AMERICAN BANKRUPTCY INSTITUTE

2019 Southeast Bankruptcy Workshop

Pre-Petition Pitfalls: How to Plan, Questions to Ask & Things to Avoid

CONCURRENT SESSION

J. Ellsworth Summers, Jr., Moderator
Burr & Forman LLP; Jacksonville, Fla.

Hon. Stephani W. Humrickhouse
U.S. Bankruptcy Court (E.D.N.C.); Raleigh

R. Stephen McNeill
Potter Anderson & Corroon LLP; Wilmington, Del.

Robert S. Westermann
Hirschler Fleischer, PC; Richmond, Va.

2019

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Panelists

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- Hon. Stephani W. Humrickhouse, Speaker
- U.S. Bankruptcy Court (E.D.N.C.); Raleigh, N.C.

- R. Stephen McNeill, Speaker
- Potter Anderson & Corroon LLP; Wilmington, Del.

- Robert S. Westermann, Speaker
- Hirschler Fleischer, PC; Richmond, Va.

General Fact Pattern

- Delaware Toy Bargain Mart ("Delaware TBM"), a retail store of toys and children's clothing, based in the Midwest, Northern, and Western states, filed for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the District of Delaware on July 19, 2019 (the "Petition Date"), largely due to the same economic atmosphere that led to the demise of its main competitors, Toys "R" Us ("TRU") and Gymboree Group, Inc. ("Gymboree"). Increased competition from online retailers such as Amazon severely reduced sales over the past couple of years. An aggressive attempt to expand and occupy the retail vacuum left in the wake of the TRU and Gymboree bankruptcies and a U.S. Department of Justice ("DOJ") investigation are also credited as events leading to TBM's bankruptcy filing.
- Delaware TBM was the surviving entity from a merger with an entity named Toy Bargain Mart ("TBM"). TBM was formed in March 2012 as an investment vehicle to acquire the assets of its predecessor Toy Bargain, LLC ("TBL") through a leveraged buyout (the "LBO") that closed on July 1, 2012. Through the LBO, TBL's sole shareholder, Toy Fund III, Ltd. ("Toy Fund") received $10 million in cash from TBM at closing.
- TBM financed the LBO through two separate credit agreements: an ABL Facility in the amount of $7 million and a Term Loan Facility in the amount of $10 million. Bank of the South ("BoS") served as administrative and collateral agent for the lenders under both Credit Agreements until January 1, 2019. BoS timely filed UCC-1 financing statements on July 1, 2012, as well as the required renewal statements in 2017. On January 1, 2019, Southeast Bank, N.A. ("SEB") was substituted for BoS as the administrative and collateral agent under the Term Loan Facility, with BoS remaining as agent for the ABL lenders under the ABL Facility.
- On July 2, 2019, in a blatant effort to obtain venue in Delaware in the event of a possible bankruptcy filing, TBM underwent a merger with a newly-formed corporate entity, Delaware TBM. Delaware TBM acquired all assets and liabilities of TBM. Delaware TBM was the surviving entity of the merger. TBM was dissolved.

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Additional Facts

- During the first year of the TRU bankruptcy in 2018, TBM purchased several leases from old TRU stores in South Carolina, among other states in the South, in an effort to expand by purchasing cheap, sub-market leases. Believing that TBM could aggressively expand in areas occupied by their former competitors, TBM purchased leases across the South in states it had never conducted business in before. The first TBM stores in the South opened in South Carolina on August 1, 2018.
- To finance the acquisition of these leases, TBM amended and restated its Term Loan Facility on May 30, 2018 to increase the maximum availability to $15 million. Once again, BoS timely filed the necessary UCC statements to reflect its security interest under the amended and restated Term Loan Facility.
- Throughout 2018, TBM sought new, cheaper vendors of toys and turned to emerging markets to satisfy those needs. On April 1, 2018, TBM entered into an informal contract with People's Republic Bike Company ("PRBC"), a Chinese company based in Guangzhou, China that produced sturdy bicycles of all types at a very low cost. Despite new U.S. trade tariffs targeting and forbidding the sale of Chinese-made bicycles in the United States, PRBC ensured that they could transport the bicycles undetected through the Canadian border to TBM's main distribution site in Duluth, Minnesota. This arrangement proved successful, and the first shipment of PRBC bikes arrived on April 15, 2018, with monthly shipments arriving thereafter on the 15th day of each month. Bicycle sales at TBM spiked tremendously after May 2018 and continued to rise every month until the Petition Date.
- In marketing materials throughout December 2018, TBM boasted of their sales on bicycles which were up 200% from the prior year. TBM declined to highlight that sales in nearly every other category continued to drop precipitously.
- On February 15, 2019, the DOJ filed a qui tam lawsuit (the "Qui Tam Action") after a TBM employee reported that the PRBC bikes were imported in violation of U.S. tariff laws and regulations. TBM's stock price plummeted overnight. To make matters worse, the expansion in the South was not proving to be profitable and online competition continued to eat away at TBM's already historically-low revenue.

