

**AVOIDING PITFALLS IN BANKRUPTCY:  
ADVANCED ISSUES IN AVOIDANCE LITIGATION**

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**I. INTRODUCTION**

The focus of this article are selective advanced, current issues and developments in avoidance action litigation. Due to the potentially unlimited breadth of the topics covered, we have not sought to be exhaustive of all such issues. We furthermore presume basic familiarity with the statutes and fundamental concepts implicated in bankruptcy avoidance actions.

**A. Setting the Stage: The Growing Significance of Avoidance Actions**

Calendar Years 2001, 2002 and 2003 all posted record breaking bankruptcy filing rates.<sup>1</sup> While total filings increased in each of these successive years, business filings slightly declined while consumer filings have continued their increase – sufficient to offset the drop in business filings.<sup>2</sup> Accounts of the impetus behind these statistics include some rush to the courthouse, despite a mending economy, to resort to the bankruptcy process prior to the possible enactment of proposed reform promising to make it more difficult for consumers to erase debts under Chapter 7 of the Bankruptcy Code ("Code") rather than making periodic payments under Chapter 13, or on the other hand, or for another example, deeper socio-economic issues confronting a progressively more fragile middle class may explain the growing use of the bankruptcy process by individuals, as Harvard professor Elizabeth Warren has argued.<sup>3</sup> In any event, these are beyond the scope of this article.

Suffice it for our purposes to note that as the use of the bankruptcy process has grown, so has the volume of ancillary litigation that bankruptcy cases generate, the bulk of which is

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<sup>1</sup> *Bankruptcy Filings Set Record in 2001*, American Bankruptcy Institute official website at [www.abiworld.org](http://www.abiworld.org) (February 19, 2002); *Record Breaking Bankruptcy Filings Reported in 2002*, [www.abiworld.org](http://www.abiworld.org) (February 14, 2002); *Bankruptcy Filings Set New Calendar Year Record in 2003*, [www.abiworld.org](http://www.abiworld.org) (February 25, 2004).

<sup>2</sup> *Annual Total, Business and Non-business Filings by District (2001-2003)*, [www.abiworld.org](http://www.abiworld.org).

<sup>3</sup> See Marcy Gordon, *Personal Bankruptcy Filings Increase*, Associated Press (November 14, 2003); Elizabeth Warren and Amelia Warren Tyagi, *The Two-Income Trap: Why Middle-Class Mothers and Fathers Are Going Broke* (Basic Books 2003). The thrust of Warren and Tyagi's book is that middle class Americans are not squandering their incomes but are devoting all resources to necessities which, because they consume virtually all available resources in today's society, leave middle class families exceedingly vulnerable to unforeseen life events, such as serious illness, divorce and temporary job loss.

comprised of avoidance actions.<sup>4</sup> While it appears that we may be slowly surmounting the crest of the aforementioned wave of bankruptcy filings, certainly at least as to business bankruptcies, this is not the case with respect to avoidance actions. The reason for this is the (typically) two year statute of limitations that applies to the commencement of such actions under Code section 546. Accordingly, accepting the fact that bankruptcy case filings peaked through the end of 2003 (and into 2004), we can expect a high rate of avoidance actions to stem from these cases through 2005-2006.

## B. Systemic Abuse Through Avoidance Actions

There is growing indication that pressures upon the courts and our judicial and bankruptcy systems are increasing under the combined weight of several factors: the volume of avoidance litigation, the approaches used to evaluate whether to assert such actions, and the procedures used by practitioners in initiating avoidance litigation are combining to exert. There are certainly other factors that contribute to such tensions, not the least of which is the judiciary's abilities to handle substantially increased case loads due to budgetary concerns.

Despite the fact that the Federal Judiciary budget comprises a mere .2% of the overall federal budget, budgetary increases for the Judiciary have lagged behind increased costs of living and the impacts of inflation, while Judge's salaries have not seen an increase since 1991.<sup>5</sup> In light of fixed mandatory expenses such as judicial salaries and costs of maintenance of federal judicial facilities, including courthouse lease obligations, the budget for the Federal Judiciary would require a 7.3% annual increase just to stay even with the effects of inflation.<sup>6</sup> However, budgetary increases have consistently lagged behind percentages required to merely maintain the same levels of staffing and service, while judicial workloads have substantially increased during the same period.<sup>7</sup> The result is a budgetary crisis which forces courts into the impossible conundrum of firing existing staff and implementing temporary furloughs for others while simultaneously attempting to grapple with their increased case loads, and this is particularly true in the bankruptcy arena.<sup>8</sup>

The period from 2002 to 2003 alone saw a national increase of nearly 25% in the commencement and pending load of adversary proceedings under bankruptcy cases, and as

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<sup>4</sup> For an example of the significance these can play, see *Order Granting in Part Motion to Defer Response Date, Direct that Rule 7016 Shall Apply to This Matter, Re-designate Proposed Hearing Date as Scheduling Conference, and for Other Relief on the Debtors' Motion to Determine that Reclamation Claims are Valueless*, dated December 19, 2003, In re Fleming Companies, Inc. et al., Case No. 03-10945 (D. Del.). Judge Walrath's recent ruling in the *Fleming Co.* case directed the debtors to file nearly 600 adversary proceedings to resolve reclamation claims and avoidance action liabilities rather than seek to dispose of all reclamation claims through an omnibus motion directed at the common, and assertedly dispositive, issues.

<sup>5</sup> See *Federal Judges' Compensation*, News Releases of the Federal Judiciary Administrative Office of Courts, [www.uscourts.gov/newsroom/pay.htm](http://www.uscourts.gov/newsroom/pay.htm) (July 1, 2004). A raise is distinguished from a cost of living adjustment.

<sup>6</sup> See *Congress Delays Action On Judiciary's Budget*, News Releases of the Federal Judiciary Administrative Office of Courts, [www.uscourts.gov/newsroom/budget.htm](http://www.uscourts.gov/newsroom/budget.htm) (December 12, 2003).

<sup>7</sup> *As workload and Resources Head in Opposite Directions, Crisis Looms for the Federal Courts*, News Releases of the Federal Judiciary Administrative Office of Courts, [www.uscourts.gov/nrarchive.html](http://www.uscourts.gov/nrarchive.html) (March 11, 2004).

<sup>8</sup> *Id.*

indicated above, one can expect the wave of adversary proceedings to peak approximately 2 years subsequent to the peak in bankruptcy case filings.<sup>9</sup>

Particularly in Chapter 11 cases, a debtor has strong incentives to devote the majority of its initial time and attention to stabilizing operations, marketing assets, and working cooperatively with creditors to maximize the possibility of a feasible plan of reorganization.<sup>10</sup> Avoidance actions understandably take a backseat position to these other concerns during the outset of a case, particularly where the pool of defendants often essentially falls within the body of voting creditors needed to approve plans of reorganization. It is neither unusual nor surprising for commentators and practitioners, particularly creditors' and defendants' attorneys, to lament the growing "check register" practice and approach to asserting avoidance actions by estate representatives.<sup>11</sup> Under this approach, the legal professional merely resorts to a debtor's check register and bank account records on the eve of the expiration of limitations to commence preference actions – through form complaints containing little to no factual detail – against any and all parties receiving payments within 90-days prior to the debtor's bankruptcy petition.

### 1. Frustration in the Courts

The absence of detailed analysis and evaluation into the merits of each such actions prior to commencing formal proceedings naturally causes courts to grapple with the additional volume of weak actions with poor prospects of success on the merits. There are, in fact, indications that the burden of this challenge has led to judicial frustration which in turn produces reactions from courts and in the case law. For example, the District of Delaware, perennially among the lead federal districts in terms of case volume over the past 15 years, is experiencing a split in authority over elementary – or so we thought – pleading standards and the threshold requirements necessary to survive Rule 8 and 12(b)(6) challenges under the Federal Rules of Civil Procedure.<sup>12</sup> The Delaware judges have apparently identified pleading requirements as a mechanism through which docket relief can be accomplished.

