Commercial/Bankruptcy/Tax Law

Bankruptcy Update, United States Supreme Court

By Matthew V. Spero and Jeannine M. Farino

The United States Supreme Court decided three bankruptcy issues this year that are important for all bankruptcy practitioners to know.

Merit Management Group, LP v. FTI Consulting, Inc.

The U.S. Bankruptcy Code permits a bankruptcy trustee to avoid certain prepetition transfers by a debtor, with a few specific exceptions. One exception is the securities safe harbor under Bankruptcy Code § 546(e), which provides:

> [T]he trustee may not avoid a transfer that is a margin payment..., or settlement payment...made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract...that is made before the commencement of the case.[1]

The securities safe harbor exception was at the heart of *Merit Management Group, LP v. FTI Consulting, Inc.*,[2] wherein the United States Supreme Court held unanimously that courts must look to the specific transfer that the trustee seeks to avoid to determine whether that transfer met the safe harbor criteria, and not the component parts of the transfer.[3]

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The *Merit* case involved two companies, Valley View Downs, LP and Bedford Downs Management Corporation, who were competing for a harness-racing license to open a racetrack casino in Pennsylvania. Bedford Downs agreed to withdraw as a competitor for the license and, in exchange, Valley View agreed to purchase all of Bedford Downs' stock for $55 million once Valley View obtained the license. Valley View engaged the Cayman Islands branch of Credit Suisse to finance the $55 million purchase price. Credit Suisse wired the $55 million to Citizens Bank of Pennsylvania, which was serving as the third-party escrow agent for the transaction. Bedford Downs' shareholders, including Merit Management Group, LP deposited their stock certificates into escrow as well. After the transaction was completed, Valley View filed for Chapter 11 relief along with its parent company, Centaur LLC. FTI Consulting Corp. was appointed trustee of the Centaur Litigation Trust.[4]

FTI sued Merit in the U.S. District Court for the Northern District of Illinois, seeking to avoid $16.5 million that Valley View transferred to Merit for the sale of the Bedford Downs stock on the grounds that the transfer was constructively fraudulent.[5] Merit argued that the safe harbor provision of 11 U.S.C. § 546(e) prevented FTI from avoiding the transfer because the transfer was a "settlement payment . . . made by or to (or for the benefit of)" a covered "financial institution" as provided under § 546(e).[6] The U.S. District Court for the Northern District of Illinois held that § 546(e) applied.[7] However, the U.S. Court of Appeals for the Seventh Circuit reversed, holding that § 546(e) was not applicable since the financial institution at issue–Credit Suisse and Citizens Bank–were mere conduits.[8]

Given the conflict among the circuit courts as to the proper application of § 546(e), the U.S. Supreme Court granted certiorari. The specific question before the Supreme Court was whether the transfer between Valley View and Merit implicated the safe harbor exception because the transfer was "made by or to (or for the benefit of) a . . . financial institution."[9]

Merit's position was that the Court should consider not only the transaction between Valley View and Merit, but also the component parts of the transaction, which included the transfers made by Credit Suisse and Citizens Bank.[10] Merit argued that since the component parts included transfers by and to financial institutions, § 546(e) prevented the transfers from being avoided.[11] On the other hand, FTI contended that the only transfer at issue for purposes of § 546(e) was the transfer between Valley View and Merit for the purchase of the stock, and since this transfer was not made by, to or for the benefit of a financial institution, the safe harbor provision was inapplicable.[12]

The Supreme Court upheld the Seventh Circuit's decision, holding that the relevant transfer at issue was between Valley View and Merit.[13] The Supreme Court established that the plain language of § 546(e) provides the specific transfer that the trustee seeks to avoid, which is the relevant transfer for purposes of § 546(e) analysis.[14] In applying this principle, the Court found that since the parties did not contend that Valley View or Merit were entities protected under § 546(e),

See BANKRUPTCY, Page 21

BANKRUPTCY ...

Continued From Page 5

the transfer between Valley View and Merit was not within the scope of § 546(e).[15]

U.S. Bank NA v. The Village at Lakeridge, LLC

In *U.S. Bank N.A. v. The Village at Lakeridge, LLC*,[16] the United States Supreme Court determined what standard of review is applicable when an appellate court is faced with reviewing a bankruptcy court's determination of whether a party qualifies as an insider within the meaning of the Bankruptcy Code.[17] Ultimately, in this context, the appellate court is faced with a mixed question of law and fact.[18] In a unanimous decision, the Supreme Court held that clear error is the proper standard of review.[19]

Lakeridge, LLC had a single owner, MBP Equity Partners. When Lakeridge filed for Chapter 11 bankruptcy, it had two substantial debts–it owed $10 million to U.S. Bank and $2.6 million to MBP. Under its plan of reorganization, the interests of U.S. Bank and MBP were impaired; however, U.S. Bank would not consent to the plan.[20] As a result, Lakeridge sought to impose the "cram-down" provision under 11 U.S.C. § 1129(9)(B)(ii) over U.S. Bank's rejection of the plan. To obtain judicial approval of a crammed down plan, another impaired class of creditors must consent to the plan; however, the consenting creditor cannot be an insider of the debtor.[21] Since MBP was an insider of Lakeridge, its vote could not be counted towards approval of the plan. Accordingly, MBP sought to transfer its claim against Lakeridge to a non-insider who could then vote as an impaired class of creditors to approve the crammed down plan. Specifically, Kathleen Bartlett, one of MBP's board members and an officer of Lakeridge, offered the claim to Robert Rabkin, a non-insider, for $5,000. Rabkin purchased the claim and consented to the plan.[22]

