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EIGHTH CIRCUIT EXPANDS SUBSEQUENT NEW VALUE PREFERENCE DEFENSE IN CASES INVOLVING THREE-PARTY RELATIONSHIPS

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A bankruptcy trustee or chapter 11 debtor-in-possession has the power under section 547 of the Bankruptcy Code to avoid a transfer made immediately prior to bankruptcy if the transfer unfairly prefers one or more creditors over the rest of the creditor body. However, not every payment made by a debtor on the eve of bankruptcy can be avoided merely because it appears to be preferential. Indeed, section 547 provides several statutory defenses to preference liability. The Eighth Circuit Court of Appeals recently addressed one such defense to preference avoidance—the "subsequent new value" exception. In *Stoebner v. San Diego Gas & Electric Co. (In re LGI Energy Solutions, Inc.)*, 2014 BL 76796 (8th Cir. Mar. 20, 2014), the court, in a matter of first impression, ruled that "new value" (either contemporaneous or subsequent) for purposes of section 547(c) can be provided by an entity other than the transferee.

AVOIDANCE OF PREFERENTIAL TRANSFERS

A fundamental goal underlying U.S. bankruptcy law is equality of distribution among similarly situated creditors. To that end, the automatic stay generally prevents creditors from acting to collect on their debts after a debtor files for bankruptcy. In addition, section 547(b) of the Bankruptcy Code provides for avoidance of transfers made by an insolvent debtor within 90 days of a bankruptcy petition filing (or up to one year, if the transferee is an insider) to or for the benefit of a creditor on account of an antecedent debt where the creditor, by reason of the transfer, receives more than it would have received if, assuming the transfer had not been made, the debtor were liquidated in chapter 7.

Section 547(c) contains nine exceptions to avoidance of a preference. Of these, the three defenses most commonly invoked by commercial creditors are the "contemporaneous exchange" defense (section 547(c)(1)), the "ordinary course payment" defense (section 547(c)(2)), and the "subsequent new value" defense (section 547(c)(4)).

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Section 547(c)(4) provides as follows with respect to the subsequent new value defense:

> The trustee may not avoid under this section a transfer . . . (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—
>
> (A) not secured by an otherwise unavoidable security interest; and
>
> (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor[.]

Thus, even where a creditor has received a preferential transfer, the transferee may offset against the preference claim any subsequent unsecured credit that was extended to the debtor. The purpose of the exception is to encourage creditors to continue working with troubled businesses. *See Jones Truck Lines, Inc. v. Full Serv. Leasing Corp.*, 83 F.3d 253, 257 n.3 (8th Cir. 1996). "It recognizes that the 'new value' effectively repays the earlier preference, and offsets the harm to the debtor's other creditors. . . . Accordingly, 'the relevant inquiry under section 547(c)(4) is whether the new value replenishes the estate.' " *Savage & Assoc., P.C. v. Level (3) Communications (In re Teligent, Inc.)*, 315 B.R. 308, 315 (Bankr. S.D.N.Y. 2004) (internal citations omitted).

"New value" is defined in section 547(a)(2) of the Bankruptcy Code to include, among other things, "money or money's worth in goods, services, or new credit." In other words, a creditor must establish that it provided the debtor with "something new that is of tangible value." *In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d 224, 230 (5th Cir. 1988).

The issue addressed by the Eighth Circuit in *LGI Energy* is whether the language "such creditor gave new value" in section 547(c)(4) means that, in order to shield a transfer from avoidance, the "new value" provided to the debtor following the transfer must have come from the recipient of the challenged transfer, as distinguished from a third party.

LGI ENERGY

LGI Energy Solutions, Inc., and an affiliate (collectively, "LGI") performed bill payment services for clients that were large utility customers. Pursuant to contracts between LGI and its customers, LGI periodically sent each customer a spreadsheet detailing its payment obligations under invoices that LGI received from the utilities that provided services to the customer. After the customer sent a check payable to LGI for the aggregate amount due, LGI deposited the funds into its own commingled bank accounts and then sent checks drawn on those accounts to the utility companies. Even though the utilities sent bills for LGI's customers to LGI, the utilities had no contracts with LGI.

Over a three-week period in November 2008, LGI paid two utility providers approximately $258,000 for utility services provided to LGI customers. After those transfers, the utilities continued to provide services to the customers and sent new invoices to LGI. LGI continued to bill the customers, which sent checks totaling $297,000 to LGI for the payment of the invoices. LGI never paid any of those funds to the utilities.

LGI ceased operating in December 2008. Shortly afterward, involuntary chapter 7 petitions were filed against LGI in Minnesota. After entry of orders for relief in the consolidated cases, the chapter 7 trustee sued the utility providers to avoid as preferential the $258,000 in payments made by LGI. Although the challenged transfers were made to satisfy LGI's antecedent obligations to its utility customers—the transfers were made "for the benefit" of the customers—the trustee elected not to sue these primary creditor beneficiaries. The utilities invoked section 547(c)(4)'s subsequent new value defense.

The bankruptcy court concluded that the utilities were "creditors" under third-party and trust beneficiary principles, even though no contractual relationship existed between the providers and LGI. In addition, the court construed the language "such creditor" in section 547(c)(4) to mean that new value for purposes of the exception must have been provided to, or for the benefit of, LGI by the utilities, rather than to LGI's customers. Accordingly, the bankruptcy court ruled that the $297,000 in services provided by the utilities to LGI's customers did not qualify as new value furnished to LGI subsequent to the $258,000 in payments LGI made to the utilities within 90 days of the bankruptcy petition date.

A bankruptcy appellate panel reversed the ruling in part on appeal. The appellate panel agreed with the bankruptcy court's conclusion that the utilities were creditors despite the absence of a contract with LGI. However, relying on *Jones Truck Lines*, the court disagreed with the bankruptcy court's reading of "such creditor" to preclude new value provided to a debtor by a third party:

> *Jones Truck Lines* can be harmonized with the [reference to "such creditor" in section 547(c)(4)] by interpreting it as a recognition that in tripartite relationships where the [preferential] transfer to a third party [here, the utility] benefits the primary creditor [here, the utility customer], new value can come from that [primary] creditor, even if the third party is a creditor in its own right.

The trustee appealed to the Eighth Circuit.

THE EIGHTH CIRCUIT'S RULING

A three-judge panel of the Eighth Circuit affirmed.

At the outset, the court severely criticized the trustee's approach in suing the utilities instead of LGI's customers, who could have warded off any liability by means of section 547(c)(4) because they clearly provided post-transfer value to LGI. According to the court, "This approach does fundamental violence to the 'prime bankruptcy policy of equality of distribution among creditors.'" If the utilities were required to return the preferential payments to LGI, the Eighth Circuit wrote, "the estate is 'doubly replenished' entirely at the expense of only two creditors, [LGI's customers], who got no benefit for their subsequent new value and will continue to be liable to the utilities for their unpaid invoices."

The Eighth Circuit distanced itself from the lower courts' determination that the utilities were "creditors" who received a transfer or its benefit within the meaning of section 547(b)(1). Because the utilities did not raise this issue on appeal, however, the Eighth Circuit noted merely that "it seems open to serious question . . . and [the ruling] should *not* be considered Eighth Circuit precedent."

