AMERICAN BANKRUPTCY INSTITUTE

# 2018 Southwest Bankruptcy Conference

# Very Good Debates

**John W. Lucas, Moderator**
*Pachulski Stang Ziehl & Jones LLP; San Francisco*

## *Judicial Debate*

Resolved: Hiring an independent CRO displaces the need for the appointment of a chapter 11 trustee under § 1104(e) of the Bankruptcy Code.

**Pro: Hon. Scott C. Clarkson**
*U.S. Bankruptcy Court (C.D. Cal.); Santa Ana*

**Con: Hon. Mary Jo Heston**
*U.S. Bankruptcy Court (W.D. Wash.); Tacoma*

## *Business Debate*

Resolved: Holders of acquired claims should be required to disclose the basis in such a claim as a condition for seeking relief in a bankruptcy case.

**Pro: Gregory E. Garman**
*Garman Turner Gordon; Las Vegas*

**Con: Thomas J. Salerno**
*Stinson Leonard Street LLP; Phoenix*

## *Consumer Debate*

Resolved: The exemption law of the state to which a debtor has recently moved should be used in the debtor's bankruptcy case, with the former state law used as a cap on homestead exemptions.

**Pro: Mark Gorton**
*Boutin Jones; Sacramento, Calif.*

**Con: Estela O. Pino**
*Pino & Associates; Sacramento, Calif.*

**CLARKSON OPENING STATEMENT**

Appointment of a Chapter 11 Trustee in all cases where a motion arises is like the rule of the 1980s. "Just because you can get a ticket to a Journey concert doesn't mean you should go."

The question before us is this:

*Can, or perhaps should, a bankruptcy court allow the employment of a Chief Restructuring Officer as a substitute for appointment of a Chapter 11 Trustee in specific cases? The answer is clearly "yes," and let me take these few minutes to say why.*

**Courts Have Discretion to Appoint a Trustee Under 11 U.S.C. § 1104.**

11 U.S.C. § 1104 states that a court shall order the appointment of a trustee either: (1) "for cause" or (2) the appointment is in the interests of creditors, equity stake holders, or other interest of the estate. In interpreting § 1104, courts have large discretion when determining whether to appoint a trustee. Moreover, many bankruptcy courts state that the burden of proof for a party moving for appointment of a trustee is a "clear and convincing" standard rather than a preponderance of evidence.

In *In re H & S Transp. Co.*, 55 B.R. 786, 790 (Bankr. M.D. Tenn. 1982), the court stated that § 1104 creates a "flexible standard" for appointment of a trustee, and must be applied on a case-by-case basis. In determining whether to employ a trustee, there is a strong presumption that the debtor in Chapter 11 case should continue to be in control and possession of the business.

Moreover, *In re Clinton Centrifuge, Inc.*, 85 B.R. 980, 983-84 (Bankr. E.D. Pa. 1988), the court denied appointment of a trustee even when the debtor's postpetition lease transactions violated 11 U.S.C. 363(b)(1). Despite the debtor's conduct, the court stated that "one would expect to find some degree of incompetence or mismanagement in most businesses . . . seek[ing] protection under Chapter 11." The concepts of incompetence and dishonesty cover a wide spectrum of conduct, and courts have broad discretion in applying such concepts to show cause. Moreover, 11 U.S.C. § 1105 gives the bankruptcy court "uncircumscribed power to terminate" a trustee's appointment. It is difficult to

maintain that a court has no discretion in deciding when a trustee is needed but unfettered discretion to terminate the appointment.

Therefore, many courts require a high standard to justify appointment of a Ch. 11 Trustee, and courts have discretion in deciding whether to appoint a trustee. Moreover, there is a strong presumption that the debtor in Chapter 11 case should continue to be in control and possession of the business.

**The considerations for appointment of a Chapter 11 Trustee.**

There is no doubt that many good reasons exist for the appointment of a Trustee. However, the appointment of a trustee is viewed as an extraordinary remedy, as it displaces current management and assumes the decision-making functions of the Debtor. and undermines the basic concept of debtor-in-possession that is rooted in Chapter 11 bankruptcy.

