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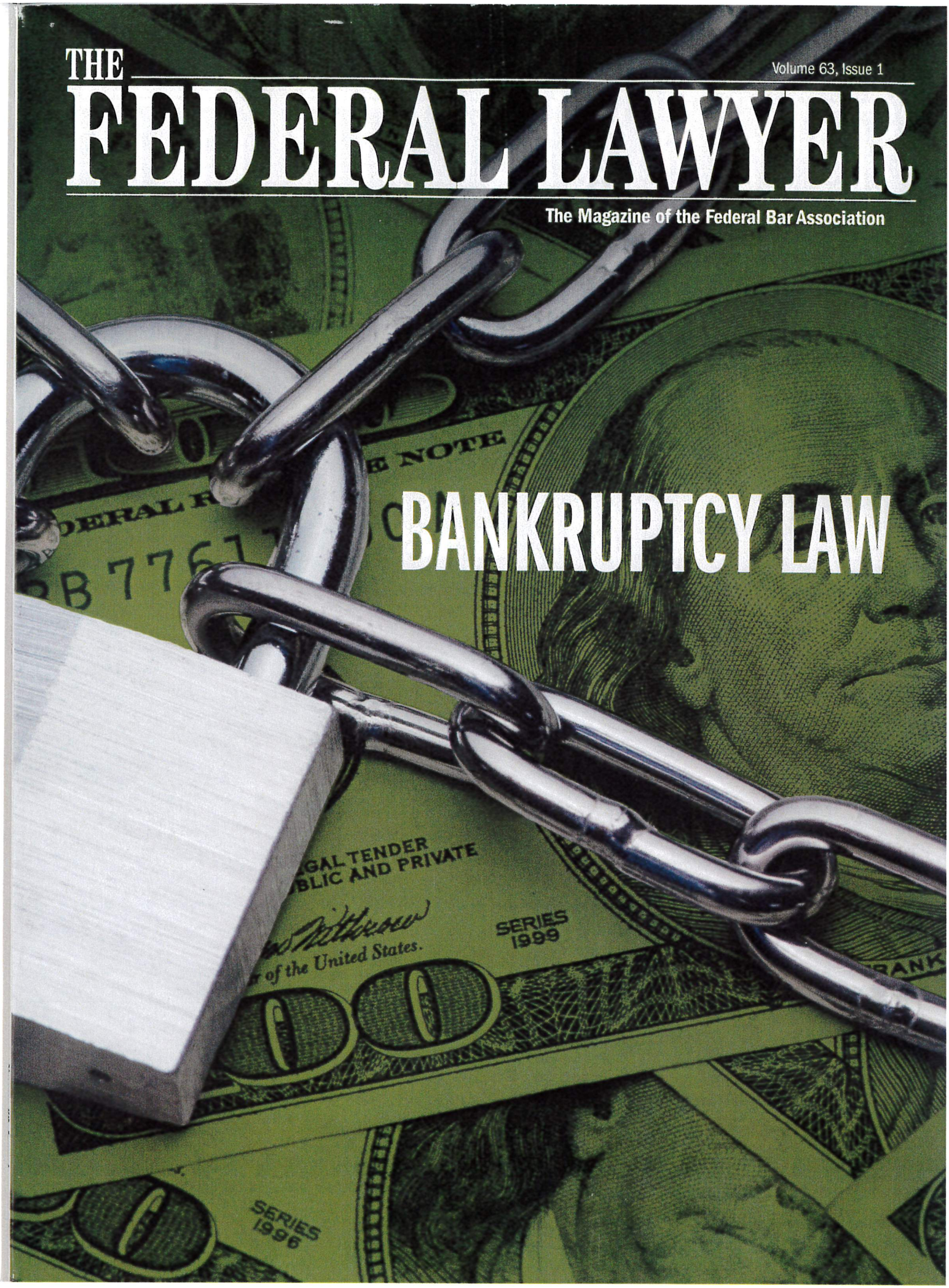


Can A Waiver of Indemnification Insulate an Insider-Guarantor From Preference Liability?