Heightened standards may reduce the incidence of procedural motions based on insufficient pleadings and notice, assist parties in narrowing issues at an early stage, and promote more thorough investigation and evaluation into the facts of a transfer prior to the assertion of formal proceedings before the courts. Not surprisingly, this split in authority within the District is a line largely drawn between the standing and visiting judges in the District. Delaware's weighty case volume promotes the practice of utilizing visiting judges<sup>13</sup>, but they

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<sup>9</sup> Table (F-8) *Adversary Proceedings Commenced, Terminated, and Pending Under the Bankruptcy Code*, Statistical Reports of the Federal Judiciary Administrative Office of Courts, <http://www.uscourts.gov/caseload2003/contents.html> (March 31, 2003).

<sup>10</sup> *TWA Inc. Post Confirmation Estate v. City & County of S.F. Airports Comm'n (In re TWA Inc. Post Confirmation Estate)*, 305 B.R. 221, 227 (Bankr. D. Del. 2004).

<sup>11</sup> Thomas D. Goldberg, *Curbing Abusive Preference Actions: Rethinking Claims on Behalf of Administratively Insolvent Estates*, 2004 ABI JNL. LEXIS 88, \*2 (May 2004).

<sup>12</sup> Hon. Lisa Fenning and Jane South, *Pleading Preferences in Delaware: Signs of an Emerging Doctrinal Split or Merely Pent-up Frustrations with Sloppy Practice?*, 5 Norton Bankr. L. Advr., at 3 (May 2004).

<sup>13</sup> See Shanon D. Murray, *Visiting judge rankles bankruptcy court*, [www.TheDeal.com](http://www.TheDeal.com) (April 11, 2001).

apparently feel more compelled to apply standard, relaxed federal pleading requirements rather than seek to address the District's particular administrative issues with its case volume.

In contrast, the District's standing judges employ somewhat heightened pleading standards recently culminating in Judge Walsh's opinion in TWA Inc. Post Confirmation Estate v. Marsh USA Inc.<sup>14</sup> In Marsh, Judge Walsh traces his progression in a five year line of cases in which the focus is on fair notice to the defendant as the lynchpin of federal pleading standards, and which reject merely pleading statutory elements as sufficient.<sup>15</sup> Rather, these cases in the aggregate demand that a plaintiff plead: (i) the nature and amount of the debt (subject transactions) at issue; (ii) the amount and date of the transfer; and (iii) parties involved in the transfer.<sup>16</sup>

(Visiting) Judge Case's March 9, 2004 decision in Neilson v. Southern (In re Webvan) underscores the split with Marsh in this same District.<sup>17</sup> Webvan follows minimum requirements and rejects any heightened standard. Identifying the transactions under which alleged transfers were made, together with the amount sought for recovery and the statutory elements, is sufficient under Webvan.<sup>18</sup>

The reasoning of Marsh is also difficult to square with the general recognition that federal pleading standards are even more liberal when viewed in the context of avoidance actions. The courts typically recognize that estate plaintiffs, such as trustees or committees, are often strangers to the transactions on which they bring suit and had no control over the relevant documentation at the time of the transactions, or over how well a debtor maintains such documentation.<sup>19</sup> In fact, Marsh actually acknowledges this relaxation of the general standard.<sup>20</sup> The apparent inconsistency can be reconciled by applying the relaxed standard for bankruptcy litigation on a case by case basis. In other words, a bankruptcy plaintiff may receive greater leeway in pleading its claim where it, *in fact*, has had little opportunity to investigate the critical facts and transactions, but in Marsh, a critical fact negated that consideration. There, the plaintiff sent a demand letter, prior to commencing suit, and containing more detail as to the specifics of the transactions than the plaintiff deemed fit to include in its formal complaint. This

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<sup>14</sup> TWA Inc. Post Confirmation Estate v. Marsh USA Inc. (In re TWA Inc. Post Confirmation Estate), 305 B.R. 228 (Bankr. D. Del. 2004).

<sup>15</sup> *Id.* at 232. Citing Valley Media, Inc. v. Borders, Inc. (In re Valley Media), 288 B.R. 189, 192 (Bankr. D. Del. 2003); Posman v. Bankers Trust Co., Adv. Pro. No. 97-245, at 3 (Bankr. D. Del., July 28 1999)(Walsh, J.). See also Phillip v. University of Rochester, 316 F.3d 291, 293 (2<sup>nd</sup> Cir. 2003) ("A complaint need only 'give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests.'") (quoting Conley v. Gibson, 355 U.S. 41, 47, 78 S. Ct. 99, 102 (1957)).

<sup>16</sup> *Id.*

<sup>17</sup> Neilson v. Southern (In re Webvan Group, Inc.), 2004 Bankr. LEXIS 269 (Bankr. D. Del. 2004).

<sup>18</sup> *Id.* at \*7. See also In re Randall's Island Family Golf Centers, Inc., 290 B.R. 55, 65 (Bankr. S.D.N.Y. 2003).

<sup>19</sup> In re Webvan Group, Inc., 2004 Bankr. LEXIS at \*5-8 n. 2 ("TWA Inc....indicated that the debtor might face difficulty in satisfying the elements...thus the situation would warrant relaxation of the rule and the debtor would be entitled to pursue these details in discovery."); In re Hollis & Co., 86 B.R. 152, 156 (Bankr. E.D. Ark. 1988)(bankruptcy cases utilize a more liberal pleading standard where the plaintiff is a third party outsider to the original transaction, such as a committee or trustee, who must rely on second hand knowledge).

<sup>20</sup> TWA v. Marsh, 305 B.R. at 234.

approach understandably did not sit well with the bench.<sup>21</sup> It should be noted that, even under the Marsh line, insolvency, reasonably equivalent value, the extent of the antecedent debt and liquidation analysis can be pled generally (through statutory language).<sup>22</sup>

## 2. Additional Examples of Abuse – Irrational Litigation

Unfortunately, there are other examples that our systemic approach to avoidance actions has become unwieldy. For example, In re Pillowtex, involved the efforts of a debtor's pre-petition law firm to be retained as bankruptcy counsel.<sup>23</sup> The firm had received substantial payments during the preference, fully disclosed these, and argued that they were made in the ordinary course. The U.S. Trustee opposed the retention. Over its objection, the Bankruptcy Court approved the retention pursuant to a stipulation by the firm that it would turn over any amounts found to have been received as preferences, with a waiver of any resulting claim. The U.S. Trustee pursued its appeal however, and a ruling on appeal was finally obtained after the Bankruptcy Court's confirmation of a plan. No creditors had opposed the retention, including the official committee, which in fact joined in the debtors' appellate brief in favor of the law firm. Accordingly, it is clear that the creditors of the estate had made a reasoned judgment that they preferred the firm's retention as debtor's counsel, and/or that they did not believe the preference case to be meritorious. Even post-confirmation, fully vested with the right to assert avoidance actions, the committee declined to assert an action against the firm. Notwithstanding, the U.S. Trustee forged on, and eventually obtained the ruling on appeal: the case would have to be remanded to determine whether the firm had received a preference, in which event it would be disqualified from its representation, required to pay any claim, and presumably, to disgorge the substantial fees earned thus far.<sup>24</sup>

Pillowtex is a good example of the competing policies and purposes of the Code and the exercise of avoidance powers. Certainly the orderly (authorized) liquidation of assets of the estate is fundamental to the Code, and actions to recover avoidable transfers do fulfill that policy by recovering transfers to (preferred) parties for eventual pro rata distributions to all creditors. Pillowtex is far from wrongly decided, but the case is still instructive in that it is very arguable that the U.S. Trustee should have dropped its appeal in deference to the reasonable views of creditors, and particularly the presumably reasoned evaluation of the committee, at some point during the case. In both examples, the practitioner's due consideration of the integrity of the judicial system should have weighed heavily in favor of declining to pursue these matters, despite that the conflicts issues clearly favored the U.S. Trustee's position. Estate and judicial resources were needlessly consumed. It also is true that the result in Pillowtex probably *did* benefit the estate considerably (by producing eventually free legal services for the debtor's reorganization), but the U.S. Trustee exerted its strong legal position over the objections of creditors and at the needless systemic cost of the appeal and the arguable injustice of having confirmed a plan and completed restructuring on the back of a law firm which may go uncompensated for its considerable efforts.

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<sup>21</sup> Fenning and South, *supra* note 13, at 5.

<sup>22</sup> See, e.g., Valley Media, 288 B.R. at 193; Zahn v. Yucaipa Capital Fund, 218 B.R. 656, 675 (D. R.I. 1998); Askanase v. Fatjo, 1993 U.S. Dist. LEXIS 19416, \*9-10 (S.D. Tex. 1993); Eide v. The Keystone Group (In re Boyt Ltd. P'ship), 1999 Bankr. LEXIS 1909, \*12 (Bankr. N.D. Iowa 1999).