The court faulted the trustee's reliance on *In re Musicland Holding Corp.*, 462 B.R. 66 (Bankr. S.D.N.Y. 2011), for the proposition that "such creditor" in section 547(c)(4) must "in all circumstances" be construed as "limiting subsequent new value to that personally provided by the creditor the trustee elects to sue to recover the preferential transfer." In *Musicland*, the Eighth Circuit explained, the court denied the preference defendant's claim of an offset for subsequent new value provided by another creditor who, unlike in *LGI Energy*, "*neither received nor benefitted* [sic] *from the preferential transfer*." Here, the Eighth Circuit emphasized, both LGI's customers and the utilities benefited from LGI's preferential payments to the utilities.

> *LGI Energy* is a positive development for those doing business with financially troubled entities because it expands the scope of the subsequent new value defense to encompass payment relationships involving multiple parties.

The Eighth Circuit agreed with the bankruptcy appellate panel that *Jones Truck Lines* adequately refuted the trustee's position. In *Jones Truck Lines*, the Eighth Circuit ruled that payments made by a debtor-employer to benefit plans to satisfy its obligations to pay pension and welfare benefits were excepted from preference liability to the extent that *the employees* provided the debtor with post-transfer new value in the form of services. The court's analysis was directed principally toward new value in the context of the contemporaneous exchange defense in section 547(c)(1). Even so, the *Jones Truck Lines* court went on to address the related subsequent new value defense under section 547(c)(4). The court wrote that "[i]f [the debtor] received no contemporaneous new value for the weekly payments [to the benefit funds], then it necessarily received subsequent new value for each payment (except the last one) because its employees continued working." *Jones Truck Lines*, 130 F.3d at 327.

In *LGI Energy*, the Eighth Circuit concluded that, even if not controlling, *Jones Truck Lines* provides persuasive authority contradicting the trustee's "inequitable" interpretation of the term "such creditor" in section 547(c)(4):

> Our decision is limited to the circumstances presented by this case, for the statute is complex. We hold that, in three-party relationships where the debtor's preferential transfer to a third party benefits the debtor's primary creditor, new value (either contemporaneous or

> subsequent) can come from the primary creditor, even if the third party is a creditor in its own right and is the only defendant against whom the debtor has asserted a claim for preference liability. As § 547(b) makes avoidable a transfer "for the benefit of a creditor," it both serves the purposes of § 547 and honors the statute's text to construe "such creditor" in the § 547(c)(4) exception as including a creditor who benefitted [sic] from the preferential transfer and subsequently replenished the bankruptcy estate with new value.

OUTLOOK

LGI Energy is a positive development for those doing business with financially troubled entities because it expands the scope of the subsequent new value defense to encompass payment relationships involving multiple parties. In one sense, the ruling can be viewed as an instance of judicial activism directed at harmonizing the Bankruptcy Code with the realities of complex financial transactions. A handful of other courts have similarly concluded that new value provided by a third party in similar three-party transactions is adequate for the transaction at issue to fall within the exceptions provided by sections 547(c)(1) and 547(c)(4). *See*, *e.g.*, *In re H&S Transp. Co.,* 939 F.2d 355, 358–60 (6th Cir. 1991); *Fuel Oil Supply*, 837 F.2d at 231; *Holmes Environmental, Inc. v. Suntrust Banks, Inc. (In re Holmes Environmental, Inc.)*, 287 B.R. 363, 386 (Bankr. E.D. Va. 2002).

However, it could be argued that the Eighth Circuit's decision was motivated more by equitable and policy considerations than by a careful examination of the plain meaning of section 547(c)(4). The court stated in no uncertain terms that it viewed the trustee's preference litigation strategy as "do[ing] fundamental violence" to the policy of equality of distribution. The problem with the court's approach is that, even though the result may have been seen as fair, it glosses over the specific language of section 547(c)(4) and related provisions in the statute. Section 547(c)(1) and section 547(c)(4) share the concept of "new value" as a defense to preference liability. The former exempts from avoidance a transfer made as "a contemporaneous exchange for new value *given to* the debtor," whereas the latter shields a transfer to the extent that "after such transfer, *such creditor* gave new value" (emphasis added). Thus, section 547(c)(1) does not specify by whom new value can be provided, but section 547(c)(4) clearly provides that "such creditor"—i.e., the transferee—must be the source.

When Congress makes a distinction of this nature between two subsections of the same statute, it is presumed to have intended that they be implemented differently. Other courts have reached this conclusion with respect to sections 547(c)(1) and 547(c)(4), ruling that only the former allows new value to be provided by a third party. *See*, *e.g.*, *Manchester v. First Bank & Trust Co. (In re Moses)*, 256 B.R. 641, 652 (B.A.P. 10th Cir. 2000); *Gray v. Chace (In re Boston Publishing Co.)*, 209 B.R. 157, 174 (Bankr. D. Mass. 1997) (same).

In *LGI Energy*, the Eighth Circuit did not conclude that the language of section 547(c)(4) is ambiguous and therefore did not offer a rationale for declining to apply it literally. Nor, in its opinion, did the court examine the legislative history of section 547(c) in an effort to discern why lawmakers chose to use different wording in sections 547(c)(1) and 547(c)(4). As such, even though the outcome may have been fair, the ruling does not provide an ideal road map for invoking the subsequent new value defense in other cases involving three-party relationships.

The court in this case could have elected a pathway more consonant with the literal terms of section 547(c)(4) that nevertheless reached the same result. As the Eighth Circuit noted, the ruling below that the utilities were "creditors" of LGI was "open to serious question." A conclusion that the utilities were not in fact creditors of LGI—given that the parties had no contractual relationship—would have resulted in no preference liability, while simplifying the resolution of the case considerably.

NEWSWORTHY

Juan Ferré (Madrid) and ***Laurent Assaya (Paris)*** have been recommended as "Leaders in their Field" by *Chambers Europe* 2014 in the practice area of Restructuring/Insolvency.

Jeffrey B. Ellman (Atlanta), Brad B. Erens (Chicago), Carl E. Black (Cleveland), Thomas A. Howley (Houston), Corinne Ball (New York), Paul D. Leake (New York), David G. Heiman (Cleveland), Heather Lennox (New York and Cleveland), Charles M. Oellermann (Columbus), Gregory M. Gordon (Dallas), Bennett L. Spiegel (Los Angeles), Richard L. Wynne (Los Angeles), Bruce Bennett (Los Angeles), James O. Johnston (Los Angeles), and ***Sidney P. Levinson (Los Angeles)*** were designated "Leaders in their Field" in the area of Bankruptcy/Restructuring by *Chambers USA* 2014.

An article featuring ***Paul D. Leake (New York)*** appeared in the "Bankruptcy Beat" column in the March 25, 2014, edition of *The Wall Street Journal*.

An article written by ***Bennett L. Spiegel (Los Angeles)*** and ***Lori Sinanyan (Los Angeles)*** entitled "Getting Fees Paid by the Chapter 11 Estate Without Proving Substantial Contribution?" was published in the March 2014 issue of *The Bankruptcy Strategist*.

An article written by ***Thomas A. Howley (Houston)*** and ***Paul M. Green (Houston)*** entitled "Oil & Gas, Bankruptcy Law: A Combustible Mix" was published in the March 2014 issue of the *Journal of Corporate Renewal*.

Philip J. Hoser (Sydney) was recognized by *Best Lawyers in Australia* 2014 in the field of Insolvency and Restructuring Law.

