AVOIDANCE ACTION REPORT

A Bi-Annual Report on the Latest Case Law Relating to Avoidance Actions and Other Bankruptcy Issues

2600 Eagan Woods Drive, Suite 400
St. Paul, Minnesota 55121
Phone: 651.406.9665 | Fax: 651.406.9676

151 West 46th Street, Fourth Floor
New York, NY 10036
Phone: 212.267.7342 | Fax: 212.918.3427

info@askllp.com
www.askllp.com

Supreme Court Limits Creditor's Use of Safe Harbor Designed for Financial Institutions

In *Merit Management Group, LP v. FTI Consulting, Inc.* the United States Supreme Court unanimously determined that the safe harbor under Section § 546(e) of the Bankruptcy Code shielding certain transfers by, to, or for financial institutions does not apply when the financial institutions are merely a conduit for a transaction. In an opinion written by Justice Sotomayor, the Court concluded that lower courts must view the "overarching transfer" between the parties to determine whether § 546(e) safe harbor applies. The effect of this decision impliedly overrules several circuit-level decisions, including decisions in the Second and Third Circuits. The *Merit Management* decision means that transferees will no longer be able to shield transfers from avoidance by using financial institutions as conduits.

Section 546 of the Bankruptcy Code is designed to shield certain critical financial transactions from avoidance. For instance, Section 546(e) shields "forward contracts" (contracts involving the sale of commodities under certain conditions), margin payments, and payments to security clearing agencies from avoidance. The purpose of these safe harbors is to prevent avoidance actions from causing uncertainty in the nation's financial markets.

Merit Management began with two competing entities wishing to open a combination harness horse racing track and casino, or "racino," in the Commonwealth of Pennsylvania. The two parties, Valley View Downs, LP and Bedford Downs Management Corporation, attempted to obtain the last available license for their respective racino projects, but in 2005 the Pennsylvania State Harness Racing Commission denied both applications. Given the opportunity to reapply, the two competitors joined forces. Beford Downs withdrew from consideration for a license, and in exchange Valley View agreed to purchase all of Bedford Downs' stock for $55 million. Valley View eventually won its license, and arranged for payment of the $55 million. Credit Suisse, Valley View's lender, wired the money to Citizens Bank of Pennsylvania, which in turn transferred the money to Bedford Down's shareholders—including the eventual defendant, Merit Management.

As luck would have it, the racino never opened. Valley View was unable to obtain a license to operate the casino portion of the establishment, and filed bankruptcy along with its parent company. The Chapter 11 proceeded to the confirmation of a liquidating plan which appointed FTI Consulting as the liquidating trustee for the bankruptcy estate.

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FTI sued Merit, alleging that the $16.5 million it received from its share of the sale proceeds was a constructively fraudulent transfer under Section 548(a)(1)(B) of the Bankruptcy Code. FTI alleged that Valley View significantly overpaid for the Bedford Down stock, such that there was no reasonably equivalent value for the transaction. In response, Merit argued that the transfer could not be avoided because it was a "settlement payment . . . made by or to (or for the benefit of)" a covered "financial institution" as described in Section 546(e) of the Bankruptcy Code. Merit argued that because the payment passed through two financial institutions, Credit Suisse and Citizens Bank, it was part of a "settlement payment" and therefore could not be avoided. In other words, because the transfer went from A – B – C –D and B and C were financial institutions, the transfer could not be avoided.

In response, FTI argued that the various intermediaries along the way were not relevant to the analysis—the transfer was between Valley View and Merit. In that analysis, the identities of B and C are irrelevant. What matters is that the transfer was from A to D, neither of which were financial institutions.

The bankruptcy court sided with Merit, finding that because the final step in the transaction was a transfer from a financial institution, the transfer was within the § 546(e) safe harbor. FTI appealed, and the Seventh Circuit reverse the bankruptcy court's decision. Merit sought a writ of certiorari, and the Supreme Court agreed to hear the case.

At oral argument, both FTI and Merit grounded their arguments on differing interpretations of the statutory language. First, Merit argued that an amendment to the statute in 2006—the parenthetical "or for the benefit of"—was intended to shield transfers from avoidance where a financial institution was acting as an intermediary. Merit posited that this amendment intended to abrogate an earlier Eleventh Circuit case holding that transfers involving intermediate financial institutions were avoidable. While clever, the Supreme Court noted that there was no evidence to support Merit's theory. The Eleventh Circuit case was decided 10 years prior to the statutory amendment, and there was nothing in the text or the legislative history that supported such a construction. Merit also argued that because parallel portions of the statute involved securities clearing agencies—which it argued are always intermediaries in a transaction—the same construction applied to financial institutions. The Supreme Court did not find `this argument persuasive either.

