

Hot Topics and the Latest and Greatest: Supreme Court and Lower Court Case Law Update

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U.S. Bankruptcy Court (W.D. Tenn.); Memphis



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SUPREME AND APPELLATE COURT CASE LAW UPDATE

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The following is a summary of some of the important bankruptcy opinions issued by the United States Supreme Court and certain federal courts of appeal from the past year:

- I. ***Law v. Siegel*** – Supreme Court Limits the Scope of Section 105(a) and A Court’s Inherent Powers to Sanction for Misconduct.

In *Law v. Siegel*,¹ the United States Supreme Court held in a unanimous decision that a bankruptcy court may not use section 105(a) of the Bankruptcy Code or its inherent power to sanction abusive litigation practices by “surcharging” a debtor’s homestead exemption in order to defray a chapter 7 trustee’s fees. The court framed the issue as follows:

The Bankruptcy Code provides that a debtor may exempt certain assets from the bankruptcy estate. It further provides that exempt assets generally are not liable for any expenses associated with administering the estate. In this case, we consider whether a bankruptcy court nonetheless may order that a debtor’s exempt assets be used to pay administrative expenses incurred as a result of the debtor’s misconduct.²

The debtor, Law, had commenced a chapter 7 bankruptcy case in 2004. He valued his California home, the only significant asset in the estate, at \$363,348 and claimed that \$75,000 of that value was covered by California’s homestead exemption and, thus, was exempt from the bankruptcy estate.³ He also claimed that a voluntary lien – a deed in trust in favor of “Lin’s Mortgage & Associates” – exceeded the home’s nonexempt value, leaving no equity recoverable for his other creditors.⁴ The chapter 7 trustee challenged the “Lin’s” lien in an adversary proceeding claiming that Lin’s was a fictional entity and part of a complicated fraudulent scheme created by the debtor. Over the next five years, the Court noted, “Lili Lin” managed – despite speaking no English – to engage in extensive and costly litigation, including several appeals, contesting the avoidance of the deed of trust and the trustee’s subsequent sale of the house.⁵

The bankruptcy court concluded that the loan was a fiction created by the debtor to preserve his equity in the house, and that “no person named Lili Lin ever made a loan to [the debtor] in exchange for the disputed deed of trust.”⁶ It thus granted the trustee’s motion to “surcharge” the debtor’s \$75,000 homestead exemption, making those funds available to defray over \$500,000 in attorney’s fees incurred by the trustee in overcoming the debtor’s repeated fraudulent misrepresentations. The Ninth Circuit Bankruptcy Appellate Panel and the Ninth Circuit Court of Appeals

1 *Law v. Siegel*, 134 S. Ct. 1188 (2014).

2 *Id.* at 1192.

3 *Id.* at 1193.

4 *Id.*

5 *Id.*

6 *Id.*

subsequently affirmed.⁷

The Supreme Court held that the Bankruptcy Court had exceeded the limits of its authority when it ordered that the homestead exemption be made available to pay the trustee’s attorney’s fees. A bankruptcy court, the Court found, may not exercise its authority to “carry out” the provisions of the Bankruptcy Code or its “inherent power . . . to sanction ‘abusive litigation practices’ by taking action prohibited elsewhere in the statute.”⁸ Specifically, the Court stated:

It is hornbook law that § 105(a) “does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.” Section 105(a) confers authority to “carry out” the provisions of the Code, but it is quite impossible to do that by taking action that the Code prohibits. That is simply an application of the axiom that a statute’s general permission to take actions of a certain type must yield to a specific prohibition found elsewhere. Courts’ inherent sanctioning powers are likewise subordinate to valid statutory directives and prohibitions. We have long held that “whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of” the Bankruptcy Code.⁹

Here, the bankruptcy court’s “surcharge” contravened section 522 of the Bankruptcy Code, which (by reference to California law) entitled the debtor to exempt \$75,000 of equity in his home from the bankruptcy estate, and which, pursuant to section 522(k), made that \$75,000 “not liable for payment of any administrative expense,” including the trustee’s attorney’s fees. Thus, the Court found, the surcharge exceeded the limits of both the court’s authority under section 105(a) and its inherent powers.¹⁰

The Court rejected the trustee’s argument that an equitable power to deny an exemption by “surcharging” exempt property in response to a debtor’s misconduct can coexist with section 522.¹¹ The Court noted that because no one timely objected to the homestead exemption, it became final before the surcharge was imposed. And a trustee who fails to make a timely objection cannot challenge an exemption.¹² In any event, even if the bankruptcy court could have revisited the debtor’s entitlement to the exemption, section 522 does not give courts discretion to grant or withhold exemptions based on whatever considerations they deem appropriate. Rather, the statute sets forth

7 *Id.* at 1194.

8 *Id.*

9 *Id.* at 1194-95 (internal citations omitted).

10 *Id.* at 1195.

11 *Id.* at 1195-96.

12 *Id.* at 1196 (citing *Taylor v. Freeland & Kronz*, 503 U.S. 638, 643-44 (1992)).

specific criteria that renders certain property exempt, and specific exceptions and limitations to that grant. A court may not refuse to honor a debtor's invocation of an exemption where the statutory exceptions are not applicable.

The Court rejected the argument that its recent decision in *Marrama v. Citizens Bank* evidenced a resurgence of the bankruptcy court's equitable powers.¹³ Regarding *Marrama*, where the Supreme Court had held that a debtor's bad faith kept him from converting his bankruptcy from a chapter 7 liquidation to a chapter 13 reorganization as permitted by section 706(a), the court stated: True, the Court in *Marrama* also opined that the Bankruptcy Court's refusal to convert the case was authorized under § 105(a) and might have been authorized under the court's inherent powers. But even that dictum does not support [the trustee's] position.... At most *Marrama's* dictum suggests that in some circumstances a bankruptcy court may be authorized to dispense with futile procedural niceties in order to reach more expeditiously an end result required by the Code. *Marrama* most certainly did not endorse, even in dictum, the view that equitable considerations permit a bankruptcy court to contravene express provisions of the Code.¹⁴

Acknowledging the inequities that resulted from its ruling which, in cases such as this, forces trustees to shoulder a heavy financial burden due to the debtor's egregious misconduct, the Court nevertheless found that it is not for courts to alter the balance that Congress struck in crafting section 522.¹⁵ Additionally, the court stated, ample authority remains to address debtor misconduct, including: (i) denial of discharge under sections 727(a)(2)-(6), (ii) sanctions for bad-faith litigation conduct under the Bankruptcy Rules, section 105(a) or a bankruptcy court's inherent powers, (iii) enforcement of monetary sanctions through the normal procedures for collecting money judgments, or (iv) possible prosecution under 18 U.S.C. § 152.

II. ***United States v. Quality Stores, Inc.* – Supreme Court Rules That Severance Payments Are Wages for FICA Purposes.**

In an opinion that is largely void of any substantive discussion of bankruptcy law, but which may have significant implications for chapter 11 debtors, the Supreme Court held in *United States*

13 *Id.* at 1197 (discussing *Marrama v. Citizens Bank*, 549 U.S. 365 (2007)).

14 *Id.* (internal citations omitted) (emphasis added).

15 *Id.* (citing *Guidry v. Sheet Metal Workers National Pension Fund*, 493 U.S. 365, 376-77 (1990)).

v. *Quality Stores, Inc.*¹⁶ that severance payments made to employees whose employment was involuntarily terminated by a chapter 11 debtor are taxable wages under the Federal Insurance Contributions Act (“FICA”).

