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# Foreword: The Trustee's Avoiding Powers

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## FOREWORD

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This Symposium issue of the *South Carolina Law Review* entitled "The Trustee's Avoiding Powers" is a welcome addition to legal literature generally and to the mass of writings concerning bankruptcy law specifically. On the whole, the various articles contained in this issue bring together related subjects concerning the ability of a trustee or a debtor in possession in a case under title 11 of the United States Code (the Bankruptcy Code) to set aside transfers of property made by a debtor prior to the filing of a petition commencing the case.

The ability of the trustee (or debtor in possession in a Chapter 11 case)[1] furthers one of the two basic purposes of the Bankruptcy Code as a whole. That purpose is to provide a means and a mechanism that promotes the equitable distribution of the debtor's property among the debtor's unsecured creditors.[2] Obviously, if a debtor were freely permitted to transfer property at any time prepetition, by any means and

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1. All of the avoiding power sections give to the trustee the particular right and standing to assert the power of avoidance. In a Chapter 11 case there ordinarily is no trustee; rather, the debtor in possession manages the property and conducts the business of the estate. Accordingly, § 1107 gives the debtor in possession the rights and powers of a trustee and it, therefore, can assert the avoiding powers contained in Chapter 5 of the Bankruptcy Code. In this Foreword, whenever "trustee" is used, it includes "debtor in possession," unless the context requires otherwise.

2. The other basic purpose of the U.S. bankruptcy laws is to give the honest debtor a fresh start, which is accomplished through the mechanism of the bankruptcy discharge. That goal is not involved in the subject matter of this Symposium.

under any circumstances, a somewhat dishonest debtor or one who wanted to play favorites would be able to do its own choosing and leave little or nothing for its general body of creditors.

The Bankruptcy Code has a variety of provisions that restrict the effectiveness of prebankruptcy transfers. Several of them are discussed in the following articles. It should be noted at the outset, however, that not all of the weapons in the trustee's arsenal to avoid transfers for the benefit of the estate are included in this Symposium. Among the exclusions are the powers of the trustee under sections 542,[3] 543,[4] 545,[5] and even 365.[6] What is included, in general for present purposes, are discussions of some problems with respect to recovering fraudulent conveyances, voidable preferences, and setoffs.

In his solo article entitled *Reception of the Uniform Fraudulent Transfer Act*, Professor Frank R. Kennedy has given the reader of and researcher using this Symposium very helpful information concerning the evolution, enactment, and utility of the Uniform Fraudulent Transfer Act (UFTA). As he notes, it has been adopted in twenty-nine states since 1984, which is a rather remarkable statistic. That is a large number of states to enact a uniform piece of legislation in such a short period of time. The UFTA is an updated version of what many states had earlier enacted as the Uniform Fraudulent Conveyance Act (UFCA). Professor Kennedy indicates the changes that the newer makes from the older and, with characteristic objectivity (he served as the reporter for the UFTA), he indicates the critical comments that have been generated by some of the changes and provisions of the newer. This article also contains helpful citations to cases that have involvement with important provisions in the Act. For anyone who has to use the UFTA, for whatever purpose, Professor Kennedy's article is highly recommended for the background that it contains and its explanatory insights into the workings of that statute.

In the jointly authored article by Professor Kennedy and Gerald K. Smith, Esquire, *Fraudulent Transfers and Obligations: Issues of Current Interest*, specific and very current problems that are plaguing the courts are discussed and solutions with respect to them are offered. Both authors bolster the discussion of the problems and their conclu-

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3. Section 542 permits the trustee to obtain property of the estate held by another under certain circumstances. 11 U.S.C. § 542 (1988).

