) abrogated sovereign immunity for tribes. *Krystal Energy Co. v. Navajo Nation*, 357 F.3d 1055, 1061 (9th Cir. 2004). She disagreed with the Sixth Circuit, which found no waiver in 2019. *In re Greektown Holdings, LLC*, 917 F.3d 451, 460- 61 (6th Cir. 2019), *cert. dismissed sub nom. Buchwald Cap. Advisors LLC v. Sault Ste. Marie Tribe*, 140 S. Ct. 2638 (2020). While the *certiorari* petition was pending in *Greektown*, the case settled, and the petition was dismissed. To read ABI's report on *Greektown*, click here.

The debtor in the First Circuit filed a petition for *certiorari*, which the Court granted in September. Oral argument was held in January. To read ABI's report on argument, click here.

The Majority's Rationale

Justice Jackson began her June 15 opinion by laying out the law on waivers of sovereign immunity. Congressional intent to waive immunity must be made in "unequivocal terms." Although the Court does not oblige Congress to use "magic words," the intent to waive must be "unmistakably clear" or "clearly discernable" from the statute.

The circuits were split because the statute arguably leaves something to be desired. For "governmental units," Section 106(a) waives sovereign immunity as to a long list of sections in the Bankruptcy Code. The Section 362 automatic stay is on the list.

Section 101(27) defines "governmental unit." Regarding waiver as to tribes, the question for the Supreme Court was whether tribes come under the rubric of "other foreign or domestic government," as used in Section 101(27).

Justice Jackson did not leave the reader in doubt. After laying out general law, she said:

> [T]he Bankruptcy Code unequivocally abrogates the sovereign immunity of any and every government that possesses the power to assert such immunity. Federally recognized tribes undeniably fit that description; therefore, the Code's abrogation provision plainly applies to them as well.

To justify the conclusion, Justice Jackson wrote a 16-page opinion, one page shorter than the dissent. She said that the statutory "definition of 'governmental unit' exudes comprehensiveness from beginning to end." By "coupling foreign and domestic together, and placing the pair at the end of an extensive list, Congress unmistakably intended to cover all governments in §101(27)'s definition, whatever their location, nature, or type," she said.

Justice Jackson found reinforcement in other aspects of the Bankruptcy Code, such as the application of the Code's "requirements generally . . . to all creditors."

Finding no "indication" that Congress "categorically" excluded "certain governments" from the Code's "enforcement mechanisms and exceptions," Judge Jackson identified the "one remaining question" as whether federally recognized tribes "qualify as governments."

Justice Jackson said that Congress "repeatedly characterizes tribes as governments." Given that the "Code unequivocally abrogates the sovereign immunity of all governments, categorically," and that "Tribes are indisputably governments," she held that "§106(a) unmistakably abrogates their sovereign immunity too."

The Tribe's Arguments Rejected

Justice Jackson devoted the final six pages of her opinion to rebutting the tribe's arguments, such as the fact that every other case finding a waiver involved a statute that specifically mentioned tribes.

Justice Jackson said that "the universe of cases . . . is exceedingly slim," and the fact that Congress had mentioned tribes specifically "does not foreclose it from using different language to accomplish that same goal in other statutory contexts."

Justice Jackson addressed the dissent by Justice Gorsuch, who described tribes as a "hybrid" that is neither "foreign" nor "domestic." She found it "hard to see why the Code would subject purely foreign or domestic governments to enforcement proceedings while at the same time immunizing government creditors that have both foreign and domestic attributes."

Finally, Justice Jackson said that the definition of "governmental unit" is "undeniably broader" in the Bankruptcy Code than it was under the former Bankruptcy Act. "[H]owever Congress may have treated governmental entities in bankruptcy law prior to 1978," she said, "it had clearly altered its view about the scope of coverage relative to governments by the time it enacted §101(27) and §106(a)."

Justice Jackson affirmed the First Circuit.

The Concurrence

Justice Thomas concurred in the judgment, but on entirely different grounds. He said that "the Court should simply abandon its judicially created tribal sovereign immunity doctrine."

Citing his own dissent in a prior case, Justice Thomas said that tribal sovereign immunity was not mandated by the Constitution but was a common law doctrine. "Because no federal law accords tribes sovereign immunity in federal court," he said, the tribe "lack[s] immunity in this federal case."

Furthermore, Justice Thomas said that governments protected by sovereign immunity have no protection for their "commercial acts."

"Accordingly," Justice Thomas said, "any common-law immunity that [the tribe] possess[es] cannot support [its] claim to immunity in federal court for their off-reservation commercial conduct."

The Dissent by Justice Gorsuch

Justice Gorsuch opened his 17-page dissent by saying that tribes were specifically mentioned in the statute every time the Court has previously found a waiver of sovereign immunity. Although the majority's interpretation was "plausible," he said that "plausible is not the standard our tribal immunity jurisprudence demands."

From "two centuries of history and precedent," Justice Gorsuch said, "Tribes [have enjoyed] a unique status in our law," meaning that they are neither "foreign" nor "domestic." Because the Bankruptcy Code does not refer to tribes specifically, he found no waiver.

Justice Gorsuch addressed the majority's notion that the Bankruptcy Code "exudes comprehensiveness." He said it's "true but not obviously helpful," because the Court has never "held that a statute's general atmospherics can satisfy the clear-statement rule when the text itself comes up short."

Quoting his own concurrence in a case last term, Justice Gorsuch "respectfully" dissented because Congress cannot use "oblique or elliptical language."

Observations

Policy arguments typically gain little or no traction in textualist decisions by the Supreme Court.

It is therefore noteworthy that Justice Jackson found support for her conclusion in "[o]ther aspects of the Bankruptcy Code" and "the Code's 'orderly and centralized' debt-resolution process," which, she said, "generally apply to *all* creditors." [Emphasis in original.]

At least when it comes to decisions involving the Bankruptcy Code, the Supreme Court might be amenable to interpreting a confusing provision in light of the larger principles undergirding the Code.

If a case one day asks the Supreme Court to decide whether arbitration agreements are enforceable in bankruptcy, the statement by Justice Jackson that the Code's provisions "generally apply to *all* creditors" suggests that arbitration agreements are unenforceable in bankruptcy, given the Code's "orderly and centralized" processes.

The opinion is *Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin,* 22-227 (Sup. Ct. June 15, 2023).

Split 5/4, the Supreme Court rules that denial of a motion to compel arbitration automatically imposes a stay pending appeal.

A Supreme Court Arbitration Opinion Could Disrupt Bankruptcies

A 5/4 arbitration decision by the Supreme Court on June 23 in a nonbankruptcy case could disrupt bankruptcies large and small.

In *Coinbase Inc. v. Bielski*, the Supreme Court held that denial of a motion to compel arbitration automatically imposes a stay on the entire action in the trial court, pending appeal from the order denying arbitration.

If *Coinbase* applies in bankruptcy cases, the bankruptcy court would at a minimum be automatically enjoined from deciding issues involving a creditor that unsuccessfully called for arbitration.

The four dissenters in the Supreme Court likened the majority's opinion to opening "Pandora's box." Disruption of bankruptcy cases may be one of the unintended, unanticipated effects to emerge from *Coinbase*. Application of *Coinbase Inc.* to chapter 11 cases may impel the Supreme Court to decide whether or not arbitration clauses are generally unenforceable in bankruptcy cases.

The Facts and the Circuit Split

A customer filed a putative class action in federal district court against an online platform for buying and selling cryptocurrencies. The complaint alleged that the platform failed to replace funds taken fraudulently from accounts.

The platform filed a motion to compel arbitration, based on an arbitration clause contained in the user agreement. The district court denied the arbitration motion.

Citing 9 U.S.C. § 16(a), the platform filed an interlocutory appeal. As Justice Brett M. Kavanaugh said in his majority opinion for the Court, "Section 16(a) authorizes an interlocutory appeal from the denial of a motion to compel arbitration."

The platform moved in district court for a stay pending appeal. The district court denied the stay, as did the Ninth Circuit. To resolve a split of circuits on whether stays pending appeal are

automatic following denial of an arbitration motion, the Supreme Court granted *certiorari* and heard argument on March 21.

The Majority Opinion

Justice Kavanaugh said that Section 16(a) contains "a rare statutory exception to the usual rule" that appeals are not taken from interlocutory orders. He also said that the section "does not say whether the district court proceedings must be stayed."

Finding an automatic stay, Justice Kavanaugh based his conclusion on a statement in *Griggs* v. *Provident Consumer Discount Co.*, 459 U.S. 56, 58 (1982), that an appeal "'divests the district court of its control over those aspects of the case involved in the appeal.'"

Justice Kavanaugh reasoned that "the entire case is essentially 'involved in the appeal,'" citing *Griggs, id*. Citing the Seventh Circuit, he said that whether the case may go ahead in district court is precisely the issue on appeal. Also citing the Seventh Circuit, he said it makes no sense to proceed in district court while the appeals court decides whether there should be a case in district court at all.

"In short," Justice Kavanaugh said, "*Griggs* dictates that the district court must stay its proceedings while the interlocutory appeal on arbitrability is ongoing." Saying that most courts impose a stay automatically, he said that "common practice makes common sense."

Dismissing five arguments advanced by the plaintiff, Justice Kavanaugh said that the benefits of arbitration could be "irretrievably lost" were the action to proceed in the trial court pending appeal.

The Dissenters

Justice Ketanji Brown Jackson dissented, joined by Justices Sonia Sotomayor and Elena Kagan. Justice Clarence Thomas joined in most of Justice Jackson's dissent.

Justice Jackson said that the majority "departs from the traditional approach" by imposing "a mandatory stay of trial court proceedings." The mandatory stay rule, she said, "comes out of nowhere" and "perpetually favor[s] one class of litigants."

Justice Jackson saw no mandatory stay rule in Section 16(a). Indeed, she said that the section "never even mentions a stay pending appeal."

Rather than justifying an automatic stay, Justice Jackson said that *Griggs* "expresses a far narrower principle" that two courts "should avoid exercising control over the same order or judgment simultaneously." To her way of thinking, "*Griggs* divests the district court of control over

only a narrow slice of the case," namely, the ability to modify the order refusing to compel arbitration.

On appeals, Justice Jackson said that only arbitrability was before the appellate court, "not the merits."

Justice Jackson began the last two pages of her 15-page opinion by saying that the majority "ventures down an uncharted path — and that way lies madness." She said that a "wide array of appeals seemingly fits the bill."

An "appeal over the proper forum for a dispute" or "all appeals over forum-selection agreements" would "arguably raise the same question," just like orders granting preliminary injunctions, Justice Jackson said. "Taken that broadly," she warned, "the mandatory-general-stay rule the Court adopts today would upend federal litigation as we know it."

Justice Jackson ended her dissent by saying that the "mandatory-general-stay rule that the Court manufactures is unmoored from Congress's commands and this Court's precedent."

Observations

The Supreme Court has yet to decide where or to what extent arbitration clauses are enforceable in bankruptcy. Is arbitration always prohibited, or only when the dispute falls within the bankruptcy court's "core" jurisdiction?

The majority opinion does not limit the automatic stay rule to particular sorts of cases. Presumably, it also applies in bankruptcy.

Suppose a creditor's agreement with the debtor contains a broadly worded arbitration clause. What if the debtor objects to the creditor's claim, the creditor invokes the arbitration agreement, and the bankruptcy court denies the motion to compel arbitration? Is the objection to claim automatically stayed pending appeal to the district court, the circuit court and the Supreme Court?

Or, what about the question of whether a creditor with an arbitration agreement is impaired by a chapter 11 plan? Or, what if the creditor claims that the plan is not fair and equitable? Are the proceedings in bankruptcy court automatically enjoined until there is a final order declining to compel arbitration?

Compelling arbitration in bankruptcy cases could stall chapter 11 cases. Depending on the nature of the issue, a *Coinbase* automatic stay pending appeal could delay, disrupt or torpedo a reorganization.

The opinion is *Coinbase Inc. v. Bielski*, 22-105 (Sup. Ct. June 23, 2023).

The Supreme Court ducked the question of whether Puerto Rico and other U.S. territories are entitled to Eleventh Amendment sovereign immunity just like states.

Supreme Court Holds that PROMESA Didn't Waive Puerto Rico's Sovereign Immunity

Over a dissent by Justice Clarence Thomas, the Supreme Court *assumed* that Puerto Rico and the Financial Oversight and Management Board are entitled to sovereign immunity like a state. In her opinion of the Court on May 11, Justice Elena Kagan reversed the First Circuit by holding that nothing in the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), waived the Oversight Board's sovereign immunity.

The Origins of PROMESA and the Board

After the Supreme Court ruled that Puerto Rico was ineligible for municipal bankruptcy in chapter 9 of the Bankruptcy Code, Congress quickly enacted PROMESA, which adopts large portions of chapter 9. Puerto Rico and many of its instrumentalities sought relief under PROMESA in 2017 in what is known as Title III debt-adjustment proceedings.

In the Title III proceedings, Puerto Rico's federally appointed Financial Oversight and Management Board in substance represented Puerto Rico and its instrumentalities. In April 2022, the First Circuit upheld confirmation of the Oversight Board's plan of adjustment for the Commonwealth of Puerto Rico. To read ABI's report, click here.

In 2017 and again in 2019, nonprofit media organizations filed suit in federal district court in Puerto Rico, asking the PROMESA court to compel the Oversight Board to disclose broad categories of information and communications regarding the proceedings. The Board filed a motion to dismiss based on Eleventh Amendment sovereign immunity, among other things.

The district court denied the motion to dismiss and ordered the production of documents and other information. The district court reasoned that the Board was entitled to sovereign immunity but that Section 106 of PROMESA had waived and abrogated immunity.

The Board appealed.

First Circuit Finds a Waiver of Immunity

The First Circuit had previously held that Puerto Rico and the Oversight Board were entitled to sovereign immunity. Therefore, the First Circuit only considered on appeal whether PROMESA had waived sovereign immunity as to the suit by the news organization.

Finding a waiver of sovereign immunity, the majority on the First Circuit panel principally relied on Section 106 of PROMESA, which says that "any action against the . . . Board, [or] . . . otherwise arising out of [PROMESA] . . . shall be brought in [the district court for the district of Puerto Rico]." 48 U.S.C. § 2126(a).

By the inclusion of Section 106, the First Circuit majority reasoned that "Congress unequivocally stated its intention that the Board could be sued for 'any action . . . arising out of [PROMESA],' but only in federal court. Congress was unmistakably clear that it had contemplated remedies for constitutional violations and that injunctive or declaratory relief against the Board may be granted." *Financial Oversight & Management Board for Puerto Rico v. Centro de Periodismo Investigativo Inc.*, 35 F.4th 1, 17 (1st Cir. May 17, 2022). To read ABI's story, click here.

The majority on the appeals court panel affirmed the district court's order denying the motion to dismiss, finding a waiver of sovereign immunity.

In dissent, Circuit Judge O. Rogeriee Thompson found "[a]bsolutely nothing in the text of [Section 106 that] sets forth an intent to abrogate Eleventh Amendment immunity." *Id*. at 21. Announcing a theme that later persuaded Justice Kagan, Judge Thompson said that the "Supreme Court has repeatedly held that jurisdiction-granting clauses like § 106 do not abrogate Eleventh Amendment immunity. [Footnote omitted.]" *Id*. at 22.

Believing there was no abrogation of sovereign immunity, Judge Thompson "respectfully" dissented, ending her opinion by saying that "today's decision should not go uncorrected." *Id*. at 25.

The Oversight Board filed a petition for *certiorari* in July 2022. The petition stated the question presented as whether Section 106 of PROMESA abrogated the Oversight Board's sovereign immunity. The Court granted the petition in October. Argument was held in January.

The Opinion of the Court

Justice Kagan restated the question presented as "whether [PROMESA] categorically abrogates (legalspeak for eliminates) any sovereign immunity the board enjoys from legal claims."

Telling the reader in the first paragraph that she was reversing, Justice Kagan said:

> Under long-settled law, Congress must use unmistakable language to abrogate sovereign immunity. Nothing in the statute creating the Board meets that high bar.

Justice Kagan found nothing "explicit" in PROMESA about the abrogation of sovereign immunity except for Title III cases. "In particular," she said, "no provision states that it is abrogating any immunity the Board possesses from legal claims."

"At the same time," Justice Kagan said, "several provisions of PROMESA contemplate that, even outside the Title III context, the Board may confront legal claims against it."

Justice Kagan found only two circumstances where Congress has issued an "unequivocal declaration" abrogating immunity. The first is when the statute "says in so many words that it is stripping immunity." The second "is when a statute creates a cause of action and authorizes suit against a government on that claim."

"PROMESA fits neither of those molds," Justice Kagan said.

Reversing the First Circuit and remanding, Justice Kagan held:

> In short, nothing in PROMESA makes Congress's intent to abrogate the Board's sovereign immunity "unmistakably clear." *Kimel*, 528 U.S., at 73. The statute does not explicitly strip the Board of immunity. It does not expressly authorize the bringing of claims against the Board. And its judicial review provisions and liability protections are compatible with the Board's generally retaining sovereign immunity.

The Dissent by Justice Thomas

Justice Kagan said that the First Circuit and the district court "simply assumed the Board's immunity before turning to the abrogation issue."

"We took the case on those terms, and we resolve it on those terms," Justice Kagan said. "That means we assume without deciding that Puerto Rico is immune from suit in federal district court, and that the Board partakes of that immunity."

Justice Thomas would have affirmed the First Circuit, but on the very ground that the majority assumed without deciding.

Justice Thomas explained how the Oversight Board claimed sovereign immunity under the Eleventh Amendment. He paraphrased the amendment to mean that "the Constitution does not allow federal or state courts to hear cases against States without their consent."

Working from the proposition that Puerto Rico is a territory and not a state, Justice Thomas said it "is difficult to see how the same inherent sovereign immunity that the States enjoy in federal court would apply to Puerto Rico." He said that the Oversight Board's argument for Eleventh Amendment immunity was "untenable."

Justice Thomas would have affirmed because he believes that the Oversight Board had not established its immunity.

Observations

For Puerto Rico, the case is notable in that the majority ducked the question of whether territories are entitled to sovereign immunity. If the question is ever presented to the Court, the dissent means that Justice Thomas would see no constitutional immunity for territories because they are not states. How he would feel about tribes of Native Americans is less clear.

Indeed, tribal sovereign immunity is *sub judice* in the Supreme Court in *Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin,* 22-227 (Sup. Ct.). The case was argued on April 24. Similar to the PROMESA case, the First Circuit had deepened an existing circuit split by holding over a lengthy dissent in *Lac du Flambeau* that Sections 106(a) and 101(27) of the Bankruptcy Code waived sovereign immunity as to Native American tribes. To read ABI's report on oral argument, click here.

The PROMESA decision doesn't indicate how the Court will decide *Lac du Flambeau*, except to say that "abrogation requires an 'unequivocal declaration' from Congress." Presumably, the decision in *Lac du Flambeau* will tell us whether "other foreign or domestic government" in Section 101(27) is an unequivocal reference to tribes that waives immunity.

It's a good bet, however, that Justice Kagan will write the opinion in *Lac du Flambeau*.

The opinion is *Financial Oversight & Management Board for Puerto Rico v. Centro de Periodismo Investigativo Inc.*, 22-96 (Sup. Ct. May 11, 2023).

Prior Terms

The Supreme Court's unanimous opinion avoids saying whether the dual system of U.S. Trustees and Bankruptcy Administrators is itself unconstitutional.

2018 Increase in U.S. Trustee Fees Held Unconstitutional by the Supreme Court

The Supreme Court ruled unanimously on June 6 that the increase in fees payable to the U.S. Trustee system in 2018 violated the uniformity aspect of the Bankruptcy Clause of the Constitution because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees.

The opinion for the Court by Justice Sonia Sotomayor said that the Uniformity Clause "is not a straightjacket: Congress retains flexibility to craft legislation that responds to different regional circumstances that arise in the bankruptcy system." She remanded for lower courts to determine the proper remedy.

Although Justice Sotomayor pointedly said that her opinion "does not today address the constitutionality of the dual scheme of the bankruptcy system itself," some of her language could be read to imply that the dual system is constitutionally questionable.

The Fee Structure's History

Justice Sotomayor recounted how U.S. Trustees were originally a pilot program after the adoption of the Bankruptcy Code in 1978. In 1986, Congress expanded the program nationwide, but not in North Carolina and Alabama, where she said there was "resistance from stakeholders." Courts in those states retained their Bankruptcy Administrators.

The U.S. Trustee system was designed to be self-funding, with fees paid by chapter 11 debtors in 48 states. Originally, Congress did not require user fees in the two exempted states. After the Ninth Circuit held in 1995 that the dual system was unconstitutional in view of the disparate fees, Congress rewrote the law to say that the Judicial Conference "may" requires fees in Bankruptcy Administrator districts to be equal to those in the other 48 states.

Fees in all states were the same until Congress raised the fees in January 2018 for the U.S. Trustee system. Justice Sotomayor said the increase was "significant."

The Judicial Conference did raise the fees in the two other states effective in October 2018. There were two differences, Justice Sotomayor said.

First, the increase was not effective in the two states until October 2018, while the U.S. Trustee fees had risen everywhere else in January 2018. Second, the increase in the two states only applied to newly filed cases. In U.S. Trustee districts, the increase applied to pending cases, not only new cases.