In this case, the debtor, an agricultural-specialty retailer, entered bankruptcy proceedings in 2001.¹⁷ The debtor made severance payments to employees who were involuntarily terminated as part of the chapter 11 bankruptcy case. The payments, which were made pursuant to plans that did not tie payments to the receipt of state unemployment insurance, varied based on job seniority and time served.¹⁸

The debtor reported the severance payments as wages on W-2 tax forms, paid the employer’s required share of FICA taxes, and withheld the employees’ share of FICA taxes. Later, believing that the payments should not have been taxed as wages under FICA, the debtor sought a refund on behalf of itself and about 1,850 former employees. When the IRS did not allow or deny the refund, the debtor initiated a proceeding in the bankruptcy court, which granted summary judgment in its favor. The district court and the Sixth Circuit Court of Appeals affirmed, concluding that severance payments are not wages under FICA.¹⁹

The Supreme Court reversed, holding that the severance payments at issue were taxable wages for FICA purposes. Writing for the court, Justice Anthony Kennedy wrote: “The severance payments here were made to employees terminated against their will, were varied based on job seniority and time served and were not linked to the receipt of state unemployment benefits.”²⁰ Noting FICA’s broad definition of the term “wages,” the Court held that severance payments constitute wages and, thus, are taxable. As a result of the ruling, the bankruptcy estate’s request for a refund, approximating \$1 million, was denied.

III. *In re Bellingham* – Supreme Court to Revisit *Stern v. Marshall*.

Executive Benefits Insurance Agency v. Arkinson (In re Bellingham) is the first opportunity

16 *United States v. Quality Stores, Inc.*, __ S. Ct. __, 2014 WL 1168968 (2014).

17 *Id.* at *2.

18 *Id.* at *3.

19 *Id.*

20 *Id.* at *10.

for the Supreme Court to revisit its controversial holding in *Stern v. Marshall*.²¹ On January 14, 2014, the Supreme Court heard oral argument in *In re Bellingham* regarding two issues:

- i. Is the procedure in 28 U.S.C. § 157(c)(2), which allows parties to consent to the resolution of fraudulent transfer actions before non-Article III bankruptcy judges, constitutional, and if so, did the courts below properly infer petitioner's consent to such resolution in this case?

- ii. In circumstances where a bankruptcy proceeding's statutory designation as "core" is found to violate Article III of the United States Constitution, may the bankruptcy judge treat the matter as "non-core" and enter proposed findings of fact and conclusions of law for de novo district judge reconsideration under 28 U.S.C. § 157(c)(1)?

While the bankruptcy community anxiously waits, it has been rumored that the Supreme Court will rule on these issues in June of 2014.

In *Stern*, the court addressed whether a bankruptcy court could enter a final judgment on a state law counterclaim asserted in defense to a proof of claim. The Court compared the bankruptcy system's "public rights" function with the "private rights" function of state law, describing public rights as those that flow solely from action of the executive or legislative branches. Ultimately, the Court held that the state law counterclaim involved private rights and, thus, the bankruptcy court lacked the constitutional authority to enter a final judgment on the counterclaim. Rather, separation of powers mandates that such matters be finally determined by an Article III court, such as a federal district court.

By now, the facts of *Stern* are well known by most bankruptcy practitioners. Litigation arose in the bankruptcy case of Vickie Lynn Marshall (Anna Nicole Smith). At issue was the bankruptcy court's ability to enter a final judgment on account of a counterclaim by the debtor, which is a core proceeding under 28 U.S.C. § 157(b)(2)(C). Pierce Marshall, the son of Vickie's late husband, filed a proof of claim against her bankruptcy estate. He claimed that Vickie had defamed him, and requested damages from the bankruptcy estate. Vickie responded to the proof of claim by filing an unrelated counterclaim against Pierce claiming that he had tortuously interfered with the gift she should have received from her husband's estate when he died. Vickie received a \$450M judgment on her counterclaim against Pierce. Pierce appealed the judgment all the way to the Supreme Court,

²¹ *Stern v. Marshall*, 131 S. Ct. 2594 (2011).

claiming that the bankruptcy court did not have authority to award that judgment.

The Supreme Court first determined that the bankruptcy judge had the statutory jurisdiction to enter the judgment under § 157(b)(2)(C). Nevertheless, noting that their ruling was a “narrow one,” the Court held that the judgment was invalid because the statute violated the Constitution. “In general,” the Court stated, “Congress may not ‘withdraw from [Article III] judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty.’”²²

Relying on 19th Century decisions, the majority reasoned that there was no room for any approach that would “chip away” at Article III jurisdiction.²³ Reaffirming its prior ruling in *Marathon*, the Court found that separation of powers requires a judiciary that: (i) is independent of the legislative and executive branches, and (ii) has life tenure and salary security, at least with those matters involving state law.

Here, the counter-claim arose under state common law and Pierce did not consent to adjudication by the bankruptcy court. Purely state law matters involve “private” rather than “public rights.” Such matters, the Court found, cannot be finally adjudicated by anyone other than an Article III judge unless they would necessarily be resolved in conjunction with the allowance or disallowance of the creditor’s claim against the estate.

As a result of *Stern*, the last three years have been filled with uncertainty and litigation regarding what matters can be finally determined before a bankruptcy court, even with respect to those matters (such as counterclaims and fraudulent transfers) which are expressly defined as being “core” under the statute. In *In re Bellingham*, the Court gets an opportunity to clear up much of this uncertainty, at least with respect to the two issues identified above.

A. Can a Litigant Waive its *Stern* Rights In a Fraudulent Transfer Action?

The first issue to be addressed in *In re Bellingham* resolves a split of authority between the Ninth Circuit Court of Appeals in *Executive Benefits Insurance Agency v. Arkinson* (*In re*

22 *Id.* at 2609.

23 *Id.* at 2620.

Bellingham)²⁴ and the Sixth Circuit Court of Appeals in *Waldman v. Stone*.²⁵ The issue is whether a litigant can waive its right to have a fraudulent transfer action (a matter that is statutorily core but which courts generally acknowledge involve “private rights”) heard by an Article III judge so that it can be determined instead by the bankruptcy court.

In *In re Bellingham*, the Ninth Circuit Court of Appeals held that a litigant can waive its *Stern* rights. Prior to its bankruptcy filing, the debtor sold insurance and annuity products. On the eve of its filing, the debtor assigned insurance commissions to an insider who used such funds to start a new company. The chapter 7 trustee sought to avoid and recover such funds as fraudulent transfers and the bankruptcy court granted summary judgment in its favor. The district court affirmed and the defendant appealed. Before the Ninth Circuit, the defendant argued, for the first time, that *Stern* precluded the bankruptcy court from determining the fraudulent transfer claim in the absence of a filed proof of claim.

