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The Rights of Secured Creditors in a Commercial Fraud Case

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The Rights of Secured Creditors in a Commercial Fraud Case

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Creditors' Rights in Federal Forfeiture Proceedings

James A. Lodoen[1]

I. Forfeiture Basics

A. When and to what does forfeiture apply

1. Any property which constitutes or is derived from proceeds of certain criminal activity--including wire fraud and securities fraud--or from a conspiracy to commit such offenses is subject to forfeiture by the United States. *See generally* 18 U.S.C. § 981 and 982.

2. Forfeiture applies to any property, of any kind, whether real or personal, and also includes any property involved in money laundering offenses.

B. Relation back doctrine

1. Forfeiture will "relate back" and vest title in the United States upon the commission of the act giving rise to forfeiture under the relevant statute. *See* 21 U.S.C. § 853(c); *United States v. United States Currency in the Amount of $228,536.00*, 895 F.2d 908, 916 (2d Cir. 1990); *see also United States v. Emerson*, 128 F.3d 557, 567, n. 5 (7th Cir. 1997) ("Once the Government wins a judgment of forfeiture, the relation-back doctrine provides that the right, title, and interest in the forfeited property vests in the United States at the time the defendant committed the offense that gives rise to the forfeiture."); *United States v. One Silicon Valley Bank Account*, 549 F. Supp. 2d 940, 958 (W.D. Mich. 2008) (relation back divests debtor's legal interest in seized assets prior to the commencement of the bankruptcy cases); *United States v. Zaccagnino*, No. 03-10095, 2006 WL 1005042, *4 (C.D. Ill. 2006).

2. While the relation back doctrine has the most pronounced effect on the interest of the criminal/property owner, it also may have a significant effect on a later trustee in bankruptcy, court-appointed receiver, or upon a third party asserting rights in or to the forfeited property, unless through an ancillary proceeding the fiduciary or third-party can meet the statutory requirements to have its interest recognized and enforced.

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II. Applicable Law

A. Criminal Forfeiture

1. Criminal forfeiture provides the government the ability to include an *in personum* forfeiture judgment in a criminal defendant's sentence. The criminal forfeiture statute is at 18 U.S.C. § 982. Proceedings are governed by this statute and by The Fed. R. Crim. P. 32.2

2. Criminal forfeiture allows the rights of the defendant in forfeited property to be determined prior to adjudicating the rights of third parties who can only assert their claims after resolution of the defendant's criminal case.

B. Civil Forfeiture

1. Civil forfeiture allows the government to obtain an *in rem* judgment against a particular piece of property used in or representing the proceeds of a particular crime. In civil forfeiture it is the property that is guilty--as compared to the defendant in criminal forfeiture. 18 U.S.C. § 981.

2. The rights of the defendant and third parties to the property in question are determined at the same time.

3. Civil forfeiture charges are often included in a criminal forfeiture as authorized by 18 U.S.C. § 983 (a)(3)(C). *See also* 28 U.S.C. § 2461 (c).

III. Criminal Forfeiture Process and Procedure

A. Preliminary Order of Forfeiture

1. An indictment or information must contain a notice to the defendant that the government will seek forfeiture of property as part of the sentence. Fed. R. Crim. P. 32.2. Once the defendant is convicted whether by trial or a plea, the court must enter the preliminary order of forfeiture.

2. The preliminary order of forfeiture cuts off the defendant's interest in the property, and allows the government to step into the defendant's shoes. "Of course, final adjudication of the government's claim is not resolved until trial, at which time the defendant may ultimately be found entitled to these assets should the government fail to prove its case for forfeiture." *United States v. Bissell*, 866 F.2d 1343, 1349 (11th Cir. 1989).

3. After a preliminary order of forfeiture is obtained, the government is required to serve notice of its intent to forfeit the property on any potentially interested third party--either by publication or where practicable by individual notice, prior to obtaining a final order of forfeiture. *See* 21 U.S.C. § 853(n)(1); Rule 32.2(b)(6).

B. Ancillary Proceeding

1. Within 30 days of receiving the above notice, a third party wishing to assert an interest in the forfeited property may file a petition to assert such right in an "ancillary proceeding" to be conducted by the court. 21 U.S.C. § 853(n)(2).

1. A petition in an ancillary proceeding is the exclusive means by which a third party may lay claim to forfeited assets. *See DSI Assocs. LLC v. United States*, 496 F.3d 175, 183 (2nd Cir. 2007). A third party is barred from intervening in a criminal case to challenge forfeiture of property.

> Except as provided in subsection (n) of this section, no party claiming an interest in property subject to forfeiture under this section may--(1) intervene in a trial or appeal of a criminal case involving the forfeiture of such property under this section; or (2) commence an action at law or equity against the United States concerning the validity of his alleged interest in the property subsequent to the filing of an indictment or information alleging that the property is subject to forfeiture under this section.

21 U.S.C. § 853(k). "There is no provision in § 853(n) to relitigate the outcome of [the]legal proceedings [against the defendant]" which gave rise to a preliminary order of forfeiture. *United States v. Porchay*, 533 F.3d 704, 710 (8th Cir. 2008).

2. Even a bankruptcy Trustee is limited to using the petition/ancillary proceeding process to assert an interest in forfeited property--an action usually not successful. *Stettin v. Alu (In re Rothstein)*, No. 09-34791, Adv. No. 10-03775, 2012 WL 4320479 at *5 (Bankr. S.D. Fla. 2012). *But see Adler v. Rothstein (In re Rothstein)*, 717 F.3d 1205 (11th Cir. 2013). In *Stettin* the bankruptcy trustee on appeal caused a restraining order issued pursuant to 18 U.S.C. § 1963(d)(1)(A) and 21 U.S.C. 853 § (1)(A) prior to the preliminary order of forfeiture being issued to be lifted because money in the debtor/defendants account was commingled from criminal and non-criminal activity. This, in essence, allowed the trustee to circumvent the prohibition against intervening in a criminal case to challenge the forfeiture.

3. The government may file a motion to dismiss a petition in an ancillary proceeding "for lack of standing, for failure to state a claim, or for any other lawful reason." Rule 32.2(c)(1)(A). Such a motion is treated as a motion under Federal Rule of Civil Procedure 12(b). *United States v. Petters (Petters 1)*, 857 F. Supp. 2d 841, 844 (D. Minn. 2012).