Moreover, once a trustee is appointed, the debtor loses exclusive right to propose a chapter 11 reorganization plan pursuant to § 1121 of the Bankruptcy Code. Any party in interest may submit a competing plan, which may delay the reorganization process. A court may be compelled to process a filed plan through a disclosure statement hearing despite it not being supported by any major constituency.

**The discretion afforded a court in appointing a Chapter 11 Trustee.**

Notwithstanding the views of some, including the Office of the United States Trustee, there is significant discretion afforded to bankruptcy courts in appointing a Chapter 11 Trustee. And, simply put, If the selection and appointment of a Chief Reorganization Officer would reduce and/or eliminate the "cause" for the appointment, then the bankruptcy court is completely justified in denying a motion to appoint a chapter 11 trustee.

The U.S. Trustee's office contends that employment of a CRO as a replacement to a Chapter 11 Trustee is contrary to the intent of the Bankruptcy Code.[1] Indeed, there is no specific statutory provision in the Bankruptcy Code for such action. However, there are provisions that allow for employment of a CRO.

The majority of companies rely on § 327(a) for authority to retain a CRO. § 327 (a) states that debtor, subject to court approval, may employ . . . "other

[1] Remarks of Clifford J. White III Before the Insol International Group of Thirty-Six, pp. 4

professionals" that are "disinterested persons." The court in *In re Madison* states that a "professional" is a person who plays a central role in the administration of the estate.[2] Given that a CRO guides a firm through the bankruptcy process, a CRO can appropriately be considered a "professional" under § 327.

If a CRO is found to be a professional, the CRO must demonstrate that he is a "disinterested person" and does not hold or represent an interest adverse to the estate.[3] § 101(14) defines a disinterested person as someone who is not a creditor, equity security holder, insider, director, officer, or employee of the debtor, and does not have an interest materially adverse to interest of the estate.[4] Because CROs are often retained at the suggestion of the largest creditors, many critics contend that CROs are not disinterested.

However, the court in *In re Bluestone* stated that a CRO has the same ability as a Chapter 11 Trustee concerning the rights, powers, and duties of a debtor in possession.[5] Moreover, selection and employment of a CRO requires court approval.[6] A court has discretion in determining whether a CRO is a "disinterested person." [7] Further, many courts have employed the Jay Alix Protocol when employing a CRO.[8] The Office of the U.S. Trustee has fully supported these Protocols. The Jay Alix Protocol has several requirements for retention of a CRO, most notably that a party may only serve as either: (1) a risis manager or CRO under § 363; (2) a financial advisor under § 327; (3) a claims administrator under 28 U.S.C. §256(c); or (4) an investor or acquirer. A firm may only serve in one of these roles, but is precluded from switching roles.[9]

**Conclusion.**

Courts have the power to approve the employment of CROs. Courts also have the authority, for cause, to appoint a Chapter 11 Trustee. When the employment of a CRO eliminates the "cause for appointment" of a Chapter 11 Trustee, generally a high standard to begin with, no reductive reading of a statute or rule, or any turf-

---

[2] *In re Madison Mgmt. Grp., Inc.*, 137 B.R. 275, 283 (Bankr. N.D. Ill. 1992)
[3] Shai Y. Waisman and John W. Lucas, "The Role and Retention of the Chief Restructuring Officer," 203
[4] 11 U.S.C. § 101
[5] *In re Blue Stone Real Estate, Constr. & Dev. Corp.*, 392 B.R. 897, 902 (Bankr. M.D. Fla. 2008).
[6] *See* 11 U.S.C. 327(a).
[7] *In re Blue Stone*, 392 B.R. at 897.
[8] Larribeau, Lisa, Chapter: 1 Retention of a CRO, pp. 12
[9] *Id.*

protecting unit of government, should impair a bankruptcy court from guiding a Chapter 11 case through the already difficult labyrinth of the reorganization process.

