Tenth Circuit: Fraudulently Transferred Assets Not Estate Property Until Recovered

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The U.S. Court of Appeals for the Tenth Circuit—in *Rajala v. Gardner*, 709 F.3d 1031 (10th Cir. 2013)—has joined the Second Circuit and departed from the Fifth Circuit by holding that an allegedly fraudulently transferred asset is not property of the estate until recovered pursuant to section 550 of the Bankruptcy Code and therefore is not covered by the automatic stay. According to the court, its decision "gives Congress's chosen language its ordinary meaning, and abides by a rule against surplusage."

Bankruptcy Code Stays Acts to Obtain Possession of Property of the Estate

Section 362(a)(3) of the Bankruptcy Code provides that the filing of a bankruptcy petition "operates as a stay, applicable to all entities, of . . . any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." Sections 541(a)(1) and 541(a)(3) of the Bankruptcy Code, respectively, define "property of the estate" to include, with certain exceptions, "all legal or equitable interests of the debtor in property as of the commencement of the case" and "[a]ny interest in property that the trustee recovers under section . . . 550" of the Bankruptcy Code.

Under section 550(a) of the Bankruptcy Code, a trustee may recover, for the benefit of the estate, transferred property "to the extent that a transfer is avoided under section 544 . . . [or] 548." Sections 544 and 548 of the Bankruptcy Code, in turn, enable the trustee to avoid fraudulent

transfers. The question before the *Rajala* court was whether allegedly fraudulently transferred property, prior to the recovery of that property pursuant to section 550(a), is "property of the estate" under section 541(a) and therefore subject to the automatic stay imposed by section 362(a).

The Facts

Generation Resources Holding Company, LLC ("GRHC") was formed in 2002 for the purpose of developing wind-generated power projects. In June 2005, GRHC entered into a memorandum of understanding ("MOU") with Edison Capital ("Edison") that contemplated Edison's purchase of three GRHC wind-power projects, including the "Lookout" project.

In late 2005, several GRHC insiders formed Lookout Windpower Holding Co., LLC ("LWHC"). Not long after its formation, LWHC closed a deal with Edison for the sale of the wind-power projects that were the subject of the MOU with GRHC. The GRHC insiders did so by causing a switch in the identity of the projects' developer from GRHC to LWHC. In March 2007, LWHC entered into a contract with an Edison subsidiary (the "Lookout Redemption Agreement"), which provided that once Lookout achieved commercial operation, Edison would pay 25 percent of a "Final Installment" contingency fee to FreeStream Capital, LLC ("FreeStream"), which GRHC had employed to provide advisory services, and 75 percent of the "Final Installment" to LWHC. Overburdened with $6 million in debt, GRHC filed for chapter 7 protection in Kansas on April 28, 2008.

In April 2009, LWHC and FreeStream sued Edison in federal district court in Pennsylvania for payment of the Final Installment due under the Lookout Redemption Agreement. In September

2009, GRHC's chapter 7 trustee brought suit against GRHC insiders (and others) in federal district court in Kansas, asserting, among other things, that the defendants had fraudulently transferred GRHC's development and redemption opportunities to LWHC.

The trustee sought an order from the Kansas district court staying the Pennsylvania action, arguing that any proceeds of the litigation were property of GRHC's estate. The Kansas district court denied the motion.

Shortly before the Pennsylvania case went to trial, the trustee filed a motion in the Pennsylvania federal court for an order staying the proceedings or, in the alternative, transferring the litigation to Kansas. The basis for this motion was the trustee's argument that the Lookout sale price was property of the GRHC estate and therefore subject to the automatic stay.

The court denied the motion in part and entered judgment in favor of LWHC and FreeStream for approximately $9 million. However, the court transferred to the Kansas bankruptcy court the issue of whether the judgment was part of GRHC's estate and ordered that the judgment funds be deposited with the bankruptcy court pending the outcome.

The reference to the Kansas bankruptcy court was then withdrawn to the Kansas district court, where the Pennsylvania case was consolidated with the trustee's pending claims.

The Kansas district court held that the bankruptcy estate does not include fraudulently transferred property until recovered through a fraudulent-transfer action, and it accordingly

granted the motions to distribute the $9 million judgment to LWHC and FreeStream. The district court also held that because the Lookout Redemption Agreement provided for FreeStream to be paid directly by Edison, FreeStream's contingency fee could not be considered part of GRHC's bankruptcy estate. The trustee appealed to the Tenth Circuit.

