AMERICAN BANKRUPTCY INSTITUTE

Views from the Bench, 2019

Avoidance Issues

James E. Van Horn, Moderator
Barnes & Thornburg LLP; Washington, D.C.

Hon. Rebecca B. Connelly, Chief Judge
U.S. Bankruptcy Court (W.D. Va.); Harrisonburg

Hon. John K. Sherwood
U.S. Bankruptcy Court (D. N.J.); Newark

Hon. S. Martin Teel, Jr.
U.S. Bankruptcy Court (D. D.C.); Washington

Luke A. Barefoot, Facilitator
Cleary Gottlieb Steen & Hamilton LLP; New York

2019

Privileged and Confidential
Consolidated Draft 8.7.19

ABI Views From the Bench: Fraudulent Conveyance

September 20, 2019

Can Termination of a Lease be a Fraudulent Transfer?

Introduction

— Section 365(c)(3) provides that a nonresidential lease that was terminated before the tenant-debtor's bankruptcy may not be assumed or assigned

— Issue often arises when (1) a trustee seeks to avoid a pre-petition lease termination under sections 547 or 548, and then assume and assign the revived lease; or (2) the estate seeks to avoid the pre-petition termination of a valuable lease and recover the value of the lease under section 550

— Circuit level authority has generally supported a majority view that a noncollusive pre-petition lease termination cannot be avoided

— Two recent Circuit Court decisions have introduced uncertainty to this view

Traditional View – Noncollusive pre-petition lease termination not avoidable

— Seventh Circuit (1976)

- Allan v. Archer-Daniels Midland Co. *(In re Commodity Merchants, Inc.)*, 538 F.2d 1260 (7th Cir. 1976)
  - Debtor and creditor entered into contract for creditor to sell commodities to debtor. Debtor failed to pay and creditor cancelled contract under a contractual provision. Bankruptcy Court (under the Bankruptcy Act) denied trustee's claim for a judgment against creditor for the debtor's profits on the contracts.
  - U.S. District Court and Seventh Circuit affirmed, finding cancellation of the contracts was not a transfer of the debtor's property.

— Seventh Circuit (1988)

- Sullivan v. Willock *(In re Wey)*, 854 F.2d 196 (7th Cir. 1988)
  - Debtor forfeited his down payment when he defaulted on a real estate contract. Bankruptcy Court found no transfer of the down payment occurred under sections 547 or 548. U.S. District Court found there was a transfer, but affirmed because the antecedent debt requirement in section 547(b) had not been satisfied.
  - Seventh Circuit affirmed, following *Commodity Merchants,* and finding forfeiture of deposit was not a transfer.

3

Recent Circuit Court Decisions

— Fifth Circuit (2017)

- Hometown 2006-1 1925 Valley View LLC v. Prime Income Asset Mgmt. LLC, 847 F.3d 302 (5th Cir. 2017)
  - Issue presented was whether contractual payments due during a required 60 day notice period prior to termination of contract rights constitute assets under the Texas UFTA.
  - U.S. District Court found they were not assets, and therefore no transfer occurred when contracts were terminated.
  - Fifth Circuit cited both *Commodity Markets* and *Wey* in finding that when a termination is pursuant to the terms of a contract, there is no transfer.
  - However, the Fifth Circuit reversed because the contracts were not freely terminable because of the 60 day notice requirement (distinguishing *Commodity Markets* and *Wey*, where the contracts were freely terminable upon default), and the waiver of the 60 day notice period effectuated a transfer of the right to continue performance and receive the payments due during this notice period, and were assets under the Texas UFTA.

4

Recent Circuit Court Decisions (cont.)

— **Seventh Circuit** (2016)

- Official Comm. of Unsecured Creditors of Great Lakes Quick Lube LP v. T.D. Invs. I LLP *(In re Great Lakes Quick Lube LP)*, 816 F.3d 482 (7th Cir. 2016)
  - Debtor negotiated a pre-petition voluntary termination of certain commercial leases with its landlord, including leases for two profitable stores. Creditors Committee brought complaint under sections 547 and 548 to recover the value of the two profitable leases.
  - Bankruptcy Court dismissed complaint, holding that the relinquishment of a leasehold interest did not constitute a "transfer" that could be avoided
  - Seventh Circuit reversed, finding that "transfer" is broadly defined, and that the debtor had an interest in the leaseholds which it gave up when it transferred its interest to the landlord. This was a transfer to one creditor that might have been an asset to other creditors if the transfer had not taken place, and if so it was a preferential transfer and therefore avoidable.
  - Seventh Circuit opinion does not distinguish, reject, or even mention its earlier decisions in *Commodity Merchants* and *Wey*.