<sup>23</sup> Staiano v. Pillowtex, Inc. (In re Pillowtex, Inc.), 304 F.3d 246 (3<sup>rd</sup> Cir. 2002).

<sup>24</sup> *Id.* at 249-254. See also Thomas J. Salerno and Jordan A. Kroop, *Last in Line, Revisiting Retentions for Professional Preferences*, 2002 ABI JNL. LEXIS 197 (December 2002).

When evaluating whether to commence avoidance litigation, the attorney would do well to consider systemic issues such as the growing incidence of these actions, the relatively dwindling resources of the judiciary, the interests of parties in an efficient resolution of their disputes, and a further fundamental policy consideration of the Code: the benefit to, and maximization of, the estate.<sup>25</sup>

One substantial consolation to the estate attorney is the potential availability of other estate professionals, namely the financial consultant and advisor, to perform these duties. This is typically true only in larger Chapter 11 cases (or Chapter 7 cases involving business debtors), where the size of the estate justifies the retention of additional supporting professionals to assist the estate's attorneys. In such contexts, the number of creditors and the scope of the debtor's business dealings promise to render the evaluation of all potentially avoidable transfers a daunting task. The growth of bankruptcy practice has thankfully led such consultants to make a point of offering avoidance action analyses, to provide the attorney with the essential financial information necessary to make its evaluation. These can include schedules of potential avoidable transfers, amounts, transactional history and dates, and even estimations of affirmative defenses and credits to arrive at the expected recovery to the estate. Having such information assists the attorney in avoiding the "check register approach" pitfall. The financial advisor can devote itself to avoidance action issues while the attorney attends to other case matters, and provide the attorney with advance detail sufficient to draft and file specific, well-reasoned and detailed complaints providing notice to defendants and the courts of the transactions at issue and true amounts at stake (with due credits for affirmative defenses).

## II. MORE EMERGING TRENDS

Avoidance litigation is not only expanding in volume, but its reach and the contexts in which it arises appear to be expanding as well. At the same time, substantive changes in the law also promise to contribute to further complications in this arena, which, in turn, typically results in more work for the practitioner.

### A. The Impact of Revised Article 9 of the Uniform Commercial Code

The most obvious recent example of the potential impacts that substantive changes in the law can have on avoidance litigation is the advent of new Article 9 of the Uniform Commercial Code ("UCC"), which is applicable in all fifty states.<sup>26</sup> There is a clear nexus between a change in the law governing secured transactions and avoidance litigation in bankruptcy. "New" Article 9 has sought to clarify the process of perfecting security interests and reduce perfection errors. This should reduce and curtail lien avoidance actions in the long run, but in the short term, transition issues and the dearth of established interpretive law may actually promote them.

The revisions implemented in the latest installment of Article 9 ("Revised") include changes in, for example, the scope of its reach: the types of transactions raising, and subject to, perfection issues. These include commercial tort claims and health-care-insurance receivables,

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<sup>25</sup> See 11 U.S.C. §§ 503 and 550 (benefit of the estate).

<sup>26</sup> Kenneth Miskin, *Survey of Legislation: Revised Article 9*, 24 U. Ark. Little Rock L. Rev. 415, 415 (Winter 2002).

but at the same time, other revisions also narrow the scope of the statute in discreet areas.<sup>27</sup> There are also changes in the classification scheme of Article 9 – significantly, the types of property falling under the definition of "proceeds." Former Article 9 defined that term generally, as being, in essence, anything that is received for the conveyance of collateral or proceeds. Revised Article 9 broadens the classification to fit dividends on account of securities or other investments, and also expands the automatic perfection period in proceeds of collateral from 10 to 20 days.<sup>28</sup> Critically, Revised Article 9 alleviates the problem of commingled proceeds and the need for tracing for secured creditors, by providing that the creditor's lien extends over the entire commingled mass.<sup>29</sup>

Most importantly, perfection issues and procedures are clarified. In general, the statute provides that the filing should take place where the debtor is "located," and a debtor which is a registered organization is located in its state of incorporation.<sup>30</sup> There remain exceptions for certain types of collateral interests, including "timber to be cut", goods subject to fixture filings, farm products, and "as-extracted collateral."<sup>31</sup> Overall however, the process is greatly simplified.

As noted, the cumulative effects of these revisions should be, in the long run, to strengthen the position of secured creditors, and therefore, diminish the occasion for lien avoidance actions. The reach of security interests covers greater types of transactions, follows proceeds more easily, and are perfected through a rather transparent filing scheme. For our purposes however, the short term significance of transition issues – changes in the appropriate places to file, or in modes of perfection, and even as to whether a given transaction gives rise to a security interest requiring perfection – in combination with old habits, is that they should keep the lien avoidance industry brisk for a few more years yet.

#### B. Assigning and Asserting Avoidance Actions

Another recent issue surfacing in avoidance litigation is the question of who has standing to assert the avoidance action?<sup>32</sup> The Pillowtex Court, admittedly in dicta, saw fit to preemptively resolve this issue as to U.S. Trustees by stating in reference to section 307 of the Code that, "[I]t is difficult to conceive of a statute that more clearly signifies Congress's intent to confer standing."<sup>33</sup> It also based its statement on the legislative history of section 307.<sup>34</sup>

The Court's reliance on section 307 as a distinct provision conferring standing on U.S. Trustees to assert avoidance actions is dubious in that the language used in that section tracks that of section 1109 (generally providing that parties-in-interest may raise and be heard on any issue in any case under Chapter 11), and that section was directly at issue in the now famous

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<sup>27</sup> C. Scott Pryor, *How Revised Article 9 Will Turn the Trustee's Strong Arm Into a Weak Finger: A Potpourri of Cases*, 9 Am. Bankr. Inst. L. Rev. 229, 237 (Spring 2001).

<sup>28</sup> *Submitted Committee Report: Report of Finance and Transactions Committee*, 23 Energy L. J. 541, 553 (2002).

<sup>29</sup> Pryor, *supra* note 28, at 255-56.

<sup>30</sup> UCC § 9-307.

<sup>31</sup> See UCC §§ 9-301, 302.

<sup>32</sup> Recall that the committee, vested with the right to bring the action, had declined.

<sup>33</sup> In re Pillowtex, Inc., 304 F.3d at 255 n. 7.

<sup>34</sup> Citing U.S. Trustee v. Columbia Gas Sys. Inc. (In re Columbia Gas Sys. Inc.), 33 F.3d 294, 296 (3<sup>rd</sup> Cir. 1994).

case of In re Cybergenics Corp., issued by the very same Court of Appeals.<sup>35</sup> Cybergenics I has since been vacated, but it initially caused a considerable furor by overturning a long recognized practice of allowing creditors' committees the standing to pursue avoidance actions.<sup>36</sup>

The holdings of Pillowtex and Cybergenics I constitute an impossible task to reconcile under the terms of the Code (despite the fact that Cybergenics I has been withdrawn, it is instructive in comparison to Pillowtex in that they were issued by the same court mere days apart). The Court in Pillowtex points to section 307 as a distinct provision conferring standing on U.S. Trustees, but that language is no more precise than in section 1109. It also based its decision on the legislative history as to U.S. Trustees, but that is a step which is never supposed to be taken under a "literal reading" rationale as used in Cybergenics I.<sup>37</sup>

In any event, the Third Circuit eventually resolved the issue (at least, based on accepted practice) in Cybergenics II, bringing its holding into accord with that of Pillowtex, and providing for the standing of both committees and U.S. Trustees to assert avoidance actions where the primary parties charged with that responsibility have abdicated it.<sup>38</sup> We must clarify that the ability of committees to institute avoidance actions under these authorities does not equate to a carte blanche approval of standing. Rather, certain standards apply to ensure that the responsibility for asserting such litigation rest with the debtor-in-possession or bankruptcy trustee in the first instance. In order for a committee to have the right to assert such a claim, generally: (i) the claim must be colorable; (ii) the debtor-in-possession or trustee must have refused unjustifiably to pursue the claim; and (iii) the committee must first obtain leave to sue from the bankruptcy court.<sup>39</sup>

The history of the Cybergenics opinions arguably illustrate a recognition by the Courts that the practical considerations tied to the administration of bankruptcy estates and the objectives of the Code inform upon the proper construction of its provisions. Perhaps, under a strictly legal analysis, Cybergenics I carries the greater weight. It was nevertheless immediately recognized by commentators as a doomed decision in light of the interests under our

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<sup>35</sup> Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.), 304 F.3d 316 (3<sup>rd</sup> Cir. 2002) ("Cybergenics I").

