Bankruptcy Court Addresses 'Two-Transfer' Theory

Tara L. Lattomus
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In *Gellert v. Coltec Industries* (In re Crucible Materials), Adv. Case No. 11-53884 (Bankr. D. Del. Oct. 31, 2012), the U.S. Bankruptcy Court for the District of Delaware considered the application of the "two-transfer" theory to claims for fraudulent conveyance and unauthorized post-petition transfer against a guarantor.

The "two-transfer" theory was developed to protect non-insiders from the extended preference recovery period applicable to insiders. Insiders are subject to a one-year reach-back period from the petition date, but for non-insiders, only 90 days. Some courts had held that once preference liability had been established against an insider, recovery could be made against non-insiders if they received a benefit from the transfer, even for transfers outside of the 90-day period. A typical situation would involve a payment from a debtor to a non-insider lender that was guaranteed by an insider and that was made between 90 days and one year prior to the bankruptcy filing.

The "two-transfer" theory viewed the payment to the lender and the benefit to the insider (reduction of the guarantee) as two separate transfers so that the lender could not be sued to recover transfers made between 90 days and one year from the petition date. However, this issue was resolved in 1994 when a statutory amendment made clear that preference payments made beyond 90 days cannot be recovered from non-insiders. The court noted that the "two-transfer" theory was developed to address this discreet issue and that, with the amendment, it is no longer good law. However, the court further acknowledged that, independent of the "two-transfer" theory, if one transfer benefits both the primary creditor and a guarantor, the transfer may be constructively fraudulent as to the guarantor if the guarantor receives something more than "some indirect, unquantifiable" benefit.

On September 15, 1980, Onondaga County Industrial Development Agency issued bonds to purchase a pollution control facility and, the same day, leased the project to Colt Industries Inc., the predecessor of Coltec Industries Inc., pursuant to a financing lease. The lease required Colt to make payments on the bonds. Crucible Materials Corp. was a wholly owned subsidiary of Colt Industries Operating Corp. (CIOC). Colt owned all of CIOC's stock. In November 1985, CMC Holding Company Inc. and the Employee Stock Ownership Plan of Crucible purchased all of Crucible's stock from CIOC. CMC Holding and Crucible merged with Crucible as the surviving company. The transaction obligated Crucible to make the payments on the bonds and later, Crucible assumed the lease and became directly liable on the bonds. Colt, however, also remained liable for the bond payments and was therefore essentially a guarantor. Crucible made payments on the bonds until a month before filing for bankruptcy.

During the course of its bankruptcy, Crucible sold the pollution control facility to Crucible Industries LLC. The sale order directed that Onondaga be paid in full satisfaction of the bonds. Crucible's bankruptcy plan was confirmed in August 2010 and provided for the formation of a litigation trust to hold all remaining assets including causes of action. The litigation trustee filed suit against Coltec alleging, among other things, that Crucible's payments on the bonds resulted in fraudulent transfers to Coltec and that the satisfaction of the bonds pursuant to the sale order resulted in an unauthorized post-petition transfer to Coltec based upon the "two-transfer" theory. Coltec moved to dismiss for failure to state a claim. The court concluded that the benefit received by Coltec (reduced liability to Onondaga) from Crucible's payment and satisfaction of the bonds was sufficiently direct and quantifiable to make the transfers recoverable if the elements of the avoidance claims were proven by the litigation trustee.

However, that is as far as the litigation trustee got. With respect to the fraudulent conveyance claims, the court ruled that because the payments on the bonds resulted in a dollar-for-dollar reduction of an antecedent debt, there could be no claim for constructive fraudulent conveyance. The court also held that Coltec did not receive an unauthorized post-petition transfer, i.e., satisfaction of its guarantee, from the payment to Onondaga on the bonds. The sale order specifically authorized the payment to Onondaga and it was necessary to transfer the assets free of encumbrances to effectuate the sale for the benefit of the estate. Accordingly, the benefit Coltec received was "incidental" and not recoverable.

Tara L. Lattomus is a member of Eckert Seamans Cherin & Mellott and focuses her practice in the area of bankruptcy and creditors' rights. She has extensive experience representing debtors, committees and creditors in Chapter 11 bankruptcy cases in Delaware and around the country.