LJN
LAW JOURNAL NEWSLETTERS
The Bankruptcy Strategist®
An ALM Publication
Volume 28, Number 6 • April 2011

Ninth Circuit Treats Corporate Insider Fairly in Fraudulent Transfer Case

By Michael L. Cook

The U.S. Court of Appeals for the Ninth Circuit, on Aug. 10, 2010, reversed a district court's adverse $6.7 million fraudulent transfer judgment against a corporate insider, a director of the debtor, in a remarkably sensible opinion. *Decker v. Tramiel* (*In re JTS Corp.*), 617 F.3d 1102 (9th Cir. 2010). The director had bought eight parcels of the debtor's real estate for $10 million in good faith two years prior to bankruptcy. Holding that the director had "no liability to the [plaintiff bankruptcy] trustee for" a constructive fraudulent transfer, the court found that the director was "a good faith transferee … entitled to an offset for the value he paid for the property," and that he was "entitled to [an additional] settlement credit" for "the amount that his codefendants paid in a settlement agreement." 617 F.3d at 1106, 1120. For corporate insiders — private equity funds, controlling shareholders, officers and directors — the case shows that insider status alone is not enough to impose liability, particularly when the insider participates in a good-faith attempt to rehabilitate a financially troubled debtor.

Facts

The director bought eight parcels of income-producing real property from the debtor prior to bankruptcy at the request of the debtor's chief financial officer, at a time when the debtor was insolvent and otherwise unable to borrow. He paid $10 million and gave the debtor an option to repurchase the property for $10 million, entitling him to "keep the greater of $1 million or the rental income generated by the property for a one-year period." *Id.* at 1107. The debtor's board, with the director "removed" and abstaining "from all voting during the sales discussion," believed that the proposed sale "was the quickest way of raising the necessary funds to keep the company running and that the repurchase option would allow a year to regain the real property … ." *Id.*

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Bankruptcy ensued two years later. The debtor's Chapter 7 trustee sued all the directors and the debtor's attorneys, alleging a constructive fraudulent transfer, among other things, under applicable California law, made available to the trustee by Bankruptcy Code ["Code"] § 544(b). Essentially, the trustee claimed that the debtor sold the property to the director for less than reasonably equivalent value. Other defendants settled with the trustee for $4.5 million.

The Bankruptcy Court

After trial, the bankruptcy court avoided the sale to the director because the net reasonably equivalent value of the real property was $11.82 million, after adjusting the value because "the property was [justifiably] sold as a bundled portfolio and it was a quick sale." *Id.* at 1107. By "adding the value of the repurchase option to the $10 million purchase price," the bankruptcy court found that the director had paid $10.433 million, but held him liable for only $1.387 million ($11.82 million less $10.433 million): The director had been a good-faith transferee under the California statute. The court later amended its judgment to give the director additional credit for the $4.5 million "paid by the settling defendants to the bankrupt estate," meaning that the trustee could recover nothing from the director. *Id.* at 1108.

The District Court

On the trustee's appeal, the district court reversed the bankruptcy court in part, holding the director liable for $6.714 million. *Id.* at 1108. Rejecting the bankruptcy court's valuation, it found the fair market value of the property to be $17.147 million and subtracted the $10.433 million, the amount the director paid. The district court also "reversed the bankruptcy court's holding that [the director] was entitled to a settlement credit of the $4.5 million paid by codefendants," reasoning that the director was not "a joint tortfeasor." *Id.* at 1108-09.

Court of Appeals

Value of the Property

Reviewing the bankruptcy court's "decision independently and without reference to the district court's decision," the court held it "must accept the bankruptcy court's findings of fact" unless clearly erroneous. *Id.* at 1109. It thus found "that the district court erred in holding that the fair market value [was] $17.147 million." *Id.* The bankruptcy court properly found that value to be $11.82 million because the debtor "wanted immediate cash and was willing to take a reduced price … to obtain the funds quickly … [in] a quick and bundled sale." *Id.* at 1110. "No evidence show [ed] that the bankruptcy court's … value determination was clearly erroneous." *Id.* Nor was there any error in the bankruptcy court's valuation of the repurchase option at $432,815.

