Bankruptcy Bulletin

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Supreme Court Limits the Financial Settlement Safe Harbor of § 546(e)

In *Merit Mgmt. Group, LP v. FTI Consulting, Inc.*, __ U.S. __, 138 S. Ct. 883 (2018), the Supreme Court declared that the only relevant transfer for purposes of the trustee's avoidance powers "is the transfer that the trustee seeks to avoid." The fact that a transfer involves intermediate financial institutions does not implicate the financial settlement safe harbor of § 546(e) if the trustee seeks to avoid only the ultimate transfer between the non-financial-institutions.

The debtor had competed with another company for years for a harness racing license. Eventually, the debtor agreed to buy the other company and the other company withdrew its bid for the license. For the buy-out, the shareholders deposited their stock certificates into an escrow bank and the debtor deposited cash into a different escrow bank. The escrow banks distributed the assets after both sides fulfilled their contractual requirements.

After the debtor failed, it filed a bankruptcy petition. The bankruptcy court confirmed a chapter 11 plan and established a litigation trust. The trustee filed suit against the former shareholders of the acquired company arguing that the transfer was constructively fraudulent because the debtor was rendered insolvent and overpaid for the shares. The former shareholders sought judgment on the pleadings under Rule 12(c), contending that the transfer was a "settlement payment . . . made by or to (or for the benefit of)" a covered financial institution. § 546(e). The trial court granted the Rule 12(c) motion. The Court of Appeals reversed, finding that the escrow banks were "mere conduits."

Before the Supreme Court, the former shareholders argued that determining the applicability of the securities safe harbor in a multi-transaction transfer requires the reviewing court to consider the "component parts" of the transaction—i.e., not only the A → D "end-to-end" transfer, but the A → B → C → D transfers that included the two intermediary financial institutions. The trustee argued that only the A → D "overarching transfer" between debtor and the former

shareholders mattered in the avoidance analysis.

Justice Sotomayor, writing for a unanimous Court, agreed with the trustee, but did not adopt the term "mere conduit." The Court relied on the plain language of § 546(e) and the statutory structure of the Code in holding that "the focus of the inquiry is the transfer that the trustee seeks to avoid." In short, § 546(e) is an exception to the trustee's avoidance powers ("[n]otwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title . . . ."). Thus, the "starting point for the § 546(e) inquiry" is *how* the trustee seeks to employ the avoidance power to which the securities safe harbor provides an exception—i.e., "the transfer the trustee seeks to avoid."

The Court further held that the Code's structure—which frames the § 546(e) exception and the avoidance powers as "two sides of the same coin"—buttresses this interpretation, and also limits the scope of how a trustee may identify an avoidable transfer: "The trustee . . . must establish to the satisfaction of a court that the transfer it seeks to set aside meets the characteristics set out under the substantive avoidance provisions. Thus, the trustee is not free to define the transfer that it seeks to avoid in any way it chooses." A defendant may, of course, argue the trustee failed to identify a transfer within the Code's specific criteria; but if the court determines the trustee properly identified such a transfer "the court has no reason to examine the relevance of component parts when considering the limit to the avoiding power . . . ."

http://my.mnbar.org/blogs/karl-johnson/2018/04/17/supreme-court-limits-the-financial-settlement-safe

Unsecured Creditor May Pursue a Fraudulent Transfer Claim in State Court After Bankruptcy Case is Closed

In *Forster v Theis et al.*, 906 N.W.2d 846 (Minn. Ct. App. 2017), the Minnesota Court of Appeals found the Minnesota state court had subject-matter jurisdiction to consider an unsecured creditor's fraudulent transfer action because the bankruptcy action was closed and the bankruptcy trustee did not reopen the bankruptcy case to pursue the avoidance action.

Plaintiffs successfully objected to discharge of the debt owed to them by the debtors pursuant to 11 U.S.C. § 523(a)(4). During the plaintiffs' post judgment discovery, they uncovered several transfers made to insiders of the debtors. The plaintiffs filed a complaint in state court seeking to avoid the transfers, arguing the transfers were voidable under the Minnesota Uniform Fraudulent Transfer Act ("MUFTA"). The defendants challenged the state court's subject-matter jurisdiction and the plaintiffs' standing. The defendants argued that the bankruptcy court had exclusive jurisdiction and the bankruptcy trustee had exclusive standing to avoid the transfers at issue.