Dan B. Prieto (Dallas) was named one of *Turnarounds & Workouts*' "Outstanding Young Restructuring Lawyers" for 2014.

On May 1, ***Brett J. Berlin (Atlanta)*** served as a panelist for a continuing legal education presentation on "Rule 2004 Examination Techniques" for the Atlanta Bar Association.

On April 23, ***Bennett L. Spiegel (Los Angeles)*** served as a panelist for a webinar entitled "Special Issues in Special Transactions," in which he focused on distressed mergers and acquisitions. The webinar was part of the M&A Private Company Boot Camp Series for 2014, a series of educational programs cosponsored by West LegalEdcenter.

On May 9, ***Amy Edgy Ferber (Atlanta)*** participated in a panel discussion entitled "Key Issues in Lender Negotiations" at The Turnaround Management Association Senate in Chicago.

An article written by ***Laurent Assaya (Paris)*** entitled "Réform du Droit des Entreprises en Difficulté: L'Ordonnance du 12 Mars 2014" was published in the April 18, 2014, issue of *Les Petites Affiches*.

Monika S. Wiener (Los Angeles) has been appointed Listserv facilitator for the American Bankruptcy Institute Legislation Committee.

Dan B. Prieto (Dallas) and ***Paul M. Green (Houston)*** were named "Rising Stars" for 2014 in *Super Lawyers* and *Texas Monthly*.

An article written by ***Richard L. Wynne (Los Angeles)*** and ***Lance Miller (Los Angeles)*** entitled " 'Trade Away!'—Bankruptcy Court for the Southern District of New York Decides That Original Issue Discount From Fair Value Exchanges Is Allowable in Bankruptcy" was posted on April 29, 2014, on the website of the *Harvard Law School Bankruptcy Roundtable*.

Charles M. Oellermann (Columbus) participated in a May 1 panel discussion on "Chapter 11: Duties of Counsel for a DIP as Fiduciary and Responsibilities to the Estate" at the Columbus Bar Association's annual Bankruptcy Law Institute.

On June 9, Jones Day's Miami Office will host a conference entitled "OGX and OSX Reorganization Proceedings—Developments, Challenges, and Opportunities for Cross-Border Restructurings in Brazil." The high-profile collapse of EBX's oil and gas empire and the ensuing reorganization proceedings of OGX and OSX provide the backdrop for the panel's discussion on Brazil's new insolvency law, the challenges for creditors of Brazilian debtors, and how the OGX and OSX reorganization proceedings will provide additional color on what to expect in future domestic and cross-border Brazilian insolvency proceedings. The panelists will include ***Pedro A. Jimenez (Miami and New York), S. Wade Angus (New York and São Paulo), Marcello Hallake (São Paulo and New York),*** Marcos Leite de Castro (partner, Stocche Forbes), Luis de Lucio (managing director, Alvarez & Marsal), and Domingos Fernando Refinetti (partner, Stocche Forbes). For additional information, please contact Nikki Girard at ngirard@jonesday.com.

FOURTH CIRCUIT WEIGHS IN ON GOOD-FAITH DEFENSE TO AVOIDANCE OF FRAUDULENT TRANSFER

Charles M Oellermann and Mark G. Douglas

An important defense in litigation brought by a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to avoid a fraudulent transfer is that the recipient provided value in exchange for the transfer and acted in "good faith." Because the Bankruptcy Code does not define "good faith," courts assessing the viability of a good-faith defense typically examine whether, on the basis of the specific circumstances, a transferee *knew* or *should have known* that a transfer was actually or constructively fraudulent. Although most courts agree that this test is an objective one, a ruling recently handed down by the Fourth Circuit Court of Appeals may have introduced an element of subjectivity into the analysis. In *Gold v. First Tenn. Bank N.A. (In re Taneja)*, 2014 BL 47157 (4th Cir. Feb. 21, 2014), a Fourth Circuit panel ruled in a split decision that: (i) the same standard applies in assessing good faith under sections 548(c) and 550(b) of the Bankruptcy Code; and (ii) a transferee bank met its burden of demonstrating good faith without introducing evidence of standard practices in the mortgage warehousing industry.

GOOD-FAITH DEFENSE TO AVOIDANCE OF FRAUDULENT TRANSFERS

Section 548(a)(1) of the Bankruptcy Code authorizes a trustee or DIP to avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor within the two years preceding a bankruptcy filing if: (i) the transfer was made, or the obligation was incurred, "with actual intent to hinder, delay, or defraud" any creditor; or (ii) the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation" and was, among other things, insolvent, undercapitalized, or unable to pay its debts as such debts matured.

Section 548(c) provides a defense to avoidance of a fraudulent transfer for a "good faith" transferee or obligee who gives "value" in exchange for a transfer or obligation:

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title [dealing with a trustee's power to avoid, respectively, transfers that are voidable under state law, statutory liens, and preferential transfers], a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

Thus, the ability of a transferee or obligee to rely on section 548(c) as a defense depends upon whether: (i) the transferee or obligee takes "for value"; (ii) the transferee or obligee acts in "good faith"; and (iii) the transfer or obligation is not otherwise avoidable. Section 550(b) of the Bankruptcy Code similarly provides that, after avoidance of a transfer, the trustee may not recover the property transferred or its value from any transferee "that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided."

WHAT IS "GOOD FAITH"?

The Bankruptcy Code defines "value" for purposes of section 548. Section 548(d)(2)(A) states that " 'value' means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."

"Good faith," however, is not defined by the Bankruptcy Code, and courts have sometimes struggled to find a reliable standard to apply in assessing whether it exists under a wide range of circumstances. *See generally Jimmy Swaggart Ministries v. Hayes (In re Hannover Corp.)*, 310 F.3d 796, 800 (5th Cir. 2002) ("[T]here is little agreement among courts as to what conditions ought to allow a transferee [the good-faith] defense. This is not surprising, as the variables are manifold."). For example, in *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Group, Inc.)*, 916 F.2d 528 (9th Cir. 1990), the Ninth Circuit explained that the standard is an objective one—namely, in gauging good faith, a court should examine what a transferee knew or should have known, rather than what the transferee actually knew from a subjective standpoint. *Accord Brown v. Third Nat'l Bank (In re Sherman)*, 67 F.3d 1348 (8th Cir. 1995); *Leonard v. Coolidge (In re Nat'l Audit Defense Network)*, 367 B.R. 207 (Bankr. D. Nev. 2007).

Other courts have refined this standard into a two-part analysis, examining: (i) whether the transferee was on inquiry notice of

suspicious facts amounting to "red flags"; and (ii) if so, whether the transferee reasonably followed up with due diligence to determine whether a transaction may not have been bona fide. *See*, *e.g.*, *Horton v. O'Cheskey (In re Am. Hous. Found.)*, 2013 BL 307573 (5th Cir. Nov. 5, 2013); *Christian Bros. High School Endowment v. Bayou No Leverage Fund LLC (In re Bayou Group, LLC)*, 439 B.R. 284 (S.D.N.Y. 2010); *Bear Stearns Securities Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1 (S.D.N.Y. 2007); *Soifer v. Bozarth (In re Lydia Cladek, Inc.)*, 494 B.R. 555 (Bankr. M.D. Fla. 2013). Whether a transferee has acted in good faith is a fact-intensive inquiry that must be determined on a case-by-case basis. *See Sherman*, 67 F.3d at 1355; *Wagner v. Ultima Homes, Inc. (In re Vaughan Co. Realtors)*, 493 B.R. 597 (Bankr. D.N.M. 2013).