4. Section 543 permits the trustee to recover property from a "custodian" under certain circumstances. *Id.* § 543.

5. Section 545 contains the provisions that allow the avoidance of statutory liens. *Id.* § 545.

6. Section 365 deals with the assumption and rejection of executory contracts. Although not strictly an avoiding power, it allows the trustee the option of nonperformance or requiring performance of prepetition contracts. *Id.* § 365 (1988 & Supp. II 1990).

sions on how they should be resolved by their actual experience in some of the cases in which the issues have been raised. Thus, what too often is lacking in the legal literature—that is, practical application of esoteric discussions—can be found in this article. Not only are suggestions set forth for resolution, they are directed specifically to the courts and offered without any expression of doubt as to their accuracy. Thus, should the practitioner have a case in which such an issue exists, not only has the brief been written but all of the research has been done. All the practitioner need do is push the appropriate button to update the research. As only one illustration, the authors note that section 546(a) of the Bankruptcy Code has been interpreted by some courts to impose a two-year limitation on a Chapter 11 debtor in possession to bring an action under one of the avoiding powers. That section, however, refers only to a trustee and runs the two-year period from the time of appointment of the trustee under section 1104. A debtor in possession is *not appointed* under section 1104 and for this, and other reasons set forth in the article, the authors rightfully conclude that the two-year period should be inapplicable to a debtor in possession.

The article by Michael L. Cook, Esquire, *The Judicially Created "Innocent Shareholder" Defense to Constructive Fraudulent Transfer Liability in Failed Leveraged Buyouts*, continues the discussion of fraudulent conveyances in an even more specific context. First, it should be recognized that the trustee has two shots at using fraudulent conveyance law: that contained in the state statutes, *e.g.*, the UFTA or UFCA, which are brought into a bankruptcy case by virtue of section 544(b),[7] or the Bankruptcy Code's own version of fraudulent conveyance law which is contained in section 548.[8] The specific instance that is the subject of Cook's well thought out piece is the leveraged buyout and actions to recover from shareholders the benefits that they received. Only two or three cases have reached the courts on the issue of shareholder liability, one of which is a court of appeals decision,[9] and Mr. Cook looks at both the reasoning of the cases and the applicable

7. Section 544(b) gives to the trustee the rights of an unsecured creditor in existence on the date of the filing of the petition; if that creditor could, under state law, avoid a fraudulent conveyance, the trustee may assert that right and use the same law to avoid the conveyance. *Id.* § 544(b) (1988).

8. Section 548 permits the trustee, *qua* trustee, to avoid a fraudulent conveyance as defined in that section if it occurred within one year prior to the filing of the petition. *Id.* § 548 (1988 & Supp. II 1990). Under § 544(b) the trustee may use the applicable state statute of limitations. *Id.* § 544(b) (1988).

9. Kaiser Steel Corp. v. Pearl Brewing Co. (*In re* Kaiser Steel Corp.), 952 F.2d 1230 (10th Cir. 1991), *cert. denied,* 112 S. Ct. 3015 (1992); *see also* Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988); Wieboldt Stores, Inc. v. Schottenstein, 131 B.R. 655 (N.D. Ill. 1991); Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988).

Bankruptcy Code provisions. It seems clear that he does not fully approve of the safe harbor contained for shareholders in section 546(e) of the Code, but he would agree that the Code is clear in its solution, and change, if needed, should come from Congress and not the courts. This is a refreshing attitude as contrasted with too many court decisions in the bankruptcy area in which the judges, from the bankruptcy courts to the courts of appeals, liken themselves unto legislators.

Professor John C. McCoid II, in *Corporate Preferences to Insiders*, reexamines the concepts of insider liability and preference liability as they presently exist in the Bankruptcy Code. As at present, section 547(b) permits a reach back of one year for payments or preferential transfers to insiders if the debtor was insolvent at the time of the transfer. As originally enacted, the Bankruptcy Code required the insider to know or reasonably have knowledge that the debtor was insolvent at the date of the transfer if that date was more than ninety days and less than one year before the filing of the petition. His examination goes to the central issue of legitimacy of the transfer.

