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The Best Offense is a Good Defense: While the Eighth Circuit's Decision in *In re Opportunity Fund LLC* Highlights Consequences and Potential Pitfalls of Substantive Consolidation, the Bankruptcy Court Ultimately Dismisses Fraudulent Transfer Claims against the Lenders.

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In our previous two news alerts,[1] we examined decisions that potentially undermine key elements of the legal structures that lenders created in response to their experiences in the United States Bankruptcy Courts during the real estate downturn of 1988 through 1992, including the involuntary restructure of their indebtedness and liens under the cram-down provisions of title 11 of the United States Code (the "Bankruptcy Code"). A recent decision by a Court of Appeals of the Eighth Circuit, hearing an appeal from a decision of the United States Bankruptcy Court for the District of Minnesota (the "Bankruptcy Court"), now raises concerns about the standing of real estate lenders to defend against substantive consolidation. As we previously pointed out, the central element of all real estate lenders' legal structures when real estate financing resumed in 1993, whether senior mortgage or mezzanine, has been the isolation of their borrower, and through it their collateral, in a separate legal entity, in an attempt to insulate and shield their borrower and collateral from being substantively consolidated with problems, claims, and rights of their borrowers' affiliates, and their attendant creditors or other parties in interest. In this third installment, we review the decision of the United States Court of Appeals for the Eighth Circuit which affirmed that lenders lacked standing to appeal a bankruptcy court's order substantively consolidating a series of special purpose entities. See Opportunity Fund LLC v. Kelley (In re Petters Co., Inc.), 882 F.3d 451 (8th Cir. May 16, 2016) ("Opportunity Fund"). Taken together, these three decisions highlight the potential for erosion of protections enjoyed (and relied upon) by lenders in the deals they've structured in recent years.

However, there is some good news. In this alert we also review the subsequent decision of the Bankruptcy Court, issued three days after the Eighth Circuit's decision in Opportunity Fund, ruling that the lenders were not liable for a constructive fraudulent conveyance. See Kelley v. Opportunity Fund LLC et al. (In re Petters Company Inc.), 550 B.R. 438 (Bankr. D. Minn. May 19, 2016) ("Petters"). In dismissing the complaint, the Bankruptcy Court held that substantive consolidation could not retroactively create a requisite creditor when in fact none existed – and thus the Trustee lacked standing to prosecute his state law fraudulent transfer claims under Bankruptcy Code section 544(b).

[1] We examined a decision of the Arizona District Court whose interpretation of an "Impaired Accepting Class" for plan confirmation purposes in non-substantively consolidated cases poses a threat to senior mortgage lender protections in common real estate financing structures, *see In re Transwest Resort Properties, Inc.*, 2016 WL 4087111, No. 10-37134 (D. Az. June 22, 2016) (Transwest Resort Properties alert), and a decision of the Delaware Bankruptcy Court declining to dismiss Chapter 11 petitions not authorized by a lender holding a "Golden Share." *See In re Intervention Energy Holdings, LLC*, No. 16-11247 (Bankr. D. Del. June 3, 2016) ("Golden Share" alert).

Lenders need to be exceedingly vigilant and understand these recent court decisions (and others that are certain to come in the future) so they can be prepared if their investments show signs of distress or actually commence bankruptcy proceedings.

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Lenders invest significant time and effort structuring loans to prevent a borrower from filing for bankruptcy. For example, lenders will sometimes require the borrower's principal to execute a "bad boy guaranty" (which can make the principal personally liable to the lender for damages up to the entire unpaid amount of the loan in the event of a bankruptcy filing) or that the lender hold a "Golden Share" (which is a non-economic voting interest in the borrower who then cannot file for bankruptcy without the lender's affirmative consent).

In addition, lenders will seek to protect the sanctity of their secured claims in the event a borrower bankruptcy cannot be prevented. For example, a lender may make a loan to a special purpose entity ("SPE") to ensure that, in the event of a borrower bankruptcy, the lender is the borrower's only creditor. By structuring the loan in this fashion, the lender seeks to ensure that (a) there is no "impaired" class of creditors whose vote to accept the plan could trigger approval of the plan under the Bankruptcy Code's "cramdown" standard; and (b) the lender has a basis to argue that the bankruptcy filing can be dismissed as bad faith filing because it is simply a two-party dispute.

The SPE-structure is also designed to avoid a bankruptcy court ordering the substantive consolidation of an SPE-borrower with any other affiliate debtor. Substantive consolidation is an extraordinary judicial remedy that disregards corporate separateness and pools the assets and liabilities of each of several companies into a single entity. While different Circuit Courts have adopted varying standards for substantive consolidation,[2] the modern view, espoused by the Third Circuit, generally looks to whether (1) the entities disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity or (2) the affairs of the debtors are so entangled that consolidation will benefit all creditors. *See In re Owens Corning,* 419 F.3d 195, 211 (3d Cir. 2005). In cases of fraud or hopeless entanglement, substantive consolidation is a remedy used to administer the estate for the benefit of creditors. However, the purpose of substantive consolidation is not to permit trustees in bankruptcy to re-write the history of the case in order to eliminate creditors' legitimate rights.

