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Eighth Circuit Holds Federal Law Controls Award of Pre-Judgment Interest on Judgments for the Value of Transfers Avoided under Section 544(b)

EIGHTH CIRCUIT BANKRUPTCY MONITOR

In *Kelley v. Boosalis (In re Petters Company, Inc.)* and *Kelley v. Kanios (In re Petters Company, Inc.)*,[1] the Eighth Circuit (Judges Loken and Benton, with Judge Kelly dissenting in part and concurring in part) held that federal law, not state law, determines whether pre-judgment interest may be awarded on judgments for the value of transfers avoided under section 544(b). In so doing, the Court split with the Ninth Circuit and the First Circuit BAP. The Court also interpreted the application of Minnesota's Uniform Fraudulent Transfer Act ("MUFTA") in the context of a Ponzi scheme.

In the proceedings below, the liquidating trustee of a bankrupt company used to facilitate a Ponzi scheme sued under sections 544(b) and 550 to avoid and recover interest payments made to early participants in the scheme who were paid in full with funds secured from later victims. The trustee prevailed and, on appeal, the defendants challenged: (a) the sufficiency of evidence that each interest payment they received was actually fraudulent; (b) the instructions given to the jury on the defendants' affirmative defense that they received the transfers in good faith and for reasonably equivalent value; (c) whether the trustee properly identified a predicate creditor; (d) whether one of the defendants could properly be held individually liable; and (e) whether the court erred in its award of pre-judgment interest based on Minnesota law.

Most of the opinion turned on application of the MUFTA as interpreted by the Minnesota Supreme Court. Those who practice regularly in Minnesota should

consult it. At a high level, the Eighth Circuit held that Minnesota law requires analysis on a "transfer by transfer basis" of whether transfers were made on account of antecedent debt and for reasonable value, thus rejecting the presumption afforded in some courts that payments made to early-stage participants in a Ponzi scheme are not made on account of antecedent debt or for reasonable value.Many practitioners will be more interested, however, in the Court's holding that federal law, not state law, controls the award of pre-judgment interest when the value of a transfer avoided under section 544(b) is recovered. The Court's primary reasoning is that while entitlement to *avoidance* under section 544(b) is (usually) governed by state law, section 544(b) does not authorize *recovery* of avoided transfers. Rather, recovery of avoided transfers is governed by section 550 which, in turn, is "the source for the award of prejudgment interest."

In so holding, the Court split with the Ninth Circuit, which held with no analysis in *In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528, 541 (9th Cir. 1990) that state law "regarding prejudgment interest is applicable via" section 544(b). It also split with the First Circuit BAP's holding in *In re Keefe*, 401 B.R. 520, 527 (1st Cir. B.A.P. 2009) that prejudgment interest is to be determined by reference to state law because while section 544(b) authorizes a trustee to assert a fraudulent conveyance claim based on state law, and section 550 "identifies the entities from whom recovery may be made," it is the applicable state fraudulent conveyance statute that provides the "substantive basis for the judgment."

The Eighth Circuit also went a step further to charge the lower court with improperly expanding the holding of *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938) that in cases where a federal court sits in diversity, the court is to apply the substantive law of the forum state. Here, the Court observed, "the district court's jurisdiction was based on a federal question, not on diversity of supplemental jurisdiction, leaving no basis for applying state law other than" section 544(b), because an avoidance claim under section 544(b) is a federal cause of action.

The question of what law governs the award of prejudgment interest is not trivial, as evidenced by what happened in this case. The district court concluded that Minnesota law mandated the award of prejudgment interest at 10%, which increased the judgment against one defendant by 80% and against another two defendants by 47%. Conversely, under federal law, the award of prejudgment interest is

discretionary – both as to whether it should be awarded and the rate at which it accrues.

In summary, those prosecuting actions under sections 544(b) and 550 should fight to avoid application of this holding or, to the extent practicable, cabin the case to its facts. Those defending should fight to see this holding replicated elsewhere before an adverse judgment is entered. As shown, the consequences can be material.

This blog post was drafted by Ryan Hardy, an attorney in the Spencer Fane LLP St. Louis, MO office. For more information, visit www.spencerfane.com.

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[1] The Court issued a consolidated opinion on the two cases.