Schulte Roth&Zabel

Alert

Ninth Circuit Insulates Corporate Insider from Preference Liability

May 13, 2015

"A corporate insider who personally guaranteed" the debtor's loan was not liable on a bankruptcy trustee's preference claim when the corporate debtor repaid its lender, held the U.S. Court of Appeals for the Ninth Circuit on May 6, 2015. *In re Adamson Apparel, Inc.*, 2015 WL 2081575 (9th Cir. May 6, 2015) (2-1). The trustee had alleged that the insider guarantor defendant ("G") had received an indirect benefit of $4.9 million when the debtor ("Adamson") repaid its obligation to the lender and that this benefit was a preference under Bankruptcy Code ("Code") Section 547(b). According to the trustee, G had been relieved of his guarantee liability when Adamson repaid its primary obligation. Affirming the dismissal of the trustee's claim by the bankruptcy court and the district court, the Ninth Circuit reasoned that G had "previously waived his indemnification rights against" Adamson in good faith and had taken "no subsequent actions to negate the economic impact of that waiver." *Id.* at *1. Because G was not a creditor—an essential element of a preference claim ("to or for the benefit of a creditor")—he could not be held liable.

Relevance of Decision
Lower courts have long wrestled with the so-called "indirect preference" to corporate insiders. According to the Ninth Circuit, no other appellate court has addressed this "unresolved issue of bankruptcy law." *Id.* The essential question in *Adamson* was whether G was a creditor, for Code Section 547(b)(1) requires that a preferential transfer be made "to or for the benefit of a creditor." G had waived his rights to indemnification and reimbursement from the debtor for any payments he would have to make on his guarantee. *Id.* at *3. The legal effectiveness of this waiver has split the bankruptcy courts.

Facts
The debtor's president and chief executive officer, G, personally guaranteed Adamson's loan from a lender. He "would ordinarily have been entitled to have Adamson reimburse him for any amount that he was obligated to pay on [Adamson's] behalf to settle the loan with [the lender], but the [relevant] agreements waived that right to indemnification," which included G's "rights to subrogation, reimbursement, or any other form of repayment." *Id.* at *1. On Dec. 18, 2003, Adamson instructed its customer to pay $4.9 million to the lender in partial satisfaction of the debt owed by Adamson to the lender, thus reducing G's guarantee obligation. Adamson filed a Chapter 11 petition nine months later. In the meantime, on March 31, 2004, G paid $3.5 million from his personal funds to the lender in order to pay the balance of the Adamson loan.

The bankruptcy trustee's predecessor, the creditors' committee, sued G to recover the $4.9 million paid by the debtor to the lender in December 2003, "arguing that [G] was a corporate insider who received a

preference because he had guaranteed the loan from" the lender, thereby reducing his guarantee obligation and receiving a benefit. After years of litigation in the bankruptcy and district courts, including a bankruptcy court bench trial in 2010, the bankruptcy court entered judgment in favor of G, holding that "he was exempt from preference liability because he was not a creditor of" Adamson. The trustee had later been substituted for the creditor's committee after the Adamson case was converted from Chapter 11 to Chapter 7. *Id.* at *2.

G testified during the bankruptcy court trial "that he would never have any right to seek indemnification from [Adamson] for any funds that he expended to settle its debt to" the lender. He stressed that the lender "had required him to include the indemnification waiver" in his guarantee, "although his own preference would have been to retain the right to seek reimbursement." G also "had never filed a proof of claim" in the debtor's bankruptcy case. *Id.*

The Court of Appeals

The bankruptcy court, said the Ninth Circuit, "had more than sufficient evidence to conclude that [G] had fully waived his right of indemnification from" Adamson. *Id.* at *4. Courts and Congress have recognized that "[i]nsiders pose special problems." *Id.* at *5, citing *In re Deprizio*, 874 F.2d 1186, 1195 (7th Cir. 1989) ("Insiders will be the first to recognize that the firm is in a downward spiral. If insiders and outsiders had the same preference-recovery period, insiders who lent money to the firm could use their knowledge to advantage by paying their own loans preferentially, then putting off filing the petition in bankruptcy until the preference period had passed."). For that reason, Congress extended "the preference-recovery period to *one year* for transactions that benefit insiders, *where the insider is a creditor*." *Id.* at *6, quoting Code § 547(b) (emphasis added).

The Seventh Circuit held in *Deprizio* that when a lender makes a loan to a corporate debtor personally guaranteed by an insider, the trustee may avoid payments made to the lender during the extended insider preference-recovery period. Also, reasoned the Seventh Circuit, a "guarantor has a contingent right to payment from the debtor: if Lender collects from Guarantor, Guarantor succeeds to Lender's entitlements and can collect from Firm. So Guarantor is a 'creditor' in Firm's bankruptcy." 874 F.2d at 1190. Although other appellate courts followed *Deprizio*, Congress amended the Code in 1994 to enable the trustee to seek recovery only from the insider, *not* from the lender. *Deprizio*'s basic insider guarantor-as-creditor analysis, though, still stands.

