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Spotlight On Section 550 Of The Bankruptcy Code

Law360, New York (July 18, 2012, 5:09 PM ET) -- The "benefit of the estate" language of section 550 of the Bankruptcy Code informs and guides most bankruptcy practice. It permits the trustee to recover property from a transfer avoided pursuant to sections 544, 545, 547, 548, 549, 553(b), or 724(a). However, the "benefit of the estate language" often is limited by courts and practitioners to take into consideration only benefit to creditors of the estate; rather than to all of the various constituencies comprising the bankrupt estate, including equity. This is too narrow an application of the statute.

As discussed below, "the benefit of the estate" language of section 550 is intended to have the broadest application encompassing any benefit, whether direct or indirect, and regardless of whether recovery is in excess of creditor's claims.

Discussion

Section 550 of the Code provides, in pertinent part:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from--
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550.

Courts routinely hold that the "benefit of the estate" language of section 550 refers to any positive benefit to the estate, whether direct or indirect. See, e.g., Calpine Corp. v. Rosetta Res. Inc. (In re Calpine Corp.), 377 B.R. 808, 813 (Bankr. S.D.N.Y. 2007 ("broadly" construing "benefit of the estate" language in section 550 to enable recovery "even in cases where distribution to unsecured creditors [pursuant to a plan of reorganization] … in no way varies with recovery of avoidable transfers."); NextWave Pers. Commc'ns Inc. v. FCC (In re NextWave Pers. Commc'ns Inc.) (hereinafter "NextWave"), 235 B.R. 305, 308-09 (Bankr. S.D.N.Y. 1999), reversed on other grounds, FCC v. Nextwave Pers. Commc'ns Inc.), 200 F.3d 43 (2d Cir. 1999) (permitting recovery in excess of creditors' claims on the ground that "benefit" is also "interpreted broadly to include an indirect benefit such as an increase in the probability of a successful reorganization."); Trans World Airlines Inc. v. Travelers Int'l AG (In re Trans World Airlines Inc.) (hereinafter "TWA"), 163 B.R. 964, 973 (Bankr. D. Del. 1994) ("[T]he unsecured creditors will benefit from the enhanced value of reorganized TWA by reason of being shareholders of the reorganized debtor.").

In NextWave, a start-up telecommunications company successfully bid $4.74 billion to buy a block of 63 licenses from the Federal Communications Commission. After the auction, the FCC sold another block of licenses to the public, which significantly devalued the licenses bought by NextWave. NextWave filed for bankruptcy and brought a constructive fraudulent conveyance claim to avoid $3.7 billion of its $4.74 billion obligation to the FCC, asserting that the company was insolvent and that the fair market value of the licenses it purchased was only $1 billion.

The FCC argued that NextWave, a small company with few creditors, could not avoid its multibillion-dollar obligations because the debtor's payment obligation could be avoided only "to the extent necessary to benefit NextWave's bona fide creditors." NextWave, 235 B.R. at 306.

The bankruptcy court flatly rejected the contention that the entire obligation could not be avoided, finding that avoidance of the entire obligation is expressly permitted by the statute, regardless of whether the recovery exceeds the claims of existing creditors. In so holding, the Bankruptcy Court looked first to the broad meaning of the term "estate":

> The "estate" [referred to in section 550] comprises all interests, including all creditors and equity. Thus, it might be inappropriate to use the avoiding powers if the benefit accrued only to the equity or to only one creditor or one class of creditors. Under the "benefit of the estate" standard, "what matters is whether creditors will receive 'some benefit from the recovery of the [challenged transfers].'" In re Kennedy Inn Associates, 221 B.R. 704, 715 (Bankr. S.D.N.Y. 1998) (quoting from In re Centennial Industries Inc., 12 B.R. 99, 102 (Bankr. S.D.N.Y. 1981). See also In re Glanz, 205 B.R. 750, 758 (proper standard is "that recovery by [the debtor] will increase [the debtor's] assets and improve its financial health to the extent that the likelihood is improved of its being able to satisfy its obligations to its creditors under [a] Plan").

Id. at 308.

As the court noted, the nature of the benefit can vary from case to case and "[r]ecovery of the avoided transfer is appropriate even if the benefit to the estate is indirect." Id. at 309 (citing 5 COLLIER ON BANKRUPTCY P 550.02[2], p. 550-7 (15th ed. 1998)).

The NextWave court went on to look at these two concepts — the breadth of the "estate" and the nature of the benefit — together:

> The term "estate" is broader than the term "creditors," In re Trans World Airlines, Inc., 163 B.R. 964, 972 (Bankr. D. Del. 1994), and benefit has been interpreted broadly to include an indirect benefit such as an increase in the probability of a successful reorganization. See In re Tennessee Wheel & Rubber Co. (Tennessee Wheel & Rubber Co. v. Captron Corp. Air Fleet), 64 B.R. 721, 725-26 (Bankr. M.D. Tenn. 1986), aff'd, 75 B.R. 1 (M.D. Tenn. 1987); In re Sweetwater, 884 F.2d 1323, 1326-7 (10th Cir. 1989) (the Tenth Circuit found that if the estate representative appointed pursuant to section 1123(b)(3)(B) realized more cash from the fund's assets than the allowed amount of administrative claims, the remainder would go to the reorganized debtor, which would then be in a better position to meet its financial commitments, if any, under the plan); In re Acequia, Inc., 34 F.3d 800, 811-12 (9th Cir. 1994) (allowing recovery of fraudulent transfers even though unsecured creditors have been paid in full when recovery would aid continuing performance of post confirmation obligations and reimburse the bankruptcy estate for fraudulent conveyance litigation costs); In re Trans World Airlines, Inc., 163 B.R. at 973 ("basic purpose of recovery pursuant to § 550(a) is to enlarge the estate for the benefit of creditors … whether any of it is distributed is a function of the conduct of the case and the negotiations of the plan of reorganization"); In re Centennial Industries, Inc., 12 B.R. at 102 (recovery sufficient so long as unsecured creditors received some benefit from the recovery of the preferences, even if it was not an increase in the amount they would receive).