Procedural History

Circuit City Stores Inc., the debtor that brought the case to the Supreme Court, had confirmed a chapter 11 plan in 2010. Until the increase went into effect, the debtor had been paying $30,000 a quarter, the maximum.

In the period after the increase, the debtor paid $632,500 in fees. Had there been no increase, Justice Sotomayor said the fees during the period would have been only $56,400.

The debtor mounted an objection to the increase on constitutional grounds and won. Bankruptcy Judge Kevin R. Huennekens of Richmond, Va., held that the increased fees violated the Uniformity Clause, if the fee is seen as a tax, and violated the Bankruptcy Clause, if the fee is considered a user fee. *In re Circuit City Stores Inc.*, 606 B.R. 260 (Bankr. E.D. Va. July 15, 2019). To read ABI's report, click here.

However, the bankruptcy court did not rule on whether the debtor was entitled to a refund, Justice Sotomayor said.

The Fourth Circuit agreed to hear an interlocutory appeal and reversed in a 2/1 decision. The majority on the Richmond, Va.-based appeals court did not believe that the increase was arbitrary. The dissenter would have held the increase to be unconstitutional. *In re Circuit City Stores, Inc.*, 996 F.3d 156 (4th Cir. April 29, 2021). To read ABI's report, click here.

Like the Fourth Circuit, the Fifth Circuit saw no constitutional infirmity. There were dissenters in both opinions. In unanimous opinions, the Second and Tenth Circuits found constitutional transgressions. The Supreme Court granted *certiorari* to resolve the circuit split and heard oral argument on April 18.

Applicability of the Bankruptcy Clause

The Bankruptcy Clause empowers Congress to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."

Defending the disparate fee structure, the U.S. Solicitor General argued that the fees were not covered by the Bankruptcy Clause because the fee statutes were not substantive law.

The language of the clause is "broad," Justice Sotomayor said, and "[n]othing in the language of the Bankruptcy Clause itself, however, suggests a distinction between substantive and administrative laws." Furthermore, she said that the Court has never "distinguished between substantive and administrative bankruptcy laws or suggested that the uniformity requirement would not apply to both."

"Not surprisingly," Justice Sotomayor said, all courts to consider the question have concluded that the fees were subject to the Bankruptcy Clause, including those courts that found no constitutional violation.

"Moreover," Justice Sotomayor said, the fees were substantive because they affected the debtor/creditor relationship by making less money available for creditors in 48 states. She said that Congress exempted debtors from the higher fees in two states "without identifying any material difference between debtors across those States."

Precedent Foretells the Outcome

Having decided that the fee structure was subject to the Bankruptcy Clause, Justice Sotomayor addressed the question of whether the disparate fees were "a permissible exercise of that Clause." She discussed the three Supreme Court cases that have confronted the meaning of the clause. "Taken together," she said, "they stand for the proposition that the Bankruptcy Clause offers Congress flexibility, but does not permit arbitrary geographically disparate treatment of debtors."

In 1908 under the former Bankruptcy Act, Justice Sotomayor said that the Supreme Court upheld the constitutionality of state homestead and exemption laws, because the general operation of the law was uniform, although the results might be different in some states. *Hanover Nat. Bank v. Moyses*, 186 U.S. 181, 187 (1902).

In 1974, the Court upheld a railroad reorganization law that only applied to railroads in the Northeast and Midwest. Based on the "flexibility" in the Bankruptcy Clause, the Court upheld the law that addressed "geographically isolated problems." *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 159 (1974)."

Justice Sotomayor read *Regional Rail Reorganization Act Cases* to mean that "Congress may enact geographically limited bankruptcy laws consistent with the uniformity requirement if it is responding to a geographically limited problem."

In *Railway Labor Executives' Assn. v. Gibbons*, 455 U.S. 457 (1982), the Court struck down a railroad reorganization law than changed the priority scheme, but only for one railroad.

From the three cases, Justice Sotomayor said that the Bankruptcy Clause "does not give Congress free rein to subject similarly situated debtors in different States to different fees because it chooses to pay the costs for some, but not others."

In other words, the clause permits "flexibility, but does not permit arbitrary geographically disparate treatment of debtors," Justice Sotomayor said.

Impermissible Lack of Uniformity

For Justice Sotomayor, the "only remaining question" was "whether Congress permissibly imposed nonuniform fees because it was responding to a funding deficit limited to the Trustee Program districts."

In the case in the Supreme Court, the geographical discrepancy cost Circuit City more than $500,000, Justice Sotomayor said. She said that the budgetary shortfall in the U.S. Trustee districts:

> existed only because Congress itself had arbitrarily separated the districts into two different systems with different cost funding mechanisms, requiring Trustee Program districts to fund the Program through user fees while enabling Administrator Program districts to draw on taxpayer funds by way of the Judiciary's general budget.

The reasons for the different fees, Justice Sotomayor said, "stem not from an external and geographically isolated need, but from Congress' own decision to create a dual bankruptcy system funded through different mechanisms in which only districts in two States could opt into the more favorable fee system for debtors."

Consequently, Justice Sotomayor held that "the Clause does not permit Congress to treat identical debtors differently based on an artificial funding distinction that Congress itself created."

Final Comments by Justice Sotomayor

The debtor took the position in the Supreme Court that the dual system itself is unconstitutional. Justice Sotomayor said that the Court was not addressing "the constitutionality of the dual scheme of the bankruptcy system itself."

Indicating that the Court was not overruling the *Regional Rail Reorganization Act Cases*, Justice Sotomayor said the opinion "should not be understood to impair Congress' authority to structure relief differently for different classes of debtors or to respond to geographically isolated problems." Rather, she said that the court was only prohibiting "Congress from arbitrarily burdening only one set of debtors with a more onerous funding mechanism than that which applies to debtors in other States."

Justice Sotomayor ended her opinion by noting how the government and the debtor disagreed about the remedy in the event of reversal. Because the Fourth Circuit had not considered remedy, she reversed and remanded for the Fourth Circuit to consider remedy "in the first instance."

Is the Dual System Constitutionally Sound?

In the context of disparate fees, Justice Sotomayor noted how the Ninth Circuit said that the dual system of U.S. Trustees and Bankruptcy Administrators was unconstitutional. *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525 (1994), *amended*, 46 F.3d 969 (1995). The question never went to the Supreme Court because Congress quickly brought the fees in line.

Litigants may have difficulty attacking the dual system on appeal given the requirement of showing actual pecuniary harm. Furthermore, does the Constitution mandate that all debtors have the same adversary? And if all debtors must have the same adversary, are court-appointed trustees constitutional in chapters 7 and 13? In other words, overturning the dual system would have wide ramifications.

Several statements by Justice Sotomayor might bear on the constitutionality of the dual system. Early in the opinion, she said that "Congress itself had arbitrarily separated the districts into two different systems." She also said that Congress may "enact geographically limited bankruptcy laws consistent with the uniformity requirement in response to a geographically limited problem."

Is the dual system unconstitutional simply because it is arbitrary? Is the dual system unconstitutional just because there was no geographical mandate? Laws are not unconstitutional just because they are arbitrary.

Although the constitutionality of the dual system is unclear, this writer believes that the system is subject to scrutiny under the Bankruptcy Clause, because Justice Sotomayor several times said the clause must be brought to bear whether the law is substantive or "administrative."

Although the disparate fees are ancient history, the last chapter has not been written. Absent settlement, the lower courts in the *Circuit City* case can decide on remand whether the debtor is entitled to a refund.

The same issue is alive in a now-revived class action that could end up giving refunds to chapter 11 debtors throughout the country that paid higher fees.

The Federal Court of Claims dismissed a class action on ruling that the disparate fees did not violate the Bankruptcy Clause. *See Acadiana Management Group LLC v. U.S.*, 19-496, 151 Fed. Cl. 121 (Ct. Cl. Nov. 30, 2020).

The debtor-plaintiff appealed and is asking the Federal Circuit to reinstate the class action. Oral argument in the Federal Circuit was postponed pending the outcome in *Circuit City*. For ABI's report on *Acadiana*, click here.

The opinion is *Siegel v. Fitzgerald*, 21-441 (Sup. Ct. June 6, 2022).

Cutting back on knee-jerk invocation of arbitration, the Supreme Court says that agreements to arbitrate are no more enforceable than ordinary contracts.

Supreme Court on Arbitration (Again): Perhaps Bankruptcy Is Exempt from Arbitration?

For the bankruptcy community, arbitration cases in the Supreme Court are important because the justices have never granted *certiorari* to decide whether arbitration agreements are generally enforceable in bankruptcy.

For example, would the high court require a debtor to arbitrate the allowance of a claim or the rejection of a contract or the question of whether a plan impairs a creditor's claim?

This term, the Supreme Court has ruled on two arbitration cases. Both times, the Court has taken a less expansive approach, finding no special rules impelling federal courts to enforce arbitration agreements.

On March 31, Justice Elena Kagan wrote for the 8/1 majority that there must be an independent basis of federal jurisdiction to mount an action in federal court to confirm (or to attack confirmation of) an arbitration award. *See Badgerow v. Walters*, 20-1143, 142 S. Ct. 1310, 212 L. Ed. 2d 355 (Sup. Ct. March 31, 2022). To read ABI's report, click here.

Writing for the unanimous Court on May 22, Justice Kagan overruled the majority of circuits, which had held that a "party can waive its arbitration right by litigating only when its conduct has prejudiced the other side."

Aligning the Supreme Court with the *minority* of circuits, Justice Kagan held that "the [Federal Arbitration Act's] 'policy favoring arbitration' does not authorize federal courts to invent special, arbitration-preferring procedural rules."

The Employer's Waiver of Arbitration

An hourly worker had signed an arbitration agreement when she accepted employment. She later brought a purported class action against the employer in district court in Iowa, alleging violations of the Fair Labor Standards Act.

The employer filed and lost a motion to dismiss. Answering the complaint, the employer raised 14 affirmative defenses, but not arbitration. Eight months into the lawsuit, the employer filed a motion to stay the litigation and compel arbitration.

The Eighth Circuit had previously held that a party could waive arbitration only if there were prejudice to the other party. The district court ruled that the prejudice requirement had been satisfied, but the Eighth Circuit reversed in a 2/1 opinion. The dissenter in the appeals court "raised doubts" about the prejudice requirement, Justice Kagan said.

The Supreme Court granted *certiorari* to resolve a circuit split. According to Justice Kagan, nine circuits "have invoked 'the strong federal policy favoring arbitration' in support of an arbitration-specific waiver rule demanding a showing of prejudice." The Seventh and the District of Columbia Circuits "have rejected that rule," Justice Kagan said.

Ruling Based on Principles of Contract Law

Without deciding, Justice Kagan assumed that federal courts properly invoke federal law on waiver in arbitration cases. She tackled the question of whether courts "may create arbitration-specific variants of federal procedural rules, like those concerning waiver, based on the FAA's 'policy favoring arbitration.'"

"Outside the arbitration context," Judge Kagan said, "a federal court assessing waiver does not generally ask about prejudice." Instead, she said, "the court focuses on the actions of the person who held the right; the court seldom considers the effects of those actions on the opposing party."

The Eighth Circuit had applied a "rule found nowhere else," Judge Kagan said.

Justice Kagan's opinion has the effect of putting limits on the policy favoring arbitration. She said that the "policy is to make 'arbitration agreements as enforceable as other contracts, but not more so.' *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404, n. 12 (1967)."

Justice Kagan held that "a court must hold a party to its arbitration contract just as the court would to any other kind. But a court may not devise novel rules to favor arbitration over litigation." She explained that the policy "*is about treating arbitration contracts like all others, not about fostering arbitration*." [Emphasis added.]

Justice Kagan vacated the judgment of the Eighth Circuit and remanded for the lower court to "focus" on the employer's conduct. "Our sole holding today is that it may not make up a new procedural rule based on the FAA's 'policy favoring arbitration,'" she said.

Observations

The two arbitration opinions this term by Justice Kagan are the latest installments in the Supreme Court's recent push to limit or cut back on the adoption of federal common law.

In *Rodriguez v. F.D.I.C.*, 140 S. Ct. 713, 206 L. Ed. 2d 62 (Feb. 25, 2020), Justice Neil M. Gorsuch used a bankruptcy case to rule that federal courts may not employ federal common law to decide who owns a tax refund when a parent holding company files a tax return but a subsidiary generated the losses giving rise to the refund. To read ABI's report, click here.

To this writer's way of thinking, it is questionable whether there is any longer a federal policy favoring arbitration. Justice Kagan's opinion makes enforcement of an arbitration agreement nothing more than a question of contract interpretation.

Let us assume that a creditor has an otherwise enforceable arbitration agreement in a contract with a debtor in bankruptcy.

It goes without saying that the contract bends to the plethora of rights conferred by the Bankruptcy Code on debtors and trustees. That is to say, contracts are enforceable only to the extent permitted by the Bankruptcy Code, and the Code presumes that virtually all disputes are relegated to the district or bankruptcy courts, absent remand or modification of the automatic stay.

But here's the rub: The Supreme Court has long held that courts must compel arbitration unless a federal statute manifests a clear intention to override the FAA. Does the Bankruptcy Code manifest a clear intention to override an arbitration agreement?

Is "clear intention" still the standard, or has it been modified by focusing on contract interpretation?

The opinion is *Morgan v. Sundance Inc.*, 21-328 (Sup. Ct. May 23, 2022).

The Supreme Court is still giving no hints about whether arbitration agreements are enforceable in bankruptcy cases.

Supreme Court Rules Again on Arbitration, Saying Nothing Explicitly About Bankruptcy

We follow arbitration cases in the Supreme Court because the justices have never granted *certiorari* to decide whether arbitration agreements are generally enforceable in bankruptcy. For example, must a debtor arbitrate the allowance of a claim or rejection of an executory contract or even enforcement of a plan that impairs a creditor's claim?

Late last week, the justices ruled 8/1 in *Badgerow v. Walters*, 20-1143 (Sup. Ct. March 31, 2022), that there must be an independent basis of federal jurisdiction to mount an action in federal court to confirm (or to attack confirmation of) an arbitration award. The opinion means this: The federal court may have had subject matter jurisdiction to compel arbitration but may not have jurisdiction later to confirm or enforce the resulting award.

As expected, the opinion has no language that would apply expressly to bankruptcy. At best, the new opinion could be read to mean that federal courts do not champion arbitration in all circumstances.

Another arbitration case was argued in the Supreme Court on March 30: *Viking River Cruises Inc. v. Moriana*, 20-1573 (Sup. Ct.). The case deals with the ability of a state to curtail an arbitration agreement. We will not speculate on the outcome.

The Issue in *Badgerow*

An employee had an arbitration clause in her employment agreement. She launched an arbitration against her employer and lost.

Alleging that the arbitration proceedings has been infected with fraud, she sued her employer in state court to vacate the arbitration award. The employer removed the suit to federal district court. The district court decided that it had jurisdiction, denied the employee's motion to remand, and confirmed the award.

The Fifth Circuit affirmed. Like the district court, the New Orleans-based appeals court looked through the petition and found subject matter jurisdiction because the employee's underlying claims were based on federal law.

The Supreme Court granted *certiorari* to resolve a 4/2 circuit split, where the majority of circuits found jurisdiction if the underlying dispute was based on federal law.

Different Jurisdiction for Compelling and Confirming

Justice Elena Kagan reversed, writing the opinion for the majority. She based the outcome on differing provisions in the Federal Arbitration Act, or FAA.

Section 4 of the FAA deals with enforcing arbitration agreements. It provides that a party may petition to enforce an arbitration agreement in "any United States district court which, save for such agreement, would have jurisdiction . . . of the subject matter of a suit arising out of the controversy between the parties."

In *Vaden v. Discover Bank*, 556 U.S. 49 (2009), Justice Kagan said, the Supreme Court held that the court will "look through" to the underlying dispute to decide whether there is jurisdiction. If there is diversity or if a federal question will be arbitrated, then the district court has jurisdiction to compel arbitration.

Enforcement of an arbitration award does not fall under Section 4 of the FAA. Rather, enforcement is under Sections 9 and 10. Justice Kagan based her holding on the conclusion that "[t]hose sections lack Section 4's distinctive language directing a look-through, on which *Vaden* rested."

In other words, ordinary rules about subject matter jurisdiction apply to petitions for confirmation of an arbitration award because Sections 9 and 10 do not have their own special provisions governing jurisdiction. When the petition to the district court is for enforcement of an award, Justice Kagan said that the court must decide whether there is jurisdiction without relying on the subject matter of the underlying dispute.

In other words, if the parties are diverse, there is jurisdiction. Or, if enforcement itself raises a federal question, there would be jurisdiction to confirm an award.

In the case on *certiorari*, Justice Kagan said that the parties were not diverse and there was no federal question regarding confirmation of the award.

Rather, the issue regarding enforcement of the arbitration award was nothing "more than a contractual resolution of the parties' dispute . . . . And quarrels about legal settlements — even settlements of federal claim — typically involve only state law, like disagreements about other contracts."

There being no diversity and no federal question controlling confirmation of the award, Judge Kagan reversed and remanded, since enforcement would turn on state contract law. Presumably,

confirmation of the award will be vacated for lack of subject matter jurisdiction, and the employee will have her day in state court to attack the confirmation award.

Any Applicability to Bankruptcy?

On the surface, there is little or nothing on the face of the opinion regarding enforcement of arbitration agreements in bankruptcy. Furthermore, the decision deals with enforcement of arbitration awards, not enforcement of arbitration clauses.

In recent terms, the Supreme Court has been adamant about enforcing arbitration agreements. *See, e.g.*, *Epic Systems Corp. v. Lewis*, 200 L. Ed. 2d 889 (Sup. Ct. May 21, 2018). One might perhaps read *Badgerow* to mean that federal courts are not bound by the FAA to enforce arbitration clauses and awards in all circumstances. However, *Badgerow* is not based on policy. It's based strictly on statutory interpretation.

When it comes to enforcement of arbitration agreements, *Vaden* and *Badgerow* both suggest that the bankruptcy court has "related to" jurisdiction even if there is no diversity and no federal question.

Still, having jurisdiction does not automatically mean that the bankruptcy court must enforce an arbitration clause. In *Epic*, the Supreme Court said that courts must compel arbitration unless the federal statute manifests a clear intention to override the FAA. Does the Bankruptcy Code manifest a clear intention to override an arbitration agreement?

Although it was decided before *Epiq*, some circuits still interpret *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220 (1987), liberally by overriding arbitration agreements in bankruptcy cases, even though the Bankruptcy Code contains no express language barring enforcement of the FAA. *See, e.g.*, *Credit One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert. denied*, 139 S. Ct. 144 (2018). To read ABI's report, click here.

Centrality of administration is evident throughout the Bankruptcy Code, in provisions like the automatic stay, the requirement to file claims, and the encompassing nature of "core" jurisdiction. Perhaps those (less than explicit) provisions in bankruptcy law would persuade the Supreme Court to override arbitration agreements in most bankruptcy disputes.

The opinion is *Badgerow v. Walters*, 20-1143 (Sup. Ct. March 31, 2022)

Justices rule that affirmative action is required before withholding property amounts to controlling estate property and results in an automatic stay violation.

Supreme Court Holds that Merely Holding Property Isn't a Stay Violation

Reversing the Seventh Circuit and resolving a split among the circuits, the Supreme Court ruled unanimously today "that mere retention of property does not violate the [automatic stay in] § 362(a)(3)."

Writing for the 8/0 Court in a seven-page opinion, Justice Samuel A. Alito, Jr. said that Section 362(a)(3) "prohibits affirmative acts that would disturb the *status quo* of estate property." He left the door open for a debtor to obtain somewhat similar relief under the turnover provisions of Section 542, although not so quickly.

In a concurring opinion, Justice Sonia Sotomayor wrote separately to explain how a debtor may obtain the same or similar relief under other provisions of the Bankruptcy Code.

Justice Amy Coney Barrett, who had not been appointed when argument was held on October 13, did not take part in the consideration and decision of the case.

The Chicago Parking Ticket Cases

Four cases went to the Seventh Circuit together. The chapter 13 debtors owed between $4,000 and $20,000 in unpaid parking fines. Before bankruptcy, the city had impounded their cars. Absent bankruptcy, the city will not release impounded cars unless fines are paid.

After filing their chapter 13 petitions, the debtors demanded the return of their autos. The city refused to release the cars unless the fines and other charges were paid in full.

The debtors mounted contempt proceedings in which four different bankruptcy judges held that the city was violating the automatic stay by refusing to return the autos. After being held in contempt, the city returned the cars but appealed.

The Seventh Circuit upheld the bankruptcy courts, holding "that the City violated the automatic stay . . . by retaining possession . . . after [the debtors] declared bankruptcy." The city, the appeals court said, "was not passively abiding by the bankruptcy rules but actively resisting Section 542(a)

to exercise control over the debtors' vehicles." *In re Fulton*, 926 F.3d 916 (7th Cir. June 19, 2019). To read ABI's report on the *Fulton* decision in the circuit court, click here.

The Circuit Split

The Second, Seventh, Eighth, Ninth and Eleventh Circuits impose an affirmative duty on creditors to turn over repossessed property after a bankruptcy filing.