The Ninth Circuit Court of Appeals held that, under *Stern*, the bankruptcy court lacked authority to enter final judgment in the fraudulent transfer action. The court held that *Stern* “point[s] ineluctably to the conclusion that fraudulent conveyance claims, because they do not fall within the public rights exception [despite their statutorily core status], cannot be adjudicated by non-Article II judges.”²⁶

Nevertheless, the court held that the Article III right is waivable and, in fact, was impliedly waived. An independent judiciary serves primarily to protect personal, not structural rights and, as a personal right, the constitutional “guarantee of an impartial and independent federal adjudication is subject to waiver.”²⁷ Referencing 28 U.S.C. § 157, the court reasoned, “If consent permits a non-Article III judge to decide finally a non-core proceeding, then it surely permits the same judge to decide a core proceeding in which he would, absent consent, be disentitled to enter final judgment.”²⁸

Noting that the fraudulent transfer defendant had “sandbagged” by failing to object to the bankruptcy court’s authority to enter final judgments before the bankruptcy court and the district

24 *Executive Benefits Insurance Agency v. Arkison (In re Bellingham)*, 702 F.3d 553 (9th Cir. 2012).

25 *Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012).

26 *Executive Benefits Insurance Agency v. Arkison (In re Bellingham)*, 702 F.3d at 560.

27 *Id.* at 567.

28 *Id.*

court, only finally raising the constitutional objection before the Ninth Circuit, the court found consent by waiver.²⁹ Accordingly, the bankruptcy court could finally adjudicate the fraudulent conveyance action without having to issue proposed findings of fact and conclusions of law subject to *de novo* review in the district court.

Conversely, in *Waldman v. Stone*, the Sixth Circuit Court of Appeals held that a litigant could not waive its *Stern* rights. In that case, the debtor was defrauded by an investor in his company who convinced him to sell the company’s assets to him for substantial consideration. Unbeknownst to the debtor, the purchase documents that were signed did not reflect much of the promised consideration. Moreover, the investor secretly made a side-deal with the debtor’s bank to purchase the company’s loan, thereby acquiring both the company’s assets and its debt.

Upon discovering the fraud, the debtor filed a chapter 11 case, sought to disallow the fraudster’s filed claims, and brought a variety of state law fraud-related causes of action against him. After trial, the bankruptcy court entered judgment in favor of the debtor on both the disallowance and fraud claims and awarded over \$3.9 million in compensatory and punitive damages.

On appeal to the Sixth Circuit, the investor argued for the first time that the bankruptcy court lacked authority under *Stern*. The Sixth Circuit agreed, holding that the defendant could not waive his right to Article III adjudication on the fraud claims. The court reasoned that “Article III has a dual character: one part personal right of the litigant, one part structural principal.”³⁰ The structural principal, the court found, is one of separation of powers:

The issue is not so much the aggrandizement of the Legislative or Executive Branches, as it is the diminution of the Judicial one. . . . To the extent Congress can shift the judicial power to judges without these protections, the Judicial Branch is weaker and less independent than it is supposed to be.³¹

Because the right to Article III adjudication is inherently structural, the court found, “it is not Waldman’s to waive.”³² Accordingly, the matter was sent back to the bankruptcy court for proposed findings of fact and conclusions of law.

Since *Waldman v. Stone* was issued, at least two additional courts of appeals have affirmed

29 *Id.* at 570.

30 *Waldman v. Stone*, 698 F.3d at 917.

31 *Id.* at 918.

32 *Id.*

the Sixth Circuit's ruling. In *Wellness International Ltd. v. Sharif*,³³ the Seventh Circuit Court of Appeals held that a constitutional objection based on *Stern v. Marshall* is not waivable because it implicates separation of powers principles. Likewise, the Fifth Circuit Court of Appeals in *Frazin v. Haynes and Boone, LLP*³⁴ held that *Stern* rights cannot be waived.

B. Is There a Statutory Gap?

The second issue resolves a split of authority between the Ninth Circuit in *In re Bellingham* and the Seventh Circuit Court of Appeals in *In re Ortiz*³⁵ regarding the issue of whether a bankruptcy court can issue proposed findings of fact and conclusions of law in statutory core matters despite that fact that title 28 only authorizes such an approach in non-core matters. This issue has come to be known as the “statutory gap” issue.

Section 157(c)(1) of title 28 of the United States Code provides that a bankruptcy judge is to submit proposed findings of fact and conclusions of law to the district court for a “proceeding that is *not a core proceeding*.”³⁶ What about statutorily core proceedings under 28 U.S.C. § 157 where, under *Stern*, the bankruptcy court can no longer enter a final judgment? By its terms, 28 U.S.C. § 157(c)(1) does not apply. And there is no other statutory provision that gives the bankruptcy court authority to submit proposed findings of fact and conclusions of law. Arguably, the only thing the bankruptcy court can do is recommend to the district court that it withdraw the reference under 28 U.S.C. § 157(d), on the grounds that the bankruptcy court cannot do anything else.

Nevertheless, most courts have determined that a bankruptcy court can issue proposed findings and conclusions in such proceedings.³⁷ In *In re Bellingham*, the Ninth Circuit Court of Appeals agreed, holding that, despite the language of 28 U.S.C. § 157(c), bankruptcy courts retain the “more modest power” to submit proposed findings to the district courts. The court stated:

In sum, § 157(b)(1) provides bankruptcy courts the power to hear fraudulent conveyance cases and to submit reports and recommendations to the district courts. Such cases remain in the core, and the § 157(b)(1) power to “hear and determine”

33 *Wellness International Network, Ltd. v. Sharif*, 727 F.3d 751, 771 (7th Cir. 2013).

34 *Frazin v. Haynes and Boone, LLP (In re Frazin)*, 732 F.3d 313 (5th Cir. 2013).

35 *Ortiz v. Aurora Health Care, Inc. (In re Ortiz)*, 665 F.3d 906, 925 (7th Cir. 2011).

36 28 U.S.C. § 157(c) (emphasis added).

37 See e.g., *Kirschner v. Agoglia*, 2012 WL 1622497 (S.D.N.Y. May 9, 2012); *In re Blixseth*, 2011 WL 3274042 (Bankr. D. Mont. Aug. 1, 2011); *In re Byce*, 2011 WL 6210938 (D. Idaho Dec. 14, 2011).

them authorizes the bankruptcy courts to issue proposed findings of fact and conclusions of law. Only the power to enter final judgment is abrogated.³⁸

Conversely, in *In re Ortiz*, the Seventh Circuit found that bankruptcy courts cannot submit proposed findings of fact and conclusions of law in any proceeding classified as core, applying a strict construction of 28 U.S.C. § 157. The court noted:

For the bankruptcy judge's orders to function as proposed findings of fact or conclusions of law under 28 U.S.C. § 157(c)(1), we would have to hold that the debtors' complaints were "not a core proceeding" but are "otherwise related to a case under title 11." As we just concluded, the debtors' claims qualify as core proceedings and therefore do not fit under § 157(c)(1).³⁹

Regarding *In re Ortiz*, the *Bellingham* Court simply stated: "We do not find the *Ortiz* court's analysis of the issue thoroughly reasoned."⁴⁰ The overwhelming majority of courts that have looked at the "statutory gap" issue have agreed and have concluded that bankruptcy courts can issue proposed findings of facts and conclusions of law in core matters, notwithstanding the limiting language of 28 U.S.C. § 157(c).

IV. ***Clark v. Rameker* – Supreme Court to Decide the Plain Meaning of "Retirement Funds."**

On March 24, 2014, the United States Supreme Court heard oral argument in *Clark v. Rameker* regarding whether an individual retirement account ("IRA") inherited by a debtor from a non-spouse constitutes exempt retirement funds under the Bankruptcy Code. The Court will resolve a circuit split between the Seventh Circuit Court of Appeals in *In re Clark*,⁴¹ wherein that court held that inherited IRAs are not exempt, and the majority view adopted by appellate courts in the Fifth,⁴² Eighth⁴³ and Ninth⁴⁴ circuits, wherein those courts held that the IRAs are exempt "retirement funds" under the Bankruptcy Code regardless of original ownership.

