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Trends and Developments

Contributed by Nelson Mullins Riley & Scarborough LLP

Nelson Mullins Riley & Scarborough LLP is a diversified law firm of more than 750 attorneys, policy advisers and professionals across 24 offices advising clients in more than 100 practice areas. Nelson Mullins' bankruptcy, creditors' rights and restructuring team includes more than 20 attorneys and has substantial resources that enable it to effectively represent both large global businesses and local companies across a range of business sectors. The bankruptcy/insolvency and financial-restructuring attorneys have experience in myriad aspects of the restructuring process,

including: distressed company representation; bank and secured creditor representation; acquisition of financially distressed assets; bankruptcy trustee, receivership and examiner practice; creditors' committee representation; bankruptcy appeals; franchise system representation; indenture trustee representation; landlord and property-owner representation; preference and claw-back litigation; as well as experience in significant bankruptcy court and US district court litigation around the country.

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diverse set of industries. He has represented clients in bankruptcy and commercial litigation matters in state, federal and appellate courts across the state of Tennessee and in the United States Court of Appeals for the Sixth Circuit.

Current State of the Restructuring Market

As of August 2019, there was a small increase in US Chapter 11 commercial bankruptcy filings in 2019 versus 2018. Total US bankruptcy filings increased 6.1% in August 2019 over August 2018, according to data provided by Epiq Systems, Inc's statistic service AACER.

In 2019, the industries with the most bankruptcy filings included energy, retail and healthcare.

Energy industry filings

By August 2019, 26 oil-and-gas producers, including Sanchez Energy Corporation and Halcón Resources, had filed for bankruptcy, according to a report by the law firm Haynes and Boone LLP. That nearly matches the 28 producer bankruptcies in all of 2018, and the total number for the year is expected to rise as companies face mounting debt maturities.

According to Fitch Ratings, energy companies with junk-rated bonds were defaulting at a rate of 5.7% as of August, the highest level since 2017. This metric is considered a key indicator of the industry's financial stress.

Retail industry filings

2019 saw big names such as Sears, Shopko, Gymboree, Charlotte Russe, Things Remembered, Payless, Diesel, Z Gallerie, and Barneys New York file for Chapter 11 protection.

Healthcare filings

By July 2019, at least 17 hospitals had filed for bankruptcy protection across nine states. These include De Queen Medical Center in Arkansas; Oswego Community Hospital, Horton Community Hospital, and Hillsboro Community Hospital in Kansas; Penobscot Valley Hospital in Maine; I-70 Community Hospital in Missouri; Washington County Hos-

pital in North Carolina (via involuntary Chapter 7); Prague Community Hospital, Haskell County Community Hospital, Drumright Regional Hospital, and Fairfax Community Hospital in Oklahoma; Hahnemann University Hospital and St Christopher's Hospital in Pennsylvania; Lauderdale Community Hospital in Tennessee; and Astria Health, a three-hospital health system in Washington. Ten of these hospital filings are associated with EmpowerHMS.

Many of the hospitals that find themselves filing for Chapter 11 protection are smaller, rural hospitals. These filings can have a devastating impact on smaller communities and rural areas where access to hospital and critical-care services is already limited.

Legal Developments in the Restructuring and Insolvency Market

Standard of review of bankruptcy court decision on determination of insider

On 5 March 2018, the United States Supreme Court reached a decision in *US Bank National Association v Village at Lakewood, LLC*, a case that, from a bankruptcy perspective at least, is notable more for what it didn't say than for what it did. The holding of the case is fairly straightforward: a clear-error standard is proper when appellate courts review a lower court's determination of whether a transaction is at arm's length. Bankruptcy courts assess whether transactions are at arm's length in part in order to determine whether parties are "insiders" of the debtor and thus subject to special rules and requirements. In this case, the court took a cautious approach, sticking to the terrain of a relatively uncontroversial civil procedure question. Although the court's reasoning may have broader application than its narrow holding, the court in general ducked many of the more interesting bankruptcy questions and thus opened the door to more disagreement and uncertainty in the bankruptcy arena.

From a bankruptcy perspective, the court's holding is indeed quite limited. The standard of review that the court affirmed seems primarily relevant to courts that use the Ninth Circuit's test, and the court did not tackle the deeper circuit split regarding what the appropriate test should be.

The limitations of the court's holding are exacerbated by the justices' varying degrees of discomfort with the Ninth Circuit's test. Justice Kagan, who penned the majority opinion, was quick to distance the court from any appearance of endorsement, stating, "We do not address the correctness of the Ninth Circuit's legal test... We simply take that test as a given in deciding the standard-of-review issue we chose to resolve." Justice Kennedy took a similar approach in his concurrence, remarking that, "The court's holding should not be read as indicating that the non-statutory insider test as formulated by the Court of Appeals is the proper or complete standard to use in determining insider status." Justice Sotomayor's approach was the most pointed: "I hope that courts

will continue to grapple with the role that an arm's-length inquiry should play in a determination of insider status."