4. The court may permit the parties to conduct discovery and a party may move for summary judgment in an ancillary proceeding. Fed. R. Crim. P. 32.2(c)(1)(B).

C. Final order of forfeiture

1. A final order of forfeiture is entered following the expiration of the third party notice period and after resolution of any third-party petitions. This gives the United States clear title to the forfeited property. *See* 21 U.S.C. § 853(n)(7); Fed. R. Crim. P. 32.2(b)(4)(A) & (c)(2).

IV. Secured Creditor Rights in Forfeiture Proceeding

A. Timing

1. As noted below, a secured creditor may be able to preserve its interest in forfeited property although even if its interest is preserved although the process by which this is determined may extend over a period of months and years. And it much prove it is entitled to the requisite statutory protection by a preponderance of the evidence.

B. Secured creditor rights which trump the government

1. Criminal forfeiture third-party rights

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a. The petitioner must have an interest in the property that arose prior to the time of commission of the acts which provide the basis for the forfeiture. 21 U.S.C. § 853(n)(6)(A); *Gowan v. The Patriot Group, LLC (In re Dreier LLP)*, 452 B.R. 391, 410 (Bankr. S.D.N.Y. 2011).

b. Alternatively, the petitioner must be a "bona fide purchaser for value" who was "reasonably without cause to believe that the property was subject to forfeiture." 21 U.S.C. § 853(n)(6)(B); *Drier,* 452 B.R. at 410.

2. Civil forfeiture "innocent owner" defenses

a. If the property interest was in existence at the time of the illegal conduct

i. prove did not know of the conduct giving rise to forfeiture; or

ii. prove that upon learning of the conduct giving rise to the forfeiture, did all that reasonably could be expected under the circumstances to terminate such use of the property. 18 U.S.C. § 983(d)(2)(A) and (d)(2)(B) (identifies some ways to establish that did what could be expected).

b. If the property interest was acquired after the time of the illegal conduct

i. Prove that is a bona fide purchaser or seller for value; and

ii. did now know and was reasonably without cause to believe that the property was subject for forfeiture. 18 U.S.C. § 983(d)(3)(a). This *bona fide* purchaser provision in virtually identical to the similar provision in the criminal forfeiture statute, 21 U.S.C. § 853(n)(6)(B) and the criminal forfeiture cases are applicable in interpreting the civil forfeiture provision. *United States v. Real Property, Including All Improvements Thereon and Appurtenances Thereto, Located at 246 Main Street, Dansville, Livingston County, NY*, 118 F. Supp.3d 1310 (M.D. Fla. 2015).

c. "Owner" is defined to mean a leasehold, lien, mortgage, recorded security interest or a valid assignment of an ownership interest. 18 U.S.C. § 983(a)(6).

C. Standing

1. A petitioner must have a "legal interest" in the forfeited property in order to have standing. 21 U.S.C. § 853(n)(2).

2. A creditor with a security interest in the LLC membership interest of an entity which owned a lodge forfeited by the government does not have standing to pursue a petition in an ancillary proceeding involving the LLC's property because it was one step too far removed from the forfeited property. *Petters I*, 857 F. Supp. 2d at 844 *citing United States v. All Funds in Account of Prop. Futures, Inc.*, 820 F. Supp. 2d 1305 (S.D. Fla. 2011)("just as shareholders lack standing to contest the forfeiture of corporate assets, LLC members lack standing to contest the forfeiture of assets owned by an LLC").

D. Bona fide purchaser for value reasonably without cause to believe the property is subject to forfeiture

1. Bona fide purchaser for value

i. While federal law determines whether an interest is forfeitable, state law fills in the gap to determine whether a party is a bona fide purchaser for value. *Petters 1*, 857 F. Supp. at 847; *accord, e.g.*, *United States v. Frykholm*, 362 F.3d 413, 416 (7th Cir. 2004); *United States v. Harris*, 246 F.3d 566, 571 (6th Cir. 2001).

ii. Under Minnesota law (and presumably by analogy other state laws), one receiving a mortgage as security for a prior loan can qualify as a bona fide purchaser under the federal statute. *Petters 1*, 857 F. Supp. at 846.

2. Reasonably without cause to believe the properties were subject to forfeiture.

a. Case Study-. *United States v. Petters (Petters II),* No. 08-364, 2013 WL 269028 (D. Minn. Jan. 24, 2013).

i. On September 9, 2008 Petters' bank renewed a $2,250,000 unsecured personal credit line. The bank reviewed Petter's financial information, and noted his interests in Polaroid, Sun Country Airlines and Fingerhut in the officer comments.

ii. Two weeks later on September 24, dozens of law enforcement officers raided the headquarters of Petters businesses in Minnetonka, Minnesota. The banker's mother-in-law called him and reported a "whole lot" of police cars at Petters offices. The banker called Petters on his cell phone and reached him in Las Vegas. Petters said the raid was nothing to be concerned about, and related to an employee who had been embezzling. The raid was widely reported in the media and the banker saw the reports the morning of the raid. The next day the banker was served with a grand jury subpoena seeking all the records of Petters and one of his companies since 2002.

iii. The banker talked to his CEO who said to try and get collateral. The banker called Petters again in Las Vegas. Petters said he had two unencumbered pieces of real estate he could pledge the next day when he returned. The banker drove to Petters' offices on Sept. 25 to have the mortgages signed. Petters again put the blame on the employee, and denied any criminal involvement. Petters signed the mortgages/deeds of trust and the next day the bank mailed them for recording. They were both recorded on Sept. 29, 2008. The media reported that Petters resigned from his companies on the 29th, and he was arrested 4 days later.

iv. Petters was charged and convicted of wire fraud, mail fraud money laundering and conspiracy in connection with a Ponzi scheme he orchestrated for more than a decade. *Petters II,* No. 08-364, 2013 WL 269028, at *2 (D. Minn. Jan. 24, 2013). He was sentenced to 50 years in prison.

v. On March 26, 2010 the court issued a preliminary order of forfeiture forfeiting Petter's interests in Colorado and Minnesota property.

vi. Standard

(a) "Reasonably" implies that knowledge of whether property may be forfeitable is analyzed using an objective standard. *Petters II,* at *4, *citing United States v. King*, No. 10 Cr. 122, 2012 WL 2261117, at *8 (S.D.N.Y. June 18, 2012).

