No. 16-492

In the Supreme Court of the United States

PEM ENTITIES LLC, PETITIONER

v.

ERIC M. LEVIN & HOWARD SHAREFF

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF OF PETITIONER

JAMES M. WILTON
GABRIELLE G. HIRZ
MEREDITH S. PARKINSON
ROPES & GRAY LLP
800 Boylston Street
Boston, MA 02199

JOHN A. NORTHEN
VICKI L. PARROTT
NORTHEN BLUE LLP
1414 Raleigh Road
Chapel Hill, NC 27515

DOUGLAS HALLWARD-DRIEMEIER
Counsel of Record
ROPES & GRAY LLP
2099 Pennsylvania Ave., N.W.
Washington, DC 20006
(202) 508-4776
Douglas.Hallward-Driemeier@ropesgray.com

D. ROSS MARTIN
GREGG M. GALARDI
ROPES & GRAY LLP
1211 Avenue of the Americas
New York, NY 100364

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases:

Cases—Continued: Page(s)

Cases—Continued: ..... Page(s)

Statutes:

Miscellaneous:

In the Supreme Court of the United States

No. 16-492

PEM ENTITIES LLC, PETITIONER

v.

ERIC M. LEVIN & HOWARD SHAREFF

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF OF PETITIONER

Respondents' brief in opposition acknowledges the split of authority regarding the source of law for debt recharacterization in bankruptcy. This case is the ideal vehicle to address that conflict. The bankruptcy court resolved this case on cross-motions for summary judgment. Pet. App. 19a. The bankruptcy court rejected respondents' assertions of insider liability based on accusations of bad acts (which respondents repeat in their counterstatement of facts), and imposed liability solely on the basis of a federal standard for debt recharacterization. Under North Carolina law, by contrast, the debt would have been recognized as valid. Thus, the choice between a state and federal rule of decision for debt recharacterization in bankruptcy is dispositive.

The time is ripe for this Court to consider the issue. Respondents concede that seven courts of appeals have ruled on whether a federal or state standard governs

debt recharacterization. The circuit split is well-developed and shows no signs of abating, notwithstanding respondents' arguments to the contrary. Two courts of appeals specifically rejected application of a federal law rule of decision applied by other circuits, holding instead that state law governs the inquiry. The Tenth Circuit has specifically reaffirmed its application of federal law in the face of the conflict. The Fourth Circuit in this case denied a motion for rehearing en banc to reconsider, in light of contrary authority, its precedent applying federal law to this issue. Numerous courts have now expressly noted the stark nature of the circuit split. Only this Court can resolve the conflict.

I. THERE IS A WELL-DEVELOPED CIRCUIT SPLIT THAT SHOWS NO SIGNS OF RESOLUTION

A. Contrary To Respondents' Assertion, The Fifth And Ninth Circuits Have Each Held That State Law Provides The Rule Of Decision For Debt Recharacterization

Respondents' attempt to minimize the conflict fails. Respondents contend that the Fifth Circuit in *Lothian Oil* does not clearly or actually adopt a state law rule of decision for debt recharacterization. Br. in Opp. 9-12. That is incorrect. In *Grossman* v. *Lothian Oil Inc. (In re Lothian Oil Inc.)*, the Fifth Circuit held that "the bankruptcy court may not allow" a claim that "asserts a debt that is *contrary to state law*," and that "recharacterizing the claim as an equity interest is the logical outcome" where "the reason for such disallowance is that *state law classifies the interest* as equity rather than debt." 650 F.3d 539, 543-544 (2011) (emphasis added), cert. denied sub. nom., *Lothian Cassidy, LLC* v.

Lothian Oil Inc., 132 S. Ct. 1573 (2012) (*Lothian Oil*). Respondents concede, as they must, that in *In re Fitness Holdings International, Inc.*, the Ninth Circuit held that, for purposes of "determin[ing] whether a transaction creates a debt or an equity interest[,] * * * a transaction creates a debt if it creates a 'right to payment' *under state law*." 714 F.3d 1141, 1141 (2013) (*Fitness Holdings*) (emphasis added). The conflict is therefore clear.