The Third, Tenth and District of Columbia Circuits held that the retention of property only maintains the *status quo*. For those circuits, a stay violation requires an affirmative action. Simply holding property is not an affirmative act, in their view.

The City of Chicago filed a *certiorari* petition in September 2019. To resolve the circuit split, the Supreme Court granted *certiorari* in December 2019. Argument was originally scheduled to be held in April 2020 but was postponed until October as a result of the coronavirus pandemic.

The Statute Demanded the Result

Justice Alito laid out the pertinent statutes. Primarily, Section 362(a)(3) stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." In the lower courts, the debtors relied on that section, but not exclusively.

With some exceptions, Section 542(a) provides that "an entity . . . in possession . . . of property that the trustee may use, sell, or lease under section 363 of this title . . . , shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate."

Justice Alito said that the case turned on the "prohibition [in Section 362(a)(3)] against exercising control over estate property." He said the language "suggests that merely retaining possession of estate property does not violate the automatic stay."

To Justice Alito, "the most natural reading" of the words "stay," "act" and "exercise control" mean that Section 362(a)(3) "prohibits affirmative acts that would disturb the status quo of estate property as of the time when the bankruptcy petition was filed." He found a "suggestion" in the "combination" of the words "that §362(a)(3) halts any affirmative act that would alter the status quo as of the time of the filing of a bankruptcy petition."

Justice Alito said that words in Section 362(a)(3) by themselves did not "definitively rule out" the result reached in the Seventh Circuit. "Any ambiguity" in that section, he said, "is resolved decidedly in" Chicago's favor by Section 542.

In view of Section 542, Justice Alito said that reading Section 362(a)(3) to proscribe "mere retention of property" would create two problems.

First, a broad reading of Section 362(a)(3) would "largely" render Section 542 "superfluous." Second, it would make the two sections contradictory. Where Section 542 has exceptions, Section 362(a)(3) has none.

Justice Alito observed that the prohibition against "control" over estate property was added to Section 362 in the 1984 amendments. "But transforming the stay in §362 into an affirmative turnover obligation would have constituted an important change," he said.

It "would have been odd for Congress to accomplish that change by simply adding the phrase 'exercise control,' a phrase that does not naturally comprehend the mere retention of property and that does not admit of the exceptions set out in §542," Justice Alito said.

Justice Alito interpreted the 1984 amendment to mean that it "simply extended the stay to acts that would change the *status quo* with respect to intangible property and acts that would change the *status quo* with respect to tangible property without 'obtain[ing]' such property."

Justice Alito ended his decision by noting what the opinion did not decide. The ruling did not "settle the meaning of other subsections of §362(a)" and did "not decide how the turnover obligation in §542 operates."

"We hold only that mere retention of estate property after the filing of a bankruptcy petition does not violate §362(a)(3) of the Bankruptcy Code." Justice Alito vacated the Seventh Circuit's judgment and remanded for further proceedings.

Justice Sotomayor's Concurrence

Justice Sotomayor said she wrote "separately to emphasize that the Court has not decided whether and when §362(a)'s other provisions may require a creditor to return a debtor's property." She said that the "the City's conduct may very well violate one or both of these other provisions," referring to subsections 362(a)(4) and (6).

In her six-page concurrence, Justice Sotomayor noted that the Court had not "addressed how bankruptcy courts should go about enforcing creditors' separate obligation to 'deliver' estate property to the trustee or debtor under §542(a)."

Although Chicago's conduct may have satisfied "the letter of the Code," she said that the city's policy "hardly comports with its spirit." She went on to explain why returning a car quickly is important so a debtor can commute to work and make earnings to pay creditors under a chapter 13 plan.

"The trouble" with Section 542, Justice Sotomayor said, is that "turnover proceedings can be quite slow" because they entail commencing an adversary proceeding. She ended her concurrence by saying that either the Advisory Committee on Rules or Congress should consider amendments "that ensure prompt resolution of debtors' requests for turnover under §542(a), especially where debtors' vehicles are concerned."

Observations

Prof. Ralph Brubaker agreed with the opinion of the Court. He told ABI that the "Court emphatically confirms the fundamental principle that the text of the automatic stay provision must be interpreted consistent with its most basic and limited purpose of simply maintaining the petition-date status quo. As Judge McKay put it in his *Cowen* opinion for the Tenth Circuit, 'Stay means stay, not go.' That guiding principle should also prove determinative in resolving the potential applicability of § 362(a)(4) and (a)(6), which the Court expressly refused to address."

Prof. Brubaker is the Carl L. Vacketta Professor of Law at the University of Illinois College of Law.

Rudy J. Cerone agreed. He told ABI that Justice Alito reached "the correct result under the history and structure of sections 362(a) and 542." He noted that the ABI Consumer Commission recommended speeding up turnover proceedings. Mr. Cerone is a partner with McGlinchey Stafford PLLC in New Orleans.

Significantly, the Court did not rule on whether debtors could achieve the same result under subsections (4) and (6) of Section 362(a), which prohibit an act to enforce a lien on property and an act to recover a claim.

In one of the cases before the Supreme Court, the bankruptcy court had relied on those other subjections in ruling for the debtor. The Supreme Court did not address subsections (4) and (6) because the Seventh Circuit did not reach those issues.

Consequently, debtors might resurrect a victory either through speedy procedures under Section 542 or a favorable interpretation of subsections (4) and (6). Reliance on the other subsections may not prevail given how Justice Alito would not permit Section 362 to perform all of the work of Section 542.

It is noteworthy how Justice Alito was skeptical that Congress would make major changes in a statute by using only a few words. At the same time, the Supreme Court has been reluctant in recent years to give importance to legislative history. Since legislative history might not succeed in altering the Supreme Court's view of the law, Congress evidently needs to attach bells and whistles to an amendment meant to change the law.

The case is *City of Chicago v. Fulton*, 19-357, 2021 BL 12454, 2021 Us Lexis 496 (Sup. Ct. Jan. 14, 2021).

Supreme Court narrows Spokeo by holding that violation of a statute won't always give rise to standing and the right to sue for damages.

Supreme Court Majority Deals a Blow to Enforcement of Consumer Protection Laws

Trimming back the already narrow definition of standing laid down in *Spokeo Inc. v. Robins*, 578 U.S. 330 (2016), the Supreme Court held 5/4 on June 25 that "an injury in law is not an injury in fact." In other words, a violation of federal law doesn't necessarily confer Article III standing to mount a lawsuit for the recovery of damages provided by statute.

A credit reporting agency maintained a list of individuals who were terrorists, drug traffickers and serious criminals. The majority held that those erroneously on the list had no standing to sue for statutory damages unless the false and defamatory report had been given to a third party.

The opinion is important in bankruptcy because the decision questions whether a debtor or trustee has standing to seek damages for violation of the automatic stay if the debtor can identify no concrete damages apart from violation of the statute. Arguably, the June 25 opinion means that a debtor or trustee is only entitled to an injunction barring further violations of the automatic stay, if the estate suffered no concrete damages from the original stay violation.

Five conservative justices were in the majority. The vigorous dissent by Justice Clarence Thomas indicates that the decision would have gone the other way were Justice Ruth Bader Ginsburg still on the bench.

As pointed out by Justice Thomas's dissent, the majority arguably intruded on the separation of powers by depriving Congress of the ability to define individuals' rights and create remedies to be enforced in federal court. Significantly, however, Justice Thomas explained in his dissent how plaintiffs in the future could bring the same claims in state courts.

Justice Brett M. Kavanaugh wrote the opinion of the Court, joined by Chief Justice Roberts and Justices Samuel A. Alito, Jr., Neil M. Gorsuch and Amy Coney Barrett. Justice Thomas wrote a dissent joined by Justices Stephen G. Breyer, Sonia Sotomayor and Elena Kagan. Justice Kagan wrote a separate dissent, joined by Justices Breyer and Sotomayor.

To read ABI's report on *Spokeo*, click here.

The Terrorist List

The government maintains lists of terrorists, drug traffickers and other serious criminals. For an extra fee, the credit reporting agency would tell its customers if someone's name appeared on the list.

The credit agency listed people with the same or similar names. It did not compare birth dates, Social Security numbers or other available identifiers. Consequently, innocent people could appear on the credit agency's list of terrorists and criminals.

The plaintiff negotiated to buy a car. The dealer refused to sell the car because the prospective buyer's name appeared on the credit agency's list of terrorists and criminals. Of course, the buyer was not a terrorist or criminal. He only shared a name with someone on the government's list.

After being denied the ability to buy a car, the plaintiff requested a copy of his credit report from the credit agency. The agency sent him a copy of the report purporting to be complete, but the report did not show him as being on the list of criminals and terrorists.

Later, the agency sent him a letter telling him that he was a potential match with someone on the government list, but it again did not tell him that the information appeared on his credit report. The letter also did not tell the plaintiff about his rights to remove incorrect information from the credit report, as required by the Fair Credit Reporting Act.

The plaintiff filed a class action in federal district court in California under the FCRA. The class of about 8,000 individuals included everyone who was erroneously on the credit agency's list during a specified time, whether or not their reports had been given to third parties. Among the class, erroneous reports for some 1,900 individuals had been given by the credit agency to third parties.

The class of 8,000 was certified. After trial, the jury awarded each of the 8,000 class members almost $1,000 in statutory damages and some $6,400 in punitive damages, for a total of more than $60 million. The Ninth Circuit affirmed 2/1 but reduced the total award to some $40 million.

The dissenter in the Ninth Circuit believed that class members had no standing if their erroneous reports had not been given to a third party, even though the FCRA gave them the right to damages.

The credit agency filed a petition for *certiorari*, which the Supreme Court granted in December 2020. It is not clear whether there was a circuit split. Oral argument was held on March 30.

The Majority Opinion

After laying out the facts, Justice Kavanaugh recounted the history of Article III standing, which requires that a plaintiff have a "personal stake" in the case. To meet the test, the plaintiff must show that (1) she or he suffered an injury that was concrete, particularized and actual or imminent; (2) the injury was likely caused by the defendant; and (3) the injury would likely be redressed by judicial relief.

In the case before the Court, Justice Kavanaugh said that the question under *Spokeo* was whether "the plaintiff's injury was 'concrete' — that is, 'real, and not abstract.'" *Spokeo*, he said, allowed for various intangible harms to be concrete, such as "reputational harms, disclosure of private information, and intrusion upon seclusion" or abridgement of free speech.

Justice Kavanaugh said that the views of Congress may be "instructive." Legislation, he said, can elevate the status of concrete, *de facto* injuries that previously were inadequate in law.

Quoting the Sixth Circuit, Justice Kavanaugh said that Congress's lawmaking power may not transform something that is not harmful into something that is. Citing *Spokeo*, he said that Article III standing requires a concrete injury even when there has been a statutory violation.

Justice Kavanaugh therefore held that "an injury in law is not an injury in fact. Only those plaintiffs who have been *concretely harmed* by a defendant's statutory violation may sue that private defendant over that violation in federal court." [Emphasis in original.] If the rules of Article III standing were different, he said, "Congress could authorize virtually any citizen to bring a statutory damages suit against virtually any defendant who violated virtually any federal law."

Applying the law to the facts, Justice Kavanaugh had "no trouble" in concluding that the 1,900 class members had suffered "concrete harm" because their erroneous reports had been given to third parties. For the remainder, "the mere presence of an inaccuracy in an internal credit file, if it is not disclosed to a third party, causes no concrete harm."

The plaintiffs cited *Spokeo* for the proposition that the risk of real harm can sometimes satisfy the requirement of concreteness. Justice Kavanaugh countered by saying that someone "exposed to a risk of future harm may pursue forward-looking, injunctive relief to prevent the harm from occurring, at least so long as the risk of harm is sufficiently imminent and substantial."

In other words, a plaintiff must show standing separately for each type of relief. "Therefore," Justice Kavanaugh said, "a plaintiff's standing to seek injunctive relief does not necessarily mean that the plaintiff has standing to seek retrospective damages."

For the majority, Justice Kavanaugh reversed and remanded to the Ninth Circuit. The 1,900 class members whose reports were disseminated to third parties "suffered a concrete harm," but the remainder did not and had no standing.

The Dissent by Justice Thomas

In his dissent joined by three liberal justices, Justice Thomas began by emphasizing the facts. The credit reports "flagged many law-abiding people as potential terrorists and drug traffickers" and in doing so violated several provisions in the FCRA. He continued:

> Yet despite Congress' judgment that such misdeeds deserve redress, the majority decides that [the credit agency's] actions are so insignificant that the Constitution prohibits consumers from vindicating their rights in federal court. The Constitution does no such thing.

Justice Thomas noted how the notion of injury in fact only emerged in 1970, 180 years after ratification of Article III. To the contrary, he said that "courts for centuries held that injury in law to a private right was enough to create a case or controversy." To his way of thinking, the entire class of 8,000 had "a sufficient injury to sue in federal court" given that the jury had found that the credit agency "violated each member's individual rights."

By way of contrast, Justice Thomas characterized the majority as holding that "the mere violation of a personal legal right is *not* — and never can be — an injury sufficient to establish standing." [Emphasis in original.] In that regard, he insinuated that the Court was cutting back on *Spokeo* because the majority had said five years ago that "Congress is well positioned to identify intangible harms that meet minimum Article III requirements" and that "the violation of a procedural right granted by statute can be sufficient in some circumstances to constitute injury in fact." *Spokeo*, *id.*, 578 U.S. at 341, 342.

Justice Thomas characterized the import of the majority's opinion as meaning that "legislatures are constitutionally unable to offer the protection of the federal courts for anything other than money, bodily integrity, and anything else that this Court thinks looks close enough to rights existing at common law . . . . Never before has this Court declared that legal injury is *inherently* insufficient to support standing." [Emphasis in original.]

Consequently, Justice Thomas said, "this Court has relieved the legislature of its power to create and define rights." If characterizing someone as a drug trafficker or terrorist was not enough, he wondered what could rise to the level of sufficient injury. What if someone were falsely labeled as a child molester or a racist? "Or what about openly reducing a person's credit score by several points because of his race?"

"If none of these constitutes an injury in fact, how can that possibly square with our past cases . . . ? Weighing the harms caused by specific facts and choosing remedies seems to me like a much better fit for legislatures and juries than for this Court," Justice Thomas said.

In a footnote near the end of his dissent, Justice Thomas observed that the majority's decision "might actually be a pyrrhic victory" for the credit agency. The Court only held that some of the class lacked standing in federal court.

Justice Thomas said that state courts would become "the sole forum for such cases" because they are not bound by Article III's requirement of a case or controversy. Moreover, defendants could not remove the suits to federal court, because federal courts would have no jurisdiction for lack of an Article III case or controversy.

"By declaring that federal courts lack jurisdiction," Justice Thomas concluded his footnote by saying that "the Court has thus ensured that state courts will exercise exclusive jurisdiction over these sorts of class actions."

Justice Kagan's Dissent

Joined by Justices Breyer and Sotomayor, Justice Kagan further developed the majority's intrusion into the separation of powers. She said that the "Court here transforms standing law from a doctrine of judicial modesty into a tool of judicial aggrandizement. It holds, for the first time, that a specific class of plaintiffs whom Congress allowed to bring a lawsuit cannot do so under Article III."

Justice Kagan said that the reporting agency had "willfully violated" the statute by preparing credit files falsely reporting class members as potential terrorists and by obscuring the mistake when class members requested copies of their files. She said that finding no injury in the real world "is to inhabit a world I don't know. [citation omitted] And to make that claim in the face of Congress's contrary judgment is to exceed the judiciary's 'proper — and properly limited — role,'" quoting *Warth v. Seldin*, 422 U.S. 490, 498 (1975).

Justice Kagan ended her dissent by saying that "Congress is better suited than courts to determine when something causes a harm or risk of harm in the real world. For that reason, courts should give deference to those congressional judgments."

Observations

Assume that a creditor willfully violates the Section 362 automatic stay but causes no injury. After last week's decision, is the debtor or trustee entitled to damages such as attorneys' fees, or is injunctive relief the only remedy?

In this writer's opinion, the majority has reincarnated substantive due process, this time under Article III. If a remedy for an injustice was not known at common law, the majority are saying that relief other than an injunction is beyond the reach of Congress.

The opinion is *TransUnion LLC v. Ramirez*, 20-297 (Sup. Ct. June 25, 2021).

Building on Bullard, the Supreme Court rules unanimously that a lift-stay motion is a "procedural unit" that's appealable if the bankruptcy court "conclusively" denies the motion.

Supreme Court Rules that 'Unreservedly' Denying a Lift-Stay Motion Is Appealable

The Supreme Court ruled unanimously today in *Ritzen v. Jackson Machinery* that an order denying a motion to modify the automatic stay is a final, appealable order "when the bankruptcy court unreservedly grants or denies relief."

In her unanimous opinion for the Court, Justice Ruth Bader Ginsburg said that a lift-stay motion is a "procedural unit" separate from the remainder of the bankruptcy case, even though the decision to retain the stay may be "potentially pertinent to other disputes."

The decision in *Ritzen* may contain a trap for creditors: A bankruptcy court could deny a creditor the right to appeal, perhaps for an extended time, by denying a lift-stay motion without prejudice or offering to reexamine the result in light of subsequent events.

The Facts

Before bankruptcy, the creditor had a contract to buy land from the debtor. The deal never closed, and the creditor sued in state court for breach of contract. Before trial, the debtor filed a chapter 11 petition.

In bankruptcy, the creditor moved to modify the stay so that the state court could decide who breached the contract. The bankruptcy court denied the motion. The creditor did not appeal.

The creditor filed a proof of claim, but the bankruptcy court disallowed the claim, ruling that the creditor, not the debtor, had breached the contract. Without objection from the creditor, the bankruptcy court confirmed the debtor's plan.

The creditor then filed an appeal from denial of the lift-stay motion and from disallowance of the claim. The district court dismissed the stay appeal as untimely and upheld the claim ruling on the merits.

The Sixth Circuit affirmed. *Ritzen Group Inc. v. Jackson Masonry LLC (In re Jackson Masonry LLC)*, 906 F.3d 494 (6th Cir. Oct. 16, 2018). To read ABI's analysis of the Sixth Circuit's opinion, click here.

The creditor filed a petition for *certiorari*, contending there was a split of circuits. The Supreme Court granted *certiorari* in May. The case was argued on November 13.

Bankruptcy Isn't Like Ordinary Litigation

Appealability is governed by 28 U.S.C. § 158(a), which gives district courts jurisdiction over appeals from "final judgments, orders, and decrees . . . in cases and proceedings referred to bankruptcy judges . . . ."

Justice Ginsburg acknowledged that ordinary rules of finality are "not attuned to the distinctive character of bankruptcy litigation." Bankruptcy, she said, is "an aggregation of individual controversies," quoting the *Collier* treatise. She explained why appeals from individual controversies cannot await resolution of the entire bankruptcy case.

The outcome was guided, if not controlled, by *Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015), where the Supreme Court held that denial of confirmation of a chapter 13 plan is not a final, appealable order. She paraphrased *Bullard* as holding that bankruptcy court orders are final when they "definitively dispose of discrete disputes within the overarching bankruptcy case."

To be final under *Bullard*, an order must alter the *status quo* and fix the rights and obligations of the parties, Justice Ginsburg said.

Justice Ginsburg framed the question as whether denial of a lift-stay motion is a "distinct proceeding" that terminates "when the bankruptcy court rules dispositively on the motion." She said that a majority of courts and leading treatises say that denial of a lift-stay motion is immediately appealable.

Addressing the facts of the case on appeal, Justice Ginsburg said that the lift-stay motion was "a procedural unit anterior to, and separate from, claim-resolution proceedings." Stay relief, she said, "occurs before and apart from proceedings on the merits of creditors' claims."

Of potential significance in the future on questions about the finality of other types of orders, Justice Ginsburg said that resolution of a stay motion "can have large practical consequences." For example, leaving the stay in place may "delay collection of a debt or cause collateral to decline in value."

The decision by Justice Ginsburg is a categorical ruling. She saw "no good reason to treat stay adjudication as the relevant 'proceeding' in only a subset of cases." Quoting Supreme Court

authority in another context, she said that finality "should 'be determined for the entire category to which a claim belongs.' *Digital Equipment Corp. v. Desktop Direct Inc.*, 511 U.S. 863, 868 (1994)."

Justice Ginsburg left little room for contending that denial of a lift-stay motion can sometimes be non-final. She said it "does not matter whether the court rested its decision on a determination potentially pertinent to other disputes in the bankruptcy case, so long as the order conclusively resolved the movant's entitlement to the requested relief."

In a footnote at the end of the opinion, Justice Ginsburg said the Court was not deciding whether denial of a motion without prejudice would be final if the bankruptcy court was awaiting "further developments [that] might change the stay calculus."

Affirming the judgment of the Sixth Circuit, Justice Ginsburg held that the stay-relief motion was the "appropriate 'proceeding.'" The order "conclusively denying" the motion was final, she said, because the "court's order ended the stay-relief adjudication and left nothing more for the Bankruptcy Court to do in that proceeding."

Observation

At first blush, the opinion seems beneficial for creditors by assuring them of their right to appeal denials of lift-stay motions. In practice, however, *Ritzen* can be used against creditors.

Suppose the bankruptcy court denies a lift-stay motion without prejudice, saying that unfolding events might persuade the court to modify the stay. Denial of a motion without prejudice could therefore cut off the ability to appeal, exerting leverage in favor of the debtor and persuading the creditor to settle.

