For Whose Benefit? Courts in Adelphia and eToys Bankruptcies Decline to Unwind Transactions Where Suits Do Not Serve Goal of Creditor Protection

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When one of the parties to a transaction files for bankruptcy, counterparties may find themselves as defendants in fraudulent transfer or other bankruptcy litigation seeking to "unwind" or "avoid" the transaction. In recent decisions by the Second and Third Circuits, defendants (represented by WilmerHale) successfully defended against such litigation on grounds that the debtor's creditors were not harmed by the challenged transactions and would not benefit if the transactions were unwound. These decisions—*Adelphia Recovery Trust v. Bank of Am.*[1] and *In re EBC I, Inc. (f/k/a eToys, Inc.)*[2]—confirm that certain bankruptcy-law remedies exist only for the benefit of the debtor's creditors, and that where those creditors will not properly receive any benefit from a suit to enforce those remedies, the suit may not proceed.

Background: Bankruptcy Avoidance Actions

The Bankruptcy Code provides debtors and trustees, and in some instances creditors' committees, with the power to unwind certain transactions that the debtor entered into before bankruptcy where those transactions disadvantaged the debtor's creditors. This includes the power to "avoid" as a "fraudulent transfer," subject to certain defenses and limitations, a transfer of assets or an incurrence of obligations, where the transfer or incurrence was intended to defraud creditors by moving assets beyond their reach, or where the transfer was "constructively fraudulent" because it depleted an insolvent debtor's assets needed to repay its creditors.[3] The trustee may also avoid as a "preferential transfer" a payment or other transfer that gave a creditor more value than it would have received through a bankruptcy liquidation, again subject to certain defenses and limitations.[4] If a fraudulent or preferential transfer is avoided, the plaintiff may recover the transferred assets or their value and, in the case of a fraudulent transfer, may potentially treat the avoided obligations as unenforceable against the debtor's other creditors. The Bankruptcy Code also provides other remedies to redress harm to creditors, including the power to "equitably subordinate" the claim of a creditor that acted inequitably toward the debtor's other creditors, so that the injured creditors' claims are paid before the claim of the wrongdoer.[5]

Because these bankruptcy remedies can upset otherwise lawful, settled transactions, courts have guarded against unduly broad use of these remedies where they would not serve their underlying purpose—to protect the debtor's creditors. The recent *Adelphia* and *eToys* decisions each highlight this proposition, from two points of view. In *Adelphia*, the avoidance action failed because the creditors of the applicable debtors were already paid in full, and therefore there were effectively no such creditors remaining to be protected. In *eToys*, the avoidance action failed because the creditors of the debtor would not have been any better off had the transfer not occurred, and therefore there was no harm to such creditors.

***Adelphia*: Bankruptcy Remedies are for the Benefit of Creditors, Not Shareholders**

The *Adelphia* litigation arose out of the bankruptcy filings of Adelphia Communications Corporation ("ACC") and more than 250 of its subsidiaries. A litigation trust formed during the bankruptcy case to represent ACC and its subsidiary debtors sued numerous banks for their participation in multi-billion dollar credit facilities that permitted ACC's management to borrow, allegedly for their own personal use, money that ACC's operating subsidiaries were ultimately required to repay. In addition to asserting liability under various theories of state tort law, the trust asserted causes of action against the banks under bankruptcy law. These causes of action—for fraudulent transfer, preferential transfer, and equitable subordination—sought to set aside and recover billions of dollars in loan obligations incurred and repaid by the operating subsidiaries to the banks.

The Second Circuit affirmed, by summary order, the district court's dismissal of all of the bankruptcy-law causes of action for "[s]ubstantially the reasons stated in the District Court's comprehensive Memorandum and Order."[6] In that ruling,[7] the district court had held that the trust could not pursue the bankruptcy causes of action to set aside the subsidiaries' loan obligations to the banks because, following a successful bankruptcy sale of assets for $19 billion, those subsidiaries had confirmed chapter 11 plans of reorganization that repaid all of their creditors in full, with interest. The court held that these bankruptcy remedies may be brought only for the benefit of the creditors of the particular debtor that engaged in the challenged transaction, and cannot be pursued where they would benefit only the debtor itself or its shareholders (or those shareholders' separate creditors).[8] Accordingly, the district court held the trust lacked standing to pursue the bankruptcy causes of action to set aside the operating subsidiaries' obligations to the banks, because those subsidiaries' creditors had been made whole and would not benefit from such relief.