FTI's argument was much more straightforward: FTI argued that the transfer was not made by, to, or for the benefit of either Credit Suisse or Citizens Bank, and therefore, it was not a settlement payment under Section 546(e). Valley View transferred the funds to Merit as part of the Bedford Downs purchase, and the financial institutions were merely intermediaries.

In the end, FTI's substantially simpler argument carried the day over Merit's conceptually difficult ones. The Supreme Court ruled that in avoiding a transfer the focus is on the "overarching transaction," not the component parts. Specifically, Justice Sotomayor's opinion honed in on the language in Section 546(e) stating that "the trustee may not avoid . . . a transfer that *is* . . . a settlement payment" (emphasis added). Merit's argument, according to the unanimous opinion, would have effectively re-written that language to a payment that only *involves* a settlement payment.

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Merit Management confirms that the scope of the Section 546(e) safe harbor does not apply to transfers in which a financial institution is only an intermediary. Crucially, *Merit Management* impliedly overturns decisions from the Second Circuit Court of Appeals that shielded such transfers under the 546(e) safe harbor. The *Merit Management* case will make it slightly easier for trustees or debtors-in-possession to avoid transfers by removing one method that creditors or transferees use to prevent transfers from avoidance.

Delaware Bankruptcy Court Finds that Liquidation Analysis under Section 547(b)(5) Must be Determined as of Petition Date

In *Stanziale v. Sprint Corporation*, Judge Gross of the Delaware Bankruptcy Court issued a decision that clarifies how a trustee's burden under Section 547(b)(5) of the Bankruptcy Code applies in cases where a creditor has a purchase-money security interest in certain assets. *Sprint* involved the bankruptcy of Simplexity, LLC, which sold and activated mobile phones for various carriers including Sprint. As part of its business, Simplexity purchased phones on credit from Sprint, with Sprint taking a purchase money security interest (PMSI) in the phones and the sale proceeds of those phones.

Simplexity's Chapter 11 case eventually converted to a Chapter 7, and Charles Stanziale was appointed as the Chapter 7 trustee. Stanziale sued Sprint to avoid over $3 million in transfers in the 90 days prior to the bankruptcy. In response, Sprint argued that its PMSI meant that it did not recover more than it would have had the case originally been a Chapter 7 liquidation and that it provided subsequent new value for some of the transfers. Both parties filed motions for summary judgment.

One of the key questions in the case was an issue of first impression in Delaware: how does a bankruptcy court apply Section 547(b)(5) in the case of a PMSI? In order to answer that question, the bankruptcy court had to decide two related issues. The first issue was when must secured status be ascertained: at the time of the transfer or the petition date? The second issue involved what a plaintiff must do to "trace" funds to determine if they were part of the creditor's collateral. The bankruptcy court started its analysis by observing that the trustee bore the burden of proof on all the elements of a preference in Section 547(b), including whether a creditor was fully secured or not. *See* 11 U.S.C. § 547(g).

On the first issue, Sprint argued that secured status must be determined at the time that the transfer is made, not at the petition date. The Chapter 7 trustee argued that secured status should be determined as of the petition date. The bankruptcy court sided with the trustee, concluding that the default rule was that secured status is determined as of the petition date.

As to the second issue, the Court determined that the liquidation analysis under Section 547(b)(5) must also be conducted as of the petition date. The trustee used an "add-back" method to determine whether Sprint would have received more than to which it was entitled in a Chapter 7 liquidation. The "add-back" method adds the amount of the alleged preference to the amount of the unpaid balance owed to the secured party and comparing it to the collateral as of the petition date. Sprint argued this method was improper, and instead argued that the Trustee bore the burden of tracing the funds. The bankruptcy court rejected Sprint's argument because Sprint's interests were exclusive to the phone handsets and their proceeds. The court noted that Simplexity's lender swept the debtor's bank accounts, including funds derived from the sale of Sprint's collateral, prior to the bankruptcy. Under the UCC, once the lender swept the bank accounts, Sprint lost its security interest in that collateral. Accordingly, the court noted that as of the petition date, Sprint was effectively unsecured, and therefore, the transfers it received during the preference period allowed it to receive more than it would have received in a Chapter 7 liquidation and were therefore avoidable.