In upcoming years, courts may be called upon to grapple with the question of whether denial without prejudice may sometimes have the trappings of a final order.

The opinion is *Ritzen Group Inc. v. Jackson Masonry LLC*, 140 S. Ct. 582, 205 L. Ed. 2d 419 (Sup. Ct. Jan. 14, 2020).

High court rules that federal courts may make federal common law only to protect 'uniquely' federal interests.

Supreme Court Uses a Bankruptcy Case to Limit the Use of Federal Common Law

The Supreme Court ruled in *Rodriguez v. Federal Deposit Insurance Corp.* that federal courts may not employ federal common law to decide who owns a tax refund when a parent holding company files a tax return but a subsidiary generated the losses giving rise to the refund.

In his eight-page opinion for the unanimous court on February 25, Justice Neil M. Gorsuch used a dispute in bankruptcy court to hold that "cases in which federal courts may engage in common lawmaking are few and far between."

The Facts

A bank's holding company was in chapter 7 with a trustee. The bank subsidiary was taken over by the Federal Deposit Insurance Corp. as receiver. The bank subsidiary's losses resulted in a $4 million tax refund payable to the parent under a pre-bankruptcy tax allocation agreement, or TAA, between the parent and the bank subsidiary.

Both the trustee for the holding company and the FDIC, as receiver for the bank, laid claim to the refund. If the holding company owned the refund, the FDIC would have nothing more than an unsecured claim.

The bankruptcy court in Colorado granted summary judgment in favor of the holding company's trustee, concluding that the TAA did not create a trust or agency under Colorado law. In the view of the bankruptcy court, the parent and subsidiary only had a debtor/creditor relationship under the TAA, leaving the FDIC with an unsecured claim for the refund.

On appeal, the district court believed that the Tenth Circuit had adopted the *Bob Richards* rule, first enunciated by the Ninth Circuit in *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262 (9th Cir. 1973). *Bob Richards* made a presumption under federal common law that the subsidiary with the losses is entitled to the refund absent a TAA that clearly gives the refund to the parent.

The district court, however, went on to analyze the TAA and found provisions supporting a ruling in favor of the holding company and other provisions where the bank subsidiary would come out on top. The district court ended up relying on tie-breaking language in the TAA that

resolved ambiguity in favor of the bank subsidiary. The district court therefore reversed and awarded the refund to the FDIC.

The Tenth Circuit affirmed the district court, first saying that the appeals court had adopted *Bob Richards* in *Barnes v. Harris*, 783 F.3d 1185 (10th Cir. 2015).

Unlike *Barnes* and *Bob Richards*, the Tenth Circuit said that the case on appeal had a written agreement in the form of the TAA. The appeals court ruled that the tie-breaking provision in the TAA created an agency relationship. In the view of the circuit court, the FDIC was entitled to the refund because the holding company was an agent for the bank.

The Tenth Circuit created ambiguity about the basis for its ruling by saying at the end of the opinion that the result did not differ from the rule in *Barnes* and *Bob Richards*.

The circuits are split 3/4. The Fifth, Ninth and Tenth Circuits have followed *Bob Richards*, while the Second, Third, Sixth and Eleventh Circuits reject *Bob Richards* and employ state law to decide who owns a refund and whether the TAA creates an unsecured debtor/creditor relationship.

The holding company's trustee filed a petition for *certiorari* in April 2019. The Court granted the petition at the end of June to answer the one question presented: Does federal common law (*Bob Richards*) or state law determine the ownership of a tax refund?

Courts Have Only 'Limited Areas' for Making Federal Common Law

The handwriting was on the wall on the second page of the opinion. Justice Gorsuch said that state law — such as "rules for interpreting contracts, creating equitable trusts, avoiding unjust enrichment" — are "readymade" for deciding the ownership dispute.

"Judicial lawmaking," Justice Gorsuch said, "plays a necessarily modest role under a Constitution that vests federal" legislative power in Congress. As a result, "only limited areas exist in which federal judges may appropriately craft the rule of decision." Appropriate areas, he said, are in admiralty law and disputes among states.

Citing Supreme Court precedent, Justice Gorsuch said that federal common law is appropriate only when "necessary to protect uniquely federal interests." He found no federal interest in deciding the owner of the tax refund.

Returning to where he began, Justice Gorsuch said that "state law is well equipped to handle disputes involving corporate property rights." A federal bankruptcy, he said, "doesn't change much."

The Remedy

The trustee and the FDIC disagreed on whether the lower courts relied on *Bob Richards* or decided the case based on state law, but Justice Gorsuch said the Supreme Court did not grant *certiorari* to decide how the case should end up under state law.

Vacating and remanding, Justice Gorsuch said that the Court "took this case only to underscore the care federal courts should exercise before taking up an invitation to try their hand at common lawmaking."

Observations

The case is an example of how the Supreme Court will make law when the justices feel like it, even if there is no longer a dispute between the parties. By the time of oral argument, neither side nor the Solicitor General was defending the *Bob Richards* rule.

With no live controversy regarding *Bob Richards*, several justices made comments at oral argument suggesting that the Court might dismiss the petition as having been improvidently granted. For instance, Justice Ruth Bader Ginsburg said, "we usually don't decide an abstract" question when there is a lack of "adversarial confrontation."

However, several justices seemed primed to strike down *Bob Richards*. Justice Brett M. Kavanaugh said the federal common law was "patently indefensible." Hinting that he would be the author of the Court's opinion, Justice Gorsuch said at oral argument that the outcome should be determined by state law, without "any thumb on the scale by federal common law."

The opinion presents a question for bankruptcy judges: May they announce a rule of bankruptcy common law if the Bankruptcy Code does not provide an answer? Must courts always purport to find an answer in the statute?

The opinion is *Rodriguez v. Federal Deposit Insurance Corp.*, 18-1269 (Sup. Ct. Feb. 25, 2020).

Despite the high court's ban on nunc pro tunc orders, may bankruptcy courts make their orders retroactive?

Supreme Court Bans *Nunc Pro Tunc* Orders

The Supreme Court has banned the term "*nunc pro tunc*" from the bankruptcy lexicon.

In a *per curiam* opinion on February 24, the Court also ruled that a state court altogether lacks jurisdiction in a removed action until the case has been formally remanded. Merely terminating the basis for federal jurisdiction does not restore the state court's jurisdiction and power to act.

The Catholic Church in Puerto Rico filed a petition for *certiorari* in January 2019, contending that rulings by the Puerto Rico Supreme Court violated the Free Exercise and Establishment Clauses of the First Amendment. The Solicitor General filed a brief in December 2019 recommending that the Court grant *certiorari* and reverse the Puerto Rico Supreme Court.

Without holding argument, the Court granted the petition, reversed and remanded, but not on First Amendment grounds. Instead, the Supreme Court ruled that the Puerto Rico courts were without jurisdiction to enter orders at the critical time.

The Complex Facts

The facts and procedural history are complex, but they boil down to this: The Catholic Church in Puerto Rico terminated a pension plan for workers in the island's parochial schools. The workers sued in an island court. Reversing the intermediate appellate court, the Puerto Rico Supreme Court reinstated the orders of the trial court in favor of the workers by directing the church to deposit $4.7 million with the court. Another order directed the sheriff to seize church assets.

Based on the Treaty of Paris of 1898, the Puerto Rico Supreme Court believed that all church entities in Puerto Rico — including schools and parishes — are liable for the debts of their brother and sister Catholic institutions. Because the high court in Puerto Rico had disregarded the corporate separateness of Catholic entities, the church filed a petition for *certiorari*, raising complex questions under the First Amendment.

For the courts in Puerto Rico, there was a jurisdiction problem that had been overlooked. Before the trial court entered its orders to deposit money and seize assets, the church had removed the suit to federal court, contending that it was related to a bankruptcy case that had been filed by the schools' pension trust.

Nothing Happened

The exact timing of events in the island and federal courts was critical to the outcome in the Supreme Court.

On March 13, 2018, the bankruptcy court dismissed the pension trust's bankruptcy, thus ostensibly terminating the basis for removal of the suit against the church entities. Later in March 2018, the Puerto Rico trial court entered the orders to deposit money and attach assets, but the case had not yet been remanded to the island court when the orders were entered.

In fact, the federal court did not enter an order remanding the suit to the Puerto Rico court until August 2018, five months after the island court had entered orders *in that suit* to deposit money and attach assets. However, the remand order in August 2018 stated that it was *nunc pro tunc* to March 13, the day the bankruptcy was dismissed.

In Latin, the phrase means "now for then."

Jurisdiction Strictly Interpreted

A stickler for details, the Supreme Court ruled on the Puerto Rico court's lack of jurisdiction without reaching the merits on the First Amendment.

Because the suit had not been remanded to the island court when the orders were entered, the Supreme Court ruled in its eight-page opinion that the Puerto Rico court "had no jurisdiction over the proceedings. The orders are therefore void."

Citing 19th century authority, the Court said that removal divests the state court of "'all jurisdiction over the case, and, being without jurisdiction, its subsequent proceedings and judgment [are] not . . . simply erroneous, but absolutely void.'" *Kern v. Huidekoper*, 103 U.S. 485, 493 (1881).

The federal court's *nunc pro tunc* order did not save the day. The high court said that a *nunc pro tunc* order may "'reflect[] the reality'" of what has occurred, citing *Missouri v. Jenkins*, 495 U.S. 33, 49 (1990). A *nunc pro tunc* order, the Court said, "presupposes" that a court has made a decree that was not entered on account of "inadvertence," citing *Cuebas y Arredondo v. Cuebas y Arredondo*, 223 U.S. 376, 390 (1912).

The Supreme Court said that nothing had occurred in the federal court in terms of remand on March 13, the date to which the court had made the remand *nunc pro tunc*. Therefore, the high court ruled that a "court 'cannot make the record what it is not,'" citing *Jenkins*, 495 U.S. at 49.

What Does It Mean for Bankruptcy?

Bankruptcy courts often make orders *nunc pro tunc*. Based on the Supreme Court's opinion, a *nunc pro tunc* order is proper only if the court announces its ruling without immediate entry of an order.

May a bankruptcy court nonetheless make an order retroactive? For example, a retention order at the outset of a case may not be entered for several days or weeks. May retention be made retroactive to the date the application was filed, assuming it was later granted? Or, will courts be required to enter provisional orders immediately?

The opinion is *Roman Catholic Archdiocese of San Juan v. Acevedo Feliciano*, 140 S. Ct. 696, 206 L. Ed. 2d 1 (2020) (Sup. Ct. Feb. 24, 2020).

The 'fraud-specific discovery rule' might permit FDCPA suits filed more than one year after the occurrence that gives rise to the claim.

Supreme Court Might Allow FDCPA Suits More than a Year After Occurrence

While closing one door, the Supreme Court opened another door today for debtors to argue that the statute of limitations does not begin to run until discovery of the existence of a claim under the federal Fair Debt Collection Practices Act, or FDCPA, 15 U.S.C. § 1692-1692p.

In 2008, a debt collector filed suit on a defaulted credit card debt. Later that year, the debt collector withdrew the suit because the complaint had been served on someone who was not the debtor at a home where the debtor was no longer living.

In 2009, the debt collector sued a second time, again serving someone not the debtor at the same address where the debtor was no longer living. There being no answer, the debt collector got a default judgment.

The debtor did not learn about the second suit until 2014, when he was denied a mortgage on account of the default judgment. Less than one year after discovery, the debtor filed suit, raising a claim under the FDCPA because the debt was allegedly time-barred. He contended that the one-year statute of limitations under the FDCPA was equitably tolled because the debt collector used a manner of service designed to ensure that the debtor would not receive service.

The Circuit Split

The district court dismissed the suit under the statute of limitations and was upheld in the Third Circuit. The Supreme Court granted *certiorari* to resolve a split of circuits.

In 2009, the Ninth Circuit had applied the so-called discovery rule in holding that limitations periods in federal practice generally begin to run when the plaintiff knows or has reason to know of the injury. *Mangum v. Action Collection Serv., Inc.*, 575 F.3d 935 (9th Cir. 2009).

En banc, the Third Circuit rejected the Ninth Circuit's holding by ruling that the statute begins to run when the violation occurs.

The Majority Opinion

Ostensibly, the case was governed by Section 1692k(d) of the FDCPA, which provides that suit must be brought "within one year from date on which the violation occurs."

Justice Clarence Thomas upheld the judgment of the Third Circuit in an opinion on December 10. Based on "dictionary definitions" of the words "violation" and "occurs," he said that the statute "unambiguously sets the date of the violation as the event that starts the one-year limitations period."

Justice Thomas described the Ninth Circuit's "discovery rule" as a "bad wine of recent vintage," citing a concurring opinion by the late Justice Antonin Scalia. According to Justice Thomas, "'Atextual judicial supplementation is particularly inappropriate when, as here, Congress has shown that it knows how to adopt the omitted language or provision."

In his brief, the debtor argued for the Court to follow a fraud-specific discovery rule with roots in 19th century Supreme Court precedent. *Bailey v. Glover*, 21 Wall. 342 (1875).

Justice Thomas did not reach the fraud-specific discovery rule. He said the debtor had not preserved the issue in the Ninth Circuit and did not raise the question in his petition for *certiorari*.

The Ginsburg Dissent

Justice Ruth Bader Ginsburg dissented from the judgment affirming the Third Circuit. She believes the debtor had preserved the issue in the appeals court and adequately raised the question in the *certiorari* petition.

Justice Ginsburg described the debt collector as having "employed fraudulent service to obtain and conceal the default judgment that precipitated [the debtor's] FDCPA claim."

"That allegation, if proved," she said, "should suffice under the fraud-based discovery rule, to permit adjudication of [the debtor's] claim on its merits."

The Sotomayor Concurrence

For future litigation on the FDCPA's statute of limitations, the concurring opinion by Justice Sonia Sotomayor is the most significant.

Justice Sotomayor agreed with the majority that the statute "typically" begins to run when the violation occurs, not when the debtor discovers the violation.

Unlike Justice Ginsburg, Justice Sotomayor also agreed with the majority that the debtor had not preserved the "equitable, fraud-specific discovery rule" in the Third Circuit. She therefore concurred in the judgment.

Justice Sotomayor wrote separately, she said, "to emphasize that this fraud-specific equitable principle is not the 'bad wine of recent vintage' of which my colleagues speak." Rather, she said, "the Court has long 'recogni[zed]' and applied this 'historical exception for suits based on fraud.'"

Justice Sotomayor ended her concurrence by telling future litigants that "[n]othing in today's decision prevents parties from invoking that well-settled doctrine."

The opinion is *Rotkiske v. Klemm*, 140 S. Ct. 355, 205 L. Ed. 2d 291 (Sup. Ct. Dec. 10, 2019).

The Supreme Court uses a copyright case to explain why the bankruptcy exception to states' sovereign immunity is unique under the Constitution.

Supreme Court Explains Sovereign Immunity in Bankruptcy Cases

A decision on state sovereign immunity involving copyrights allowed the Supreme Court to explain the rationale underlying *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006), the high court's authority largely abrogating states' sovereign immunity in bankruptcy cases.

Scholars will argue whether the Supreme Court's March 23 copyright decision modified *Katz*. The answer is, "Probably not much, if at all." However, the Court's discussion of *stare decisis* suggests that the justices are not likely to revisit *Katz*.

Seminole Tribe

The Court's seminal decision on state sovereign immunity is *Seminole Tribe of Florida* v. *Florida*, 517 U.S. 44 (1996). There, the justices laid down two hurdles for congressional abrogation of sovereign immunity.

First, Congress must abrogate sovereign immunity using "unequivocal statutory language." *Id*. at 56. Second, the Constitution must have a provision allowing Congress to encroach on the state's sovereign immunity.

Seminole Tribe was a 5/4 decision, with justices divided along ideological lines. It led to a concern that sovereign immunity would preclude bankruptcy courts from disallowing claims filed by states or allow states to disregard the discharge of claims.

Katz largely laid those concerns to rest. The high court held that proceedings to set aside a preference were not barred by sovereign immunity because bankruptcy proceedings are essentially *in rem*.

The Copyright Case

This term, the Supreme Court granted *certiorari* in *Allen v. Cooper* because the Fourth Circuit held that a federal statute was invalid.

Allen involved a photographer who had taken pictures of an early 18th century shipwreck that belonged to the State of North Carolina. The photographer copyrighted the pictures.

Years later, the state published photos, and the photographer sued for copyright infringement. The district court allowed the suit to go forward, ruling that Congress abrogated sovereign immunity for copyright infringement in the Copyright Remedy Clarification Act of 1990, or CRCA.

The Fourth Circuit reversed on an interlocutory appeal, holding that the CRCA was invalid as to copyrights.

The Supreme Court Decision

The result was largely a foregone conclusion. In *Florida Prepaid Postsecondary Ed. Expense Bd.* v. *College Savings Bank*, 527 U.S. 627 (1999), the Supreme Court ruled that the CRCA did not validly extinguish sovereign immunity with regard to patents.

In her March 23 opinion for the Court, Justice Elena Kagan surveyed the rationale behind *Seminole Tribe* and the limits on the power of Congress to abrogate sovereign immunity.

Because *Florida Prepaid* had invalidated the CRCA as to patents, it was a short hop for Justice Kagan to hold that the CRCA's abrogation of sovereign immunity was also invalid as to copyrights.

The Discussion of *Katz*

Opposing the conclusion reached by Justice Kagan, the photographer based much of his argument on *Katz*, another 5/4 decision, but with the more liberal justices in the majority this time. In short, Justice Kagan said that *Katz* was inapplicable to copyrights.

Florida Prepaid said that Congress could not use the power of Congress over patents in Article I to end sovereign immunity. Given that the Bankruptcy Clause of the Constitution is also in Article I, how does it follow that the Court reached a contrary conclusion in *Katz*?

Katz, Justice Kagan said, "held that Article I's Bankruptcy Clause enables Congress to subject nonconsenting States to bankruptcy proceedings (there, to recover a preferential transfer). We thus exempted the Bankruptcy Clause from *Seminole Tribe's* general rule that Article I cannot justify haling a State into federal court."

"In bankruptcy, we decided, sovereign immunity has no place," Justice Kagan said bluntly.

Everything *Katz* "is about and limited to the Bankruptcy Clause; the opinion reflects what might be called bankruptcy exceptionalism. In part, *Katz* rested on the 'singular nature' of bankruptcy jurisin diction. That jurisdiction is, and was at the Founding, 'principally *in rem*' . . . ," Justice Kagan said. [Citation omitted.]

Justice Kagan continued, saying that "*Katz* focused on the Bankruptcy Clause's 'unique history.' The [Bankruptcy] Clause emerged from a felt need to curb the States' authority." [Citation omitted.] The Bankruptcy Clause, she said, "was *sui generis* . . . among Article I's grants of authority."

Justice Kagan went on to say that the Bankruptcy Clause "had a yet more striking aspect . . . . [T]he Court . . . went further [in *Katz* and] found that *the Bankruptcy Clause itself* did the abrogating . . . . Or stated another way, we decided that no congressional abrogation was needed because the States had already 'agreed in the plan of the Convention not to assert any sovereign immunity defense' in bankruptcy proceedings." [Emphasis in original; citations omitted.]

In other words, the states waived sovereign immunity in bankruptcies by having adopted the Constitution. In Justice Kagan's terms, sovereign immunity in bankruptcy is "governed by principles all of its own."

Stare Decisis

Writing about *Allen*, we would be remiss if we did not mention Justice Kagan's discussion of *stare decisis* and the dissent by Justice Clarence Thomas.

Finding no difference between patents and copyrights, Justice Kagan said that the Court could have no other result in view of *Florida Prepaid* and the principle of *stare decisis*.

To reverse one of the Court's own precedents, Justice Kagan said there must be special justification over and above a belief that the precedent was wrongly decided.

Justice Thomas concurred in the judgment because he saw *Florida Prepaid* to be "binding precedent." However, he disagreed with Justice Kagan's discussion of *stare decisis*.

Requiring "'special justification . . . does not comport with our judicial duty under Article III,'" Justice Thomas said, quoting one of his prior concurring decisions.

In a footnote, Justice Thomas said he continues to believe that *Katz* was "wrongly decided."

Finally, we note how the justices remain split on the larger questions regarding sovereign immunity.

In *Allen*, Justices Stephen G. Breyer and Ruth Bader Ginsburg concurred in the judgment. They believe that *Seminole Tribe* was wrongly decided. They concurred in the judgment because their "longstanding view has not carried the day."

The opinion is *Allen v. Cooper*, 18-877, 140 S. Ct. 994, 206 L. Ed. 2d 291 (Sup. Ct. March 23, 2020).

Supreme Court says that activities not required by state law in nonjudicial foreclosure may be covered by the FDCPA.

Nonjudicial Foreclosure Is *Not* Subject to the FDCPA, Supreme Court Rules

The Supreme Court ruled unanimously today that nonjudicial foreclosure is not subject to regulation by the federal Fair Debt Collection Practices Act, known as the FDCPA, 15 U.S.C. § 1692-1692p.

The opinion for the Court by Justice Stephen G. Breyer contained an important caveat: Nonjudicial foreclosure is exempt from the FDCPA only with regard to actions *required* by state law.