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Debtor Pitfalls

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Avoidance Action Questions

- Can TBM seek to avoid the $10 million payment to Toy Fund in connection with the LBO as a fraudulent conveyance?
- Does the merger between TBM and Delaware TBM affect Delaware TBM's ability to avoid as preferences any transfers made by TBM to its creditors?

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Fraudulent Transfer Takeaways

- Where transactions would normally be safe from fraudulent transfer claims 6 years following the transaction, those transactions may be subject to transfer in a bankruptcy if the IRS is a creditor of the debtor.
- The IRS's statute of limitations on fraudulent conveyance claims is at least 10 years, and it is potentially unlimited under certain circumstances.
- Because the trustee's ability to step into the shoes of the IRS to assert its avoidance powers, if the debtor wishes to protect its transferees from the risk on these claims, it should ensure that the IRS is paid in full prior to the bankruptcy filing.
- Nevertheless, the debtor's fiduciary duty to its creditors may require it to consider bringing these claims once the bankruptcy has filed.
- Otherwise, a transferee's best defense to these claims is likely to argue that the debtor could not have been insolvent at the time of the transfer if it continued to operate outside of bankruptcy for more than 6 years.

Preference Takeaways

- When the debtor is the surviving entity from a pre-petition merger, transfers made by the non-surviving entity are not avoidable as preferences because the transfer was not made for or on account of an antecedent debt owed by the debtor before the transfer was made.
- If the avoidance of the transfer is critical to the Debtor's reorganization, the non-surviving entity should be placed into bankruptcy as well.
- Whether or not the non-surviving entity has been dissolved pre-petition may affect the ability to place that entity into bankruptcy to attempt to avoid preferences.

Secured Lender Pitfalls

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Consignment Facts

- Beginning in 2014, TBM determined that it could generate larger revenues and minimize its borrowing needs by selling a significant portion of goods on a consignment basis. To implement this new strategy, TBM entered into pay by scan ("**PBS**") agreements with approximately 100 of its toy vendors, who agreed to sell their merchandise to TBM on a consignment basis. At its peak, the sale of consigned goods pursuant to these PBS agreements equaled approximately 15% of TBM's total sales.
- Although most of these consignment vendors failed to file UCC financing statements reflecting their consignment interests, a few of them, including Smart Toy, LLC ("**Smart Toy**") filed UCC-1 statements and notified BoS of its consignment interest. Smart Toy was one of TBM's first consignment vendors, and it began selling consigned goods to TBM on May 3, 2014. Smart Toy, however, forgot to file a UCC renewal statement before May 3, 2019. Another vendor, Late Toy, Inc ("**Late Toy**") only filed its UCC-1 statement on June 15, 2019, approximately 1 month before the petition date.

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Consignment Questions

- Does Smart Toy have priority over BoS and/or SEB with respect to its consignment goods?
- Did Smart Toy's failure to file a renewal statement in 2019 affect its priority with respect to BoS and/or SEB?
- Does Late Toy have priority over BoS and/or SEB as a result of its UCC-1 filing in June 2019? If so, when did that priority arise? Is the filing of the UCC-1 avoidable as a preference?