In *In re Clark*, the debtor commenced a chapter 7 bankruptcy case. Thereafter, the debtor

38 *Executive Benefits Insurance Agency v. Arkison (In re Bellingham)*, 702 F.3d at 566.

39 *Ortiz v. Aurora Health Care, Inc. (In re Ortiz)*, 665 F.3d at 915.

40 *Id.* at 915 n. 8.

41 *In re Clark*, 714 F.3d 559 (7th Cir. 2013).

42 *In re Chilton*, 674 F.3d 486 (5th Cir. 2012).

43 *In re Nessa*, 426 B.R. 312 (B.A.P. 8th Cir. 2012).

44 *In re Hamlin*, 465 B.R. 863 (B.A.P. 9th Cir. 2012).

claimed an exemption under section 522(b)(3)(C) for an IRA valued at approximately \$300,000, which she had inherited from her mother pre-petition. Sections 522(b)(3)(C) and 522(d) (the statutes are similar and are applicable depending on whether the debtor elects the state or federal exemptions) provide that a debtor may exempt “retirement funds” to the extent that the funds are exempt from taxation under various sections of the Internal Revenue Code. Although the Bankruptcy Code does not define the term “retirement funds”, it is universally acknowledged that the term includes 401(k) accounts and IRAs, among other instruments. The chapter 7 trustee objected to the claimed exemption, arguing that the inherited IRA did not constitute “retirement funds” under the statute because the IRA was not set up by the debtor for her retirement but, rather, was set up by the debtor’s mother.

On appeal to the Seventh Circuit Court of Appeals, the court held that retirement funds, such as IRAs, are no longer retirement funds when they are inherited by a debtor from a non-spouse. The designation of “retirement funds,” the court found, is dictated by the debtor’s specific relationship to the funds. Retirement funds, the court explained, are unique to the retiree, and are specifically created to support his or her retirement. However, upon that individual’s death, the retirement funds lose their intended purpose and, thus, cease being retirement funds, at least for purposes of the Bankruptcy Code exemptions.

In support of its conclusion that an IRA’s status changes upon the death of the original retiree, the court noted that when an IRA is inherited by a non-spouse, contributions can no longer be made to the IRA, the balances cannot be rolled over to other accounts, and distributions must begin either within a year of the original owner’s demise in accordance with IRS distribution tables or be completed in full within five years.⁴⁵ In other words, the funds in the IRA do not remain in trust (free from claims of creditors) until the inheriting party retires.

As a result of this change in character, the court held, sections 522(b)(3)(C) and 522(d)(12), by their plain meaning, are inapplicable to retirement funds inherited by non-spouses. The IRA, the court reasoned, simply is not a “retirement fund” of the debtor. This result, the court concluded, was consistent with the purpose of various applicable Internal Revenue Code provisions.⁴⁶ More-

45 *Id.* at 559.

46 *Id.* at 560.

over, absent such a ruling, the debtor would receive a windfall in that she would be entitled to keep all of the \$300,000 for herself (to the detriment of her creditors), and indeed would not even need to wait until she is retirement age to start enjoying the funds.

Conversely, the Fifth, Eighth and Ninth Circuit all held that IRAs are exempt “retirement funds” regardless of who created them. The rationale for this conclusion is a plain reading of section 522 of the Bankruptcy Code, which does not expressly exclude “retirement funds” when they were not established by and for the debtor. In *In re Chilton*, for example, the Fifth Circuit determined that the defining characteristic of “retirement funds” is that they are “set apart” for retirement. What happens to them after they have been set apart, that court found, is not relevant.⁴⁷ Referencing the general rule that exemptions should be construed liberally in favor of the debtor, the court reasoned that since the Bankruptcy Code does not specifically require the “retirement funds” be in accounts established by and for the benefit of the debtor, there was no reason to read such a requirement into the statute. The court also relied on the fact that section 522(b)(4)(C) of the Bankruptcy Code specifically provides that a direct transfer of retirement funds that are exempt under the Internal Revenue Code to another account does not alter their status as retirement funds, and therefore does not alter their status as exempt funds.⁴⁸

The implications of *In re Clark* are significant as substantial funds held in IRAs alone are transferred through inheritance every year. If the trustee prevails in *In re Clark*, such funds will be available to satisfy claims of creditors in bankruptcy. If the debtor prevails, future debtors will arguably receive a windfall as they will be permitted to obtain immediate access to the funds free from the claims of their creditors. The contrasting opinions by appellate courts require clarification of this issue. Fortunately, the Court will likely provide such clarification in the coming months.

V. ***In re McKenzie* – Sixth Circuit Holds that Section 502(d) Can Be Used Defensively Even When the Statute of Limitations Has Passed.**

⁴⁷ *In re Chilton*, 674 F.3d at 489.

⁴⁸ *Id.* (discussing 11 U.S.C. § 522(b)(4)(C) (“[a] direct transfer of retirement funds from [one] fund or account that is exempt from taxation under [Internal Revenue Code] ... § 408 ... shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer.”)).

In *In re McKenzie*,⁴⁹ the Sixth Circuit Court of Appeals addressed two matters of first impression, holding that: (i) a creditor who seeks relief from the automatic stay has the burden to prove the validity of its perfected security interest in collateral, and (ii) the expiration of the two-year statute of limitations on bankruptcy avoidance actions does not prevent the trustee from asserting them defensively under section 502(d) of the Bankruptcy Code.

In this case, the debtor, a prominent entrepreneur, pledged his interests in certain assets, including his equity in various entities, to his law firm shortly before the petition date to secure legal fees owed to the firm.⁵⁰ Post-petition, the law firm moved for relief from the automatic stay with respect to those membership interests on the basis that the debtor had no equity in the membership interests. The trustee objected to the request for stay relief on a variety of grounds, including that the pledge to the law firm was a preferential transfer, and the bankruptcy court and district court ruled in favor of the trustee by denying stay relief.⁵¹

On appeal to the Sixth Circuit, the law firm made a variety of arguments, the most notable of which were: (i) that it should not have to bear the burden of establishing the validity of its secured interest in the pledged membership interests, and (ii) that the trustee could not use his hypothetical lien creditor status and avoidance powers defensively under section 502(d) of the Bankruptcy Code where, as here, the two year statute of limitations for bringing an avoidance action had passed.⁵²

On the first issue, the court noted that a court may grant a motion for relief from stay under section 362(d)(2)(A) if, among other things, the debtor “does not have an equity [interest] in [the] property.” While the parties had stipulated that the debtor did not have an equity interest in the membership interests *if the pledge to the law firm was valid*, the bankruptcy court had nevertheless required the law firm to establish the validity of its security interest in the pledged property. The law firm contended that the bankruptcy court had erred in placing this burden of proof on it, especially in light of the stipulation.

Noting that the issue of “[w]hether a creditor has the burden of establishing the validity of its security interest” on a stay relief motion is one of first impression in the Sixth Circuit, the court

49 *Grant Konvalinka & Harrison, P.C. v. Still (In re McKenzie)*, 737 F.3d 1034 (6th Cir. 2013).

