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POSTPETITION TRANSFERS: LET'S GET IT BACK

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POSTPETITION TRANSFERS: LET'S GET IT BACK

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I. INTRODUCTION.

The Bankruptcy Code, 11 U.S.C. §§ 101-1330, has been in effect for more than twenty-six years. Although many Code provisions have been amended, § 549, dealing with avoidance of postpetition transfers, has remained constant. Compared to preferential transfer and fraudulent conveyance actions, there are relatively few reported decisions which address avoidance and recovery of postpetition transfers.

Litigating § 549 postpetition transfer issues is somewhat infrequent because § 549 appears so straightforward; the author believes that nearly all disputes are settled. When litigated, the author suspects that bench decisions regularly occur--there are few written opinions. These materials contain selected written opinions by the trial and appellate courts. Many of the issues raised by the opinions are addressed in a problem solving context.

The problems in these materials are intended to review the basic § 549 avoidance and recovery principles. Statutory defenses and some uncommon nonstatutory defenses are also addressed by the problems.

The reader should note that there seems to be a growing trend of using available § 547 defenses in the § 549 context. The panelists intend to give practical advice. Participants at the roundtable are welcomed to share their knowledge about this area of the law.

II. AVOIDANCE OF POSTPETITION TRANSFERS.

A. The Operative Statutory Subsection.

11 U.S.C. § 549(a) states:

(a) Except as provided in subsection (b) or (c) of this
section, the trustee may avoid a transfer of property
of the estate--

(1) that occurs after the commencement of the case; and
(2)(A) that is authorized only under section 303(f) or 542(c) of this
title; or
(B) that is not authorized under this title or by the court.

B. Elements And Burden Of Proof.

For a plaintiff-trustee to prevail, it must be shown that:

1. a transfer occurred;

2. the transfer was of property of the estate;

3. the transfer was after commencement of the case; and

4. the transfer was not authorized by the Bankruptcy Code or the bankruptcy court.

See, e.g., Gibson v. United States (In re Russell), 927 F.2d 413, 417-18 (8th Cir. 1991); Nelson v. Kingsley (In re Kingsley), 208 B.R. 918, 920 (Bankr. 8th Cir. 1997); Krol v. Wilcek (In re H. King & Associates), 295 B.R. 246, 291 (Bankr. N.D. Ill. 2003); Litzler v. American Elk Conservatory, Inc. (In re Kelso), 196 B.R. 363, 368 (Bankr. N.D. Tex. 1996).

FED. R. BANKR. P. 6001 states:

> "Any entity asserting the validity of a transfer under § 549 of the Code shall have the burden of proof."

See Manuel v. Allen (In re Allen), 217 B.R. 952, 955 (Bankr. M.D. Fla. 1998) ("If a transfer is established, the burden of proving the validity of the transfer rests with the defendants in this proceeding.").

Query: Who has the burden of proving "property of the estate" and the timing of the transfer, i.e., "after the commencement of the case"?

1. *"Trustee."*

It is probable that a bankruptcy court will only permit § 549 avoidance powers to be exercised by a trustee or a chapter 11 debtor-in-possession. See In re Shah, 2001 WL 423024 (Bankr. E.D. Pa. 2001) (only trustees and debtors-in-possession, through § 1107, can exercise avoidance powers under § 549 (a)); cf. Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 120 S.Ct. 1942 (2000) (concluding only a trustee or D-I-P may use the § 506(c) surcharge power).

A creditor may not exercise the trustee's (or D-I-P's) avoidance powers, absent a court granting derivative standing. In re The Gibson Group, Inc., 66 F.

3d 1436 (6th Cir. 1995) (a creditor or creditors' committee may obtain derivative standing when a demand is made upon the D-I-P to take action, the demand is declined, a colorable claim exists, and the failure to act is unjustified in light of the D-I-P's duties).

In Glinka v. Murad (In re Housecraft Indus. U.S.A., Inc.), 310 F.3d 64, 68 (2d Cir. 2002), the Second Circuit, after challenge by the defendant to a secured creditor's standing, affirmed that standing may be conferred "to bring suit on behalf of a bankruptcy estate when the trustee unjustifiably refused to do so." In Glinka, it was determined the secured creditor could seek recovery of fraudulent conveyance and postpetition transfer claims, when the bankruptcy court ratified a joint prosecution agreement by the creditor and trustee.

2. *"Transfer."*

11 U.S.C. § 101(54) defines "transfer" as follows:

> [T]ransfer means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption[.]

The Bankruptcy Code mandates "an expansive definition of transfer." Barnhill v. Johnson, 503 U.S. 393, 400,112 S.Ct. 1386, 1390 (1992). "A transfer is a disposition of an interest in property. The definition of transfer is as broad as possible." H.R. Rep. No. 595, 95th Cong. at 314 (1977). "'What constitutes a transfer and when it is complete' is a matter of federal law." Barnhill v. Johnson, 503 U.S. 393, 397-98, 112 S.Ct. 1386, 1389 (1992) (quoting McKenzie v. Irving Trust Co., 323 U.S. 365, 369-70, 65 S.Ct. 405, 407-08 (1945)).

Problem 1: What constitutes a "transfer"?

(a) payment of funds? In re M & L Business Machine Co., 59 F.3d 1078 (10th Cir. 1995).

(b) payment of life insurance proceeds? Matter of Hargis, 887 F.2d 77 (5th Cir. 1989).

(c) a judicial tax sale? Compare In re Shah, 2001 WL 423024 (Bankr. E.D. Pa. 2001) with In re Shamdlin, 890 F.2d 123 (9th Cir. 1989).

(d) execution of an employment contract? In re Allen, 217 B.R.

952 (Bankr. M.D. Fla. 1998).

(e) notation of a lien on a vehicle title? In re Weaver, 131 B.R. 804 (S.D. Ohio 1991).

(f) granting a deed of trust or mortgage? Compare In re McConville, 110 F.3d 47, 49 (9th Cir. 1997) (stating that "creation of a lien does not transfer property for purposes of § 549"; as a result of disregarding § 364, the court rescinds the unauthorized postpetition lending arrangement) with In re Auxano, Inc., 96 B.R. 957, 960 (Bankr. W.D. Mo. 1989) ("taking a security interest in real estate is a 'transfer' as that term is defined in 11 U.S.C. Section 101(50)." [now § 101 (54)]).

