

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF MAINE**

In re:)	
)	Chapter 7
GREAT NORTHERN PAPER, INC.,)	
Debtor)	Case No. 03-10048
)	
)	
BCC EQUIPMENT LEASING CORP.,)	
Plaintiff)	Adv. Proc. No. 03-1081
v.)	
)	
GARY GROWE, et al.)	
Defendants)	
)	
)	
KATAHDIN FEDERAL CREDIT UNION,)	
Plaintiff)	Adv. Proc. No. 03-1082
v.)	
)	
GARY GROWE, et al.)	
Defendants)	
)	

MEMORANDUM OF DECISION

Great Northern Paper (“GNP” or “Debtor”) filed a voluntary Chapter 11 petition on January 9, 2003. The case was converted to Chapter 7 after the sale of substantially all of the Debtor’s assets. These consolidated adversary proceedings arise out of GNP’s pre-petition transfer of certain of its assets to its parent, Inexcon Maine, Inc. (“IMI”). IMI, in turn,

mortgaged the assets to Katahdin Federal Credit Union (“KFCU”) to secure repayment of loans made by KFCU to IMI or one of IMI’s shareholders, Lambert Bedard (“Bedard”).

BCC Equipment Leasing Corporation (“BCC”), the Debtor’s largest creditor, brought an adversary proceeding seeking to equitably subordinate the liens and claims of KFCU (Count I) and avoid the transfers of property to KFCU as a fraudulent transfer (Count II). KFCU commenced a separate adversary proceeding, seeking a declaration that it is entitled to full payment of the loans it made to IMI and Bedard. The Trustee asserted a counterclaim against KFCU based upon fraudulent transfer under Maine’s Uniform Fraudulent Transfer Act (“UFTA”) through §§ 544 and 550 (Counterclaim Counts I - III) and equitable subordination (Counterclaim Count IV). The two adversary proceedings have been consolidated. Before me is the Chapter 7 Trustee’s motion for partial or full summary judgment on Courts I, II and IV of his counterclaims against KFCU .

I. Background

Shortly after seeking relief under Chapter 11 the Debtor determined that it could not reorganize and sought to sell its assets as a going concern to the highest bidder. After a contested bidding procedure a sale of substantially all of GNP’s operating assets for roughly \$100 million was approved, including assets which had been transferred to IMI and mortgaged to KFCU before the commencement of the case. Recognizing that it could not comply with the asset sale agreement without recapturing the property conveyed to IMI, GNP commenced an adversary proceeding against IMI and others to avoid the pre-petition transfers under state law

through 11 U.S.C. §§ 544 and 550.¹

This action was put on a fast track because closing by a fixed date was a condition of sale and because the shutdown of operations had caused economic hardship throughout the region. Recognizing that KFCU claimed a mortgage interest in the disputed property to the extent of about \$3 million, the court, on its own motion, ordered that KFCU be added as a necessary party.

Following mediation before another judge, the original parties agreed to settle their dispute and dismiss the avoidance action, subject to court approval after notice and hearing in the Chapter 11 case. Among other things, IMI had agreed to reconvey most of the transferred assets to the Debtor without admitting liability. Having been added as a party, KFCU refused to go along. To overcome this problem, the Debtor dismissed KFCU from the action and the remaining parties agreed that their compromise would have no effect on the claims or interests of others in the disputed property, thereby preserving the status quo with respect to KFCU and other disputed lien holders.

The settlement agreement was presented to the court as the key to a timely closing of the sale of assets and it was approved over KFCU's objection. To protect the interests of KFCU and the other disputed lien holders, the order approving the sale required that a portion of the sale proceeds be placed in escrow pending resolution of those disputes. No appeal from the settlement order was taken. Sometime later the sale closed.

Presently, the Trustee seeks a determination that: (1) the transfer of certain assets by GNP to IMI and then by IMI to KFCU as security for repayment of a loan on June 4, 2001 was

¹ Specific provisions of the Bankruptcy Code, 11 U.S.C. §§ 101 et. seq. will hereinafter be referred to simply by their section number.

fraudulent; (2) KFCU is not entitled to a good faith transferee defense; (3) the Trustee is entitled to recover substantially all of the funds escrowed for the protection of KFCU under § 550; (4) KFCU's mortgage interest in the escrowed funds to be limited to \$155,000, the stipulated value of the Guest House; and (5) KFCU's interest be subordinated to the claims of general unsecured creditors under § 510(c).

II. Summary judgment standard

Summary judgment is proper “if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.”

Fed.R.Civ.P. 56(c); see also Rosenberg v. City of Everett, 328 F.3d 12, 17 (1st Cir. 2003).

