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Fifth Circuit Applies New York Fraudulent Transfer Law to Suit Against Lenders for Receipt of Downstream Guaranty Payment Despite Debtor's Full Payment to All Other Creditors

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The United States Court of Appeals for the Fifth Circuit recently reversed a district court's dismissal of a fraudulent transfer complaint against lenders for their receipt of pre-bankruptcy guaranty payments from a corporate debtor. The author of this article discusses the case and its implications.

The United States Court of Appeals for the Fifth Circuit reversed a district court's dismissal of a fraudulent transfer complaint against lenders for their receipt of pre-bankruptcy guaranty payments from a corporate debtor.[1] The debtor had previously guaranteed its subsidiary's obligations to the defendant lenders.[2] According to the court, the "district court erroneously applied Georgia rather New York State law to the avoidance claim."[3] Unlike the applicable Georgia law, New York law "treats certain guarantees as transfers under its fraudulent transfer law."[4] Equally important, the court affirmed the district court's holding that the plaintiff

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litigation trust had standing to bring the fraudulent transfer claim against the lenders despite the debtor's full payment of all other creditors' claims under a confirmed reorganization plan.[5]

STANDING OF LITIGATION TRUST TO SUE

The plaintiff litigation trust succeeded the Chapter 11 debtor-in-possession in prosecuting the suit against the lenders after the bankruptcy court had confirmed the debtor's Chapter 11 reorganization plan. Under that plan, the debtor had paid all creditors in full. The defendant lenders, therefore, relied on *Adelphia Recovery Trust v. Bank of America, N.A.*[6] to argue that the plaintiff lacked standing to sue. In *Adelphia*, the district court held that the litigation trust lacked standing under Bankruptcy Code § 544(b) to assert an avoidance claim because the relevant "creditors have been paid in full with interest and would not benefit from" avoiding a transfer.[7]

The Fifth Circuit, however, affirmed the district court's holding that the litigation trust had standing to sue. It relied on decisions from the Eighth and Ninth Circuits finding benefit to the bankruptcy estate from the prosecution of fraudulent transfer claims.[8] According to the Fifth Circuit in *Mirant*, "[o]nce a trustee's avoidance powers are triggered at the time of [the bankruptcy petition's filing], they persist until avoidance will no longer benefit the estate under § 550."[9] Further, because the "fraudulent transfer injured the estate, and because § 550 ensures that the injury is redressed,…a trustee may… avoid a transfer *to the extent it benefits the estate*."[10] Thus, the plaintiff litigation trust had standing "to the extent that [its] successful avoidance of fraudulent transfers will benefit the bankruptcy estate."[11] The defendants could apparently be liable, therefore, for at least any unpaid administrative expenses of the estate, to be established later at trial.[12]

CHOICE OF LAW

The court of appeals reversed and remanded to the district court "for the application of New York Law" to the fraudulent transfer claim here.[13] Analogizing the claim to a tort action, the court relied on §§ 6 and 145 of the Restatement (Second) of Conflict of Laws to "provide the appropri-

ate analytical framework…to determine whether New York or Georgia law" applies here.[14] Although "both New York and Georgia have sufficient contacts with this issue for their constructive fraudulent transfer laws to" apply, no one fact favored "either state." [15] There were "relevant parties in both New York and Georgia," and there was "no one location where the relationship of the parties is clearly centered …."[16]

The basic policies underlying the fraudulent transfer laws, reasoned the court, favored "the application of New York law."[17] Specifically, § 6 of the Restatement confirmed that New York law best achieved the "basic policies underlying the fraudulent transfer laws," namely, "the protection of creditors from fraudulent transfers."[18] New York, like most other states "treats…guarantees as [voidable] transfers under its fraudulent transfer law," but "Georgia's now-repealed statute does not treat guarantees as transfers."[19] Because any choice-of-law rule should "further harmonious relations between states and…facilitate commercial intercourse between them," Restatement § 6, New York law "reflects the approach taken by an overwhelming majority of the states."[20]

The defendant lenders were not citizens of Georgia, and its citizens "would not benefit from the application of Georgia law."[21] Moreover, "Georgia has replaced its repealed statute with one that treats guarantees as transfers for the purposes of fraudulent transfer law," giving Georgia "little interest in applying its now-repealed statute" when its citizens would gain "nothing…from…application of that statute."[22]

COMMENTS

The standing issue is still litigable outside the Fifth, Eighth and Ninth Circuits. Something must be wrong with any system that allows a litigation trust to sue only for its own legal fees. If, and only if, other creditors will benefit should the suit be allowed to proceed. As the Second Circuit said more than 60 years ago, "[i]t would be a mockery of justice to say that the [debtor] may claim through and in the right of creditors whose debts have been paid and discharged …."[23] A fraudulent transfer suit thus "cannot be maintained where [it] would only benefit the debtor."[24] Still, on a proper showing, "creditors can benefit indirectly," but a court may "limit a

plaintiff's recovery" after trial.[25]

The lenders in *Mirant* are free to argue on remand that the parent debtor received reasonably equivalent value or "fair consideration" for its payment. The debtor had guaranteed the obligation of its subsidiary — a "downstream guaranty" — and may have benefitted from the loan.[26]

The court's choice-of-law holding is sound. It is consistent with Code § 548(a) (trustee may avoid "any transfer…or any obligation") and with §§ 4 and 5 of the Uniform Fraudulent Transfer Act (creditor may avoid "transfer made or obligation incurred"), adopted by 43 states.

