AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Claims Chat

By Cory D. Kandestin and Christopher M. De Lillo[1]

Are Avoidance Recoveries Capped in the Amount of Unpaid Claims?

Cory D. Kandestin
Richards, Layton & Finger, PA
Wilmington, Del.

Christopher M. De Lillo
Richards, Layton & Finger, PA
Wilmington, Del.

Cory Kandestin is counsel and Chris De Lillo is an associate with Richards, Layton & Finger, PA in Wilmington, Del.

Consider this scenario: A debtor confirms its plan and transfers avoidance actions to a litigation trust. The trust then sues the debtor's former owner, who sold the company through a leveraged transaction prior to bankruptcy, on the basis that the sale was a fraudulent transfer. Let's assume that the litigation trust sues to recover the full payment to the former owner (*e.g.*, $100 million), but the amount of unpaid creditors' claims in the bankruptcy case totals only $20 million. If the litigation trust prevails on its fraudulent-transfer claim, can it recover $100 million or $20 million?

Outside of bankruptcy, the answer is clear: Under state law, only a creditor may bring a fraudulent-transfer action, and the creditor may not recover in excess of its unpaid claim. This rule is expressly written into the Uniform Fraudulent Transfer Act (UFTA) and the Uniform Voidable Transactions Act, both of which provide that a creditor "may recover judgment for the value of the asset transferred ... or the amount necessary to satisfy the creditor's claim, whichever is less."[2]

Surprisingly, inside bankruptcy, courts have been split on this issue. Unlike the UFTA, the Bankruptcy Code provision governing fraudulent transfer recoveries — 11 U.S.C. § 550(a) — contains no explicit cap. Courts interpreting § 550(a) have reached divergent conclusions, with some reading it to impose no limit on a fraudulent-transfer recovery and others reading it consistently with state law. This article explores both sides of the issue, beginning with a recent bankruptcy court decision in *DSI Renal Holdings*.[3]

Background

When simplified, *DSI Renal*'s facts are not much different than the basic scenario outlined above. DSI Renal operated a hospital and a chain of clinics. In a pre-petition restructuring transaction, it transferred ownership of its clinic business to a group of lenders, shareholders and new investors. In exchange, the group provided about $132 million in consideration, partly in the form of new cash and partly by converting existing debt to equity. Less than two years later, the group sold the business for nearly $690 million.

Meanwhile, the debtors filed for chapter 7. The trustee brought an adversary proceeding against the now-former owners, alleging that they took the business at an unfairly low price, then turned around and sold it for far more. Among other things, the trustee asserted a fraudulent-transfer claim alleging that DSI Renal did not receive reasonably equivalent value in exchange for its clinic business. The trustee sought to recover $678 million, the amount of the sale proceeds received by the defendants plus interest. However, the debtors' official claims register listed only $166 million of claims asserted against the estates. The defendants filed a summary-judgment motion arguing that in the event of liability, the trustee's damages should be capped at that lesser amount.[4]

Arguments and Holding

The *DSI Renal* defendants premised their argument on the principle that fraudulent-transfer claims historically are designed to remedy creditor harms.

1 The views herein are those of the authors and not necessarily those of Richards, Layton & Finger, PA or its clients.

2 Unif. Fraudulent Transfer Act § 8(b); Unif. Voidable Transactions Act § 8(b) (same).

3 *Giuliano v. Schnabel (In re DSI Renal Holdings LLC)*, 2020 WL 550987 (Bankr. D. Del. Feb. 4, 2020) (Owens, J.).

4 *Id.* at *4. *DSI Renal* also addressed whether the Bankruptcy Code capped the trustee's separate breach-of-fiduciary-duty claim against the debtors' directors and officers. The court found that it did not.

5 *See, e.g., In re Cybergenics Corp.*, 226 F.3d 237, 243-46 (3d Cir. 2000) (discussing principle that avoidance powers are not assets of debtor, but powers given to trustee "to pursue those fraudulent-transfer claims for the benefit of all creditors").

Several Third Circuit cases directly or indirectly recognize this principle by interpreting § 550(a)'s language that any avoidance be "for the benefit of the estate" to mean that avoidance must be for the benefit of "creditors."[5] The defendants also argued that under the particular facts of the case, allowing an excess recovery made no sense: Under the restructuring agreements, DSI Renal's former equityholders (who would benefit from any excess recovery) had promised to return any future avoidance proceeds to the defendants. Therefore, the surplus recovery would roundtrip back to the defendants, but only after the trustee and his professionals took their cut of fees.