The Fourth Circuit's ruling in *Taneja* has already been criticized by some commentators and industry professionals for corrupting the objective element of the test for good faith.

In *Taneja*, the Fourth Circuit examined the meaning of "good faith" as used in section 548(c).

TANEJA

Beginning in the 1990s, Vijay K. Taneja ("Taneja") owned and operated Financial Mortgage, Inc. ("FMI"), a business engaged in originating home mortgages and selling the loans to secondary purchasers who aggregated the mortgage loans and securitized them for sale to investors. As part of that business, FMI worked with several financial institutions known as "warehouse lenders." Those lenders advanced funds to FMI under lines of credit so that FMI could originate mortgages. Under those arrangements, FMI was obligated to sell the mortgage loans to secondary purchasers within a certain period of time, after which the lines of credit were replenished.

At some point after 1999, FMI had difficulty selling mortgage loans and, under Taneja's control, began engaging in fraudulent conduct. The fraud included selling the same mortgage loans to several different secondary purchasers and conspiring with other affiliated entities controlled by Taneja to have those entities serve as intermediaries as a way to conceal the fraud. This scheme continued through 2007–08, when the market for mortgage-backed securities began to implode as part of the financial crisis. The fraudulent scheme resulted in losses of nearly $14 million to warehouse lenders, approximately $19 million to secondary purchasers, and unspecified millions to investors.

One of FMI's warehouse lenders was First Tennessee Bank N.A. ("FTB"). In July 2007, FTB agreed to provide FMI with a $15 million line of credit. Before doing so, FTB analyzed financial statements and tax records provided by FMI and Taneja, checked FMI's references, and examined FMI's "quality control plan." The bank also conducted due diligence, using a "private mortgage database" that contained information regarding mortgage irregularities and reports of fraud or suspected fraud. FTB's investigation did not reveal any negative business information regarding either FMI or Taneja.

The lending agreement obligated FTB to send funds directly to an insured title agent. After each mortgage transaction closed, FMI was required to send the loan documentation, including the promissory note, to the bank within two business days.

From September 2007 to March 2008, FMI made payments to FTB aggregating nearly $4 million, but the payments were often untimely. FTB loan officers met with Taneja and other FMI representatives twice during that period. The loan officers later testified that: (a) Taneja claimed that FMI's failure to produce loan documentation in a timely fashion was caused by the unexpected departure of one of its loan processors; (b) FMI's chief secondary purchaser confirmed that it had not bought FMI's outstanding loans due to the lack of supporting documentation; and (c) Taneja's lawyer assured the officers that the mortgages were "good" and represented "arms-length transactions."

In April 2008, FTB learned that the mortgages originated by FMI had been falsified. The bank immediately declared FMI in default under the lending agreement.

In June 2008, Taneja (who was later convicted and imprisoned for the fraud), FMI, and various affiliates filed for chapter 11 protection in the Eastern District of Virginia. A bankruptcy trustee appointed for all of the debtors sued FTB in the bankruptcy court to avoid the $4 million in payments made by FMI to the bank as fraudulent transfers under section 548(a) and to recover the funds under section 550(a). FTB invoked the good-faith defense under section 548(c).

At trial, the bankruptcy court heard the testimony of the FTB officers who had been in charge of the lending relationship with FMI. Although the witnesses had considerable experience in warehouse lending, they were not qualified as experts in the industry. Both testified that during the "market meltdown" of 2007–08, banks spent more time analyzing mortgage loans, such loans were more difficult to sell, and more loans remained outstanding on the bank's warehouse lines of credit than in previous years.

The bankruptcy court, relying on the loan officers' testimony, ruled that FTB had established its good-faith affirmative defense under section 548(c) and dismissed the avoidance proceeding. Among other things, the court found that, although the bank was concerned about FMI's failure to sell its loans quickly in 2007, the bank reasonably thought that the lagging secondary mortgage market, rather than any misconduct, caused the delay. The court concluded that FTB "did not have any information that would [reasonably] have led it to investigate further, and the bank's actions were in accord with the bank's and the industry's usual practices."

A district court affirmed the ruling, and the trustee appealed to the Fourth Circuit.

THE FOURTH CIRCUIT'S RULING

A three-judge panel of the Fourth Circuit affirmed in a split decision. Both the majority and dissenting opinions discussed whether the bankruptcy court had erred in: (i) misapplying the good-faith standard; and (ii) concluding that FTB presented sufficient objective evidence to prove that it had accepted the payments from FMI in good faith.

The majority explained that the Fourth Circuit recently interpreted the term "good faith" in the context of section 550(b)(1) of the Bankruptcy Code in *Goldman v. City Capital Mortg. Corp. (In re Nieves)*, 648 F.3d 232 (4th Cir. 2011). In *Nieves*, the Fourth Circuit ruled that the proper focus in evaluating good faith in the context of section 550(b)(1) is determining "what the transferee [actually] knew or should have known" when it accepted the transfer. In addition, the court determined that good faith has components that are both subjective (honesty in fact) and objective (observance of reasonable commercial standards):

> Under the subjective prong, a court looks to "the honesty" and "state of mind" of the party acquiring the property. Under the objective prong, a party acts without good faith by failing to abide by routine business practices. We therefore arrive at the conclusion that the objective good-faith standard probes what the transferee knew or should have known taking into consideration the customary practices of the industry in which the transferee operates.

Id. at 239–40 (citation omitted). In *Taneja*, the majority concluded that the good-faith standard adopted in *Nieves* should apply in determining good faith under section 548(c).

The trustee did not allege that FTB had actual knowledge of FMI's fraudulent conduct at the time of the transfers. Thus, under *Nieves*, the *Taneja* panel's inquiry concerned whether the bank should have known about the fraud in keeping with customary practices in the industry.

The majority rejected the trustee's argument that FTB could not prove good faith without showing that "each and every act taken and belief held" by the bank constituted "reasonably prudent conduct by a mortgage warehouse lender." The majority also rejected the trustee's contention that such evidence should have been presented in the form of third-party expert testimony.

"We decline," the majority wrote, "to adopt a bright-line rule requiring that a party asserting a good-faith defense present evidence that his every action concerning the relevant transfers was objectively reasonable in light of industry standards." Rather, the court emphasized, "our inquiry regarding industry standards serves to establish the correct context in which to consider what the transferee knew or should have known."

The majority was similarly loath to adopt an "inflexible rule" that expert testimony must be presented in every case to prove good faith. Such a rule, the court wrote, "unreasonably would restrict the presentation of a defense that ordinarily is based on the facts and circumstances of each case and on a particular witness' knowledge of the significance of such evidence."

Having laid the groundwork regarding the appropriate standard and the nature of the evidence necessary to satisfy it, the majority ruled that: (i) the bankruptcy court applied the correct legal standard in evaluating whether FTB proved its good-faith defense; and (ii) the bankruptcy court did not err in concluding

that, on the basis of testimony by FTB's officers regarding their experience in mortgage warehousing and their efforts to investigate Taneja, FMI, and the circumstances surrounding FMI's failure to timely submit mortgage loan documentation, FTB should not necessarily have known of FMI's fraudulent conduct. According to the majority, "[W]hen considered as a whole, the circumstances relied on by the trustee indicated only that FMI had financial difficulties, which was not uncommon in the warehouse lending industry during 2007 and 2008."