(b) The Petters Court found the facts to be undisputed that the bank lacked *actual* knowledge that the properties were forfeitable when its interest arose, or that they were purchased with fraud proceeds. The Court found that racing to record the collateral documents in order to protect the property from claims of other creditors is a far cry from knowing that the assets are proceeds of fraud and subject to criminal forfeiture. *Petters II*, at *5.

b. A transferee who is granted a deed for value knowing that the transferor was engaged in fraud, was found to not have reasonable cause to believe that the property was subject to forfeiture where the transferee was ignorant of the fact the property in question was involved in, traceable to, or derived from proceeds traceable to a crime. *Unites States vs. Real Property*, 118 F. Supp. at 1330-31.

V. Unsecured Creditor Rights in Forfeiture Proceeding

A. Generally

1. Unsecured creditors generally do not have standing to assert a claim in an ancillary proceeding because they do not have an interest in any particular asset. *See, e.g., United States v. White*, 675 F.3d 1073, 1080-81 (8th Cir. 2012); *In re Douglas*, 190 B.R. 831, 836 (Bankr. S.D. Ohio 1995); *United States v. One 1965 Cessna 320C Twin Engine Airplane, Serial No. 0813841-1, License No. N3062T*, 715 F. Supp. 808, 812 (E.D. Ky. 1989) (collecting cases).

VI. Forfeiture vs. Bankruptcy Trustee or Receiver

A. General Law

1. If the government obtains an order of forfeiture covering specific property of the defendant who is or becomes a debtor in bankruptcy, the property does not become property of the bankruptcy estate. *United States v. Pelullo*, 178 F.3d 196, 201 (3d Cir. 1999); *United States v. One Silicon Valley Bank Account*, 549 F. Supp. 2d 940,958 (W.D. Mich. 2008).

2. Courts have dismissed lawsuits by trustees against the United States seeking turnover of bankruptcy estate assets that are the subject of criminal forfeiture. *See In re Global Vending*, No. 04-23562-BKC-PGH, 2005 WL 2451763, at *3 (Bankr. S.D. Fla. June 1, 2005) *In re GuildMaster, Inc.*, No. 12-62234, 2013 WL 1331392, at *8 (Bankr. W.D. Mo. Mar. 29, 2013).

3. Section 853(k) prevents parties from commencing an action against the United States concerning the validity of their interest in property subsequent to the filing of an indictment. Arguably the trustee stands in the shoes of the criminal defendant itself – and § 853(k) might not apply to actions of the criminal defendant to challenge

forfeiture of its property. At least one court has rejected this argument. In *In re GuildMaster, Inc.*, the court held that § 853(k) is not expressly limited to third parties and that § 853(k) imposes an absolute bar on all suits claiming an interest in forfeitable property unless the action is brought within the confines of an ancillary proceeding under § 853(n). *In re GuildMaster, Inc.*, 2013 WL 1331392 at *7.

B. Coordination Agreements

1. In the Mark Dreier and Petters Ponzi schemes, there was tension between the governments right to forfeit assets including any cash recovered from avoidance actions in a bankruptcy, and the Trustees' interests in maximizing assets for their bankruptcy estates and in not expending resources to claw back payments only to later have these funds forfeited by the government.

2. These potential fights were avoided by entering into Coordination Agreements among the United States Attorney and the various bankruptcy estates, which among other things allocated certain assets and causes of action among the government and the Trustees. For example, in Petters the government agreed not to forfeit any of the entity (corporate) assets, which are all administered through the entities various bankruptcy cases.

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Receivers – Obstacle Or Tool For Secured Creditors?

Robert M. Charles, Jr.[2]

Federal or state court receiverships are to an extent the product of statutory authority, but more often crafted by the form of court order appointing and authorizing the receiver. The needs of the parties crafting the receivership, often secured creditors, may come into conflict with the bankruptcy process as it may affect the debtor/defendant in receivership, other creditors, and third parties. The following points attempt to highlight some of the issues.

VII. Receivership As A Bankruptcy Proofing Tool

Counsel for secured creditors increasingly add language to receivership orders to limit borrower options. For example, an order appointing a receiver will often enjoin the borrower from transferring collateral. Enforceability of such a provision may be problematic.

Where a debtor violates such an injunction in preparation for a bankruptcy filing, the bankruptcy court may be asked to treat the transfer as void in violation of the injunction. A California bankruptcy court's finding the asset was not property of the estate due to a void transfer was reversed by the Ninth Circuit Bankruptcy Appellate Panel on the theory that California law would treat the transfer as violative of the injunction, but not void.[3] The BAP affirmed the bankruptcy court's termination of the automatic stay to permit continuation of the state court litigation with respect to potential avoidance of the transfer. The grant of stay relief may also expose the debtor and counsel to threat of contempt sanctions.[4]

In a case involving a defunct Kentucky utility company, a receiver argued that it had ownership and control over the utility's assets, including a $3.4 million surcharge claim, against the authority of a chapter 7 trustee appointed in an involuntary case after the receiver took certain actions. The bankruptcy court held that the Kentucky utility regulatory structure did not divest the debtor of ownership of its assets, and so the receiver, as a custodian, was required to relinquish control to the chapter 7 trustee in bankruptcy under § 543, who could seek to reinstate and prosecute the surcharge claim as property of the estate.[5]

The Fourth Circuit reversed a district court's determination that a proceeding to hold petitioning creditors in contempt for filing an involuntary bankruptcy petition was not subject to the automatic stay. A secured creditor obtained a federal receiver to collect debt. One week later,

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[3] *In re Domum Locis, LLC*, 2015 WL 4697747 (B.A.P. 9th Cir. 2015).

[4] *Id*., slip op at 6, n.12.

[5] *In re Bullitt Utilities, Inc.*, 558 B.R. 173 (Bankr. W.D. Ky. 2016).

creditors filed an involuntary petition in bankruptcy. The receiver went back to the appointing court for an order enjoining the creditors from prosecuting the involuntary petition. After the bankruptcy court noted this was a violation of the automatic stay, the appointing court held the petitioning creditors in contempt, and directed that they could purge the contempt by withdrawing the involuntary bankruptcy petition. They sought to do so and the bankruptcy court denied the motion to dismiss. The Fourth Circuit easily found that the receivership court's order violated the automatic stay.[6] The secured creditor could seek stay relief or dismissal of the involuntary case.

