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Is There Standing to Prosecute Fraudulent Transfer Claims if Unsecured Creditors Have Been Fully Paid?

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The answer to this question depends, in part, on where the debtor's case is pending. In the Second Circuit, courts allow defendants to escape exposure to fraudulent transfer actions if the debtor's estate cannot identify at least one general unsecured creditor who would benefit from a recovery in that litigation. In contrast, courts in the Fifth, Eighth and Ninth Circuits hold that a debtor's estate has standing to bring such claims, even after all allowed claims of general unsecured creditors have been paid in full, if the estate as a whole would benefit, for example through the payment of professional fees and other administrative expenses of the estate. It is unclear whether this split among the Circuit Courts of Appeal will affect the conduct of debtors and creditors in order to influence the outcome of avoidance actions brought by or against them.

Contexts in Which This Issue Arises

In re Petters Co., Inc., 495 B.R. 887 (Bankr. D. Minn. 2013) exemplifies one context in which this issue appears. There, the Chapter 11 bankruptcy trustee had commenced more than 200 adversary proceedings to recover for the estate allegedly fraudulent transfers made in connection with a Ponzi scheme. In its pleadings, the trustee stated generally that at all material times, there existed at least one creditor who held an unsecured claim, and that the challenged transfers "are avoidable under applicable nonbankruptcy law by a creditor holding an unsecured claim in the bankruptcy case." *See Petters*, 495 B.R. at 896.

The bankruptcy court rejected this general allegation as insufficient to satisfy the heightened pleading standards established under *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), and Fed. R. Civ. Pro. 8(a). The court held that in

order for the trustee to have standing to bring an avoidance action under Bankruptcy Code section 544(b)(1), the trustee must identify an actual "predicate unsecured creditor" having standing as of the petition date to avoid fraudulent transfers under applicable state law.

The court explained that it could not accept a trustee's bare assertion that a predicate creditor is out there somewhere, because specific, fact-based avenues of defense turn on the identity of the predicate creditor and the nature of its past dealings with the relevant debtor. *See Petters*, 495 B.R. at 899-900. First, the qualification of the predicate entity as a creditor in bankruptcy had to be demonstrated. Second, the defendant was entitled to know the substantive aspects of the theory for avoidance of its claim that could be asserted by the predicate creditor itself. *See id* at 900. The court permitted the trustee to amend its complaint in order to identify this predicate creditor.

Another context in which the debtor often has to establish its standing is when post-confirmation, avoidance actions are commenced by the debtor's successor trustee on behalf of the debtor's estate. In such instances, a disclosure statement estimating the level of distributions to be made to unsecured creditors has been approved by the bankruptcy court, potentially signaling that the estate may recover enough funds to pay all allowed unsecured claims in full.

The Second Circuit's Position

Cases decided in the Second Circuit establish that unless at least one general unsecured creditor would benefit from a successful outcome in fraudulent transfer litigation, a debtor (or its successor trustee) lacks standing to pursue the litigation. In *Adelphia Recovery Trust v. Bank of America, N.A.,* 390 B.R. 80 (S.D.N.Y. 2008), the plaintiff post-confirmation trust (Plaintiff Adelphia RT) asserted certain avoidance, equitable subordination and equitable disallowance claims against various commercial banks and other financial institutions (collectively, Defendant Banks). The Defendant Banks moved to dismiss under Fed. R. Civ. Pro. 12(b)(6).

According to the Defendant Banks, Adelphia RT lacked standing because at the time of their motion to dismiss, the Debtors' joint plan of reorganization had been implemented, and all unsecured claims entitled to distributions from the estate of the relevant debtor had been paid in full, with post-petition interest. *Adelphia*, 390 B.R. at 91.

In ruling for the Defendant Banks, the *Adelphia* court examined earlier Second Circuit precedent interpreting section 70(c) of the Bankruptcy

Act of 1898 (the precursor to section 544(a) of the Bankruptcy Code): *Whiteford Plastics Co. v. Chase National Bank*, 179 F.2d 582 (2d Cir. 1950) and *Vintero Corp. v. Corporacion Venezolana De Fomento* (*In re Vintero Corp.*), 735 F.2d 740 (2d Cir.), cert. denied, 469 U.S. 1087 (1984). In these cases, the Court of Appeals held that a transfer could not be avoided unless its avoidance would benefit a creditor of the debtor that had made the transfer.

The *Adelphia* court explained that in *Whiteford*, the Second Circuit refused to allow a debtor to avoid a defectively recorded lien because under the terms of the debtor's confirmed plan, the unsecured creditors of the debtor would not have received any distribution from such avoidance. *Adelphia*, 390 B.R. at 93 (citing 179 F.2d at 584). The court reiterated the Second Circuit's assessment that "'[i]t would be a mockery of justice to say that the alleged bankrupt may claim through and in the right of creditors whose debts have been paid and discharged; that he may avoid a transaction, valid as to himself but voidable as to creditors, in the right of non-existing creditors.'" *Adelphia*, 390 B.R. at 93 (citing 179 F.2d at 584, quoting *In re J.C. Winship Co.*, 120 F. 93, 96 (7th Cir. 1903)).

In *Vintero*, the Second Circuit held that the Chapter 11 debtor could avoid an unperfected security interest only to the extent that avoidance would benefit third-party creditors. To prevent the debtor from receiving a windfall, the avoided security interest would remain fully enforceable against the debtor. *Adelphia*, 390 B.R. at 93 (citing 735 F.2d 740, 742). Because the purpose and substance of section 544 conformed substantially to that of section 70c of the Bankrupty Act, the *Adelphia* court rejected the argument that *Whiteford Plastics* and *Vintero* should be disregarded because they interpreted the Bankruptcy Act as opposed to the Bankruptcy Code. *Adelphia*, 390 B.R. at 94.