The Circuit Split

After a homeowner defaulted on his mortgage, the lender hired a law firm, which gave notice that it was retained to conduct nonjudicial foreclosure under Colorado law. The homeowner responded with a letter purporting to invoke rights under Section 1692(g) of the FDCPA, which obliges a debt collector to halt collection activities until it provides the debtor with a "verification of the debt."

However, the law firm proceeded to initiate nonjudicial foreclosure. The homeowner then filed suit alleging violation of the FDCPA. The district court dismissed the suit, finding that the law firm was not a "debt collector" within the purview of the FDCPA. The Tenth Circuit affirmed, holding that merely enforcing a security interest through nonjudicial foreclosure is not governed by the FDCPA.

The circuits were split. The Fourth, Fifth and Sixth Circuits held that the FDCPA applies to nonjudicial foreclosure, while the Ninth and Tenth Circuits concluded that it does not. The Supreme Court granted *certiorari* on June 28, 2018, to resolve the split and heard oral argument on January 7.

The Statutory Provisions

The FDCPA applies to "debt collectors," defined in the first sentence of 15 U.S.C. § 1692a(6) as someone who "regularly collects or attempts to collect, directly or indirectly, debts owed . . . or due another." The definition makes the statute applicable to a law firm pursuing *judicial* foreclosure when the lender is entitled to a deficiency judgment.

The case turned on the meaning of the third sentence in Section 1692a(6), which applies to enforcement of security interests. "For the purpose of section 1692f(6) [governing the conduct of someone repossessing property nonjudicially]," the third sentence of Section 1692a(6) says that the "term [debt collector] also includes any person who uses [the mail or interstate commerce] in any business the principal purpose of which is the enforcement of security interests."

The third sentence applies to nonjudicial foreclosure. However, Section 1692f(6) does not impose all of the FDCPA's regulations on those who only enforce security interests. Section 1692f(6) only prohibits certain activities, such as threatening to repossess when there is no intention of repossessing or there is no right to repossess. The law firm was not alleged to have violated the proscriptions in Section 1692f(6).

The Unanimous Opinion

Writing for the Court, Justice Breyer said that the FDCPA would apply to nonjudicial foreclosure if the statute contained only the primary definition in the first sentence of Section 1692a(6). If the third sentence did not contain the reference to someone whose principal business "is the enforcement of security interests," he said that a person engaged in nonjudicial foreclosure proceedings "would qualify as a debt collector for all purposes," because foreclosure "is a means of collecting a debt."

Justice Breyer said that the primary definition of "debt collector" in the first sentence in Section 1692a(6) does not apply only to someone who attempts to collect from a debtor. Even if nonjudicial foreclosure were not a direct attempt to collect a debt, he said, "it would be an *indirect* attempt to collect a debt." [Emphasis in original.]

The third sentence in Section 1692a(6) changed the result, however. The phrase "[f]or the purpose of section 1692f(6)," Justice Breyer said, "strongly suggests that one who does no more than enforce security interests does *not* fall within the scope of the general definition. Otherwise why add this sentence at all?" [Emphasis in original.]

Justice Breyer also surmised that Congress did not intend for the FDCPA to be generally applicable to nonjudicial foreclosure "to avoid conflicts with state nonjudicial foreclosure schemes."

For "those of us who use legislative history to help interpret statutes," he said that "the history of the FDCPA supports our reading." He alluded to how competing versions of the bill would or would not have made nonjudicial foreclosure subject to regulation. The third sentence, he said, "has all the earmarks of a compromise: The prohibitions contained in Section 1692f(6) will cover security-interest enforcers, while the other 'debt collector' provisions of the Act will not."

Caveats in the Opinion

Justice Breyer added two caveats to say that specific acts in connection with nonjudicial foreclosure could conceivably be subject to the FDCPA, although nonjudicial foreclosure generally is not.

The homeowner argued that the third sentence applies only to a "repo man," meaning someone who repossesses personal property and has no interaction with the debtor. Judge Breyer rejected this contention, saying, "if Congress meant to cover only the repo man, it could have said so."

In the same paragraph, Justice Breyer went on to say it is "at least plausible that 'threatening' to foreclose on a consumer's home without having legal entitlement to do so is the kind of 'nonjudicial action' without 'present right to possession' prohibited by that section." He went on to say parenthetically, "We need not, however, decide precisely what conduct runs afoul of Section 1692f(6)."

Of greater significance, Justice Breyer said near the end of his 14-page opinion, "This is not to suggest that pursuing nonjudicial foreclosure is a license to engage in abusive debt collection practices like repetitive nighttime phone calls . . . ."

Because the case before the Court involved "only steps required by state law, we need not consider what *other* conduct (related to, but not required for, enforcement of a security interest) might transform a security-interest enforcer into a debt collector subject to main coverage of the Act." [Emphasis in original.]

The Concurring Opinion

Justice Sotomayor concurred in the opinion. Calling it "a close case," she said that Justice Breyer made "a coherent whole of a thorny section of statutory text." She was persuaded to concur because the third sentence would be superfluous "if all security-interest enforcement is already covered" by the first sentence.

Justice Sotomayor made two points: (1) "[T]oday's opinion does not prevent Congress from clarifying today's opinion if we have gotten it wrong," and (2) enforcing a security interest does not confer blanket immunity from the FDCPA.

"I would see as a different case one in which the defendant went around frightening homeowners with the threat of foreclosure without showing any meaningful intention of ever actually following through." In such a case, she said, there would be a question of whether the person was actually in the business of enforcing a security interest or "was simply using that label as a stalking horse for something else."

The case is *Obduskey v. McCarthy & Holthus LLP*, 139 S. Ct. 1029, 203 L. Ed. 2d 390 (Sup. Ct.).

Supreme Court gets around to overruling Lubrizol almost 35 years later.

Licensee May Continue Using a Trademark after Rejection, Supreme Court Rules

Today, the Supreme Court handed down its decision in *Mission Product Holdings Inc. v. Tempnology LLC*, 17-1657 (Sup. Ct.), reversed the First Circuit and held that rejection of an executory trademark license does not bar the licensee from continuing to use the mark. As Justice Elena Kagan said, "A rejection breaches a contract but does not rescind it."

The opinion was almost unanimous, with Justice Neil M. Gorsuch dissenting; he believes the petition for *certiorari* should have been dismissed as improvidently granted. In his view, the Court could not grant effective relief.

Justice Sonia Sotomayor wrote a concurring opinion to say that nondebtor parties to rejected trademark licenses may have more rights following rejection than parties to other types of intellectual property licenses whose rights are limited by Section 363(n).

The Court granted *certiorari* in October to resolve a split of circuits.

The Circuit Split

It took decades, but the Supreme Court ruled on May 20 that the Fourth Circuit was wrong almost 35 years ago when it held that rejection of an executory license for intellectual property precludes the nonbankrupt licensee from continuing to use the license. *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985).

Lubrizol was subjected to withering criticism, prompting Congress three years later to adopt Section 365(n) and the definition of "intellectual property" in Section 101(35A). Together, they allow a nondebtor to continue using patents, copyrights and trade secrets despite rejection of a license.

Congress did not mention trademarks, leading most lower courts to interpret the omission as meaning that rejection cuts off the right to use trademarks.

In 2012, the Seventh Circuit differed with *Lubrizol* when it handed down *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7th Cir. 2012), and held that rejection does not preclude the continued use of a mark. According to Circuit Judge Frank Easterbrook, "nothing about this process [of rejection] implies that any other rights of the other contracting party have

been vaporized." If a licensor's breach outside of bankruptcy would not bar continued use of the mark, the same would hold true in bankruptcy after rejection by the licensor, he said.

In Tempnology's chapter 11 case, the debtor had granted the licensee a nonexclusive, nontransferable, limited license to use the debtor's trademarks. Following *Lubrizol*, the bankruptcy court rejected the license and ruled that the licensee could not continue using the license. The Bankruptcy Appellate Panel reversed, following *Sunbeam*.

The First Circuit reversed the BAP in January 2018. *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 879 F.3d 389 (1st Cir. Jan. 12, 2018).

In a 2/1 opinion, the First Circuit majority in *Tempnology* sided with *Lubrizol* and criticized *Sunbeam* for "largely [resting] on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark." The majority favored "the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise." To read ABI's discussion of the First Circuit's opinion in *Tempnology*, click here.

As it had done in the First Circuit, the debtor argued in the Supreme Court that allowing the licensee to continue using the trademark would force the debtor to continue shouldering the onerous burden of policing the quality of the licensee's use of the mark. Absent quality control, the debtor contended, the licensor abandons the mark, and it reverts to the public domain. Rejection frees the debtor from the burden of policing the mark and is thus a necessary adjunct to the power of rejection, according to the debtor.

Justice Kagan's Opinion

Mootness

Joined by all justices except Justice Gorsuch, Justice Kagan began by holding that the appeal was not moot.

Initially, the bankruptcy judge had only granted a plain, vanilla motion to reject the trademark license. Following rejection, the debtor returned to court, where the bankruptcy judge issued a declaration saying that rejection terminated the licensee's use of the mark. Later still, the license terminated by its own terms.

To counter the notion of mootness, the licensee contended that it had a claim for damages resulting from its inability to use the mark. The debtor responded by saying that the bankruptcy court had authorized distribution of the last funds in the estate. The licensee countered by saying it might prevail on the bankruptcy court to compel other creditors to disgorge distributions.

Justice Kagan held that the appeal remained "a live controversy." "If there is any chance of money changing hands, [the licensee's] suit remains alive." Citing the Court's precedent, she said that "courts often adjudicate disputes whose 'practical impact' is unsure at best, as when 'a defendant is insolvent.'"

The Merits: Rejection Isn't Rescission

Justice Kagan said that the text of Section 365 and "fundamental principles of bankruptcy law" lead to a conclusion that rejection is not rescission. In particular, she relied on Section 365(g), which provides that rejection "constitutes a breach of such contract" immediately before the filing of the bankruptcy petition.

Or "more pithily for current purposes," Justice Kagan said that "rejection is a breach." In turn, breach "means in the Code what it means in contract law outside bankruptcy."

As an example, Justice Kagan supposed that a debtor had leased a copy machine to a law firm. Were the debtor to reject the lease, she said the debtor could stop servicing the machine, but the debtor "cannot take it back."

Applying the same notion to trademarks, Justice Kagan said that "breach does not revoke the license or stop the licensee from doing what it allows."

Justice Kagan also bought into the idea that the power to reject does not convey the same remedies as avoidance actions, which, she said, are "exceptional cases in which trustees . . . may indeed unwind pre-bankruptcy transfers."

No Negative Inference from Section 365(n)

The debtor argued that the omission of trademarks from Section 365(n) meant that Congress intended for rejection to cut off use of a mark.

"Still," Justice Kagan said, "Congress's repudiation of *Lubrizol* for patent contracts does not show any intent to *ratify* that decision's approach for almost all others. Which is to say that no negative inference arises. Congress did nothing in adding Section 365(n) to alter the natural reading of Section 365(g) — that rejection and breach have the same results." [Emphasis in original.]

Aiding Reorganization

The debtor argued that it would be better able to reorganize if the court relieved it of the burden of policing the use of the mark. To that, Justice Kagan said, "The Code of course aims to make

reorganization possible. But it does not permit anything and everything that might advance that goal."

Justice Kagan said that Section 365 therefore does not "relieve the debtor of the need . . . to invest the resources needed to maintain a trademark. . . . The resulting balance may indeed impede some reorganizations, of trademark licensors and others."

For the Court, Justice Kagan held that rejection "has the same effect as a breach outside of bankruptcy. Such an act cannot rescind rights that the contract previously granted. Here, that construction of Section 365 means that the debtor-licensor's rejection cannot revoke the trademark license."

Danielle Spinelli, a former Supreme Court law clerk, represented the licensee. Douglas Hallward-Driemeier, a former Assistant Solicitor General, argued for the debtor. Assistant Solicitor General Zachary D. Tripp argued on behalf of the government in favor of reversing *Lubrizol*.

Justice Sotomayor's Concurrence

Justice Sotomayor said she concurred "in full." She wrote "to highlight two potentially significant features of today's holding."

First, Justice Sotomayor said the opinion does not mean that "every trademark licensee has the unfettered right to continue using licensed marks post rejection." The opinion may not apply, she said, if provisions in the license or "state law" might "bear" on continued use of the mark.

Second, and of greater significance, Justice Sotomayor said that the "holding confirms that trademark licensees' postrejection rights and remedies are more expansive in some respects than those possessed by other types of intellectual property." For instance, she said that licensees of patents, copyrights and four other types of intellectual property (which are covered by Section 365(n)) "must make all [their] royalty payments."

The Dissent

Dissenting, Justice Gorsuch said nothing about the merits. He would have dismissed the *certiorari* petition for having been improvidently granted.

The case should have been considered moot, Justice Gorsuch said, because the licensee "hasn't come close to articulating a viable legal theory on which a claim for damages could succeed. And where our jurisdiction is so much in doubt, I would decline to proceed to the merits . . . . [T]here is no need to press the bounds of our constitutional authority . . . ."

The Irony, Import and Utility of the Decision

For appellate jurisprudence, the inability of Justice Gorsuch to prevail in his view about mootness seems to mean that the Court can reach the merits even when the existence of a live controversy is in doubt.

James M. Wilton of Ropes & Gray LLP in Boston, one of the counsel for the debtor, told ABI that "the decision will enhance the negotiating leverage of trademark licensees vis a vis secured lenders and other creditors and make it more difficult for debtor-licensors to rebrand their businesses and reorganize."

In the very hypothetical that Justice Kagan mentioned, the bankruptcy of a lessor of personal property will not enable the debtor to use rejection as a means for recovering the equipment for lease to someone else at a higher price.

Ironically, some non-debtor third parties would now be better off had Congress not come to their aid. Section 365(n) is not the only Code provision where a party to a rejected contract or lease would have greater rights after *Mission Product*.

Judge Kagan mentioned real property leases, contracts for the sale of real property and time-share interests in Sections 365(h) and (i). Having balanced the interests of debtor and creditors in those sections, Congress could have given third parties fewer rights and remedies than they might otherwise have been found to have following *Mission Product*. Nonetheless, the certainty provided by Sections 365(h) and (i) is perhaps a fair trade-off.

The opinion is *Mission Product Holdings Inc. v. Tempnology LLC*, 139 S. Ct. 1652, 203 L. Ed. 2d 876 (Sup. Ct.).

'No objectively reasonable basis' is the high court standard to find civil contempt for violating the discharge injunction.

Court Rejects Strict Liability for Discharge Violations

Today, the Supreme Court rejected a strict-liability standard for the imposition of contempt for violating the discharge injunction. Instead, the justices held unanimously that the bankruptcy court "may impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order."

The opinion for the Court by Justice Stephen G. Breyer also rejected the Ninth Circuit's idea that a subjective, good faith belief about the inapplicability of the discharge injunction is a defense to contempt. It is unclear from the opinion whether the Court's standard for a discharge violation also applies to violations of the automatic stay under Section 362.

A Discharge Violation Was Unclear

The procedural history of the case in the lower courts was exceptionally complex. Suffice it to say that the debtor had transferred his interest in a closely held corporation. After the debtor received his chapter 7 discharge, two other shareholders sued him in state court for transferring his interest without honoring their contractual right of first refusal. They also sued the transferee of the stock.

After the debtor raised his discharge as a defense in state court, the parties agreed he would not be liable for a monetary judgment. The state court eventually ruled in favor of the creditors and unwound the transfer.

The creditors then sought attorneys' fees as the prevailing parties, invoking a fee-shifting provision in the shareholders' agreement. The state court ruled that the debtor "returned to the fray" and thereby made himself liable for post-discharge attorneys' fees.

Meanwhile, the debtor reopened his bankruptcy case, seeking to hold the creditors in contempt for violating the discharge injunction. The bankruptcy judge sided with the debtor and imposed sanctions. The Bankruptcy Appellate Panel reversed the finding of contempt, ruling that the creditors' good faith belief that their actions did not violate the injunction absolved them of contempt.

Meanwhile, the state appellate court and a federal district court in related litigation both ruled that the debtor's participation in the litigation did not constitute returning to the fray, thus taking

away the grounds for imposing attorneys' fees and lending credence to the notion that the creditors did technically violate the injunction.

In sum, judges disagreed over whether the discharge injunction applied to the litigation to recover attorneys' fees.

The debtor appealed the BAP's opinion to the Ninth Circuit, where Circuit Judge Carlos T. Bea upheld the BAP in April 2018 and found no contempt. However, he expanded the defense available to someone charged with contempt of a discharge injunction. The appeals court held that "the creditor's good faith belief that the discharge injunction does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is unreasonable."

The debtor filed a petition for *certiorari*, which the Supreme Court granted in January. Oral argument was held on April 24.

The Standard Borrowed from Equity

In his 11-page opinion, Justice Breyer said the outcome was informed by Section 524(a)(2), the statutory discharge injunction, and by Section 105(a), the bankruptcy version of the All Writs Act.

Those two sections, according to Justice Breyer, "bring with them the 'old soil' that has long governed how courts enforce injunctions." The "old soil," he said, includes "the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction."

Justice Breyer cited Supreme Court precedent from 1885 holding that civil contempt should not be found "where there is [a] *fair ground of doubt* as to the wrongfulness of the defendant's conduct." *California Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 618 (1885) (emphasis added by Justice Breyer).

Justice Breyer then cited *Schmidt v. Lessard*, 414 U.S. 473, 476 (1974) (*per curiam*), for the notion that "principles of 'basic fairness requir[e] that those enjoined receive explicit notice' of 'what conduct is outlawed' before being held in civil contempt."

Although subjective intent is not "always irrelevant," Justice Breyer said, "This standard is generally an *objective* one." [Emphasis in original.] Again citing high court precedent, he said that "a party's good faith, even where it does not bar civil contempt, may help determine an appropriate sanction."

Given that the "typical discharge order entered by a bankruptcy court is not detailed," Justice Breyer held that civil contempt "therefore may be appropriate when the creditor violates a

discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope."

The Rejected Standards

Justice Breyer rejected the Ninth Circuit's "good faith belief" standard. Recognizing the realities of life for debtors, he said that the rule proposed by the circuit court "may too often lead creditors who stand on shaky legal ground to collect discharged debts, forcing debtors back into litigation (with its accompanying costs) to protect the discharge that it was the very purpose of the bankruptcy proceeding to provide."

On the other hand, he also rejected a strict-liability standard that would authorize a contempt finding "regardless of the creditors' subjective beliefs about the scope of the discharge order, and regardless of whether there was a reasonable basis for concluding that the creditor's conduct did not violate the order."

In support of strict liability, the debtor argued that a creditor can turn to the bankruptcy court for a so-called comfort order declaring that a proposed action would not violate the discharge injunction. To that, Justice Breyer said that a "risk averse" creditor would seek a comfort order "even when there is only a slight doubt" about a violation of discharge. Often, he said, there will "be at least some doubt as to the scope of" the discharge.

Frequent use of comfort orders, Justice Breyer said, would run contrary to Section 523(c)(1), where only three categories of debts require advance determinations of dischargeability.

Frequent resort to comfort orders, according to Justice Breyer, would "alter who decides whether a debt has been discharged, moving litigation out of state courts, which have concurrent jurisdiction over such questions, and into federal courts."

Because the Ninth Circuit had not employed the proper standard, the Justice Breyer vacated the judgment of the appeals court and remanded "the case for further proceedings consistent with this opinion."

What About the Automatic Stay?

Does the Supreme Court's standard for contempt of the discharge injunction also apply to violations of the automatic stay under Section 362(a)?

Justice Breyer said that the language in Section 362(k)(1) "differs from the more general language in Section 105(a)." Section 362(k)(1) allows an individual to recover actual damages, costs, attorneys' fees and even punitive damages (in "appropriate circumstances") for "any willful violation" of the automatic stay.

The debtor argued that lower courts have often imposed strict liability for violating the automatic stay. Coupled with the different purpose of the automatic stay, the absence of the word "willful" in the discharge context prompted Justice Breyer to reject the idea of importing lower courts' standards for violation of the automatic stay to contempt of the discharge injunction.

Parenthetically, Justice Breyer noted that the use of "willful" in Section 362(k)(1) is "a word the law typically does not associate with strict liability." However, he ducked the question, saying that "[w]e need not, and do not, decide whether the word 'willful' supports a standard akin to strict liability."

Although the Court made no holding about automatic stay violations, Justice Breyer's parenthetical observation can lay the foundation for contending there is also no strict liability for stay violations.

So, the question remains: Is the contempt standard different for automatic stay violations?

Craig Goldblatt of Wilmer Cutler Pickering Hale & Dorr LLP in Washington, D.C., observed that "the Code sets out a standard for the stay but not the discharge injunction. Bankruptcy lawyers think they serve a similar role and so read them to be parallel. But there is no textual basis for that."

"In the absence of text," Goldblatt said in a message to ABI, "the Court says you read the discharge injunction just like you would any injunction outside of bankruptcy. That is all that he needed to say to resolve this case. Because it is not a case about the automatic stay, it presented no basis to opine on how the automatic stay works."

Goldblatt therefore concluded, "*Taggart* has nothing at all to do with the automatic stay." He has argued three bankruptcy cases in the Supreme Court.