Id.

Based on these decisions from a wide array of courts, NextWave found that it could grant the remedy the debtor requested even though it went well beyond what was necessary to benefit creditors:

> Contrary to the FCC's position that avoidance be limited to the extent of the claims of existing creditors, it is well settled that once an obligation is deemed voidable the entire transfer is avoided to the extent necessary to benefit the estate, without regard to the size of the claims of the existing creditors whose rights and powers the debtor-in-possession is asserting … In this case, the appropriate remedy is avoidance of the entire obligation and reinstatement of the obligation to the extent of value given.

Id. at 308-09.

Thus, where a transfer is avoidable, the debtor may avoid the whole transfer even if the avoidance will provide a benefit to equity holders as well as to creditors, who collectively comprise the "estate."

Similarly, in Calpine, defendants moved to dismiss the debtor's fraudulent transfer action on the ground that the plan of reorganization would satisfy the claims of all creditors by issuing equity in the reorganized debtor. In re Calpine Corp., 377 B.R. at 813. The bankruptcy court denied the motion on the ground that the former creditors would benefit by virtue of an increase in the value of their equity stake in the reorganized debtor:

> Under the proposed plan of reorganization, several classes of unsecured creditors will be impaired because they are receiving only an equity stake in the reorganized company. See Davison v. East Tenn. Equity, Ltd. (In re Southern Indus. Banking Corp.), 59 B.R. 638, 641 (Bankr. E.D. Tenn. 1986) ("to the extent that plaintiff's recovery of fraudulent transfers and preferences operates to increase the assets and financial health of the successor-in-interest, it also operates to proportionately increase the value of those ownership rights in the successor-in-interest which constitute a portion of the unsecured creditors distribution under the plan.").

Id. at 814.

Similarly, in TWA, a defendant in an avoidance action moved to dismiss for lack of standing on the ground that TWA's confirmed Chapter 11 plan provided that all of the proceeds of the action would be used to repay exit financing TWA incurred to Carl Icahn in order to confirm its plan and none of the proceeds would be used to pay prepetition creditors. TWA, 163 B.R. at 973. The bankruptcy court rejected this argument:

> TWA argues, and I agree, that the unsecured creditors will benefit from the enhanced value of reorganized TWA by reason of being shareholders of the reorganized debtor. It is of little moment that the recovery may be immediately paid to Icahn. If a $13 million payment to Icahn does not come out of the recovery, then it will necessarily come out of other TWA assets.

Id.

It is thus well established that in determining whether a recovery in an avoidance action is "for the benefit of the estate" one cannot adopt a myopic view of how the proceeds are allocated under a comprehensive Chapter 11 plan.

Moreover, whether some of the benefit will flow to equity is immaterial as a matter of law. As discussed above, courts have "decline[d] to embrace an all-encompassing bright-line rule holding that a fraudulent conveyance claim can never be brought to benefit equity."[1]

In re Calpine Corp., 377 B.R. at 813 n.3 (citing In re Bayou Group LLC, 372 B.R. 661, 664 (Bankr. S.D.N.Y. 2007) (denying motion to dismiss avoidance action where alleged facts suggested recovery to equity could constitute benefit to the estate under section 550)); see also Mellon Bank NA v. Dick Corp, 351 F.3d 290, 293 (7th Cir. 2003) (Code does not require that all benefit must flow to unsecured creditors, but instead "speaks of benefit to the estate — which in bankruptcy parlance denotes the set of all potentially interested parties," including equity); Acequia Inc. v. Clinton (In re Acequia Inc), 34 F.3d 800, 811 (9th Cir. 1994) (reversing district court's imposition of "cap" on recovery to extent of unsecured creditors claims and following example of many courts that "have refused to dismiss avoidance actions" where litigation could benefit estate "even though the unsecured creditors had received full distributions under a plan of reorganization").

Conclusion

Whether constructing plans of reorganization or crafting adversary complaints, practitioners should avoid a narrow reading of section 550 and not be hesitant to impress upon the court and interested parties the lawful need to protect and "benefit" all estate constituencies even seeking, where possible, recovery in excess of creditor's claims.

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[1] See also Citicorp Acceptance, 884 F.2d at 1327 (permitting recovery in excess of creditors claims because the remainder would "go to the reorganized debtor who will then be in a better position to meet its financial commitments, if any, under the plan."); TWA, 163 B.R. at 973 (permitting recovery in excess of creditors claims because such creditors were also "shareholders of the reorganized debtor" who would "benefit from the enhanced value of" the reorganized corporation); Temex Energy v. Hastie & Kichner, P.C. (In re Amarex, Inc.), 96 B.R. 330, 334 (W.D. Okla. 1989) (appointee under section 1123(b)(3)(B) who sought avoidance of certain transfers was a "representative of the estate" acting for the "benefit [of] the unsecured creditors," where recovery would "increase the financial assets of the debtor's successor-in-interest and would thus increase the value of the [creditors'] ownership rights in the successor-in-interest."); DuVoisin v. East Tenn. Equity, Ltd. (In re Southern Indus. Banking Corp.), 59 B.R. 638, 641 n.5 (Bankr. E.D. Tenn. 1986) (same).