The Tenth Circuit's Ruling

A three-judge panel of the Tenth Circuit affirmed. As an initial matter, the court concluded that it had jurisdiction to review the district court's order. According to the Tenth Circuit, because the order "deemed § 362 inapplicable to the judgment proceeds, [it] was essentially an order granting relief from the automatic stay," which is generally considered an "appealable final order." The court also rejected the defendant-appellees' argument that the appeal was moot because the trustee had no effective remedy, finding it likely that at least some measure of effective relief could be fashioned were the stay reimposed on the disbursed funds. In addition, the Tenth Circuit affirmed the district court's ruling that FreeStream's fee could not be considered property of GRHC's bankruptcy estate because, among other things, the plain language of the Lookout Redemption Agreement required FreeStream's payment to come directly from Edison (as owner of Lookout).

The Tenth Circuit then turned to the question of whether the automatic stay applies to unrecovered property that is the subject of a fraudulent-transfer claim. The court began by acknowledging the circuit split on the issue. Under the Fifth Circuit's ruling in *Am. Nat'l Bank of Austin v. MortgageAmerica Corp. (In re MortgageAmerica Corp.)*, 714 F.2d 1266 (5th Cir. 1983), property alleged to have been fraudulently transferred is considered property of the estate pursuant to section 541(a)(1) and is therefore subject to the automatic stay even before it is

recovered, because the debtor continues to have a "legal or equitable interest" in the property fraudulently transferred. By contrast, in *Fed. Deposit Ins. Corp. v. Hirsch (In re Colonial Realty Co.)*, 980 F.2d 125 (2d Cir. 1992), the Second Circuit held that, because section 541(a)(3) expressly provides that estate property includes "[a]ny interest in property that the trustee recovers under section . . . 550," the automatic stay does not apply to allegedly fraudulently transferred property until the transfer is avoided under section 544 or 548 and the property is recovered under section 550.

The Tenth Circuit sided with the Second Circuit. First, citing the "plain meaning" rule of statutory construction, the court stated, "although § 541 is very broad, . . . it plainly does not include fraudulently transferred property until that property is recovered." Therefore, the court wrote, "because the statute's plain meaning is not demonstrably at odds with Congress's intent, it should control."

The court rejected the trustee's argument that the judgment proceeds were estate property because GRHC retained an "equitable interest" in the funds. After considering the definition of "equitable interest"—an interest held by virtue of an equitable title or claims on equitable grounds, such as the interest held by a trust beneficiary—the Tenth Circuit concluded that "[r]eading 'equitable title' to include any property a trustee merely alleges to have been fraudulently transferred would violate the concept of equity." According to the court, fundamental principles of equity jurisprudence demand that, before a complainant can have standing in court, he must show that he has a good and meritorious cause of action. "[A] mere allegation, without any showing of merit," the court wrote, "cannot create 'equitable title.' "

Again invoking principles of statutory construction, the court explained that, "if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." In this case, the court wrote, "§ 541(a)(3) provides that the estate includes '[a]ny interest in property that the trustee recovers' pursuant to his avoidance powers." The court agreed with the Second Circuit's view in *Colonial Realty* that "interpreting § 541(a)(1) to include fraudulently transferred property would render § 541(a)(3) meaningless with respect to property recovered in a fraudulent transfer action."

The Tenth Circuit rejected the trustee's argument that section 541(a)(3) is "a belt and suspenders" designed to ensure that assets will be available to satisfy creditor interests, reasoning that "there are already several mechanisms for safeguarding debtor assets." For example, the court explained, the trustee may seek a preliminary injunction or temporary restraining order pending resolution of a fraudulent-transfer claim. Because this was not one of the "rare cases" where the plain meaning of the statute leads to an absurd result, the Tenth Circuit concluded that the plain meaning of the statute should control.

Lastly, though not addressed by either party, the court noted that a broad reading of section 541 could potentially violate the Due Process Clause (U.S. CONST. AMENDS. V and XIV, § 1) by allowing the trustee to enjoin another party's property rights solely on the basis of allegations of fraud. For example, the court explained, because the stay imposed by section 362 is automatic, the "[m]ere filing of a fraudulent-transfer claim could deprive a bona fide purchaser of his property without judicial supervision, a finding of probable cause, the posting of a bond, or a showing of exigent circumstances—let alone a pre-deprivation opportunity to be heard." For this

additional reason, the Tenth Circuit was reluctant to adopt the trustee's broad interpretation of section 541. Instead, the court adopted the statute's plain meaning. It held that fraudulently transferred property is not part of the bankruptcy estate until recovered, and it accordingly affirmed the district court's determination that the automatic stay did not prevent disbursement of the judgment proceeds to LWHC and FreeStream.

Outlook

Rajala widens a rift in the federal circuit courts of appeal concerning inclusion in the bankruptcy estate of property that is subject to avoidance by a bankruptcy trustee, chapter 11 debtor in possession, or other estate representative (e.g., a creditors' committee or plan-liquidation trustee). The ruling is a cautionary tale. It places the burden squarely on estate representatives to be proactive in investigating potential avoidance claims and, where such claims are deemed to be meritorious, to seek provisional relief in a timely manner to ensure that potential estate property is preserved for the benefit of all stakeholders.