Section 1109(b) provides: "A party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter." 11 U.S.C. § 1109.

<sup>36</sup> See, e.g., Louisiana World Exposition v. Fed. Ins. Co., 858 F.2d 233, 246-47 (5<sup>th</sup> Cir. 1988); Coral Petroleum Inc. v. Banque Paribas-London, 797 F.2d 1351, 1363 (5<sup>th</sup> Cir. 1986); In re STN Enter. Inc., 779 F.2d 901, 904 (2<sup>nd</sup> Cir. 1985); In re First Capital Holdings Corp., 146 B.R. 7, 13 (Bankr. C.D. Ca. 1992); In re Joyanna Holitogs, Inc., 21 B.R. 323, 326 (Bankr. S.D.N.Y. 1982). See also Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery, 330 F.3d 548, 561 (3<sup>rd</sup> Cir. 2003) ("Cybergenics II").

<sup>37</sup> Cybergenics I, 304 F.3d at 323. The Cybergenics I Court also based its decision largely on the Supreme Court's opinion in Hartford Underwriters Insurance Company v. Union Planters Bank N.A., 530 U.S. 1, 120 S. Ct. 1942, 147 L. Ed. 2d 1 (2000), in which the Court held that the use of the phrase "the trustee may" in section 506 of the Code excludes the inclusion of other parties thereunder. 530 U.S. at 4-8.

<sup>38</sup> See, e.g., In re First Capital Holdings Corp., 146 B.R. at 10 (a debtor-in-possession's directors and officers cannot be relied upon to zealously pursue claims against themselves).

<sup>39</sup> See Louisiana World Exposition v. Fed. Ins. Co., 858 F.2d at 247.

bankruptcy system of continuing to allow creditors' committees the standing to pursue avoidance actions.<sup>40</sup> Factoring Pillowtex into the equation expands our notion of this unwritten policy interest into one generally favoring the expansion of the standing of estate parties to pursue estate claims rather than allow those assets of the estate to go wasted.

#### 1. Section 550 and Expanding Notions of "Benefit of the Estate"

This policy of expanding standing to pursue avoidance actions also turns upon the courts' reading and treatment of section 550 of the Code. That section provides, in essence, that transfers avoided under other Code sections may be recovered "for the benefit of the estate." Earlier cases have overwhelmingly held that a debtor-in-possession cannot assign, sell or otherwise transfer avoidance claims.<sup>41</sup> Even where the assignment, sale or transfer was approved by a court, the assignment was held to be of no effect.<sup>42</sup> The result was that the recipient of such an assignment had no standing to pursue such claims.<sup>43</sup>

These holdings largely turned upon the issue of section 550, construing this section as denying standing to pursue an action where the estate did not stand to receive the eventual recovery.<sup>44</sup> If the assignment of the claim was an outright assignment to a third party, then recovery would not be for the benefit of the estate, and the courts reasoned that section 550 forbids recovery in such circumstances. The trend toward greater assignability thus understandably began with assignments of the right to prosecute claims where the recovery would still go to the estate.<sup>45</sup> Assignments to committees, and even to individual creditors, of the right to prosecute claims do not raise the same section 550 issue as outright assignments because the estate still owns the recovery. In approving an assignment of avoidance claims to a liquidating trustee, the Tenth Circuit in the seminal Sweetwater case explained that a critical reason for the validity of the assignment was the fact that the recoveries were still owned and held by the estate, whereas "creditors should not be able to pursue an avoidance action for their exclusive benefit."<sup>46</sup>

Not surprisingly, the practical and economic considerations in administering a bankruptcy estate, especially through a Chapter 11 reorganization, eventually led to favoring an expansive view of the outright transferability of avoidance actions and standing to assert them rather than allowing the doctrine to impede the estate's ability to obtain maximum value for its avoidance action assets. Since section 550 is read to negate standing where a successful

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<sup>40</sup> See, e.g., Leonard P. Goldberger, *Cybergenics II: Sounds Great, But Will It Work?*, 2002 ABI JNL. LEXIS 195 (December 2002).

<sup>41</sup> In re Texas General Petroleum Corp., 58 B.R. 357, 358 (Bankr. S.D. Tex. 1986); In re Huntsville Small Engines, Inc., 228 B.R. 9, 11-12 (Bankr. N.D. Ala. 1998); In re Sapolin Paints, Inc., 11 B.R. 930, 937 (Bankr. E.D.N.Y. 1981).

<sup>42</sup> Beldon-Hall Mfg. Co. v. Mercer & Ferdon Lumber Co., 175 F. 335 (6<sup>th</sup> Cir. 1909); Texas General Petroleum Corp., 58 B.R. at 358; Huntsville Small Engines, Inc., 228 B.R. at 11-12.

<sup>43</sup> In re Metal Brokers Int'l, Inc., 225 B.R. 920, 921-22 (Bankr. E.D. Wis. 1998); In re North Atlantic Millwork, Corp., 155 B.R. 271, 281 (Bankr. D. Mass. 1993). Moreover, a defendant that was not given notice of the assignment cannot be denied the right to challenge the assignee's standing. Huntsville Small Engines, 228 B.R. at 11-12; Metal Brokers Int'l, 225 B.R. at 921-22.

<sup>44</sup> TWA v. Travelers Int'l AG. (In re Trans World Airlines, Inc.), 163 B.R. 964, 969-71 (Bankr. D. Del. 1994))(there is no standing, right to recover, where there is no possible benefit to the estate.).

<sup>45</sup> In re Sweetwater, 884 F.2d 1323, 1328 (10<sup>th</sup> Cir. 1989).

<sup>46</sup> *Id.*

recovery by the assignee would not benefit the debtor's estate, a relaxed view of the assignability of avoidance actions and the standing of assignees to assert them proceeded largely by steadily expanding notions of the concept of "for the benefit of the estate." By broadening their notions of such benefits to include indirect benefits obtained from the assignment rather than strictly from recovery, Courts have expanded the situations under which an assignee will have standing and thereby increased the estate's ability to assign these assets.

a. Liens on Avoidance Actions

We should also distinguish between outright conveyances of avoidance actions, such as through a sale or assignment, and the encumbrance of avoidance action assets through liens. As to pre-petition liens, the cases typically have held that under section 552, such liens could not attach to avoidance actions because they only come into being with the commencement of a bankruptcy case.<sup>47</sup>

The rule is not without exception however. Courts have recognized distinctions between blanket liens and liens on specific assets. Blanket liens are subject to the rationale above, that they cannot encumber avoidance action assets that do not spring into being until the commencement of a case, while liens over specific property could, even originally, give rise to a lien over the proceeds of recovery of an avoidance action where that action relates to the specific pre-petition property encumbered.<sup>48</sup> For example, where the lender has a pre-petition lien over a specific asset, including proceeds thereof, and that asset is fraudulently transferred prior to bankruptcy, then the post-petition avoidance of that transfer recovers property subject to the lender's lien.

As to post-petition (debtor-in-possession credit and replacement) liens, most courts have simply refused historically to allow such liens to cover avoidance actions.<sup>49</sup> The weakening of this restriction began through distinguishing liens on avoidance actions to liens on the recovery from such actions.<sup>50</sup> In the latter instance, the estate maintains control over the assertion of avoidance actions. Note that no standing issue applies because the secured party has no right to bring the action. However, once recovery is obtained, the secured creditor under these authorities can assert a lien over such proceeds. Still, when addressing assignments of the claims themselves, the assignee must still surmount the issue of standing under section 550

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<sup>47</sup> William H. Medford and Bruce H. White, *Debtor Financing and Liens on Avoidance Actions*, 2004 ABI JNL. LEXIS 12, \*2-3 (March 2004). *Citing In re Tek-Aids Industries Inc.*, 145 B.R. 253, 256 (Bankr. N.D. Ill. 1992); *In re Pearson Industries Inc.*, 178 B.R. 753, 764-65 (Bankr. N.D. Ill. 1995); *In re Ludford Fruit Productions Inc.*, 99 B.R. 18, 24-25 (Bankr. C.D. Ca. 1989); *In re Integrated Testing Products Corp.*, 69 B.R. 901, 904-05 (D. N.J. 1987).

