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***Sunset Aviation, et al.:* Delaware Bankruptcy Court Rejects Trustee's Attempt to Retroactively Apply Substantive Consolidation Order**

By Melissa A. Hager and John A. Pintarelli¹

The authors, along with Adam A. Lewis, Senior Counsel, represented Shorenstein Co. LLC in this matter along with Delaware counsel, Michael Joyce of Cross & Simon LLP.

On September 8, 2011, Judge Walsh of the United States Bankruptcy Court for the District of Delaware held that an order substantively consolidating multiple debtors' estates does not automatically have retroactive or *nunc pro tunc* effect.² The court held that: (i) as a general rule, absent language to the contrary, an order becomes effective on the date it is entered, and (ii) retroactive³ relief is a form of extraordinary relief that is only permissible when necessary and appropriate to carry out the provisions of the Bankruptcy Code.

The court's ruling arose in the context of a trustee's attempt—in substantively consolidated bankruptcy cases that were filed on different dates—to pursue various preference actions by relying on the preference period for the first-filed bankruptcy case as a means of asserting claims against defendants who were creditors of the last-filed case. The trustee in *Sunset Aviation* had hoped to capture payments made to these defendants occurring before the 90-day preference period of the last-filed case.

Sunset Aviation is notable for two reasons. First, as a general proposition, unless a debtor-in-possession or trustee requests and obtains retroactive relief when seeking substantive consolidation, parties in a Delaware bankruptcy case should assume that a substantive consolidation order is prospective in nature. Second, plaintiffs in avoidance actions should not assume that attempts to effectively extend the preference period applicable to the estates of the substantively consolidated debtors will automatically be deemed "necessary and appropriate" under the Bankruptcy Code.

BACKGROUND

On February 25, 2009, Regal Jets, LLC ("Regal") filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code.⁴ On June 10, 2009, the Court entered an order converting Regal's case to one under Chapter 7 of the Bankruptcy Code.⁵ On March 6, 2009, Sunset Aviation, Inc. ("Sunset") filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code.⁶ On May 1, 2009, JetDirect Aviation, Inc. ("JetDirect" and, collectively with Regal and Sunset, the "Debtors") filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code.⁷

Alfred T. Giuliano, Chapter 7 Trustee for the Debtors (the "Trustee"), filed a motion seeking substantive consolidation of the Debtors on July 27, 2010 (the "Substantive Consolidation Motion").⁸ On August 19, 2010, the court entered an order granting the Trustee's requested relief (the "Substantive Consolidation Order").⁹

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On February 24, 2011, the Trustee filed a complaint (the “Complaint”) to avoid and recover transfers made by the Debtors to Shorenstein Co. LLC (“Shorenstein”).¹⁰ Count I of the Complaint sought to “avoid all the transfers of an interest of the Debtors’ property made by the Debtors to Defendant within the Preference Period,” pursuant to [section 547](#) of the Bankruptcy Code.¹¹ In the case of Shorenstein, the transfers at issue were made by JetDirect. The Trustee asserted that “[f]or purposes of calculating the Preference Period, the substantively consolidated Debtors share the earliest bankruptcy petition filing date of February 25, 2009.” Thus, for purposes of calculating the preference period, the Trustee asserted the 90-day period should be between November 27, 2008 and February 25, 2009, the date on which Regal Jets filed its petition.¹²

The Complaint listed a single transfer in the amount of \$443,690.00 (the “Transfer”) made from JetDirect to Shorenstein on December 2, 2008 as an avoidable preferential transfer under section 547 of the Bankruptcy Code.¹³

On May 11, 2011, Shorenstein filed a motion to dismiss (the “Motion to Dismiss”) on the basis that the Trustee sought to use Regal’s petition date as a means of bringing the Transfer within the 90-day statutory preference period as set forth in section 547 of the Bankruptcy Code. Had the Trustee relied on JetDirect’s petition date, Shorenstein averred, the Transfer would have been clearly outside the 90-day preference period.

IS A SUBSTANTIVE CONSOLIDATION ORDER ISSUED WITH AUTOMATIC RETROACTIVE EFFECT?

The primary issue was whether the Substantive Consolidation Order had retroactive effect when the order did not expressly state it was retroactive.

The Trustee urged the court to adopt the findings of two non-Delaware cases, *Baker & Getty* and *Evans Temple*, and hold that “the earliest filing date is controlling” for purposes of calculating the preference period where two or more debtors’ estates have been substantively consolidated.¹⁴ The Trustee argued that the *Baker & Getty* and *Evans Temple* decisions (i) recognized the findings inherent in the Substantive Consolidation Order and (ii) promoted the equitable principles of the Bankruptcy Code. The Trustee further maintained that the doctrine of *res judicata* barred Shorenstein’s arguments raised in its Motion to Dismiss.¹⁵

Shorenstein argued that adopting the Trustee’s position would have the inequitable effect of (i) extending the applicable preference period beyond the period codified in the Bankruptcy Code and (ii) making certain pre-petition transfers from JetDirect unauthorized post-petition transfers.

The court found two District of Delaware cases cited by Shorenstein controlling on the issue of the retroactive application of a substantive consolidation order.¹⁶ In *Garden Ridge and GC Cos.*, the District of Delaware held that an order substantively consolidating the estates of multiple debtors is not automatically retroactive.¹⁷

The court found that, “[a]s a general principle, orders are not deemed to have retroactive effect unless they expressly provide for it.”¹⁸ Absent language to the contrary, an order becomes effective on the date it is entered. In addition, as the court noted in a previous decision, “*nunc pro tunc* relief is a form of extraordinary relief.”¹⁹ The court also noted that neither the Substantive Consolidation Motion nor the Substantive Consolidation Order itself contained any language to suggest a retroactive application. *Garden Ridge* made it clear that the language of the order—*i.e.*, whether it is expressly retroactive—is controlling.

