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On the Edge

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Does Federal Common Law Define a Business Trust's Eligibility for Chapter 11?

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Many courts have struggled to determine whether an entity is a "business trust" that is eligible to be a "debtor" under the Bankruptcy Code. Only a "person" (defined as an individual, partnership or corporation)[1] can file a voluntary case under title 11. The definition of "corporation" is limited to business entities, which includes business trusts.[2] Furthermore, the burden of proof in establishing eligibility for bankruptcy relief lies with the party filing the petition.[3] Thus, ascertaining whether an entity such as a business trust qualifies for relief pursuant to chapter 11 presents the petitioner with an important initial question to establish whether it may file.

The crux of the issue, however, arises from the Code's failure to define what a business trust is within the context of bankruptcy. Moreover, there is "no uniform standard ... to define what constitutes a 'business trust.'"[4] This deficiency has subsequently forced many courts to develop their own standards with respect to whether federal common law or state law should apply. Although the issue remains largely unsettled, the U.S. Bankruptcy Court for the District of Delaware, in a June 2021 decision, declined to follow several cases that hold that whether an entity is a business trust is a question of federal law. Instead, it "embraced the bedrock principle of *Butner v. United States* that bankruptcy judges should not unsettle non-bankruptcy rights in the absence of a clear directive from Congress."[5]

History of Business Trusts in the Bankruptcy Code

The Code's lack of a proper definition for what constitutes a business trust has allowed courts to fluctuate on interpreting its meaning. Nonetheless, the Code's history, and its development over time, provides some clarity with respect to its intent when including business trusts within the definition of "corporation." In the 1926 amendment, the drafters included a definition of "corporation" for the first time. The original definition included "any business conducted by a trustee or trustees wherein beneficial interest or ownership is evidenced by certificate or other written instrument."[6]

Over the years, the definition of "corporation" has evolved. It was not until 1978 that the Code made a specific provision for the inclusion of business trusts.[7] This newly added provision removed the requirement of a written certificate, and many courts determined that Congress included business trusts in the Code because of their similarity to corporations.[8]

Although the purpose of including business trusts appears evident, what constitutes one remains an open question. Courts have developed several approaches in attempting to label which business trusts fall within and outside of the Code's purview. Some courts have used a categorical approximation approach that simply excludes certain trusts based on inherent characteristics incompatible with serving a business purpose.[9] For example, certain courts

1 11 U.S.C. § 101(41).
2 11 U.S.C. § 101(9)(A)(v).
3 *In re EHT US1 Inc.*, ___ B.R. ___, No. 21-10036 (CSS), 2021 WL 2206507, at *8 (Bankr. D. Del. June 1, 2021).
4 *In re Catholic Sch. Emps. Pension Trust*, 599 B.R. 634, 653 (B.A.P. 1st Cir. 2019).
5 *EHT US1 Inc.*, 2021 WL 2206507, at *2.
6 Jared W. Speier, "Clarifying the Business Trust in Bankruptcy: A Proposed Restatement Test," 43 *Pepp. L. Rev.* 1065, 1079 (2016).
7 *Id.*
8 *Id.* (citing *In re Old Second Nat'l Bank of Aurora*, 7 B.R. 37, 38 (Bankr. N.D. Ill. 1980)).
9 *Id.* at 1081 (citing Takemi Ueno, Comment, "Defining a 'Business Trust': Proposed Amendment of Section 101(9) of the Bankruptcy Code," 30 *Harv. J. on Legis.* 499, 503 (1993)).

have categorically discarded family and land trusts because the goal of the trust was to preserve property and not engage in business.[10] A majority of courts, however, have decided to take a more individualized general inquiry approach. Under this approach, courts do not deny eligibility solely on the trust's categorical classification, but look to see if it is in fact engaging in any for-profit or businesslike activity.[11] Regardless of approach, courts have relied largely on a combination of state or federal common law and the Code to determine chapter 11 eligibility.

The Split of Authority

In determining the chapter 11 eligibility of a "business trust," a split of authority exists as to which law governs: the law of the jurisdiction in which the trust resides, or federal common law.[12] Overall, the weight of authority leans in favor of applying federal common law. Historically, many bankruptcy courts have concluded that federal law governs the chapter 11 eligibility of a "business trust."[13] In a 2002 decision, the U.S. Court of Appeals for the Sixth Circuit stated that "the definition of 'business trust' properly belongs to federal, rather than state, law."[14] More recently, the U.S. Bankruptcy Appellate Panel of the First Circuit[15] and the U.S. Bankruptcy Court for the Western District of Pennsylvania[16] held that whether a business trust is eligible for bankruptcy relief is a matter under federal law. Courts holding that federal law applies have found the language of Article I, § 8, Clause 4 of the Constitution instructive.[17] That directive provides that "Congress shall have the power ... to establish ... uniform laws on the subject of bankruptcies."

The argument bolstering those courts' adherence to federal common law emerges from concerns that to hold that state law governs the question of whether an entity is a business trust "would result in different results in different states and an entity would be eligible for relief in one state but not another."[18] These courts have crafted federal common law on the issue because "[t]here is no federal [statutory] law that creates business entities."[19] However, not all courts have agreed that federal common law should apply.

The Bedrock Principle of *Butner*

In making chapter 11 eligibility decisions rather than following federal common law, some courts have turned to the bedrock principles of *Butner v. U.S.*[20] In *Butner*, the U.S. Supreme Court rejected the federal common law standard in bankruptcy proceedings. *Butner*'s specific facts concerned a dispute between a bankruptcy trustee and mortgage lender regarding the rights to the rent collected in the interim period between the bankruptcy filing and the foreclosure of property. The Court chose not to adopt a federal rule of equity like many previous circuit courts had chosen to do for the sake of uniformity, reasoning that doing so would require a federal statute on the subject at hand.[21] Because Congress had not exercised that power with regard to a mortgagee's rental interest in a bankrupt estate, the property-right issue had to be determined by state law.[22] The Court opined that when interests are

> created and defined by state law ... there is no reason why such interest should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment ... by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."[23]

Through *Butner*, the Court signaled its adherence to constitutional interpretative considerations requiring that state law govern in the absence of express congressional legislation on a topic, opposing the use of undefined court-created considerations of equity merely because such schemes are viewed as interpretively easier.

