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Case Study: Onkyo Electronics V. Global Technovations

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Case Study: Onkyo Electronics V. Global Technovations

On Sept. 13, 2012, the U.S. Court of Appeals for the Sixth Circuit became the first circuit court to opine on whether *Stern v. Marshall*, 131 S. Ct. 2594 (2011), permits a bankruptcy court to fully adjudicate and enter final judgment in a fraudulent transfer action.

In *Onkyo Europe Electronics GMBH v. Global Technovations Inc.* No. 11-1582, the Sixth Circuit concluded that the bankruptcy court had constitutional authority to enter a money judgment, for \$6.1 million, against the defendants in an action brought by a Chapter 11 debtor to avoid a fraudulent transfer under section 544(b) of the Bankruptcy Code and the Uniform Fraudulent Transfer Act (UFTA) as enacted in Florida.

Background and Lower Court Decisions

Boiled down to their essence, the facts of the case are rather simple. Prior to seeking Chapter 11 relief, the debtor, GTI, purchased from the three defendants (sellers) the common stock in Onkyo America Inc. The purchase price was \$25 million, paid \$13 million in cash and \$12 million in three-year promissory notes. The notes went unpaid.

When GTI entered bankruptcy some 16 months after the transaction, the sellers filed proofs of claim for the \$12 million unpaid purchase price. GTI subsequently brought an action in the bankruptcy court, under section 544(b) of the Bankruptcy Code, to avoid the \$12 million obligation and recover the \$13 million payment. Section 544(b) permits the trustee to avoid transfers and obligations incurred by a debtor that are voidable under applicable law by an unsecured creditor.

Here, applicable law was the Florida UFTA, which would render GTI's transfer (the \$13 million in cash) and obligation incurred (the \$12 million in notes) an avoidable fraudulent transaction if GTI did not receive reasonably equivalent value in exchange and was insolvent when the transaction occurred or became insolvent as a result of the transaction. GTI also sought disallowance of the sellers' proofs of claim under Bankruptcy Code Section 502(d), which authorizes disallowance where the claimant is subject to an avoidance action and has not satisfied its liability to the estate.

From expert testimony and other evidence over a 17-day trial, the bankruptcy court found the fair market value of the OAI stock to be \$6.9 million, for which GTI paid \$21.6 million in value (the court discounted the \$12 million face value of notes to a present value of \$8.6 million). The court determined the \$6.9 million stock value not to be reasonably equivalent to the \$21.6 million consideration because Florida law generally requires the debtor to receive value of at least 70 percent of the value the debtor transferred before there can be reasonable equivalence.

As a result, and because the insolvency element of the Florida UFTA was satisfied, the court ordered that the obligation to pay the \$12 million in notes was avoided; that GTI was entitled to a \$6.1 million money judgment, being the difference between the \$13 million in cash paid by GTI and the \$6.9 million value of the stock; and that the sellers' proofs of claim were disallowed unless and until the \$6.1 million judgment was paid.

Importantly, the sellers were entitled to the credit of \$6.9 million against their liability only because the court determined that under the Florida UFTA, the sellers were "good-faith transferees." The U.S. District Court for the Eastern District of Michigan affirmed the bankruptcy court's rulings. Both the bankruptcy and district court decisions were issued before the Supreme Court's *Stern v. Marshall* ruling in June of 2011.

Fraudulent Transfer Decisions Post-Stern

After *Stern*, many bankruptcy and district court decisions have examined whether a fraudulent transfer action is among those "core" proceedings under 28 U.S.C. § 157(b) as to which the bankruptcy court may constitutionally enter a final judgment, or alternatively, whether the court has the authority only to submit proposed findings of fact and conclusions of law to the district court for de novo review.

The courts have applied varying analyses — some construing *Stern* broadly and some narrowly — and reached divergent results, often depending on whether the action is brought under Bankruptcy Code Section 544(b)(1) in conjunction with state fraudulent transfer law or under section 548, and particularly whether the defendants had filed proofs of claim in the bankruptcy case.

For example, in Official Comm. of Unsecured Creditors of *Appalachian Fuels LLC v. Energy Coal Res. Inc.* (In re Appalachian Fuels LLC), (Apr. 18, 2012), the court held that the bankruptcy court had authority to enter final orders and judgments on Section 544 and 548 claims. However, several district court decisions have held to the contrary, at least where the defendants had not filed proofs of claim. See, e.g., *Kirschner v. Agolia* (S.D.N.Y. May 9, 2012); *Stettin v. Centurion Structured Growth LLC* (S.D. Fla. Dec. 19, 2011).