Resolved: ***Holders of acquired claims should be required to disclose the basis in such claim as a condition for seeking relief in a bankruptcy case.***

Pro: Greg Garman

1. Modern Financual Instruments Have Left a Gap In BK Code That Needs To Be Filled

2. Bankruptcy Was Built On Disclosure
    a. Since codification, BK system was built to be a transparent process;
    b. Renegotiation and Restructuring Is Better Than Liquidation
    c. Pre-Bankruptcy, parties are free to agree agree to terms negotiated
    d. Post-Bankruptcy, all important agreements require court approval, after notice/hearing/disclosure

3. Transparency is Important To Protect The Process
    a. Transparency was designed to maximize recovery and create confidence in the process;
        i. Section 107 – Public Proceedings and Public Documents
        ii. Petition Public/Schedules Public/Employment Process Public/Claims Process Public/Sale Process Public/Plan Process Public
        iii. Cash Collateral/DIP requires court approval with vast amounts of information

4. Disclosure Is Required In Non-Bankruptcy Restructurings
    a. Outside of BK, control is gained via equity, in BK control is usually gained via debt
    b. BK Code is similar (and sometimes modeled after) the '34 Securities Act
        i. The 34 Act requires equity holders who acquire 5% of a public company public disclosures that are invasive – including purpose of acquisition
        ii. Similar rules govern parties attempting to take over companies through Tender offers

5. Credit Default Swaps, Derivatives, Shorts, Hedging and Non-Economic Based Claims Trading All Pose Dangers to The BK System
    a. BK system assumes creditors are attempting to maximize recovery
    b. Statutory gap when they act differently
    c. Reorganization can be replaced with liquidation because of unforeseen motivations
    d. Explosion of exotic instruments
    e. Undermines the system as a whole, but it the priority schemes and plan process especially

6. BK Rule 2019 Was A First Step To Plugging The Regulatory Hole
    a. Applies to groups and committees
    b. Requires "Disclosable Economic Interest"

7. Similar Purpose Behind Rule 3001
    a. Admittedly its been limited in recent years,
    b. Designed to provide transparency to the motivations of claims traders/holders
    c. Courts have fund one of the evils of bk trading is the increased burden on estate of monitoring, administering and objecting to claims

8. Use DBSB North America 421 B.R. 133 (Bankr.SDNY 2009) As Example
    a. DISH made an investment not for purposes of a traditional creditor, but to gain a foothold and advantage in effort to acquire strategy asset.
    b. Paid 100 cents for claims late in game not for purpose of maximizing recovery
    c. Bad Faith/Undermines BK/Makes Liquidation more likely.

9. Pull It All Together/Conclusion

Con: Tom Salerno

1. So Greg wants us all to disclose what was paid for acquired debt....other than intense curiosity, to what end? Really?

    a. Will concede it would be entirely different in dealing with insiders—whole different ballgame!
    b. Let's play this out in the non-insider context.

2. Secondary trading in debt is not a bad thing—not at all!

    a. Creates liquidity for claims holders.
    b. Doesn't hurt the debtor—they borrowed $100—even after a trade claim, debtor still owes $100.

3. So what's really the point of requiring disclosure of what a non-insider bought a debt for?

    a. What is really gained by this process?
    b. Requiring disclosure will do two (2) things in commercial cases—
        i. Create litigation leverage over the holder of a debt; and
        ii. Create instability in the secondary debt market.
        iii. Not evil or harmful to the integrity of the process--consider a recent 9th Circuit decision that held that buying up debt just to block a plan isn't the basis for designating claims as bad faith. [Get case name].

    c. Bottom line—a transaction involving non-debtor parties negotiating a discount in debt somehow accrues to the benefit of the estate? If it doesn't (which legally it does not)—what precisely is the point in requiring disclosure?

DOCS_SF:97553.1 68700/001

4. Partisanship aside, this issue was examined by the ABI Bankruptcy Review Commission in 2014—at great length. The group that examined this was not made up of investment bankers and vulture traders. It was a truly bipartisan group.