While the justices seemed to express disapproval of the Ninth Circuit's test, not enough justices were comfortable endorsing an alternative test. That decision leaves the field open for more tests to develop, and possibly more splits to emerge, in the lower courts. This may also help explain why the justices decided to grant certiorari on this case. Although they may not have been ready or able to agree on a different test, they all seemed to want to send a message – of varying degrees of force – to the Ninth Circuit about the flaws in its test.

Trade mark licensee rights in bankruptcy

On 20 May 2019, the US Supreme Court handed down its opinion in *Mission Product Holdings, Inc v Tempnology, LLC*, in which it reversed the First Circuit and held that rejection of an executory trade mark licence does not bar the licensee from continuing to use the mark. As Justice Kagan, writing for the majority, said, "A rejection breaches a contract but does not rescind it."

In so holding, the court recognised that section 365 and "fundamental principles of bankruptcy law" mandate that rejection is not the same as rescission. In particular, the court relied upon the Bankruptcy Code section 365(g), which provides that rejection "constitutes a breach of such contract" immediately before the filing of a bankruptcy petition.

Or, more concisely, the court recognised that "rejection is a breach". In turn, breach "means in the Code what it means in contract law outside bankruptcy". Breach is the basis for relief, but not the relief itself, which would be rescission. As an example, Justice Kagan proposed the hypothetical example of a debtor who had leased a copy machine to a law firm. If the debtor rejected the lease, the debtor could stop servicing the machine, but the debtor could not take it back. Applying the same notion to trade marks, the court reasoned that "breach does not revoke the licence or stop the licensee from doing what it allows".

This decision will probably enhance the negotiating leverage of trade mark licensees vis-à-vis secured lenders and other creditors and make it more difficult for debtor-licensors to rebrand and reorganise their businesses.

In the very hypothetical example that the court relied upon, the bankruptcy of a lessor of personal property will not enable the debtor to use rejection of a contract as a means for recovering the equipment for lease to someone else at a higher price.

It's worth noting that some non-debtor third parties would now no doubt be better off had congress not attempted to come to their aid.

Standard for imposition of contempt for violating the discharge injunction

On 3 June 2019, the Supreme Court issued its opinion in *Taggart v Lorenzen*, in which it rejected a strict-liability standard for contempt claims regarding violations of the discharge injunction. The court unanimously held that a 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”, rejecting the argument that a subjective, good-faith belief about the inapplicability of the discharge injunction is a defence to contempt.

In so holding, the court relied upon section 524(a)(2), the statutory discharge injunction, and on section 105(a), the bankruptcy version of the All Writs Act. The decision rested on a long-standing interpretive principle: when a statutory term is “obviously transplanted from another legal source”, it “brings the old soil with it”. Because the Bankruptcy Code provides that a discharge order “operates as an injunction”, under 11 USCA § 524(a)(2), and that a court may issue any “order” or “judgment” that is “necessary or appropriate” to “carry out” other bankruptcy provisions, 11 USCA § 105(a), these provisions bring with them the “old soil” that has long governed how courts enforce injunctions in the civil context.

The court recognised that in cases outside the bankruptcy context, civil contempt should not be found “where there is [a] fair ground of doubt as to the wrongfulness of the defendant’s conduct” (citing *California Artificial Stone Paving Co v Molitor*), and that “principles of ‘basic fairness requir[e] that those enjoined receive explicit notice’ of ‘what conduct is outlawed’ before being held in civil contempt” (citing *Schmidt v Lessard*, per curiam). The court recognised that this standard is generally an objective one, and a party’s subjective belief will not ordinarily insulate a party from civil contempt if that belief was objectively unreasonable.

Subjective intent, however, is not always irrelevant, the court added. Civil contempt sanctions may be warranted regarding a party’s bad-faith actions, and a party’s good faith may help to determine an appropriate sanction. The court reasoned that these traditional civil contempt principles apply equally in the bankruptcy discharge context and that under the fair ground of doubt standard, civil contempt may be appropriate when the creditor violates a discharge order based on an objectively unreasonable understanding of either the discharge order or the statutes governing its scope.

Given that the “typical discharge order entered by a bankruptcy court is not detailed”, the court held that civil contempt “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 constitutionality of PROMESA’s Financial Oversight and Management Board

On 25 February 2019, the United States Court of Appeals for the First Circuit issued its opinion in the *Aurelius Investment, LLC v Commonwealth of Puerto Rico* case, which could have a devastating impact on Puerto Rico’s restructuring efforts. This case addresses the constitutionality of the Financial Oversight and Management Board (the Board) that was established by the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). PROMESA effectively provides Puerto Rico with a bankruptcy scheme that is similar, but not identical, to the Bankruptcy Code.