The Sixth Circuit's Ruling

The Sixth Circuit framed the Stern issue narrowly — "whether the bankruptcy court had jurisdiction to require Onkyo to pay GTI \$6.1 million."

Interestingly, while the Sixth Circuit characterized the issue as one of subject matter jurisdiction, most courts have viewed Stern as dealing only with the authority of bankruptcy courts either to enter final judgments or proposed findings of fact and conclusions of law, i.e., an issue of the proper allocation of authority between the district court and the bankruptcy court. See, e.g., *Dev. Specialists Inc. v. Akin Gump Strauss Hauer & Feld LLP* (S.D.N.Y. 2011) ("Stern makes clear that the issues of jurisdiction and final adjudicative power are distinct").

Because the sellers had filed proofs of claim, the case was "fundamentally unlike" *Granfinanciera S.A. v. Nordberg*, 492 U.S. 33 (1989), upon which the court in Stern relied to a significant degree and where the Supreme Court had determined that the defendants in a fraudulent transfer action were entitled to a jury trial because they had not filed proofs of claim.

Here, however, Onkyo had "voluntarily" entered the bankruptcy case, and GTI's defense to that claim was the fraudulent transfer cause of action. The Sixth Circuit stated Stern's "limited" holding as follows: "when a claim is a 'state law action independent of the federal bankruptcy law and not necessarily resolvable by a ruling on the creditor's proof of claim in bankruptcy,' the bankruptcy court cannot enter a final judgment."

As such, the court easily concluded that there was no constitutional defect with the bankruptcy court's fully adjudicating whether the sale was a fraudulent transfer — it was not possible for the bankruptcy court to rule on the sellers' proofs of claim without first resolving the fraudulent transfer claim.

The more difficult question for the Sixth Circuit was whether the bankruptcy court could properly make the additional finding, a state law issue, that Onkyo was a "good-faith transferee" and "good-faith obligee" under Florida law because that finding might not have been necessary in resolving the proofs of claim. The court noted that in many cases, it will be necessary for the bankruptcy court to make the good-faith determination in order to determine how much of a proof of claim should be disallowed.

In this case, however, the finding turned out not to be necessary as a factual matter because the value of the stock was ultimately determined to be only \$6.9 million — far less than the \$13 million in cash. Thus, the \$12 million claim had to be disallowed in its entirety.

Nevertheless, the court concluded, "[w]e do not believe that Stern requires a court to determine, in advance, which facts will ultimately prove strictly necessary to resolve a creditor's proof of claim." Accordingly, the court affirmed the district court's judgment affirming the bankruptcy court's ruling.

Implications

The Sixth Circuit's analysis in GTI is noteworthy for several reasons. First, it construed Stern narrowly, focusing on limiting language in Stern holding that the matters beyond the bankruptcy court's final adjudicatory powers are those that involve state law, are independent of federal bankruptcy law and need not be resolved in the claims allowance process.

Post-Stern, many courts have noted this and other limiting language in the Stern opinion, but have determined that the court's underlying rationale requires the case to be construed broadly. Courts adopting this approach have viewed avoidance actions as quintessentially suits at common law that must be decided by an Article III judge (at least where the defendant has not filed a proof of claim). Thus, GTI may assist those litigants who advocate for a constricted view of Stern's reach.

Second, the court's analysis in GTI is interesting because it did not approach the Stern issue as whether a bankruptcy court is empowered to enter final judgment in fraudulent transfer actions categorically. Rather, the court examined the issue on a more granular level and focused on whether a particular finding or issue in the action was beyond the bankruptcy court's authority to enter a final money judgment — namely, the "good-faith transferee" issue.

It is difficult to assess how this approach might impact future litigation involving Stern issues in the Sixth Circuit, but one may reasonably conclude that if Stern is applicable on an issue-by-issue basis, then the potential exists for even more litigation of Stern issues.

Finally, in future cases involving the particular issue in GTI — whether a bankruptcy court has authority to make the good-faith transferee finding under the UFTA and enter final judgment — it is submitted that a litigant is not foreclosed from the position that the bankruptcy court may not enter final judgment if, at the conclusion of the trial, the facts are such that the good-faith determination was not necessary for purposes of resolving the defendant's proof of claim.

It is true that the court states that the bankruptcy court is not required to determine in advance which facts will be necessary to the claims allowance process. However, if the bankruptcy court ultimately need not have made the state law good-faith determination in order to resolve the defendant's proof of claim, the defendant may reasonably argue that the court should not enter final judgment but rather, issue proposed findings of fact and conclusions of law.