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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

5th Cir. Subordinates Guaranty Claims

Law360, New York (June 10, 2015, 11:00 AM ET) -- A creditor's guaranty claim "arising from equity investments in a debtor's affiliate should be treated the same as equity investments in the debtor itself — i.e., ... subordinated to the claims of general creditors," held the U.S. Court of Appeals for the Fifth Circuit on April 28, 2015. *In re American Housing Foundation*, 2015 WL 1918854, at *8 (5th Cir. April 28, 2015). Also reversing the trustee's preference judgment against the creditor because the debtor's business was not a "Ponzi scheme," the court held that the creditor could rely on the "ordinary course of business defense" to the trustee's preference claim. *Id.* at *15. Finally, because the record before it was unclear as to whether the creditor "gave value to" the debtor and because the "bankruptcy court applied the wrong standard" as to whether the creditor had received $1 million "in good faith," the Fifth Circuit reversed the lower court's dismissal of the trustee's fraudulent transfer claim and remanded the case for trial. *Id.* at *17-18.

This case deals with important issues arising under Bankruptcy Code Sections 510(b) (mandatory subordination of securities fraud claims); 547(c)(2) (ordinary course of business defense to preference claims); and 548(c) (good-faith-for-value defense to fraudulent transfer claims).

Relevance

A contractual guaranty claim arising from the purchase or sale of a security has confused the bankruptcy courts. See, e.g., *In re Wyeth Co.*, 134 B.R. 920, 921-22 (Bankr. W.D. Mo. 1991) (debt based on notes should not be subordinated). Also, whether the creditor's claim arose from the purchase of a security has troubled lower courts, particularly when the agreement in question is between two nondebtors. See, e.g., *In re Washington Mutual Inc.*, 462 B.R. 137, 144 (Bankr. D. Del. 2011) ("Because the agreement in question is between two non-debtors, it cannot provide a basis for subordination."). Moreover, whether a creditor can be held liable to a debtor's estate when the debtor's affiliate, but not the debtor, makes the cash payment has also troubled courts. See, e.g., *In re Southmark Corp.*, 49 F.3d 1111, 1115 (5th Cir. 1995) (reversed lower courts; payment by debtor corporate parent to creditor of subsidiary held preferential because funds belonged to parent; "[A] preliminary requisite [for a preference claim under Section 547(b)] is that the transfer involve property of the debtor's estate"); In re Sakowitz Inc., 949 F.2d 178, 181 (5th Cir. 1991) ("[P]roperty held in trust for another is not property of ... estate ....").

Whether allegedly preferential payments made to the creditor could be subject to the ordinary course of business defense when they were "made in furtherance of [a] Ponzi scheme" is also a key issue in American Housing. 2015 WL 1918854, at *14. Finally, the decision clarifies "the appropriate legal standard" for the good-faith-for-value defense to fraudulent transfer claims contained in Code Section 548(c). See *In re Hannover Corp*, 310 F.3d 796, 800-01 (5th Cir. 2002) ("... there is little agreement among the courts regarding the appropriate legal standard for this defense").

Facts

The Chapter 11 debtor (AHF) developed low-income housing projects as a nonprofit, tax-exempt entity. It owned or managed housing units across nine states, having created single-purpose limited partnerships (LPs) to fund its projects. “Either AHF or one of its wholly-owned subsidiaries served as the general partner for these LPs.” 2015 WL 1918854, at *1.

The creditor here, “T,” was one of many private investors in certain LPs, serving as a limited partner. “AHF guaranteed repayment of those investments, often unconditionally, and sometimes with interest.” Because many of the AHF properties were eligible for tax credits and other tax exemptions, investors were able to “make an equity contribution to the development of rental units for low-income households” and receive “a dollar-for-dollar reduction of their tax liability,” a common method of funding low-income housing developments. *Id.*

“T” had invested more than $5 million in five AHF LPs where either AHF or a wholly owned subsidiary served as the general partner (taking 1 percent or less equity interest in the LP). *Id.* at *2. “T” and other limited partners would take the remaining equity in an LP. For each investment, “AHF purported to guaranty repayment of the investment — sometimes with interest.” For one particular LP, “AHF guaranteed the return of [T’s] ‘Initial Capital Contribution’ — defined as the amount of cash [T] invested ....” T “sought significant tax benefits as a result of most of his investments” and also “received quarterly interest payments in relation to his investments in” a particular LP.

