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Case Study: In Re Northstar Development

Law360, New York (May 02, 2012, 1:29 PM ET) -- A recent opinion from the United States Bankruptcy Court for the Western District of New York shows that even the best laid strategies can return to haunt the insiders of a debtor. In Wallach v. Buchheit (In re Northstar Development Corp.),[1] the court equitably subordinated most of the $3.2 million unsecured claim of the debtor's sole shareholder (the "principal") because he delayed the debtor's bankruptcy filing in order to save himself from $100,000 in preference liability.

The court held that "[b]y causing the debtor to delay the filing of its bankruptcy petition, [the principal] insulated himself from potential liability on a cause of action that might otherwise have inured to the benefit of other creditors to whom he owed a duty of good faith." This opinion highlights the dichotomy of interests between insolvent, closely held companies and their controlling shareholders, and should serve as a cautionary tale for the latter.

In Northstar, the debtor owned the Statler Towers, a landmark building in Buffalo, N.Y. The debtor sold the building on Aug. 18, 2006, after it became insolvent. Between Sept. 1, 2006, and Feb. 16, 2007, the debtor paid a total of $100,000 to the principal in partial repayment of the principal's unsecured loan to the debtor. Though the debtor no longer had any ongoing business operations after the building sale, the principal did not cause the debtor to file its Chapter 7 petition until Feb. 1, 2008 — a date that was safely outside of the one-year look-back period for preference payments to insiders under the Bankruptcy Code. The court did not interpret the delay as a mere coincidence, noting that the payments "would have constituted a preference ... but for the fact that the debtor delayed the filing of its petition until a date more than one year after [the principal's] receipt of funds."

Following the debtor's bankruptcy filing, the Chapter 7 trustee for the debtor's bankruptcy estate brought an adversary proceeding against the principal, asserting counts of, among other things, equitable subordination of the principal's $3.2 million general unsecured claim. Interestingly, in support of his equitable subordination claim, the trustee did not focus on the principal's decision to delay the bankruptcy filing. Instead, he focused primarily on the fact that the principal allowed the debtor to operate with inadequate capitalization.

The court rejected the trustee's inadequate capitalization theory, but nevertheless found that the facts warranted equitable subordination of the principal's unsecured claim. By paying himself $100,000 and then delaying the bankruptcy filing until the look-back period for recovering those payments had elapsed, the principal breached the fiduciary duties that he owed to the debtor's creditors.

The court observed: "First, he caused the debtor to distribute its limited cash resources to himself rather than proportionately among all creditors. Second, by causing the debtor to delay the filing of its bankruptcy petition, [the Principal] insulated himself from potential liability on a cause of action [i.e., preferential transfer pursuant to section 547(b)(4)(B)] that might have inured to the benefit of other creditors to whom he owed a duty of good faith."

Accordingly, the court imposed a steep penalty against the principal by subordinating almost the entirety of his $3.2 million claim to the claims of the debtor's other general unsecured creditors. The court reasoned as follows:

> One learned treatise has observed that a claim should be subordinated only to the extent necessary to offset the harm suffered . ... In the present instance ... [the principal's claim] represents more than 95.5% of all unsecured claims that have been filed to date. Therefore, unless subordinated, the defendant's claim would realize nearly the entire amount that the trustee might distribute from any recovery on his causes of action against the defendant himself. Equity demands an outcome more fair than any such cyclical regurgitation. In violation of his fiduciary obligations as an officer and director of the corporation, the [principal] attempted to secure an advantage over all other creditors. In fairness, these other creditors should now receive a similar advantage over the [principal].[2]

Perhaps the most ironic part of Northstar is that the principal did not even get to keep the $100,000 that the debtor paid him. The payments of those funds to him were avoidable as fraudulent transfers under the New York Debtor and Creditor Law. As the court noted: "As a general rule in New York for purposes of fraudulent conveyance law, the payment of an unsecured debt to an insider is deemed to be without good faith, and therefore lacking in fair consideration." Indeed, the principal agreed on the first day of trial to repay the $100,000 to the debtor's estate. Thus, the principal was not even able to accomplish the ultimate goal of his decision to delay the bankruptcy filing.

Northstar represents a weapon in the arsenal of trustees and creditors seeking to pursue officers and directors of insolvent companies after a bankruptcy filing. It also presents a straightforward message for those officers and directors, i.e., you may not delay a bankruptcy filing for the sole purpose of avoiding your personal liability.

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[1] 465 B.R. 6 (Bankr. W.D.N.Y. 2012).

[2] Id. at 17.

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