Courts applying state law base their decisions on an approach to statutory interpretation that is fundamentally different from those courts that apply federal law. Those courts embracing a federal rule reason that Bankruptcy Code Section 105(a) grants bankruptcy courts substantive equitable authority to recharacterize debt as equity. *See Redmond* v. *Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139, 1146 (10th Cir. 2015); *Cohen* v. *KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 454 n.6 (3d Cir. 2006) (*SubMicron*); *Fairchild Dornier GmbH* v. *Official Comm. of Unsecured Creditors (In re Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225, 231 (4th Cir. 2006); *Bayer Corp.* v. *MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726, 748 (6th Cir. 2001). By contrast, the Fifth and Ninth Circuits reason that debt recharacterization may only be exercised under the courts' claims disallowance authority found in Bankruptcy Code Section 502(b)(1). *Lothian Oil*, 650 F.3d at 543; *Fitness Holdings*, 714 F.3d at 1148. They expressly reject that Section 105(a) provides independent authority to recharacterize debt as a matter of federal law. *Lothian Oil*, 650 F.3d at 543; *Fitness Holdings*, 714 F.3d at 1149.

Lower courts also recognize the existing conflict. See, *e.g.*, *Goodman* v. *H.I.G. Capital, LLC (In re Gulf Fleet Holdings, Inc.)*, 491 B.R. 747, 773 (Bankr. W.D. La. 2013) (holding that "[t]he Fifth Circuit * * * recently changed the landscape of recharacterization actions"); *Gecker* v. *Flynn (In re Emerald Casino, Inc.)*, No. 02B22977, 2015 WL 1843271, at *8 (N.D. Ill. Apr. 21, 2015) (noting that "the circuits are split"); *Duke and King Mo., LLC* v. *Nath Cos.* (*In re Duke & King Acquisition Corp.)*, 508 B.R. 107, 156-157 (Bankr. D. Minn. 2014) (finding courts have derived their debt recharacterization authority from "differing sources" and imposed multiple different tests).

B. The Circuit Split Is Entrenched And Appears To Be Deepening

Contrary to respondents' suggestion, there is no reason to believe that the conflict will abate without this Court's intervention. Those circuits that have adopted one or the other rule are unlikely to reverse course. The Fifth and Ninth Circuits adopted a state law rule of decision after expressly rejecting other courts' adoption of a federal test. See *Lothian Oil*, 650 F.3d at 543; *Fitness Holdings*, 714 F.3d at 1148.

On the other side of the split, the Tenth Circuit has expressly considered whether to change its approach in light of *Fitness Holdings* and *Lothian Oil*, but decided to retain a thirteen factor federal test. See *In re Alternate Fuels, Inc.*, 789 F.3d at 1146 (holding that the "Tenth Circuit's *Hedged-Investments* Test [r]emains [g]ood [l]aw"). Similarly, in this case, the panel applied a federal test comprised of "the eleven factors adopted by [the Fourth Circuit previously] in *Dornier*," Pet. App. 6a, and then the court of appeals declined peti-

tioner's request for en banc rehearing to consider the reasoning of *Dornier* in light of Fitness *Holdings* and *Lothian Oil*. There is no reason to believe the seven courts of appeals that have already addressed the issue will converge on one rule.

Decisions within those circuits that have not ruled confirm the unsettled nature of the issue and suggest that the split is likely to deepen further. The Seventh Circuit has acknowledged that it has "never definitively stated whether we recognize a cause of action for re-characterization." *FCC* v. *Airadigm Commc'ns*, *Inc. (In re Airadigm Commc'ns*, *Inc.)*, 616 F.3d 642, 657 n.11 (2010). Lower courts in that circuit are divided. Respondents cite one case for the proposition that lower courts in the Seventh Circuit have favored a federal rule of decision, Br. in Opp. 10 (citing *In re Emerald Casino, Inc.*, 2015 WL 1843271), but ignore a different lower court decision within the same district adopting a state law rule of decision, see *In re SGK Ventures*, *LLC*, 521 B.R. 842, 860-861 (Bankr. N.D. Ill. 2014) (affirming that it was "unlikely that the Seventh Circuit would find that the equitable power of a bankruptcy court" permits recharacterization).