Under PROMESA, the Board is charged with independent supervision and control over Puerto Rico’s financial affairs. When the Board filed several Title III proceedings on behalf of various Puerto Rico government instruments, a number of entities challenged the proceedings, arguing, among other points, that the appointment of the Board violated the Appointments Clause of Article II, section 2, clause 2 of the constitution, which provides:

“[The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint... all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.”

In response to this argument, Puerto Rico argued that the Board was appointed pursuant to the Territorial Clause of Article IV, section 3, clause 2 of the constitution, which provides congress with the “power to dispose of and make all needful Rules and Regulations respecting the Territory... belonging to the United States.”

While it appears from the language of PROMESA that congress presumed to establish the Board under its Territorial Clause powers, the First Circuit “reject[ed] th[e] notion that Article IV enhances Congress’s capabilities in the intramural competitions established by our divided system of government” to provide to congress the ability to “assume what is otherwise a power of the President”. *Aurelius*, 915 F.3d at 851. The First Circuit recognised that the Appointments Clause was designed “to prevent congressional encroachment on the President’s appointment power, while curbing Executive abuses by requiring Senate confirmation of all principal officers”.

Based on this logic, the First Circuit determined that the appointment of the Board under PROMESA was carried out in violation of the Appointments Clause, and was therefore unconstitutional. The First Circuit did not go so far as to completely undo everything done by the Board. Instead, relying on an “ancient tool of equity, the de facto officer

doctrine”, the First Circuit determined that, because the Board was acting under the colour of authority provided by PROMESA, the actions taken prior to its ruling would not be deemed a nullity by means of the unconstitutional appointment of the Board.

The Supreme Court of the United States granted certiorari in this case on 20 June 2019, with oral arguments to be held in October. If the Supreme Court upholds the First Circuit’s holding and further strikes down the application of the de facto officer doctrine, the consequences could be devastating for Puerto Rico’s reorganisation efforts.

First Circuit upholds dismissal of bondholders’ claims in PROMESA case

In another set of appeals arising from PROMESA and Puerto Rico’s financial problems, the First Circuit, in a pair of opinions dated 26 March 2019, upheld the dismissal of certain bondholders’ claims seeking declaratory relief as to their rights to immediate payment of certain General Obligation Bonds (GO Bonds) of Puerto Rico. See *Aurelius Capital Master Ltd v Commonwealth of Puerto Rico* (In re Financial Oversight and Management Board for Puerto Rico), also known as “Aurelius II”, and *Assured Guaranty Corp v Financial Oversight and Management Board for Puerto Rico* (In re Financial Oversight and Management Board for Puerto Rico, as representative for the Puerto Rico Highways and Transportation Authority), also known as “Assured”.

In the *Aurelius II* case, the First Circuit determined that the bondholders’ claims were either barred by the terms of PROMESA, unripe, or seeking improper declaratory judgments. The more interesting, and potentially impactful, decision is the First Circuit’s ruling in *Assured*.

In *Assured*, the First Circuit upheld dismissal of the bondholders’ claims under an interpretation of PROMESA, and for all intents and purposes Bankruptcy Code sections 922 and 928, that a government debtor may pay GO Bond obligations while a bankruptcy is pending, but is not compelled to make such payments. This holding could have a significant impact on government bond ratings and the bond market, as a whole.

Section 922 of the Bankruptcy Code provides that, notwithstanding the automatic stay, “a petition filed under [Chapter 9] does not operate as a stay of application of pledged special revenues in a manner consistent with section [928] of [Chapter 9] to payment of indebtedness secured by such revenues”. The First Circuit’s interpretation of this language is such that, a debtor government entity is well within its powers to pay such obligations during the course of a bankruptcy, and a bond trust may accept such payments without violating the automatic stay. But this protection does not compel payment during the pendency of the case.

The First Circuit denied rehearing en banc, over a thorough dissent by Circuit Judge Lynch, on 31 July 2019. In her dissent, Judge Lynch effectively lays the groundwork for an appeal to the United States Supreme Court, arguing that “further review is warranted, if not by this court, then by the Supreme Court”. Turning to the legislative history of Bankruptcy Code sections 922 and 928, Judge Lynch sets forth an argument as to why certiorari should be granted in this case.

If the Supreme Court does take up the issue, a ruling either way on this issue will be of critical importance to the government bond markets.

California bankruptcy court holds it has jurisdiction over the FERC regarding rejection of PPAs

On 7 June 2019, the United States Bankruptcy Court for the Northern District of California issued a decision in the bankruptcy case of California’s primary electric utility PG&E Corporation and Pacific Gas and Electric Company (collectively, PG&E) regarding the interplay between the Bankruptcy Code and the authority of the Federal Energy Regulatory Commission (the FERC). In its ruling, the court determined that it, and not the FERC, had sole authority under section 365 of the Bankruptcy Code with respect to PG&E’s ability to assume or reject power purchase agreements (PPAs).