    *a.* With respect to this particular issue, the Commission considered whether claims purchasers should be required to disclose the price they paid for claims. *See* Final Report, § VI.D. The majority of the Commissioners believed that the price paid for a claim or the reason for the purchase of claims "would be irrelevant to the merits or substantive legal issues in a dispute in the case." *Id.* In the circumstances where it might matter, several Commissioners noted that bankruptcy courts already have the ability to sanction inappropriate conduct through tools such as claim subordination or vote designation. *Id.*
    b. Ultimately, the Commission agreed that an active secondary market for claims trading enhances liquidity opportunities for debtors and creditors and thus it "perceived little benefit to increased regulation of claims trading activities." *Id*.

5. So, if acquisition price is somehow relevant , why wouldn't an equipment supplier's basis, or a landlord's basis as to how rent was arrived at or even a vendor's basis in the costs of goods sold to the debtor also be relevant? How much profit margin are you baking into the goods here? Don't even get me started on big pharma!

    a. Once that Pandora's box is open, the market reaction could result in a plague upon distressed companies with fewer parties willing to do business with debtors and companies facing financial distress. Debtors are not necessarily helped by having "par" debtholders in their capital structure.
    b. Moreover, par debtholders seeking secondary market transactions may well be hesitant to sell debt knowing that public disclosure of the sales price will be required since it puts them at a strategic disadvantage in negotiating such transactions.
    c. The acquisition basis is also proprietary information to the claims purchaser. It will create instability in the secondary

debt marketplace—no one will want to play in a market that they will have to disclose confidential proprietary information.

6. So, let's be careful what we ask for here. The law of unintended consequences can be harsh!

    a. Shutting down or severely impeding the debt market benefits who, exactly? The debtor? No—stuck with a bunch of par players in the case.
    b. Vultures will always exist out there—shining a light on their pricing/acquisition costs likely will only make them look for other shiny things to invest in…
    c. Like litigation financing---but I digress!

## Affirmative Opener

***RESOLVED: The exemption law of the state to which a debtor has recently moved should be used in the debtor's bankruptcy case, with the former state law used as a cap on homestead exemptions***.

1. Where we are, how we got here, why we need change and how the change would work.

2. Where we are

   A. Describe BAFJA exemption amendments

   B. 730 continuous domicile - BAPCPA extended from 91 to 730 days the number of days prior to the filing that a debtor must be domiciled in a state in order to claim that state's exemptions. See Code § 522(b)(3)(A)

      - 180 prior to the 730 – 522(b)(3)(A)

      - Savings clause 522(b)(3)(C) hanging paragraph

   C. 1215 day federal cap - with respect to real property acquired by the debtor within the 1215-day period prior to the bankruptcy, and claimed by the debtor under state law as a homestead, the exemption may not exceed $125,000 [now $160,375 as of April 1, 2016]. § 522(p)(1)

      - Caveat – federal cap NA to farmer and intrastate transfers – 522(p)(2)

        – federal cap applies to
        felons involved in abusive filing 522(q)(1)(A) and

debtors who engaged one of the enumerated acts of wrongdoing, including securities fraud, in § 522(q)(1)(B)

But – these bad actors can, get relief from cap to the extent the amount over "is reasonably necessary for the support of the debtor or any dependent." 522(q)(2)

D. 10 year dishonest -§ 522(o)(4) hanging paragraph provides a ten-year disallowance of exemptions obtained by means of the fraudulent conversion of nonexempt assets to exempt form

3. How we got here

A. Discuss exemption history & no political force for uniform federal exemptions.

B. Describe American Mobility and need for bk to accommodate, but a small %

C. Describe the impetus for BAPCPA and how we got here – Millionaire Mansion Loophole, lobbyists and failure to consider experts

4. Why we need change

A. Describe problems with literal application of state exemptions
   - residency
   - location - extraterritoriality
   - interpretation

5. How the change would work

A. The resolution would be implemented subject to the following limitations:

(1) The application of the former state amount may not increase the homestead unless the increase is to reach the 522(d)(1) federal homestead amount.

(2) The debtor would be allowed a homestead on a residence in the former state if she has none in the filing state.

B. Examples of two honest debtors
under current law
under resolution

## CON

1. My colleague is correct, the current system is not ideal. It has created litigation and can be seen as punishing ordinary working Americans moving states for reasons unrelated to exemption planning such as upward mobility, retaining their jobs in the face of plant closures, or even caring for elderly or infirm family members.