NOTES

[1] *In re Mirant Corp.*, 2012 WL 919 620 (5th Cir. 3/20/12).

[2] *Id*. at *1.

[3] *Id*.

[4] *Id*. at *6 (N.Y. Debtor &Creditor Law § 273 makes "every obligation incurred" by an insolvent debtor voidable if made without "fair consideration").

[5] *Id.* at *2.

[6] 390 B.R. 80, 91-97 (S.D.N.Y. 2008).

[7] *Id*. at 97, citing *Whiteford Plastics Co. v. Chase Nat'l Bank,* 179 F.2d 582 584 (2d Cir. 1950) (*held*, debtor barred from suing to avoid defectively recorded lien because only debtor, not unsecured creditors, would benefit) and *In re Vintero Corp*., 735 F.2d 740 (2d Cir. 1984)(same).

[8] *Stalnaker v. DLC, Ltd.*, 376 F.3d 819, 823-24 (8th Cir. 2004) (administrative claims still needed to be paid out of the estate; unsecured creditors not the sole beneficiaries of the litigation); *In re Acequia*, 34 F.3d 800, 807-08, 812 (9th Cir. 1994)(2-1) (standing should be evaluated on date of bankruptcy petition's filing; Code § 1123(b)(3)(B) authorized post-confirmation prosecution of debtor's claims; to hold otherwise would cause debtors to "delay filing plans of reorganization until completing all potential litigation," contrary to the statutory "goal of quick and equitable reorganization"; estate would benefit because recovery would "secure performance of [debtor's] post-confirmation obligations" and "reimburse…estate for…costs of" fraudulent transfer litigation).

[9] 2012 WL 919 620, at *4.

[10] *Id*.

[11] *Id*.
[12] *Id*.
[13] *Id*. at *5.
[14] *Id*.
[15] *Id*. at *6.
[16] *Id*.
[17] *Id*.
[18] *Id*.
[19] *Id*.
[20] *Id*.
[21] *Id*. at *7.
[22] *Id*.
[23] *Whiteford Plastics*, 179 F.2d at 584.
[24] *In re Tronax, Inc*., 464 B.R. 606, 617 (Bankr. S.D.N.Y. 2012).
[25] *Id*. at 617-18 (e.g., good faith transferee gets credit for "improvement," "increase in value," "value paid."). *See In re JTS Corp*., 617 F.3d 1102, 1115, 1119 (9th Cir. 2010) (*held*, Code § 550 requires that "amount of recovery must be calculated to the extent that it benefits the estate," but good faith defendant insider "entitled to an offset…of the entire settlement amount paid to the trustee" by other defendants).
[26] *In re Metro Communications, Inc.,* 945 F.2d 635, 647 (3d Cir. 1991) ("indirect benefits…of this guaranty" may have had value); *In re Image Worldwide*, 139 F.3d 574, 581 (7th Cir. 1998) (cross-stream guarantees may provide reasonably equivalent value when the transaction strengthens the viability of the corporate group); *In re WT Grant Co*., 699 F.2d 599 (2d Cir. 1983)…("…there is no showing that the trustee could have established lack of fair consideration for the guaranty …. Through its subsidiary, [corporate parent debtor] received the full benefit of [loans] in return for its guaranty …."); *Rubin v. Mfrs. Hanover Trust*, 661 F.2d 979, 991, 994 (2d Cir. 1981) (legal standard is whether defendant's "giving of the consideration to the third person…confers an economic benefit upon the debtor;" remanded to determine whether economic benefit indirectly received by debtor was sufficient); *Klein v. Tabatchnik*, 610 F.2d 1043, 1047 (2d Cir. 1979) (benefit "may come indirectly through benefit to third person."); *McNellis v. Raymond*, 420 F.2d 51 (2d Cir. 1970) (individual debtor made payments on defendant's loans to company he controlled; because defendant lender made loans to corporation, debtor received indirect benefit); *In re Lawrence Paperboard*

Corp., 76 B.R. 866, 871 (Bankr. D. Mass. 1987) (corporate parent received benefit when subsidiary received benefit); *In re Jeffrey Bigelow Design Group, Inc*., 956 F.2d 479, 485 (4th Cir. 1992) ("…indirect benefits may furnish fair consideration.").

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