One of the potential perils of substantive consolidation is highlighted in the Eighth Circuit Court of Appeals' recent *Opportunity Fund* opinion. As discussed in greater detail below, over the objection of certain lenders, the Bankruptcy Court ordered the substantive consolidation of Petters Company, Inc. ("PCI"). The lenders appealed and the District Court dismissed their appeal, finding that the lenders were not "aggrieved" with respect to the substantive consolidation of the debtors. By a majority decision, the Eighth Circuit rejected the lenders' argument that they were in fact "aggrieved" because the Bankruptcy Court's substantive consolidation order would result in the loss of certain defenses they would otherwise have to claims of constructive fraudulent transfer brought against them by the chapter 11 trustee (the "Trustee"). The Eighth Circuit found that the loss of affirmative defenses was insufficient to create a direct pecuniary harm to the lenders. The Eighth Circuit's decision creates a troubling precedent for lenders, potentially denying them standing to protect their interests following a substantive consolidation ruling.

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[2] *See, e.g., Eastgroup Properties v. Southern Motel Association, Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991); *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 765−66 (9th Cir. 2000); *Union Sav. Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515, 518 (2d Cir. 1988); *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 276 (D.C. Cir. 1987); *In re Vecco Constr. Indus., Inc.,* 4 B.R. 407, 410 (Bankr. E.D. Va. 1980).

I. Petters Background

In 2008, Thomas Petters was indicted for perpetrating a multi-billion dollar Ponzi scheme through PCI. For ten years, Petters and several co-conspirators fabricated documents to entice investors into lending money purportedly to purchase electronics to be sold to big-box retailers, such as Costco and Sam's Club. The money, however, was not used for that purpose. Shortly after the indictment, PCI and several SPEs were placed into receivership. The receiver then filed the companies for chapter 11 and the Trustee was appointed.[3]

To fund PCI, Petters used various SPEs, which held illusory accounts receivable and had no appreciable assets. PCI also served as a holding company for several of the SPEs. Two groups of lenders made loans to certain SPEs. Another group of lenders did not make loans directly to the SPEs, but only to other lenders. Each lender was a "net winner" (*i.e.*, was repaid) from the Ponzi scheme and, as such, did not file proofs of claim in bankruptcy. The Trustee commenced avoidance actions against each of the lenders alleging constructive fraudulent transfers in the hope of recovering funds to the bankruptcy estate. The Trustee then moved to substantively consolidate the assets and liabilities of PCI and the SPEs. The Bankruptcy Court granted the motion finding that PCI and the SPEs had engaged in massive commingling and the erosion of corporate boundaries. The lenders appealed.

In the District Court, the Trustee moved to dismiss the appeal, arguing that the lenders did not have standing as "persons aggrieved" by the order granting substantive consolidation. The District Court agreed and dismissed the appeal. The Lenders appealed to the Eighth Circuit, arguing that they were indeed "persons aggrieved" because substantive consolidation, among other things, impaired their rights by precluding potential affirmative defenses to the Trustee's claims under the avoidance actions. More specifically, the lenders argued (as discussed in depth below) that, whereas no creditors existed as to their SPEs prior to the bankruptcy cases, the substantive consolidation of their SPEs might be used by the Trustee to satisfy the state law fraudulent transfer requirement that an actual creditor existed and was harmed by the loans. *See* 11 U.S.C. § 544(b). Additionally, the lenders argued that substantive consolidation transformed both groups of lenders into initial transferees of PCI, rather than subsequent transferees, and therefore, eliminated good faith affirmative defenses otherwise available to the lenders in the avoidance actions. *See* 11 U.S.C. § 550(b)(1).[4]

II. Eighth Circuit Decision

In a 2-1 decision, the Eighth Circuit affirmed the District Court's decision that the lenders were not aggrieved and stated that "any potential pecuniary harm to the lenders [was] several steps removed and not a direct pecuniary impact." The majority noted that several steps needed to occur before the lenders would suffer a pecuniary harm: "[the Trustee] must prevail in the avoidance actions, the lenders must pay the judgment in full, and then they must file a valid proof of claim against the consolidated estate."

The majority also noted that the "persons aggrieved" doctrine is designed to prevent the prolonging of bankruptcy cases by parties whose interests are not central to the bankruptcy process. Since the majority viewed the lenders' rights as ancillary to the bankruptcy process, allowing them to appeal the Bankruptcy Court's order would undermine the rationale of the standard and bring the bankruptcy proceedings to a grinding halt.

[3] Ultimately, Petters was convicted of wire fraud, mail fraud, conspiracy and money laundering in connection with his $3.65 billion-dollar Ponzi scheme and sentenced to 50 years in prison. *See United States v. Petters*, 663 F.3d 375, 378 (8th Cir. 2011); see also Petters case.

[4] *Opportunity Fund*, at 458.