2. Previous version of 522(b)(2)(A) statute before the enactment read as follows

   …any property that is exempt under Federal law, other than subsection(d) of this section, or State or local law that is applicable on the date of the filing of the petition at the place in which the debtor's domicile has been located for the 180 days immediately preceding the date of the filing of the petition, or for a longer portion of such 180-day period than in any other place…

   (b)(2)(3) not only added the 730 day domicile requirement discussed by Mr. Gorton, but made the exemption subject to subsections (o) and (p).

3. The statute was amended to deal with perceived abuses. OJ Simpson and Ken Lay, are the poster children for the abuses, neither of which ever filed bankruptcy.

4. Resolution is not ideal.

   A. It is incomplete.

   B. There are no temporal limits. What is the meaning of recent? Leaving the definition of the term recent to development of case law will lead to additional litigation and inconsistent results across the country.

C. Using the former state law as a cap may be seen as exporting the former state's exemption law, which may not be extraterritorial.

D. The resolution can cause manipulation such as an abusive millionaire debtor moving from a state with no cap to a state with a cap, but invoking the no cap from the previous state.

E. It does not deal with abuse because it does not have any provision for dealing with a net increase in the homestead exemption.

5. Perhaps the way to solve the problem is to return to the alignment of venue and exemption law and allow the abusive debtors to be dealt with under 522(o), (p), and (q). 522(o), (p), and (q), which are not perfect solutions and may need to be enhanced or modified. On the other hand, we have 13 years of case law interpreting and enhancing these code sections. These code sections focus on the debtor's conduct and not on the mere happenstance of geography for the non-abusive debtor.

6. The goal is to protect honest Debtors and to prevent abuse, and to minimize litigation. The resolution, as written, does not go far enough to accomplish these goals and can create additional problems of manipulation without additional provisions as suggested by my colleague.


***Fourth Circuit avoids a result that would have left some debtors ineligible for any exemptions.***

# Three Circuits Approve Extraterritorial Application of a State's Exemptions

Joining the Eighth and Ninth Circuits and handing down another debtor-friendly opinion, the Fourth Circuit cleaned up some of the mess that Congress made in Section 522(b)(3)(A) regarding exemptions claimed by individuals who change their domicile before filing bankruptcy.

The May 4 opinion by Circuit Judge Robert B. King rejected plausible interpretations of the statute that could leave some debtors ineligible for any exemptions, state or federal.

The debtor moved to West Virginia from Louisiana four months before filing bankruptcy. Utilizing Louisiana's exemption statute, he claimed exemptions for about $3,500 of personal property located in West Virginia.

The trustee objected to the exemptions, contending that Louisiana exemptions could not be applied extraterritorially in view of the Supreme Court's presumption against extraterritoriality. The bankruptcy court allowed the exemptions and was upheld on appeal by District Judge Irene M. Keeley of Clarksburg, W.Va.

Again upholding the exemptions in the circuit court, Judge King characterized Judge Keeley's opinion as "well reasoned" and "comprehensive." To read ABI's discussion of Judge Keeley's opinion, click here.

## The Statutory Mess

Attempting to prevent abuse, Congress made a hash out of Section 522(b)(3)(A) and compounded the problem by adding the so-called hanging paragraph, which, Judge King said, "has been the subject of some dispute in the bankruptcy courts."

Generally, a debtor is eligible for exemptions in the state where the debtor had been domiciled for 730 days before bankruptcy. To deter exemption shopping by people who would move within two years before bankruptcy to take advantage of another state's more generous exemptions, Section 522(b)(3)(A) provides that the debtor must take exemptions from the state where he or she resided for the largest part of the 180-day period before the 730-day period.


The statute had a problem, however, because Section 522(b)(3)(A) would leave some debtors eligible for no exemptions. To fill the gap, Congress added the hanging paragraph, which allows the debtor to claim federal exemptions specified in Section 522(d) if (b)(3)(A) makes a debtor ineligible for any state's exemptions.