VIII. Receivership As A Claims Management Tool

The appointment of a receiver ordinarily forces claimants to file their claims in the receivership court or process.[7] The *Barton* doctrine, explained below, provides a similar function, by forcing claimants to seek relief from the appointing court before bringing an action on a claim against an entity in receivership.[8]

IX. Receivership As A Forum Selection Tool

A receivership order may enjoin litigation against the entity in receivership or its assets absent leave of the receivership court.[9]

Under a long line of cases, federal courts protect the authority of receivers via the *Barton* doctrine.[10] The rule "requires a party to obtain leave from the appointing court before bringing suit against a court-appointed receiver."[11] A court lacks jurisdiction over such a suit.[12] The rule protected the receiver acting within the scope of the receiver's authority.[13] The rule does not

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[6] *Gilchrist v. Gen. Elec. Capital Corp.*, 262 F.3d 295 (4th Cir. 2001).

[7] *See Sicherman v. Nat'l Credit Union Admin. Bd.*, 535 B.R. 196 (N.D. Ohio 2015) (affirming dismissal of bankruptcy trustee's complaint for failure to file claim with the liquidating agent for a failed credit union).

[8] *In re NorVergence, Inc.*, 424 B.R. 663, 704-05 (Bankr. D.N.J. 2010) (action for conversion, consumer fraud, and unjust enrichment would be dismissed absent leave from the appointing court for action against the defendant in receivership).

[9] *Liberte Capital Grp., LLC v. Capwill*, 462 F.3d 543, 551 (6th Cir. 2006) ("the receivership court may issue a blanket injunction, staying litigation against the named receiver and the entities under his control unless leave of that court is first obtained").

[10] *Barton v. Barbour*, 104 U.S. 126, 26 L. Ed. 672 (1881).

[11] *In re VistaCare Group, LLC*, 678 F.3d 218, 224 (3d Cir. 2012), *quoted* in *In re Provider Meds, LP*, 514 B.R. 473, 475 (Bankr. N.D. Tex. 2014).

[12] *Satterfield v. Malloy*, 700 F.3d 1231, 1234 (10th Cir. 2012) (suit against bankruptcy trustee).

[13] *Secs. & Exch. Comm'n v. N. Am. Clearing, Inc.*, 656 Fed. App'x 969, 974 (11th Cir. 2016).

prohibit suit in the appointing court,[14] and thus the receivership court is the required forum. In effect, the doctrine protects the appointing court's interest in administering the receivership.[15] The doctrine prohibits suit against federal as well as state court receivers.[16] The appointing court's denial of a motion for leave to bring an action against the receiver/trustee is reviewed for abuse of discretion.[17]

Application of the *Barton* doctrine occurs most often in suits for damages against the court-appointed fiduciary,[18] but is not limited to suits against a receiver for alleged misconduct. In a New York action, the district court declined to consent to insurers amending a coverage dispute to name the receiver appointed in a securities fraud class action as defendant for the purpose of forcing arbitration of an insurance coverage dispute.[19] The insurers were enjoined from proceeding with the arbitration against the receiver for the insured.

However, the bankruptcy court's inherent authority, particularly with regard to the automatic stay, may bring a receiver up against an unhappy bankruptcy judge. In a Florida case, a state court receiver was appointed concerning intellectual property. The receiver took the position that individuals had rights in the technology and sought an assignment. The debtor filed its bankruptcy filing after the receivership action was commenced and asserted that the intellectual property was property of the debtor. The receiver asserted that efforts to force the individuals to assign rights under penalty of contempt in the receivership action was not an action or proceeding against the debtor. The bankruptcy court agreed with the debtor that the demand for assignment of the debtor's (alleged) intellectual property rights was an effort to exercise control over property of the estate in violation of the automatic stay. As a sanction, the receiver was ordered to pay the debtor's attorneys' fees of almost $18,000.[20]

In a Michigan case, a state court receiver sought to have the debtor held in contempt for failure to pay restitution. The debtor sought sanctions for violation of the stay. The bankruptcy court found that the exception to the stay for a criminal action or proceeding did not apply to the effort to have monetary relief obtained against the debtor for alleged civil contempt.[21]

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[14] *In re Provider Meds, LP*, 514 B.R. at 476-77 (suit against trustee).

[15] *McIntire v. China MediaExpress Holdings, Inc.*, 113 F. Supp. 3d 769, 773 (S.D.N.Y. 2015) (citing *In re Lehal Realty Assocs.*, 101 F.3d 272, 277 (2d Cir. 1996).

[16] *In re DMW Marine, LLC*, 509 B.R. 497 (Bankr. E.D. Pa. 2014) (suit by bankruptcy trustee against federal court receiver).

[17] *Secs. & Exch. Comm'n*, 656 Fed. App'x at 973-74.

[18] *E.g., Villegas v. Schmidt*, 788 F.3d 156 (5th Cir. 2015) (allegations of gross negligence and breach of fiduciary duty against bankruptcy trustee dismissed).

[19] *McIntire v. China MediaExpress Holdings, Inc.*, 113 F. Supp. 3d 769 (S.D.N.Y. 2015).

[20] *In re Daya Medicals, Inc.*, 560 B.R. 855 (Bankr. S.D. Fla. 2016).

[21] *In re Storozhenko*, 458 B.R. 905, 459 B.R. 697 (Bankr. E.D. Mich. 2011).