50 *Id.* at 1035.

51 *Id.* at 1036.

52 *Id.* at 1037.

noted that numerous bankruptcy courts in other jurisdictions have imposed such a requirement on creditors.⁵³ The bankruptcy court, in imposing such a requirement on the law firm, had found that implicit in a determination that a party is entitled to lift the stay is a determination that the party is a creditor who has a lien against the property of the debtor.

In support of its contrary position, the law firm relied on section 362(g) of the Bankruptcy Code, which provides:

(g) In any hearing under subsection (d) or (e) of this section concerning relief from the stay of any act under subsection (a) of this section –

- (1) the party requesting such relief has the burden of proof on the issue of the debtor’s equity in [the] property; and
- (2) the party opposing such relief has the burden of proof on all other issues.

11 U.S.C. 362(g). The law firm argued that the stipulation between the parties satisfied its requirement under section 362(g)(1) and, thereafter, the trustee had the burden on all other issues, including challenging the validity of the law firm’s lien.⁵⁴

Noting that the stipulation was conditional (*i.e.* it assumed a valid security interest), the court held that the law firm was required to prove the validity of its lien. The validity of a creditor’s security interest, the court found, “is often determinative of the debtor’s lack of equity in the property, and consequently affects the ultimate issue – whether the bankruptcy court should terminate the automatic stay.”⁵⁵ The court reasoned, “requiring a creditor to establish the validity of its

⁵³ *Id.* at 1038-39 (citing *In re Elmira Litho., Inc.*, 174 B.R. 892, 900 (Bankr. S.D.N.Y. 1994) (noting that “[t]he secured creditor who seeks relief from the automatic stay under § 362(d)(2) must demonstrate ... that its claim is secured by a valid, perfected lien in property of the estate”); *In re Cabrillo*, 101 B.R. 443, 450-51 (Bankr. E.D. Pa. 1989) (denying relief under § 362(d)(2) because the creditor failed to prove that it held a valid security interest in the collateral); *In re Playa Dev. Corp.*, 68 B.R. 549, 553 (Bankr. W.D. Tex. 1986) (“In considering a motion for relief from the stay, it is necessary to observe that the moving party has the burden of establishing the validity and perfection of its security interest....”); *In re Dahlquist*, 34 B.R. 476, 481 (Bankr. D. S.D. 1983) (“[A] creditor must establish the validity and perfection of its security interest ... and must carry the ultimate burden of proof with respect to equity.”); *United Cos. Fin. Corp. v. Brantley*, 6 B.R. 178, 184 (Bankr. N.D. Fla. 1980) (explaining that a creditor must “establish the validity and perfection of its security interest ... and ... must carry the ultimate burden of proof with respect to equity”). *But see In re Allstar Bldg. Prods., Inc.*, 834 F.2d 898, 899-900 (11th Cir. 1987) (noting that the debtor bears the burden of establishing that a creditor has failed to perfect its security interest).

⁵⁴ *Id.*

⁵⁵ *Id.*

security interest makes sense as a matter of sound judicial policy because the creditor will likely be in the best position to show that its interest is valid.⁵⁶

The court also affirmed the bankruptcy court's decision to allow the trustee to use his avoidance powers defensively to defeat the law firm's motion for stay relief.⁵⁷ The court noted that a bankruptcy trustee has the ability to avoid liens granted on the eve of bankruptcy but, to do so, must bring such action no later than two years after the bankruptcy court enters an order for relief under section 546(a)(1)(A). Here, the trustee failed to timely bring such a claim. Accordingly, the law firm asserted that the bankruptcy court had erred when it allowed the trustee to use his avoidance powers defensively to defeat the motion for stay relief.

The court noted that section 502(d) of the Bankruptcy Code "requires disallowance of a claim of a transferee of a voidable transfer *in toto* if the transferee has not paid the amount or turned over the property received as required under the sections under which the transferee's liability arises." The Sixth Circuit, the court noted, had not previously addressed whether a trustee may use his avoidance powers defensively following the expiration of the statutory limitation on filing avoidance actions. The majority view among bankruptcy courts, the court found, is that a trustee may exercise his avoidance powers in such instances.⁵⁸ Nevertheless, the law firm urged the court to adopt the minority position, which prohibits trustees from using their avoidance powers defensively after the expiration of the statute of limitations.⁵⁹

The court found that the minority view suffers from several flaws: First, it fails to account for the distinction between avoidance actions, in which a trustee seeks affirmative relief from the bankruptcy court, and defenses in which a trustee seeks no affirmative relief. Although [the law firm] characterizes the Trustee's defensive use of his avoidance powers as a "procedural windfall," the Trustee in fact receives no such windfall. He is instead "limited under ... § 502(d) to offsetting the claim asserted by the creditor." Section 502(d) does not permit any additional recovery by the trustee.⁶⁰

The court relied on the fact that the text of section 502(d) and its predecessor statute do not refer to

56 *Id.* at 1040.

57 *Id.* at 1041.

58 *Id.* (discussing *In re McLean Indus., Inc.*, 196 B.R. 670, 676 (Bankr. S.D.N.Y. 1996); *In re Am. W. Airlines, Inc.*, 217 F.3d 1161, 1168 (9th Cir. 2000)).

59 *Id.* (citing *In re Mktg. Assocs. Of Am. Inc.*, 122 B.R. 367, 370 (Bankr. E.D. Mo. 1991)).

60 *Id.* at 1041-42.

the statute of limitations in section 546(a)(1)(A) or contain a statute of limitations of their own.⁶¹ If such a limitation was intended by Congress, the court reasoned, it easily could have included a reference to section 502(d) in section 546(a). Finally, the court held that the trustee's defensive use of avoidance powers outside of the statute of limitations is consistent with the central purpose of the Bankruptcy Code, to ensure equality of distribution among creditors.⁶²

VI. ***In re Friedman's, Inc.* – Third Circuit Holds That Post-Petition Payments Do Not Affect Subsequent New Value Analysis.**

In *In re Friedman's Inc.*,⁶³ the Third Circuit Court of Appeals held that a postpetition payment made to a preference defendant on account of prepetition invoices did not affect the ability of the preference defendant to use such prepetition invoices as new value to reduce its preference exposure. Designating the issue as one of first impression, the court specifically found that “where ‘an otherwise unavoidable transfer’ is made after the filing of a bankruptcy petition, it does not affect the new value defense.”⁶⁴

In this case, the debtor was operating in chapter 11. In the ninety days prior to the petition date, the debtor made payments to the defendant, an employee staffing company, totaling \$81,997.57. After receipt of the transfers, but prior to the petition date, the defendant provided staffing services valued at \$100,660.88 to the debtor and invoiced the debtor for such services. Such invoices remained unpaid as of the petition date.

Postpetition, the debtor filed a motion seeking authority to pay its employees and independent contractors, including the defendant, prepetition wages, compensation and related benefits. Such motions are customary in operating chapter 11 cases to avoid loss of employee morale and to

61 *Id.* at 1042.

62 *Id.* (citing *Union Bank v. Wolas*, 502 U.S. 151, 161 (1991)).

63 *Friedman's Liquidating Trust v. Roth Staffing Companies, LP (In re Friedman's Inc.)*, 738 F.3d 547 (3d. Cir. 2013).