U.S. Bank objected to the debtor's plan on the basis that Rabkin was a non-statutory insider because he had a romantic relationship with Bartlett and the purchase was not an arms-length transaction.[23] The Bankruptcy Court rejected U.S. Bank's argument after conducting an evidentiary hearing, which revealed that Rabkin purchased the claim as a "speculative investment," although he indeed had a relationship with Bartlett.[24] The Ninth Circuit affirmed, holding that the finding by the Bankruptcy Court was entitled to clear error review and, as such, should not be reversed.[25]

The Bankruptcy Code identifies certain parties who qualify as insiders, including a director, officer or person in control of the debtor.[26] This list is not exhaustive, however, and Courts have held that a party may be considered a "non-statutory" insider depending upon "whether the person's transaction with the debtor was at arm's length."[27]

The United States Supreme Court agreed with the Ninth Circuit, establishing that the proper standard of review is clear error.[28] U.S. Bank contended that a mixed question of law and fact is subject to *de novo* review, while Lakeridge argued that a clear error standard should apply.[29] The Court found that when a bankruptcy judge is determining insider status, the analysis is three-fold where the judge is confronted with issues that are legal and factual and issues that are a combination of the two.[30] In turn, when an appellate judge is reviewing the bankruptcy judge's determination of insider status, each of the aforementioned components is subject to a different standard of review.[31] Here, the question before the Court dealt specifically with whether Rabkin was a "non-statutory" insider, which the Court deemed to be a mixed question of law and fact. Ultimately, the Court found that the determination of whether Rabkin's purchase of MBP's claim was an arms-length transaction was primarily fact-intensive and, therefore, clear error was the appropriate standard of review.[32]

Lamar, Archer & Cofrin, LLP v. Appling

In *Lamar, Archer & Cofrin, LLP v. Appling*,[33] the United States Supreme Court determined "what constitutes a statement respecting the debtor's financial condition" under 11 U.S.C. § 523.[34] The debtor, Appling, owed the petitioner, Lamar, Archer & Cofrin, LLP, legal fees relative to the petitioner's representation of the debtor in a litigation. The debtor represented to the petitioner that he would be able to pay all current and future legal fees from a tax refund that he was expecting to receive. The debtor never paid the final invoice, so as a result, the petitioner sued the debtor and obtained a judgment against him. Subsequently, the debtor and his wife filed for bankruptcy under Chapter 7. The petitioner commenced an adversary proceeding, alleging that its claim was non-dischargeable under 11 U.S.C. § 523(a)(2)(B) on the grounds that the debt arose from "false pretenses, a false representation or actual fraud, other than a statement...representing the debtor's financial condition" and that the false statement at issue was related to the debtor's statements about his tax refund.[35] The debtor moved to dismiss the complaint, arguing that the alleged statement concerning the debtor's financial condition that the petitioner relied upon must be in writing.[36] The bankruptcy court denied the motion, finding that the debtor made two misrepresentations, which the petitioner replied upon, and as a result incurred damages. The District Court affirmed; however, the Eleventh Circuit reversed, finding that a statement relative to a debtor's financial condition may relate to a single debt, but because the statement was not in writing, the claim was dischargeable.[37]

Generally, a debt may be deemed non-dischargeable in a bankruptcy when it was procured by "false pretenses, a false representation or actual fraud."[38] Statements that fall within this category are not required to be in writing in order to be considered non-dischargeable.[39] In addition, a debt is non-dischargeable if made in writing and if it is a "materially false" statement "respecting the debtor's...financial condition."[40] Here, the statement at issue was made about a single asset and was not committed to writing. In applying the plain language of the Bankruptcy Code, the Supreme Court held that a statement about a single asset can be considered a statement respecting the debtor's financial condition, and if the statement is not in writing, the debt may be discharged, even if it is false.[41]

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1. 11 USC §546(e).
2 138 S. Ct. 883 (2018).
3. *Id.* at 886.
4. *Id.* at 885.
5. *Id.*
6. *Id.*
7. *Id.* at 885-86.
8. *Id.* at 886.
9. *Id.* at 888.
10. *Id.* at 886.
11. *Id.* at 887.
12. *Id.* at 886-87.
13. *Id.* at 892-93.
14. *Id.* at 893-96.
15. *Id.*
16 138 S. Ct. 960 (2018).
17. *Id.* at 962.
18. *Id.* at 963.
19. *Id.*
20. *Id.*
21. 11 USC §1129(a)(10).
22. 138 S. Ct. at 962.
23. *Id.*
24. *Id.* at 964.
25. *Id.* at 962.
26. 11 USC §101(31)(B)(i)-(iii).
27. 138 S. Ct. at 962.
28. *Id.*
29. *Id.* at 966.
30. *Id.* at 965.
31. *Id.* at 965-66 (finding that when an appellate court assess a purely legal conclusion made by a bankruptcy judge, the standard of review is *de novo* while issues that are purely factual are subject to clear error standard of review).
32. *Id.* at 968-69.
33. 138 S. Ct. 1752 (2018).
34. *Id.* at 1757.
35. *Id.* at 1754 (quoting 11 USC §523(a)(2)(B)).
36. 138 S. Ct. at 1754.
37. *Id.* at 1755.
38. *Id.* at 1757 (citing 11 USC §523(a)(2)(A)).
39. *Id.*
40. *Id.* at 1757 (quoting 11 USC §523(a)(2)(B)).
41. *Id.*