Furthermore, the district court rejected the trust's argument that it could pursue the bankruptcy causes of action for the benefit of two other groups of purported creditors—intercompany claimants and creditors of parent companies. As to the first group, the court held that the holders of any disputed intercompany claims against the operating subsidiaries were not existing creditors who would benefit from the bankruptcy causes of action, because those claims had been resolved under the terms of a settlement in the chapter 11 plan and were entitled to no distributions. As to the second group, the court held that the trust could not pursue the bankruptcy causes of action for the benefit of the separate creditors of the operating subsidiaries' parent companies (which creditors had not been paid in full), because the plan respected the corporate separateness of the parent and subsidiary debtors, and accordingly the unpaid creditors of the parent companies were not creditors of the particular operating subsidiaries that incurred the challenged loan obligations. This reasoning highlights both the importance of the "for the benefit of creditors" principle of avoidance actions and the relevance of the terms of chapter 11 plans consummated before such actions are litigated.

eToys: Fraudulent Transfer Law Turns on Harm to Creditors, Not Gain by Transferee

In the *eToys* decision, the Third Circuit affirmed the dismissal of a fraudulent transfer action challenging the termination of a contract with the debtor because the termination did not harm the debtor's creditors, even though it purportedly benefited the counterparty. Before its bankruptcy filing, eToys, an online retailer, entered into a marketing services agreement with America Online, Inc., pursuant to which it pre-paid for two years of advertising in the shopping area of AOL's website. The payments were non-refundable, and AOL had the right to terminate the agreement if eToys became insolvent, a provision AOL believed was important to protect its members and brand. Months later, eToys announced that it was insolvent and would cease operations, and AOL accordingly terminated the agreement (prior to eToys' bankruptcy filing). After filing for bankruptcy, eToys sought to avoid the termination and to recover the value of the unused advertising services as a constructively fraudulent transfer under Bankruptcy Code section 548. That provision permits a trustee to avoid certain pre-bankruptcy transfers of the debtor's interests in property if the debtor was insolvent and received less than "reasonably equivalent value" in exchange for the transferred property.[9]

In affirming the dismissal of eToys' fraudulent transfer claim, the Third Circuit held that AOL's termination of the agreement (to the extent it was a "transfer" of eToys' advertising rights back to AOL) did not leave eToys and its creditors any worse off. The bankruptcy court had found that even if the agreement had not been terminated, eToys could not have realized any value from the advertising rights because it had gone out of business and it was prohibited under Bankruptcy Code section 365(c) from assigning those rights for sale to any third party.[10] The Third Circuit rejected eToys' argument that its estate was entitled to the value AOL might have realized by reselling the advertising rights following termination of the agreement. The Court of Appeals explained that "[b]ecause 'the fraudulent conveyance laws are intended to protect the debtor's creditors, ... the question whether the debtor received reasonable value must be determined *from the standpoint of the creditors*.'"[11] Thus, the relevant question was not what value AOL might have gained from terminating its contract with the debtor, but what value the debtor's creditors lost as a result—if any. Because eToys could not have realized any value from the advertising rights in any event, the termination of those rights did not diminish the assets from which the claims of eToys' creditors could be satisfied, and the termination therefore could not be challenged as a fraudulent transfer.[12]

The Bottom Line

The recent Court of Appeals decisions in *Adelphia* and *eToys* emphasize that the Bankruptcy

Code's avoidance remedies are intended to redress harm to the creditors of the particular debtor on whose behalf the avoidance action is commenced. Accordingly, if there is no harm to those creditors, or if those creditors' claims have otherwise been satisfied, then, like the defendants in *Adelphia* and *eToys*, a defendant may be able to argue that the avoidance action should not proceed, even if the other elements of the avoidance claim are met. Therefore, it is important for defendants in bankruptcy avoidance actions to assess not only the traditional bankruptcy defenses, but also whether the question "For whose benefit?" will affect the viability of those actions.

[1] 2010 WL 2094028, No. 09-0039-cv (2d Cir. May 26, 2010).

[2] 2010 WL 2094028, No. 09-0039-cv (2d Cir. May 26, 2010).

[3]*See* 11 U.S.C. § 548(a)(1)(A)-(B); id. § 544(b) (incorporating state fraudulent-transfer law).

[4]*See* 11 U.S.C. § 547.

[5]*See* 11 U.S.C. § 510(c).

[6] 2010 WL 2094028, at *1.

[7]*Adelphia Recovery Trust v. Bank of Am.*, 390 B.R. 80 (S.D.N.Y. 2008).

[8]*Id*. at 93-94 (citing *Whiteford Plastics Co. v. Chase Nat'l 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)).

[9]*See* 11 U.S.C. § 548(a)(1)(B).

[10]*In re EBC I, Inc. v. America Online, Inc. (In re EBC I, Inc., f/k/a eToys, Inc.)*, 380 B.R. 348, 362-63 (Bankr. D. Del. 2008). While sections 365(a) and (f) of the Bankruptcy Code generally permit assumption and assignment of executory contracts by debtors in bankruptcy, section 365(c) prohibits assumption or assignment of an executory contract if applicable law excuses the counterparty from accepting performance from or rendering performance to an entity other than the debtor. *See* 11 U.S.C. §§ 365(a), (c)(1), and (f)(1). In the *eToys* case, the bankruptcy court determined that pursuant to applicable Virginia state law, under which a contract is not assignable where the identities of the parties to the contract are material to the ongoing performance of the contract, the AOL contract was not assignable, and that assignment was therefore prohibited under section 365(c). *See* 380 B.R. at 363.

[11] 2010 WL 2181597, at *1 ((emphasis added) (quoting *Mellon Bank, N.A. v. Metro Commc'ns, Inc.*, 945 F.2d 635, 646 (3d Cir. 1991))).

[12]*Id*. at *2.

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