The Case at Hand

The trustee conceded that the debtor could invoke Louisiana exemptions under Section 522(b)(3)(A) for property located in Louisiana. However, the trustee disputed the claim for exemptions covering the debtor's property in West Virginia, even though Louisiana does not limit the application of its exemptions to Louisiana residents or to property in Louisiana.

The trustee argued for the presumption against extraterritoriality, also known as the anti-extraterritoriality approach, under which a bankruptcy court may not give extraterritorial effect to any state's exemption laws. His theory would have precluded the debtor from using Louisiana law to exempt property in West Virginia.

The Fourth Circuit's Analysis

Judge King said that "almost all courts" have rejected the trustee's theory because it "would lead to nonsensical results." An example: Debtors who move would be ineligible for exemptions because they likely would have no property in their former domicile, the only state in which they could have exemptions under the anti-extraterritoriality approach. Judge King said that the only bankruptcy court to adopt this theory was "promptly overturned on appeal."

The second minority view, called the preemption approach, would permit a debtor to apply a state's exemption laws to nonresidents and out-of-state property, even if state law does not allow extraterritorial effect. Like Judge Keeley, Judge King rejected the idea. If "Congress had intended to override state laws limiting the use of exemption schemes to in-state residents or in-state property, it would not have placed the hanging paragraph in Section 522(b)(3)," he said.

The preemption approach, he said, would make the hanging paragraph applicable only to debtors who had resided in foreign countries.

Judge King adopted the so-called state-specific approach, which is followed by the Eighth and Ninth Circuits and a majority of courts. He said it best embodies congressional intent and the bedrock principle that "exemptions are entitled to the most liberal construction in favor of the debtor."

Judge King said there were no principles of Louisiana law that would bar out-of-state debtors from utilizing Louisiana's exemption statute. He also rejected the trustee's reliance on the Supreme Court's presumption against extraterritoriality.


Citing Fourth Circuit precedent, Judge King said that the presumption does not apply to conduct that occurs largely within the U.S. Therefore, he allowed the debtor to rely on Louisiana law and exempt property in West Virginia.

A Proposal to 'Fix' Section 522

In the circuit court, *pro bono* co-counsel for the debtor was Eugene Wedoff, the immediate past president of American Bankruptcy Institute and a former bankruptcy judge in Chicago.

In a message to ABI, Judge Wedoff said that "Section 522 is very much in need of a Congressional 'fix.'"

Judge Wedoff believes that Congress should "make the debtor immediately subject to the exemption law of the state to which a debtor has moved, but cap the homestead exemption and perhaps other very large exemptions for two years after the move at the level set by the debtor's former state of domicile."

Judge Wedoff said that his proposal would "eliminate the 'millionaire's loophole' that Congress was concerned about in BAPCPA without creating the confusion caused by applying a state's exemptions to debtors who are no longer domiciled in that state."

The "simplest fix," Judge Wedoff said, would be "a set of uniform federal exemptions, but that is very unlikely to be politically possible."

The opinion is *Sheehan v. Ash*, 17-1867 (4th Cir. May 4, 2018).


***Newly appointed Circuit Judge Willett has a way with words.***

# Belatedly Purchasing a Claim Won't Confer Appellate Standing, Circuit Rules

Belatedly purchasing a claim will not bestow appellate standing, according to an erudite opinion by newly appointed Fifth Circuit Judge Don R. Willett.

The chapter 7 trustee for a corporate debtor filed an application to hire special counsel for a suit against the debtor's owner, among other defendants. The owner opposed the retention, contending that the lawyer had a conflict because the lawyer also represented the debtor's primary creditor.

The bankruptcy court approved the retention, ruling that the owner lacked standing to object. The owner appealed, and the district court dismissed the appeal for lack of appellate standing. So did Judge Willett in a June 20 opinion after the owner went to the Fifth Circuit.

Perhaps sensing that his appeal was doomed to dismissal for lack of standing, the owner purchased a claim while his appeal was pending in district court. The owner aimed to take advantage of Section 327(c), which provides that a lawyer is not disqualified from representing a chapter 7 trustee "solely because of such person's employment by or representation of a creditor."

If "there is objection by another creditor," the subsection goes on to say that the court "shall disapprove such employment if there is an actual conflict of interest."