5

Discussion Points

— Can sections 548 and 365(c)(3) be reconciled?

— Can the *Prime Income* and *Great Lakes* decisions be reconciled with the earlier Seventh Circuit decisions? Any common themes/issues?

— What are the potential implications for lessors under the *Prime Income* and *Great Lakes* decisions?

6

Potential Extraterritorial Application of Fraudulent Transfer Remedies: Introduction

- Sections 548 and 550(a) of the Bankruptcy Code provide for the avoidance of fraudulent transfers and for the recovery of such avoided transfers from the initial or subsequent transferee.
- There is a long-standing presumption that, unless Congress expresses its intent for a law to have extraterritorial effect, that law applies only within the territorial jurisdiction of the United States. See Morrison v. Nat'l Australia Bank Ltd., 561 U.S. 247, 255 (2010)
- Courts apply a two-step test to determine whether a statute applies exterritorialy:
  - "The first step asks whether the presumption against extraterritoriality has been rebutted. It can be rebutted only if the text provides a clear indication of an extraterritorial application.
  - If the presumption against extraterritoriality has not been rebutted, the second step of our framework asks whether the case involves a domestic application of the statute." WesternGeco LLC v. ION Geophysical Corp., 138 S. Ct. 2129, 2136 (2018) (internal citations omitted).
- Courts also consider concerns of international comity, which requires an inquiry into whether the application of U.S. law abroad would be reasonable under the specific circumstances of the case.

Extraterritorial Application of Fraudulent Transfer Provisions: Madoff Cases

These cases involve the collapse of Bernard L. Madoff Securities ("BLMIS"), which had many foreign investors. Some of those foreign investors received transfers from BLMIS though foreign "feeder funds" prior to BLMIS's bankruptcy. The BLMIS Trustee sought to avoid those transfers and claw-back the funds from overseas.

— Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 513 B.R. 222 (S.D.N.Y. 2014)
  - Judge Rakoff first held that the transfers at issue, which were received abroad by foreign subsequent transferees from foreign feeder funds, were not domestic and would require extraterritorial application of the fraudulent transfer provisions of the Bankruptcy Code and that Congress did not express an intent for those provisions to apply extraterritorially. He held, in the alternative, that principles of international comity prevented the recovery in this case because the foreign feeder funds were subject to foreign liquidation proceedings in their home countries.

— Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, No. 08-01789 (SMB), 2016 WL 6900689 (Bankr. S.D.N.Y. Nov. 22, 2016)
  - Judge Bernstein echoed the concerns of the District Court regarding international comity in dismissing the Trustee's claims against certain subsequent foreign transferees. Specifically, applying the fraudulent transfer provision of the Bankruptcy Code abroad would interfere with the liquidation proceedings of the foreign feeder funds. With respect to extraterritorially, Judge Bernstein held that a transfer between two foreign entities and two foreign accounts would require an impermissible application of U.S. law extraterritorially.

— In re Picard, Tr. for Liquidation of Bernard L. Madoff Inv. Sec. LLC, 917 F.3d 85 (2d Cir. 2019)
  - Earlier this year, the Second Circuit vacated the decisions below and held that where an initial transfer is voidable under § 548 and that transfer originates in the U.S., that transfer may be recovered regardless of whether it is a foreign subsequent transfer. With respect to comity, the court held that because Madoff's fraud was domestic, U.S. interests predominate, even in the fact of foreign insolvency proceedings.

Extraterritorial Application of Fraudulent Transfer Provisions: Discussion Points

— Courts have answered the question of whether Congress intended the sections of the Bankruptcy Code governing the avoidance and claw-back of fraudulent conveyances to apply extraterritorially differently. Why have they come to different conclusions?

— How much weight should be given to the principle of international comity?

— Does the Second Circuit's ruling expand the power of bankruptcy courts?

— How likely is a grant of *certiorari*? Would the Court take *certiorari* without a clear circuit split?