64 *Id.* at 549.

ensure a continuing workforce for the restructuring company.⁶⁵ The bankruptcy court granted the motion and the debtor paid the defendant \$72,412.71 pursuant to the order post-petition on account of its prepetition staffing services.

Over a year later, a liquidating trustee, the successor in interest to the debtor, commenced a preference action seeking to recover the \$81,997.57 in payments made to the defendant during the ninety days prior to the petition date. Among other defenses, the defendant argued that the transfers were not avoidable because it had provided new value subsequent to their receipt, which exceeded the amount of the transfers. The trustee argued that the defendant's new value had to be reduced by the post-petition payment of \$72,412.71 that the debtor had paid to the defendant pursuant to the wage order.⁶⁶ Absent such a result, the trustee claimed, the defendant would be receiving double credit for the prepetition invoices (in that it would be using such invoices as new value to reduce its preference exposure and it would have received payment in full pursuant to the wage order).

In finding for the defendant, the court began its analysis by looking at the plain language of the subsequent new value defense, set forth in section 547(c)(4)(B) of the Bankruptcy Code.⁶⁷ The court found that the language of the subsequent new value defense is silent as to when a payment must be made by a debtor to defeat a creditor's new value defense, and noted that district and bankruptcy courts are nearly equally divided on this issue.⁶⁸ The court acknowledged that analo-

65 *Id.* at 550.

66 *Id.* at 551.

67 *Id.* at 553.

68 *Id.* (comparing *In re Phoenix Rest. Grp., Inc.*, 373 B.R. 541 (M.D. Tenn. 2007) (holding that post-petition payments made pursuant to Critical Vendor Order could not be used to offset prepetition new value); *In re Schabel*, 338 B.R. 376 (Bankr. E.D. Wis. 2005) (holding that new value must remain unpaid at time of filing of bankruptcy petition); *In re Thurman Constr., Inc.*, 189 B.R. 1004 (Bankr. M.D. Fla. 1995) (finding that new value must remain unpaid as of petition date, rather than date court adjudicates preference action); *In re Braniff, Inc.*, 154 B.R. 773 (Bankr. M.D. Fla. 1993) (following "majority rule" that new value remain unpaid as of petition date); and *In re Energy Coop., Inc.*, 130 B.R. 781 (N.D. Ill. 1991) (post-bankruptcy payments by debtor do not limit new value defense); with *In re Furr's Supermarkets, Inc.*, 485 B.R. 672 (D. N.M. 2012) (holding that cutting off preference calculation at petition date "makes no economic sense"); *In re Login Bros. Book Co.*, 294 B.R. 297 (N.D. Ill. 2003) ("[B]oth the plain language and policy behind the statute indicate that the timing of a repayment of new value is irrelevant."); *In re MMR Holding Corp.*, 203 B.R. 605 (Bankr. M.D. La. 1996) ("An unavoidable post-petition transfer on account of new value extended subsequent to a preference *should* limit the use of § 547(c)(4) by the amount of the unavoidable transfer, as without a reduction in the new value offset, the transferee would be receiving double use of the new value...."); and *In re D.J. Mgmt. Grp.*, 161 B.R. 5 (Bankr. W.D.N.Y. 1993)

gous cases exist in the context of prepetition invoices being paid post-petition pursuant to section 503(b)(9) of the Bankruptcy Code.⁶⁹ Nevertheless, the court found, the fact that courts are divided in their interpretations of the subsequent new value defense does not mean that the provision is ambiguous.⁷⁰ Indeed, the plain meaning of the subsequent new value defense language could be determined by considering the statutory context and the underlying policy goals.

Starting with the statutory context, the court found numerous contextual indicators in the Bankruptcy Code that point to the petition date as the cutoff for analysis of the new value defense.⁷¹ First, the court found, section 547 is titled “Preferences,” which suggests that it concerns transactions “occurring during the preference period, which is by definition pre-petition.”⁷² Second, the court noted that the fact that the preference test contained in section 547(b)(5) (known as the “hypothetical liquidation test”) must be performed as of the petition date supports using that date as the cutoff for determining new value.⁷³ Third, the court found, the preference cause of action accrues as of the petition date, as evidenced by the fact that the statute of limitations for filing a preference action in a voluntary case begins to run on that date.⁷⁴ “The fact that the statute of limitations for a preference avoidance action under § 547 generally begins on the petition date suggests that the calculation of preference liability should remain constant post-petition.”⁷⁵ Fourth, extending the preference analysis past the petition date would be inconsistent with the “improvement-in-position” defense articulated in section 547(c)(5) for creditors with a floating lien on a debtor’s inventory and receivable. That provision, the court explained, requires an analysis of a creditor’s collateral position “as of the date of the filing of the petition.”⁷⁶ Lastly, the court reasoned that if it allowed

(holding that post-petition payments on new value must be considered under § 547(c)(4)).

69 *Id.* at n.2 (comparing *In re Commissary Operations, Inc.*, 421 B.R. 873, 878 (Bankr. M.D. Tenn. 2010) (holding that deliveries entitled to a § 503(b)(9) claim are not disqualified from constituting new value) with *In re T.I. Acquisition, LLC*, 429 B.R. 377 (Bankr. N.D. Ga. 2010) (holding that new value defense does not apply where creditor has been paid for goods pursuant to § 503(b)(9)) and *In re Circuit City Stores, Inc.*, 2010 WL 4956022 (Bankr. E.D. Va. Dec. 1, 2010) (concluding that same materials cannot be the basis for both a new value defense and § 503(b)(9) claim).

70 *Id.* at 554.

71 *Id.* at 555.

72 *Id.*

73 *Id.* at 555-56.

74 *Id.* at 556.

75 *Id.*

76 *Id.* (discussing 11 U.S.C. § 547(c)(5)).

post-petition payment to affect the preference analysis, it would seem logical also to consider post-petition extensions of new value to be available as a defense, an approach that has been almost universally rejected by bankruptcy courts which have assigned the petition date as a cutoff for the provision of new value.⁷⁷ Accordingly, the court held that the context of the Bankruptcy Code supports the conclusion that post-petition payments by a debtor should not affect a creditor's new value

⁷⁷ *Id.* at 557 (citing cases).

defense.

Turning to the policy goals underlying the preference provision and the new value defense, the court rejected the plaintiff’s argument that such policy should compel it to conclude that post-petition payments defeat a new value defense. The court noted that both the Supreme Court and Congressional records articulate two primary policies underlying section 547, specifically: (i) discouraging creditors from racing to the courthouse to dismember the debtor during its slide into bankruptcy, and (ii) facilitating the prime policy of equality of distribution among creditors of the debtor.⁷⁸ Notably, the court stated, these purposes focus on the prepetition period.⁷⁹ Thus, the court reasoned, “it makes sense that the equality should be measured, and inequalities rectified, as of the petition date.”⁸⁰

The court next focused on the policies behind the subsequent new value defense, identifying two primary purposes of the defense: (i) encouraging trade creditors to continue dealing with troubled businesses, and (ii) treating fairly a creditor who has replenished the estate after having received a preference.⁸¹ The court emphasized the importance of treating a creditor who provides new value to a distressed debtor fairly.⁸² The court noted that it is clear that even if a creditor is paid post-petition for new value it provided pre-petition, the creditor still replenished the debtor’s estate during the preference period, and therefore aided the debtor in avoiding bankruptcy to whatever extent possible. The fact that the defendant happens to get paid for such new value post-petition as a result of a court order or some other provision of the Bankruptcy Code does not negate this fact.