Professor McCoid indicates that he does not have a quarrel with the present provision that sets a different time for the avoidance of insider preferences from the time set forth for the avoidance of transfers to noninsiders. What he proposes is that the emphasis should be on whether the transfer or repayment actually constituted an injury to the debtor, that is, was the transfer in the best interest of the debtor. He points out that in a bankruptcy case, at least, because of the collective nature of the case itself, when a preference is recovered, the preferee is placed in the same position as the rest of the unsecured creditors and will share pro rata on the revived claim; however, if a preference against insiders is recoverable under state law, it can be at the instance of an individual creditor who would then achieve the preferred position, at least vis-a-vis the insider. This appears lacking in soundness of doctrine. The article is an interesting excursion into the several issues of insider guarantees and will stimulate further debate.

Professor David Gray Carlson takes on a discussion of section 544(a) of the Bankruptcy Code in his article entitled *The Trustee's Strong Arm Power Under the Bankruptcy Code*. In the first portion of the article he briefly describes the historical development of section 544(a), tracing its forebears through its immediate lineage of section 70c of the Bankruptcy Act of 1898 together with some of the interpretive problems of that former section. In the second portion of his article he expounds on the question that he raises about whether the strong arm power avoids the transfer it attacks, *e.g.*, avoids a security interest in a debtor's property that was not perfected at the date of the filing of the petition as against a judicial lien creditor under appropriate state law, or whether it merely subordinates the secured claim of that creditor to the trustee. He rightfully acknowledges that in the multitude of instances there will be no difference in the result. Professor Carlson does, however, posit one situation, that of a nonrecourse security interest, in which a difference may eventuate and therefore permit a problem worthy of discussion.

Subordination, of course, comes into play when section 551 may be used by the trustee. Under that section an avoided transfer is automatically preserved for the benefit of the estate when it is in the interest of the estate for it to be done. That situation will arise when the holder of the avoided transfer has superior rights in property to those of another whose interest is not avoidable by the trustee. Instead of giving the junior interest holder a windfall by elevating its rights, section 551 preserves the priority of the avoided transfer and permits its exercise by the trustee. In this sense, one can speak of subordination and the author presents interesting hypotheticals to spell out the relationships and interrelationships that can become involved, all of which makes for interesting reading and contemplation. Professor Carlson continues his discussion into the Chapter 11 plan confirmation area.

Professor Carlson's article goes into the other provisions of section 544(a), such as the provision that grants the trustee the rights of the judicial lien creditor as of the date of the filing of the petition and assumes that credit is extended on that same date, as well as the trustee's status as a bona fide purchaser of real property, also at the date of the filing of the petition. In addition, he discusses those cases that disallow the trustee to avoid transfers under the strong arm clause. In all, the article is a thorough treatment and analysis of a most important avoiding power of the trustee.

Dean Philip T. Lacy has written an article that discusses the setoff right and limitations contained in section 553 of the Bankruptcy Code. It is entitled *Setoff and the Principle of Creditor Equality*. In this article he examines the criticisms that have been levelled at the Bankruptcy Code's recognition of the setoff right, albeit encouraging its nonuse by awarding the creditor with a secured claim in a title 11 case to the extent of the right of the setoff if it had not been exercised prior to the filing of the petition.[10] Dean Lacy suggests and pointedly notes that the Bankruptcy Code's treatment is consistent with the underlying policies of the trustee's other avoiding powers, particularly that dealing with preferences. What has to be recognized is that Congress started with the policy of referring to state law for the right of setoff. Congress did not write a law of setoff in the Bankruptcy Code just as it did not write a law of setoff in the Bankruptcy Act of 1898. In the

10. Section 553 permits the exercise of the right of setoff if the creditor has such a right under state law; § 506(a) converts that right, if it had not been exercised prepetition, to a secured claim postpetition. 11 U.S.C. § 553 (1988 & Supp. II 1990).

Bankruptcy Code it continued a recognition of the right of a creditor to setoff but only under circumstances in which it would have such a right absent a case under the Bankruptcy Code. Pursuant to the former bankruptcy law, the exercise of the right could occur up to the point of the filing of the petition and in a number of Chapter XI cases, banks setoff a debtor's loan against its bank account, leaving nothing for the debtor to work with in the ensuing Chapter XI case. In the Bankruptcy Code Congress attempted to ameliorate this situation somewhat and balance off the interests involved. Thus, the encouragement not to setoff and the concomitant loss if a setoff occurs and there is a betterment in position during the ninety days preceding the filing of the petition.