(g) the ownership designation of an annuity contract? In re Pepmeyer, 275 B.R. 539 (Bankr. N.D. Iowa 2002) (under Iowa law, an annuity contract is "property"; transfer occurred when the debtor signed the ownership designation).

(h) a debtor-in-possession's refusal to accept a settlement offer? In re Kelso, 196 B.R. 363 (Bankr. N.D. Tex. 1996) ("[T]he court must first determine that a settlement offer may be considered property of the estate, before it can determine that it has been transferred.")

(i) withdrawal of an individual debtor's wholly owned corporation as a general partner in a limited partnership? In re Hill, 265 B.R. 296 (Bankr. M.D. Fla. 2001) (a "transfer" occurred when debtor withdrew his corporation as general partner and substituted his daughter).

(j) a payment to a creditor who drew on a letter of credit? In re Farm Fresh Supermarkets of Maryland, Inc., 257 B.R. 770 (Bankr. D. Md. 2001) (drawing on a standby letter of credit, which is similar to a guarantee, did not transfer property of the estate).

(k) the shareholders in a subchapter S corporation *refusing* to waive loss carrybacks and utilizing net operating losses to obtain individual rights to refunds? In re Forman Enterprises, Inc., 281 B.R. 600 (Bankr. W.D. Pa. 2002) ("Refusing to transfer an asset not owned by the estate to the estate can hardly be termed a transfer.").

(l) the postpetition disclaimer of an inheritance? In re Wood,

291 B.R. 829 (Bankr. C.D. Ill. 2003) (under Illinois law, a disclaimer relates back to date of death of testator).

postpetition "policy loans" against life insurance policies owned by the debtor? Phoenix Amer. Life Ins. Co. v. Devan, 308 B.R. 237 (D. Md. 2004) (so-called policy loans "entail mere withdrawal and retention by the debtor of its own property" and are not transfers of property of the estate; by contrast, postpetition interest payments on policy loans are transfers of property of the estate and may be avoided under § 549; interest payments are not in the ordinary course of business of operating retail clothing stores).

3. *"Property Of The Estate."*

11 U.S.C. § 541(a) defines property of the estate. Such property includes "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). Property of the estate is broadly defined. 11 U.S.C. § 541(a)(1)-(7); § 1306(a) (chapter 13 cases); United States v. Whiting Pools, Inc., 462 U.S. 198, 204-05, 103 S.Ct. 2309, 2313-14 (1983). Property interests are generally determined by state law unless a federal purpose requires a different result. Butner v. United States, 440 U.S. 48, 55, 99 S.Ct. 914, 918 (1979).

"For bankruptcy purposes, the 'property of the estate' includes only the debtor's equity in the property." In re Bean, 252 F.3d 113, 117 (2d Cir. 2001) (citing In re Mahendra, 131 F.3d 750, 755 (8th Cir. 1997)); United States v. Rauer, 963 F.2d 1332, 1337 (10th Cir. 1992). Therefore, when a debtor sells property postpetition, satisfies the lien, and then turns the balance of the proceeds over to the trustee, the lienholder is not liable to turn over the funds that satisfied the lien; the trustee may "recover only the equity [the debtor] held in the Property the day he filed for bankruptcy . . . ." In re Bean, 252 F.3d at 117.

Certain types of property are explicitly excluded from property of the estate. 11 U.S.C. § 541(b)(1)-(5). Also, restrictions on transfers of spendthrift trusts, including ERISA-qualified trusts, are enforceable and excluded from property of the estate. 11 U.S.C. § 541(c)(2); Patterson v. Shumate, 504 U.S. 753, 112 S.Ct. 2242 (1992).

The payment of funds subject of a statutory trust is not avoidable because the funds are not property of the estate. Begier v. Internal Revenue Service, 496 U.S. 53, 110 S.Ct. 2258 (1990) (trust fund taxes paid by debtor); In re Suwannee Swifty Stores, Inc., 266 B.R. 544 (Bankr. M.D. Ga. 2001), aff'd, 67 Fed. Appx. 583, 2003 WL 21067111 (11th Cir. 2003) (lottery ticket funds subject to state statutory trust are not property of the estate even though the funds were comingled).

Problem 2: The debtors file a chapter 11 bankruptcy case. After one debtor dies and the other obtains the life insurance proceeds, a payment is made to the debtors' attorney on a prepetition obligation. Matter of Hargis, 887 F.2d 77 (5th Cir. 1989) (the insurance proceeds were received more than 180 days after the petition was filed; the transfer was made out of nonestate assets and cannot be avoided; a fiduciary duty exists only with respect to estate funds).

Problem 3: A debtor corporation engages in a Ponzi scheme and defrauds many creditor-investors. A creditor receives payment from the debtor after filing of the case. In re M & L Business Mach. Co., 59 F.3d 1078 (10th Cir. 1995) (although property acquired fraudulently does not pass title to the debtor, the defrauded claimant must be able to identify or trace the property). What if the debtor only defrauded one person to obtain funds? Cf. In re Newpower, 233 F.3d 922 (6th Cir. 2000) (embezzled funds are not property of estate; creditor can take action to recover funds and traceable property).

Problem 4: A debtor buys a vehicle one week before filing a chapter 7 bankruptcy. Twelve days after the filing, the vehicle title was issued and the creditor's lien was noted on the title. In re Weaver, 131 B.R. 804 (S.D. Ohio 1991) (under Ohio law, neither debtor nor estate acquired any rights in the vehicle until the title was issued; the debtor could not transfer any interest in the vehicle until the title was issued).

Problem 5: A chapter 11 debtor has its plan confirmed. Later, the case is converted to chapter 7 because the reorganized debtor defaults on its plan payments. The chapter 7 trustee files a § 549 action against a bank to recover postpetition plan payments. In re Chattanooga Wholesale Antiques, Inc., 930 F. 2d 458 (6th Cir. 1991); see also 11 U.S.C. § 1141.