In contrast, a Maryland district court dismissed for lack of jurisdiction under the *Barton* doctrine a debtor's adversary complaint alleging a violation of the automatic stay by a state court trustee appointed to sell marital property.[22]

The turnover provisions of § 543 are a different animal. The bankruptcy court has the power to order turnover and determine compensation owed to the receiver.[23]

The bankruptcy court in a turnover action must decide whether the receiver must turn over estate property, not the receivership court.[24] In a California case, the receiver sought contempt sanctions from the receivership court for the debtor's filing a turnover complaint. To avoid the conflict between forums, the bankruptcy parties removed the receivership action to bankruptcy court, so that the bankruptcy court enjoyed the jurisdiction in both actions. The bankruptcy court noted, however, that a bankruptcy court may not practically enjoin an action by a state court judge, so the remedy for improper prosecution of the state court action would be in the state courts.[25]

X. Receivership As A Collection Device

As the receivership for Bernard L. Madoff Investment Securities LLC has proven to the tune of billions of dollars, a receiver may be a vehicle for collection efforts, including the assertion of fraudulent transaction actions. Such actions are routine.[26]

A receivership order typically expresses the jurisdiction of the receivership court and the receiver over the defendant's assets. An order in a Federal Trade Commission receivership action extended the jurisdiction of the receivership over non-defendant entities via preliminary injunction, "where the assets were controlled by the receivership defendants, held to benefit defendants in their efforts to keep assets from the receivership, and many of the assets were capitalized entirely with funds from the receivership defendants."[27] The Ninth Circuit affirmed the preliminary injunction and exercise of jurisdiction via summary proceedings, as opposed to the traditional process of summons and complaint.[28]

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[22] *Tshiani v. Monahan*, 533 B.R. 506 (D. Md. 2015).

[23] *In re Crespo*, 561 B.R. 25 (Bankr. D. Conn. 2016).

[24] *In re Si Yeon Park, Ltd.*, 198 B.R. 956, 963-64 (Bankr. C.D. Cal. 1996).

[25] *Id.*, 198 B.R. at 970.

[26] *See Carney v. Horion Invs. Ltd.*, 107 F. Supp. 3d 216 (D. Conn. 2015) (receiver action under Connecticut Uniform Fraudulent Transfer Act not barred by *Waggoner* rule) (*see Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991)).

[27] *F.T.C. v. Johnson*, 567 Fed. App'x 512, 514 (9th Cir. 2014).

[28] *Id.*, 567 Fed. App'x at 515.

Similarly, in the FTC litigation with Kevin Trudeau, the receiver collected profits from entities affiliated with and under the control of the defendant, in order to distribute those assets to the victims.[29]

The Seventh Circuit had no difficulty affirming a default against offshore bankers and their business associates for violation of an order freezing the receivership entity's assets and ordering turnover of the entities' assets to the receivership.[30]

XI. Receivership In Cooperation With Bankruptcy

Although the cases often address conflicts between receivers and the bankruptcy process, it is not unusual for the two paradigms to cooperate. In the Petters Company, Inc. Ponzi scheme, the receiver was later appointed as chapter 11 trustee after petitioning for relief for the entities in receivership.[31]

XII. Receivership In Lieu Of Bankruptcy

Nor is it unusual for a bankruptcy court to decline to proceed with a bankruptcy case where a receivership is already in place and capable of marshaling assets and paying claims.[32]

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[29] *Fed. Trade Comm'n v. Trudeau*, 845 F.3d 272 (7th Cir. 2016) (denial of fees to counsel for the affiliates in compliance with subpoenas).

[30] *S.E.C. v. Homa*, 514 F.3d 661 (7th Cir. 2008).

[31] *Ritchie Capital Mgmt., L.L.C. v. Kelley*, 785 F.3d 273 (8th Cir. 2015) (affirming settlement allocation between receivership and bankruptcy estates).

[32] *In re Bilzerian*, 264 B.R. 726 (Bankr. M.D. Fla. 2001) (no asset chapter 7 dismissed in favor of receivership where debtor was obligated on $139 million in nondischargeable debt).

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Application of Bankruptcy Code Section 546(e)

Randye B. Soref[33]

Discussion of 11 U.S.C. §546(e)

Section 546(e) of the Bankruptcy Code creates a "safe harbor" for certain transfers made to or for the benefit of a variety of various financial services industry participants, including financial institutions. Transfers covered by the safe harbor include "margin" payments, "settlement" payments, or transfers made in connection with a pre-petition securities contract. While recent Second Circuit case law has resulted in the applicability of Section 546(e) being reasonably well-settled, a subsequent decision from the United States Bankruptcy Court for the Western District of New York may cast doubt on the breadth of the safe harbor provision.

The Statute

11 U.S.C. § 546(e) reads:

> (e) 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, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

Distilled down, Section 546(e) protects (1) commodity brokers, (2) forward contract merchants, (3) stockbrokers, (4) financial institutions, (5) financial participants, and (6) securities clearing agencies from avoidance actions related to (a) margin payments, (b) settlement payments, or (c) payments made in connection with a securities, commodity or forward contract. Courts, particularly the Second Circuit, have historically read 546(e) broadly as a means of furthering Congress' intent to protect the securities markets.

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The ABI Commission Recommendations

In December, 2014, the ABI's Commission to Study the Reform of Chapter 11 (The "**Commission**") issued its Final Report and Recommendation (the "**Report**"). The Report proposed, among other things, that the safe harbor provisions of Section 546(e) be revised to eliminate (or limit) from the safe harbor's scope: (1) CMBS repurchase agreements (on the grounds that these are analogous to secured financing arrangements); (2) payments made in connection with leveraged buyouts if the securities are not public as such transaction do not threaten the public securities markets); and (3) nondealer counterparties to *physical* supply contracts. To date, none of these recommendations have been implemented.

The Key Cases

Nine cases generally define the landscape of the protections afforded by Section 546(e): *In re Tribune Co. Fraudulent Conveyance Litigation*[34], *In re Bernard L. Madoff Investment Securities LLC,*[35] *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.,*[36] *In re MCK Millennium Centre Parking, LLC,*[37] *FTI Consulting, Inc. v. Merit Management Group, LP,*[38] *In re Quebecor World (USA) Inc.,*[39] *Contemporary Industries Corp. v. Frost,* [40] *In re QSI Holdings, Inc.,*[41] and *In re Munford*.[42]

In re Tribune Co. Fraudulent Conveyance Litigation

In *Tribune*, creditors of the Tribune Media Company sought to recover certain prepetition payments made to former shareholders in connection with an $8 billion dollar leveraged buyout transaction. The United States District Court for the Southern District of New York held that Section 546(e) did not apply because the plaintiffs were individual creditors, not the bankruptcy trustee. On appeal, the Second Circuit concluded that Section 546(e) *does* protect transferees from suits by individual creditors because upon Tribune's bankruptcy filing, all avoidance claims vested in the trustee, and allowing individual creditors to pursue avoidance actions otherwise barred by 546(e) would be contrary to the express purpose of the provision.