The Court of Appeals acknowledged that only a bankruptcy trustee may avoid fraudulent transfers under §§ 544 and 548 while a bankruptcy case is pending. Here, however, the bankruptcy case was closed and the bankruptcy trustee did not reopen the bankruptcy case to seek to avoid the transfers. In reaching its decision, the court rejected the defendants' argument that the doctrine of equitable tolling preserves the bankruptcy trustee's exclusive standing to pursue the fraudulent transfer claim.

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Potential Adversary Proceeding Defendant is Not a "Person Aggrieved" With Standing to Appeal Plan Confirmation

In *Wigley v. Wigley (In re Wigley)*, 997 F.3d 681 (8th Cir. 2018), the Eighth Circuit considered whether a non-party to a bankruptcy proceeding has standing to appeal a bankruptcy court order that allows litigation to proceed against the non-party.

Prior to the bankruptcy case, a creditor sued the debtor for past-due and future accruing rent based on a personal guaranty. While the action was pending, the debtor transferred some of his assets to his wife. After obtaining judgment against the debtor, the creditor (and others) sued the debtor and his wife in state court under the Minnesota Uniform Fraudulent Transfer Act. The state court found the debtor and his wife jointly and severally liable for $795,098 of fraudulently transferred funds. The debtor then filed for Chapter 11 bankruptcy.

The debtor's first proposed plan of reorganization sought to settle the fraudulent transfer action for a $350,000 payment from his wife. The bankruptcy court denied confirmation, concluding that the proposed settlement was not fair. The court eventually confirmed a subsequent plan, which did not settle the fraudulent transfer action, and separately granted the creditor's motion for relief from stay so that the creditor could exercise its rights against the debtor's wife. The debtor's wife appealed to the BAP, which dismissed her appeal for lack of standing.

The Eighth Circuit affirmed, explaining that only a "person aggrieved" has standing to appeal an order of the bankruptcy court. An individual is a "person aggrieved" only if she has been "directly and adversely affected pecuniarily" by the order. The Eighth Circuit found that the wife's alleged harm—which was based on potential litigation—was too indirect to confer standing. The court reaffirmed its prior holding that "a bankruptcy court order allowing litigation to proceed against an adversary defendant does not make that defendant a party aggrieved." *See Opportunity Finance, LLC. v. Kelley*, 822 F.3d 451, 458 (8th Cir. 2016). Because the wife's risk of liability and burden of litigation pre-existed the bankruptcy proceeding, the bankruptcy court's orders did not increase her burdens or diminish her rights. Therefore, she was not a "person aggrieved" and lacked standing to appeal.

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Supreme Court: the Standard of Review for Non-Statutory Insider Status is Clear Error Under Ninth Circuit Test, But The Test May be Wrong

In *U.S. Bank Nat'l Assoc., Trustee, by and through CWCapital Asset Mgmt LLC v The Village at Lakeridge, LLC*, ___ S.Ct. ____ (2018), the Supreme Court declared that the standard of review for a determination of non-statutory insider status under the Ninth Circuit's "arm's length" test is clear error. The Justices explicitly declined to endorse the Ninth Circuit's test.

The debtor owed $10 mm to a bank and $2.76 mm to an entity that owned 100% of the debtor. In its chapter 11 plan of reorganization, the debtor placed each creditor in a separate class and proposed to impair both claims. The bank voted against the plan. The owner's vote did not count for purposes of cramdown under § 1129(a)(10) because the owner was an insider under § 101(31)(B)(iii), which provides a non-exhaustive list of insiders.