According to Judge Willett, the owner contended that Section 327(c) bestows standing on a creditor who might otherwise lack a pecuniary interest to confer appellate standing.

To assert "standing because he is *now* a creditor . . . proves too little, too late. Now matters not. Standing is 'determined as of the commencement of the suit.' And [the owner] was not a creditor at the time the trustee sought to employ [the firm] or at the time the bankruptcy court held a hearing on his objection," Judge Willett said. [Emphasis in original.]

Given that the owner purchased a claim while his appeal was pending in district court, Judge Willett held, "Timing matters, though, and [the owner] cannot belatedly claim creditor status and establish standing retroactively."


The opinion is also noteworthy for Judge Willett's summary of Fifth Circuit jurisprudence on appellate standing in the bankruptcy context. However, we recommend reading the six-page opinion for his delightful use of the English language. Here are some examples:

"In bankruptcy litigation, the mishmash of multiple parties and multiple claims can render things labyrinthine, to say the least. To dissuade umpteen appeals . . . ."

"Because the order does not reach [the owner's] wallet, he cannot reach this court."

"Allowing each and every party to appeal each and every order would clog up the system and bog down the courts. Given the specter of such sclerotic litigation, standing to appeal a bankruptcy court order is, of necessity, quite limited."

A former justice of the Texas Supreme Court, Judge Willett was nominated to the circuit court by President Trump. He received his commission in January 2018 following a 50-47 vote in the Senate.

The opinion is *Furlough v. Cage (In re Technicool Systems Inc.)*, 17-20603 (5th Cir. June 20, 2018).


***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 March5 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).


***To warrant 'designation,' a claim purchaser must have an 'ulterior motive' beyond self-interest.***

# Buying Just Enough Unsecured Claims to Defeat Confirmation Is Ok, Ninth Circuit Says

Buying barely enough unsecured claims to defeat confirmation of a plan is not reason in itself for barring a secured creditor from voting the purchased claims against confirmation of a chapter 11 plan, according to the Ninth Circuit.

In *Figter Ltd. v. Teachers Ins. & Annuity Association of America (In re Figter)*, 118 F.3d 635, 639 (9th Cir. 1997), the Ninth Circuit ruled that a secured creditor was entitled to vote unsecured claims against confirmation of a chapter 11 plan when the lender had purchased all the claims in the class. In his June 4 opinion, Ninth Circuit Judge N. Randy Smith expanded *Figter* by ruling emphatically that a secured creditor is not in bad faith by purchasing just enough claims to defeat confirmation, thereby adversely affecting other creditors.

Owed about $4 million, the secured creditor spent $13,000 on advice of counsel to purchase just over half in number of the chapter 11 debtor's unsecured claims. The purchased claims represented only 10% of the unsecured class in amount.

The lender's counsel testified that the client made no attempt at purchasing all unsecured claims. The client's motivation, the lawyer said, was to acquire a blocking position and do what was best for the lender.

Although the debtor had the required two-thirds vote in amount in the unsecured class to confirm the plan, the debtor was facing defeat because a majority in number of unsecured creditors were not voting in favor of the plan as required by Section 1126(c). The plan would pay unsecured creditors in full in a few months.

The debtor moved to "designate" the unsecured claims purchased by the lender under Section 1126(e), which provides that the court "may designate any entity whose acceptance or rejection of such plan was not in good faith . . . ." In substance, "designate" means to disallow voting.

The bankruptcy court designated the claims and later confirmed an amended version of the plan. Judge Smith said that the bankruptcy court based designation on just two facts: (1) the lender did not offer to purchase all unsecured claims, and (2) voting the purchased claims against the plan would give the lender an "unfair advantage" and would be "highly prejudicial" to other creditors.


The district court affirmed, but the Ninth Circuit reversed.

Judge Smith said that the Bankruptcy Code does not define "good faith" as used in Section 1126(e). *Figter*, he said, defined "bad faith" as an attempt to "secure some untoward advantage over other creditors for some ulterior purpose." Judge Smith quoted *Figter* as holding that designation applies to creditors who were "'not attempting to protect their own proper interests, but who were, instead, attempting to obtain some benefit to which they were not entitled.'"