In re MCK Millennium Centre Parking, LLC

MCK Millennium Centre stands for the proposition that payments made to a commercial mortgage backed securities loan servicer are not avoidable, thanks to Section 546(e), because such payments were made in "connection with a securities contract." The Debtor in *MCK Millennium Centre* made over $5,000,000.00 in prepetition payments on one of its subsidiaries

[34] 818 F.3d 98 (2d Cir. 2016)
[35] 773 F.3d 411 (2d Cir. 2014)
[36] 651 F.3d 329 (2d Cir. 2011)
[37] 532 B.R. 716 (Bankr. N.D. Ill. 2015)
[38] 830 F.3d 690 (7th Cir. 2016)
[39] 719 F.3d 94 (2d Cir. 2013)
[40] 564 F.3d 981 (8th Cir. 2009)
[41] 571 F.3d 545 (6th Cir. 2009)
[42] 98 F.3d 604 (11th Cir. 1996)

loans (on which the debtor was not an obligor) that had been securitized and placed into a CMBS trust. After the bankruptcy filing, and conversion to Chapter 7, the bankruptcy trustee sought to avoid the payments which had been made to the CMBS trust's servicer. The United States District Court for the Northern District of Illinois held that the payments were protected by Section 546(e) because the servicer was a "financial institution" and the payments were made on a securitized loan. The CMBS nature of the transaction was critical, as it led the court to conclude that the payments were on account of a "securities contract" (the underlying CMBS security documents). Notable here is the fact that there was no dispute that the servicer was a "financial institution", as it was a national bank. As a result, a case involving a different type of servicer may require different analysis.

In re Bernard L. Madoff Investment Securities, LLC

The basic Ponzi-scheme facts of the *Madoff* case are well-known and do not need recitation here. The *Madoff* case did generate an impactful decision with respect to Section 546(e). In December, 2014, the Second Circuit held that payments from Madoff to his "investors" were "settlement payments" and payments in connection with a "securities contract," even though there were never any underlying investments due to Madoff's fraud. In reaching its decision, the Second Circuit indicated that Section 546(e)'s intent to create stability in the securities markets is paramount. Permitting recovery of payments that were represented to be settlement payments on account of a securities contract risked market disruption and could not be allowed.

In re Munford

Munford, a 1996 case from the 11th Circuit, is one of the older cases in this area. In *Munford*, the 11th Circuit denied safe harbor protection to former shareholders in connection with a leveraged buyout because the bank that initially received the LBO funds was a "mere conduit" and never obtained a beneficial interest in the funds. Absent a beneficial interest in the funds, the bank (the purported "financial institution" for safe harbor purposes) cannot qualify as a transferee under Section 546(e) and thus cannot trigger its protections.

FTI Consulting, Inc. v. Merit Management Group, LP

In *FTI*, the Seventh Circuit followed *Munford* in concluding that where a financial institution receives a payment, but is acting as a mere "conduit" for the ultimate recipient, Section 546(e) does not apply. In *FTI*, the bankruptcy trustee sued one of the debtor's former shareholders who had received payments in connection with a leveraged buyout transaction. The former shareholder claimed that 546(e) protected the transfer because the money went from the debtor and through two of the shareholder's banks. Because those banks were "financial institutions," the shareholder argued that he was entitled to the safe harbor's protections. The Seventh Circuit disagreed and held that Section 546(e) does not apply when the only way it touches the securities markets, via a financial institution, is through a bank acting as an intermediary (and not the ultimate beneficiary of the funds).

Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.

The Second Circuit's 2010 decision in *Enron* represents another fencepost in the Section 546(e) landscape. *Enron* involved payments made through the Depository Trust Company to redeem commercial paper. Prior to its collapse, Enron redeemed over $1 billion in commercial paper at above market prices, with payments (and the paper) passing through DTC. After bankruptcy, the trustee sought to avoid those transfers. The trustee's argument that redeeming commercial paper was not within the protections of Section 546(e) because there was no purchase or sale fell flat with the Second Circuit. The Second Circuit concluded that the term "settlement payments" has a broad meaning in the securities industry and encompasses any payment that completes or finalizes a securities transaction. Because commercial paper is traded on the securities market, the payments made to redeem that paper are "settlement payments" connected to a securities transaction. As a result, the transfers could not be avoided.

In re Quebecor World (USA) Inc.

Another notable Second Circuit case is *Quebecor World*, in which the Court of Appeals held that Quebecor's prepayment of $376 million in privately-placed notes was protected by Section 546(e). Prior to its bankruptcy filing, Quebecor prepaid the notes through the noteholders' indenture trustee. Post-petition, the Unsecured Creditors Committee filed an adversary proceeding to avoid the transfer. The Bankruptcy Court, District Court and Second Circuit all agreed that the payment was a "settlement payment" or a payment in connection with a securities contract under Section 546(e). The Second Circuit relied on language in the underlying note documents that provided for the purchase and repurchase of the notes to conclude that the notes represented a "securities contract." *Quebecor* represents additional evidence that the Courts will broadly construe the terms "settlement payment" and "securities contract."

Contemporary Industries Corp. v. Frost and *In Re QSI Holdings, Inc.*

In 2009, the Eighth and Sixth Circuits decided that Section 546(b) applies to both public and private securities transactions, thereby establishing a majority rule among the circuits.

Contemporary's shareholders sold their stock to an outside investment group in a leveraged buyout, which among things included the pledge of Contemporary's assets to secure the acquisition financing and payment of $26 million to the old shareholders from the loan proceeds. Contemporary filed bankruptcy and sought to avoid the payments to the old shareholders. The shareholders asserted the payments were exempt from avoidance under Section 546(e). The Bankruptcy Court agreed. The Eighth Circuit, in a case of first impression, held that the payments to the old shareholders were "settlement payments" within the meaning of Section 546(e). The Court determined "settlement" refers to "the completion of a securities transaction," and a "settlement payment is generally the transfer of cash or securities made to complete securities transaction." "The Eighth Circuit agreed that the payments were made by or to a . . .financial institution" as required by Section 546(e).

In *QSI Holdings*, the Sixth Circuit reached the same result. Certain principal shareholders of Quality Stores, Inc. entered into a merger agreement with another entity.