PAUL AVRON AND JORDI GUSO

The Ninth Circuit in *Stahl v. Simon* (*In re Adamson Apparel Inc.*)[1] addressed an issue that has divided bankruptcy courts and puts a different spin on *Levitt v. Ingersoll Rand Financial.* (*In re Deprizio*).[2] In *Deprizio,* the Seventh Circuit held that a trustee could avoid, as preferential, payments made to a lender during the extended one year look-back period that, by definition, benefited a guarantor by reducing his guarantee exposure dollar for dollar.[3] In the wake of *Deprizio*, Congress amended the U.S. Bankruptcy Code to apply the extended look-back period to payments made on loans guaranteed by insiders, but limited recovery by trustees to insiders and not the lender-recipients of the underlying payments.[4]

In *Stahl v. Simon*, the Ninth Circuit reviewed a bankruptcy court judgment in favor of an insider–guarantor on a Chapter 7 trustee's preference action. Adamson Apparel Inc. (the debtor), which manufactures and sells clothing and accessories, obtained a loan from CIT Group Commercial Services and, to secure the loan, granted CIT a lien on its inventory and accounts receivable.[5]

Adamson Apparel President and CEO Arnold Simon, subsequently entered into a cash collateral pledge agreement and limited guarantee in favor of CIT, each of which waived any right to indemnification if and to the extent Simon was called upon to satisfy the underlying debt or any portion thereof.[6]

In late 2003, BP Clothing LLC bought a substantial amount of inventory from Adamson Apparel (upon which CIT held a perfected lien), who instructed BP Clothing to pay the purchase price (approximately $5 million) to CIT to pay down the underlying debt owed to it by Adamson Apparel.[7] In September 2004, Adamson Apparel filed a Chapter 11 petition.[8] Prior to the filing, Simon paid CIT $3.5 million, the balance of the debt owed to CIT, from his personal funds.[9] A creditors committee filed a preference action against Simon as the beneficiary of the approximately $5 million payment made to CIT by BP Clothing.[10] The creditors committee sought to recover an "indirect preference" from the insider for payments made by the debtor to its secured creditor where the payments reduced the insider–guarantor's liability to the secured creditor. Because a preference is a transfer on account of an antecedent debt, a preference may only be recovered from one who is a creditor.

Although Simon did not directly receive any of the proceeds of the sale to BP Clothing, § 550(a)(1) of the Bankruptcy Code permits the estate to recover a transfer avoided under § 547 from the initial transferee or "the entity for whose benefit such transfer was made." This cause of action is commonly referred to as an "indirect preference" because the defendant is not the recipient of the transfer but, rather, the one who benefited from the transfer. Indirect preference claims are not limited to claims against insiders. For example, these claims may also be brought against subordinate lienholders who "benefit" from payments made to the senior lienholder.[11]

The bankruptcy court granted Simon's motion for summary judgment, holding that he was not a "creditor" as required by Code § 547(b), given his waiver of the right to indemnification from the debtor.[12] On intermediate appeal, the district court reversed and remanded with direction for the bankruptcy court to examine whether, because of an ambiguity between the pledge and guarantee, Simon had unequivocally and irrevocably waived a right to indemnification from the debtor.[13]

The referenced ambiguity that existed between the pledge and guarantee was that the former provided that Simon "defers all statutory, contractual, common law, equitable, and all other claims against [Adamson Apparel]," while the latter provided that Simon "irrevocably waives and agrees that he will not exercise any and all rights which he has or may have at any time … to assert any claim against Adamson [Apparel] or any other party on account of payments made under this Guaranty or otherwise, including … any and all existing and future rights of subrogation, reimbursement, exoneration, contribution and/or indemnity."[14]

On remand, Simon testified as to his understanding that he never had a right to indemnification, that CIT required the indemnification waiver and his preference was to maintain that right, and that he never filed a proof of claim against the estate.[15] The bankruptcy court entered judgment for Simon because the committee failed to demonstrate he was a creditor, finding that Simon's testimony prevailed over any ambiguity between the pledge and guarantee.[16] The district court affirmed, holding that the bankruptcy court did not commit clear error in concluding that the committee failed to demonstrate Simon was a creditor.[17] Given conversion of the debtor's Chapter 11 case to a case under Chapter 7, the trustee took over the appeal to the Ninth Circuit.[18]

The Ninth Circuit was asked to determine whether, given that (1) the insider–guarantor waived his right to indemnification from the debtor, (2) there was a bona fide basis for that waiver, and (3) the insider–guarantor neither purchased the lender's claim nor filed a claim against the debtor's estate, the insider-guarantor had preference exposure for monies paid to the lender within the one year look-back period that reduced his guarantee exposure. The Ninth Circuit affirmed the bankruptcy court's judgment, which had been affirmed on intermediate appeal to the district court, in favor of the insider–guarantor, holding that because Simon waived his right to indemnification from the debtor, did not purchase the lender's claim, and did not file a claim against the debtor's estate, he was not a creditor of the estate and, thus, was immune from preference liability.