Problem 6: Before filing of the bankruptcy petition, a supplier-creditor and the debtor enter into an agreement that the debtor's customers will remit joint checks to the supplier-creditor and the debtor for furnishings and equipment purchased from the supplier-creditor. The debtor files for chapter 11 relief. After filing, in accordance with the agreement, the creditor cashes a joint check from a customer and applies the funds to pay the debtor's prepetition indebtedness. In re Network 90 Degrees, Inc., 98 B.R. 821 (Bankr. N.D. Ill. 1989), aff'd, 126 B.R. 990 (N.D. Ill. 1991) (in a § 549 action, the court states the debtor gave up control of the property prepetition and therefore did not transfer property of the estate). But see In re Libby Int'l, Inc., 247 B.R. 463, 467, 469 (Bankr. 8th Cir. 2000) (in a § 547 action, the court criticizes Network 90 Degrees as misapplying the earmarking doctrine; "[t]he doctrine was originally based upon the rationale that since the funds were provided by a third party for a specific purpose of paying a selected creditor, the debtor had no actual control over the disbursement [and] [t]hus, because the estate was not diminished by the payment, the payee should not required to return the funds"; "In this instance

a creditor was not substituted, there was merely a diversion of an income source. The fact that a debtor did not handle the checks does not compel the conclusion that it has no interest in them.").

Problem 7: The debtor owed its landlord over $300,000 in rent. Facing eviction, the debtor filed a chapter 11 case. One week after filing, the landlord was granted relief from stay to obtain possession of the leased premises. The debtor then negotiated an agreement with the landlord whereby a related nondebtor corporation would pay $100,000 and the debtor would pay $13,000 per month to be applied to the prepetition lease arrearages. After the case converted, the chapter 7 trustee sued to recover the payments as avoidable postpetition transfers. In re Westchester Tank Fabricators, Ltd., 207 B.R. 391 (Bankr. E.D.N.Y. 1997) (earmarking doctrine may apply in § 549 avoidance actions; $100,000 payment from a nondebtor corporation is not property of the estate; the other monthly payments made by the D-I-P are avoidable).

Problem 8: Prepetition, an attorney entered into an agreement with a debtor to provide representation for criminal tax matters. The debtor gave the attorney a note for up to $35,000 with the debt to be secured by a deed of trust on real property. The debtor then filed for chapter 7 relief. The attorney continued to provide representation to the debtor postpetition. The prepetition debt was $5,000; the postpetition debt totaled $10,000. The chapter 7 trustee sued the attorney to avoid the attorney's lien under § 549. In re Mahendra, 131 F.3d 750 (8th Cir. 1997) (debtor's equity in real property is property of the estate; the attorney was not entitled to payment from the estate for his postpetition legal services; the attorney's attempt to rely upon future advances to increase his secured debt and reduce the estate's equity constituted an avoidable postpetition transfer).

Query: Can the postpetition advance clause and deed of trust reduce the debtor's exemption in the property rather than reducing the property of the estate?

Problem 9: The debtor makes a hole-in-one at a golfing event and wins a prize--a 1999 Cadillac Escalade. Two weeks later, the debtor files for chapter 7 relief. He schedules an asset, "possible hole-in-one contest prize," and lists the value at $3,000. He claims the prize as exempt in an amount of $2,500. At the § 341 meeting, the debtor testified he had agreed to split the prize equally with his buddies in the foursome. (The trustee knows of no other evidence that would refute this testimony.) The trustee further investigates the facts and finds that, two months after filing, the debtor took possession of the Cadillac, then valued at $43,000. The debtor sold the vehicle to First buddy for $36,000. The proceeds were divided: First buddy: $8,000 (credited to $36,000 purchase price); Second buddy: $9,000; Third buddy: $9,000; and debtor: $10,000. Under § 549, the trustee sues First buddy for $36,000; Second buddy for $9,000; and Third buddy for $9,000. In re Ackhoff, slip op. case no. 99-54903,

Adv. No. 00-4127 (Bankr. E.D. Mich., February 22, 2001) (Rhodes, J.), aff'd 272 B.R. 633 (E.D. Mich. 2002) (the entire vehicle and the proceeds received therefrom were property of the estate; the agreement to split the prize constituted a debtor-creditor relationship; as prepetition creditors, the three buddies received avoidable postpetition transfers).

4. *"After Commencement Of The Case."*

A voluntary case, a joint case, or an involuntary case is commenced by filing a bankruptcy petition. 11 U.S.C. §§ 301, 302 & 303. The commencement of the case is easily determined with certainty. However, in some instances involving payment by check, an issue exists as to when the "transfer" occurs.

Problem 10: The landlord received a rent check from the debtor for $11,000 on March 5 to pay the March rent. An involuntary petition was filed on March 6. On March 7, the check was honored. Was the transfer prepetition or postpetition? Compare In re Oakwood Markets, Inc., 203 F.3d 406 (6th Cir. 2000) (for § 549(a) purposes, a transfer occurs when a check is honored) with Quinn Wholesale, Inc. v. Northen, 873 F.2d 77 (4th Cir. 1989) (for § 549(a) purposes, a transfer occurs upon delivery of a check).

Query: Has Quinn been implicitly overruled by Barnhill v. Johnson, 503 U.S. 393, 399, 112 S.Ct. 1386, 1390 (1992) (date of honor applies for § 547(b) avoidance purposes; "For the purposes of payment by ordinary check, therefore, a 'transfer' as defined by § 101(54) occurs on the date of honor, and not before.")? See In re Franklin, 254 B.R. 718 (Bankr. W.D. Tenn. 2000) (date of honor rule applies; although trustee may recover from transferee, bank which, without notice of the case, paid the chapter 13 debtor's check was not liable under safe harbor of § 542).

Problem 11: The debtors obtain and mail a *certified* check in the amount of $25,000 to a bank to pay down their mortgage and increase their homestead exemption. The next day, the debtors file a chapter 7 case. The check arrived at the bank's offices four days after the filing and the debtors' account was promptly credited. The chapter 7 trustee demanded return of the payment asserting that it constituted an avoidable postpetition transfer. When did the transfer occur? cf. In re Mora, 199 F.3d 1024 (9th Cir. 1999) (transfer of a mailed cashier's check occurred when the check was received and the bank had physical possession of it; rationale: the purchaser of the check may regain control over it prior to receipt by the payee).