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The court determined it was not appropriate to use its equitable powers and a retroactive order to rewrite section 547 of the Bankruptcy Code by extending the preference period beyond 90 days.²⁰

The court also found the two non-Delaware cases relied on by the Trustee to be factually distinguishable. The court noted that in *Baker & Getty*, the creditor bank had extended a loan to an individual but received transfers from the affiliate brokerage firm that filed its bankruptcy petition first.²¹ The Court of Appeals for the Sixth Circuit affirmed lower court decisions that (i) substantively consolidated the estates of the brokerage firm and its affiliate and (ii) for purposes of section 547 of the Bankruptcy Code, found it appropriate to utilize the first-filed petition date of the combined estates for calculating the preference period because “evidence exists that the Bank did treat the debtors as one entity”²² Similarly, in *Evans Temple*, the court noted that the creditor treated the individual and business entity debtors as one entity.²³ The creditor, Carnegie, was listed as a creditor of both debtors and, in its pleadings, could not attribute the actions of the separate debtors.²⁴ As a result, the court found that these facts strongly suggested that Carnegie did not distinguish between Evans as an individual and the church such that the original filing date was the controlling one.²⁵

In Shorenstein’s case, however, the court found that (i) Shorenstein was a creditor only of JetDirect and received the transfer from JetDirect and (ii) the Trustee had failed to provide any evidence that Shorenstein, or any particular creditor, treated Regal, Sunset and JetDirect as one entity, thereby rendering the non-Delaware cases inapplicable.²⁶

Lastly, the court found the doctrine of *res judicata* inapplicable because the parties were arguing over what the Substantive Consolidation Order itself said; that issue had not been raised expressly or implicitly previously, including in the Trustee’s substantive consolidation motion.²⁷ Accordingly, the court held that (i) May 1, 2009 was the proper date to calculate a preference payment made by JetDirect and (ii) the December 2, 2008 payment made to Shorenstein fell outside the 90-day preference period.²⁸ Thus, the Trustee failed to plead an essential element of a preferential transfer under section 547 of the Bankruptcy Code, and the Trustee’s complaint was dismissed with prejudice.

SUNSET AVIATION’S IMPACT

Sunset Aviation makes a number of practical points for bankruptcy practitioners. First, it confirms that a *nunc pro tunc* order is extraordinary and such relief can only be obtained upon explicit request. Second, a bankruptcy court’s use of its equitable powers to issue a *nunc pro tunc* order can only be granted to further the objectives of the Bankruptcy Code, not rewrite its specific provisions. Lastly, a debtor-in-possession or Trustee cannot avail itself of relief that (i) it did not request, (ii) is not included in or contemplated by an order entered by the court, or (iii) was not noticed to creditors.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

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² *Guliano v. Shorestein Co. LLC (In re Sunset Aviation, Inc.)*, No. 11-50965, 2011 Bankr. LEXIS 3310, at *1 (Bankr. D. Del. Sept. 8, 2011).

³ *Id.*

⁴ *Id.* at *1-2.

⁵ *Id.* at *2.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.* at *3.

¹³ *Id.*

¹⁴ *First Nat'l Bank of Barnesville v. Rafoth (In re Baker & Getty Fin. Servcs., Inc.)*, 974 F.2d 712, 721 (6th Cir. 1992); *Evans Temple Church of God in Christ & Cmty. Ctr., Inc. v. Carnegie Body Co. (In re Evans Temple Church of God in Christ & Cmty. Ctr., Inc.)*, 55 B.R. 976 (Bankr. N.D. Ohio 1986).

¹⁵ *Shorestein Co.*, 2011 Bankr. LEXIS 3310, at *21.

¹⁶ *Id.* at *12.

¹⁷ See *In re Garden Ridge Corp.*, 338 B.R. 627, 641 (Bankr. D. Del. 2006), *aff'd sub nom Ferguson v. Garden Ridge Corp. (In re Garden Ridge Corp.)*, 399 B.R. 135 (D. Del. 2008); *Walton v. Post-Petition Comm. Of Unsecured Creditors (In re GC Cos.)*, 298 B.R. 226, 231-32 (D. Del. 2003).

¹⁸ *Shorestein Co.*, 2011 Bankr. LEXIS 3310, at *16.

¹⁹ *In re Valley Media, Inc.*, No. 01-11353 (PJW), Adv. Proc. No. 02-04553 (PJW), 2003 WL 2195410, at *3 (Bankr. D. Del. Aug. 14, 2003).

²⁰ *Shorestein Co.*, 2011 Bankr. LEXIS 3310, at *17 (citing *In re Hoffman Bros. Packing Co., Inc.*, 173 B.R. 175, 186 (B.A.P. 9th Cir. 1994)).

²¹ *Id.* at *18 (citing *Baker & Getty*, 974 F. 2d at 715).

²² *Id.* (citing *Baker & Getty*, 974 F. 2d at 720).

²³ *Id.* at *19 (citing *Evans Temple*, 55 B.R. at 983).

²⁴ *Evans Temple*, 55 B.R. at 983.

²⁵ *Id.*

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²⁶ *Shorenstein Co.*, 2011 Bankr. LEXIS 3310, at *20-21.

²⁷ *Id.* at *21 (stating that because the Trustee did not request retroactive effect to the Motion for Consolidation, creditors were not on notice that the Trustee was seeking such a remedy and therefore *res judicata* could not act as a bar to the motion to dismiss).

²⁸ *Id.* at *22.