Commercial/Bankruptcy/Tax Law

Bankruptcy Update, United States Supreme Court

The United States Supreme Court decided two bankruptcy cases this year that are of interest to all bankruptcy practitioners. The Court is also scheduled to hear arguments in two other bankruptcy cases.

Recent Supreme Court Decisions

In ***Mission Product Holdings, Inc. v. Tempnology, LLC,*** the Supreme Court resolved the issue of whether rejection of an executory trademark license bars the licensee from continuing to use the trademark.[1] For many years there was a split among the Circuit Courts on this issue. In *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.,*[2] the Fourth Circuit held that the rejection of an executory contract precludes the licensee from continuing to use the license, while the Seventh Circuit in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*[3] held that it does not.

The facts of the *Mission Products* case are that Mission Product Holdings had entered into a contract with Tempnology, LLC, which gave Mission a license to use Tempnology's trademarks. When Tempnology filed for Chapter 11 relief, it rejected its contract with Mission, entitling Mission to a pre-petition claim for any damages that resulted from Tempnology's breach. In an action for a declaratory judgment, Tempnology argued that when it rejected the contract, Mission's rights to use Tempnology's trademarks were terminated. The Bankruptcy Court agreed with Tempnology's position and held that Tempnology's rejection revoked Mission's right to use its trademarks.[4] The Bankruptcy Appellate Panel reversed the Bankruptcy Court's decision, but on appeal the First Circuit adopted the holding of the Fourth Circuit in *Lubrizol,* holding that Mission's rights to use the trademarks under its contract with Tempnology were terminated upon rejection.[5]

In a seven to one opinion written by Justice Kagan, the Supreme Court held that rejection of an executory trademark license does not bar the licensee from continuing to use the trademark.[6] Generally, Bankruptcy Code § 365(a) gives the debtor (or the trustee) the ability to assume or reject an executory contract. Relying upon the language of Bankruptcy Code § 365(g), which states that, "the rejection of an executory contract…constitutes a breach of said contract" immediately before the filing of the bankruptcy petition, the Court found that a rejection is a breach, and does not have the same effect as a termination or revocation.[7] To that end, the Court considered the meaning of "breach" in contract law outside of a bankruptcy case and, in the context of trademarks, a breach of a licensing agreement does not prevent the licensee from continuing to use the license for the trademark.[8]

In its second bankruptcy case of the term, ***Henry Schein, Inc. v. Archer & White Sales, Inc.,*** the Supreme Court resolved a disagreement among the Circuit Courts as to whether the "wholly groundless" exception is consistent with the Federal Arbitration Act ("FAA"). The FAA provides that parties to a contract may opt to have disputes resolved by an arbitrator as opposed to a court. The parties may also agree by contract to have an arbitrator decide whether a matter is subject to arbitration. However, even when a contract delegates to an arbitrator the question of arbitrability (whether a claim is subject to arbitration), some federal courts have taken it upon themselves to resolve this question "if the argument that the arbitration agreement applies to the particular dispute is 'wholly groundless.'"[9]

Archer & White, a small business, had entered into a contract with Pelton and Crane for dental equipment. Archer & White sued Pelton and Crane's successor in interest, Henry Schein, Inc., in federal court in Texas for alleged violations of federal and state antitrust law. Schein invoked the FAA and asked the District Court to refer the parties to arbitration. Archer & White objected, arguing that the dispute was not subject to arbitration. The question then became, who decides whether the claim at issue is subject to arbitration. Schein argued that the contract incorporated the American Arbitration Association's rules that the arbitrator had to decide whether the claim was subject to arbitration, while Archer & White took the position that Schein's argument for arbitration was wholly groundless and, thus, the District Court may resolve the issue of arbitrability.