Lower courts in the First Circuit appear to favor a state law rule of decision. See, *e.g.*, *Blasbalg* v. *Tarro (In re Hyperion Enterprises*, *Inc.)*, 158 B.R. 555, 561 (D.R.I. 1993)(applying a multi-factor test derived from the Rhode Island Supreme Court); *Aquino* v. *Black (In re AtlanticRancher, Inc.)*, 279 B.R. 411, 433-434 (Bankr. D. Mass. 2002) (applying the factors adopted in *Hyperion*). At least one lower court in the Eighth Circuit has expressed extreme skepticism about invoking "equitable powers under § 105(a) as a warrant to create

new remedies that would be at marked odds with other, specific provisions of the Bankruptcy Code." *In re Duke & King Acquisition Corp.*, 508 B.R. at 156-160. Respondents' portrayal of some developing consensus for a federal rule of decision is thus incorrect.

Still further, even the courts of appeals that adopt a federal rule of decision have failed to agree on a consistent test for debt recharacterization. The Eleventh Circuit applies a two prong test that is inconsistent with the *Autostyle* multi-factor approach. *In re N & D Props., Inc.*, 799 F.2d 726, 733 (11th Cir. 1986). Even the courts of appeals that have adopted multi-factor tests apply different variations. The Fourth Circuit here applied the "eleven factors adopted * * * in *Dornier*." Pet. App. 6a. The Third Circuit applies a seven factor test. *SubMicron*, 432 F.3d at 455-456. The Tenth Circuit, a thirteen factor test. *Sender* v. *Bronze Grp., Ltd. (In re Hedged-Investments Assocs., Inc.)*, 380 F.3d 1292, 1298 (2004).

Lower courts in other circuits have embraced other variants of federal rules. See, *e.g.*, *Moglia* v. *Quantum Indus. Partners, LDC (In re Outboard Marine Corp.)*, No. 00 B 37405, 2003 WL 21697357, at *5 (N.D. Ill. July 22, 2003) (adding to *AutoStyle* test two state law-derived factors borrowed from *Hyperion*); *Bunch* v. *J.M. Capital Fin., Ltd. (In re Hoffinger Indus, Inc.)*, 327 B.R. 389, 408 (Bankr. E.D. Ark. 2005) (applying fifteen factors, including eleven factors applied in *AutoStyle*). Respondents' claimed "well-established" federal test based on *AutoStyle*, Br. in Opp. 13, is more fiction than fact.

There is no benefit in this Court delaying review while waiting for more development in the lower

courts. Rather, the lower courts are in dire need of direction from this Court to establish uniformity on this important question of bankruptcy law.

II. This Case, Involving A Purchase Of Bona Fide Third-Party Debt, Is An Ideal Vehicle To Resolve The Circuit Split

A. The Bankruptcy Court Rejected All Claims Other Than Debt Recharacterization

While respondents seek to muddy the waters by repeating their allegations of bad acts against petitioners, Br. in Opp. 1-2, the posture of this case makes it the ideal vehicle to resolve the circuit split. In bankruptcy court, respondents raised causes of action for fraudulent transfer and equitable subordination, but those were denied on summary judgment. The only relief granted was on their debt recharacterization claim. Pet. App. 38a-39a. Respondents did not appeal the dismissal of their claims for fraudulent transfer and equitable subordination. The sole issue before this Court is whether the courts below erred in using the Fourth Circuit's federal rule of decision for debt recharacterization.