DISSENTING OPINION

Fourth Circuit Judge James A. Wynn, Jr., dissented. In his opinion, Judge Wynn explained that good faith has not just a subjective component, but also an objective "observance of reasonable commercial standards" element. FTB, the judge wrote, "failed to proffer any evidence to support a finding that it received transfers from FMI with objective good faith in the face of several alleged red flags."

Judge Wynn agreed with the majority's conclusion that FTB could meet its burden as to the objective element of the test without presenting expert testimony on prevailing industry standards. However, he argued that FTB failed to elicit such testimony from its (nonexpert) witnesses, relying instead on "generalities from those witnesses such as having read the *Wall Street Journal* and having worked in the industry for many years." Such generalities, Judge Wynn posited, constitute evidence of commercially reasonable standards in the warehouse lending industry that is inadequate to satisfy the objective component of the good-faith defense. Moreover, he questioned whether FTB's response to the red flags raised by FMI's conduct comported "with that of a reasonable warehouse lender."

Finally, Judge Wynn discounted FMI's reliance on what it portrayed as a reasonable response in the face of the turmoil in the economy and the mortgage industry during the financial crisis, rather than demonstrating how, in the face of red flags, its conduct comported with industry practices and standards. According to the judge:

> If economic turmoil gives businesses a free pass on needing to prove objective good faith, even businesses falling far short of industry standards but rather "wil[l]ful[ly] ignoran[t] in the face of facts which cried out for investigation[,]" *In re Nieves*, 648 F.3d at 241, could succeed with a good faith defense so long as their implosion coincided with an economic downturn. This is not, and should not be, the law.

OUTLOOK

The Fourth Circuit's ruling in *Taneja* has already been criticized by some commentators and industry professionals for corrupting the objective element of the test for good faith. Under existing case law, if a DIP or trustee claims that a transferee "should have known" of a transferor's fraud, a two-part analysis is required. First, the court must examine whether red flags existed that should have alerted a reasonably prudent transferee to potential fraud. If the court concludes that the transferee had "inquiry notice" due to the existence of red flags, the transferee can still establish a good-faith defense under section 548(c) if it can demonstrate that a reasonably diligent inquiry would not have revealed the fraud. Both the inquiry notice and diligent inquiry elements are objective tests.

Taneja muddies the waters by injecting an element of subjectivity into this analysis. The Fourth Circuit majority did not require FTB to demonstrate that a reasonably prudent warehouse lender would not have been alerted to the fraud. Instead, the majority ruled that the bank's nonexpert witnesses adequately demonstrated that FTB received the transfers in good faith and without knowledge that should have alerted the bank that the transfers were fraudulent. As noted in the dissent, an objective inquiry would have required FTB to present evidence demonstrating that its conduct followed routine industry standards and that its response to the red flags (e.g., late payments, inadequate loan documentation) would not have alerted a reasonably prudent mortgage warehouse lender to FMI's fraud.

IN BRIEF: DEBT PURCHASER'S CREDIT BID LIMITED POST-*FISKER*

In the March/April 2014 edition of the *Business Restructuring Review*, we discussed an important ruling from a Delaware bankruptcy court restricting a creditor's right to credit bid an acquired claim in bankruptcy sale of the underlying collateral. In *In re Fisker Automotive Holdings, Inc.*, 2014 BL 13998 (Bankr. D. Del. Jan. 17, 2014), *leave to app. denied*, 2014 BL 33749 (D. Del. Feb. 7, 2014), *certification denied*, 2014 BL 37766 (D. Del. Feb. 12, 2014), the bankruptcy court limited the amount of the credit bid to the discounted purchase price actually paid for the debt.

In concluding that the right to credit bid under section 363(k) of the Bankruptcy Code is not absolute and may be limited "for cause," the court relied on a controversial ruling handed down in 2010 by the Third Circuit Court of Appeals. In *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), the Third Circuit observed in a footnote that imposing a limit on credit bidding "for cause" does not require the secured creditor to "engage in inequitable conduct." On the contrary, according to the Third Circuit, "[a] court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment."

In *Fisker*, the bankruptcy court held that limiting the amount of the credit bid was warranted because an unrestricted credit bid would chill bidding and because the full scope of the underlying lien was as yet undetermined. The court also expressed concern as to the expedited nature of the proposed sale under section 363(b) of the Bankruptcy Code, which in the court's view was never satisfactorily explained. As a postscript, although the debt purchaser was outbid at the ensuing auction of Fisker's assets, the losing bidder and Fisker's other creditors reached a settlement in mid-April whereby the loser will receive as much as $90 million of the $149.2 million sale proceeds—a significant return on its $25 million investment to acquire the debt from the U.S. government.

Given the importance of credit bidding as a distressed acquisition tool, along with the court's ruling limiting the credit bid to the amount paid for the debt, distressed debt purchasers have kept a close watch on the way subsequent courts have interpreted and applied *Fisker*.

A Virginia bankruptcy court, in a published April ruling, was apparently the first to do so. In *In re The Free Lance-Star Publishing Co. of Fredericksburg, Va.*, 2014 BL 103869 (Bankr. E.D. Va. Apr. 14, 2014), *leave to appeal denied*, 2014 BL 130156 (E.D. Va. May 7, 2014), the court found "cause" under section 363(k) to limit a credit bid by an entity that purchased $39 million in face amount of debt with the intention of acquiring ownership of the debtors, which owned various radio stations and newspapers.

The court limited the credit bid in connection with a sale of the debtors' assets under section 363(b) on the basis of its findings that: (i) the creditor's liens on a portion of the assets to be sold had been improperly perfected; (ii) the creditor engaged in inequitable conduct by forcing the debtor into bankruptcy and an expedited section 363 sale process in pursuing its clearly identified "loan to own" strategy; and (iii) the creditor actively "frustrate[d] the competitive bidding process" and attempted "to depress the sales price of the Debtors' assets." The court accordingly limited the debt purchaser's credit bid to $14 million. Although the capped amount appears to correspond to the approximate value of the collateral that was subject to the creditor's valid and perfected liens, the court stated at a March 25, 2014, hearing that it "wishes it had more information with regard to the amount . . . that the lender paid . . . for the loan." Transcript of Mar. 25, 2014, Hearing at 197:1–198:10 (quoted in Doc. No. 177).

On May 8, 2014, a Virginia district court denied the creditor's motion for leave to appeal the interlocutory ruling. *See DSP Acquisition, LLC v. Free Lance-Star Publishing Co. of Fredericksburg, VA*, 2014 BL 130156 (E.D. Va. May 7, 2014). In its motion, the creditor argued that the credit-bidding issue is at the heart of the sale process and an anticipated May 15, 2014, auction and that the issue must therefore be resolved prior to the auction. It also contended that, absent immediate appellate review, the integrity of the sale process would be jeopardized.

Relying on the Delaware district court's ruling denying a motion for leave to appeal the credit bid limitation in *Fisker*, the district court rejected the creditor's arguments:

> [T]here is no risk of irreparable harm if the issues are not resolved before the auction because there is no pending issue regarding the assets subject to sale and the Bankruptcy Court will determine who receives the proceeds (and how much) after the sale. Thus, if the Bankruptcy Court determines that the amount of [the] credit bid was incorrect, it can accordingly adjust the payment to [the creditor] at a later stage of the proceedings.