Query: What if the check was deposited in the bank's lockbox the day before filing?

5. *"That Is Not Authorized Under [The Code] Or By The Court."*

A trustee may generally avoid a postpetition transfer of estate property unless the transfer is authorized by the Bankruptcy Code or the bankruptcy court. Code-authorized transfers may be accomplished by a § 363 sale, a § 554 abandonment, or by the debtor exempting property under § 522(b). See George M. Treister, et al., FUNDAMENTALS OF BANKRUPTCY LAW § 4.04 at 217 (4th ed. 1996). Possible other examples of Code-authorized transfers include encumbering estate property under § 364, granting relief from stay under § 362 (d) to permit a secured creditor to foreclose its collateral, and dispositions of property in the ordinary course of business, without notice or a hearing, pursuant to § 363(c)(1). See also Wilmington Trust Co. v. WCI Steel, Inc. (In re WCI Steel, Inc.), 313 B.R. 414 (Bankr. N.D. Ohio 2004) (debtor's postpetition funding contributions to collectively bargained pension plan are authorized under § 1113(f) and thus are not avoidable as postpetition transfers under § 549) (citing United Steelworkers of America v. Unimet Corp. (In re Unimet Corp.), 842 F.2d 879 (6th Cir. 1988)). But see Scharffenberger v. Billmire (In re Allegheny Health, Education & Research Foundation), 313 B.R. 673, 677-78 (Bankr. W.D. Pa. 2004) (section § 1108, which authorizes a debtor in possession to operate its business, "does not authorize the debtor to make postpetition payments with respect to prepetition debt"). Granting relief from stay is not tantamount to an abandonment of property; although the secured creditor may foreclose, the debtor may not transfer the property. In re Shelton, 273 B.R. 116 (Bankr. W.D. Ky. 2002), vacated on other grounds and remanded, 95 Fed. Appx. 801, 2004 WL 834776 (6th Cir. 2004) (granting relief from stay to a creditor does not authorize transfer of the property by the debtor).

Authorization of a transfer by the court should often be a simple matter to determine. "It is axiomatic that a court speaks through its orders." In re Markey, 144 B.R. 738, 745 (Bankr. W.D. Mich. 1992); see also, Williams v. Brown, 921 F. 2d 277, 1990 WL 208669, at **1 (Table) (6th Cir. 1990) ("Since a court speaks through its orders and judgments, the language in the judgment is controlling."). Therefore, absent an ambiguity in a court order, it should be readily ascertainable whether a postpetition transfer was authorized.

What if a court improperly permits a postpetition transfer in one of its orders? Cf. Stoll v. Gottlieb, 305 U.S. 165, 59 S.Ct. 134 (1938) (even if the court did not have subject matter jurisdiction, a final order providing for release of a guaranty was binding based upon res judicata principles); United States v. United States Smelting Refining & Mining Co., 339 U.S. 186, 198, 70 S.Ct. 537, 544 (1950) ("The rule of the law of the case is a rule of practice, based upon the sound policy that when an issue is once litigated and decided, that should be the end of the matter.").

What if a transferee mistakenly relies on a court order as authorizing a payment that was not actually authorized? Scharffenberger v. Billmire (In re Allegheny Health, Educ. & Research Found.), 313 B.R. 673, 677 (Bankr. W.D. Pa. 2004) (an otherwise avoidable postpetition transfer is not "shielded from

avoidance" simply because the transferee "incorrectly, albeit innocently and perhaps in good faith, relies on a court order as authorizing a transfer that is not, in fact, authorized by such court order").

It bears repeating that the defendant who asserts that a postpetition transfer was authorized by the court bears the burden of proof. FED. R. BANKR. P. 6001. Therefore, a plaintiff-trustee is not required to comb through the court's voluminous files to determine whether an authorization order was previously signed and docketed. The defendant-transferee has the burden of producing the court order.

Problem 12: After filing of the case, the chapter 12 debtors transferred nonexempt stock to a newly-created trust. After conversion, the chapter 7 trustee sues to avoid the transfer under § 549. In re Kingsley, 208 B.R. 918, 921 (B.A.P. 8th Cir. 1997) (the transfer was not authorized by the Code or the court; allegations of ancillary fraud are irrelevant).

Query: What if the stock was claimed as exempt? Does it matter whether the debtors transferred the stock before expiration of the applicable 30-day objection period or after expiration of the objection period?

> *Problem 13:* The chapter 11 debtor has its plan confirmed. Later the case is converted to chapter 7 because the reorganized debtor fails to make its plan payments. The chapter 7 trustee files an action against a bank that was paid $4,000 after filing but before confirmation. The bank applied the payment toward its prepetition indebtedness. In re Chattanooga Wholesale Antiques, Inc., 930 F.2d 458, 465 (6th Cir. 1991) ("No order of the court authorized this payment; it was made long before entry of either the adequate protection order or the order of confirmation."); see also Litzler v. CitiCapital Commercial Corp. (In re TIC United Corp.), 305 B.R. 270 (Bankr. N.D. Tex. 2003) (where confirmed plan provides for payment to creditor and debtor defaults under plan, court does not "authorize" different payment to be made to creditor at different time).

Query: What if a subsequent adequate protection order ratified the $4,000 payment to the bank?

Problem 14: During a chapter 11 case, the D-I-P elected to carry forward its net operating losses without a court order. If the election was made to carry the operating losses backward, a substantial tax refund would have been generated. The subsequently-appointed trustee seeks to avoid the election as an unauthorized postpetition transfer under § 549(a). Was the election in the ordinary course of business and therefore authorized by the Code? Streetman v. United States, 187 B.R. 287 (W.D. Ark. 1995) (to determine ordinary course of business, a two-prong test must be shown--the horizontal and vertical

dimension tests; the horizontal test, comparing the debtor's business to other similar businesses, could not be readily applied in this case; the vertical dimension test, or the "creditor expectation" test, was not shown because a particular transaction was at issue as opposed to the debtor's general chapter 11 status; because the transfer was not in the ordinary course of business, the trustee could avoid the D-I-P's postpetition election).