— How would extraterritorial application of the fraudulent transfer provisions impact Chapter 15?

9

Does Returning the Funds Act as a Defense to a Fraudulent Transfer Action? Introduction

— Sections 548 and 550 of the Bankruptcy Code provide for the avoidance of fraudulent transfers and for the recovery of such avoided transfers from the initial or subsequent transferee

— Courts are split as to whether a transferee's pre-petition return of the funds it received can act as a defense to a fraudulent transfer action

— Some courts, such as the Seventh Circuit, find that an otherwise fraudulent transfer should not be legitimized or offset by any pre-petition payments to the debtor

— Other courts, such as the Eleventh Circuit, allow for the application of equitable principles to reduce or eliminate the amount of recovery on account of pre-petition payments returned to the debtor

10

Circuit Split

— **Seventh Circuit**: No defense for pre-petition return of funds

- Nostalgia Network, Inc. v. Lockwood, 315 F.3d 717 (7th Cir. 2002) – held that once a court makes a finding that a transfer was fraudulent, there should be no further inquiry.
  - The U.S. District Court (ND IL) ruled the transferee committed constructive fraud under Illinois state law and required the transferee to return the entire amount of the fraudulent transfer even though some of the transferred funds had been used to pay the debtor's creditors.
  - The Seventh Circuit affirmed, finding that the fact that some or all of the money later seeped back to the debtor does not legitimize the transfer. It also noted that while there was no finding of actual fraud, the seeping back of the transferred money to the debtor is strong evidence of actual fraud. If a debtor transfers money to someone the debtor expects to retransfer it back, the inescapable implication is that the debtor is parking its money in a place it hopes its creditors won't know to look.

11

Circuit Split (cont.)

— **Eleventh Circuit**: Recovery of a fraudulent transfer may be adjusted to reflect pre-petition payments returned to debtor

- Kingsley v. Wetzel *(In re Kingsley)*, 518 F.3d 874 (11th Cir. 2008) – held that a court may apply equitable principles to reduce recovery on account of pre-petition payments returned to the debtor.
  - The Bankruptcy Court found a transfer constituted actual fraud under section 548, but adjusted the amount recoverable under section 550 by the amount the transferee subsequently repaid to the debtor. The Bankruptcy Court determined that recovery of the pre-petition transfers would result in an inequitable windfall to the bankruptcy estate.
  - The Eleventh Circuit affirmed, finding that (1) the cornerstone of the bankruptcy courts has always been the doing of equity; (2) in fraudulent transfer actions, there is a difference between avoiding the transaction and actually recovering the property or the value thereof; and (3) bankruptcy courts have consistently held that section 550 is designed to restore the estate to the financial condition that would have existed had the transfer never occurred.

12

Circuit Split (cont.)

— **First Circuit:** Eleventh Circuit approach if no actual fraud

- Dahar v. Jackson *(In re Jackson)*, 459 F.3d 117 (1st Cir. 2006) - In the absence of any finding of actual fraud, it would be a windfall to the estate to allow full recovery without making an equitable adjustment to account for the proceeds the transferee used to pay the debtor's bills and cover the debtor's family expenses, and thus it was equitable to credit the transferee for the amount of these payments.

— **Third Circuit:** Seventh Circuit approach

- Cardiello v. Arbogast, 533 F. Appx 150 (3rd Cir. 2013) *(non precedential opinion)*
  - Where there is an fraudulent transfer followed by the transferee paying debt of the transferor, this does not render the initial transfer legally irrelevant as the initial transfer places the funds out of all creditors' reach and therefore hinders or delays creditors seeking satisfaction of the debts owed them (discussing and citing *Nostalgia Network*).
  - Third Circuit noted it is aware of no authority suggesting that any later expenditure from a transferee that happens to confer some value upon the transferor sanitizes a transfer that was fraudulent when made.

13

Discussion Points

— Would adopting the Seventh Circuit's approach (no defense for return of transferred funds) result in an inequitable windfall to the estate?

— Should there be a distinction made if the transfer was actual or constructive fraud in determining whether the recovery should be adjusted?

— Should the equitable doctrine of unclean hands be considered?