Mirant and Others Take a Different View

In *In re Mirant Corp.*, 675 F.3d 530 (5th Cir. 2012), the Fifth Circuit Court of Appeals affirmed the district court's decision that the debtor had standing to pursue avoidance actions despite the absence of a general unsecured creditor who would benefit from their successful outcome. It held that even after all allowed claims of general unsecured creditors are satisfied, to the extent that successful avoidance of fraudulent transfers will benefit the bankruptcy estate, Article III standing exists to avoid such transfers that injured the estate. 675 F.3d at 534.

In that case, to expand its overseas operations, Mirant Corporation (Mirant) sought to acquire several power islands through its subsidiary Mirant Asset Development and Procurement B.V. (MADP). Commerzbank A.G. agreed to provide financing to MADP that was guaranteed by the latter. After Commerzbank's financing was syndicated to other lenders and the acquisition faltered, Mirant was forced to make payments under its guaranty, and it later sought relief under Chapter 11.

As a debtor-in-possession, Mirant commenced avoidance actions to avoid the parent guaranty as a constructive fraudulent transfer and to recover payments made by Mirant (which was succeeded post-confirmation by MC Asset Recovery, LLC (MCAR)). Commerzbank and other lenders moved to dismiss, arguing among other things that MCAR lacked standing and that it "failed to state a claim upon which relief could be granted because MCAR could neither use the Federal Debt Collection Procedures Act (FDCPA) to avoid the Guaranty nor could MCAR avoid the Guaranty under other applicable law." *Mirant*, 675 F.3d at 532.

Although the district court found that MCAR had standing, it granted summary judgment, finding that the FDCPA was not applicable law under 11 U.S.C. § 544(b) and that applicable state law, which it found to be the law of Georgia, did not allow Mirant's guaranty to be avoided. *Id*. The Fifth Circuit upheld the district court's decision on standing, but it found that the district court erroneously applied Georgia state law as opposed to the law of New York to the avoidance claim and vacated the judgment of dismissal.)

In analyzing standing, the Fifth Circuit acknowledged the split among the federal courts. *Mirant*, 675 F.3d at 533 (citing *Adelphia*, *supra*; *Stalnaker v. DLC, Ltd.*, 376 F.3d 819, 822-23 (8th Cir.2004); *In re Acequia*, 34 F.3d 800 (9th Cir. 1994)). The Fifth Circuit noted with favor that the Eighth and Ninth Circuit Courts of Appeals found that standing existed although there were no unsecured creditors who would benefit from the avoidance of a fraudulent transfer. *Mirant*, 675 F.3d at 533-34. The Fifth Circuit highlighted the rationale promulgated in *Acequia* in which the Ninth Circuit allowed a trustee to pursue an avoidance action notwithstanding that the debtor's unsecured creditors were paid pursuant to its plan of reorganization:

First the 'existence of a section 544(b) cause of action' should be evaluated at the time the bankruptcy petition is filed. Second, the Bankruptcy Code [under section 1123(b)] authorizes post-confirmation pursuit of a debtor's causes of action. '[T]hird, if confirmation and

payment precluded application of section 544(b), debtors undoubtedly would delay filing plans of reorganization until completing all potential litigation, a result that would contravene the Bankruptcy Code's goal of quick and equitable reorganization.'

Mirant at 534 (citing *Acequia* at 807-812) (further citations omitted).

It also agreed with the Eighth Circuit that "the bankruptcy 'estate' is not synonymous with the concept of a pool of assets to be gathered for the sole benefit of unsecured creditors," *Mirant* at 534 (citing *Stalnaker* at 823), particularly where professionals' administrative claims would have been left unpaid by virtue of the unsecured creditors having settled on the eve of trial. *Mirant* at 534 (citing *Stalnaker* at 823-24).

Analysis

It is highly unusual for all unsecured creditors to be paid in full in bankruptcy cases. As a practical matter, even in those situations, defendants in fraudulent transfer actions and their counsel may not know that all allowed unsecured claims have been paid. This is especially true in situations where the plaintiff is a trustee for a post-confirmation liquidating trust.

If an estate is able to pay all unsecured claims, it seems unjust to permit professionals to continue to prosecute avoidance actions where the recoveries would inure essentially only to their own benefit and not to the benefit of creditors. This is especially true where the claim is being prosecuted based not on section 548 of the Bankruptcy Code, but based upon a state's fraudulent transfer statute that requires the plaintiff to identify at least one unsecured creditor whose claim was unpaid as of the date of the transfer and that remains unpaid.

At the same time, depending upon the facts of the case, it may be somewhat unfair to permit defendants who have intentionally prolonged the pendency of their cases through any range of dilatory tactics to escape liability because the plaintiff has managed to recover from other defendants an amount of funds sufficient to pay of all creditors. In effect, those defendants who reached settlements and paid their settlement obligations sooner than other defendants would unwittingly bear the burden of restoring funds needed to pay off creditors. On the other hand, one might argue that they should have known better than to settle "too early" and that they did so knowingly, for various reasons of their own.

In sum, as long as there is a split in the circuits, the law will remain somewhat unclear, will provide strategic advantages and disadvantages to various parties in interest, and it will not always produce a perfectly equitable outcome.

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