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The *Sprint* case provides valuable guidance as to how a court will look at cases where defendants assert that a purchase-money security interest means that a trustee cannot meet his or her burden under Section 547(b)(5). Merely pointing to the existence of a PMSI is not enough; instead a court will examine whether a creditor is secured as of the petition date and whether there are any funds or assets subject to the PMSI remaining. Given that most distressed companies are subject to substantial blanket liens on their assets, creditors cannot take for granted that a PMSI will shield them from preference liability.

California Supreme Court Limits Clawback of Proceeds of Litigation Transferred from Defunct Law Firm

The California Supreme Court ruled that the trustee of a defunct law firm cannot claw back fees related to matters transferred to other firms. Heller Ehrman was a global law firm employing 700 employees, but the firm shut its doors as a consequence of the 2008 financial meltdown. As the firm wound down, its attorneys found new positions at numerous other law firms. As part of its dissolution, Heller Ehrman issued a "*Jewel* waiver," a California waiver that disclaimed the defunct firm's interests in the proceeds of any hourly litigation that departed with an attorney. The firm eventually filed a Chapter 11 liquidating bankruptcy, and a court appointed a plan administrator to handle the remaining wind-down.

The administrator sued a number of law firms who hired Heller Ehrman attorneys, alleging that the *Jewel* waiver was a fraudulent transfer. This raised a critical question: what property interest does a defunct law firm have in the proceeds of a departed attorney's hourly matters?

The administrator argued that Heller Ehrman had a property interest in the hourly fees accrued post-dissolution, and the failure of either the departing lawyers or their new law firms to provide reasonably equivalent value for that property constituted a fraudulent transfer. The defendant law firms argued that there was no fraudulent transfer because the rights to post-dissolution fees was not property of the firm to begin with, and even if it were, those rights had no value at the time of the transfer. Both parties filed motions for summary judgment.

The bankruptcy court sided with the administrator, concluding that that the defunct firm had a property interest in the unfinished work and that no reasonably equivalent value was provided for the transfer. The law firms appealed to the district court, which reversed the bankruptcy court. The district court examined the Revised Uniform Partnership Act (RUPA) in reaching its conclusion that there was no property interest at stake in the transfer. The district court reasoned that under RUPA, a dissolved law firm has no right to seek an accounting from a former partner for hourly fees incurred on matters performed at the old firm. Thus, there was no asset that could be fraudulently transferred.

The plan administrator appealed to the Ninth Circuit Court of Appeals. Because the case involved questions of state law that had not been clearly decided, the Ninth Circuit requested that the California Supreme Court issue a ruling.

The California Supreme Court's ruling engaged in a deep analysis of the current state of California partnership law. *Jewel* and the other cases interpreting it had all been decided prior to California's enactment of RUPA. This meant that the California Supreme Court was obligated to re-examine those questions in light of the new statutory framework for partnerships. In so doing, the supreme court determined that Heller Ehrman had no property rights in the fees its former attorneys earned on matters transferred post-dissolution.

Specifically, the supreme court noted that under RUPA, many of the duties that a partner has to a partnership expire upon dissolution. While a partner has fiduciary and other duties to account for business during the life of a partnership, those obligations cease when the partnership dissolves. Further, there is no concrete expectation of future profits from work at a law firm: a client has the right to fire its attorneys at any time and for any reason. A partnership like Heller Ehrman has only a limited interest in work done by its partners, and the supreme court held that interest was insufficient to qualify as a property right that could be transferred.

In addition, the supreme court, guided by submissions from a number of *amici*, determined that the policy

implications of giving dissolved law firms property interests in transferred litigation would be harmful to both lawyers and clients. Lawyers would be substantially less likely to move between firms if their former firms could demand payments from their work, and clients would lose the opportunity to work with the lawyers of their choice.

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While this decision applies only California law, the majority of states and the District of Columbia have adopted RUPA, meaning that other states would likely follow similar logic. This seemingly narrow decision could apply in many other contexts where trustees, administrators, receivers, or others seek to recover assets from dissolved partnerships. This case also highlights the fact that property interests are defined by state law, and understanding the nuances of state property laws can potentially make or break an avoidance claim.