In many, if not most instances, borrowing and paying back money, without court approval, will constitute an avoidable postpetition transfer. Unless proper facts are shown to exist by the lender, such borrowing and repayments are not within the ordinary course of business exceptions under § 364(a) or § 363(c)(1). In re Lodge America, Inc., 259 B.R. 728 (D. Kan. 2001) (court uses vertical and horizontal dimension tests to determine ordinary course; court affirms bankruptcy court's determination that § 105 may not be utilized to approve the loan and repayment of the loan after it was repaid).

Problem 15: The chapter 11 debtor pays prepetition indebtedness to employees, utility companies, and key suppliers to keep its business going. After conversion, the trustee sues to avoid the transfers under § 549(a). In re CoServ, L.L.C., 273 B.R. 487 (Bankr. N.D. Tex. 2002) (permitting payment of critical vendors under extraordinary circumstances); In re Gulf Air, Inc., 112 B.R. 152 (Bankr. W.D. La. 1989) (the "doctrine of necessity" permits the court to enter orders to immediately pay prepetition debt when payment is essential for reorganization efforts); In re Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989) (doctrine of necessity permits payment of prepetition wages and benefits to nonstriking employees and not making payments to striking employees); but see Capital Factors, Inc. v. Kmart Corporation (In re Kmart Corp.), 291 B.R. 818 (N.D. Ill. 2003), aff'd, 359 F.3d 866 (7th Cir. 2004) (prohibiting payment of prepetition indebtedness to critical vendors); cf. Matter of B & W Enterprises, Inc., 713 F.2d 534, 537 (9th Cir. 1983) (after filing, the debtors paid prepetition creditors *without notice*, hearing, or authorization by the court; after the trustee sued to recover postpetition transfers, the creditors defended on the basis of doctrine of necessity; "Even if we were convinced that the Necessity of Payment Rule survived the 1978 Act, appellants have not presented to this court sufficient justification for extending the Necessity of Payment Rule to trucking reorganizations.").

Query: Would the Ninth Circuit have made this statement if the bankruptcy court had entered an explicit order, after notice, which authorized payment of prepetition debts? See Scharffenberger v. Billmire (In re Allegheny Health, Education & Research Foundation), 313 B.R. 673, 678-79 (Bankr. W.D. Pa. 2004) (authorization to make "necessary" postpetition payments on prepetition debt "arises not automatically from § 105(a) but only from an order that is ultimately issued by a court").

Problem 16: A bank holds an unperfected security interest in the debtor's

inventory. After the chapter 11 case is filed, the debtor and the bank enter into a stipulation that the bank has a perfected security interest and is entitled to a continuing lien to adequately protect its interest. The bankruptcy court approved the stipulation under § 363(c)(2). After conversion to chapter 7, the trustee discovers the bank is unperfected and seeks to recover the proceeds from the final sale of the debtor's inventory. In re Knudson, 929 F.2d 1280, 1286 (8th Cir. 1991) ("The clear import of the stipulation is that, henceforth, the bank was to be recognized as having a security interest in the inventory and proceeds from inventory sales. For that reason, the court holds that the stipulation did grant a security interest to the bank. That grant having occurred postpetition, the provisions of 11 U.S.C. § 549(a)(2)(B) apply.").

III. EXCEPTIONS TO AVOIDANCE.

A. Involuntary Cases.

1. Transfers for Value During the Gap Period, § 549(b).

11 U.S.C. § 549(b) states:

> In an involuntary case, the trustee may not avoid under subsection (a) of this section a transfer made after the commencement of such case but before the order for relief to the extent any value, including services, but not including satisfaction or securing of a debt that arose before the commencement of the case, is given after the commencement of the case in exchange for such transfer, notwithstanding any notice or knowledge of the case that the transferee has.

"Read literally, this provision is incomprehensible. Language appears to have been inadvertently omitted." In re Rainbow Music, Inc., 154 B.R. 559, 562 (Bankr. N.D. Cal. 1993).

Section 549(b) "protects 'involuntary gap' transferees to the extent of any value (including services, but not including satisfaction of a debt that arose before the commencement of the case), given after commencement in exchange for the transfer. Notice or knowledge of the transferee is irrelevant in determining whether he is protected under this provision." H.R. Rep. No. 595, 95th Cong. at 375 (1977).

Problem 17: During the involuntary gap period, the debtor pays its attorneys $6,200 for prepetition services. As a result, the attorneys continue to represent the debtor during the gap period and after the order for relief. After conversion to chapter 7, the trustee sues to recover the postpetition transfer. In

re Interco Systems, Inc., 202 B.R. 188 (Bankr. W.D.N.Y. 1996) (in § 549 there is no ordinary course of business exception such as is included in § 547(c)(2); "the exception contained in Section 549(b) is only intended to protect the post-petition payment of post-petition services provided in the 'gap period', not payment of pre-petition services.").

Problem 18: The debtor pays its March 1996 rent in the amount of $11,600 (to cover the lease payment obligations for the entire month). On March 6, an involuntary case is filed. On March 7, the bankruptcy court authorized a sale of the debtor's assets (and an assignment and assumption of the debtor's lease to the purchaser of the assets). After conversion to chapter 7, the trustee sues the debtor's landlord to recover the March rent payment as a postpetition transfer. (After all, the debtor only had the ability to possess the leased premises for seven days in March.) In re Oakwood Markets, Inc., 203 F. 3d 406, 410 (6th Cir. 2000) (for § 549(b) purposes, "the extent of value given must be determined from the 'giver's' perspective, here [the landlord]"; the fact the debtor lost its right to possess the premises does not change the result--the landlord honored the assumption and assignment of the debtor's lease).

Problem 19: On December 23, 1993, an involuntary petition was filed. The next day, the debtor's manager convinced his mother, "Varner", to loan additional capital to the debtor. The debtor paid Varner $10,000 to cover the loan expenses. Thereafter, Varner loaned the debtor $50,000 in July 1994 and $60,000 in September 1994. After a lengthy gap period, an order for relief was finally entered on December 20, 1994. In re Pucci Shoes, Inc., 120 F.3d 38, 40-41 (4th Cir. 1997) ("§ 549(b) imposes no requirement that the value provided for a transfer be made prior to or simultaneously with the transfer"; although a promise to perform services is insufficient, in this instance, the creditor performed during the gap period).