Id. at *2.

Most recently, the bankruptcy court in *In re Charles Street African Methodist Episcopal Church of Boston*, 2014 BL 134241 (Bankr. D. Mass. May 14, 2014), denied in part a chapter 11 debtor's motion to limit a credit bid on the basis that the secured creditor's claims were subject to bona fide dispute because the debtor had filed counterclaims against the creditor which, by way of setoff, could have reduced the amount of the claims to zero. The debtor, in an attempt to auction its assets, had sought an expedited "up or down" decision on credit-bidding rights without the need for an evidentiary hearing. It explicitly disavowed reliance on *Fisker* and the alternative theories limiting credit bids articulated in the ruling (e.g., bid chilling and bidding for an improper purpose or with an ulterior motive).

In finding that "cause" was lacking under section 363(k) to limit the credit bid, the court explained that: (i) despite the debtor's counterclaims, which did not relate to the validity of the secured creditor's claims or liens, the claims were "allowed" (a designation that the debtor did not dispute); and (ii) the claims were not likely to be consumed entirely in a credit bid for the assets.

The court rejected the debtor's argument that "credit risk" associated with collecting on its counterclaims was a valid reason under the circumstances to limit credit-bidding rights. According to the court, "[The debtor] would be using a denial of credit bidding as, in essence, a form of prejudgment security, a purpose that I doubt it was intended to serve." *Id.* at *7.

However, the court ruled that, because the terms of the auction included the payment of a $50,000 breakup fee if the stalking-horse bidder did not prevail, the secured creditor was required to include at least $50,000 in cash as part of its bid. Thus, the court did partially limit the credit bid.

TAKING SIDES—*LYONDELL* LIMITS THE USE OF THE SECTION 546(e) SAFE HARBOR IN FRAUDULENT TRANSFER LITIGATION

Amanda Suzuki

In *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014), the U.S. Bankruptcy Court for the Southern District of New York held that the "safe harbor" under section 546(e) of the Bankruptcy Code for settlement payments made in connection with securities contracts does not preclude claims brought by a chapter 11 plan litigation trustee on behalf of creditors under state law to avoid as fraudulent transfers pre-bankruptcy payments to shareholders in a leveraged buyout ("LBO") of the debtor. By its ruling, the *Lyondell* court contributed to a split among the courts in the Southern District of New York, aligning itself with the district court in *In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013), and against the district court in *Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013). *Lyondell* and *Tribune* appear to signal that even in the Second Circuit, where courts have liberally interpreted the scope of the Bankruptcy Code's financial safe harbors, the reach of section 546(e) is not without bounds.

BANKRUPTCY AVOIDANCE POWERS AND LIMITATIONS

The Bankruptcy Code gives a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") the power to avoid, for the benefit of the estate, certain transfers made or obligations incurred by a debtor, including fraudulent transfers, within a specified time prior to a bankruptcy filing. Fraudulent transfers include transfers that were made with "actual" fraudulent intent—the intent to hinder, delay, or defraud creditors—as well as transfers that were "constructively" fraudulent, because the debtor received less than

"reasonably equivalent value" in exchange and, at the time of the transfer, was insolvent, undercapitalized, or unable to pay its debts as such debts matured.

Fraudulent transfers can be avoided by a bankruptcy trustee or DIP for the benefit of the estate under either: (i) section 548 of the Bankruptcy Code, which creates a federal cause of action for avoidance of transfers made or obligations incurred up to two years before a bankruptcy filing; or (ii) section 544, which gives the trustee or DIP the power to avoid transfers or obligations that may be avoided by creditors under applicable nonbankruptcy law. Some state fraudulent transfer laws that may be utilized under section 544 have a reach-back period longer than two years.

Section 546 of the Bankruptcy Code imposes a number of limitations on these avoidance powers. Specifically, section 546(e) prohibits, with certain exceptions, avoidance of transfers that are margin or settlement payments made in connection with securities, commodity, or forward contracts. The purpose of section 546(e) and other financially focused "safe harbors" in the Bankruptcy Code is to minimize "systemic risk" to the securities and commodities markets that could be caused by a financial contract counterparty's bankruptcy filing. Like sections 544 and 548, section 546(e) is expressly directed at a bankruptcy trustee or, pursuant to section 1107(a), a DIP: "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, *the trustee* may not avoid a transfer that is a margin payment . . . or settlement payment . . . ." (emphasis added).

PREEMPTION

The Bankruptcy Clause of the U.S. Constitution grants authority to Congress to establish a uniform federal law of bankruptcy. U.S. CONST., art. I, cl. 8. The Supremacy Clause of the Constitution mandates that federal laws, such as those concerning bankruptcy, "shall be the supreme Law of the Land; . . . [the] Laws of any State to the Contrary notwithstanding." U.S. CONST., art. VI, cl. 2. Thus, under the doctrine of preemption, "state laws that interfere with or are contrary to federal law are preempted and are without effect pursuant to the Supremacy Clause." *In re Loranger Mfg. Corp.*, 324 B.R. 575, 582 (Bankr. W.D. Pa. 2005); *accord Hillsborough County v. Automated Medical Labs, Inc.*, 471 U.S. 707, 712 (1985). Through the years, three types of federal-law preemption over state law have been developed by the courts: (i) express preemption; (ii) field preemption; and (iii) conflict preemption. *In re Nickels Midway Pier, LLC*, 332 B.R. 262, 273 (Bankr. D.N.J. 2005). Express preemption applies "when there is an explicit statutory command that state law be displaced." *Id.* Field preemption applies when federal law "is sufficiently comprehensive to warrant an inference that Congress 'left no room' for state regulation." *In re Miles*, 294 B.R. 756, 759 (B.A.P. 9th Cir. 2003); *Hillsborough County*, 471 U.S. at 713. Conflict preemption applies if state law conflicts with federal law such that: "(1) it is impossible to comply with both state law and federal law; or (2) the state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Nickels Midway Pier*, 332 B.R. at 273.

Lyondell contributes to a split of authority in the Southern District of New York on the application of section 546(e). Whereas *Barclays* continued the trend of liberally applying the safe harbor consistent with its purpose to protect financial markets against systemic risk, *Tribune* and *Lyondell* have departed from this approach, limiting the reach of section 546(e) by tempering the need to protect markets with other important bankruptcy principles, such as the protection of creditors' rights.

In *Lyondell*, the court considered, among other things, whether section 546(e), either by its own terms or under preemption principles, bars state-law fraudulent transfer claims with respect to a prepetition LBO, which claims were assigned as part of a chapter 11 plan to a post-bankruptcy litigation trust established for the benefit of creditors.

LYONDELL

In December 2007, Basell AF S.C.A. acquired Lyondell Chemical Company ("Lyondell") through an LBO. The transaction was financed entirely by debt and was secured by the assets of the target company rather than the acquirer. As a result of the LBO, Lyondell took on approximately $21 billion of secured indebtedness. About $12.5 billion of the amount borrowed was paid to Lyondell stockholders, many of which were investment banking houses, brokerage firms, or other financial institutions.