Respondents argue that *Fitness Holdings* presents a better vehicle for consideration of debt recharacterization, but the opposite is true. This case differs from *Fitness Holdings* in two critical respects, each of which supports using this case as the vehicle to resolve the circuit split.

First, in *Fitness Holdings*, the debt recharacterization issue is intermingled with other causes of action rather than being isolated for review. Like this case, *Fitness Holdings* involved creditors who alleged

wrongful acts by insiders and brought several causes of action: fraudulent transfer (incorporating a debt re-characterization issue), equitable subordination, and breach of fiduciary duty. Although the Ninth Circuit has reviewed that case twice, it remains at the motion-to-dismiss stage with multiple legal theories remaining. *Leslie* v. *Hancock Park Capital II, L.P. (In re Fitness Holdings Int'l)*, 660 F. App'x 546, 548 (2016). The facts are not fully developed, and the debt recharacterization issue is not isolated. As a result, this Court's decision in *Fitness Holdings* would not necessarily be outcome determinative. In contrast, the present case has a fully developed record, a trial court decision, and no material disputed facts. Pet. App. 22a. A merits decision by this Court would undoubtedly be outcome determinative.

Second, the facts relevant to recharacterization are simpler in this case. In *Fitness Holdings*, the insiders made investments documented as mere unsecured promissory notes. 714 F.3d at 1143. The trustee claimed that the notes were, in reality from the outset, equity interests subject to recharacterization and therefore their repayment was an improper dividend and constructive fraudulent transfer. This case, by contrast, involves recharacterization of unquestionably bona fide third-party secured mortgage debt loaned by a bank, recharacterized only because an insider purchased that debt.

The bankruptcy court here determined that the insider took no wrongful action with respect to the bankruptcy estate (rejecting an equitable subordination cause of action) but nevertheless deemed debt originated as an arm's length mortgage loan to be mere equity. As noted in the petition (at 26-27), the multi-factor test

applied by the lower court to recharacterize bona fide third-party debt, when statutory doctrines like equitable subordination were not available, highlights problems that this Court has previously identified. This case would allow the Court to consider an uncluttered, well-developed record and illuminate the outer bounds of debt recharacterization analysis.

B. It Is Clear, and Respondents Do Not Contest, That Application Of North Carolina Law Would Be Outcome Determinative

Respondents do not dispute that use of a federal rather than state rule of decision for debt recharacterization was outcome determinative in this case. Indeed, respondents' opposition itself demonstrates this, because it attaches a judgment of North Carolina Business Court handed down after the filing of the petition for certiorari. This state court judgment provides an unusual opportunity to observe exactly how a North Carolina court would address these facts. In a state court action by respondents, the court addressed the fact that the debt at issue was originally made by a bank as a bona fide secured mortgage loan, and held that there were no wrongful acts that would support the state court "ignor[ing] the existence of that debt." Br. in Opp. 8a; see also *ibid.* (holding that petitioner's purchase of the loan "indirectly benefited" respondents since it forestalled the bank's foreclosure of the real estate).

Accordingly, and as indicated in the petition (at 23-25), respondents are receiving different treatment in bankruptcy court than they would have received in state court due to the application of a federal rule of decision for debt recharacterization. Other cases have al-

so recognized the often outcome-determinative nature of the choice between state and federal rules of decision. See, *e.g.*, *Gernsbacher* v. *Campbell* (*In re Equip. Equity Holdings, Inc.)*, 491 B.R. 792, 862 (Bankr. N.D. Tex. 2013) (finding that Massachusetts law "seems to 'set the bar higher' and require pragmatic and equitable balancing, rather than rigid computation of factors in [the federal rule's] checklist"); *Goodman* v. *H.I.G. Capital, LLC (In re Gulf Fleet Holdings, Inc.)*, 491 B.R. 747, 774-775 (Bankr. W.D. La. 2013) (holding that "these allegations may support a pre-*Lothian Oil* claim for equitable recharacterization under section 105" but were insufficient under Louisiana law); see also Pet. 23 (collecting state law cases).