Use of State Law

Code Section 544(b) "enables a bankruptcy trustee to avoid any transfer of property that an unsecured creditor with an allowable claim could have avoided under plicable state law." *Id.* at 1111. "The purpose of this section was to recognize the body of state laws addressing fraudulent transfers and allow a trustee the choice of avoiding transfers under § 544 and the applicable state fraudulent transfer law, or under only federal law pursuant to § 548." *Id.* Here, the trustee could not use § 548 (the federal fraudulent transfer law) because the transfer was made more than two years prior to bankruptcy, outside the applicable federal reachback period. She therefore relied on California law to attack the underlying fraudulent transfer.

Code § 550(a), authorizing the trustee to recover the property transferred or its value, after her avoiding a transfer under § 544 or § 548, provides that "to the extent that a transfer is avoided under § 544 … [or] 548 … the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property." Thus, § 550 was intended to "restore the estate to the financial condition it would have enjoyed if the transfer has not occurred." *Id.* at 1111, quoting *In re Acequia*, 34 F.3d 800, 812 (9th Cir. 1994). Because of its "equitable underpinnings, a trustee's recovery under § 550 is limited if the transferee took the transfer for value in good faith without knowledge of its voidability. *Id.* at 1112, citing § 550 (b)(i). As shown below, the court reconciled federal and state fraudulent transfer law in fashioning an equitable remedy here. Regardless of whether the trustee sues under federal or state fraudulent transfer law, therefore, her claim is thus subject to the good faith limitation.

Good Faith Transferee

Code § 548(c) "provides that a trustee's recovery may be reduced by the value given for the transfer if the transferee made the transfer in good faith." *Id*. at 1111. Rejecting the trustee's claim that the director here was not a good-faith purchaser, the court found that California law also limited a creditor's recovery by providing a credit "for what a good faith transferee paid." *Id*. at 1114. The application of the good-faith doctrine is "a matter of law." *Id*. Analyzing one of its earlier decisions, *In re Agricultural Research and Technology Group Inc.*, 916 2d 528, 531 (9th Cir. 1990), the court held that the defendant transferee there was not a good-faith transferee when the debtor had actually intended to defraud its creditors and when the transferee "should have known that [the debtor] was running a Ponzi scheme based on statements made to [the defendant] and from [the debtor's] willingness to accept little value in exchange for the transfer … . [The defendant] not only knew of the fraud, but was an active participant." *Id*., quoting *Agricultural Research*, 916 F.2d at 538-540.

Based on a review of its own precedents, the court held "the trustee may recover under § 544(b) and § 550, but … [the director here] has shown he is a good faith transferee." Although the director paid less than reasonable value, "the amount of recovery must be calculated to the extent that it benefits the estate, as § 550 expressly requires, and must further the intent of § 550 to promote equity and restore the estate to its prior condition." *Id*. at 1115.

> Here the record establishes that [the director] was objectively a good faith transferee who gave [the debtor] $10 million in exchange for real property to enable [the debtor] to survive financially. [The debtor] had no source for capital and it was [the debtor] who approached [the director] and suggested that they do the real property transfer. To protect the company, [the director] agreed to the deal, but gave [the debtor] an option to repurchase the property at the exact same price for a period of a year. If [the debtor] exercised the option, [the director] would keep the greater of $1 million or the property's rental income and retain a return on his investment. [The director] instructed board members they should get an independent appraisal of the property and removed himself from all board discussions and votes regarding the transfer. [The director] was not aware of any appraisals of the property and testified that he may have stated they were worth $12 to $13 million at [an earlier] time … . Finally, [the debtor's] board members stated that given the circumstances, and [the debtor's] dire need for cash, the real property transaction was fair … . This conclusion effectuates the intent of § 550 to restore the bankrupt estate to the financial condition it enjoyed prior to the transfer …. Allowing the estate to profit by taking value that should be returned to a good faith transferee does not promote the purpose of § 550 to restore equity … . Moreover, allowing state law good faith transferee exceptions in cases asserting § 544 claims permits a symmetry with the Bankruptcy Code. *Id*. at 1116.