In early January 2009, just 13 months after the LBO, Lyondell and numerous affiliates filed for chapter 11 protection in the Southern District of New York. Ultimately, the bankruptcy court confirmed a chapter 11 plan for Lyondell that provided for, among other things: (i) the creation of a litigation trust (the "Creditor Trust") to which certain estate causes of action were abandoned; and (ii) the assignment by creditors of their state-law claims, including state-law fraudulent transfer actions, to the Creditor Trust. After the effective date of the plan, the trustee of the Creditor Trust sued all Lyondell shareholders who had received more than $100,000 in connection with the LBO, alleging that the payments were actually or constructively fraudulent and therefore avoidable under state law. The defendants moved to dismiss, asserting, among other things, that the claims were: (i) barred by the terms of the section 546(e) safe harbor; and (ii) preempted by section 546(e).

THE DECISION: CREDITOR TRUST CLAIMS ARE NOT BARRED BY 546(e) OR PREEMPTION PRINCIPLES

The bankruptcy court denied the defendants' motion to dismiss on the basis of section 546(e). The court concluded that, by its terms, section 546(e) does not apply to claims asserted by or on behalf of creditors; rather, it applies only to claims brought by a bankruptcy trustee or DIP. Furthermore, the court ruled that the state-law claims were not preempted by either section 546(e) or other federal law.

The defendants argued that, even though section 546(e) expressly bars only actions brought by a "trustee" to avoid certain financial transactions as constructively fraudulent transfers, the provision also bars similar state-law claims asserted on behalf of creditors. The court flatly rejected this argument, admonishing that "[w]hile the Movants spend 10 pages in their brief arguing the matter as if sections 544 and 548—and hence section 546(e)—apply to this case, this is not a case about sections 544 and 548." The claims at issue, the court explained, were being asserted not on behalf of the estate, but on behalf of individual creditors. Thus, the court wrote, "there is no statutory text making section 546(e) applicable to claims brought on behalf of individual creditors, or displacing their state law rights, by plain meaning analysis or otherwise." Quoting *Tribune*, the court emphasized that "if Congress intended section 546(e) to be more broadly applicable, 'it could simply have said so.' "

Also following the reasoning of *Tribune*, the court rejected the defendants' position that, under all three types of preemption doctrine, the absence of a safe harbor similar to section 546(e) in state fraudulent transfer laws should mean that the states' "similar but not congruent" constructive fraudulent transfer avoidance statutes are preempted by section 546(e) and therefore invalid. In this regard, the court initially determined that Congress had not expressly preempted any state-law causes of action for fraudulent transfers.

The bankruptcy court also concluded that there was no "field preemption" because "Congress has not evidenced any intention to wholly occupy the fields of avoidance or recovery of fraudulent transfers." Rather, the court explained, the history of state and federal fraudulent transfer law has long demonstrated a shared interest with the states in protecting creditors from constructively fraudulent transfers. Indeed, the court noted, state fraudulent transfer laws predate the federal equivalents, with no subsequent attempt by Congress to preclude enforcement of existing state laws.

Finally, the court found no "conflict preemption." The defendants argued that the congressional policy underlying the enactment of section 546(e) would be undermined by allowing the state-law fraudulent transfer action to proceed. In response, the court concluded that it is not impossible for a party to comply with both federal and state fraudulent transfer laws. The court similarly determined that, considering lawmakers' intent with respect to section 546(e) in the context of general bankruptcy policy:

> [A]t least in the context of an action against cashed out beneficial holders of stock, at the end of the asset dissipation chain, state law fraudulent transfer laws do not "stand as an obstacle" to the "purposes and objectives of Congress"—even if one were to ignore the remainder of bankruptcy policy and focus solely on the protection against the "ripple effects" that caused section 546(e) to come into being.

Accordingly, following much of the reasoning in *Tribune*, the *Lyondell* court ruled that the state-law fraudulent transfer laws were not preempted by section 546(e) or any other federal law.

The *Lyondell* court determined that the defendants' reliance on *Barclays*, in which the court granted a motion to dismiss state constructive fraudulent transfer claims brought by a litigation trust, was misplaced. According to the *Lyondell* court, *Barclays* is

factually distinguishable—in *Barclays*, the same trust prosecuted both estate and individual creditor claims, whereas in *Lyondell*, the Creditor Trust held only claims assigned by creditors, and the estate specifically abandoned its section 544 rights.

The *Lyondell* court also faulted both the *Barclays* court's ultimate judgment and its reasoning, particularly with respect to preemption. The *Lyondell* court appeared to be particularly troubled by the *Barclays* court's focus on the congressional objective of protecting the financial markets and the court's failure to consider other congressional bankruptcy objectives, such as the "longstanding and fundamental principles that insolvent debtors cannot give away their assets to the prejudice of their creditors." According to the *Lyondell* court, this narrow focus prevented the *Barclays* court from drawing the proper conclusion that "[p]rotecting market participants is not the same thing as protecting markets." Characterizing the analysis in *Barclays* as "flawed" and "less thorough than that of *Tribune*," the *Lyondell* court ruled that nothing in section 546(e) demands that state-law fraudulent transfer claims be either expressly or impliedly preempted.

OUTLOOK

Lyondell contributes to a split of authority in the Southern District of New York on the application of section 546(e). Whereas *Barclays* continued the trend of liberally applying the safe harbor consistent with its purpose to protect financial markets against systemic risk, *Tribune* and *Lyondell* have departed from this approach, limiting the reach of section 546(e) by tempering the need to protect markets with other important bankruptcy principles, such as the protection of creditors' rights. Although *Tribune* and *Lyondell* both involved specific, somewhat narrow circumstances in which the claims at issue were clearly state-law claims that were not being asserted by the bankruptcy trustee or DIP, the two opinions signal that, even in the Second Circuit (where courts are known for liberally construing the safe harbor), the scope of section 546(e) is not without limits. Furthermore, in the preemption context, *Tribune* and *Lyondell* suggest that protection of the financial markets will not always trump other bankruptcy policies.

Both *Barclays* and *Tribune* have been appealed to the Second Circuit, which will hear the appeals in tandem and is expected to weigh in on these important issues later this year.

IN BRIEF: CHAPTER 11 PLAN PAYMENT OF OFFICIAL COMMITTEE MEMBERS' LEGAL FEES DISALLOWED ABSENT SHOWING OF SUBSTANTIAL CONTRIBUTION

In the March/April 2014 issue of *Business Restructuring Review*, we discussed a recent trend among bankruptcy courts in the Southern District of New York confirming chapter 11 plans containing provisions that treat the fees and expenses of unofficial committees or individual official committee members as administrative expenses without the need to demonstrate that the applicants made a "substantial contribution" to the estate, as required by sections 503(b)(3)(D) and 503(b)(4) of the Bankruptcy Code. *See, e.g., In re AMR Corp.*, 497 B.R. 690 (Bankr. S.D.N.Y. 2013); *In re Lehman Brothers Holdings Inc.*, 487 B.R. 181 (Bankr. S.D.N.Y. 2013); *In re Adelphia Communications Corp.*, 441 B.R. 6 (Bankr. S.D.N.Y. 2010).

Prior to 2005, section 503(b) of the Bankruptcy Code authorized the payment of legal fees incurred in chapter 11 cases by ad hoc committees and individual official or unofficial committee members as administrative expenses. Section 503(b)(3) confers administrative-expense status on "the actual, necessary expenses, *other than compensation and reimbursement specified in" section 503(b)(4)* (emphasis added), incurred by six categories of creditors or custodians.