The Ninth Circuit in *Adamson* identified "[t]wo separate lines of cases" that had developed after the *Deprizio* decision, one "relied upon the Trustee and the other by [G]." One line of cases holds that good faith "indemnification waivers are valid and excuse an insider guarantor from preference liability … .They 'apply the letter of the statute to the facts before [them]' rather than focusing on broader concerns of public policy. … Because a guarantor has no legally cognizable claim against the borrower's estate once he has waived his right to indemnification, these courts concluded that insider guarantors who have done so in good faith were not 'creditors' … and therefore were not subject to preference liability." 2015 WL 2081575, at *6.

The trustee relied on the other line of cases holding that these "waivers are simply not valid" because the "insider could still obtain a claim against the debtor, simply by purchasing the lender's note rather than paying on the guarantee." In that way, the "waiver of subordination rights" would "be a sham provision, unenforceable as a matter of public policy." *Id.* at *7, quoting *In re Telesphere Commc'ns Inc.*, 229 B.R. 173, 176 n.3 (Bankr. N.D. Ill. 1999).

The Ninth Circuit rejected the trustee's authorities, declining to "establish a bright-line rule based on a fear of what *could* happen." Instead, it reasoned, "the sounder approach is to consider what actually *has* happened," and to examine "the totality of the facts … for evidence of 'sham' conduct … ." In the case before it, "the record indicates that the waiver at issue was not a sham." *Id.*

First, the lender's lien on the debtor's inventory and accounts receivables would have satisfied its claim "to the extent of the remaining inventory and accounts receivable even in the absence of [G's] guarantee." *Id.* Moreover, G "never filed a proof of claim in the bankruptcy case … . [T]he funds at issue here were not sufficient to cover Adamson's entire debt to [the lender], and [G] personally paid [the lender] over $3.5 million to clear Adamson's debt without ever seeking reimbursement." G could have simply purchased the balance of the lender's claim and then filed a claim as the lender's successor. "Instead, he personally paid the debt without ever filing a claim against the estate." *Id.* at *8.

G also "had no unilateral right to purchase the note from [the lender] if Adamson defaulted," possibly explaining why G had not bought the lender's note "rather than pay it off when called upon to do so." Finally, the trustee presented "no evidence that the debt in question was the only debt that [G] guaranteed on Adamson's behalf." The court thus had "no reason to assume that he did not personally guarantee additional Adamson debts … . [G] would have received no benefit by satisfying [the lender's] debt first rather than any other debts of equivalent magnitude that he might have personally guaranteed." In sum, "the waiver … was not a sham … . [G's] waiver prevented him from filing a claim to recover the amount that he personally paid to satisfy the balance of Adamson's debt to [the lender] … . [A] waiver totally eliminating [G's] right to recover over $3.5 million has … economic substance … ." Because G had no claim against the debtor's estate, he was not "a creditor under the … Code." *Id.* at *9.

"In order to be subject to preference liability," added the court, "a person or an entity must be a creditor … . A person is a creditor only if he has a right to payment from the debtor … . Here, [G] waived any such right at the insistence of [the lender]. Nothing in the … Code prevented him from doing so, nor does any portion of the Code subject [G] to preference liability simply because he received a benefit—and a contingent one at that—from the [debtor's] payment … to [the lender]." *Id.*, citing *Deprizio*, 874 F.2d at 1190-92 (*held*, corporate insiders not "creditors" subject to preference claim when corporate debtor paid Internal Revenue Service for delinquent wage withholding taxes, despite benefit insiders received by being relieved of personal liability for taxes).

Although the trustee's public policy concern is "far from frivolous," Congress should address it, said the court. According to the Ninth Circuit, its "equitable powers are limited by the text of the Code as presently worded." *Id.* at *10.

The Dissent

The dissent argued that insider guarantors are creditors "even if they nominally have waived their right to indemnity." *Id.* In its view, the waiver had no economic significance because "the insider could still obtain a claim against the debtor simply by buying the lender's note rather than paying on the guarantee." The waiver thus "could only be seen as an effort to eliminate, by contract, a provision of the … Code." It viewed the waiver as "a sham provision, unenforceable as a matter of public policy." *Id.* (citations omitted).

Comment

Adamson is analytically sound, but this kind of litigation will continue. The trustee will probably seek *en banc* review by the entire Ninth Circuit because of the dissent and contrary lower court authority.

Outside the Ninth Circuit, *Adamson* is not binding, regardless of its persuasive reasoning. Also, trustees and creditors' committees will stretch to find any facts showing bad faith by a corporate debtor's insiders.

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

Schulte Roth&Zabel
New York | Washington DC | London
www.srz.com