Although the Delaware Bankruptcy Court rejected federal common law as the prevailing determinant of an entity's eligibility for a chapter 11 claim despite the weight of authority, its reasoning may become the new standard.

Application of *Butner* in *In re EHT US1 Inc.*

Disagreeing with the federal common law approach taken by the Sixth Circuit, the First Circuit Bankruptcy Appellate Panel, and several lower courts, Hon. **Christopher S. Sontchi** of the Delaware Bankruptcy Court applied the state of incorporation standard set out in *Butner* to determine whether an offshore real estate investment trust (REIT) was a "business trust" eligible for chapter 11.[24] *In re EHT US1 Inc*. dealt largely with REITs organized under the laws of Singapore, which filed chapter 11 petitions in Delaware.[25] After the REITs filed their claim for relief, the largest creditor filed a motion asking the bankruptcy court to dismiss the petitions, arguing that the REITs were not business trusts and, therefore, were ineligible to be chapter 11 debtors.[26]

The bankruptcy court specifically rejected the argument that applying state law as opposed to federal common law would lead to divergent results with entities "eligible for

10 *Id.*
11 *Id.* at 1083.
12 *In re EHT US1 Inc.*, 2021 WL 2206507, at *9 (citing *In re Dille Family Trust*, 598 B.R. 179, 189 (Bankr. W.D. Pa. 2019); *Cutler v. 65 Security Plan*, 831 F. Supp. 1008, 1014-15 (E.D.N.Y. 1993)).
13 *See In re Sung Soo Rim Irrevocable Intervivos Tr.*, 177 B.R. 673, 676 (Bankr. C.D. Cal. 1995) (calling "availability of access to the federal bankruptcy courts and the availability of bankruptcy relief itself" a question of "federal, not state, law"). *See also Cutler*, 831 F. Supp. at 1015; *In the Matter of Arehart*, 52 B.R. 308, 310-11 (Bankr. M.D. Fla. 1985)).
14 *Brady-Morris v. Schilling (In re Kenneth Allen Knight Tr.)*, 303 F.3d 671, 679 (6th Cir. 2002).
15 *See Catholic School Employees Pension Trust*, 599 B.R. at 654 ("[T]here is consensus that federal law should govern the determination of eligibility for trusts.").
16 *See In re Dille Family Tr.*, 598 B.R. at 191-92, 2019 WL 826568, at *10.
17 *In re EHT US1 Inc.*, 2021 WL 2206507, at *10 (citing *Cutler*, 831 F. Supp. at 1015 (E.D.N.Y. 1993); *Arehart*, 52 B.R. at 310-11). *See also In re Dille Family Trust*, 598 B.R. at 191.
18 *In re EHT US1 Inc.*, 2021 WL 2206507, at *10.
19 *Id.* at *9.
20 *Butner v. United States*, 440 U.S. 48 (1979).
21 *Id.* at 54.
22 *Id.* at 55.
23 *Id.*
24 *In re EHT US1 Inc.*, 2021 WL 2206507, at *1.
25 *Id.*
26 *Id.*

relief in one state but not another."[27] Following the logic of *Butner*, the bankruptcy court held that using state law would provide identical results because each decision would rely on the jurisdiction of the state of incorporation. Even though results may be different in different states, the definition of a business trust would be uniform "based on the law of the jurisdiction under which the trust exists."[28]

Once the bankruptcy court made the determination that state law would govern the dispute, it turned its analysis to whether the REIT was a business trust under Singapore law — the "state" of incorporation in this instance. Singapore, like the U.S., does not provide a single definition of the term "business trust" and requires the trust to carry on like a business and generate profits.[29] The bankruptcy court ultimately determined that because the REITs were engaged in business, as required by Singapore's laws, this was sufficient to qualify them as a business trust under the Code, and therefore they were eligible for chapter 11 proceedings. This reasoning granted needed clarification to parties in one of the busiest corporate bankruptcy jurisdictions on the question of what law will govern any bankruptcy proceeding when a trust formed in a particular state subsequently files a petition for relief in Delaware.

The New Standard?

Although the Delaware Bankruptcy Court rejected federal common law as the prevailing determinant of an entity's eligibility for a chapter 11 claim despite the weight of authority, its reasoning may become the new standard. Undeniably, it finds support in the Supreme Court's 2020 ruling in *Rodriguez v. F.D.I.C.*, which held that federal courts may not employ federal common law to decide who owns a tax refund when a parent holding company files the tax return but a subsidiary generated the losses giving rise to the refund.[30] Rather, state law governs.[31] The unanimous opinion stated that "cases in which federal courts may engage in common lawmaking are few and far between."[32] With the constitutional interpretative precedent set by the *Butner* Court, overlaid with its decision in *Rodriquez*, practitioners should be cognizant of the currently divergent and potentially shifting landscape and interpretations surrounding the definition of "business trust" when examining whether a business trust is eligible for chapter 11 relief. abi

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27 *Id.* at 10.
28 *Id.*
29 *Id.* at *12.
30 *Rodriguez v. F.D.I.C.*, ___ U.S. ___, 140 S. Ct. 713, 716-19, 206 L. Ed. 2d 62 (Feb. 25, 2020)).
31 *Id.*
32 *Id.* at 716.