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Relying on Fifth Circuit precedent, the District Court agreed with Archer & White that Schein's argument for arbitration was wholly groundless.[10] Ultimately, the District Court denied Schein's motion to compel arbitration and the Fifth Circuit affirmed the decision.[11]

In a unanimous decision, the Supreme Court held that the "wholly groundless" exception is inconsistent with the text of the FAA. The Court found that it is obligated to interpret the FAA as written, which expressly requires the Court to interpret the underlying contract as it was written.[12] Accordingly, when the parties agree in their contract to delegate arbitrability to an arbitrator, a court may not override the contract, regardless of whether the court believes that the argument that the arbitration agreement applies to the particular dispute is groundless.[13]

Although the underlying case was not before a bankruptcy court, this decision will certainly have implications for all bankruptcy matters. Essentially, under *Schein,* if a creditor wishes to invoke an arbitration provision in a pre-petition contract with a debtor, the bankruptcy court may not bar the creditor from doing so, which could lead to core bankruptcy issues being litigated outside of the bankruptcy court.

What to Expect this Term

This term, the United States Supreme Court is scheduled to hear oral argument in two bankruptcy cases that are certain to have an impact for practitioners.

In the first case, ***Ritzen Group, Inc. v. Jackson Masonry, LLC,*** the United States Supreme Court will decide whether an order denying relief from an automatic stay is a final order under 28 USC § 158(a)(1).

Before Jackson Masonry filed for bankruptcy relief, a defendant in a breach of contract lawsuit brought by Ritzen Group, Inc., obtained an automatic stay of the contract suit due to the bankruptcy filing.[14] Ritzen filed a motion for relief from the automatic stay, which was denied. Ritzen Group, Inc. did not appeal.[15] Subsequently, Ritzen and Jackson filed adversary proceedings against each other that resulted in a bench trial. The Bankruptcy Court found that it was Ritzen, and not Jackson, that had breached the contract.[16] Ritzen filed two appeals to the District Court, one as to the order denying relief from the automatic stay, and the other as to the Bankruptcy Court's determination on the merits of the breach of contract claim.[17] The District Court found that the appeal from the order denying relief from the automatic stay was untimely.[18]

On appeal, the Sixth Circuit looked to the language of 28 USC § 158(a), which provides that an order by the Bankruptcy Court may be appealed immediately if it is "(1) 'entered in [a] …proceeding' and (2) 'final'–terminating that proceeding."[19] In doing so, it determined that an order denying stay relief terminates a proceeding, and thus is a final order.[20] Since such orders are final within the meaning of 28 USC § 158(a), Ritzen was required to file its appeal of that order within fourteen days of the ruling, pursuant to Fed. R. Bankr. P. 8002(a).[21]

There is a split among the Circuit Courts on this issue. As stated by the Sixth Circuit, some circuits have adopted various tests in determining the finality of the order, while others do not have a general test, but determine the finality of an order on a case by case basis.[22] It will be interesting to see if the Supreme Court establishes a bright line rule for orders denying lift stay motions, or if it will adopt an approach to be applied on a case by case basis.

In the second case awaiting oral argument, ***Rodriguez v. FDIC,*** the Supreme Court will determine whether courts should determine ownership of a tax refund paid to an affiliated group based on the federal common law "Bob Richards Rule," as three circuits have held, or based on the law of the relevant state, as four other circuits have held.

The Internal Revenue Service issued a tax refund to United Western Bancorp, Inc. (UWBI), a holding company that owned several subsidiaries, including United Western Bank, which is its principal subsidiary.[23] UWBI had a tax allocation agreement with its subsidiaries, including United Western Bank, which provided that it would file consolidated tax returns on behalf of itself and its subsidiaries.[24] The tax refund at issue was the result of operating losses incurred by United Western Bank.[25] Since UWBI filed the tax return under the tax allocation agreement, the Internal Revenue Service issued the tax refund to it.

UWBI subsequently filed for Chapter 7 relief. The Chapter 7 Trustee commenced an adversary proceeding against the FDIC,

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We welcome the following new members

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will turn on how one gauges its effectiveness.

One item to bear in mind is that there will be a not insignificant cost associated with the taxes that are being deferred. The Joint Committee on Taxation estimates that this cost could be in the range of $1.6 billion between 2018 and 2027.[14] In considering the success of the incentive at issue, this cost should be weighed against the measurable outcomes realized by the increase in economic activity.

Additionally, some have pointed to some potential unintended consequences resulting from opportunity zone investments. Among them could be an increase in housing prices due to the influx of capital and the creation of new jobs. Such an occurrence would not only diminish the intended impact of the incentive provided by the Tax Act, but it may also exacerbate the actual problem the legislation sought to address in the first place.