Initially, the Ninth Circuit found no error in the remand ordered by the district court, finding that an ambiguity under applicable New York law existed between the pledge and guarantee.[19] The Ninth Circuit, like the district court before it, found no error in the bankruptcy court's finding that Simon waived any right to indemnification based on the language in the guarantee, Simon's testimony that he understood he had no right to indemnification, and the fact that he had not filed a proof of claim.[20]

The trustee urged the Ninth Circuit to join cases "in stepping away from the plain text of the Code" and hold that a waiver of the right to indemnification, even if unconditional, does not preclude preference liability for an insider–guarantor where he or she is the beneficiary of a transfer to the lender.[21] These cases, the Ninth Circuit recognized, stemmed from the Seventh Circuit's decision in *Deprizio*.[22] Quoting from *Deprizio*, the Ninth Circuit recognized that "[i]nsiders pose special problems"; that is, they "will be the first to recognize that the firm is in a downward spiral. If insiders and outsiders had the same preference–recovery period, insiders who lent money to the firm could use their knowledge to advantage by paying their own loans

preferentially, then putting off filing the petition in bankruptcy until the preference period had passed."[23] Unsurprisingly, Simon urged the Ninth Circuit to join cases that post-dated *Deprizio* but pre-dated the amendments to the Code, holding that a bona fide waiver of the right to indemnification was valid and excused an insider-guarantor from preference liability.[24] Those cases, the Ninth Circuit stated, "'apply the letter of the statute to the facts before [them]' rather than focusing on broader concerns of public policy."[25] The Ninth Circuit agreed that the concern expressed in the cases relied upon by the trustee about "sham" waivers—that is, that such waivers were invalid because the insider could purchase the underlying debt from the lender—transformed the insider from a guarantor into a lender, making the insider a creditor.[26] The Ninth Circuit elected to focus on what *actually* transpired, however, as opposed to what *might* transpire and, in doing so, explained that "courts should instead examine the totality of the facts before them for evidence of 'sham' conduct in the circumstances."[27] The Ninth Circuit rejected application of a bright line rule and instead opted for an examination of the totality of the circumstances to determine if the waiver was a "sham."[28]

Applying that construct, the Ninth Circuit concluded that Simon's indemnification waiver was not a sham because: (1) CIT's lien secured its claim, and it would be paid first from its collateral in the absence of Simon's guarantee; (2) Simon never filed a proof of claim, and the payment from BP Clothing fell substantially short of satisfying the underlying debt, hence Simon's payment of $3.5 million of his personal funds; (3) Simon had no contractual right to purchase the debt from CIT; and (4) the committee presented no evidence that the debt Simon guaranteed was the only debt Simon guaranteed on Adamson Apparel's behalf.[29]

The Ninth Circuit explained that, given that it was dealing "with a clearly drafted statute," requiring that the preference defendant be a "creditor" it was "not at liberty to deviate from the text in favor of a generalized notion of public policy."[30] The Ninth Circuit reiterated that Simon waived any right to indemnification at CIT's insistence, that that waiver was not precluded by the Code, nor did the Code impose preference liability "simply because [Simon] received a benefit—and a contingent one at that—from the payment by BP Clothing to CIT."[31]

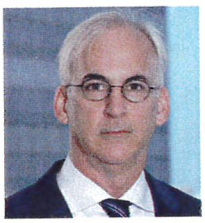
Finally, the Ninth Circuit noted that public-policy concerns surrounding the issue of insider–guarantor preference liability were valid, but it was for Congress, not the courts, to address them.[32] The Ninth Circuit held that when an insider–guarantor, like Simon, had a bona fide basis for waiving the right to indemnification and took no action to mitigate the economic impact of that waiver, i.e., purchase the lender's claim and/or file a proof of claim, "he is absolved on any preference liability to which he might otherwise have been subjected."[33]

Judge Susan Graber, in her dissent, argued that Simon was a "creditor" under the line of cases urged by the trustee, holding that the indemnification waiver was ineffective and that it was an error for the majority to consider "extraneous facts" on appeal in determining that the waiver was valid. Graber explained that "[e]very bankruptcy court to have addressed the issue since the … 1994 amendments to the Bankruptcy Code have agreed: insider-guarantors such as Simon are 'creditors' for purposes of the Code even if they nominally have waived their right to indemnity."[34]