Quality's pre-merger shareholders were paid $208 million in cash and stock for their equity interests. Quality filed bankruptcy and sought to avoid the shareholder payments. The shareholders asserted that the transfers were exempt from avoidance under Section 546(e). The Bankruptcy Court agreed and dismissed the case. The Sixth Circuit affirmed. In affirming, the Sixth Circuit determined that the payment to shareholders were "settlement" payments and followed Contemporary's reasoning.

A Different Direction?

A recent decision from the United States Bankruptcy Court for the Western District of New York, decided after the series of Second Circuit cases, diverged from the general consensus that the terms used in Section 546(e) are to be broadly construed. In *In re TVGA Engineering, Surveying, P.C.*[43], the Bankruptcy Court held that a privately-held company's repurchase of stock from an individual was not made to a "financial institution" "in connection with a securities contract." After distinguishing *Enron* (not redeeming debt), *Tribune* (not an LBO), and *Quebecor* (not payment indenture trustee for notes), the Court concluded that the transfer at issue was not made "for the benefit of" a financial institution, as the bank at issue was a mere conduit or intermediary involved only in clearing the check used for the payment; the checking account the payments came from was a "substitute for cash." It remains to be seen whether other courts try to distinguish the Second Circuit line of cases to limit the scope of Section 546(e) or adopt the Second Circuit's broad application.

[43] 2016 WL 8117948 (Bankr. W.D. N.Y. 2016)

American Bankruptcy Institute
Spring Meeting 2017

The Rights of Secured Creditors in a Commercial Fraud Case

Defending a Fraudulent Transfer Claim – Solvency Defense Case Example

Richard J. Corbi[44]

I. Case

In re Adelphia Communications Corp., 512 B.R. 447 (Bankr. S.D.N.Y. 2014), proposed findings of fact and conclusions of law, *affirmed*, *In re Adelphia Communications Corp.*, Civil Case No. 14-CV-5532 (VEC), 2015 WL 1208588 (S.D.N.Y. Mar. 17, 2015), *affirmed*, *In re Adelphia Communications Corp.*, 652 Fed. Appx. 19 (2d Cir. 2016).

II. The Statute: 11 U.S.C. § 548

(a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily--

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

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(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

III. Case Study: *In re Adelphia Communications Corp.*

A. Factual Background:

1. Transactions at Issue in the Fraudulent Conveyance Litigation:

- On January 28, 1999, Adelphia paid defendants nearly $150 million to repurchase its own common stock.
- On October 1, 1999, Adelphia's affiliate Olympus Communications, L.P. paid FPL $108 million to redeem FPL's interest in a joint venture partnership between Olympus and FPL.

2. Adelphia's Solvency as of January 28, 1999

- As a result of the fraudulent methods Adelphia's executives used to run the company, no reliable financial projections existed.

- Valuation methodologies utilized by the Plaintiff's expert and the Defendants' expert.

i. Plaintiff's Expert Valuation Methodologies:

  - Utilized a discounted cash flow ("DCF") even though he acknowledged that other methodologies such as the comparable company analysis and the precedent transaction using a value per subscriber ("VPS") metric were available.
  - Utilized the DCF notwithstanding the fact that there no reliable financial projections from management and there was a handicap to the use of the DCF.
  - Utilized a 36.7% profit margin as the basis for the projection of future cash flows in his DCF model despite the fact that he know that the Debtor's restated profit margin was 39.7% as of the first quarter of 1999 from a previous litigation in the same chapter 11 case.
  - Assumed that the Debtors would be penalized forever for its pre-January 1999 fraud even after the fraud was fully disclosed and corrective actions.
  - Developed his own cash flow projections for the Debtors for the next ten years based on compiled reports from Paul Kagan Associates and Donaldson Lufkin Jenrette so he could apply the DCF method.

ii. Defendants' Expert Valuation Methodologies:

i. Utilized the comparable company and precedent transaction using a VPS metric, resulted in an equity cushion of $3.3 billion to $3.7 billion.
ii. Debtors' publicly reported debt-to-EBITDA ratio was 9.8x as of the end of the year 1998, in excess of the publicly reported 8.75x cap.
iii. Markets were ready to finance the Debtor in 1999.
iv. The Debtor was able to raise financing for 3 acquisitions in 1999.
v. The Plaintiff's expert acknowledged that the debt-to-EBITDA ratio would not have prevented the Debtors from accessing the capital markets. In addition, despite the Debtors' leverage, they would not have been precluded by accessing additional financing or the capital markets.

B. Bankruptcy Court's Analysis:

a. The Court agreed with Defendants' valuation method, but after implementing various "sanity checks", valued the Debtors at $2.8 billion at the time of the 1999 transactions.
b. The Court explained that three conditions must be met for the DCF method to be relevant and reliable: (1) when a company has accurate projections of future cash flows; (2) when such projections are not tainted by fraud; and (3) when at least some of the cash flows are positive. The Court explained that this case was the "poster child" for the deficiencies in attempting to use the DCF valuation method.
c. The Court found that the Plaintiff's attempt to develop alternative projections to be flawed and filled with cherry picked data from third party sources.
d. The Court noted that the Debtors' subscribers' was the most accurate methods of financial data, thus making the VPS analysis more reliable. The Court noted that the Plaintiff's valuation method provided too much room for speculation while the Defendants' analysis was more closely tied to the market.
e. Furthermore, because the Debtors had 1,478,529 subscribers, the Debtors could have sold 818,529 subscribers and still retained the 660,000 subscribers as required under its debt covenants pursuant to their loan agreements. According to the Court, at $3,000 per subscriber, the Debtors could have raised $2.46 billion from sales.
f. The Court also concluded that because the fraud was in its infancy and not sufficiently pervasive, it would not have prevented the Debtors from obtaining financing from third parties or precluded new lending.

THE RIGHTS OF SECURED CREDITORS IN A COMMERCIAL FRAUD CASE

Hosted by
the American Bankruptcy Institute
Commercial Fraud and Secured Credit Committees

Robert M. Charles, Jr.

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Non-Bankruptcy (Receivership) Issues

Using receivership to create a non-bankruptcy asset collection and claims resolution tool

- Receivership collects assets
- Receivership may commence litigation, including state law avoidance powers (Uniform Avoidable Transfer Act and its ilk)
- Receiverships may require filing and determination of claims
- Receivership order may require all actions by, against or on behalf of the defendant in receivership to be brought in the receivership court
- Using the *Barton* doctrine to fend off challenges to receiver litigation
- Using the *Barton* doctrine to require claims against receivership assets to be filed in the receivership court.