AHF’s principal used T’s investments “to obtain funds and fraudulently divert them from the LPs, using the funds [for his benefit and] … for purposes other than the purported aims of the LPs.” In particular, one particular LP, of which AHF was general partner, was a “conduit bank account for [AHF’s fraudulent activities].” Id.

Creditors of AHF filed an involuntary Chapter 11 petition against it, and the court ordered the appointment of a Chapter 11 trustee. The bankruptcy court later approved a Chapter 11 plan that classified creditors’ claims. Unsecured creditors would recover between 20 and 40 percent. T filed a claim against the AHF estate based on AHF’s guaranty of his investment. In his claim, “T” asserted fraud, breach of fiduciary duties, plus money had and received, in addition to breach of the guaranty. In response, the trustee sued “T”, objecting to his claim and asserting that “the guarantees are not valid contractual obligations and, alternatively, that the entirety of [T’s claim] should be subordinated to the claims of all [other] general unsecured creditors.” *Id.* at *5. The trustee also asserted claims for preferential and fraudulent transfers based on payments to “T” made by an AHF LP, not AHF.

The bankruptcy court “held a 25-day trial in this matter.” In its findings, the bankruptcy court held that AHF’s guaranty would enable “T” to “bootstrap [his] investments into something more than” his interests in the LP. *Id.* at *5. After recharacterizing “T”’s claim as equity under Texas law, the court then held that T’s unliquidated claims also fell within the “requirements of Section 510(b).” Although “T” argued that he owned no interest in AHF, but only in the LPs, the bankruptcy court held that “Section 510(b) also applies to affiliates of the debtor ..., given that AHF fully controlled even the LPs for which it did not serve as a general partner.” *Id.* at *6.

As for the fraudulent transfer claims asserted by the trustee, the bankruptcy court found that “T” had given “value … in good faith for his investments,” noting that “T” had not defrauded “other creditors of AHF.” But the court voided “various preferential transfers made to [T] within 90 days of] AHF’s …

bankruptcy, reasoning that the funds came from an account" that had been "wholly controlled by AHF and, therefore, constitute[d] payments from AHF." The district court affirmed the bankruptcy court's judgment in full. *Id.* at *6.

Mandatory Subordination: Code Section 510(b)

The Fifth Circuit found it unnecessary to consider the bankruptcy court's recharacterization of "T"'s claims under Texas law because Code Section 510(b) "mandates the subordination of" "T"'s claim. *Id.* at *7. Instead of focusing on any "misconduct" by "T", the court "focused on the nature of the claims and transactions at issue."

Code Section 510(b) provides in relevant part that "a claim for damages arising from the purchase or sale of … a security … of the debtor or of an affiliate of the debtor … shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security …." According to the court, Section 510(b) "serves to effectuate one of the general principles of corporate and bankruptcy law: that creditors are entitled to be paid ahead of shareholders in the distribution of corporate assets." *Id.* at *8, quoting In re *American Wagering Inc.*, 493 F.3d 1067, 1071 (9th Cir. 2007).

This mandatory subordination clause "applies whether the securities were issued by the debtor *or by an affiliate of the debtor*." *Id.*, quoting A. Resnick & H. Sommer, 4 Collier on Bankruptcy, ¶ 510.04[04] (16th ed. 2014) (emphasis added). Thus, "claims arising from equity investments in a debtor's affiliate should be treated the same as equity investments in the debtor itself — i.e., both are subordinated to the claims of general creditors." Here, the court found that "T"'s "claims are claims 'for damages arising from the purchase or sale of' a 'security … of an affiliate of [AHF].'"