Section 552 provides that "property acquired by the estate after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." 11 U.S.C. §552.

<sup>48</sup> Medford and White, *supra* note 51, at \*4-5. *Citing Pearson Industries Inc.*, 178 B.R. 753; *In re Figearo*, 79 B.R. 914, 917-18 (Bankr. D. Nev. 1987).

<sup>49</sup> *See supra* note 50.

<sup>50</sup> *Gonzales v. Nabisco Div. of Kraft Foods, Inc. (In re Furrs)*, 294 B.R. 763, 768-71 (Bankr. D. N.M. 2003).

and its apparent mandate that avoided transfers may only be recovered for the benefit of the estate.<sup>51</sup>

#### b. Indirect Benefits

As a result of the increasingly popular recognition that bankruptcy serves as a legitimate economic tool for businesses, courts have begun to recognize that tangible, if indirect, benefits adhere to the availability of avoidance actions as a transferable asset subject to encumbrance. The rationale is that the availability of avoidance actions to serve as collateral or sale assets raises the abilities of the debtor to obtain more favorable financing or greater consideration for its assets, thereby conferring upon the estate much needed flexibility and value.<sup>52</sup>

In a recent decision, Mellon Bank, N.A. v. Dick Corp., the Seventh Circuit held that an avoidance action assigned to the debtor's pre-petition secured creditors as adequate protection of their interests primed under the court-approved debtor-in-possession financing, would still be pursued and recovered for the benefit of the estate, notwithstanding that all recovery would actually go to the secured creditors<sup>53</sup> As the Court explained:

The potential to recover funds from preference recipients was put to use for the estate's benefit...when the bankruptcy court promised this value to the objecting secured lenders to compensate them for risk while new super-secured funds were raised and the assets were sold. Instead of calling off the sale, or distributing some assets to the secured creditors, or taking some other step that (the bankruptcy judge believed at the time) would have made creditors as a whole worse off, the judge used the value of these assets to protect the secured creditors' position and thus facilitate what appeared to be the most productive course of action.<sup>54</sup>

Accordingly, Mellon Bank stands for a number of critical propositions under section 550. First, section 550 under its terms is not limited to "actual disbursements to unsecured creditors."<sup>55</sup> More broadly stated, "benefits" can include indirect benefits that flow to the estate.<sup>56</sup> Finally, a strict standing rule would undermine efforts to sell the business because restricting the use of avoidance claims reduces the estate's ability to use such assets to maximize value, and encourages the debtor to make preferential transfers to favored vendors who would not need to repay the firm.<sup>57</sup>

This latter rationale has been criticized by commentators who argue that where avoidance actions cannot be sold for value, that same value remains with the estate. They also question whether the potential, eventual failure of standing in some instances would in reality

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<sup>51</sup> See, e.g., Jerald I. Ancel, *et al.*, *Dangerous Dicta for DIP Lenders: The Risk of a Valid but Valueless Replacement Lien*, 2002 ABI JNL. LEXIS 111 (July 2002).

<sup>52</sup> Randall D. Crocker, *Unbounded Benefit: Defining Benefit to the Estate in Light of Qualitech*, 2004 ABI JNL. LEXIS 42, \*8-9 (February 2004).

<sup>53</sup> Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290 (7<sup>th</sup> Cir. 2003).

<sup>54</sup> *Id.* at 292-93. Also explaining that, "The Supreme Court's decision in Hartford Underwriters did not disturb decisions allowing a lineal descent of statutory rights." *Id.* at 291. *Citing* 530 U.S. at 13 n.5.

<sup>55</sup> *Id.* at 293.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

prompt debtors to siphon funds off to preferred creditors on the eve of bankruptcy, especially as we have already touched on mechanisms designed to allow committees and individual creditors to sue where the debtor refuses to do so.<sup>58</sup> It seems at least arguable that the ability to sell avoidance actions is still preferable because a sale liquidates that asset without the need to incur litigation expenses and also brings funds into the estate earlier rather than later (although the purchaser will certainly factor in the costs of pursuit, as well as the likelihood of recovery in formulating the amount of its offer). At the least, the greater transferability of avoidance actions and the standing to assert them does confer flexibility if not greater value, and this flexibility appears largely to underpin the relaxing trend. Such cases recognize that the estate derives benefits from an action which produces proceeds to partly fund the administrative expenses of the estate, or even indirect benefits from the ability to convey avoidance actions to would-be DIP lenders who would theoretically factor the asset into their extension of credit.

A mere four months' prior to the Mellon Bank opinion, the case of In re Furrs evinced a similarly broad conception of benefit to the estate, albeit in a slightly different context.<sup>59</sup> Furrs involved a settlement agreement among a trustee and the debtor's secured lenders, providing for a sharing of recovery of avoidance actions asserted by the trustee.<sup>60</sup> In the course of litigation, the Trustee was met with the defensive argument that the sharing arrangement meant that (at least a portion of) the recovery was not for the benefit of the estate within the meaning of section 550, and that the trustee accordingly lacked the standing to assert the action.

Rejecting that argument, the Court explained that: (i) the term "estate" is broader than the term "creditors"; (ii) section 550 is satisfied once there is some "identifiable" benefit to the estate; (iii) "the estate benefits when the action increases the value or assets of the estate"; and (iv) such requirement is satisfied where the trustee may devote recoveries towards funding the expenses of administering the estate.<sup>61</sup>

The example can be taken even further. In the Enron case, the debtors successfully requested that the bankruptcy court approve preference waivers to employees who had received bonuses as an incentive for such employees to remain with the debtors until a date certain while waiving their claims against the debtors. Presumably, that request should have implicated the same considerations as with a debtor's historical inability to convey these avoidance actions, which are considered to be held collectively by creditors. The maneuver was approved by the Court as to most of the employees, but rejected as to employees deemed to be insiders.<sup>62</sup> This underscores the advantage to the flexible use of avoidance assets. Presumably, the avoidance liabilities of a number of these employees failed to obtain a level where formal litigation would be worthwhile, in addition to the delicate public relations and fairness concerns typically raised by suits against former employees (excluding senior management). Instead, the debtors here were able to use their avoidance assets as additional consideration to assist them in retaining key employees during their reorganization efforts.

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<sup>58</sup> See Goldberg, *supra* note 12, at \*54.

<sup>59</sup> In re Furrs, 294 B.R. at 783.

<sup>60</sup> *Id.* at 767-68.

<sup>61</sup> *Id.* at 772-73. Furrs contains a very thorough discussion of the section 550 issue. *Accord Silverman Consulting, Inc. v. Hitachi Power Tools, U.S.A., Ltd.* (In re Payless Cashways, Inc.), 290 B.R. 689, 696-97 (Bankr. D. Kan. 2003).

<sup>62</sup> A. Mechele Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck?*, 11 Am. Bankr. Inst. L. Rev. 93, 101 n. 43 (Spring 2003).

## 2. Additional Assignment Issues

At this point, some readers may be inquiring why they have not seen these issues arise in connection with their more complex Chapter 11 cases, where such issues might be expected to arise more often. If those cases eventually resulted in confirmed plans, the quick answer is that section 1123(b)(3)(B) moots the issue by providing a specific authorization for the assignment of avoidance actions in plans of reorganization. In the Sweetwater case, the Tenth Circuit noted that Congress had implemented an exception to the rule forbidding the assignment of avoidance actions through section 1123(b)(3)(B) by providing that a plan of reorganization could include the assignment of avoidance actions to a third party for the benefit of the estate as a whole.<sup>63</sup>

It is easy to see why assignments in plans have not raised the same negative reactions as have assignments in other contexts, because a plan is viewed as a contract among its beneficiaries, including the class (or classes) of general unsecured creditors of the estate. More importantly, the assignee is typically a liquidator who still serves as a fiduciary for the estate, and so the recovery often remains with the estate such that no standing issue is implicated. When one moves beyond this core context, however, to outright assignments to third parties outside of the plan context, then Courts will have to rely upon doctrines of indirect benefits in order to give effect to such assignments.