Assuming the Court said nothing about automatic stay violations with respect to individuals, what about violations of the stay protecting corporate debtors where there is no statutory standard like 362(k)(1)? Does the absence of a statutory standard for corporate debtors throw the issue back to common law regarding injunctions?

However, the standards may be different, because, as Justice Breyer observed, the automatic stay has a shorter duration and a different purpose in preventing disruptions in the administration of bankruptcy cases.

The high court's ruling on discharge violations may touch off decades of litigation over the standard for deciding whether someone violated the automatic stay.

The opinion is *Taggart v. Lorenzen*, 139 S. Ct. 1795, 204 L. Ed. 2d 129 (Sup. Ct. June 3, 2019).

Bankruptcy needs blanket judicial immunity from the Federal Arbitration Act after the Supreme Court's Schein decision.

Supreme Court Decision on Arbitration Has Ominous Implications for Bankruptcy

Justice Brett M. Kavanaugh wrote his first opinion for the Supreme Court in what *The New York Times* called a "minor arbitration case."

If Justice Kavanaugh's ruling in *Henry Schein Inc. v. Archer & White Sales Inc.* is applied rigorously in bankruptcy, it's a "really big deal," because bankruptcy judges will not be able to bar creditors from initiating arbitrations over "core" issues such as allowance of claims, objections to dischargeability of debts, and even adequate protection.

Indeed, *Schein* could be interpreted to mean that the bankruptcy court cannot bar a creditor from initiating arbitration against an individual or corporate debtor, even if the call for arbitration was frivolous.

'Wholly Groundless'

Schein was argued on October 29 and decided for the unanimous Court by Justice Kavanaugh on January 8. By contract, the parties agreed to arbitrate before the American Arbitration Association and according to AAA rules.

Later, the plaintiff filed suit under federal and state anti laws, seeking damages and an injunction. The contract called for arbitration "except for actions seeking injunctive relief . . . ." The rules of the AAA call for the arbitrator to decide issues of arbitrability.

Invoking the Federal Arbitration Act, 9 U.S.C. § 2, the defendant responded to the complaint by asking the district judge to refer the case to arbitration. Adopted in 1925, the FAA provides that a contract calling for arbitration "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

Following Fifth Circuit authority, the district court refused to compel arbitration, finding that the demand for arbitration was "wholly groundless" because the plaintiff was seeking an injunction. The Fifth Circuit affirmed.

The Circuit Split

The circuits were split. The Fourth, Fifth, Sixth and Federal Circuits have held that a federal court could refuse to compel arbitration if the demand was "wholly groundless."

The Tenth and Eleventh Circuits ruled to the contrary, holding that the arbitrator alone is entitled to rule on the arbitrability of the dispute, if the contract so provides.

To resolve the split, the Court granted *certiorari* on June 25.

Justice Kavanaugh's Rationale

In substance, Justice Kavanaugh said the Court had already decided the question. In 2010, the high court ruled that the parties may agree by contract that an arbitrator, not the court, will resolve threshold arbitrability questions, not just the merits of the dispute. *Rent-A-Center West Inc. v. Jackson*, 561 U. S. 63, 68−70 (2010).

Justice Kavanaugh said that "some federal courts nonetheless will short-circuit the process" by deciding the arbitrability question if the demand for arbitration is "wholly groundless." Those courts, he said, adopted the "wholly groundless" exception to *Rent-A-Center* "to block frivolous attempts to transfer disputes from the court system to arbitration."

Reversing the Fifth Circuit, Justice Kavanaugh held that the "court possesses no power to decide the arbitrability issue" if "the parties' contract delegates the arbitrability question to an arbitrator."

Justice Kavanaugh reaffirmed the principle that a court can decide whether there was a valid arbitration agreement before referring a dispute to arbitration. "But," he said, "the court may not decide the arbitrability issue" if "a valid agreement exists, and if the agreement delegates the arbitrability issue to an arbitrator."

Justice Kavanaugh rejected the policy argument that the "wholly groundless" exception is "necessary to deter frivolous motions to compel arbitration." He said that arbitrators can quickly and efficiently dispose of frivolous cases, imposing costs and attorneys' fees on the movant "under certain circumstances."

Because the lower courts had not considered the issue, Justice Kavanaugh remanded the case for the Fifth Circuit to rule on whether the agreement "in fact delegated the arbitrability question to an arbitrator." He said the judge "'should not assume that the parties agreed to arbitrate arbitrability unless there is clear and unmistakable evidence that they did so,'" quoting *First Options of Chicago Inc. v. Kaplan*, 514 U.S. 938, 944 (1995).

Fewer and Fewer Exceptions to Arbitration

The implications of Justice Kavanaugh's opinion for bankruptcy cases are better understood in the context of the progression of recent Supreme Court authority.

In 1987, the Supreme Court ruled that a court could decline to enforce an arbitration agreement if there was an inherent conflict between arbitration and the statute's underlying purpose. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 227 (1987).

Building on *McMahon*, the Second, Fourth, Fifth and Ninth Circuits have held in bankruptcy cases that the court may decline to compel arbitration if the issue is "core" and arbitration would represent a "severe conflict" with the Bankruptcy Code.

Last year, the Second Circuit utilized that concept to override an arbitration agreement when a debtor mounted a class action contending that the creditor had violated the discharge injunction. *One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert*. denied Oct. 1, 2018.

Anderson and the other circuit decisions overriding arbitration agreements in bankruptcy cases were all decided before *Epic Systems Corp. v. Lewis*, 138 S. Ct. 1612, 1624 (May 21, 2018), where the Supreme Court held last term that the language of a statute must be "clear and manifest" before a court can disregard an arbitration agreement. In *Epic*, the Supreme Court nixed a class action and required individual arbitration of a former employee's claim that the employer's failure to pay overtime violated the Fair Labor Standards Act.

Epic was a 5/4 decision, with the justices divided on ideological grounds.

Applying *Epic* and *Schein* to Bankruptcy Cases

Assume that a debtor and a creditor had a prebankruptcy agreement to arbitrate all disputes, including any arising in bankruptcy, such as the allowance of claims, counterclaims, preferences, and adequate protection. Further assume that the agreement called for the arbitrator to decide whether the dispute was arbitrable, even following bankruptcy.

If *Epic* and *Schein* were applied rigorously, the bankruptcy judge arguably would have no right to bar the creditor from initiating arbitration. If the dispute raised a core issue — such as the allowance of a claim, dischargeability or adequate protection — the bankruptcy judge might have no power to bar arbitration even if there was a "severe conflict" with bankruptcy law.

A chapter 11 debtor could find itself defending dozens of arbitrations, giving the bankruptcy judge little ability to confirm a plan or avoid liquidation. Or, an individual debtor might be fighting dischargeability in several arbitrations.

The prospect of arbitrating dischargeability is not fanciful. *See Williams v. Navient Solutions LLC (In re Williams)*, 564 B.R. 770 (Bankr. S.D. Fla. 2017) (debtor compelled to arbitrate student loan dischargeability); *but see Golden v. JP Morgan Chase Bank NA (In re Golden)*, 587 B.R. 414 (Bankr. E.D.N.Y. 2018), and *Roth v. Butler University (In re Roth)*, 18-50097, 2018 BL 427188 (Bankr. S.D. Ind. Nov. 16, 2018) (arbitration of dischargeability of student loan not permitted). For ABI's discussion, click here.

Supreme Court authority on arbitration seems headed to a pivotal case for the justices to decide whether bankruptcy represents a general exception to the enforceability of arbitration agreements.

In that regard, bankruptcy cases have an element not present in *Epic* and *Schein*. The underpinning of the Bankruptcy Code is centrality of administration. Bankruptcy law has always recognized that an individual cannot win a fresh start and a company cannot reorganize if issues related to bankruptcy must be litigated in several forums. Bankruptcy is designed so one judge decides all core disputes. Even if there is a *Stern* problem, the case goes to a district judge in the same courthouse.

Epic's requirement of a statute's "clear and manifest" exception to arbitration may be found in the centrality of administration of bankruptcy cases. And if that's not enough, the most conspicuous feature of bankruptcy is the automatic stay.

Surely, a creditor cannot continue or initiate arbitration without relief from the automatic stay. If the automatic stay is not a "clear and manifest" exception to arbitration, it's hard to imagine what is.

Justice's Kavanaugh's opinion reaffirms the power of courts to determine in the first instance whether an arbitration agreement is valid. An arbitration clause purportedly enforceable in bankruptcy could be viewed as an invalid agreement, just like an agreement is invalid if it waives the automatic stay or precludes the filing of bankruptcy.

But the question remains: Is a contract calling for arbitration of bankruptcy issues an invalid contract that the bankruptcy court can override, or does *Schein* require the bankruptcy court to refer the dispute to an arbitrator who will decide whether bankruptcy questions are arbitrable?

To read ABI's discussion of *Anderson*, click here, here and here.

The Supreme Court opinion is *Henry Schein Inc. v. Archer & White Sales Inc.*, 139 S. Ct. 524, 202 L. Ed. 2d 480 (Sup. Ct. Jan. 8, 2019).

Intermediate transfers to financial institutions do not trigger the safe harbor.

Supreme Court Narrowly Interprets the Safe Harbor, Overrules the Majority of Circuits

Resolving a split of circuits, the Supreme Court ruled unanimously today in *Merit Management Group LP v. FTI Consulting Inc.* that the so-called safe harbor under Section 546(e) only applies to "the transfer that the trustee seeks to avoid." In other words, using a bank as an escrow agent does not preclude a trustee from recovering a constructively fraudulent transfer under Section 548(a)(1)(B), when the trustee is seeking to recover from the ultimate recipient of the transfer but not from an intermediary bank.

The Supreme Court had been asked to resolve a split of circuits and decide whether the safe harbor applies when a financial institution is only a "mere conduit." Instead, the unanimous opinion by Justice Sonia Sotomayor decided the case on a different and broader ground. The opinion may lead to a rethinking of safe harbor cases and might open the door to suits that previously were believed to rest comfortably within the safe harbor.

The Seventh Circuit Opinion

The case came to the Supreme Court from the Seventh Circuit, where a bankruptcy trustee had sued a selling shareholder in the leveraged buyout of a non-public company. The transaction was structured so that the purchase price for the stock initially came from an investment bank and was transferred to a commercial bank acting as escrow agent. As escrow agent, the bank paid a total of $16.5 million to the selling shareholder. The trustee sued the selling shareholder for receipt of a constructively fraudulent transfer.

The district court granted a motion to dismiss, reasoning that the safe harbor applied because the transfer included both a transfer from an investment bank and a transfer to a commercial bank, before the funds ended up in the hands of the selling shareholder.

On appeal, the Seventh Circuit reversed, in an opinion by Chief Circuit Judge Diane P. Wood. *FTI Consulting Inc. v. Merit Management Group LP*, 830 F.3d 690 (7th Cir. July 28, 2016).

The Seventh Circuit 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 it turns out that the seller was rendered insolvent.

Since the purchaser was buying stock, it was clear to the Seventh Circuit that the transfers were either a settlement payment or a payment in connection with a securities contract. The appeals

court said it was therefore only necessary to decide whether the safe harbor protects transactions "simply [because they were] conducted through financial institutions."

The Seventh Circuit refused to "interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." Instead, the appeals court said "it is the economic substance of the transaction that matters."

The Chicago-based appeals court therefore reversed the district court, which had utilized the safe harbor to dismiss the trustee's suit.

The Seventh Circuit opinion deepened an existing circuit split because the Second, Third, Sixth, Eighth and Tenth Circuits have invoked the safe harbor when a financial institution is nothing more than a conduit. The Eleventh Circuit was aligned with the Seventh, requiring the financial institution to be more than a conduit.

The defendant-selling shareholder filed a petition for *certiorari*, which the Supreme Court granted in May 2017. Oral argument was held on Nov. 6.

The Unanimous Opinion

The seeds for Justice Sotomayor's opinion were sown in an exchange at oral argument between Justice Anthony M. Kennedy and former Solicitor General Paul D. Clement, counsel for the trustee. Justice Kennedy asked whether the opinion should be qualified to require that the financial institution have an "equity participation" before the safe harbor applies.

Clement said he had a "simpler way to write the opinion[: by just looking] to the transfer that the trustee seeks to avoid." And that's what Justice Sotomayor did.

Laying out the statute in full text in her opinion, Justice Sotomayor traced the many amendments to the safe harbor, saying Congress "each time expand[ed] the categories of covered transfers or entities."

In pertinent part, Section 546(e) 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 . . . ."

Justice Sotomayor framed the question as whether the safe harbor applied because the transfer was "'made by or to (or for the benefit of) a . . . financial institution.'" She said that asking whether the bank had a beneficial interest in the transferred property "put the proverbial cart before the horse."

Before deciding whether the transfer was made to a covered entity, "the court must first identify the relevant transfer," she said.

Justice Sotomayor devoted the bulk of her opinion to explaining why the "language of Section 546(e)," the "specific context in which that language is used, and the broader statutory structure all support the conclusion that the relevant transfer for purposes of the Section 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid." She said the trustee properly identified the transfer as the sale of stock by the seller to the buyer, not intermediate transfers involving investment or commercial banks.

Uttering a phrase that will be cited countless times in the future, Justice Sotomayor cautioned that a trustee "is not free to define the transfer it seeks to avoid in any way it chooses."

Justice Sotomayor devoted the final third of her 19-page opinion to refuting the selling shareholder's arguments. The last part of her opinion arguably broadens the scope of the holding and makes the safe harbor more narrow than it is now generally understood to be.

She said that the addition of "(or for the benefit of)" in 2006 was only intended for the scope of the safe harbor to match the scope of the avoiding powers, where similar language is used. She rejected the selling shareholder's contention that the language was intended to bar avoidance if the financial institution was an intermediary without a financial interest in the transfer.

Next, the selling shareholder mounted an argument based on the inclusion of a securities clearing agency as one of the entities covered by the safe harbor.

If the relevant transfer is from the buyer to the seller, Justice Sotomayor said, "the question then becomes whether the transfer was 'made by or to (or for the benefit of)' a covered entity," such as a clearing agency.

Answering her own question, Justice Sotomayor said, "If the transfer that the trustee seeks to avoid was made 'by' or 'to' a securities clearing agency . . . , then Section 546(e) will bar avoidance, and it will do so without regard to whether the entity acted only as an intermediary."

On the next page, Justice Sotomayor acknowledged there was "good reason to believe that Congress was concerned about transfers '*by* an industry hub.'" [Emphasis in original.]

She went on to say that the safe harbor protects securities transactions "'made by or to (or for the benefit of)' covered entities. See Section 546(e). Transfers 'through' a covered entity, conversely, appear nowhere in the statute."

What exactly did the justice mean by her statements?

It was generally understood, at least before today's opinion, that a trustee could not recover a fraudulent transfer resulting from the sale of stock in a publicly held company, because the payoff to the selling shareholder would have been made through a "covered entity," like a clearing agent. Does today's opinion mean that a trustee for a public company can recover from selling shareholders but, of course, not from a clearing agent?

It had also been held that the LBO of a privately held company was protected by the safe harbor, if the sale of the stock utilized a bank somewhere in the stream of payments. It seems reasonably clear that an LBO of a privately held is no longer protected, unless the transferee is a financial institution.

However, what results if the transfer ends up in the coffers of a bank that held a lien on the stock being sold? May the trustee recover only from the beneficial owner of the stock but not from the bank where the money ended up?

The meaning of *Merit Management* will be debated in other contexts. For instance, the Second Circuit held in *Note Holders v. Large Private Beneficial Owners (In re Tribune Co.)*, 818 F.3d 98 (2d Cir. 2016), that the safe harbor bars suits by creditors under state law to recover payments made in securities transactions.

In *Tribune*, the Second Circuit concluded that Congress intended broad protection for securities markets, even to the extent of barring creditors from prosecuting claims that belong to them and not to bankruptcy trustees. Does *Merit Management* undercut the Second Circuit's notion that the safe harbor broadly immunizes any transaction involving securities whenever there has been a bankruptcy?

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

Some justices are critical of the existing test for ruling on non-statutory insider status.

Supreme Court Says Insider Status Is Reviewed for Clear Error Under Existing Test

The Supreme Court used a bankruptcy case to elucidate the standard of review when an appellate court confronts a mixed question of law and fact. According to Justice Elena Kagan, who wrote the March 5 opinion for the unanimous Court, clear error was the proper standard of review because the arm's-length nature of the transaction was primarily factual in nature.

In concurring opinions, four justices questioned whether the Ninth Circuit employed the proper legal test for non-statutory insider status. Implying that the dissenter in the Ninth Circuit was on the right track, they laid out a test for non-statutory insider status that would be more consonant with the statute and produce a different outcome.

At oral argument in the Supreme Court on October 31, it seemed possible that the justices might rule that review is *de novo* when the facts in the trial court were undisputed. However, the Court's opinion hewed to the traditional notion that inferences taken from undisputed facts are reviewed for clear error.

The Ninth Circuit Decision

In this chapter 11 reorganization, there were only two creditors. One was a bank with a $10 million secured claim. The other was the debtor's general partner, who had a $2.8 million unsecured claim.

The bank opposed the plan and could have defeated confirmation for lack of an accepting class, because the insider's vote could not be counted under Section 1129(a)(10) in cramming down the plan on the bank.

To create an accepting class and open the door to confirmation via cramdown, the insider sold her claim for $5,000 to a very close friend. The plan provided a $30,000 distribution on the unsecured claim.

The bankruptcy judge ruled that the buyer automatically became an insider by purchasing the insider's claim. The Bankruptcy Appellate Panel reversed and was upheld by the Ninth Circuit in a 2-1 opinion.

All three circuit judges agreed that the purchaser did not automatically become an insider by purchasing the insider's claim. The majority then said that status as an insider entails a "factual

inquiry that must be conducted on a case-by-case basis." To be a non-statutory insider, the appeals court laid out a two-part test. A claim buyer "must have a close relationship with the debtor and negotiate the relevant transaction at less than arm's length."

The Ninth Circuit did not remand the case to the bankruptcy court because the bankruptcy judge had ruled that the buyer purchased the insider's claim in an arm's-length transaction. Since the purchaser bought the claim at arm's length, the second prong of the test had not been met, leading the majority on the Ninth Circuit to rule that the purchaser was not a non-statutory insider.

The majority on the circuit court therefore 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 Petition for *Certiorari*

The bank filed a petition for *certiorari*, which was granted in March 2017. The Court limited its review to the appellate standard of review. The U.S. Solicitor General, who had opposed granting *certiorari*, submitted a merits brief on the side of the debtor and argued that the Ninth Circuit properly applied the clear-error standard of appellate review. The Solicitor General did not take a position on whether the bankruptcy judge committed clear error.

The Unanimous Opinion

In her 11-page opinion for the unanimous court, Justice Kagan said that courts have developed standards for non-statutory insiders that "are not entirely uniform." Many, she said, focus on whether the transaction was conducted at arm's length.

The buyer and seller were in a romantic relationship but lived apart and kept their finances separate. Despite the close relationship, the bankruptcy judge had found that the sale of the claim was negotiated at arm's length.

Justice Kagan said that the bankruptcy court had correctly applied the Ninth Circuit's two-part test. The Supreme Court, however, did not include a review of the test within the grant of *certiorari*. Instead, the Court only agreed to review the proper appellate standard for a ruling on non-statutory insider status.

Parsing the standards of appellate review, Justice Kagan said that findings of historical fact — such as "what, when or where, how or why" — are reviewable for clear error.

On the other hand, whether historical facts satisfy the test for non-statutory insider status is a mixed question of law and fact, Justice Kagan said. She then said that mixed questions "are not all alike."

Pinpointing the standard of review for mixed questions "all depends," she said, on whether the work of the appellate court is "primarily legal or factual."

Deciding whether the sale of the claim was "conducted as if the [buyer and seller] were strangers to each other" was "about as factual sounding as any mixed question gets," Justice Kagan said. Indeed, she said, applying the Ninth Circuit's two-part test amounts to what the Court "previously described as 'factual inferences[] from undisputed facts."

Justice Kagan said that the bankruptcy court had the "closest and the deepest understanding of the record" from hearing the witnesses and presiding over the presentation of evidence.

The appellate standard of review was therefore for clear error because the appellate court was called on to perform "[p]recious little" legal work in applying the Ninth Circuit's two-part test.

Approaching the issue from a different direction, Justice Kagan said that even a *de novo* review "will not much clarify legal principles or provide guidance to other courts resolving other disputes."

The Concurring Opinions

Justice Sonia Sotomayor wrote a seven-page concurring opinion joined by Justices Anthony M. Kennedy, Clarence Thomas, and Neil M. Gorsuch.

Justice Sotomayor said it "is not clear to me" that the two-prong test in the Ninth Circuit "is consistent with the plain meaning of the term 'insider' as it appears in [Section 101(31) of] the Code."

The enumerated statutory insiders in Section 101(31) do not lose that status, Justice Sotomayor said, by negotiating at arm's length. Therefore, she said, "it is not clear why the same should not be true of non-statutory insiders."

Finding shortcomings in the Ninth Circuit's test, Justice Sotomayor proceeded to offer two other tests.

First, the court could focus on "commonalities" between enumerated insiders and "characteristics of the alleged non-statutory insider." Second, the court might consider "other aspects of the parties' relationship" if the transaction was negotiated at arm's length.