The dissent wrote, however, that since substantive consolidation would result in the lenders losing certain of their Bankruptcy Code-based defenses to the Trustee's avoidance actions – including potential defenses under Bankruptcy Code sections 544(b) and 550(a) – the lenders must be considered "aggrieved persons" with standing to appeal the substantive consolidation order.

As the dissent concluded:

> [T]his is not the type of appeal the persons aggrieved doctrine was designed to prevent – an appeal by 'marginally interested parties . . . litigating satellite issues up and down the appellate chain while the bankruptcy case stalls out. . . . The substantive consolidation order fundamentally alters the entire Petters bankruptcy proceeding. . . . This is a fundamental reorganization of a bankruptcy proceeding that strips Opportunity Finance and Epsilon of two significant defenses to a billion-dollar avoidance action. The persons aggrieved doctrine was not designed to prevent appeals of this magnitude.[5]

III. Bankruptcy Court Decision

There is, however, a silver lining. Immediately following the release of the *Opportunity Fund* decision, the Bankruptcy Court issued a memorandum ruling regarding the lenders' motion to dismiss the avoidance actions. The Bankruptcy Court specifically addressed how substantive consolidation impacted the Trustee's derivative standing to prosecute state-law avoidance actions under section 544(b) of the Bankruptcy Code that required the Trustee to prove the existence of a predicate creditor with a right to payment from the debtor.[6] Specifically, the Bankruptcy Court ruled that where an SPE has only one pre-petition creditor (the lender), substantive consolidation cannot be used retroactively to create a requisite creditor in order to give the Trustee standing to pursue a claim for fraudulent transfer. *See Kelley v. Opportunity Fund LLC et al. (In re Petters Company Inc.)*, 550 B.R. 438 (Bankr. D. Minn. May 19, 2016) ("*Petters*").

The Bankruptcy Court framed the issue as follows:

> [C]an the Trustee use creditors whose pre-petition claims lay against some of the Debtor-entities whose estates were substantively consolidated, to satisfy the predicate-creditor requirement for the avoidance of transfers that were actually made by other Debtor-entities, when the transferor-Debtor lacked any third-party creditors of its own, not related to it, as of the relevant date?[7]

The Trustee argued that the post-petition substantive consolidation order had a direct effect on his cases as to the fraudulent transfer causes of action. According to the Trustee, the pooling of claims into a single estate entitled the Trustee to utilize the right of avoidance that any creditor of any Debtor held against its own debtor pre-petition, against any transferee of any of the Debtors. Thus, the Trustee

[5] *Opportunity Fund*, at 463.
[6] The ruling does not deal with certain other grounds for dismissal argued by the defendants, stating that other issues will be dealt with separately. As of the date of this article, no additional rulings appear on the bankruptcy docket for the *Petters* cases.
[7] *Petters*, at 445.

asserted, "[t]he common sense, and well-recognized, effect of [substantive consolidation] is a complete and unqualified merger of the respective Debtors' estates, including a combination of their debt structures, into one, singular, consolidated estate," rendering standing challenges moot or subject to "straight-out reject[ion]."[8]

The Bankruptcy Court rejected the Trustee's argument as "largely conclusory" and "deeply flawed". As explained by the Bankruptcy Court, the Trustee's argument ignored the historical and separate pre-petition existence of the debtors. Additionally, the Trustee's argument was inconsistent with the text of the substantive consolidation order, itself, which did not change the status or structure of the Debtor-entities as separate persons under non-bankruptcy law but rather altered only the structure of the bankruptcy estates that were associated with those Debtor-entities. Finally, substantive consolidation did not alter the underlying substantive law governing avoidance rights held by the consolidated estate in the PCI cases:

> Where substantive consolidation is ordered, all rights of avoidance premised on such a pre-bankruptcy reality go with everything else in and associated with the prior estates, into a coordinated administration by the trustee of the post-consolidation estate. If all pre-consolidation rights of avoidance are expressly preserved by the grant of substantive consolidation, they are assumed bodily into the estate. Necessarily, they retain all of the substantive integrity they had when they reposed in the separate debtors' estates. The passage alone does not alter anything about such preserved rights of avoidance.[9]

Accordingly, the Bankruptcy Court held that its substantive consolidation order did not permit the Trustee to satisfy the predicate-creditor requirement when the transferor-Debtor lacked any third-party creditors of its own, not related to it, as of the relevant date. As such, the Trustee lacked standing to pursue its state-law avoidance claims under Bankruptcy Code section 544(b).

IV. <u>Conclusion</u>

While the Eighth Circuit's holding that the Petters lenders were not "aggrieved persons" despite the substantive consolidation of their borrower SPEs and the potential loss of litigation defenses is troubling, lenders may breathe a sigh of relief at the ultimate ruling of the Bankruptcy Court – which minimized the impact of the substantive consolidation ruling on their pre-petition defense. It remains important for lenders to pay attention to substantive consolidation risks in the structuring of their loans, especially to minimize the chances of being "crammed down" by impaired creditors in the context of a bankruptcy case.

[8] *Id.* at 450.
[9] *Id.* at 454.

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