The application of inconsistent rules of decision inside and outside of bankruptcy is precisely what this Court's decisions have sought to avoid. See, *e.g.*, *Travelers Cas. & Sur. Co. of Am.* v. *Pac. Gas & Elec. Co.*, 549 U.S 443 (2007); *Raleigh* v. *Illinois Dep't of Revenue*, 530 U.S. 15 (2000); *Butner* v. *United States*, 440 U.S. 49 (1979). This case provides the Court a perfect vehicle to set the lower courts on a path that respects the statutory scheme of the Bankruptcy Code and this Court's prior decisions.

III. Resolution Of The Circuit Split Is Important To Bankruptcy And Commercial Law

This Court has long prioritized the uniform treatment of claims inside and outside of bankruptcy "to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'" *Butner* v. *United States*, 440 U.S. 49, 55 (1979) (quoting *Lewis* v.

Manufacturers Nat'l Bank of Detroit, 364 U.S. 603, 609 (1961)). Accordingly this Court has repeatedly held that state law determines the allowance of bankruptcy claims. See, *e.g.*, *Travelers Cas. & Surety Co. of Am.*, 549 U.S. at 450.

When respondents call for a period of "percolation" to allow the "various States to serve as laboratories," Br. in Opp. 12-13, they entirely miss the point of the question presented. This Court does not determine what the state law rules of decision are. "[F]ederal judges who deal regularly with questions of state law in their respective districts and circuits are in a better position" to determine what the state rules are. *Butner*, 440 U.S. at 58. Petitioners seek this Court's review of the federal question concerning interpretation of bankruptcy law: whether Congress has granted the bankruptcy courts substantive equitable powers to adopt a federal rule of debt recharacterization even when inconsistent with the claims allowance provisions of the Bankruptcy Code and the state law of debt recharacterization.

Respondents do not contest that the issue is important. Resolving the circuit split would provide important clarity to insiders investing in small businesses and traders of third-party debt claims. See Mark A. Salzberg, *Debt Recharacterization Lessons from 4th Cir.*, Law360 (Sept. 19, 2016), https://www.law360.com/articles/841401/debt-recharacterization-lessons-from-4th-circ. Uniformity is best served by application of state law. When loans are made, those transactions are documented under local state law. Creditors (and their local lawyers) are in a position to know the state law that applies to their individual transactions and may be

reticent to loan money to small businesses in financial distress without certainty that, in bankruptcy court, they can rely on the enforceability of loans under state law. A party making or purchasing a loan should not have to consult bankruptcy counsel regarding a special set of federal bankruptcy debt recharacterization rules. Inconsistent decisions among the circuits concerning the law applicable to debt recharacterization in bankruptcy make the enforceability of rescue loans uncertain and inhibit investment in distressed businesses. The regularity of using state law to determine these questions as part of the claim allowance process in bankruptcy under Section 502(b)(1) will, therefore, facilitate reorganization.

Even one of the courts that adopted a federal rule has cautioned that "excessive suspicion about loans made by owners and insiders of struggling enterprises would discourage legitimate efforts to keep a flagging business afloat." *Sender* v. *Bronze Grp., Ltd. (In re Hedged-Investments Assocs., Inc.)*, 380 F.3d 1292, 1299 n.1 (10th Cir. 2004). Debt recharacterization has been litigated in hundreds of decisions and is a regularly recurring issue in the bankruptcy courts. There is an undisputed and deepening circuit split, and this is an ideal vehicle for this Court to provide much needed guidance to the lower courts.

CONCLUSION

For the foregoing reasons and those stated in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted,

DOUGLAS HALLWARD-DRIEMEIER
D. ROSS MARTIN
JAMES M. WILTON
GREGG M. GALARDI
GABRIELLE G. HIRZ
MEREDITH S. PARKINSON
ROPES & GRAY LLP

Counsel for Petitioner

JOHN A. NORTHEN
VICKI L. PARROTT
NORTHEN BLUE LLP

MARCH 2017