An additional assignment issue in plan contexts involves notice to the defendant of the assignment. Defendants have asserted *res judicata* defenses to avoidance claims based upon a previously confirmed plan. In bankruptcy contexts, the doctrine of *res judicata* serves to prevent a debtor from failing to disclose a potential cause of action to a creditor prior to plan confirmation, because a creditor's evaluation of, and vote on, the plan would surely be greatly affected by such information.<sup>64</sup> Courts have therefore required the specific identification of assigned claims in plans (or a related disclosure statement) in order to defeat a *res judicata* defense.<sup>65</sup>

The rationale of expanding the use of avoidance claim assets to third parties for their personal benefit is not without its negative systemic implications. The avoidance action scheme is strongly tilted in favor of the plaintiff, and it is arguable that these were never intended for use by an assignee unrelated to the estate, for its personal benefit. This concern is greatly magnified by the reality that the pre-petition secured lender often stands as the party likely to receive an assignment of such assets, if not a liquidating trustee. There is some inescapable sense of inequity in allowing secured creditors to utilize the tilted statutory scheme of avoidance actions and the favorable principles of bankruptcy litigation (such as a court's extension of *in*

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<sup>63</sup> Sweetwater, 884 F.2d at 1328.

<sup>64</sup> See In re Goodman Bros. Steel Drum Co., 247 B.R. 604, 610 (Bankr. E.D.N.Y. 2000); Huntsville Small Engines, 228 B.R. at 13-14; In re Holly's, Inc., 172 B.R. 545, 566 n.26 (Bankr. W.D. Mich. 1994).

<sup>65</sup> In re Worldwide Direct, Inc., 280 B.R. 819, 823 (Bankr. D. Del. 2002); In re USN Communs., Inc., 280 B.R. 573, 588 (Bankr. D. Del. 2002) ("most courts hold that where a disclosure statement and/or plan of reorganization expressly reserves an action for later adjudication, *res judicata* does not apply."); In re Goodman Bros. Steel Drum Co., 247 B.R. 604, 610-13 (Bankr. E.D.N.Y. 2000); In re County of Orange, 219 B.R. 543, 564 (Bankr. C.D. Cal. 1997); In re Envirodyne Industries, Inc., 174 B.R. 986, 991 n. 8 (Bankr. N.D. Ill. 1994). The Sixth Circuit is the most stringent in terms of specificity requirements. See Browning v. Levy, 283 F.3d 761 (6<sup>th</sup> Cir. 2002).

*personam* jurisdiction over all claimants filing claims under the case) to pursue unsecured creditors of the estate for avoidable transfers which are generally intended to benefit the estate's creditors.<sup>66</sup>

### III. TRENDS SPECIFIC TO PREFERENCE CASES

We move now to a survey of recent trends specific to litigating avoidance cases, with a particular emphasis on preference actions, as these claims peculiar to bankruptcy appear to constitute the most common avoidance litigation.<sup>67</sup> Among these trends, perhaps the most fascinating relate to the use of section 502(d) of the Code.

#### A. The Growing Debate Over Section 502(d)

Section 502(d) provides, in essence, that the court shall disallow any claim of an entity from which property is recoverable under [the avoidance provisions of the Code] or that is a transferee of a transfer which is avoidable. The intent of the statute seems facially transparent: a creditor is not allowed to share in distributions from the estate if it has refused to turn over its avoidance liability to the estate. Despite the apparently straightforward effect of the statute, it has given rise to not one but two interesting approaches. Even more interesting is the fact that one such approach pertains to the estate side of the equation, whereas the other is a defensive measure which has been adopted by defendants in avoidance litigation.

##### 1. The Section 502(d) End-Around – Plaintiffs' Use of Section 502 Where Avoidance Actions May Not be Commenced (Post-limitations).

Debtors and estates are with increasingly frequency seizing upon a court's willingness to address avoidance action liabilities in the context of claims objections, even where an avoidance action has not been, or may not even be, commenced. The rationale flows as follows. First, the statute is phrased in mandatory terms, making it attractive to estate parties in seeking the disallowance of claims. The estate representative, through a claim objection giving rise to a contested matter, objects to a claim based on alleged liability for the return of avoidable transfers, irrespective of whether the estate has commenced formal litigation to recover the transfer, or even *can* commence such an action. Rather than complete an action to recover funds, the representative must merely establish at a more procedurally abbreviated hearing that the creditor(s) received an avoidable transfer.

Courts have sanctioned this approach to section 502(d), holding that it may be used prior to a judgment obtained under sections 547, 548, or 550, may be used defensively as a claim objection, and may even be resorted to where an actual avoidance suit might be

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<sup>66</sup> Goldberg, *supra* note 12, at \*55. The transaction or litigation costs of recovering relatively small preferences might well outweigh the value to creditors of making the recovery. In response to pressure from the consumer finance industry, the drafters of the 1984 amendments to the Code excepted from preference avoidance transfers by an individual consumer debtor to a given creditor of property of an aggregate value of less than \$600. 11 U.S.C. § 547(c)(7). Although the cost-benefit analysis would appear to be the same for all preferences, the exception applies only to consumer cases, a limitation explainable by the identity of the lobby that sponsored the amendment.

<sup>67</sup> Space constraints dictate that we leave the audience to resort to their state law expertise of fraudulent transfers, which are essentially analogous to those used in bankruptcy.

unavailable (such as where it is time-barred).<sup>68</sup> In other words, the claim objector need not pursue or await the resolution of a full blown avoidance action, but may resort to a mini-trial within the claim objection process, and thereby side-step the formal requirements of the avoidance action process to substantively assert these claims, even where they are procedurally barred.<sup>69</sup>

The potential benefit to estate interests from the use of this tactic is extremely significant. Through this end-around, an estate can seek to disallow a claim asserted in the millions on account of avoidance action liabilities which may be in the thousands. In this way, the section is actually preferable to the actual avoidance action provisions of the Code in situations where the amount at stake in the potential avoidance action does not justify commencing suit. It is critical to recognize however, that disallowance under this provision is a "temporary disability" in that the claim is subject to disallowance only until the claimant has paid in its liabilities to the estate, and a claimant which stands to receive a substantial distribution would not reasonably allow a far lesser liability to the estate to negate such distributions rather than simply paying it. Still, the approach confers substantial leverage on the estate representative, for it can avoid the procedural requirements of formal litigation and withhold distributions from the creditor unless the creditor is willing to pay in additional funds to the estate when it has most likely already suffered losses in connection with the debtor's case and may have little information on the eventual extent of distributions it may receive on its claim(s). One interesting aspect of this leverage is that setoff under section 553 is unavailable to the creditor despite that any creditor subject to such a claim objection clearly has an asserted claim back against the estate.<sup>70</sup>

## 2. The Section 502(d) Defense Against Avoidance.

Oddly enough, section 502(d) has also simultaneously given rise to a defense to avoidance actions which, almost assuredly, was not intended by the drafters of the Code. The rationale of the defense is that, because the section mandates disallowance where a claimant has avoidance action liability to the estate, any prior, formal and affirmative allowance of a claim carries the necessary implication that there can be no avoidance liability at issue with respect to that claimant.<sup>71</sup> The defense has its genesis in the Supreme Court decision in Katchen v.

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<sup>68</sup> In re Mid Atlantic Fund, Inc., 60 B.R. 604, 609 (S.D. N.Y. 1986); In re Discount Family Boats, Inc., 233 B.R. 365, 368 (Bankr. N.D. Tex. 1999); In re Chase & Sanborn Corp., 124 BR 368, 370 (Bankr. S.D. Fla. 1991); In re Coral Petroleum, Inc., 60 B.R. 377, 383 (Bankr. S.D. Tex. 1986)(claims shall be disallowed for voting purposes, irrespective of whether claims for avoidance are fully adjudicated, until such time as any amount for which the creditor is eventually found liable is returned to the estate).

<sup>69</sup> Note also the potential intersection with standing issues. It is generally accepted that standing to object to a claim is much broader than the standing to assert an avoidance action. See In re Williamson, 43 B.R. 813, 820 (Bankr. D. Utah 1984).

<sup>70</sup> MicroAge, Inc. v. Viewsonic Corp. (In re MicroAge, Inc.), 291 B.R. 503, 510 (9<sup>th</sup> Cir. B.A.P. 2002)(explaining that a creditor may not offset its liabilities in connection with section 502(d) against its claim against the estate because the turn over of all such liabilities is a precondition to an allowed claim.) Note that this is a very different issue than the use of setoff as a substantive defense to a preference claim.