14

Tribal Sovereign Immunity: Introduction

- Sections 106(a) of the Bankruptcy Code abrogates sovereign immunity as to a governmental unit with respect to sections 548 and 550, which provide for the avoidance and recovery of fraudulent transfers.
- Section 101(27) defines "governmental unit" as the "United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government."
- The question for courts is whether Native American tribes qualify as a governmental unit under section 101(27) and therefore whether fraudulent transfers to Native American tribes may be avoided and recovered under the relevant provisions of the Bankruptcy Code.
- Supreme Court authority recognizes Native American tribes as "domestic dependent nations that exercise inherent sovereign authority. " Michigan v. Bay Mills Indian Cmty., 572 U.S. 782, 788 (2014) (internal citation omitted). Although Congress has the power to abrogate that sovereign immunity, but Congress must do so "unequivocally." Id. at 790.

15

Tribal Sovereign Immunity: Circuit Split

— **Ninth Circuit: Tribal Immunity is Abrogated**

- Krystal Energy Co. v. Navajo Nation, 357 F.3d 1055 (9th Cir. 2004) – held that it was clear on the face of the statute that Congress intended to abrogate sovereign immunity of all *domestic governments*, which necessarily included Native American tribes. The Court's reasoned that Supreme Court precedent recognizing Native American tribes as "domestic dependent nations" was sufficient to show that Congress explicitly abrogated tribal sovereign immunity through its use of the term "domestic government" in the statute.

— **Eighth and Sixth Circuits: Tribal Sovereign Immunity is Not Abrogated**

- In re Whitaker, 474 B.R. 687 (B.A.P. 8th Cir. 2012) – disagreed with the rationale in Krystal Energy and found that Congress did not "unequivocally express" its intent to abrogate the sovereign immunity of Native American tribes in sections 106(a) and 101(27) of the Bankruptcy Code. The Court held that Congress must explicitly state that it intends to abrogate the sovereign immunity of Native American tribes and also noted that the Supreme Court has never actually referred to Native American tribes as "governments."
- In re Greektown Holdings, LLC, 917 F.3d 451 (6th Cir. 2019) – followed In re Whitaker and held that Congress had not sufficiently expressed its intent to abrogate tribal sovereign immunity. Specifically, the Court stated "While it is true that Congress need not use magic words to abrogated tribal sovereign immunity, it must unequivocally express that purpose." Id. at 461 (internal citations omitted).
  - On March 18, 2019, Buchwald Capital Advisors LLC, Litigation Trustee to the Greektown Litigation Trust, filed a petition for certiorari to appeal the Sixth Circuit's opinion in In re Greektown. That petition has not yet been granted.

16

Tribal Sovereign Immunity: Favorable Trend for Tribes?

A review of recent bankruptcy and nonbankruptcy decisions may reflect a trend of ruling in favor sovereign immunity and the rights of Native American tribes. Examples:

— **Fourth Circuit: Lending Entity as "Arm of Tribe" Entitled to Sovereign Immunity**

- Williams v. Big Picture Loans, LLC, 929 F.3d 170 (4th Cir. 2019) – A class action was filed against a lending entity, which provided paydays loans at allegedly unlawfully high interest rate. The lending entity (which was formally distinct from the tribe) moved to dismiss the class action for lack of subject matter jurisdiction asserting that as an arm of the tribe it was entitled to sovereign immunity. The district court denied the motion. The Fourth Circuit held that the entity was entitled to sovereign tribal immunity and reversed and remanded the case with instructions to dismiss the case, noting "an entity's entitlement to tribal immunity cannot and does not depend on a court's evaluation of the respectability of the business in which a tribe has chosen to engage."

— **Supreme Court:**

- Herrera v. Wyoming, 139 S. Ct. 1686 (2019) – A member of the Crow Tribe was convicted of off-season hunting and hunting without a state hunting license on unoccupied federal land. The defendant appealed to the District Court of Wyoming in Sheridan County, arguing that Wyoming's statehood had not abrogated the Indian treaty rights which existed at the time Wyoming became a state, which included the right to hunt on unoccupied lands of the United States. The conviction was affirmed, the Supreme Court of Wyoming denied petition for review, the defendant filed a petition for review, and the U.S. Supreme Court granted certiorari. The U.S. Supreme Court, in a 5-4 decision, vacated the conviction. The Court found that rights under the Indian treaty had not been abrogated by Wyoming's statehood, reinforcing that if Congress intends to abrogate Indian treaty rights it must clearly express an intent to do so. Further, the Supreme Court emphasized that a treaty must be interpreted "in the sense in which they would naturally be understood by the Indians."