First, "T" sought damages for fraud, breach of fiduciary duty plus money-had-and-received — all unliquidated tort claims. Despite conflicting decisions by bankruptcy courts holding that a liquidated contractual claim should not be subordinated, the court found that "the unpaid debt [here] is itself an equity investment." "T" was not "merely seeking recovery under independent promissory notes, but rather under guaranties … 'intimately intertwined' with the LP agreements." Disregarding the form and looking at the substance of "T"'s claim, the court found that "T" was merely trying to recover a portion of his equity investment. In other words, "T"'s "guaranty claims here are essentially breach of contract claims" and "are fairly characterized as claims for 'damages.'" *Id.*

Second, "T" purchased "securities" within the meaning of Section 510(b). Code Section 101(49)(A)(xiii) defines "security" to "include … [an] interest of a limited partner in a limited partnership." Because the guaranties here "induced" "T" to make his investments in the AHF LPs, the court found "at least 'some nexus or causal relationship' between [T's] claims and his purchase of the LP interests." *Id.* at *9, citing *In re SeaQuest Diving LP*, 579 F.3d 411, 421 (5th Cir. 2009). Indeed, "T" was "effectively attempting to recoup his equity investments in the LPs through his claims" against AHF.

Finally, the court found that the LPs were "affiliates of AHF." Each LP was "operated under [a]n … operating agreement by a debtor," consistent with Code Section 101(2)(C). The LP agreements here constituted an operating agreement, defining the business and purposes of each entity, showing that the entity operated through its general partner, AHF. In most of the LP agreements, AHF served as a general partner, while in others, a wholly owned subsidiary of AHF served as general partner.

Although "AHF was not a direct party to those agreements," AHF "had complete control over these LPs." *Id.* at *10. Despite contrary bankruptcy court decisions that were not binding on the Fifth Circuit, "the existence of a shell conduit between a debtor and an entity" should not "preclude a finding of affiliate status." *Id.* at *11. "Congress clearly intended that claims arising from the purchase of securities of entities over which the debtor exercised sufficient control — i.e., entities which qualify as affiliates … — be treated no differently than claims arising from the purchase of securities of the debtor itself." Id.

Preferential Transfers

The bankruptcy and district courts had found that cash transfers from an AHF affiliate's account to "T" in the amount of $157,500 constituted preferences under Code Section 547(b). Although "T" argued that AHF had no interest in the funds transferred, the Fifth Circuit found that the affiliate here was controlled by AHF and used "as a conduit bank account." Thus, payments to T from this account constituted payments from AHF. *Id.* at *13. In other words, AHF was the de facto owner of the funds in the affiliate's account.

But the Fifth Circuit agreed with "T" that he was entitled to assert the ordinary course of business defense under Code Section 547(c)(2). Despite the trustee's argument that the transfers could not have been made in the ordinary course of the debtor's business because they furthered AHF's "Ponzi scheme," the court held that "AHF's business does not constitute a Ponzi scheme …." AHF had been engaged in a "substantial legitimate business …." *Id.* at *15. Unlike the classic Ponzi scheme, which relies on new funds from new investors to pay off prior investors, AHF had a legitimate business "in which there were [only] some fraudulent or Ponzi-like transactions …." *Id.* Therefore, the court reversed the preference judgment and remanded the matter to the bankruptcy court to enable "T" to prove his ordinary course of business defense.

