Strike Back at the Trustee Empire:

Creditors Fight the Strong Arm of the Chapter 11 Trustee

By David H Conaway

The North Carolina U.S. Bankruptcy Court for the Western District (Charlotte) recently ruled that a trustee for a bankruptcy estate could assert avoidance actions to recover property (or its value) transferred by the debtor to a third party that occurred ten (10) years prior.

Setting the Stage

1 Suppliers of goods and services to customers that file for Chapter 11 know all too well about preference claims against them under Section 547 of the Bankruptcy Code, to recover payments made to the suppliers within 90 days prior to the Chapter 11 filing.

In addition, often Chapter 11 estates assert "avoidance" claims against suppliers under Section 548 of the Bankruptcy Code, commonly referred to as "fraudulent" conveyances, although fraud is not required. Unlike preference claims, the look-back period for "fraudulent" conveyances under Section 548 is two (2) years.

2 Section 548 of the Bankruptcy Code allows a trustee to avoid transfers of debtors' property to creditors, or obligations incurred by a debtor to a creditor, that occurred within two (2) years prior to the bankruptcy filing, if the debtor:

a. Made the transfer to hinder, delay or defraud a creditor, or

b. Received less than or reasonably equivalent value for the transfer or obligation and

i Was insolvent;

ii Was left with unreasonably small capital to operate; or

iii Unable to pay debts as they came due.

3 Section 544 of the Bankruptcy Code, known as the "strong-arm provision," allows a trustee to also assert any avoidance claims that a hypothetical creditor of the debtor could assert against third parties.

This provision is routinely used by trustees to take advantage of state law avoidance statutes which almost always have longer look-back periods than Section 548 of the Bankruptcy Code. Virtually every U.S. state has a "fraudulent" transfer statute, for example, the Uniform Fraudulent Conveyance Act ("UFCA"), the Uniform Fraudulent Transfer Act ("UFTA") or the Uniform Voidable Transfer Act ("UVTA"). At their essence, these statutes allow creditors of a debtor to assert claims against third parties to avoid transfers of property from the debtor or obligations incurred by the debtor to third parties, either (1) with the intent to defraud creditors or (2) for less than reasonably equivalent value. North Carolina's fraudulent transfer law is based on the Uniform Voidable Transactions Act (2014). In states that have adopted the UFTA or UVTA, the majority have a four (4) year look-back period.

4 In addition, under the Internal Revenue Code, the IRS, as a creditor of a debtor, can assert claims against third parties to avoid transfers of property from the debtor to third parties. The IRS's statute of limitations, or look-back period, is ten (10) years.

5 The North Carolina Bankruptcy Court addressed the issue of whether the Section 544 "hypothetical creditor" could be the IRS. If so, clearly the look-back period against creditors is two to three times longer, increasing potential liability substantially.

An interesting aside, in the Madoff Investment Securities, LLC Chapter 11 proceeding in New York, the trustee initiated thousands of fraudulent conveyance suits to recover payments made to investors.

Bernard Madoff orchestrated the largest Ponzi scheme in history. He solicited investors to buy into “investment funds” that were to generate well above market returns. However, he commingled the investors’ funds into a JP Morgan Chase checking account. When investors sought to withdraw their money, Madoff used this checking account, essentially “robbing Peter to pay Paul.” The scheme worked until 2008 when the markets collapsed, prompted by the Lehman Brothers collapse and subsequent Chapter 11 filing.

To date, the Madoff estate has recovered approximately $15 billion from investors, reportedly about 75% on the dollar for creditors.

We were heavily involved in the Madoff case on behalf of several foreign investment interests.

See my articles “Madoff: Insolvency Laws Without Borders” and “US Sale of the Century: Five Days in September” (regarding the Lehman Brothers Chapter 11) for more information.

Why is This Important to Suppliers?

It is common in commercial sales transactions for a supplier to do business with customers with a number of related entities and affiliates. Often a supplier will invoice one customer entity, and deliver goods or services to an affiliate, which is a separate legal entity. When a customer enterprise group has a common cash management system, one affiliate company may pay the invoices, but a separate affiliate company utilizes the goods or services. When a customer group files Chapter 11, often the bankruptcy estate will assert a “fraudulent conveyance” claim against the supplier on behalf of the paying entity that received

no products or consideration for the payment made.

For example, if a supplier sells a customer group $1 million per year, then the potential exposures would be:

- Section 548 two year look-back - $2 million
- State Law four year look-back - $4 million
- IRS 10 year look-back - $10 million

Unlike Section 547 preference actions, where compelling defenses exist, "fraudulent" conveyance claims are fundamentally based on lack of contract consideration.