In support of her dissent, Graber quoted from the following language in *Telesphere Liquidating Trust v. Galesi (In re Telesphere Communications Inc.)*[35]: "[S]uch a waiver has no economic impact—if the principal debtor pays the note, the insider guarantor would escape preference liability, but if the principal debtor does not pay the note, the insider could still obtain a claim against the debtor, simply by purchasing the lender's note rather than paying on the guarantee. Thus, the [waiver] could only be seen as an effort to eliminate, by contract, a provision of the Bankruptcy Code. The attempted waiver of subordination rights was thus held to be a sham provision, unenforceable as a matter of public policy."[36]

Judge Graber heavily criticized the majority for considering "additional facts in an open-ended inquiry into whether the waiver was a 'sham'" as "not supported by precedent or by logic" and "irrelevant."[37] Judge Graber explained that such waivers "are invalid for purposes of the Bankruptcy Code because they attempt to defeat the one-year look-back period via contract, even though the waivers have no real-world economic impact."[38] Finally, Judge Graber argued that the issue of whether Simon's $3.5 million payment to CIT was on behalf of Adamson Apparel or a personal debt was in dispute, that the bankruptcy court expressly declined to reach that issue and, therefore, the majority engaged in unauthorized appellate fact-finding and, in all events, got it wrong, pointing to a proffer by the committee made to the bankruptcy court on remand.[39]

The authors submit that the Ninth Circuit's adoption of a totality of the circumstances approach to considering the validity of an indemnification waiver by an insider–guarantor is the proper approach. To have a blanket prohibition on such waivers without looking into whether it was required by the lender and whether the insider filed a claim are appropriate inquiries for a bankruptcy court to make before determining if an insider–guarantor is subject to preference liability on an "indirect preference" claim as the beneficiary of a payment made by the debtor to the holder of the insider's guarantee. ⊙



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Endnotes

1 785 F.3d 1285 (9th Cir. 2015).

2 874 F.2d 1186 (7th Cir. 1989) (hereafter, *Deprizio*).

3 *Id.* at 1200-01.

4 *Adamson Apparel,* 785 F.3d at 1292.

5 *Id.* at 1287.

6 *Id.* at 1288.

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.*

11 *See Gladstone v. Bank of Am. N.A. (In re Vassau)*, 499 B.R. 864 (Bankr. S.Cal. 2103); *see also Matter of Prescott,* 805 F.2d 719 (7th

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Illinois,[19] Michigan,[20] and New York,[21] have found the rent approach to be more consistent with congressional intent.

To resolve this split, the court focused its analysis on the text of the statute—"the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease." Judge Carey concluded that a natural reading of this language supports utilizing the time approach over the rent approach for three reasons. First, comparing the greater or lesser of two things is only possible when using parallel units. Because the first element of the § 502(b)(6) comparison is temporal (one year), the second element (remaining term) must necessarily refer to time. Second, allowing a rent-based claim would render the "without acceleration" prohibition meaningless in situations where escalation clauses are present.[22] Finally, according to the court, the time approach is more constituent with the clear congressional intent from prior versions of the statute that expressly limited damages based on temporal measurements.

While the Third Circuit has yet to weigh in on the time vs. rent debate, the court's decision in *Filene's* likely means that debtors in Delaware can successfully foil future rent-based landlord claims.[23] However, until Congress clarifies the meaning of § 502(b)(6), a split of authority will remain, notwithstanding the *Filene's* decision.[24] As always, practitioners must know the law of the jurisdictions in which they appear for their clients. ⊙

Endnotes

[1] *In re Filene's Basement,* No. 11-13511-KJC, 2015 WL 1806347, at *1-2 (Bankr. D. Del. Apr. 16, 2015). The landlord was the successor in interest to an affiliated entity. Filene's was successor in interest to a prior tenant.

[2] *Id.* at *2.

[3] *Id.*

[4] *Id.* at *2-3.

[5] *Id.*

[6] 11 U.S.C. § 365(a).

[7] *See, e.g., Sharon Steel Corp. v. Nat'l Fuel Gas Dist. Corp. (In re Sharon Steel Corp.),* 872 F.2d 36, 39-40 (3d Cir. 1989).