Eighth Circuit BAP Concludes that Business Owner's Former Spouse Not a Non-Statutory Insider

The Bankruptcy Appellate Panel for the Eighth Circuit Court of Appeals recently issued a decision i*n In re Top Hat 430, Inc.* rejecting an expansive interpretation of who is a "non-statutory insider" for the purpose of clawing back preferential or constructively fraudulent payments. Top Hat bought and sold used jewelry from consumers, taking in old jewelry and either selling off the component gemstones and precious metals or reselling the complete piece for a profit. In order to keep the business afloat, Top Hat obtained bridge loans from lenders, one of whom was Pennie Glasser, the ex-wife of the company's president. Ms. Glasser was also a low-level employee at the business, helping sort the jewelry as the company processed it. When Top Hat received a tranche of private placement funding, it repaid the bridge investors, including Ms. Glasser. Ms. Glasser also received a substantial interest payment. However, despite the funding, the business did not succeed and filed for bankruptcy less than a year later.

The Chapter 7 trustee for the Top Hat estate sued Ms. Glasser, asserting that she was an insider of the business and therefore her repayment on the bridge loan could be clawed back as a preference and as a constructively fraudulent transfer under state law. The trustee's claim depended on the ex-wife being an insider and thus subject to a longer one-year reach-back period. Further, the trustee could not rely on the enumerated list of "insiders" as defined by the Bankruptcy Code, but had to assert that she was a "non-statutory insider"—someone who exerted sufficient control over the debtor to effectively become an insider. The trustee claimed that the ex-wife was an insider because of her "close" relationship with the debtor's President (including having some children together), because she allegedly had inside information about the condition of the business, and that the terms of the bridge note were not made at arm's length. The trustee's assertion that it was not a less-than-arm's-length transaction was based on the favorable interest rate of the bridge note as well as a personal guarantee from the ex-husband.

In response, Ms. Glasser contended that she was in the same position as any other lender. She had, at best, a "cordial" relationship with her ex-husband, but they were not particularly close. Further, the debtor's CFO testified that Ms. Glasser had no special information about the company, and that the company gave both Ms. Glasser and her husband the same information it gave to all other lenders. Further, Ms. Glasser was not involved in negotiating the terms of her bridge note—her current husband, who was not an insider, had requested the personal guarantee as a condition of making the loan.

At trial, the bankruptcy court determined that Ms. Glasser was not an insider of the debtor. The court cited a case involving a multi-factor test used to determine whether an ex-spouse may be a non-statutory insider: *In re O'Neill,* No. AP 15-07005, 2016 WL 1604396 (Bankr. D.N.D. Apr. 19,

2016). Applying those factors, the court concluded that because Ms. Glasser divorced her ex-husband years ago, remarried, and had no financial ties with him, the mere fact that they were once married did not make her an insider. Likewise, the court noted that Ms. Glasser had no apparent influence over when she got paid—to the contrary, the evidence at trial was that her requests for payment were routinely ignored.

However, despite concluding that she was not an insider, the court concluded in dicta that the transaction was not made at arm's length because the terms of Ms. Glasser's bridge note were more favorable than those of other lenders.

The Chapter 7 trustee appealed. The BAP affirmed the bankruptcy court's conclusion that Ms. Glasser had no close relationship that would make her a non-statutory insider. The BAP focused on the fact that there was no evidence that Ms. Glasser had any degree of control over who received payments on the bridge note.

The BAP went further by stating that the terms of the bridge note were negotiated at arm's length. The BAP observed that it was Ms. Glasser's current husband that negotiated the bridge note. The note's favorable terms were in line with the risk of a short-term bridge note and were calculated to protect against a potential default. The BAP accepted Glasser's argument that the terms of bridge note were due to hard negotiation rather than the debtor's favoritism.

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Top Hat demonstrates that despite some cases that have provided an expansive definition of who may be deemed a non-statutory insider, the analysis is nevertheless fact-intensive. The key element missing in the Chapter 7 trustee's case was evidence that Ms. Glasser had power to influence how and when she received payment on the bridge note. Plaintiffs seeking to avoid transactions based on the defendant being a non-statutory insider cannot merely rely on indicia of a "close" relationship, but must demonstrate how that relationship led to favorable treatment.

Editors:

Edward E. Neiger, Esq. ..... eneiger@askllp.com

Joseph L. Steinfeld Jr., Esq. ..... jsteinfeld@askllp.com

Jay Reding, Esq. ..... jreding@askllp.com

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