Problem 20: After an involuntary petition was filed, the debtor's board of directors approved 5-year employment contracts for its CEO and CFO, each who served on the board. The new agreements slightly increased salaries and provided for bonuses and full salaries upon severance, for a minimum of five years. The contracts were guaranteed by the debtor's (apparently solvent) subsidiary corporation (in which the debtor held a 50% equity interest). Approximately two weeks after the new employment contracts were signed, an order for relief was entered. The debtor's officers filed a lawsuit to enforce the employment contracts. The trustee counterclaimed and sought to avoid the employment agreement under § 549. In re Geothermal Resources International, Inc., 93 F.3d 648 (9th Cir. 1996) (the officers provided value to the extent they provided services and earned salaries under the employment contracts during the gap period; however, because the employment contracts were not made in the ordinary course of business under § 549(a)(2), the contracts are avoidable).

2. Other Exceptions to Avoidance of "Gap Period" Transfers.

Problem 21: After the debtor's chapter 11 petition is filed, the secured creditor accepts payments of over $2,000,000 from estate assets and applies the payments against the debtor's outstanding loan obligations. Thereafter, the creditor sells its loan portfolio (including its loans to the debtor) to a third party. Sixth months after confirmation of the debtor's chapter 11 plan, the plan's Liquidation Supervisor files an adversary proceeding against the creditor seeking to avoid the gap payments as unauthorized postpetition transfers. What result? Fleet Nat'l Bank v. Gray (In re Bankvest Capital Corp.), 375 F.3d 51 (1st Cir. 2004) (because the gap payments were applied to the debtor's loan with the secured creditor prior to the sale of the loan portfolio to the third party, the sale did not result in a transfer of the secured creditor's claim relative to the gap payments; further, were the court to "undertake the exercise of avoiding the gap payments," the creditor would be entitled to claim against the estate which, by virtue of § 502(h), "would have the status of a prepetition secured claim;" "[t]he fact that [the secured creditor] would be entitled to receive exactly what it would be forced to return through avoidance [of the postpetition transfer] renders avoidance pointless").

B. Good Faith Purchasers Of Real Property.

11 U.S.C. § 549(c) states:

> The trustee may not avoid under subsection (a) of this section a transfer of real property to a good faith purchaser without knowledge of the commencement of the case and for present fair equivalent value unless a copy or notice of the petition was filed, where a transfer of such real property may be recorded to perfect such transfer, before such transfer is so perfected that a bona fide purchaser of such property, against whom applicable law permits such transfer to be perfected, could not acquire an interest that is superior to the interest of such good faith purchaser. A good faith purchaser without knowledge of the commencement of the case and for less than present fair equivalent value has a lien on the property transferred to the extent of any present value given, unless a copy or notice of the petition was so filed before such transfer was so perfected.

A purchaser cannot successfully assert the § 549(c) good faith safe harbor when it has constructive knowledge of the bankruptcy proceeding from a title report. In re Bean, 252 F.3d 113, 116 (2d Cir. 2001).

When an involuntary transfer occurs by a creditor violating the automatic stay, courts have wrestled with whether a defense exists under § 549(c) or whether relief, if any, may only be obtained under § 362.

In 40235 Washington Street Corporation v. Lusardi, 329 F.3d 1076, 1079 (9th Cir. 2003), it was squarely held that "section 549(c) of the Bankruptcy Code does not create an exception to the automatic stay provision [§ 362(a)] . . . .". The court noted it had never previously *directly* addressed the issue and it found persuasive the analysis of a Ninth Circuit BAP opinion. See Value T Sales, Inc. v. Mitchell (In re Mitchell), 279 B.R. 839, 841-44 (Bankr. 9th Cir. 2002). In reaching this holding, the Ninth Circuit clarified language in some of its earlier decisions. Schwartz v. United States (In re Schwartz), 954 F.2d 569, 575 (9th Cir. 1992) (transfers that violate § 362(a) are void); Phoenix Bond & Indemnity Co. v. Shamblin (In re Shamblin), 890 F.2d 123, 127 n. 5 (9th Cir. 1989) (the panel refused to decide whether § 549(c) applies when the automatic stay is in effect).

What if the debtor was a willing participant in the transfer? Would there be a different result? *Cf*. In re Cady, 266 B.R. 172, 179 n. 4 (Bankr. 9th Cir. 2001), aff'd, 315 F.3d 1121 (9th Cir. 2003) (when debtor voluntarily transfers real property to lienholder who took no action to foreclose, it is "questionable" whether § 362(a) is violated); In re Trans-Eagle Corp., 244 B.R. 146, 147 (Bankr. N.D. Cal. 1999) (a creditor and the debtor entered into a security agreement after commencement of the case and the court approved the stipulation; on its own initiative, the court reconsidered its approval that creation of the security interest "is not void as a violation of 11 U.S.C. § 362(a)"; without deciding the issue, the court noted that Shamblin and Schwartz (predecessors to 40235 Washington Street) might not apply to instances when the debtor was involved in the transfer).

Other courts take a different approach. "[T]he more correct approach is that a postpetition transfer of real estate is excepted from the application of the automatic stay when the purchaser satisfies the elements of section 549(c)." In re Shah, 2001 WL 423024 (Bankr. E.D. Pa. 2001). In 40235 Washington Street, the Ninth Circuit cites a number of cases that either assume or opine that § 549 (c) creates an exception to § 362(a). See, e.g., Sikes v. Global Marine, Inc., 881 F.2d 176, 179 (5th Cir. 1989). The Ninth Circuit criticizes these decisions because they fail to adequately consider the "textual, structural and policy arguments." 40235 Washington Street, 329 F.3d at 1083.