The role of summary judgment is to look behind the facade erected by the pleadings and assay the parties' proof in order to determine whether a trial will serve any useful purpose. Conventional summary judgment practice requires the moving party to assert the absence of a genuine issue of material fact and then support that assertion by affidavits, admissions, or other materials of evidentiary quality. Once the movant has done its part, the burden shifts to the summary judgment target to demonstrate that a trialworthy issue exists. . . .

In conducting this tamisage, the . . . court must scrutinize the record in the light most flattering to the party opposing the motion, indulging all reasonable inferences in that party's favor. This standard is notoriously liberal--but its liberality does not relieve the nonmovant of the burden of producing specific facts sufficient to deflect the swing of the summary judgment scythe. Moreover, the factual conflicts relied upon by the nonmovant must be both genuine and material. For this purpose, "genuine" means that the evidence is such that a reasonable factfinder could resolve the point in favor of the nonmoving party, and "material" means that the fact is one that might affect the outcome of the suit under the applicable law.

Mulvihill v. Top-Flite Golf Co., 335 F.3d 15, 19 (1st Cir. 2003) (citations omitted).

III. Fraudulent Transfer

A. Factual Background

The relevant facts follow. On June 5, 2001, GNP transferred various properties to IMI including the Dolby Landfill, log scales, airport hangar, and approximately 3800 acres of land. According to Bedard, the consideration for that transfer was GNP's ability to get financing from KFCU through IMI. In order to secure repayment of a \$700,000 loan from KFCU, IMI granted KFCU a mortgage on the property it had acquired from GNP. IMI advanced \$620,000 of the loan proceeds to or for the benefit of GNP. That advance was reflected on the books of GNP and IMI as a loan from IMI to GNP. The property acquired by IMI had a value in excess of \$4,000,000. GNP subsequently repaid the loan to IMI and IMI repaid its loan to KFCU.² KFCU discharged the mortgage, but IMI retained title to all of the transferred properties. At the time of the loan GNP was experiencing cash flow problems and was generally not paying its debts as they became due, but about 90 days after they became due.

KFCU, through its attorney, was informed by GNP's attorneys that the consideration for the transfer of the properties from GNP to IMI to be cancellation of the GNP stock owned by IMI.

There are a number of creditors who held claims against GNP at the time of the disputed transfer on June 4, 2001 and who continued to hold claims at the time GNP filed its bankruptcy petition.

² KFCU's ongoing interest in the \$3 million held in escrow arises from additional mortgages granted by IMI on the same properties.

B. Analysis

1. Section 550

To the extent a transfer of property is avoided under § 544, section 550 allows a trustee to recover fraudulently transferred property, or its value, from an initial transferee or any immediate or mediate transferee of an initial transferee. See § 550(a)(1) and (2).

IMI is the undisputed initial transferee of property of the estate recovered pursuant to the settlement of a § 544 action. As IMI's mortgage, KFCU is undeniably an immediate transferee of IMI whose interest attached to the proceeds of sale by court order. The question is whether the settlement with IMI placed the proceeds in escrow beyond the reach of the Trustee under §550(a)(2).

KFCU's defense is that there may be no recovery under § 550(a)(2) without an avoidance under § 544. According to KFCU, the voluntary reconveyance of property by IMI without an admission of liability was not an avoidance of a transfer under § 544 even though it occurred as part of the settlement of an action brought under that section. Consequently, the settlement precludes recovery by the Trustee.

The plain language of § 550 does not require an adjudication under § 544 in favor of a plaintiff. A voluntary transfer may suffice as an avoidance under § 544 if the underlying facts allow the court to conclude that the § 544 action was the direct cause of the reconveyance.

In this instance the joinder of KFCU was ordered on the court's own motion because its apparent mortgage interest in the subject property made it a necessary party. Had KFCU remained a party its interest in the transferred properties would have been determined. The sticking points in this case are the settlement without KFCU and its dismissal without an

adjudication of liability under § 550(a)(2). But the reservation of rights with respect to KFCU in the settlement and approval order and the court ordered transfer of its interest to the sale proceeds left KFCU's defenses undisturbed. The Trustee now has the right to prove a fraudulent transfer as against IMI to meet the avoidance requirement of § 550 without naming IMI as a party and KFCU has a right to defend.

2. 14 M.R.S.A. § 3576(1)

Count I of the Trustee's counterclaim against KFCU is based upon 14 M.R.S.A. § 3576(1), which provides:

Transfers without receipt of reasonably equivalent value. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

Insolvency is defined at 14 M.R.S.A. § 3573 to mean:

1. Debts greater than assets. A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation.
2. Presumption of insolvency. A debtor who is generally not paying his debts as they become due is presumed to be insolvent.