In contrast, the trustee argued that § 550(a) is a floor, not a cap. Citing precedent from the U.S. Supreme Court and the Southern District of New York, the trustee asserted that § 550(a) (specifically, "for the benefit of the estate") is satisfied as long as the avoidance benefits the estate in any way.[6] The trustee anchored his argument in § 550(a)'s plain language, which, under his reading, lacked any express limitation on a debtor's power to recover other than the minimal requirement that the recovery benefit the estate. The trustee also argued that if there was a prohibition on excess recoveries, then it applied only to a debtor and not to a trustee seeking to recover on a debtor's behalf.[7]

The court held that a fraudulent-transfer recovery in bankruptcy may not exceed unpaid creditors' claims. The court first found no basis for the trustee's differentiation of debtors and trustees, noting that the appropriate question is who may benefit from a fraudulent-transfer recovery (only creditors, or equity, too), which does not depend on who brings the claim (the debtor vs. the trustee).

The court also held that § 550(a)'s "for the benefit of the estate" language really means "for the benefit of creditors." Here, the court relied heavily on binding Third Circuit decisions holding that avoidance recoveries should "maximize the bankruptcy estate for the benefit of creditors"[8] and that "[a] debtor is not entitled to benefit from any avoidance."[9] Based on this authority, the trustee's reading of § 550(a) to allow for a recovery in excess of creditors' claims (*i.e.*, recovery to the debtor and its equityholders) could not stand. The court also held that allowing a fraudulent-transfer recovery in excess of creditors' claims (and thus on behalf of equity) would grant the debtor greater rights inside of bankruptcy than outside, both under state fraudulent-transfer law and the parties' private agreements. Thus, any potential recovery would be limited to the "total amount necessary to satisfy all allowed creditor claims and expenses in the Debtors' bankruptcy cases," which included any secured, administrative and priority claims.[10]

The Existing Court Split: *Moore v. Bay* and the Plain Meaning of § 550

It could be tempting to view *DSI Renal* as a case that was dependent on particular Third Circuit authority whose reasoning might not apply in other circuits, but *DSI Renal* also separately addressed — and rejected — a key argument often presented by plaintiffs seeking to recover in excess of creditors' claims: The Supreme Court's decision in *Moore v. Bay* provides for an unlimited avoidance recovery.[11] *DSI Renal*'s analysis on this point was not dependent on circuit-specific authority, and it highlights an important issue on which courts still disagree.

Courts that have allowed a plaintiff to recover in excess of the creditors' claims often cite *Moore* as sanctioning that result. However, *Moore* did not squarely address that precise issue. Rather, in a two-paragraph decision written in somewhat opaque language, Justice Oliver Wendell Holmes Jr. held that when a trustee steps into the shoes of a "triggering creditor" to avoid a transfer, the trustee may recover for the benefit of all of the estate's creditors, not only for the benefit of the triggering creditor.[12] Stated differently, *Moore* held that any recovery was not limited to the triggering creditor's claim. Although *Moore* was decided under the Bankruptcy Act, the Bankruptcy Code's legislative history shows that Congress intended for the Code to "follow ... *Moore v. Bay*," meaning that *Moore* is still good law,[13] but just what that law constitutes is not so clear.

Some courts have held that *Moore*'s reasoning allows a trustee to recover an entire transfer, even in excess of all creditors' claims — a rule of complete avoidance and recovery.[14] These courts read § 550(a) the same way as *DSI Renal*'s trustee. Specifically, they interpret § 550(a)'s language requiring a recovery to "benefit the estate" to mean that as long as the recovery provides some benefit to the estate, then a plaintiff may recover the entire transfer — even if it exceeds creditors' claims.[15] Although this creates a divergence between federal and state fraudulent-transfer law, these courts tend to view § 550(a)'s plain language as controlling over any contrary state law principles.[16]

Other courts disagree,[17] tending to consider the purpose and policy of fraudulent-transfer law when interpreting § 550(a).[18] Because fraudulent-transfer law is fundamentally

6 *DSI Renal*, 2020 WL 550987, at *4 (citing *Moore v. Bay*, 284 U.S. 4 (1931); *Tronox Inc. v. Anadarko Petroleum Corp. (In re Tronox Inc.)*, 464 B.R. 606 (Bankr. S.D.N.Y. 2012)).

7 *Id.*

8 *In re Cybergenics Corp.*, 226 F.3d at 243-44.

9 *In re Majestic Star Casino LLC*, 716 F.3d 736, 761 n.26 (3d Cir. 2013); *see also Cybergenics*, 226 F.3d at 244 ("[C]ourts have limited a debtor's exercise of avoidance powers to circumstances in which such actions would in fact benefit the creditors, not the debtors themselves.").

10 *DSI Renal*, 2020 WL 550987, at *8-9.

11 *See Moore*, 284 U.S. at 5.