Of these six categories, the fourth in subparagraph (D) consists of "a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than [an official committee], in making a substantial contribution in a case under chapter 9 or 11 of this title." Subparagraph (F) covers the sixth category, "a member of [an official committee], if such expenses are incurred in the performance of the duties of the committee."

Before 2005, section 503(b)(4) provided that allowed administrative expenses included "reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under" section 503(b)(3). Thus, allowed administrative expenses formerly included legal fees incurred by an unofficial committee in making a substantial contribution, as well as a member of an official committee.

However, section 503(b)(4) was amended in 2005. It now provides for the payment as an administrative expense of fees "rendered by an attorney or an accountant of an entity whose expense is allowable under subparagraph (A), (B), (C), (D), or (E)" of section 503(b)(3). Thus, subparagraph (F)—pertaining to legal fees of official committee members—is no longer included. By excluding subparagraph (F), the amendment "make[s] it clear that a committee member is not entitled to reimbursement as an administrative expense for professional fees incurred by the committee member." 4 Collier on Bankruptcy ¶ 503LH[3] (16th ed. 2014); *see also* H.R. Rep. No. 109-31, pt. 1, at 142 (2005) ("Expenses for attorneys or accountants incurred by individual members of creditors' or equity security holders' committees are not recoverable, but expenses incurred for such professional services . . . by such committees themselves would be.").

The *AMR*, *Lehman*, and *Adelphia* bankruptcy courts concluded that section 503(b) is not the exclusive source of authority for the payment by a bankruptcy estate of the fees and expenses of unofficial committees or individual official committee members. Instead, those courts reasoned, fees may also be authorized under: (i) section 1123(b)(6), which provides that a chapter 11 plan may include any provision "not inconsistent" with applicable provisions of the Bankruptcy Code; and (ii) section 1129(a)(4), which provides that a court shall confirm a plan only if payments made under the plan for services or for costs and expenses in connection with a chapter 11 case are "reasonable."

The bankruptcy court's ruling in *Lehman* was recently vacated on appeal. In *Davis v. Elliot Mgmt. Corp. (In re Lehman Bros. Holdings, Inc.)*, 2014 BL 92862 (S.D.N.Y. Mar. 31, 2014), U.S. District Court Judge Richard Sullivan construed the lack of explicit authority in section 503(b) to mean that the fees and expenses of individual official committee members may not be paid as administrative expenses:

> Relevant here, official committee members' professional fee expenses are not included in § 503(b). The problem is not that such expenses are not listed—the list is not exhaustive—but instead that the structure of § 503(b)(3) and (4) glaringly exclude [sic] professional fee expenses for official committee members.

Thus, Judge Sullivan concluded, "because § 503(b)—the sole source of administrative expenses—excludes paying professional fee expenses on the basis of committee membership," individual committee members "cannot have their professional fee expenses paid as administrative expenses solely on the basis of their committee membership."

Moreover, the judge ruled that the requirements of section 503(b) may not be circumvented by characterizing the payment of such fees as "permissive plan payments" authorized under sections 1123(b)(6) and 1129(a)(4). According to Judge Sullivan, "[N]either the need for flexibility in bankruptcy cases, the consensual nature of [the plan provision] nor a bankruptcy court's approval of a payment as 'reasonable' can justify a plan provision that is merely a backdoor to administrative expenses that § 503 has clearly excluded." If an official committee member "perform[s] extraordinary work to benefit the estate, above and beyond normal committee duties," Judge Sullivan wrote, the committee member may "seek to be reimbursed under § 503(b)(3)(D) and 503(b)(4), which provide for payment of the professional fees incurred by entities that have made a 'substantial contribution in a case.' " He accordingly vacated the ruling below and remanded the case for factual findings on the issue of substantial contribution.

CLAIMS TRADERS ALERT

A decision recently handed down by the U.S. District Court for the Western District of Washington should be of interest to lenders and distressed debt purchasers. In *Meridian Sunrise Village, LLC v. NB Distressed Debt Investment Fund Ltd. (In re Meridian Sunrise Village, LLC)*, 2014 BL 62646 (W.D. Wash. Mar. 6, 2014), a lender group had provided $75 million in financing to a company for the purpose of constructing a shopping center. The loan agreement provided that the lenders were prohibited from selling, transferring, or assigning any portion of the loan to entities other than "Eligible Assignees." The term "Eligible Assignees" was defined as "any Lender, Affiliate of a Lender or any commercial bank, insurance company, financial institution or institutional lender approved by Agent in writing and, so long as there exists no Event of Default, approved by Borrower in writing, which approval shall not be unreasonably withheld."

After a nonmonetary default in 2012 triggered liability under the loan agreement for default interest and other penalties, the debtor filed for chapter 11 protection in the Western District of Washington on January 18, 2013. Over the debtor's objection, one of the lenders then sold its debt to a hedge fund that later resold a portion of the debt to two other distressed investors (collectively, the "Funds"). Shortly afterward, the debtor sought an order from the bankruptcy court enjoining the Funds from exercising any rights that Eligible Assignees would have under the loan agreement, including the right to vote on the debtor's proposed chapter 11 plan.

The debtor argued that it had negotiated those limitations specifically to avoid assignments of the debt to "predatory investors—investors who purchase distressed loans in the hope of obtaining control of the underlying collateral in order to liquidate for rapid repayment." The bankruptcy court granted the injunction. After the Funds' request for a stay pending appeal was denied, the court confirmed the debtor's chapter 11 plan on the basis, in part, of votes cast in favor of the plan by the prepetition lenders that had not sold their claims. The Funds appealed the confirmation order as well as the injunction, claiming that the bankruptcy court erroneously denied them the right to vote on the plan when it concluded that they were not "financial institutions."

On appeal, the debtor argued that, under the terms of the loan agreement, "hedge funds that acquire distressed debt and engage in predatory lending" do not fall within the meaning of "financial institutions" and should therefore not be included in the definition of "Eligible Assignees." The district court agreed.

The court rejected as overly broad the Funds' reading of "financial institution" to encompass any entity that manages money. This interpretation, the court wrote, would allow assignment to any entity that "has some remote connection to the management of money" and would drain any force from the limitation inherent in the Eligible Assignees provision. The court also reasoned that the remaining language in the loan agreement's assignment limitation ("commercial bank, insurance company, . . . or institutional lender") would have no meaning if the term "financial institution" were as broad as the Funds suggested.

The district court concluded that the parties knew of the materiality of the Eligible Assignees limitation in the loan agreement and had intentionally limited the term to exclude assignment to "distressed asset hedge funds who candidly admit they seek to 'obtain outright control' of assets." The court ruled that "the Loan Agreement permitted only 'Eligible Assignees' to vote on the plan, and thus the Funds were rightfully precluded from voting."

The district court also held that, even if the Funds had been permitted to vote, the three entities comprising the Funds would be entitled to one collective vote only (as distinguished from three). According to the court, a creditor-assignor cannot split up a claim in a way that artificially creates or enhances voting power that the original assignor never had. Permitting the Funds to have three votes, the court reasoned, would arbitrarily increase the voting power of their claim and violate the majority voting requirements of the Bankruptcy Code by preventing the remaining members of the class from accepting a chapter 11 plan without the Funds' cooperation.

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