Had the trial court applied one of her proposed tests, Justice Sotomayor said it "is conceivable" that the standard for review might have been different.

In the penultimate paragraph of her concurrence, Justice Sotomayor said that the facts of the case as applied to one of her two alternative tests may have resulted in a finding that the purchaser was an insider, even if the clear-error test were applied.

In a signal that she and her three colleagues were dissatisfied with the Ninth Circuit's existing test, Justice Sotomayor ended her opinion by imploring courts "to grapple with the role that an arm's-length inquiry should play in a determination of insider status."

Justice Kennedy wrote a separate two-page concurrence to emphasize that the Court's opinion should not be taken as an endorsement for the Ninth Circuit's existing two-part test. He also questioned whether the bankruptcy judge was correct in finding that the purchaser was not an insider, but said "*certiorari* was not granted on this question."

The opinion is *U.S. Bank NA v. The Village at Lakeridge LLC,* 15-1509 (Sup. Ct. March 5, 2018).

High court resolves a circuit split on Section 523(a)(2)(B) and the meaning of "financial condition."

A False Statement About One Asset Isn't Grounds for Nondischargeability

The Supreme Court resolved a split of circuits today by holding that a false statement about one asset must be in writing to provide grounds for rendering a debt nondischargeable under Section 523(a)(2).

The 15-page opinion by Justice Sonia Sotomayor focused primarily on the plain language of the statute and the meaning of the word "respecting." The opinion was unanimous, except that Justices Clarence Thomas, Samuel A. Alito Jr. and Neil M. Gorsuch did not join in a section of the decision where Justice Sotomayor buttressed her conclusion by relying on legislative history surrounding the adoption of the Bankruptcy Code in 1978.

The case pitted courts' aversion to those who lie against the statutory language and its history. In a sense, the result is akin to *Law v. Siegel*, 134 S. Ct. 1188 (2014), where the Supreme Court ruled that the bankruptcy court does not have a "roving commission" to do equity. In *Law*, the high court barred the imposition of sanctions by invading property made exempt by statute, even though the debtor persistently committed fraud.

A ruling the other way would have led to anomalous results. If a smaller lie about one asset could result in nondischargeability, a bigger lie about a debtor's entire net worth would provide no grounds for nondischargeability unless it were in writing.

While courts may not be favorably inclined toward debtors who lie orally to obtain credit, Congress made a decision in Section 523(a)(2)(B) that a materially false statement "respecting the debtor's . . . financing condition" must be in writing to provide grounds for nondischargeability of the related debt.

The Case Below

A client told his lawyers that he was to receive a large tax refund enabling him to pay his legal bills. The lawyers continued working, based on the oral representation.

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. Years later, they obtained a judgment they could not collect after the client filed bankruptcy.

Affirmed in district court, the bankruptcy judge held that the claim for legal fees was not discharged. The Eleventh Circuit reversed in a Feb. 15, 2017, opinion by Circuit Judge William Pryor, *Appling v. Lamar, Archer & Cofrin LLP (In re Appling)*, 848 F.3d 953 (11th Cir. Feb. 15, 2017). To read ABI's discussion of the Eleventh Circuit opinion, click here.

The creditor filed a petition for *certiorari*, which the Supreme Court granted on the recommendation of the U.S. Solicitor General, who later submitted an *amicus* brief supporting the debtor, arguing that the Eleventh Circuit was correct, and contending that an oral misstatement about one asset is a statement about "financial condition" that must be in writing before the debt can be declared nondischargeable.

The circuits were split. The Fifth and Tenth Circuit held that a false statement about one asset can result in nondischargeability, while the Eleventh Circuit had joined the Fourth in holding that a statement about any asset must be in writing to provide grounds for nondischargeability.

The justices heard oral argument on April 17.

Another 'Plain Language' Opinion

The creditor-petitioner argued that a statement about a debtor's overall financial condition is the only type of statement "respecting" financial condition that can result in nondischargeability under Section 523(a)(2)(B). According to the creditor, a lie about one asset is not about "financial condition." Rather, the law firm contended that a lie about one asset falls within the ambit of Section 523(a)(2)(A) and leads to a nondischargeable debt because it is a "false representation." Under (a)(2)(A), there is no requirement that a "false representation" be in writing before the debt can be nondischargeable.

As is her style, Justice Sotomayor was quick to the point. In the second paragraph of her opinion, she said that the "statutory language makes plain that a statement about a single asset can be a 'statement respecting the debtor's financial condition.'" If the statement was not made in writing, she said, "the associated debt may be discharged, even if the statement was false."

Justice Sotomayor said that the Bankruptcy Code does not define three critical terms: "statement," "financial condition," and "respecting." Only "respecting" was in dispute, she said.

Looking to several dictionaries, Justice Sotomayor said that "respecting" means "in view of: considering; with regard or relation to: regarding, concerning." At least in the context of the instant case, she said that "related to" does not have a "materially different meaning" than "about," "concerning," "with reference to," or "as regards." The words all have circular definitions, she said.

In the realm of statutory construction and drafting, Justice Sotomayor said that "respecting" "generally has a broadening effect" and "covers not only its subject but also matters relating to that subject." She rejected the notion that (a)(2)(B) only refers to overall financial condition, because that interpretation would read "'respecting' out of the statute."

Broadening her opinion further, she said that a statement is "respecting" financial condition "if it has a direct relation to or impact on the debtor's overall financial condition."

A narrower interpretation, according to Justice Sotomayor, "would yield incoherent results." For example, she said that a false statement, such as, "I am above water," could not result in nondischargeability unless it were in writing, while saying, "I have $200,000 in equity in my house" could lead to nondischargeability. "This, too, is inexplicably bizarre," she said.

Justice Sotomayor traced the language in the Bankruptcy Code to a phrase first adopted by Congress in 1926, which the circuits consistently interpreted to include even one of a debtor's assets. Having used the same word in the Bankruptcy Reform Act of 1978, she said that Congress "intended for it to retain its established meaning."

Justices Thomas, Alito and Gorsuch did not join in the last section of Justice Sotomayor's opinion, where she grounded the result in legislative history underpinning Section 523(a)(2)(B). She quoted from a 1995 Supreme Court decision citing the legislative history as saying that Congress drafted Section (a)(2) in a manner intended to prevent abuse by creditors who might otherwise trap debtors into making statements that could result in denial of discharge.

The opinion is *Lamar, Archer & Cofrin, LLP v. Appling*, 16-1215 (Sup. Ct. June 4, 2018).

Jevic ***opinion continues to permit first-day wage and critical vendor orders, although its effect on gift plans is debatable.***

Supreme Court Reverses *Jevic*, Bars Structured Dismissals that Violate Priority Rules

Reversing the Third Circuit in *Czyzewski v. Jevic Holding Corp.*, the Supreme Court ruled 6/2 today in an opinion by Justice Stephen G. Breyer that the bankruptcy court, without consent from affected parties, cannot approve so-called structured dismissals that "deviate from the basic priority rules," not even in rare cases.

Justice Breyer was careful to narrow the Court's holding so the opinion would not be interpreted to preclude first-day wage or critical vendor orders.

Joined by Justice Samuel A. Alito, Jr., Justice Clarence Thomas dissented, saying that the writ of *certiorari* should have been dismissed as improvidently granted.

The Facts

In the unsuccessful reorganization of Jevic Holding Corp., the official unsecured creditors' committee had sued the secured lender for receipt of a fraudulent transfer. The committee and the lender negotiated a settlement calling for the lender to set aside some money for distribution to general unsecured creditors following dismissal in a scheme that did not follow the ordinary priority rules contained in Section 507.

Since it would give them nothing on their $8.3 million in wage priority claims, workers objected to the settlement because some settlement proceeds were to be held in a trust exclusively for lower-ranked general unsecured creditors.

The bankruptcy court in Delaware approved the settlement and structured dismissal and was upheld in district court. The Third Circuit, in a 2-1 opinion, upheld the structured dismissal, eliminating any chance of recovery by priority wage claimants through the bankruptcy. Although the dissenter in the Third Circuit concurred that structured dismissals could be approved on occasion, he did not believe *Jevic* was a proper case.

The Supreme Court granted *certiorari* in June 2016 to resolve a split of circuits. Before granting *certiorari*, the Supreme Court sought comment from the Solicitor General, who subsequently urged granting the petition and reversing the court of appeals.

Justice Breyer's Opinion

Justice Breyer cited the American Bankruptcy Institute Commission report's definition of structured dismissals. He went on to say that the ABI report referred to structured dismissals as "increasingly common."

Justice Breyer observed that the Bankruptcy Code "does not explicitly state what priority rules – if any – apply to a distribution" when a chapter 11 case is dismissed. He noted, however, that a chapter 11 plan cannot violate rules of priority over objection from an impaired creditor class.

Since Section 349(b) does not say when there is "cause" to depart from the ordinary rules governing the effects of dismissal, he said the propriety of structured dismissals was a "complicated question." Nonetheless, he said, the answer is "simple": Structured dismissals are not permissible.

The Bankruptcy Code's "priority system constitutes a basic underpinning of business bankruptcy law," the opinion says. Justice Breyer said the Court "would expect to see some affirmative indication of intent if Congress actually meant to make structured dismissals a backdoor means to achieve the exact kind of nonconsensual priority-violating final distributions that the [Bankruptcy] Code prohibits in chapter 7 liquidations and chapter 11 plans."

Justice Breyer was careful to ensure that the opinion is not read broadly to prohibit common practices in chapter 11 cases that depart from the rules and timing of distributions, such as first day orders allowing payment of pre-petition wages and claims of so-called critical vendors. Those practices, he said, are designed to enhance the chance for a successful reorganization.

On the other hand, Justice Breyer said, a "priority-violating" distribution in a structured dismissal "is attached to a final disposition; it does not preserve the debtor as a going concern."

He left the door open to other priority-defying practices if there is a "significant offsetting bankruptcy-related justification."

Justice Breyer ended his discussion of the merits by saying that a structured dismissal is not permissible even in a "rare case." He said that allowing them sometimes would result in "similar claims being made in many, not just a few, cases." He concluded that "Congress did not authorize a 'rare case' exception."

The Standing Question

Justice Breyer's majority opinion had a three-page discussion of standing that may be pertinent if the question avoided in *Spokeo Inc. v. Robbins*, 136 S. Ct. 1540, 194 L. Ed. 2d 635 (Sup. Ct. May 16, 2016), comes back to the Supreme Court.

The respondents contended that the workers had no standing because they suffered no injury. Although they got nothing under the settlement, the bankruptcy judge said they likewise would have received nothing if the settlement were disapproved.

The workers had standing, Justice Breyer said, because "a settlement that respects ordinary priorities remains a reasonable possibility." Furthermore, he said, the fraudulent transfer claim "could have litigation value" because the defendants were willing to pay $3.7 million in settlement. Consequently, "the structured settlement cost petitioners something. They lost a chance to obtain a settlement that respected their priorities. Or, if not that, they lost the power to bring their own lawsuit."

On an issue that may arise if a case like *Spokeo* comes back to the high court, Justice Breyer cited *McGowan v. Maryland*, 366 U.S. 420 (1961), and said that "a loss of even a small amount of money is ordinarily an 'injury'" that gives rise to standing.

'Gift' Plans

The majority opinion does not explicitly discuss the related question of so-called gift plans, where a lender allows some typically small portion of its collateral to be diverted to a low-ranking class, passing over a higher ranking class.

The holding in *Jevic* could be authority to bar gift plans to the extent they result from settlements negotiated by creditors' committees based on claims that belong to the estate.

On the other hand, gift plans arguably are permissible if they promote "significant Code-related objectives" that *Jevic* would allow.

The Dissent

Joined by Justice Alito, Justice Thomas dissented, saying the *certiorari* petition should have been denied as having been improvidently granted. He said the petitioners argued a different issue from the one for which the Court granted *certiorari* to resolve a circuit split.

On the question presented in the petitioners' brief, Justice Thomas said there is no circuit split.

The opinion in the Supreme Court is *Czyzewski v. Jevic Holding Corp.*, 15-649, 2017 BL 89680, 85 U.S.L.W. 4115 (Sup. Ct.). The opinion in the Third Circuit is *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. May 21, 2015).

High court allows a business model that is based on the inadvertence of trustees and creditors.

Supreme Court Allows Debt Collectors to File Time-Barred Proofs of Claim

Resolving a split of circuits, the Supreme Court held 5/3 today in *Midland Funding LLC v. Johnson* that a debt collector who files a claim that is "obviously" barred by the statute of limitations has not engaged in false, deceptive, misleading, unconscionable, or unfair conduct and thus does not violate the federal Fair Debt Collection Practices Act.

Writing the opinion for the majority in favor of the debt collector, Justice Stephen G. Breyer said that the conclusion on one issue — false, deceptive or misleading — was "reasonably clear." The second issue — unfair or unconscionable — presented a "closer question," he said.

Although importuned to do so by the debt collector, the majority did not rule that the later adoption of the Bankruptcy Code impliedly repealed aspects of the FDCPA. However, the opinion opens the door for debt collectors to purchase time-barred claims for pennies on the dollar and profit by filing those otherwise uncollectable claims, because trustees and debtors will not always object.

Justice Sonia Sotomayor dissented, in an opinion joined by Justices Ruth Bader Ginsburg and Elena Kagan. Justice Sotomayor said, "It takes only common sense to conclude that one should not be able to profit on the inadvertent inattention of others." Justice Neil M. Gorsuch did not participate because he had not been seated on the Supreme Court when the case was argued in January.

Before the high court adjourns for the summer in late June, the justices will rule on a second FDCPA case, *Henson v. Santander Consumer USA Inc.*, and decide whether someone who purchases a claim outright becomes exempt from the FDCPA.

The Facts

The Supreme Court granted *certiorari* to review a decision from the Eleventh Circuit holding that the filing of a stale claim violates the FDCPA, thereby enabling the debtor to recover attorneys' fees and up to $1,000 in statutory damages. The case involved a proof of claim filed by a debt collector where the statute of limitations "had long since run," Justice Breyer said.

The face of the proof of claim disclosed the date of the last activity, from which a lawyer would have known that the claim would be uncollectible.

The chapter 13 debtor objected to the claim, and it was disallowed. The debtor then filed suit under the FDCPA in federal district court in Alabama. The district judge dismissed the suit, saying the FDCPA did not apply. The Eleventh Circuit reversed in May 2016. To read ABI's discussion of the Eleventh Circuit's opinion and the splits of circuits, click here and here.

The Majority Opinion

Justice Breyer broke his majority opinion into two parts. First, he asked whether filing a stale claim was "false, deceptive or misleading." The answer to that question, he said, was "reasonably clear."

Like "the majority of Courts of Appeals that have considered the matter," he said that filing stale claims was neither false, deceptive, nor misleading, in part because Alabama, like most other states, provides that "a creditor has a right to payment of a debt even after the limitations period has expired." He also said that Congress adopted the "broadest available definition of claim," defining the term in Section 101(5)(A) to include a disputed claim. The statute of limitations, Justice Breyer said, has always been an affirmative defense.

He said that the "audience" in a chapter 13 case is a trustee who "is likely to understand" when a claim is time-barred.

Although the courts of appeals have uniformly found a violation of the FDCPA when debt collectors file ordinary civil suits to collect a time-barred claims, Justice Breyer was careful to say that the Court was not deciding that issue.

The second issue — whether filing a time-barred claim is unfair or unconscionable — was a "closer question," Justice Breyer said. The "context of a civil suit differs significantly from" a bankruptcy claim, he explained, since a "knowledgeable trustee is available" when a debtor files a bankruptcy petition.

The FDCPA and the Bankruptcy Code, Justice Breyer said, have "different purposes and structural features." The FDCPA "seeks to help consumers," but not necessarily by "closing a loophole in the Bankruptcy Code." To invoke the FDCPA would upset a "delicate balance" and "authorize a new significant bankruptcy-related remedy in the absence of language in the [Bankruptcy] Code providing for it."

Effectively barring debt collectors from filing stale claims, Justice Breyer said, would require creditors to investigate the merits of affirmative defenses. "The upshot could well be added complexity" and a "change in settlement incentives."

Justice Sotomayor's Dissent

Joined by Justices Ginsburg and Kagan, Justice Sotomayor devoted a significant portion of her dissent to explaining how "[p]rofessional debt collectors have built a business out of buying stale debt, filing claims in bankruptcy . . . and hoping no one notices that the debt is too old." She mentioned that the very same debt collector before the Supreme Court had entered into a consent decree with the government prohibiting the filing of further civil suits to collect stale debts and had paid $34 million in restitution.

Justice Sotomayor believes that filing a stale claim is unfair and unconscionable, just like filing an ordinary civil suit. She said, "Debt collectors do not file these claims in good faith; they file them hoping and expecting the bankruptcy system will fail."

"[E]veryone with actual experience in the matter insists" it is false, Justice Sotomayor said, to believe that bankruptcy trustees are effective gatekeepers who weed out time-barred claims.

The opinion is *Midland Funding LLC v. Johnson*, 137 S. Ct. 1407, 197 L. Ed. 2d 790, 85 U.S.L.W. 4239 (Sup. Ct. May 15, 2017).

Justice Gorsuch's maiden opinion is a unanimous decision favoring debt purchasers.

A Debt Purchaser Is *Not* a 'Debt Collector' Regulated by the FDCPA, Supreme Court Holds

In a unanimous opinion written by Justice Neil M. Gorsuch, the Supreme Court ruled today that someone who purchases a defaulted debt is not a "debt collector" and is therefore not subject to the federal Fair Debt Collection Practices Act, or FDCPA.

The case, *Henson v. Santander Consumer USA Inc.*, was argued on April 18, the second day Justice Gorsuch sat on the bench after being sworn in the week before as the high court's 113th justice. The opinion was Justice Gorsuch's first for the Supreme Court, even though he did not ask a single question or make any comments at oral argument.

Santander had purchased a portfolio of defaulted auto loans from a bank. The district court and the Fourth Circuit both held that Santander was not a "debt collector" and thus not subject to the regulations and remedies afforded to consumers under the FDCPA. The Supreme Court granted *certiorari* to resolve a split because other circuits had held that purchasing debt did not give a debt collector immunity from the FDCPA.

The FDCPA only applies to debt collectors, a term defined in 15 U.S.C. § 1692a(6) as anyone who "regularly collects or attempts to collect . . . debts owed or due . . . another." Justice Gorsuch set about deciding how to classify entities "who regularly purchase debts originated by someone else and then seek to collect those debts for their own account." He framed the question as whether the FDCPA treats "the debt purchaser . . . more like the repo man or the loan originator?"

Justice Gorsuch said the "plain language" of the definition "focuses our attention on third party collection agents working for a debt owner – not on a debt owner seeking to collect debts for itself." He said the statute "does not appear to suggest that we should care how a debt owner came to be a debt owner."

"All that matters," he said, "is whether the target of the lawsuit regularly seeks to collect debts for its own account or does so for 'another.'" That analysis, he said, "would seem" to mean that a debt purchaser does not fall under the statutory definition.

Justice Gorsuch then launched into a complex statutory and grammatical analysis, focusing largely on the word "owed." He cited two grammar books alongside the Oxford English Dictionary to debunk the notion that "owed," a past participle, means a debt previously owed to another.

Harping on the use of the past participle "doesn't follow even as a matter of good grammar, let along ordinary meaning," Justice Gorsuch said. Focusing also on how "owed" is used elsewhere in the FDCPA, he could not "see why a defaulted debt purchaser like Santander couldn't qualify as a creditor" under the "statute's plain terms."

The debtor did not fare any better with a policy argument based on the idea that the business of purchasing defaulted debt did not exist when the FDCPA was adopted. The debtor wanted the Court to believe that Congress would have viewed defaulted debt purchasers more like debt collectors than debt originators.

Justice Gorsuch declined to consult a crystal ball because "it is never our job to rewrite a constitutionally valid statutory text under the banner of speculation about what Congress might have done." He said the "proper role of the judiciary" is to "apply, not amend, the work of the People's representatives."

The opinion theoretically leaves the door open for a different result in a later case given two questions the Court did not decide. First, the debtor argued that Santander fell under the FDCPA because it regularly collected debts for another. Justice Gorsuch said that question was not raised in the petition for *certiorari*, and the Court did not agree to review it.

Second, Justice Gorsuch said the Supreme Court had not agreed to address another aspect of the definition of a debt collector in Section 1692a(6), which includes someone "in any business the principal purpose of which is the collection of any debts."

Today's decision was the high court's second venture this term into the FDCPA. On May 15 the Court held 5/3 in *Midland Funding LLC v. Johnson*, 16-348, 2017 BL 161314, 85 U.S.L.W. 4239 (Sup. Ct. May 15, 2017), that filing a time-barred claim does not violate the FDCPA. To read ABI's discussion of *Midland Funding*, click here.

The opinion is *Henson v. Santander Consumer USA Inc.*, 137 S. Ct. 1718, 198 L. Ed. 2d 177, 85 U.S.L.W. 4346 (Sup. Ct. June 12, 2017).

The Bristol-Myers decision on state class actions may eventually affect bankruptcy venue.

Did the Supreme Court Hint that Bankruptcy Venue Is Too Broad?