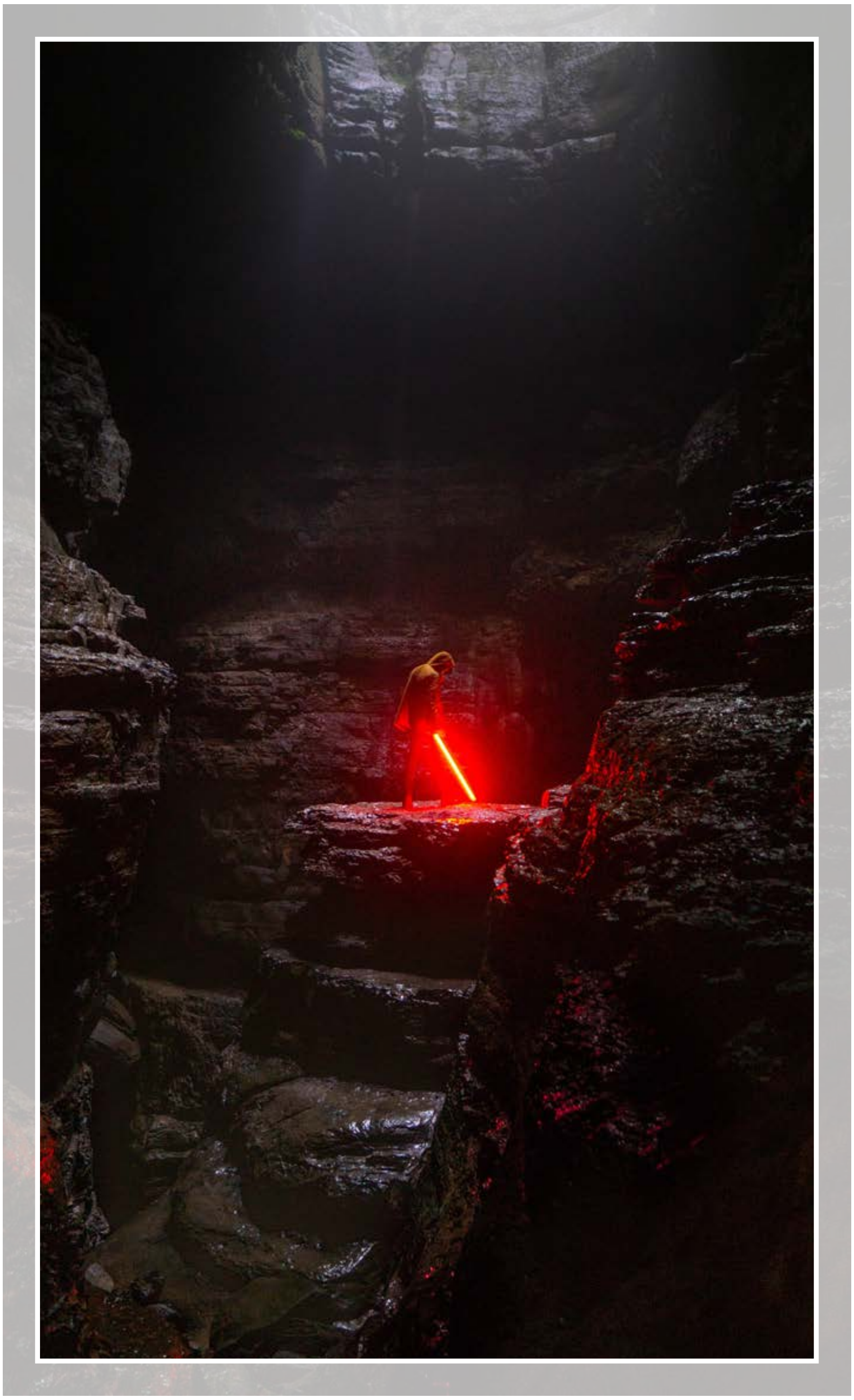
In a Chapter 11 case in Chicago, we successfully defended a 548 fraudulent conveyance claim for zero (0) liability by connecting the consideration dots based on the company group's cash management system.

The North Carolina Bankruptcy Court Ruling

In re Zagaroli (W.D.N.C., 2020), seven years prior to the Chapter 7 filing, the debtor transferred several parcels of real estate to his parents.

The trustee sued the parents to recover the real estate or its value. As it happens, the IRS filed a claim in the debtor's Chapter 7 case for about $4,100.

The issue for the North Carolina Bankruptcy Court was whether the trustee is able to use the IRS as its "golden creditor" to take advantage of the ten (10) year look-back period that only the IRS enjoys. Since the transfers at issue were seven years prior, this was the trustee's only hope, because the look-back periods under Section 548 and under North Carolina's state law avoidance statute had long since passed.



The North Carolina Bankruptcy Court ruled that the "plain meaning" of Section 544 allowed the trustee to step into the shoes of the IRS to avoid transfers under the Internal Revenue Code ("IRC"). By stepping into the shoes of the IRS, the trustee is able to invoke the North Carolina UVTA and the

IRC, both of which are available to the IRS to seek to avoid the transfers outside the bankruptcy. The court further reasoned that the opposing position would have resulted in leaving both the trustee and the IRS without the right to avoid offending transfers that occurred outside the state law look-back period.

Of the seven (7) other U.S. Bankruptcy Courts to address this issue, the majority have ruled in favor of the trustee using the IRC's ten (10) year statute of limitations. Thus, U.S. Bankruptcy Courts in forty-three (43) states appear to have not addressed this issue. Of the Chapter 11 "hotspots," Delaware has not addressed the issue; New York ruled in an analogous context that the trustee could use the U.S. Government's six (6) year statute of limitations under the Fair Debt Collection Practices Act ("FDCPA"); and the Fifth Circuit Court of Appeals in Texas ruled that the trustee could not utilize the longer statute of limitations of the FDCPA.

Takeaways

As the IRS is frequently a creditor in Chapter 11 cases, the potential for Chapter 11 estates to use the IRS as its "golden creditor" could substantially increase the risk of loss for suppliers.

Although a number of Bankruptcy Courts have reached the same conclusion as the North Carolina Bankruptcy Court, the majority of U.S. Bankruptcy Courts, including Delaware, have not addressed the issue, and the New York and Texas courts are split. Given this, and because the only Circuit Court case (Texas) supports suppliers' positions, suppliers have an opportunity to fight back against Chapter 11 estates seeking to expand liability.

We hope you have found this useful and informative. Please contact us if you have any questions about this or any other matter. ■

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