What if the issue arises in a circuit where stay violations are "voidable" rather than "void"? See, e.g., Easley v. Pettibone Michigan Corp., 990 F.2d 905, 911 (6th Cir. 1993) ("[A]ctions taken in violation of the automatic stay are invalid and voidable and shall be voided absent limited equitable circumstances."). Unless special equitable circumstances are demonstrated, e.g., the debtor "intentionally or unreasonably withheld notice of her petition", "the foreclosure

sale is void [and] the sale did not result in a transfer for purposes of § 549(c)." In re Smith, 224 B.R. 44, 47 (Bankr. E.D. Mich. 1998) (Rhodes, J.). See also In re Fjeldsted, 293 B.R. 12 (Bankr. 9th Cir. 2003) (concluding that whether to annul the stay requires balancing the equities; a bona fide purchaser status is insufficient, by itself, to validate a postpetition sale in contravention of the automatic stay); Singleton v. Abusaad (In re Abusaad), 309 B.R. 895 (Bankr. N.D. Tex. 2004) (in the Fifth Circuit, actions taken in violation of the automatic stay are "voidable;" unless the action is made valid by a subsequent judicial determination, the transfer is of no effect; consequently, there is no need to "avoid" the transfer and "§ 549 is never implicated").

Problem 22: The debtor filed for chapter 11 relief in July 1989. Although it listed Bryan County, Oklahoma, as a real property tax creditor on its schedules, the debtor did not notify the creditor of the case. The debtor-in-possession also failed to record any notice of the bankruptcy filing in the appropriate local records. In October 1990, a tax sale was conducted; no bids were received. Bryan County became the owner of the property subject to the debtor-in-possession's two-year right of redemption. In June 1993, a "tax resale" took place and a third person, also without knowledge of the bankruptcy case, paid $325 for the property. In October 1993, the debtor sued to avoid the postpetition transfer and sought to recover the value of the property from Bryan County (the debtor apparently asserted the value to be the repurchase price it paid--$39,500). Compare Matter of T.F. Stone Co., Inc., 72 F.3d 466 (5th Cir. 1995) (in a postpetition tax sale, "present fair equivalent value" in § 549(c) is equivalent to "reasonably equivalent value" in § 548(a); because the tax sale was not collusive and it complied with applicable state law, the postpetition transfer was not avoidable; the court did not discuss any automatic stay violation in its analysis) with In re Glendenning, 243 B.R. 629 (Bankr. E.D. Pa. 2000) (in a postpetition judicial sale, assuming a § 549 transfer occurred notwithstanding violation of the automatic stay, § 549(c) "present fair equivalent value" is not the same as § 548(a) "reasonably equivalent value").

C. Postpetition Transfer Statute Of Limitations.

11 U.S.C. § 549(d) states:

> An action or proceeding under this section may not be commenced after the earlier of--
>
> (1) two years after the date of the transfer sought to be avoided; or
>
> (2) the time the case is closed or dismissed.

This statutory subsection must be contrasted with the general statute of limitations, for avoidance actions under §§ 544, 545, 547, 548, or 553, which is

set forth in 11 U.S.C. § 546(a).

Are the statutes of limitations imposed by § 549(d) and § 546(a) waivable or jurisdictional? "Aside from the fact that they affect different sections of title 11, the only difference between these two code provisions [i.e., § 546(a) and § 549 (d)] is the point at which the two-year limitations period begins to run." In re Pugh, 158 F.3d 530, 532 (11th Cir. 1998). The Eleventh Circuit held the statute of limitations is waivable, relying upon the Bankruptcy Code plain language, the legislative history, and the statutory scheme. Id. at 538.

To the contrary, the Sixth Circuit previously held that § 546(a) is jurisdictional and Bankruptcy Rule 9006(a) cannot be used to extend the time period to commence an avoidance action. In re Butcher, 829 F.2d 596 (6th Cir. 1987). However, apparently the Sixth Circuit has seen the error in its Butcher analysis. In a subsequent *en banc* decision, that court ruled that FED. R. CIV. P. 6(a), which is similar to B.R. 9006(a), could be used to determine a statute of limitations period and the limitations period is not jurisdictional. Bartlik v. United States Dept. of Labor, 62 F.3d 163, 165-66, n. 1 (6th Cir. 1995) (*en banc*). In an analogous situation, the U.S. Supreme Court has recently held that the time limitations for objecting to a debtor's discharge, set forth in Bankruptcy Rule 4004, are not "jurisdictional" and may be waived if not timely raised by the debtor. Kontrick v. Ryan, 540 U.S. 443, 124 S. Ct. 906 (2004).

Problem 23: Individual debtors filed for chapter 11 relief in the summer of 1984. Eventually, the case was converted to chapter 7 in September, 1987. In March 1989, the debtors conveyed scheduled real property to their son without notice to the trustee or without obtaining bankruptcy court approval. In October 1991, more than two years after the transfer, the trustee sued to recover the debtors' postpetition transfer. Is the suit time-barred? Olsen v. Zerbetz, 36 F.3d 71 (9th Cir. 1994) (collecting cases) ("We hold that § 549(d) can be equitably tolled"; the debtors violated their duty to cooperate with the trustee; the trustee had no duty to regularly check to see whether the debtors clouded legal title to the real property).

Another possible defense to a § 549 avoidance action is that the plaintiff lacks standing to bring the action. In re Trident Shipworks, Inc., 262 B.R. 107 (Bankr. M.D. Fla. 2001) (entity who acquired debtor's assets under a confirmed plan could not sue to recover alleged postpetition transfer). See discussion in II.B.1. above (standing is generally limited to a trustee or D-I-P).

IV. POSTPETITION TRANSFER RECOVERIES.

11 U.S.C. § 550(a) permits the successful § 549 trustee-plaintiff to recover, for the estate, the property, or, if the court orders, the value of the property transferred. Recovery may be made from the initial transferee of the transfer (or entity for whose benefit the transfer was made), § 550(a)(1), or any

subsequent transferee, § 550(a)(2). Notwithstanding such possible joint liability, the trustee is only entitled to a single satisfaction. § 550(d).

However, the trustee may not recover from a subsequent transferee "that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith without knowledge of the voidability of the transfer avoided." 11 U.S.C. § 550(b)(1).

An issue may exist whether § 550(b)(1) is an affirmative defense which requires the subsequent transferee to carry the burden of persuasion. Wasserman v. Bressman (In re Bressman), 327 F.3d 229, 235-36, n. 2 (3rd Cir. 2003) (assuming that transferee bears the burden but acknowledging that the issue is a “difficult one”; also noting that some authority states that “the burden should rest on the party seeking to recover the property, at least as to the issues of the subsequent transferee’s good faith and knowledge”) (quoting the dissent in In re Nordic Village, Inc., 915 F.2d 1049, 1055-56 (6th Cir. 1990), rev’d on other grounds, 503 U.S. 30, 112 S.Ct. 1011 (1992)).