The court also rejected the plaintiff’s argument, which had some support in the case law, that cutting off the preference analysis at the petition date results in unequal treatment of creditors.⁸³

The court reasoned:

If it is a rule in bankruptcy that all creditors must be treated equally, surely the exceptions swallow the rule. It could be said that some creditors are treated more equally than others. There are special provisions for aircraft leases and shopping center leases, and some claims are given priority over others. The balancing of

78 *Id.* at 557-58 (citing *Union Bank v. Wolas*, 502 U.S. 151, 161, 112 S. Ct. 527 (1991) and H.R. Rep. No. 95-595, at 177-78, U.S. Code Cong. & Admin. News 1978, pp. 6137-38).

79 *Id.* at 558.

80 *Id.*

81 *Id.* (citing *In re New York City Shoes*, 880 F.2d 679, 680-81 (3d. Cir. 1989)).

82 *Id.* at 559.

83 *Id.* at 560.

interests in, for instance, wage orders, has been held to justify the type of unequal treatment condemned in cases that would include the post-petition payment in the preference analysis. Inequality per se is not to be avoided; indeed, reasoned and justified inequality sometimes prevails, usually based on what is in the best interest of the estate. For this reason, the courts positing that the interpretation that “results in absolutely equal treatment of all unsecured claims” is the “most reasonable interpretation of section 547(c)(4)” are misguided.⁸⁴

Preferences, the court concluded, are not about “replenishment” and “equality” but, rather, requiring that if a creditor has been preferred, he must disgorge, thereby setting things straight before bankruptcy.

Finally, returning again to the concept that the Bankruptcy Code does not give equal treatment to the claims of *all* creditors, but rather carves out special treatment for creditors or claims of certain kinds, the court highlighted the fact that section 503(b)(9) claimants “are afforded priority status for administrative expenses” and critical vendors can “be given preferred treatment under § 105 and § 363.”⁸⁵ Such creditors are *not* similarly situated and that, the court found, is ok because the enhanced rights given to such creditors is in the best interests of the estate. “The scheme of the Bankruptcy Code,” and the court oversight provided after the filing, “ensur[es] that *similarly situated creditors* are treated equally” post-petition.⁸⁶ For this reason, the court concluded, the “preference analysis need not account for post-petition activity.”⁸⁷

Accordingly, the court held that the defendant’s receipt of the post-petition payments pursuant to the wage order did not affect the calculation of its preference liability. The preference analysis closes at the petition date. As such, the court affirmed the orders of the lower courts, finding that the defendant had a complete new value defense.

VII. ***In re LGI Energy Solutions, Inc.* - Eighth Circuit Holds that Section 547(c) New Value Need Not Come from the Recipient of the Preferential Transfer.**

84 *Id.* (internal citations omitted).

85 *Id.* at 560.

86 *Id.* at 561.

87 *Id.*

In *In re LGI Energy Solutions, Inc.*,⁸⁸ the Eighth Circuit Court of Appeals held that when a debtor makes a preferential transfer to a third party for the benefit of a primary creditor in a tri-party relationship, a subsequent transfer by the primary creditor to the debtor constitutes “new value” under section 547(c) of the Bankruptcy Code that can shield the third party from preference liability.

In this case, the debtor performed bill payment services for its clients, which consisted of large utility customers including restaurant chains Buffets and Wendy’s (collectively, the “Restaurants”).⁸⁹ Utility companies that provided services to the Restaurants sent invoices directly to the debtor, rather than to the Restaurants.⁹⁰ The debtor periodically provided invoice summaries to the Restaurants, which in turn paid the aggregate invoice amounts to the debtor. The debtor placed these payments into a comingled account and used the pool of money to pay the utility companies for the outstanding invoice amounts. The utility companies had no contractual relationship with the debtor.

During the ninety day period prior to the debtor’s bankruptcy filing, the debtor made payment on behalf of the Restaurants for a total of \$75,053.85 to San Diego Gas & Electric Company and \$183,512.74 to Southern California Edison Company (collectively, the “Utilities”) to pay outstanding invoices for utility services provided to the Restaurants. Subsequent to the alleged preferential transfer, the Utilities provided services to the Restaurants and sent invoices directly to the debtor, while the Restaurants paid roughly \$297,000 (the “Restaurant Payments”) to the debtor pursuant to their existing contractual arrangement. Because of the debtor’s financial difficulties, none of the Restaurant Payments were passed on to the Utilities.

Post-petition, the debtor’s chapter 7 trustee brought preference actions seeking to avoid and recover from the Utilities the \$75,053.85 and \$183,512.74 in payments (collectively, the “Transfers”) that were made to the Utilities. The bankruptcy court held that: (i) the Transfers were preferential transfers within the meaning of section 547(b) to the Utilities who were creditors notwithstanding the absence of a contractual relationship, and (ii) the language of section 547(c)(4) required that subsequent “new value” be provided by the creditor that received the preferential

88 *Stoebner v. San Diego Gas & Elec. Co. (In re LGI Energy Solutions, Inc.)*, 2014 WL 1063209 (8th Cir. Mar. 20, 2014).

89 *Id.* at *2.

90 *Id.* at *3.

transfer (in this case the Utilities)⁹¹ and, as a result, while the Utilities were entitled to a new value defense for the minimal value of utility services provided to the Restaurants after the Transfers, they were not entitled to offset the entire amount of the Restaurant Payments to the debtor, which would have eliminated any exposure they had on the preference.

The Utilities appealed to the Bankruptcy Appellate Panel for the Eighth Circuit on various grounds. Relevant to the subsequent new value defense, the Utilities argued that they were entitled to a new value offset for the amount of the Restaurant Payments, rather than the value of the utility services provided to the Restaurants after the Transfers. The BAP overruled the bankruptcy court's findings and held that the Utilities were entitled to a "new value" defense in the amount of the Restaurant Payments.⁹² The trustee appealed the BAP's decision to the Eighth Circuit, arguing that the language of the preference statute mandates that any subsequent "new value" setoff must be provided by the same creditor who received the preferential transfer.

The Eighth Circuit Court of Appeals affirmed the BAP, holding that the statutory purpose of sections 547(b) and (c) was furthered by permitting a party other than the preferential transferee to provide new value in a tri-party arrangement such as this.⁹³ The court found that the debtor made the preferential transfers at issue to satisfy its antecedent obligations to the Restaurants to pay their outstanding utility invoices. Thus, the transfers were "for the benefit" of the Restaurants. The court noted that the obvious reason the trustee sued the Utilities instead of the Restaurants (who were the primary beneficiaries of the preferential Transfers) is because the trustee knew the Restaurants would assert a subsequent new value defense for the Restaurant Payments. The court explained:

Instead of suing the primary creditor beneficiaries, the trustee set out to avoid the § 547(c)(4) exception by suing the utilities, the immediate transferees of the preferential transfers. At the outset, it is essential to note that this approach does fundamental violence to "the prime bankruptcy policy of equality of distribution among creditors." If the utilities must return the preferential transfers to the bankruptcy estate, the estate is "doubly replenished" entirely at the expense of [the Restaurants], who got no benefit for their subsequent new value and will continue to be liable to the utilities for their unpaid invoices. The question remains, is this inequitable result

91 The subsequent new value defense provides a creditor with a defense to a preference "to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor..." 11 U.S.C 547(c)(4).