For purposes of 14 M.R.S.A. § 3576(1), the Trustee has shown (1) the existence of creditors whose claims arose before the transfer of properties and (2) that GNP received less than reasonably equivalent value for the transferred properties. GNP's failure to pay debts as they came due at the time of the transfer also gives rise to the presumption of insolvency. Pursuant to Federal Rule of Evidence 301 "a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to

such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.” KFCU has failed to overcome the § 3573(2) presumption by showing that GNP was paying its debts as they became due. Instead, KFCU has attempted prove solvency under § 3573(1) by showing that GNP’s book value exceeded its debts. This effort is unsuccessful because the § 3573(1) test of insolvency is measured by fair value, not book value. Thus, KFCU has not overcome the presumption of insolvency. The Trustee has satisfied all the elements required for a fraudulent transfer under 14 M.R.S.A. § 3576(1).

3. 14 M.R.S.A. § 3575(1)(B)

Count II of the Trustee’s counterclaim is based on 14 M.R.S.A. § 3575(1)(B), which provides:

Fraudulent transfer. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

...

B. Without receiving a reasonably equivalent value in exchange for the transfer or obligations and the debtor:

- (1) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
- (2) Intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as the debts became due.

There are creditors with claims arising before and after the transfer, and GNP received less than reasonably equivalent value. There is no evidence concerning whether GNP was engaged or was about to be engaged in a business or transaction for which its remaining assets

were unreasonably small. Thus, the Trustee has not satisfied the elements of § 3575(1)(B)(1) .

With respect to § 3575(1)(B)(2), however, GNP reasonably should have believed that it would incur debts beyond its ability to pay its debts as they became due because of its failure to pay debts as they became due at the time of the transfer. Consequently, the transfer was fraudulent under 14 M.R.S.A. § 3575(1)(B)(2).

4. Good faith defense

Pursuant to 14 M.R.S.A. § 3578, a creditor entitled to relief under Maine's Uniform Fraudulent Transfer Act may obtain avoidance of a transfer to the extent necessary to satisfy the creditor's claim, subject to the limitations in § 3579. The limitation which KFCU claims is applicable is that a transferee who takes in good faith and for reasonably equivalent value has a defense to the fraudulent transfer action. 14 M.R.S.A. § 3579(1). This is an affirmative defense for which KFCU bears the burden of proof. See In re Model Imperial, Inc., 250 B.R. 776, 797 (Bankr. S.D. Fl. 2000). KFCU received reasonably equivalent value as collateral for its loan. The issue here is whether KFCU is entitled to the good faith defense. I conclude that KFCU has successfully presented the following facts raising that defense: KFCU inquired about the consideration that GNP would receive for the transfer to IMI, and was informed by GNP's attorneys that the consideration was cancellation of IMI's stock in GNP. There are no facts currently before me to suggest that KFCU was aware that GNP's stock was worthless.

The Trustee, relying heavily on the Model Imperial case, asserts that KFCU does not qualify for the good faith defense because it cannot remain willfully ignorant of GNP's fraudulent transfers. "Fundamental to the concept of good faith is that a transferee may not remain willfully ignorant of facts which would cause it [to] be on notice of a debtor's fraudulent

purpose” Model Imperial, 250 B.R. at 798. In that case, following trial, the court determined that the lender was not entitled to a good faith defense because, among other things, it made a loan which was inconsistent with industry practices, in violation of its own written policies and procedures, and made apparently with little or no due diligence. Id. at 798 -799. For the time being there are disputed material facts in the case which make summary judgment on the issue of KFCU’s good faith defense inappropriate. That issue will be determined at trial.

IV. Equitable Subordination

A claim may be subordinated under § 510(c) upon a showing of fraud or inequitable conduct. Katz v. Department of Justice (In re Bellucci), 29 B.R. 814, 815 (1st Cir. BAP 1983). I decline to enter summary judgement because there are disputed facts concerning whether KFCU is entitled to a good faith defense to the fraudulent transfer action and many of those disputed facts also weigh on the issue of whether KFCU engaged in inequitable conduct. Further, KFCU has made clear its position that it holds no claim against the estate. Therefore, if the Trustee recovers under § 550(a)2), there will be no claim or interest to subordinate.

V. Conclusion

The Trustee’s motion for summary judgement will be granted in part. The Trustee has satisfied the elements of a fraudulent transfer under 14 M.R.S.A. §§ 3576(1) and 3575(1)(B)(2). I am unable to enter judgment on those counts, however, because KFCU has generated material facts sufficient to raise a good faith transferee defense under 14 M.R.S.A. § 3579. The remainder of the Trustee’s motion for summary judgment will be denied. At trial, the Trustee may (1) pursue its equitable subordination claim; (2) attempt to prove that the 6/4/01 transfer was fraudulent under 14 M.R.S.A. § 3575(1)(B)(1); and/or (3) attempt to prove that the Guest

House Transfer was fraudulent. KFCU may present defenses to any of those claims, and may present its good faith defense. A separate order will issue.

DATED: October 6, 2004

A handwritten signature in cursive script that reads "Louis H. Kornreich".

Louis H. Kornreich
United States Bankruptcy Judge