Thus, the court reconciled § 548(c), allowing for a federal law reduction in recovery for a good faith transferee, with Code § 544(b), which allows for the avoidance of fraudulent transfers under state law.

Settlement Credit

The court reversed the district court's holding that the director was not entitled to a settlement credit for the amount paid by his codefendants. Reviewing California law, it found that the law's "fundamental purpose" was "to preclude a double recovery arising out of the same wrong." *Id*. at 1116. *Vesey v. United States*, 626 F.2d 627, 633 (9th Cir. 1980). In the complaint here, "the trustee alleged that all the defendants were liable for the concerted and separate acts which culminated in the real property transfer to [the director] and that they knew of the disparity between the purchase price and fair market value of the real property … . [She alleged] [the director] and the settling defendants combined to carry out the same injury, *i.e.*, the fraudulent transfer of the real property … . [T]heir concerted conduct produced the same injury and the decision to sell the property by the settling directors with the aid of the attorneys proximately caused the actual harm of the real property transaction … . [There was] the same indivisible injury, which was the sale of the real property at less than its value." *Id*. at 1118.

A plaintiff's recovery under California law must therefore be reduced by "the amount the plaintiff has actually recovered in a good faith settlement," not by the settling defendant's "proportionate responsibility" for the wrong. *Id*. Here, the settlement agreement with the other defendants did not allocate an amount of liability for the director's harm, but he was properly "entitled to an offset … of the entire settlement amount paid to the trustee." *Id*. at 1119.

Conclusion

Benefit, Not Harm

The court reached the right, fair result. In no sense was the director here a participant in any wrongdoing. Indeed, the debtor's estate benefited not only from the director's providing it with value of $10.433 million for an asset worth $11.82 million, but also from the $4.5 million paid by the other defendants. The estate thus suffered no injury, but did realize a net gain of about $3 million. Moreover, the debtor's chief financial officer had suggested that the director buy the real property, after failing "to secure funds from several banks." *Id*. at 1109. *JTS* is thus consistent with other recent appellate rulings. *See, e.g., In re U.S. Med. Inc.*, 531 F. 3d 1272, 1275 (10th Cir. 2008) (major creditor with designee on debtor's board of directors plus 10.6% equity interest held not to be an insider; creditor had some involvement, but no control over debtor's business; creditor sensitive to potential conflicts of interest and dealt with debtor at arm's length); *Wooley v. Faulkner* (*In re SI Restructuring, Inc.*), 532 F.3d 355, 364 (5th Cir. 2008) (reversing lower court's subordination of insider secured claims, held, subordination "inappropriate" because the trustee failed to show that insider "loans to the debtor harmed either the debtor or the general creditors.").

Bad Facts Can Drive a Different Result

Another circuit, however, held that a corporate debtor's pre-bankruptcy severance payment of $2.7 million to its former chief executive officer were fraudulent transfers, relying on Code § 548(a)(i)(B)(ii)(IV) (trustee may avoid transfer for "less than reasonably equivalent value … to or for the benefit of an insider under an employment contract" outside "ordinary course of business."). *In re TransTexas Gas Corp.*, 597 F.3d 298 (5th Cir. 2010). Among other things, noted the Fifth Circuit, the officer had "used overreaching tactics, abusing his position of authority to obtain favorable," unjustified terms. *Id*. at 306.

Settlement Credit

The court's settlement credit analysis is also fair. The court never mentioned it, but Code § 550(d) limits a trustee "to only a single satisfaction" when recovering a fraudulent transfer. *In re Prudential of Florida*, 478 F.3d 1291, 1302 (11th Cir. 2007) (bankruptcy court must "arrive at an equitable valuation of [a settlement] cause of action as a percentage of the total settlement amount."); *In re Bean*, 252 F.3d 113 (2d Cir. 2001) (Code § 550(d) "categorically limits" the trustee's recovery; the trustee had already recovered directly from debtor).