92 *Stoebner v. Sand Diego Gas & Elect. Co. (In re LGI Energy Solutions, Inc.)*, 482 B.R. 809, 812 (8th Cir. BAP 2012).

93 *In re LGI Energy Solutions, Inc.*, 2014 WL 1063209 at *4.

mandated by the statute?⁹⁴

The lynchpin of the trustee’s theory, the court found, was his assertion that, because the statutory language in section 547(c)(4) limits the subsequent new value exception to new value “such creditor” gave to or for the benefit of the debtor and, thus, only subsequent new value given by the Utilities, not the Restaurants could be considered.⁹⁵ In rejecting this theory, the court relied primarily on its prior decision in *In re Jones Truck Lines, Inc.*,⁹⁶ wherein the Eighth Circuit held that transfers made by the debtor to an employee benefit fund pursuant to a collective bargaining agreement were exempted from preference liability to the extent that the employees (on whose behalf the transfers were made) provided the debtor with contemporaneous or, alternatively, subsequent new value by continuing to work for the debtor. The court found the facts of the present case to be “closely analogous” to *In re Jones Truck Lines*, noting that the debtor’s “preferential transfers to the [Utilities] were based upon its contractual obligations to the [Restaurants], who benefitted from those transfers by having their utility bills paid.” The court found that other courts have rejected the trustee’s restrictive interpretation of the term “such creditor” in the subsequent new value defense, at least in tri-party transactions.⁹⁷

In addition to avoiding the inequitable treatment of the Restaurant creditors that would result from adopting the trustee’s theory, the court found that the BAP’s interpretation of section 547(c)(4) was consistent with the statutory purpose of “encourag[ing] creditors to deal with troubled businesses.”⁹⁸ Either the Utilities or the Restaurants, the court reasoned, could have stopped using the debtor as a bill-paying middleman at any time. The Restaurants continued to make utility bill payments (*i.e.* the Restaurant Payments) to the debtor after the preferential transfers – the subsequent new value at issue – because the Utilities and the Restaurants continued to deal with a

94 *Id.* at *5.

95 *Id.* at *6 (citing *In re Musicland Holding Corp.*, 462 B.R. 66 (Bankr. S.D.N.Y. 2011)).

96 *Id.* (discussing *Jones Truck Lines, Inc. v. Central States Se. and Sw. Areas Pension Fund (In re Jones Truck Lines, Inc.)*, 130 F.3d 323 (8th Cir. 1997)).

97 *Id.* at *8 (citing *In re H&S Transp. Co.*, 939 F.2d 355, 358-60 (6th Cir. 1991) (boat owner as subrogee can assert fuel suppliers’ new value to maritime transport debtor); *In re Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d 224, 231 (5th Cir. 1988) (“under these circumstances, new value received by a debtor need not be provided by the creditor to whom the [preferential] transfer was made but may be provided by the fully secured third party.”)).

98 *Id.* at *9.

troubled business, not because the Utilities continued to provide utility services to the Restaurants.

Cautious not to create binding precedent that alleged third party new value should always be considered, the court expressly limited its holding to the “circumstances presented by this case” where a tri-party relationship exists.⁹⁹ Specifically, the court held that, in three-party relationships where the debtor’s preferential transfer to a third party benefits the debtor’s primary creditor, new value (either contemporaneous or subsequent) can come from the primary creditor, even if the third party is a creditor in its own right and is the only defendant against whom the debtor has asserted a claim of preference liability.¹⁰⁰

VIII. ***In re KB Toys, Inc.* - Third Circuit Clarifies Impact of Section 502(d) in the Context of Claims Trading.**

In *In re KB Toys, Inc.*,¹⁰¹ the Third Circuit Court of Appeals addressed a district court split regarding the impact of section 502(d) of the Bankruptcy Code in the context of claims trading. The court held that a trade claim that is subject to disallowance pursuant to section 502(d) in the hands of the original claimant is likewise disallowable in the hands of a purchaser of such claim.

Pursuant to section 502(d) of the Bankruptcy Code, an otherwise valid bankruptcy claim can be disallowed unless a claimant returns any property that is avoidable and recoverable by the bankruptcy estate. In this case, ASM Capital purchased various claims from creditors of the debtors. Subsequent to the transfer of the claims, the transferors each went out of business. The liquidation trustee of the debtors’ post-confirmation trust pursued preference causes of action against each of the transferors and, thereafter, obtained default judgments. Upon obtaining judgments in the preference actions, the trustee objected to ASM’s assigned claims on section 502(d) grounds arguing that such claims should be disallowed pending the recovery of the preferential transfers by the trust.

The bankruptcy court disallowed ASM’s claims, concluding that a claims purchaser holding a trade claim is subject to the same section 502(d) challenge as the original creditor. Put differently, the bankruptcy court held that, “under § 502(d), ‘[d]isabilities attach to and travel with the

99 *Id.*

100 *Id.*

101 *In re KB Toys, Inc.*, 736 F.3d 247 (3d. Cir. 2013).

claim.”¹⁰² Additionally, because ASM was a sophisticated entity who had access to the debtor’s statement of financial affairs, which listed potentially avoidable payments to the transferors, it was not entitled to protection as a “good faith” purchaser. The district court affirmed, adopting the reasoning of the bankruptcy court.

On appeal, the Third Circuit Court of Appeals identified the issue as follows: “whether a trade claim that is subject to disallowance under § 502(d) in the hands of the original claimant is similarly disallowable in the hands of a subsequent transferee.”¹⁰³ The court began its analysis by focusing on the text of section 502(d). The court noted that the language of section 502(d) stating that “‘any claim of any entity’ who received an avoidable transfer shall be disallowed” focuses on claims, and not claimants. Accordingly, the court found “claims that are disallowable under § 502(d) must be disallowed no matter who holds them.”¹⁰⁴ To hold otherwise, the court reasoned, would contravene the aims of section 502(d), the first of which is to ensure equality of distribution of estate assets. If a transferred claim was protected from disallowance, an original claimant who received an avoidable transfer would have an incentive to sell its claim and “wash” the claim of any disability. Such a result would also undermine a second aim of section 502(d), coercing compliance with judicial orders, including judgments granted in preference actions. Finally, the court found that the legislative history behind section 502(d) supported its conclusion.

ASM argued that its claims should not be disallowed because it purchased such claims in “good faith” and was therefore entitled to the protections of a good faith purchaser under section 550(b) of the Bankruptcy Code, which provides that the trustee may not recover an avoidable transfer from a good faith transferee. The court rejected this argument, noting that section 550(b) protects a good faith transferee who purchases *property of the estate* that is avoidable under the various avoidance actions. ASM, however, did not purchase property of the estate. ASM purchased *claims* against the debtors’ estates. A claim against an estate is not property of that estate and, thus, on its face, section 550(b) is inapplicable to ASM.

Moreover, the court declined to extend the principles of section 550(b) to protect ASM.

102 *Id.* at 251.

103 *Id.* at 249.

104 *Id.* at 252.

“Claim purchasers are entities who knowingly and voluntarily enter the bankruptcy process.”¹⁰⁵ A purchaser of claims knowingly takes on risks inherent in bankruptcy and, indeed, it is that risk that motivates many creditors to sell their claims. Disallowance under section 502(d), the court found, is one of those risks.

105 *Id.* at 255.