On the other hand, proponents point to the flexible nature of the incentive, particularly the ability of investors to pool resources through opportunity funds in order to deploy them according to the needs of specific communities. This flexibility may, if properly exercised, lessen any unintended consequences.

Only time will tell whether opportunity zones are revitalized by this incentive, or whether it will just amount to providing tax breaks for investors with no corresponding benefit to the intended beneficiaries.

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1. IRS Notice 2018-48, IRS Notice 2019-42.
2. IRC § 1400Z-2(d)(1).
3. Proposed Reg. § 1400Z2(a)-1(b)(9).
4. IRC § 1400Z-2(a)(1).
5. IRC § 1400Z-2(b).
6. IRC § 1400Z-2(b)(2).
7. IRC § 1400Z-2(c).
8. IRC § 1400Z-2(d)(1)(D)(i)(II)
9. 83 FR 54279.
10. 84 FR 18652.
11. *See, e.g.*, Senator Cory A. Booker, "Statement for Hearing Before the Joint Economic Committee Implementation of the Opportunity Zones Program," May 17, 2018, available at https://bit.ly/2XwH7bi.
12. *Id.*
13. Economic Innovation Group, "Opportunity Zones: Tapping into a $6 Trillion Market." March 21, 2018.
14. Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1, The 'Tax Cuts and Jobs Act,'" JCX-67-17, Dec. 18, 2017, available at https://bit.ly/2s0oElt.

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as receiver for United Western Bank, alleging that the tax refund belonged to UWBI and, thus, was part of the bankruptcy estate.[26] The Bankruptcy Court agreed with the Trustee, granting him summary judgment. The FDIC appealed to the District Court, which reversed the Bankruptcy Court's decision, but the Trustee then appealed to the Tenth Circuit.[27] The Tenth Circuit agreed with the District Court, finding that the refund belonged to the FDIC, and remanded the matter to the Bankruptcy Court.[28]

According to the Trustee, three Circuit Courts, including the Tenth Circuit, apply the common law "Bob Richards Rule," derived from the Ninth Circuit's decision in *In re Bob Richards Chrysler-Plymouth Corp.*,[29] which provides that a tax refund paid to an affiliate is presumed to belong to the corporate subsidiary whose losses gave rise to the refund, unless the parties agree otherwise. Four Circuits reject this approach, and instead follow applicable state law to determine ownership of the refund.

In applying the Bob Richards Rule, the Tenth Circuit found that the tax allocation agreement was ambiguous with regards to the relationship it intended to create between UWBI and its first-tier affiliates, including

United Western Bank, as to the ownership of IRS tax refunds.[30] However, the agreement contained a method for resolving such ambiguities, which provided that any ambiguity must be resolved in favor of the insured depository institution.[31] Therefore, the Tenth Circuit found that the agreement must be construed in favor of United Western Bank and the FDIC, and as such, held that the refund belonged to the FDIC.[32]

All in all, last year was an important year for bankruptcy practitioners, yielding two noteworthy decisions, and the upcoming Supreme Court term will likely also produce two significant decisions for those who practice bankruptcy law.

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1. 139 S.Ct. 1652 (2019).
2. 756 F.2d 1043 (4th Cir. 1985).
3. 686 F.3d 372 (7th Cir. 2012).
4. *Id.*
5. 879 F.3d 389 (1st Cir. 2018).
6. 139 S.Ct. at 1656.
7. *Id.* at 1661.
8. *Id.*
9. 139 S.Ct. 524, 527 (2019).
10. . *Id.*
11. *Id.* at 528-529.
12. *Id.* at 529.
13. *Id.*
14. 906 F.3d 494, 497 (6th Cir. 2018).
15. 906 F.3d at 497.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.* at 497-98 (quoting 28 USC §158(a)).
20. *Id.* at 498.
21. *Id.*
22. *Id.* at 498-499.
23. 914 F.3d 1262, 1264 (10th Cir. 2019).
24. 914 F.3d at 1264.
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. 29. 473 F.2d 262 (9th Cir. 1973).
30. 30. 914 F.3d at 1273.
31. 31. *Id.* at 1274.
32. 32. *Id.*

COMMITTEES...