In June, the Supreme Court took a long step toward allowing plaintiffs to mount nationwide class actions in state court only in states where the defendants are incorporated or headquartered, or maintain their principal assets. Will *Bristol-Myers Squibb v. Superior Court of California*, 16-466, 2017 BL 208398, 85 U.S.L.W. 4400 (Sup. Ct. June 19, 2017), prompt courts to revisit rulings under the bankruptcy venue statute that allow companies to reorganize in Delaware or New York regardless of where they are located?

The answer is: By emphasizing the due process rights of defendants, *Bristol-Myers* could be read to imply that courts should assign more significance to the interests of creditors and employees in making bankruptcy venue decisions.

Bankruptcy Venue Standards

The bankruptcy venue statute, 28 U.S.C. § 1408, allows companies to file chapter 11 petitions in the states where they are incorporated or have a principal place of business, or where their principal assets are located. Since many of the country's larger companies are incorporated in Delaware or New York, those states are proper venues, even if the debtor has virtually no operations there.

There is another loophole: the affiliate venue provision in subsection 1408(2). As happened with Eastern Airlines, a large company with an inconsequential affiliate can file in New York or Delaware if that affiliate is incorporated in one of those states or has its principal assets there, even if the parent might not otherwise be eligible for venue in those favored jurisdictions.

If venue is proper under the generous bankruptcy venue rules, a court will change venue under 28 U.S.C. § 1412 "in the interest of justice or for the convenience of the parties." Assuming venue was proper in the first place, courts are generally prone to allow the case to proceed in the district chosen by the debtor and preferred by the major institutional lenders. The preferences of ordinary trade creditors and employees usually do not carry the day on a change of venue motion.

Bristol-Myers and Class Actions

In *Bristol-Myers*, the plaintiffs tried using a notion of jurisdiction that could be called the class action cousin of expansive bankruptcy venue. They sued a huge pharmaceutical company in

California, alleging harmful effects from a blockbuster drug that was generating billions a year in sales throughout the U.S.

Among the 600 plaintiffs, only 86 were California residents. The remainder were from 33 other states.

In the 8/1 opinion for the majority on June 19, Justice Samuel A. Alito Jr. said that the pharmaceutical defendant was incorporated in Delaware, had its head office in New York, and had substantial operations in New York and New Jersey. In California, the company had about 400 employees and five research facilities. The drug was neither developed nor manufactured in California; the marketing, manufacturing and regulatory approval for the drug were managed in New York or New Jersey.

In view of the Supreme Court's decision in *Daimler AG* v. *Bauman*, 571 U.S. 134 S. Ct. 746, 187 L. Ed. 2d 624, 82 U.S.L.W. 4043 (2014), the California Supreme Court concluded that the state trial court did not have general jurisdiction over the manufacturer. However, the state's high court did find specific jurisdiction. The Supreme Court granted *certiorari* to decide whether the exercise of specific jurisdiction violated the Due Process Clause of the Fourteenth Amendment.

Justice Alito explained the differences between general and specific jurisdiction. General jurisdiction arises where the defendant is "at home," for instance, in the state of incorporation. As Justice Alito said, a state court with general jurisdiction can "hear any claim against that defendant, even if all the incidents underlying the claim occurred in a different state."

"Specific jurisdiction is very different," he said. To exercise specific jurisdiction within the bounds of the Constitution, the suit must "'aris[e] out of or relat[e] to the defendant's contacts with the forum.'" Quoting another high court precedent, he said that specific jurisdiction is limited to "'issues deriving from, or connected with, the very controversy that establishes jurisdiction.'"

Justice Alito said there was no specific jurisdiction within constitutional boundaries for the non-California residents, because they did not claim to have suffered harm in that state and all of the conduct giving rise to their claims arose in other states.

Justice Alito made several observations that might be relevant in the bankruptcy context. It is often argued that bankruptcy venue far from a company's employees and the bulk of its trade creditors puts a burden on them and makes participation difficult or expensive. In the context of class actions, Justice Alito that the "the 'primary concern' is the 'burden on the defendant.'" He also alluded to "practical problems resulting from litigating in that forum."

On a topic that is arguably less significant in federal courts, he mentioned the "coercive power of a state that may have little legitimate interest in the claims in question."

At the end of his opinion, Justice Alito cited the defendant's admission that all of the plaintiffs could have sued together in either New York or Delaware.

Of ominous significance for bankruptcy cases and class actions alike, he said the opinion leaves "open the question of whether the Fifth Amendment imposes the same restrictions on the exercise of personal jurisdiction by a federal court."

The sole dissenter, Justice Sonia Sotomayor, summarized the majority opinion as meaning that "a corporation that engages in a nationwide course of conduct cannot be held accountable in a state by a group of injured people unless all of those people were injured in the forum state." She said, "there is nothing unfair about subjecting a massive corporation to suit in a state for a nationwide course of conduct that injures both forum residents and nonresidents alike."

She interpreted the opinion to mean that the Court has barred "nationwide class actions in any state other than those in which a defendant is 'essentially at home.'"

In substance, the majority and the dissent focused on fairness, although the majority focused on fairness to the defendant while Justice Sotomayor focused on fairness to the injured plaintiffs.

Implications of *Bristol-Myers* in Bankruptcy

Does *Bristol-Myers* mean anything about bankruptcy venue? Facially, the opinion means nothing at all.

Bristol-Myers deals with constitutional limitations on state courts' exercise of jurisdiction. In that sense, *Bristol-Myers* is irrelevant because bankruptcy courts clearly have subject matter jurisdiction, and, within the limits of *Stern v. Marshall*, its predecessors and progeny, bankruptcy courts exercise personal or *in rem* jurisdiction over the debtor, its assets and its creditors. Furthermore, most courts have upheld venue in the popular districts despite a debtor's lack of connections with those forums, as long as venue is technically proper.

Bristol-Myers, however, focused on fairness to the defendants as a matter of constitutional law. If that is the test, the identity of the defendant is not so clear in bankruptcy. Are creditors the defendants in bankruptcy? Or is the debtor more akin to the defendant? Or does *Bristol-Myers* imply there must be fairness to both creditors and debtors?

Bankruptcy venue has not been thought to raise questions of due process. In light of *Bristol-Myers*, should courts consider whether a distant bankruptcy venue impinges the due process rights of a debtor's employees and creditors? What about the rights of institutional lenders with the most dollars at risk?

It seem clear that the bankruptcy venue statute does not raise a due process violation on its face. If there is a conflict with the Constitution, it would arise "as applied." In venue decisions, though, courts already weigh the interests of distant creditors and employees, but perhaps not with the weight required if there were constitutional issues afoot.

If *Bristol-Myers* means anything in the bankruptcy context, it may mean that bankruptcy courts should give more weight to the interests of creditors and employees when deciding venue disputes. *Bristol-Myers* could therefore mean that a debtor's choice of venue may not be as broad as it seems on the face of the statute.

If the Supreme Court drops the other shoe and someday rules that the Fifth Amendment imposes the same restrictions in federal court, the direct implications for bankruptcy will be unavoidable. If class actions in federal court are limited to states of incorporation, principal office or principal assets, using a subsidiary as a venue hook for the entire enterprise may no longer be available if *Bristol-Myers* is expanded to cover federal courts. And if there are constitutional considerations beyond the language of the venue statutes, courts may begin forcing companies to reorganize closer to home.

Although broad bankruptcy venue has been criticized for decades, Congress has not been moved to amend that statute. Congressional acquiescence will not matter, however, if constitutional issues are at the forefront.

The opinion is *Bristol-Myers Squibb v. Superior Court of California*, 16-466, 2017 BL 208398, 85 U.S.L.W. 4400 (Sup. Ct. June 19, 2017)

Congress is the last resort for Puerto Rico to deal with looming debt default.

Supreme Court Invalidates Puerto Rico's Local Law for Municipal Debt Adjustment

The Supreme Court ruled by a vote of 5-2 that Congress both excluded Puerto Rico from chapter 9 municipal bankruptcy and precluded the island commonwealth from adopting local laws to deal with the insolvencies of its instrumentalities, such as municipal power and water companies.

The two dissenters said that "preemption here means that a government is left powerless and with no legal process to help its 3.5 million citizens." They concluded their dissent by saying, "Statutes should not easily be read as removing the power of a government to protect its citizens."

What the Opinion Means

In practical terms, Justice Clarence Thomas' June 13 majority opinion means that legislation by Congress is the last and only hope for Puerto Rico to avert a debt crisis. It is questionable whether Puerto Rico could even use some form of an equity receivership to keep the lights on and the water flowing.

To the dissenters' argument that Puerto Rico and its people "should not have to wait for possible congressional action," Justice Thomas said that "our constitutional structure does not permit this Court to 'rewrite the statute that Congress has enacted.'"

Two weeks in a row, the Supreme Court has handed down opinions allowing Puerto Rico's government to exercise less power than the states. Last week, the high court ruled in *Commonwealth of Puerto Rico v. Sanchez Valle* that the island does not have sovereign power like the states.

In the 6-2 opinion on June 9, Justice Elena Kagan held that Congress was the source of the island's sovereign powers to enact criminal laws, unlike the states, whose sovereign powers antedate the adoption of the Constitution. Consequently, the Court last week ruled that the Double Jeopardy Clause of the federal Constitution prohibits Puerto Rico, unlike a state, from prosecuting someone who had already pleaded guilty in federal court.

How Puerto Rico Was Excluded from Bankruptcy

Puerto Rico could have authorized its municipalities to use chapter 9 until the 1984 amendments to the Bankruptcy Code. For reasons it did not explain, Congress in that year prohibited Puerto Rico's instrumentalities from filing under chapter 9 when it wrote Section 101(52) of the Code to define "States" as including Puerto Rico, except for the purpose of deciding who is eligible for chapter 9. In turn, Section 109(c), referred to as the "gateway," provides that only a "municipality" can be a debtor in chapter 9. "Municipality" is defined in Section 101(40) as an instrumentality of a "State."

The definitions and cross-references mean that Puerto Rico's municipalities are ineligible for chapter 9, and the commonwealth has not argued otherwise.

No longer having access to federal bankruptcy courts, Puerto Rico still faces Section 903(1) of the Code, which says "State law" cannot bind non-consenting creditors to a debt adjustment.

Puerto Rico's Solution

Puerto Rico's governor admitted that the island is saddled with debts that are "not payable." Ineligible for chapter 9 municipal bankruptcy, Puerto Rico adopted its Public Corporation Debt Enforcement and Recovery Act in June 2014. The statute was structured so the island's public corporations could restructure debt in a manner akin to a chapter 9 debt adjustment.

That same month, bond funds affiliated with Franklin Resources Inc. and others sued the commonwealth in federal district court in Puerto Rico. In February 2015, a district judge in San Juan held that the Recovery Act was preempted by Section 903(1) of the Bankruptcy Code and therefore violated the Supremacy Clause of the U.S. Constitution on its face.

In what amounted to a 2-1 opinion in July 2015, the First Circuit held that the preemption of Puerto Rico's law was evident from the "plain meaning" of the Bankruptcy Code.

The Supreme Court granted *certiorari* at Puerto Rico's request, even though there was no split of circuits. The case was argued on March 22.

Justice Thomas' Majority Opinion

Puerto Rico presented the case to the Supreme Court as a question of statutory interpretation. The commonwealth did not contend there were residual sovereign or constitutional powers justifying the adoption of the Recovery Act. Consequently, the majority opinion does not address any theories other than statutory interpretation, while the dissenters only hint that the result could or should have been different under some notion of Puerto Rico's sovereignty or the equal protection rights of the island's residents.

Puerto Rico contended that the preemption contained in Section 903(1) does not apply to the commonwealth because nothing in chapter 9 is applicable to its municipalities given the definition in Section 101(52).

Justice Thomas rejected the argument in view of what he called the "plain text" of the statute. Although the 1984 amendment made Puerto Rico's instrumentalities ineligible for chapter 9, he held for the Court that the island "is still a 'State' for the purposes of the preemption provision" in Section 903(1). He said the dissenters' interpretation of the statute was "capacious."

The very first paragraph in Justice Thomas' opinion might be read as slamming the door on any notion that a state not electing chapter 9 eligibility retains some sovereign power to deal with the insolvencies of its instrumentalities. He said that the Bankruptcy Code "pre-empts state bankruptcy laws that enable insolvent municipalities to restructure their debts over the objections of creditors."

That statement may or may not mean that a state cannot impose a moratorium on debt payment. The majority opinion does not explicitly say that a state cannot enact a law compromising the payment of the state's own debt, as opposed to the debt of its municipalities.

Justice Samuel Alito recused himself, leaving seven justices to decide the case.

The Dissenters

Justice Sonia Sotomayor dissented in an opinion joined by Justice Ruth Bader Ginsburg. Because Puerto Rico's instrumentalities are ineligible for chapter 9, they believe that "nothing in the operation of a Chapter 9 case affects Puerto Rico's control over its municipalities." They went further to say that the definition carving out the island "excluded Puerto Rico from Chapter 9 for all purposes — it shut the gate and barred it tight."

By issuing the opinion now, rather than waiting until the Court's term ends at the end of June, the justices are placing the onus on Congress to pass pending legislation to help Puerto Rico restructure its debt under federal oversight.

The opinion is *Commonwealth of Puerto Rico v. Franklin California Tax-Free Trust*, 195 L. Ed. 2d 298, 84 U.S.L.W. 4393 (Sup. Ct. June 13, 2016).

Supreme Court reverses Fifth Circuit on 'actual fraud' dischargeability case.

Supreme Court: Misrepresentation Not Required for 'Actual Fraud' Nondischargeability

Reversing the Fifth Circuit, the Supreme Court held in *Husky International Electronics Inc. v. Ritz* that a debt can be nondischargeable for "actual fraud" under Section 523(a)(2)(A) of the Bankruptcy Code in the absence of a fraudulent misrepresentation to the creditor.

Writing the majority opinion on May 16, Justice Sonia Sotomayor held that "actual fraud" subsumes "forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation." A "fraudulent conveyance of property made to evade payments to creditors" is among the types of actual fraud that can result in a nondischargeable debt, she said.

Dissenting in the 7-1 decision, Justice Clarence Thomas argued that the majority's opinion ignores the plain meaning of the statute. Citing the *Norton* and *Collier* treatises that agree with his interpretation, he said that the "context" of the subsection "dictates that 'actual fraud' ordinarily does not include fraudulent transfers."

The majority's decision means that the debt owing to a creditor who suffers an identical injury will be discharged if that creditor does not mount an objection or holds a debt so small that objecting to dischargeability would be foolish.

The Facts of the Case

A man caused his company to transfer funds to other companies that he owned or controlled. The man later went bankrupt. Husky, owed $164,000 by the company, sued the man in bankruptcy court to hold him liable for the corporate debt and to bar discharge of the debt under Section 523(a)(2)(A).

The bankruptcy judge found that property transferred from the company to the bankrupt was a constructive fraudulent transfer because it was made without adequate consideration. Nonetheless, the bankruptcy judge rejected the request to bar discharge of the $164,000 debt to Husky. Reversing the bankruptcy court in part, the district court held that Husky was entitled to pierce the corporate veil and make the man personally liable for the debt. Nevertheless, the district court agreed with the bankruptcy court by ruling that the debt was dischargeable because the man made no misrepresentation to Husky. In a May 2015 opinion penned by Circuit Judge Carolyn King, the Fifth Circuit upheld discharge of the debt because there was no misrepresentation to Husky.

Harkening back to the *Prosser* hornbook definition of "actual fraud," the Fifth Circuit held that denial of discharge of a debt under the subsection requires misrepresentation made by the bankrupt to the creditor and reliance by the creditor. Judge King's opinion said there was no authority for the proposition that actual fraud encompasses constructive fraudulent transfers.

Underpinning the Fifth Circuit's holding was the fact that the bankrupt made no misrepresentations to the creditor.

Judge King spent the better part of her opinion explaining why a 2000 decision by Circuit Judge Richard A. Posner in *McClellan v. Cantrell* was wrong. In that case, Judge Posner held that a fraudulent misrepresentation was not the only form of fraud that renders a debt nondischargeable under subsection (a)(2)(A).

In July 2015, the First Circuit decided a similar case and agreed with Judge Posner's conclusion. To resolve a 2-1 split, the Supreme Court granted *certiorari* and heard argument on March 1.

The Statute

Section 523(a)(2)(A) prohibits discharge of debts "obtained by ... false pretenses, a false representation or actual fraud."

The former Bankruptcy Act barred discharge of a debt obtained by "false pretenses or false representation." When it adopted the Bankruptcy Code in 1978, Congress added "actual fraud." Justice Sotomayor said it was "therefore sensible" to interpret the new language as not meaning "the same thing as 'a false representation.'"

The Majority Opinion

The majority opinion says it is "equally important" under common law that "fraudulent conveyances, though a 'fraud,' do not require a misrepresentation from a debtor to a creditor." As an example, Justice Sotomayor pointed to a transfer to a relative, where the fraud occurs due to "concealment and hindrance," not from "inducing a creditor to extend a debt."

Summing up the first part of the opinion, Justice Sotomayor said that "false representation has never been a required element of 'actual fraud,' and we decline to adopt it today."

Justice Sotomayor next dealt with the debtor's argument that not requiring a misrepresentation would create overlap with subsections (a)(4) and (a)(6), which except debts from discharge for fraud or defalcation while acting in a fiduciary capacity and for willful and malicious injury to property. She admitted there is overlap, but said that "overlap is inevitable." She saw "no reason

to craft an artificial definition of 'actual fraud' merely to avoid narrow redundancies in Section 523 that appear unavoidable."

The debtor also argued that a broader interpretation of (a)(2)(A) overlaps with Section 727(a)(2), which can result in denial of discharge of all debts if the debtor committed a fraudulent transfer with actual intent to hinder, delay or defraud within one year of bankruptcy.

Although the two sections "cover some of the same conduct, they are meaningfully different," Justice Sotomayor said. A Section 727 violation is broader by preventing discharge of all debt, but is narrower than subsection (a)(2)(A) regarding timing.

The Dissent

Dissenting, Justice Thomas said that subsection (a)(2)(A) only covers situations where money or property was "obtained by" actual fraud. He said that a violation occurs "only when the fraudulent conduct occurs *at the inception of the debt.*" [Italics in original.] In the case on *certiorari*, the debtor's fraudulent transfers to his companies "did not trick the creditor into selling his goods."

The Application of *Husky* in Practice

Husky entailed fraudulent transfers for lack of adequate consideration that contributed to making the company unable to pay its debts. Even though the transfers were technically made by the debtor's company, the debtor himself would have been denied a discharge of all his debt under established principles had he orchestrated the company's fraudulent transfers within one year of his own bankruptcy with actual intent to hinder or delay the company's creditors.

As a result of *Husky*, an individual who orchestrates his company's fraudulent transfer more than a year before bankruptcy will forfeit dischargeability of debt owing to a particular creditor, so long as that creditor mounts an objection.

A similarly situated creditor who does not bother to object will see that debt discharged, despite suffering an identical injury.

To promote equality of treatment of creditors, will trustees now initiate proceedings on behalf of all similarly situated creditors to preclude the discharge of those debts? Or can one creditor mount a dischargeability objection on behalf of a class of similarly situated creditors?

In either instance, the result, if successful, would be equivalent to a denial of discharge even though the infringing fraudulent transfer occurred more than one year before bankruptcy.

Were he still alive, Justice Antonin Scalia might have agreed with Justice Thomas and lent a strong voice in favor of upholding the Fifth Circuit. As it is, the lower courts must now struggle with the task of crafting rules so that dischargeability objections do not morph into denials of discharge. They must also confront the task of ensuring that debts owing to deep-pocket creditors are not the only ones discharged when a debtor's conduct could result in the denial of discharge of debts owing to many creditors.

Arguably, the *Husky* opinion finds the Supreme Court making what the majority see as a logical extension of the statute. Justice Scalia might have attacked *Husky* as judicial legislating. In any event, creditors now have a new weapon to use against debtors, and bankruptcy courts must begin crafting new rules to deal with problems created by *Husky*.

The opinion is *Husky International Electronics Inc. v. Ritz*, 136 S. Ct. 1581, 194 L. Ed. 2d 655 (Sup. Ct. May 16, 2016).

Faculty

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Hon. John T. Gregg is a U.S. Bankruptcy Judge for the Western District of Michigan in Grand Rapids, appointed on July 17, 2014. He was recently appointed to the Bankruptcy Appellate Panel for the Sixth Circuit. Previously, Judge Gregg was a partner with the law firm of Barnes & Thornburg LLP, where he focused on corporate restructuring, bankruptcy and other insolvency matters. Judge Gregg served as chair of the education committee of the National Conference of Bankruptcy Judges for 2022, serves on the ABI's Board of Directors, was recently inducted as a Fellow of the American College of Bankruptcy, and is a member of the American Law Institute. He is a frequent writer and speaker on bankruptcy and other commercial issues, and he has written and co-edited numerous secondary sources, including *Collier Guide to Chapter 11*, published by LexisNexis; *Strategies for Secured Creditors in Workouts and Foreclosures*, published by ALI-ABA; *Issues for Suppliers and Customers of Financially Troubled Auto Suppliers*, published by ABI; *Michigan Security Interests in Personal Property*, published by the Institute of Continuing Legal Education; *Handling Consumer and Small Business Bankruptcies in Michigan*, published by the Institute of Continuing Legal Educa-

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