The owner then sold its $2.76 mm claim for $5,000.00 to a man who was in a romantic relationship with an officer and director of the

owner. The claim purchaser voted in favor of the plan. The bank objected that the claim purchaser was also an insider because of his romantic relationship and because the transaction was not at arm's length. The lower courts all applied the Ninth Circuit test, under which a creditor is a non-statutory insider if two conditions are met: (1) the creditor's relationship with the debtor is comparable to that of the insiders listed in the statute; and (2) the relevant transaction is negotiated at less than arm's length.

The bankruptcy court held that the transaction was conducted at arm's length based on its findings that the claim purchaser viewed the claim as a "speculative investment" and did adequate due diligence. Therefore, the bankruptcy court held that the bank failed to prove the second prong of the test. The Ninth Circuit held that whether the transaction was at arm's length was primarily a factual question and therefore entitled to clear error review. Under this deferential standard, the Ninth Circuit affirmed.

Justice Kagan, writing for a unanimous Court, rejected the bank's argument that application of the test used in the Ninth Circuit requires development of legal principles such that the issue should be reviewed *de novo*. Instead, the Court held that there is a near-universal understanding that "arm's length" means the transaction was conducted as though the parties were strangers. Because this determination is fact intensive, the Court affirmed the use of a clear-error standard of review. The Court explicitly noted that it declined to address the question of whether the Ninth Circuit's test is correct.

Justices Kennedy and Sotomayor filed separate concurrences to clarify that the "Court's holding should not be read as indicating that the non-statutory insider test as formulated by the [Ninth Circuit] is the proper or complete standard to use in determining insider status." Justice Kennedy specifically asked whether the test should include an inquiry as to whether the same deal could and should have been offered to other parties who might pay a higher price.

While declining to address whether the Ninth Circuit's test is correct, Justice Sotomayor (joined by Kennedy, Thomas, and Gorsuch, JJ) pointed out that a statutory insider is presumed to be incapable of conducting a transaction at arm's length and cannot vote in favor of a plan under any circumstances. Consequently, applying an "arm's length" test for non-statutory insiders results in disparate treatment of similar individuals. Significantly, Justice Sotomayor noted that the standard of review may be different with a different test.

For now, non-statutory insider status is to be reviewed for clear error *if* the legal test involves a determination of whether the transaction was conducted at arm's length, but the appropriateness of the test may be up for debate.

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Avoidance of Initial Transfer is Not Prerequisite to Recovery from Subsequent Transferees

In companion cases, *Kelley v. McDonald (In re Petters Co., Inc.*), Adv. No. 17-4107-KHS (Bankr. D. Minn. Jan. 17, 2018), and *Kelley v. Stapleton* (*In re Petters Co., Inc.*), Adv. No. 17-4108-KHS (Bankr. D. Minn. Jan. 17, 2018), the bankruptcy court denied the defendants' motions to dismiss the trustee's fraudulent transfer actions, holding that 11 U.S.C. § 550 does not require actual avoidance of the initial transfer before a trustee can sue a subsequent transferee. Rather, the trustee need only allege that the initial transfer is avoidable.

In each case, the defendants were subsequent transferees. The trustee's suits to avoid the

initial transfers were still pending. The subsequent transferees moved for dismissal under Federal Rule of Bankruptcy Procedure 7012(b)(6) for failure to state a claim, arguing that 11 U.S.C. § 550 implicitly requires that the initial transfer be actually avoided before the trustee can sue a subsequent transferee. The court denied the motions, holding that the trustee need only allege that an initial transfer is avoidable when suing a subsequent transferee to recover the value of the property transferred pursuant to 11 U.S.C. § 550(a).

The court acknowledged a split of authority, and sided with a majority of courts examining the legislative history of § 550 and applying a less restrictive interpretation of § 550(a). The court reasoned that the language, "to the extent that," as used in § 550 was intended to incorporate protections granted to transferees. So if an initial transferee has an avoidance defense, then a subsequent transferee may also raise that defense. Any amount granted under § 550(a) would be limited to the initial transfer amount, but the ability to avoid is not limited. The court further reasoned that to hold otherwise under a strict interpretation of § 550(a) would lead to an absurd, futile, and costly result in which the trustee would have to prepare and incur costs of filing the same complaint at a later time to assert the same causes of action.

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