[8] *Taylor Wharton Int'l LLC v. Blasingame (In re Taylor-Wharton Int'l LLC),* No. 10-52792-BLS, 2010 WL 4862723, at *3 (Bankr. D. Del. Nov. 23, 2010) (noting that rejection constitutes a pre-petition breach, not rescission of the contract).

[9] *In re Connectix Corp.,* 372 B.R. 488, 491 (Bankr. N.D. Cal. 2007).

[10] *Id.* at 492; *see also Oldden v. Tonto Realty Corp.,* 143 F.2d 916, 918 (2d Cir. 1944).

[11] *Connectix,* 372 B.R. at 492.

[12] *Id.*

[13] *Id.*

[14] 11 U.S.C. § 502(b)(6).

[15] *Connectix,* 372 B.R. at 491-93; *see also In re Iron-Oak Supply Corp.,* 169 B.R. 414, 420 (Bankr. E.D. Cal. 1994).

[16] *In re Shane Co.,* 464 B.R. 32, 40 (Bankr. D. Colo. 2012).

[17] *In re Ace Elec. Acquisition LLC,* 342 B.R. 831, 833 (Bankr. M.D. Fla. 2005).

[18] *Sunbeam-Oster Co. v. Lincoln Liberty Ave. Inc. (In re Allegheny Int'l Inc.),* 145 B.R. 823, 828 (W.D. Pa. 1992); *see also In re Peters,* No. 03-11077-DWS, 2004 WL 1291125, at *6 n. 20 (Bankr. E.D. Pa. May 7, 2004).

[19] *Schwartz v. C.M.C., Inc. (In re Communicall Cent., Inc.),* 106 B.R. 540, 544 (Bankr. N.D. Ill. 1989).

[20] *In re Gantos Inc.,* 176 B.R. 793, 795-96 (Bankr. W.D. Mich. 1995).

[21] *In re Andover Togs Inc.,* 231 B.R. 521, 540-41 (Bankr. S.D.N.Y. 1999).

[22] The court found unpersuasive the argument that the rent approach more appropriately provides landlords the benefit of their bargain by accounting for negotiated lease escalators. Congress started with the premise that landlords had no claim at all and, unlike other unsecured creditors, enjoy the added protection of ultimately reclaiming their property. According to the court, the time approach strikes the better balance of competing economic interests by providing landlords a set period of time to relet the premises.

[23] The *Filene's Basement* decision was not appealed to the district court.

[24] The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 suggested in its Final Report and Recommendations that § 502(b)(6) should be clarified consistent with the time approach.

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Cir. 1986).

[12] *Adamson Apparel,* 785 F.3d at 1288.

[13] *Id.* at 1289.

[14] *Id.* at 1290.

[15] *Id.* at 1288.

[16] *Id.* at 1289.

[17] *Id.*

[18] *Id.*

[19] *Id.* at 1289-91.

[20] *Id.* at 1291.

[21] *Id.* (citing cases, including *Miller v. Greystone Bus. Credit II LLC (In re USA Detergents Inc.),* 418 B.R. 533, 541-42 (Bankr. D. Del. 2009)).

[22] *Id.*

[23] *Id.* at 1292 (quoting *Deprizio,* 874 F.2d at 1195).

[24] *Id.* (citing cases, including *O'Neil v. Orix Credit Alliance Inc. (In re Ne. Contracting Co.),* 187 B.R. 420, 423-24 (Bankr. D. Conn. 1995)).

[25] *Id.* at 1293 (quoting *Hendon v. Assocs. Comm. Corp. (In re Fastrans),* 142 B.R. 241, 246 (Bankr. E.D. Tenn. 1992)).

[26] *Id.*

[27] *Id.* at 1293-94 (noting that the "mere possibility of such avoidance does not mean that it will routinely occur.").

[28] *Id.*

[29] *Id.*

[30] *Id.* at 1295 (citing *Norwest Bank Worthington v. Ahlers,* 108 S. Ct. 963, (1988)).

[31] *Id.*

[32] *Id.* at 1295-96.

[33] *Id.* at 1296.

[34] *Adamson Apparel,* 785 F.3d at 1296 (citing cases, including *Miller v. Greystone Bus. Credit II,* Note 21, *supra*).

[35] 299 B.R. 173, 177 n.3 (Bankr. N.D. Ill. 1999).

[36] *Adamson Apparel,* 785 F.3d at 1297.

[37] *Id.*

[38] *Id.*

[39] *Id.*