Problem 24: After filing a chapter 11 case and before a trustee is appointed in the converted chapter 7 case, the debtor quitclaims real property to his father. The father borrows money from Folks Bank to pay off the prior mortgage and grants Folks Bank a new mortgage on the real estate. The chapter 7 trustee sues to avoid the quitclaim deed transfer and avoid Folks Bank’s mortgage. The bank asserts it is a subsequent good faith transferee for value and entitled to defenses under § 550(b)(1) and (e). What result? In re Shelton, 273 B.R. 116 (Bankr. W.D. Ky. 2002) (the trustee did not seek to “recover” the property from the bank under § 550(a); when a mortgage is avoided recovery is unnecessary because the avoided lien is automatically preserved for the estate by operation of law under § 551), vacated on other grounds and remanded, 95 Fed. Appx. 801, 2004 WL 834776 (6th Cir. 2004) (affirming the district court’s conclusion that the bank was not entitled to the § 550 defenses, but remanding for a determination as to whether the transfers resulted in any diminution of the estate; if the transfers did not diminish the estate, the court held that the “earmarking doctrine” would provide a defense to avoidance of the transfers under § 549).

Problem 25: A corporate debtor files for chapter 11 relief. Its principal (the sole officer, director, and shareholder) pays prepetition tax liabilities from the debtor's bank account to the IRS ($20,000) and the State ($25,000). Because the principal was personally liable for trust fund taxes, and he directed that payment be made to those taxes first, the payments satisfied his indebtedness to the IRS ($10,000) and to the State ($10,000). After conversion, the chapter 7 trustee sues the IRS, the State, and the debtor's principal for recovery of postpetition transfers. What results? See, e.g., Seminole Tribe of Florida v. Florida, 517 U.S. 44, 116 S.Ct. 1114 (1996); United States v. Nordic Village, 503 U.S. 30, 112 S.Ct. 1011 (1992);§ 106 [1994 amendment] and § 550

(a)(1). See also Begier v. IRS, 496 U.S. 53, 110 S.Ct. 2258 (1990) (§ 547 preference action).

Problem 26: Debtor telecommunications corporation files for chapter 11 and permits its employees to continue to make contributions to a 401(k) plan. Prepetition, the Debtor had entered into a contract with the Defendant to provide the investment vehicle for the employees to contribute funds into their respective 401(k) accounts. (Postpetition, the Debtor also paid matching funds to the Defendant to be credited to employees' accounts.) A plan is confirmed. Under the terms of the confirmed plan, the creditors' trustee sues the Defendant to recover postpetition payments made to the Defendant and credited to the individual employees' accounts. What result? In re Parcel Consultants, Inc., 287 B.R. 41 (Bankr. D. N.J. 2002) (assuming that property of the estate was transferred, the court determines the Defendant is not an initial transferee but is a "mere conduit"; the Defendant had no beneficial interest in the funds received and did not have dominion and control over the funds; the Defendant "was obligated to deposit the funds at the direction of the employee participants, and not at its own discretion"). Cf. Taunt v. Hurtado (In re Hurtado), 342 F.3d 528 (6th Cir. 2003) (in a fraudulent conveyance recovery action, the Sixth Circuit discusses the necessity of "dominion" over funds in order to become an initial transferee; the debtor's mother who received funds from the debtors and paid bills according to the debtor's instructions was an initial transferee from whom recovery could be made).

Problem 27: After the chapter 11 debtor-in-possession status was terminated by the conversion to chapter 7, attorneys continued to represent the individual debtor in Securities and Exchange Commission disciplinary proceedings and criminal proceedings. The attorneys instructed the debtor that all payments for attorneys' fees must come from non-estate assets. Attorneys' fees were then paid by the debtor's wife, purportedly from her substantial personal assets. The chapter 7 trustee discovered that estate assets were in a Cook Islands trust and funds from the trust were paid to the wife who then paid the attorneys. The trustee sues the attorneys to recover postpetition transfers. The attorneys assert they are subsequent transferees immune from recovery under § 550(b)(1). What result? See Wasserman v. Bressman (In re Bressman), 327 F.3d 229 (3rd Cir. 2003) (the court discusses the issue of whether a subsequent transferee is "without knowledge of the voidability of the transfer avoided"; by the trustee giving notice to the attorneys of the possible challenge to the receipt of their payments, such notice does not provide "knowledge of the avoidability" or require the attorneys to independently investigate facts; the proper standard is whether the facts known to the attorneys would suggest to a reasonable person that they were receiving estate assets--if the facts do not suggest this, there is no duty to investigate).

Problem 28: Lacking notice of the debtor's pending chapter 11 case, the Defendant Bank continues performing under its "factoring" financing agreement

with the debtor postpetition. Seven months postpetition, the case is converted to chapter 7 and the Defendant finally receives notice of the debtor's bankruptcy. However, since the filing date, the Defendant has advanced $192,200.00 in new loans to the debtor. It has also collected $163,847.00 of the debtor's postpetition accounts receivable. Assuming that the transfer of $163,847.00 can be avoided under § 549, what amount should the chapter 7 trustee recover from the Defendant? Dobin v. Presidential Fin. Corp. of Del. Valley (In re Cybridge Corp.), 312 B.R. 262 (D.N.J. 2004) (the trustee's recovery should be zero; §§ 550(d) and 105(a) empower bankruptcy courts to grant the recipient of a postpetition transfer a credit on the grounds that it has already returned the property to the estate).

Problem 29: The chapter 13 debtor fails to schedule a bank account. Postpetition, he uses funds in the account to buy a vehicle directly from a dealer for $15,000 cash. After conversion of the case, the chapter 7 trustee discovers the transaction. (Of course, the vehicle is now worth much less than the $15,000 purchase price.) The trustee sues the dealer to recover the postpetition transfer and requests a money judgment in the amount of $15,000. What, if any, defenses does the dealer have? Does it make any difference whether the vehicle was bought before or after confirmation of a chapter 13 plan?