Fraudulent Transfers

The bankruptcy court did not dispose of whether the cash transfers to T were fraudulent transfers, but merely held that "T" was entitled "to the good faith defense under Section 548(c)." *Id.* at *16. According to the Fifth Circuit, however, "T" was "entitled to the good faith defense only 'to the extent [he] gave value to [AHF] in exchange for' the transfers at issue." Moreover, courts "generally construe the term 'value' broadly for purposes of the Bankruptcy Code." *Id.*, citing *In re Fairchild Aircraft Corp.*, 6 F.3d 1119, 1127 (5th Cir. 1993) (considered "indirect financial effects," e.g., "synergy from joining two enterprises, … increase in a credit line, and" a guaranty; aircraft manufacturer's payments for commuter airline's fuel in attempt to keep airline afloat constituted reasonably equivalent value when (1) commuter airline was part of USAir system and manufacturer viewed US Air as "potential major customer"; and (2) keeping airline "marketable" gave manufacturer opportunity to recoup its investment and make additional sales in event that buyer could not be found); *In re Fruehauf Trailer Corp.*, 444 F.3d 203, 212 (3d Cir. 2006) ("We have interpreted 'value' to include any benefits, … whether direct or indirect …. [T]he mere opportunity to receive an economic benefit in the future constitutes 'value' …."). Because the bankruptcy court made inconsistent findings as to whether AHF had received value, the Fifth Circuit remanded the issue to the bankruptcy court for further disposition.

The Fifth Circuit also remanded the issue of "T"'s "good faith." The bankruptcy court found that "T"'s "actions did not defraud other creditors of AHF," but this was the "wrong standard." 2015 WL 1918854, at *17. Instead, if "T" had "been put on inquiry notice" of the debtor's "possible insolvency or of [the debtor's] possibly fraudulent purpose," it must then "satisfy a 'diligent investigation' requirement," *Id.*, citing *In re Bayou Group LLC*, 439 B.R. 284, 310-12 (S.D.N.Y. 2010). In short, the bankruptcy court, on remand, must "apply this test in the first instance." *Id.* at *18.

Comments

The Fifth Circuit's broad reading of the mandatory subordination requirement of Code Section 510(b) is consistent with decisions in other circuits. *In re Med Diversified*, 461 F.3d 251, 246 (2d Cir. 2006) (claims should be subordinated if claimant "(1) took on the risk and return expectations of a shareholder, rather than a creditor, or (2) seeks to recover a contribution to the equity pool presumably relied upon by creditors in deciding whether to extend credit to the debtor"; issue was "whether a claim for fraudulent inducement and breach of contract for failure to issue common stock in the debtor in exchange for the plaintiff's shares in another company was one 'arising from' an agreement to purchase or sell a security;" reading "arising from" broadly, held claimant took on "risk and return expectations of a shareholder" because he "bargained not for cash but to become a stockholder in the debtor…"); *In re Telegroup Inc.*, 281 F.3d 133, 142 (3d Cir. 2002) (claims subordinated; arose from breach of agreement to use best efforts to register stock; claimants were "equity investors seeking compensation for a decline in the value of" the debtor's stock; although claimants never intended to buy a long-term stake in debtor, claims subordinated because "claimants retained the right to participate in corporate profits" of debtor; Code Section 510(b) prevents claimants from using breach of contract claim to recover value of equity investment "in parity with general unsecured creditors"); *In re Geneva Steel Co.*, 281 F.3d 1173, 1180 (10th Cir. 2002) (subordinated claim for fraud; shareholder deceived into holding and not selling his securities; claimant sought to shift losses onto creditors; fraudulent retention claim based on "a risk only the investors should shoulder"); *In re Betacom of Phoenix Inc.*, 240 F.3d 823, 830 (9th Cir. 2001) (subordinated claim arising from breach of obligation to deliver stock under merger agreement; "investors and creditors have different expectations"; investor has "greater financial expectations" than a creditor).

The Fifth Circuit's broad reading of "value" in American Housing, however, differs from the one taken by a different panel of that court within the past year. See *In re Positive Health Management*, 769 F.3d 899, 909 (5th Cir. 2014) (held, transferee gave "value" only to extent it provided debtor with office space having a "market rent" value; focused on "value that … transferee gave up as its side of the bargain," but disregarded evidence of other indirect economic benefits received by debtor).

—By Michael L. Cook, Schulte Roth & Zabel LLP

Michael Cook is a partner in Schulte Roth & Zabel's New York office.

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