17

Tribal Sovereign Immunity: Discussion Points

— How explicit should Congress be in order to abrogate tribal sovereign immunity?

— The abrogation of sovereign immunity as to a "governmental unit" applies to several other sections of the Bankruptcy Code. What is the broader impact of this issue?

— How does tribal sovereign immunity from the fraudulent transfer provisions of the Bankruptcy Code affect debtors and other creditors?

— What are the implications of these decisions for tribal businesses, particularly in the gaming space?

18

Faculty Biographies

Luke A. Barefoot is a partner in the New York office of Cleary Gottlieb Steen & Hamilton LLP, where his practice focuses on restructuring and insolvency-related disputes, with a particular focus on cross-border matters. His recent representations include acting for ESL Investments as purchaser in the *Sears Holdings* bankruptcy, and for the ad hoc bondholder group in the contested chapter 15 proceedings for Oi S.A. Mr. Barefoot received his J.D. with distinction from Stanford Law School.

Hon. Rebecca B. Connelly is the Chief Judge for the U.S. Bankruptcy Court for the Western District of Virginia in Harrisonburg, appointed in July 2012. She is a former standing chapter 13 trustee and chapter 12 trustee for the Western District of Virginia. Judge Connelly has been a member of ABI since 1994 and has served as a contributing editor and a features author for the *ABI Journal*, a member of the Consumer Bankruptcy Committee, and a speaker at ABI's Annual Spring Meeting and Winter Leadership Conference, and most recently for "Eye on Bankruptcy." She also serves on the board of CARE and is an adjunct professor of law at Washington and Lee University School of Law. Judge Connelly received her B.A. in 1985 from the University of Maryland and her J.D. in 1988 from Washington & Lee University School of Law.

Hon. John K. Sherwood is a U.S. Bankruptcy Judge for the District of New Jersey in Newark, appointed in June 2015. In private practice, he had more than 25 years of experience in bankruptcy and debtor/creditor matters, including related litigation. Some of his noteworthy engagements were Ocean Place Development Resort (counsel to debtor), MagnaChip Semiconductor Finance Co. (counsel to creditors' committee), Quebecor World (USA) Inc. (litigation counsel), Le Nature's Inc. (counsel to creditors' committee) and the City of Detroit (counsel to union). Judge Sherwood was president of the New Jersey Bankruptcy Lawyers Foundation from 2008-13 and an active member of ABI and the Turnaround Management Association. He was selected by *Chambers USA* from 2013-14 as one of America's Leading Lawyers for Business, and he was recognized in *The Best Lawyers in America* (2012-15) for his work in bankruptcy and in *Super Lawyers* (2006, 2009-14), where he was featured in the bankruptcy section and corporate counsel edition. Judge Sherwood received his undergraduate degree from James Madison University in 1983 and his J.D. in 1986 from Seton Hall University School of Law.

Hon. S. Martin Teel, Jr. has served as U.S. Bankruptcy Judge for the District of Columbia since 1988. Following graduation from law school, he clerked for Judge Roger Robb of the U.S. Court of Appeals for the D.C. Circuit. From 1971-88, he served in the Tax Division of the U.S. Department of Justice, first as a trial attorney and then as an assistant section chief. Judge Teel received his J.D. from the University of Virginia School of Law in 1970.

James E. Van Horn, CPA, CIRA is a partner in the Washington, D.C., office of Barnes & Thornburg LLP, where he focuses on restructuring and insolvency law. He is ranked as a Band 1 bankruptcy/restructuring attorney by *Chambers USA*. Mr. Van Horn is an ABI Director and a member of the Georgetown Views from the Bench Advisory Board. Prior to joining Barnes & Thornburg, he was a partner with McGuireWoods and a senior consultant in the Bankruptcy and Restructuring Services Practice of FTI Consulting, Inc., as well as a senior associate in the Business Recovery Services

Division of PricewaterhouseCoopers LLP. Mr. Van Horn received his M.B.A. from Joseph M. Katz Graduate School of Business and his J.D. from the University of Pittsburgh School of Law.