12 *Id.*

13 S. Rep. No. 95-989, at 85 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5871 ("It follows *Moore v. Bay*.").

14 *See, e.g., PAH Litig. Tr. v. Water St. Healthcare Partners LP (In re Physiotherapy Holdings Inc.)*, 2017 WL 5054308, at *8 (Bankr. D. Del. Nov. 1, 2017) ("*Moore v. Bay* is codified by Section 550. A trustee may thus avoid a transfer beyond the extent necessary to satisfy a creditor's claim."); *In re Tronox Inc.*, 464 B.R. at 616 (noting different purposes of fraudulent-transfer proceedings under state law and bankruptcy law; because "recovery under § 544(b) is governed by § 550, it follows that Congress intended to incorporate *Moore*'s rule of complete avoidance into § 550"); *MC Asset Recovery LLC v. S. Co.*, 2006 WL 5112612, at *4-5 (N.D. Ga. Dec. 11, 2006) (same); *In re DLC Ltd.*, 295 B.R. 593, 606-07 (B.A.P. 8th Cir. 2003) (same), *aff'd*, 376 F.3d 819 (8th Cir. 2004); *see also In re Acequia Inc.*, 34 F.3d 800, 811-12 (9th Cir. 1994) (allowing recovery even though plan paid unsecured creditors in full).

15 *See, e.g., In re Tronox Inc.*, 464 B.R. at 614 ("In other words, the 'for benefit of the estate' clause in § 550 sets a minimum floor for recovery in an avoidance action — at least some benefit to the estate — but does not impose any ceiling on the maximum benefits that can be obtained once that floor has been met.").

16 *See, e.g., id.* at 616 ("Nor is there any basis for the argument that state law is controlling where the recovery in a proceeding under § 544(b), as well as § 548, is controlled by § 550, a federal statute.").

17 *See, e.g., Wellman v. Wellman*, 933 F.2d 215, 218-19 (4th Cir. 1991) (affirming dismissal of §§ 548 and 550 claims where creditors were satisfied in full and, if successful, debtor would have retained stock recovered in avoidance action); *Balaber-Strauss v. Harrison (In re Murphy)*, 331 B.R. 107, 123-26 (Bankr. S.D.N.Y. 2005) ("The purpose of fraudulent-conveyance law, whether state or federal, and of Section 548 is to prevent harm to creditors by a transfer of property from the debtor.... Fraudulent-conveyance laws were not designed to affect the legal relationship between the transferor and transferee."); *Harstad v. First Am. Bank (In re Harstad)*, 155 B.R. 500, 511 (Bankr. D. Minn. 1993) (holding "[t]he plaintiffs' post-petition recovery from preferences would not benefit creditors [pursuant to the confirmed plan]. Thus, even if the plaintiffs had standing to avoid the transfers under section 547, they would not have the right to recover them under section 550."); *Allonhill LLC v. Stewart Lender Servs. Inc. (In re Allonhill LLC)*, 2019 WL 1868610, at *52 (Bankr. D. Del. April 25, 2019) ("To the extent [that] Allonhill prevails on its avoidance claims, it cannot recover in excess of outstanding creditor claims. To hold otherwise would result in a windfall to equity (primarily the Allons) that Section 550 and Third Circuit law precludes.").

18 *See, e.g., In re Murphy*, 331 B.R. at 122 ("That objective [of bankruptcy avoidance powers to protect creditors from prejudice due to diminution of the estate] can and must be reconciled with state law and public interest by limiting the measure of avoidance damages under Sections 548 and 550 to the amount necessary to make creditors of the debtor's estate whole.").

a creditor remedy, § 550(a) should be interpreted in light of that principle. This approach has the benefit of consistently interpreting otherwise nearly identical state and federal fraudulent-transfer laws.

Conclusion

DSI Renal highlights a true tension in the law regarding the scope of fraudulent-transfer recoveries. On the one hand, *Moore v. Bay* does not expressly hold that a plaintiff may recover in excess of aggregate creditors' claims. On the other hand, § 550(a) does not expressly cap claims and instead requires that any recovery merely benefit the "estate," a term that (outside of the Third Circuit) could be broader than just "creditors" in this context. Yet interpreting § 550(a) to allow for a recovery in excess of creditors' claims would create an inconsistency between state and federal fraudulent-transfer law, even though they ought to be consistently interpreted. To date, there has been no universal resolution to this tension, and intra-district inconsistencies continue to exist in jurisdictions like Delaware[19] and the Southern District of New York.[20] abi

Reprinted with permission from the ABI Journal, Vol. XXXIX, No. 6, June 2020.

The American Bankruptcy Institute is a multi-disciplinary, nonpartisan organization devoted to bankruptcy issues. ABI has more than 12,000 members, representing all facets of the insolvency field. For more information, visit abi.org.

19 *Compare In re Physiotherapy Holdings Inc.*, 2017 WL 5054308, at *8, *with In re Allonhill LLC*, 2019 WL 1868610, at *52, and *In re DSI Renal Holdings LLC*, 2020 WL 550987, at *9.
20 *Compare In re Tronox Inc.*, 464 B.R. at 614-15, 617, *with In re Murphy*, 331 B.R. at 122-25.