PG&E is a buyer under nearly 400 PPAs. PG&E asserts that the ability to modify or reject these executory contracts will be of critical importance in its restructuring efforts. Prior to PG&E’s Chapter 11 filing, various counterparties under these PPAs initiated proceedings before the FERC seeking to prevent PG&E from amending or rejecting these contracts. Prior to PG&E’s bankruptcy filing, but after PG&E’s announcement of its intent to file, the FERC issued rulings stating that it had concurrent jurisdiction over this issue along with the bankruptcy court, should PG&E file for bankruptcy. In response to these rulings, PG&E filed an adversary proceeding shortly after filing for Chapter 11 protection, seeking a judgment that the bankruptcy court was the sole forum with jurisdiction over these determinations.

The bankruptcy court agreed with PG&E. In its strongly-worded opinion, describing the FERC’s actions as “Kafkaesque”, the bankruptcy court determined that the FERC had acted beyond its authority to assume jurisdiction, pre-filing, of powers that it would not have had post-petition. Contract rejection is a core matter squarely within the jurisdiction of the bankruptcy courts, according to the PG&E court, and the FERC’s attempts to pre-emptively confer jurisdiction for itself when bankruptcy was announced, but not yet filed, was improper. The court further rejected the FERC’s interpretation of Bankruptcy Code section 365 as void, as such a determination is outside the scope of its authority.

The bankruptcy court certified this decision for direct appeal to the United States Court of Appeals for the Ninth Circuit under 28 USCA § 158(d), and the Ninth Circuit will become the latest in an increasing line of courts to address the interplay between the Bankruptcy Code and the powers of the FERC. The Sixth Circuit currently has before it a similar dispute in a case between FirstEnergy Solutions and the Ohio Valley Energy Corporation. If either the Sixth or Ninth Circuit overturns the decisions below, it will lead to a circuit split with the Fifth Circuit's opinion in *Mirant Corp v Potomac Electric Power Co* (In re *Mirant Corp*), which could make this issue ripe for Supreme Court review.

Bankruptcy Cases before the Supreme Court During the October 2019 Term

The Supreme Court began its 2019 term in October, and has a host of cases to consider, raising a number of important and interesting issues for bankruptcy practitioners.

Finality of bankruptcy court orders

Ritzen Group, Inc v Jackson Masonry, LLC, 20 May 2019, deals with the finality of orders denying requests for stay relief under 28 USC § 158. The question presented for review is: "Whether an order denying a motion for relief from the automatic stay is a final order under 28 USC § 158(a)(1)". The appellant argues that the Supreme Court's decision in *Bullard v Blue Hills Bank* set the standard for "finality" under section 158 and that the Sixth Circuit's test articulated a different, and inconsistent, standard.

Ownership of tax refunds

Rodriguez v Federal Deposit Insurance Corporation, 28 June 2019, deals with the law governing ownership of tax refunds. The question presented for review is: "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 hold, or based on the law of the relevant states, as four circuits hold". The appellant argues that the common-law Bob Richards rule is flawed and does not reflect the stringent requirements for common law-making.

Fair Debt Collection Practices Act

Rotkiske v Klemm, 25 February 2019, deals with the applicability of the discovery rule with respect to claims under the limitations period of the Fair Debt Collection Practices Act (FDCPA). The question presented for review is: "Whether the 'discovery rule' applies to toll the one (1) year statute of limitations under the Fair Debt Collection Practices Act, 15 USC §§1692, et seq, as the Fourth and Ninth Circuits have held but the Third Circuit (sua sponte en banc) has held contrarily". The appellant argues that he discovered a default judgment against him with regard to a case where an unknown third party accepted service on his behalf. He argues that equitable tolling is applicable in this case based on his failure to discover the FDCPA claim until four years later, when he attempted to apply for a mortgage loan. The Third Circuit relied on the Supreme Court case of *TRW Inc v Andrews* (13 November 2001) for its position that the discovery rule did not apply because the statute of limitations for the FDCPA is embedded within the statute itself. The Third Circuit did leave the door open, however, for equitable tolling based on a creditor's intentionally misleading acts.

PROMESA

Financial Oversight and Management Board for Puerto Rico v *Aurelius Investment, LLC* (and other consolidated cases), 20 June 2019, addresses the constitutionality of the Financial Oversight and Management Board appointed by congress in connection with the passage of PROMESA. As discussed in more detail above, the case turns on whether congress's appointment of the Board violated the Appointments Clause of Article II of the constitution, which vests with the president the sole authority to appoint officers of the United States.

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