Using receivership to bankruptcy proof collateral or a debtor

- Prohibition in a receivership order against transfers of collateral
- Prohibition in a receivership order against bankruptcy filing
- Requiring receiver consent to a bankruptcy filing
- Prohibition against use of receivership property by anyone (DIP, trustee) other than the receiver

Using receivership to compete with the bankruptcy process

- What court decides if an asset is property of the estate
- Use of the turnover provisions of § 543
- Use of state court contempt to punish violation of a "no bankruptcy" prohibition
- Can § 305 be used to dismiss a bankruptcy case in favor of a receivership
- Compare bankruptcy cooperation with receivership including appointing receiver as trustee

Application of Bankruptcy Code Section 546(e)

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The Safe Harbor of Section 546(e)

- Section 546(e) of the Bankruptcy Code creates a “safe harbor” for certain transfers made to or for the benefit of a variety of various financial services industry participants, including financial institutions, margin and settlement payments or transfers made in connection with a pre-petition securities contract.

Ambiguity no more – the Second Circuit speaks regarding Section 546(e)

- *In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F. 3d (2d Cir. 2016). Creditors sought to recover prepetition payments to former shareholders in connection with a leveraged buyout. Section 546(e) protected the former shareholders/transferees, because upon Tribune's bankruptcy filing, all avoidance claims vested in only in the trustee.
- *In re Bernard L. Madoff Investment Securities LLC*, 773 F.3d 411 (2d Cir. 2014). Payments from Madoff to his "investors" were "settlement payments" and payments in connection with a securities contract even though there were never any underlying investments due to Madoff's fraud.
- *Enron Creditors Recovery Corp. v. Alfa S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011). The term "settlement payments" should be construed broadly and required only "an exchange of money or securities that completes a securities transaction."
- *In re Quebecor World (USA) Inc.*, 719 F. 3d 94 (2d Cir 2013). Relying on language in the underlying note documents (providing for the purchase and repurchase of notes), the Court held that the debtor's prepayment of $376 Million in privately-placed notes was protected by Section 546(e) as either a settlement payment or a payment in connection with a securities contract.

Continuing interpretation and application of Section 546(e) by other courts

- *In re MCK Millennium Centre Parking, LLC*, 532 B.R. 716 (Bankr. N.D. Ill. 2015). Payments made to a commercial mortgage backed securities loan servicer are not avoidable because such payments are made in "connection with a securities contract."
- *In re Munford*, 98 F. 3d 604 (11th Cir. 1996) and FTI Consulting v. Merit Management Group, LP, 830 F. 3d 690 (7th Cir. 2016). Safe harbor protection to former shareholders was denied because the bank that received the funds was a mere conduit, never obtained a beneficial interest and did not qualify as a protected transferee.
- *Contemporary Industries Corp. v. Frost*, 564 F. 3d 981 (8th Cir. 2009) and QSI Holdings v. Alford (In re QSI Holdings), Inc, 571 F. 3d 545 (6th Cir. 2009), cert. denied, 130 S. Ct. 1141 (2010). Section 546(e) applies to both public and private securities transactions, thereby establishing a majority rule among the circuits.

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Creditors' Rights in Federal Forfeiture Proceedings

Forfeiture Basics

- When and to what does forfeiture apply
- Relation back doctrine
- Criminal forfeiture
- Civil forfeiture

Criminal forfeiture process and procedure

- Indictment or information contains notice to defendant of intent to forfeit
- Preliminary order of forfeiture issued after conviction and cuts off defendant's interest in property
- Government provides notice to third parties of intent to forfeit property prior to obtaining final order of forfeiture
- Ancillary Proceeding
  - Exclusive means for third parties (creditors) to assert interests in property
  - File a petition to assert rights within 30 days of receiving government notice of intent to forfeit
  - Motions to dismiss, discovery and summary judgment may follow

Elements to preserve third party (creditor) rights

- Petitioner must have "legal interest" in the property to have standing
- Interest must have arisen prior to bad acts giving rise to forfeiture

  OR
- Must be a (1) bona fide purchaser for value and (2) reasonably without cause to believe that the property was subject to forfeiture.

Elements to preserve third party (creditor) rights

- *United States v. Petters* (2013)
  - Sept. 9, 2008 Bank renews $2.25 million unsecured note
  - Sept. 24 FBI raids Petters MN headquarters. Banker calls Petters in Las Vegas and Petters said raid is nothing to be concerned about. Banker calls again and asks for mortgages on two unencumbered homes
  - Sept. 25 bank served with subpoena and Petters signs mortgages-recorded on Sept. 29
  - March 26, 2010 preliminary order of forfeiture issued forfeiting two homes
  - Applying objective standard, the Court found that bank lacked actual knowledge that properties were forfeitable or that they were purchased with fraud proceeds.

Defending a Fraudulent Transfer Claim

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Solvency Defense Case Example

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FACTUAL BACKGROUND

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BANKRUPTCY COURT ANALYSIS

- The Court agreed with Defendants' valuation method, but after implementing various "sanity checks", valued the Debtors at $2.8 billion at the time of the 1999 transactions.
- The Court explained that three conditions must be met for the DCF method to be relevant and reliable: (1) when a company has accurate projections of future cash flows; (2) when such projections are not tainted by fraud; and (3) when at least some of the cash flows are positive. The Court explained that this case was the "poster child" for the deficiencies in attempting to use the DCF valuation method.
- The Court found that the Plaintiff's attempt to develop alternative projections to be flawed and filled with cherry picked data from third party sources.
- The Court noted that the Debtors' subscribers' was the most accurate methods of financial data, thus making the VPS analysis more reliable. The Court noted that the Plaintiff's valuation method provided too much room for speculation while the Defendants' analysis was more closely tied to the market.
- Furthermore, because the Debtors had 1,478,529 subscribers, the Debtors could have sold 818,529 subscribers and still retained the 660,000 subscribers as required under its debt covenants pursuant to their loan agreements. According to the Court, at $3,000 per subscriber, the Debtors could have raised $2.46 billion from sales.
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