<sup>71</sup> LaRoche Industries Inc. v. General American Transportation Corp. (In re LaRoche Industries Inc.), 284 B.R. 406 (Bankr. D. Del. 2002)("§ 502(d) stands for the proposition that if a claim is allowed there is no longer a voidable transfer due from that claimant. In essence, a voidable transfer, such as a preference, must be determined, as part of the claims process and not at a later time, especially after distribution under the plan has been made.").

Landy.<sup>72</sup> There, the Court addressed the substantially equivalent provision to section 502(d) of the former Bankruptcy Act, and held that the section required the resolution of preference claims prior to allowance or disallowance of claims.<sup>73</sup>

Not all courts construing the Code recognize this defense, however, and it appears to be losing steam in recent days.<sup>74</sup> The Courts rejecting the defense opine that the Chapter 11 process argues in favor of addressing reorganization issues first, which may involve claim settlements, and putting off avoidance litigation for a later date, and particularly in the event of conversion.<sup>75</sup> Other courts have held that section 502(d) is a claim objection statute, and therefore does not apply (cannot be resorted to by the defendant) in the absence of a claim objection, thereby forestalling the defensive use of the section in avoidance litigation.<sup>76</sup>

## B. Trends in Asserting Affirmative Defenses

### 1. The Ordinary Course Defense of 547(c)(2) and the Growing Trend of Debt Restructures

Another recent trend we have noted with respect to preference defenses, and specifically pertinent to the ordinary course of business defense, is the growing recognition of debt restructuring agreements, and payments made pursuant thereto, as being within the ordinary course. At the risk of oversimplification, section 547(c)(2) of the Code excepts from avoidance payments made within the ordinary course of business, and specifically, payments: (i) made on account of debts incurred in the ordinary course of dealings between the parties; (ii) made according to the parties' ordinary course of dealing, and (iii) made according to ordinary business terms (in the industry).

Debt restructuring agreements pose interesting questions for this defense, because they arise from collection actions with respect to an original debt, which the defense certainly was not intended to protect. Prior decisions considered these agreements to be *per se* extraordinary.<sup>77</sup> They reason that a restructuring agreement by definition arises from unusual collection activity by a creditor to obtain a favorable position with a troubled debtor, the exact antithesis of the ordinary course defense.<sup>78</sup>

The difficulty emanates from practical considerations over the growing use of these agreements in various industries. In short, they are becoming less unusual, blurring the line

<sup>72</sup> Katchen v. Landy, 382 U.S. 323, 86 S.Ct. 467, 15 L. Ed. 2d 391 (1966).

<sup>73</sup> 382 U.S. at 330-31.

<sup>74</sup> In re TWA Inc. Post Confirmation Estate, 305 B.R. at 227; Rhythms NetConnections Inc. v. Cisco Systems Inc. (In re Rhythms NetConnections Inc.), 300 B.R. 404 (Bankr. S.D.N.Y. 2003); Peltz v. Goldcoast Workstation Group (In re Bridge Information Systems Inc.), 293 B.R. 479 (Bankr. E.D. Mo. 2003).

<sup>75</sup> In re TWA Inc. Post Confirmation Estate, 305 B.R. at 226-27.

<sup>76</sup> Except, presumably, where a claim objection is also asserted. In re Bridge Information Systems Inc., 293 B.R. at 488.

<sup>77</sup> Red Way Cartage Co., Inc. v. Stanley Kubicki (In re Red Way Cartage Co.), 84 B.R. 459 (Bankr. E.D. Mich. 1988); Prod. Steel, Inc. v. Sumitomo Corp. of Am. (In re Prod. Steel, Inc.), 54 B.R. 417, 423 (Bankr. M.D. Tenn. 1985).

<sup>78</sup> Danny M. Awdeh, *Putting The Brakes On The Ordinary Course Of Business Exception To Avoidable Preferences: Restructuring Agreements As Per Se Non-Ordinary Under 11 U.S.C. § 547(c)(2)*, 19 Bank. Dev. J. 215, 224 (2002).

distinguishing what constitutes an unusual collection practice from ordinary commercial practice. Accordingly, Courts have begun to recognize that what is ordinary for an industry could include considerations of whether that industry is healthy or marked by financially troubled entities, or whether other particular characteristics of the industry result in the commonplace incidence of debt restructuring agreements.<sup>79</sup>

The Ninth Circuit Court of Appeals held exactly that in Kaypro v. Justus, seizing on a similar holding in In re Roblin Industries Inc.<sup>80</sup> In Roblin, the Court had stated that it was unwilling to hold that restructuring agreements could never be within the ordinary course, where industries were using them more and more frequently, because this would have the unnatural prejudicial effect of preventing those industries from resorting to the defense, or requiring them to actually act outside of their customary practices in order to do so.<sup>81</sup> Kaypro goes a step further, holding that the courts' conception of what is ordinary must include what is ordinary for troubled debtors, i.e., that the ordinary course of a debtor's industry includes industry practices adopted by business which are similarly situated with the debtor (facing similar financial difficulties).<sup>82</sup>

Contrast this growing trend expanding the defense to the law applied in the Tenth Circuit, which remains notoriously stringent in its application of the defense. The Court of Appeals in In re Hoffman, explained that "ordinary course" could mean either: (i) terms that creditors in similar situations would commonly use, even if the situation itself is extraordinary, or (ii) terms that are used in usual or ordinary situations.<sup>83</sup> It chose the latter meaning, and further elaborated that "ordinary business terms therefore are those used in 'normal financing relations'; the kinds of terms that creditors and debtors use in ordinary circumstances, *when debtors are healthy*."<sup>84</sup>

As further elaborated in Gonzales v. Nabisco:

This interpretation raises difficulties for defendants because it makes irrelevant evidence of similar businesses' treatment of delinquent customers who are having financial problems... This definition by the Tenth Circuit has been called "unique" because it flatly rejects both the "party focused view" (court excludes late payments from preference attack when the manner and timing conform to the manner and timing of previous payments made and accepted between the parties) and the "industry-terms view" (court asks whether the manner and timing of the late payments conforms to the general and accepted methods of the parties' industry) adopted by the other circuits.<sup>85</sup>

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<sup>79</sup> William H. Medford and Bruce H. White, *Restructuring Agreements and the Ordinary Course of Business Exception How to Avoid Avoidance*, 2001 ABI JNL. LEXIS 53, \*4-7 (March 2001).

<sup>80</sup> Kaypro v. Justus (In re Kaypro), 218 F.3d 1070 (9<sup>th</sup> Cir. 2000); In re Roblin Industries Inc., 78 F.3d 30, 42 (2<sup>nd</sup> Cir. 1996).

<sup>81</sup> In re Roblin Industries Inc., 78 F.3d at 42.

<sup>82</sup> In re Kaypro, 218 F.3d at 1074.

<sup>83</sup> Clark v. Balcor Real Estate Fin. (In re Meridith Hoffman Partners), 12 F.3d 1549, 1553 (10<sup>th</sup> Cir. 1993).

<sup>84</sup> *Id.* (emphasis supplied)

<sup>85</sup> *Memorandum Opinion on Cross Motions for Summary Judgment and Orders Denying Cross Motions for Summary Judgment*, Gonzales v. Nabisco Division of Kraft Foods, Inc., Adv. No. 02-

The tensions with restructuring agreements are difficult to reconcile. On the one hand, viewing these agreements as ordinary arguably has the effect of legitimizing preferences. It validates and rewards the creditor for seeking to obtain a preference, potentially including liens obtained on previously unsecured debt. It therefore also favors creditors already possessing superior knowledge and leverage, because these creditors will typically be in the best position to know when a restructuring agreement is advantageous, and to obtain concessions from the debtor.

## 2. 547(c)(4) New Value and the Garland v. Leathers Methodologies

Another disagreement among the Circuits with respect to the proper application of a section 547 affirmative defense, is the proper method of calculating the so-called "subsequent new value" defense of section 547(c)(4). Under this defense, the creditor can offset any new value advanced against the prior preferential payment. Different courts however, have utilized different rules of calculation, the effects of which can be very significant.