According to *Figter*, "bad faith explicitly does not include 'enlightened self-interest, even if it appears selfish to those who do not benefit from it,'" Judge Smith said. Therefore, purchasing claims to obtain a blocking provision and to protect a creditor's own claim "does not demonstrate bad faith or an ulterior motive," *Figter* held.

Purchasing all unsecured claims was only one factor prompting the *Figter* court to find good faith, Judge Smith said. He cited Second Circuit authority for the proposition that purchasing claims to block a plan is not bad faith in itself.

Judge Smith faulted the bankruptcy court for not analyzing the lender's motivation and failing to identify an "ulterior motive." Citing *Figter*, he said that self-interest and ulterior motive are not identical. Ulterior motive is attempting to obtain a benefit to which the creditor is not entitled, Judge Smith said, again citing *Figter*.

Examples of bad faith, according to Judge Smith, include purchasing a claim to block a lawsuit against the purchaser or buying claims to destroy a competitor's business. "There must be some evidence beyond negative impact on other creditors," Judge Smith said.

In sum, the bankruptcy court erred by making no findings about the lender's motivation and by considering the effect on other creditors without evidence of bad faith.

The opinion is *Pacific Western Bank v. Fagerdala USA-Lompoc Inc. (In re Fagerdala USA-Lompoc Inc.)*, 16-35430 (9th Cir. June 4, 2018).


***'Plain language' of Section 502(b) prevents debtors from settling claim objections brought by creditors, Utah judge rules.***

# Debtor's Settlement Cannot Compromise a Creditor's Claim Objection

Relying on the plain language of Section 502(b), a bankruptcy court refused to approve a settlement proposed by a debtor because it would have compromised a claim objection that a creditor was prosecuting against a secured lender.

"When a party files an objection to a claim, their rights to be heard on the claim objection should not be abridged or modified by a settlement," Bankruptcy Judge William T. Thurman of Salt Lake City said in his July 27 opinion.

Judge Thurman based his decision on the plain language of Section 502(b), which provides that the court "*shall determine* the amount of such claim" once an objection has been filed. [Emphasis added.]

Judge Thurman conceded that the Tenth Circuit had not reached the issue, but, he said, the appeals court has clearly said "there is no need to venture into policy interpretations" when the "language of the Code is unambiguous."

As a result of his holding, Judge Thurman said that bankruptcy courts might "be required to resolve claim objections before approving a settlement." To conclude otherwise, he said, "would strip creditors of their claim objection rights under the clear language of the Code."

The breadth of Judge Thurman's holding may be limited by a footnote where he conjectured that a debtor may be able to compromise a creditor's claim if it were property of the estate or derivative in nature.

In the case before him, the claims were not entirely derivative. The judge said that the creditor was asserting "some direct claims" against the lender that were "its primary contention in this case." Therefore, Judge Thurman's opinion might be distinguished from cases where debtors propose settlements of claims that are estate property.

The opinion might also be viewed as the court's refusal to approve a settlement containing a so-called third party release, which occurs when creditors are barred from asserting claims they otherwise could prosecute against the proposed recipient of the release.


When it comes to third party releases, the courts are split, with some circuits, like the Ninth, barring them altogether. In that regard, click here to read ABI's discussion of *In re Grove Instruments Inc.*, where Bankruptcy Judge Christopher J. Panos of Worcester, Mass., declined last month to approve a settlement in a chapter 7 case containing a bar order precluding creditors from bringing suit on independent, non-derivative claims against the corporate debtor's officers and directors.

The issue came to Judge Thurman in a messy case fraught with conflicts of interest suggesting that the debtor's board members proposed a settlement that was not in the best interests of the estate. Further, the board had neutered the company's chief restructuring officer, in substance compelling him to support a settlement that he initially opposed.

Had the settlement been approved, it would have allowed insiders to purchase the assets, in the process freezing out an offer from another prospective buyer that the restructuring officer preferred.

The opinion is *In re CS Mining LLC*, 16-24818 (Bankr. D. Utah July 27, 2017).