Professor Charles Jordan Tabb follows with a general discussion of preferences in *Rethinking Preferences.* I am not sure that anyone who went through the various amendments to former section 60 of the 1898 Bankruptcy Act in the 1950s, the consideration of it that resulted from the inclusion of the floating lien in Article 9 of the Uniform Commercial Code in the 1960s, and the hearings and drafting and final enactment of section 547 of the Bankruptcy Code as well as its becoming effective in the 1970s will want to do any rethinking about it in the 1990s. Fortunately, a respite existed in the 1980s and, perhaps, that is all to which one is entitled.

Professor Tabb takes on the ordinary course of business exception in section 547(c)(2) and concludes that it should be eliminated. Perhaps it should, but two problems immediately spring to mind. The business community would be up in arms. Therefore, something would have to replace it. What could that be? It should be remembered that all of subsection (c) is new to the Bankruptcy Code; it was made necessary by the elimination of the former element necessary to recover a voidable preference, which was that the transferee had reasonable cause to believe that the debtor was insolvent at the time of the transfer. This was not carried forward in the Bankruptcy Code because it was too hard to prove and because (almost a cause and effect) it was illogical to the underlying policy of avoiding preferences. But, its elimination required something in its place if one did not wish to invalidate every single transfer (payment) during the critical period. Congress did not wish to do this; therefore, it included subsection (c) as a laundry list of exceptions to the voidable preferences that a trustee could actually avoid.

The author discusses the issues surrounding the way in which section 547(c)(2) came to be written and amended, and now interpreted by the Supreme Court in *Union Bank v. Wolas.*[11] Subsection (c)(2)

11. 112 S. Ct. 527 (1991).

should be revisited by Congress, but whether it should be repealed in its entirety is questionable. A good thought to leave the subject with is that all of subsection (c) should be repealed and in its place a simple provision could be added to the effect that the trustee must prove, to recover a transfer that is voidable under section 547(b), that, at the time of the transfer, the transferee had reasonable cause to believe that the debtor was insolvent!

Finally, Professor Lester Brickman tackles the matter of retainer fees in cases under the Bankruptcy Code in *The Use of Advance Fee Attorney Retainer Agreements in Bankruptcy: Another Special Law for Lawyers?* As his article points out, the matter of debtors' counsel obtaining prepetition retainers under a variety of agreements has come under scrutiny by bankruptcy courts and not all pass muster.

One matter that should be kept in mind by the courts and discussants is that the Bankruptcy Code takes a very emphatic and affirmative approach in setting forth the supervisory function of the bankruptcy judge when it comes to payments made by a debtor to an attorney prior to the filing of the petition. That role transcends a trustee's avoiding powers. If the attorney received a payment for services already rendered, the trustee may be able to recover the payment as a voidable preference under section 547. But the term "preference" has nothing to do with the *court's* power to review a prepetition payment to the debtor's attorney for a determination of *reasonableness*. It should not matter what the form of the payment was, what kind of a retainer agreement was entered into, or what the specific provisions of the agreement were. Section 329 of the Bankruptcy Code gives to the court all the power it needs and, as a general rule, particularly when called to the court's attention, courts are not loathe to exercise the power. Sometimes, the key is calling it to the attention of the court; creditors should be on active guard as should the United States trustee.

Professor Brickman has done a service to the bar generally, as well as to a greater public audience, by calling this matter to everyone's attention and by proffering well thought out solutions.

The editors of the *South Carolina Law Review* are to be congratulated for a job extremely well done. They have garnered together a host of first rate authors who have contributed with unanimity first rate articles, each requiring one to think about important issues and even rethink well-established positions. In addition, the editors prepared and successfully carried off a live Symposium in which all of the authors discussed their articles. The live Symposium, on March 20, 1992, in Columbia, South Carolina, was very well received by the members of the bar and bench who attended. I wish the editors well and, based on prior performance, I am sure that their legal careers in whatever form will bring them much success and happiness.