Under the Garland Rule, subsequent advances of new value may be used to offset prior (even if not immediately prior) preferences. This rule benefits the creditor because it is able to "carry forward preferences" until they are exhausted by subsequent advances of new value.<sup>86</sup> In contrast, minority Courts using the Leathers Rule, or "transactional approach," hold that new value given by the creditor may be used to offset only the immediately preceding preference.<sup>87</sup> "Excess" new value which may remain after application against an immediately preceding, potentially preferential transfer, is lost. Therefore, once each provision of new value has been applied to the immediately preceding preferential transfer, this rule has the effect of carrying forward the remaining balance of each preferential transfer and insulating it against all subsequent provisions of new value.

Under the Garland Rule, if there is excess exposure for avoidance after the application of a provision of new value, that balance is added to the next potentially preferential transfer, so that any subsequent advance of new value may negate it. However, under both rules, if at any time the exposure balance reaches zero, where new value more than accounts for the transfer exposure, that surplus new value cannot be carried and applied against a later, potentially preferential transfer.

## II. AVOIDING TRANSFERS THROUGH RECHARACTERIZATION AND EQUITABLE SUBORDINATION

Finally, we discuss two additional doctrines which may not be classically thought of as avoidance claims but which, when resorted to, can have extremely beneficial advantages for the estate in avoiding the need to make distributions on a creditor's claim: recharacterization, and equitable subordination under section 510(c) of the Code.

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<sup>86</sup> 1091, at 10-11 n. 3 (D. N.M. June 20, 2003)(Strazynski, J.). The Court goes on to explain that the standard does in fact utilize industry terms, but merely refines the scope of the industry. *Id.* In re Thomas W. Garland, Inc., 19 B.R. 920 (Bankr. E.D. Mo. 1982). See also Mosier v. Ever-Fresh Food Co. (In re IRFM, Inc.), 52 F.3d 228, 232 (9<sup>th</sup> Cir. 1995); Jobin v. Lalan (In re M&L Business Mach. Co.), 160 B.R. 851, 855 (Bankr. D. Colo. 1993).

<sup>87</sup> Leathers v. Prime Leather Finishes Co., 40 B.R. 248 (D. Maine 1984). See also Krohn v. ADM Milling Co. (In re Dependable Food Prods.), 193 B.R. 662, 666 (Bankr. E.D.N.Y. 1996) (Leathers represents the minority view).

## A. Recharacterization

Under this doctrine, a plaintiff can seek to have a court recharacterize a creditor's extension of credit into a contribution of equity. Of course, as the creditor's claim is recharacterized as an equity interest, it loses virtually all hope of distributions under a Chapter 11 case. The doctrine also has two separate lines of developing authority, one used by most Circuits, and one created by the Fifth Circuit as a subset of subordination.

Generally outside of the Fifth Circuit, Courts applying recharacterization inquire whether an alleged loan was **in fact** an equity contribution at the outset.<sup>88</sup> As these cases inquire whether a loan transaction was in fact a loan or a disguised capital contribution **at the outset**, they apply a factor analysis which primarily tests for the hallmarks of a loan transaction.<sup>89</sup>

Conversely, the Fifth Circuit treats recharacterization as a derivative of equitable subordination. The Fifth Circuit is not concerned with whether a loan was in fact originally a loan, but with whether the circumstances surrounding the advance equitably dictate that the advance be deemed a capital contribution.<sup>90</sup>

## B. Equitable Subordination and the Relationship to Recharacterization

Because the recharacterization claim is a subset of subordination under Fifth Circuit jurisprudence, the Circuit's standard applicable to recharacterization must be derived from the standard it promulgated for equitable subordination claims, which is generally accepted in all Circuits.

A tripartite test determines whether a claim should be subordinated. Under this test, subordination is justified if: (i) the claimant engaged in inequitable conduct; (ii) the misconduct resulted in injury to the creditors or conferred an unfair advantage on the claimants; and (iii) equitable subordination of the claim would not be inconsistent with the provisions of the Code.<sup>91</sup>

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<sup>88</sup> See Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.), 269 F.3d 726, 748 (6<sup>th</sup> Cir. 2001)("Recharacterization is appropriate where the circumstances show that a debt transaction was actually [an] equity contribution **ab initio**.")(internal quotations omitted)(emphasis in original); In re Exide Techs., Inc., 299 B.R. 732, 740 (Bankr. D. Del. 2003).

<sup>89</sup> The factors are: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments. Roth Steel Tube Co. v. Commissioner, 800 F.2d 625, 630 (6<sup>th</sup> Cir. 1986).

<sup>90</sup> In re Fabricators, Inc., 926 F.2d 1458, 1469 (5<sup>th</sup> Cir. 1991)("When an insider makes a loan to an undercapitalized corporation, a court may recast the loans as contributions to capital."), *citing* Spach v. Bryant, 309 F.2d 886, 888 (5<sup>th</sup> Cir. 1962). See also Blasbalg v. Tarro (In re Hyperion Enters.), 158 B.R. 555, 559-560 (D. R.I. 1993)(discussing the different approaches to recharacterization).

<sup>91</sup> In re Mobile Steel Co., 563 F.2d 692, 699-700 (5<sup>th</sup> Cir. 1977). The final prong of the standard is a reference to the Supreme Court's holding in United States v. Noland, 517 U.S. 535, 116 S. Ct.

The categories of inequitable conduct contemplated by the Fifth Circuit initially encompassed: (i) fraud, illegality, or breach of fiduciary duties; (ii) under-capitalization; and (iii) a claimant's use of the debtor corporation as a mere instrumentality or alter ego.<sup>92</sup> The Court of Appeals has since refined the three categories of inequitable conduct as: (i) misuse of the fiduciary position to the disadvantage of other creditors; (ii) use of control over the debtor to the disadvantage of other creditors; and (iii) actual fraud.<sup>93</sup> Those three categories remain applicable today.<sup>94</sup>

The confusion with recharacterization stems in part from the mixed categories of inequitable conduct promulgated in Fabricators and in Cajun Electric. In Fabricators, it is apparent that the Court of Appeals was including recharacterization as one type of subordination, hence the reference to undercapitalization. In Cajun Electric, the court had moved beyond this practice to treat recharacterization as a separate doctrine, thereby explaining why undercapitalization has been removed from the equation.

Under this standard, applied to recharacterization, it appears that *initial* undercapitalization can, by itself, equate to inequitable conduct, but this is not the case with equitable subordination.<sup>95</sup> It should be noted that recharacterization is still possible outside of the context of initial capitalization, but that in other contexts, recharacterization will also require some other, additional inequitable conduct. Viewed this way, the doctrine recognizes that a loan taken as a substitute for adequate initial capitalization is more egregious than a loan taken as a substitute for an additional infusion of capital later in the debtor's operating existence. The foregoing should also establish that these types of claims are at their strongest when addressing the claims of insiders, where the type and degree of control tends to be more extensive, and where fiduciary relations are more likely to exist.<sup>96</sup>

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1524, 134 L. Ed. 2d 748 (1996), in which the court held that a claim may not be categorically subordinated at the policy level. In other words, a bankruptcy court cannot substitute its policy decision for Congress's in determining what classes of claims should receive distributions in what order, but must make its decision based upon the specific facts of the claim. 517 U.S. at 543. It should also be noted that subordination can be tailored by amount and priority (the extent to which a claim is subordinated), whereas recharacterization is an "all-or-nothing" proposition.

<sup>92</sup> Fabricators, 926 F.2d at 1467.

<sup>93</sup> In re Cajun Electric Power Coop., Inc., 119 F.3d 349, 357 (5<sup>th</sup> Cir. 1997) (*citing In re United States Abatement Corp.*, 39 F.3d 556 (5<sup>th</sup> Cir. 1994)).

<sup>94</sup> With the caveat that, where recharacterization and initial undercapitalization are at issue, the initial undercapitalization by itself constitutes the inequitable conduct justifying recharacterization.

<sup>95</sup> Hyperion Enters., 158 B.R. at 560 (explaining that where insider shareholders make secured loans to their corporations, that initial undercapitalization can itself constitute inequitable conduct, but that as to subordination, inadequate capitalization does not suffice as inequitable conduct.).

<sup>96</sup> If the claimant is an insider, less egregious conduct will support equitable subordination or recharacterization of their claim. Fabricators, 926 F.2d at 1465.