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gation committee outweigh the cons. Surprisingly, out of the 100 or so New York state court decisions on independent litigation committees since *Auerbach*, very few have issued from the Supreme Court of New York, Nassau County. The paucity of decisions suggests that the technique is being underutilized in our home court, so to speak. Commercial litigators who are not already doing so may benefit from adding the independent litigation committee procedure to their repertoire.

Robert P. Lynn, Jr. is a partner at Lynn Gartner Dunne, LLP in Mineola. Katharine Smith Santos is a senior associate with the firm. They are currently representing the defendants in a pending lawsuit involving an independent litigation committee in the Commercial Division of Supreme Court, Nassau County.

1. *Auerbach v. Bennett*, 47 N.Y.2d 619, 629 (1979).
2. *Jones v. Surrey Coop. Apts.*, 263 A.D.2d 33, 36 (1st Dept. 1999).
3. *Auerbach*, 47 N.Y.2d at 631, 635; *Davidowitz v. Edelman*, 153 Misc.2d 853, 856 (Sup. Ct., Kings Co., 1992).
4. *See, e.g., Kaplan v. Wyatt*, 484 A.2d 501, 510 (Del. Ct. of Chancery 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).
5. *Id.* at 506.
6. 47 N.Y.2d 619 (1979).
7. *Id.* at 631.
8. *Id.* at 633.
9. *Id.* at 634.
10. Deborah A. deMott, Shareholder Deriv. Actions L. & Prac. § 5:26 (2018-2019).
11. *Auerbach*, 47 N.Y.2d at 636; *cf. Parkoff v. Gen. Tel. & Elecs. Corp.*, 53 N.Y.2d 412 (1981).
12. *Id.* at 623-24.
13. *In re Bank of New York Mellon Corp.*, 123 A.D.3d 514, 515-16 (1st Dept. 2014).
14. *Halebian v. Berv*, 548 Fed. Appx. 641, 647 (2d Cir. 2013) (applying the Federal Rules of Civil Procedure).
15. *Peller v. S. Co.*, No. 1:86-CV-975-RCF, 1988 WL 90840, at *1 (N.D. Ga. Mar. 25, 1988).
16. 430 A.2d 779 (Del. 1981).
17. *Id.* at 788.
18. *Id.* at 789.
19. *Kaplan v. Wyatt*, 484 A.2d at 511-12.

QUESTION...

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seek an advance determination in bankruptcy court even where there is only slight doubt as to whether a debt has been discharge... risk[ing] additional federal litigation, additional costs and additional delays."[13]

The Supreme Court's ruling is its first decision on the application of contempt in a bankruptcy context and brings clarity to an issue that arises relatively frequently in bankruptcy courts. Following *Taggart*, creditors should continue to exercise extreme extra caution before attempting to collect a debt that may have been discharged in a bankruptcy case. Creditors must investigate to determine whether there is a legitimate legal argument that collection can be pursued regardless of the discharge order. If challenged, creditors should also be prepared to pass the "no fair ground of doubt" test in the event that it is sued for civil contempt as a result of the attempted collection.

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1. 139 S.Ct. 1795 (2019).
2. 11 USC § 524(a)(2).
3. *Taggart*, 139 S.Ct. at 1799-1800.
4. *In re Ybarra*, 424 F.3d 1018, 1027 (9th Cir. 2005).
5. *Taggart*, 139 S.Ct. at 1799.
6. *Id.* at 1800-1801.
7. *See In re Pratt*, 462 F.3d 14, 19-21 (1st Cir. 2006) (holding that a creditor's violation of a discharge order was actionable despite the lack of "bad faith"); *In re Fina*, 550 F. App'x 150, 154 (4th Cir. 2014) (holding a "good faith mistake is generally not a valid defense" to the violation of a discharge order); *In re Hardy*, 97 F.3d 1384, 1390 (11th Cir. 1996) ("the focus of the court's inquiry in civil contempt proceedings is not on the subjective beliefs or intent of the alleged contemnors in complying with the order, but whether in fact their conduct complied with the order at issue.")
8. *Taggart*, 139 S.Ct. at 1799.
9. *Id.* at 1801.
10. *Id.* at 1802.
11. *Id.*
12. *Id.* at 1803.
13. *Id.*