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Key Takeaways

- Delaware recently joined most other courts that have considered the issue in holding that a lender's actual knowledge of a consignment relationship will provide the consignment vendor with a superior claim to the consigned goods and the proceeds thereof whether a UCC-1 statement was filed or not.
- To demonstrate actual knowledge, the consignment vendor must show that the other creditor actually knew that the consignee sold the goods of the specific consignment vendor in dispute.
- Actual knowledge falls within the "general knowledge" exception provided by section 9-102(a)(20)(A)(iii) of the UCC, which is also satisfied if the competing creditor knew that the debtor was selling 20% or more of its inventory on consignment.
- An agent's knowledge of a competing consignment interest will be imputed to the participating lenders.
- Providing notice to a predecessor agent is not sufficient to satisfy the PMSI requirements under section 9-324(b) of the UCC.
- If a consignment interest is identified on the schedules to a loan agreement, the lenders under that agreement will be charged with actual knowledge of the consignment relationship regardless of whether the consignment vendor subsequently files a UCC renewal statement.
- **Actual knowledge is a highly factual issue that varies from case to case.**

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Discovery Question

- If SEB pursues litigation against Smart Toy, or any other consignment vendor, seeking to establish its priority in the consigned goods, is SEB responsible for collecting and producing documents in the possession of its predecessor agent, BoS?

Discovery Takeaways

- All cases that have addressed this question have found that a successor agent (or more generally, any assignee) that pursues claims that could have been asserted by its predecessor is obligated to produce documents in the possession of its predecessor that are relevant to the litigation.
- Successor administrative agents, and their counsel, should ensure that they negotiate rights to access any documents, including ESI, related to any potential claims that may be pursued by the successor agent.
- The notions of fundamental fairness relied upon in these cases could also be expanded to apply to any situation involving the possibility of separating a litigation right, including any affirmative defenses, from related litigation obligations.

Discovery – Things to Consider

- When producing documents in response to discovery requests by a defendant, is the administrative agent responsible for searching the documents and emails in the possession of all the current lenders?
  - Winnick indicates yes, at least for current lenders
- What about documents in the possession of former lenders?
- Would the successor agent be liable for spoliation or other issues caused by the predecessor agent or any of the lenders?

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Trade Creditor/Vendor Pitfalls

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Creditor Facts

- Kidz Athletic Clothing Co. ("**KACC**") was a small regional children's clothing vendor located in the South that decided to begin to sell clothing to TBM's South Carolina stores. No written contract existed between KACC and TBM. Given TBM's financial state and credit history, KACC required a $45,000 security deposit (the "**Deposit**"), which was paid by TBM to KACC on August 1, 2018 in a written agreement that allowed KACC to offset the Deposit against any unpaid invoices of TBM and its affiliates. Beginning on August 1, 2018, KACC started to ship children's shorts and t-shirts to three TBM stores in South Carolina. TBM would send a request for products to KACC on the first day of each month, and KACC would immediately issue an invoice payable and due within 30 days (*i.e.*, "**Net 30 Terms**"). TBM timely paid invoices dated August 1, 2018, September 1, 2018, October 1, 2018, November 1, 2018, and December 1, 2018 on the last day of each respective month. KACC always cashed the checks fifteen (15) days after receipt of the checks.
- From August 1, 2018 onward, KACC enjoyed high sales of children's bike shorts. In their December 2018 board meeting (the "**Board**"), KACC management was somewhat taken aback at the bike short sales because bike short sales had spiked 300% since August 2018 and TBM accounted for nearly 90% of all bike short sales despite being a new customer. One Board member mentioned that she saw Instagram posts from her friends stating that TBM was importing bikes from China tariff-free and linking those imports to TBM's incredible bike sales in Q4 of 2018. Her comments were marked on the official minutes of the Board meeting. The other Board members dismissed the comments. KACC continued shipping supplies to TBM and no other action was taken.
- In late December 2018, KACC credit managers became concerned with TBM's credit conditions and began issuing invoices payable by certified checks on a cash-only basis to TBM. Without any other choice, TBM felt pressured to abide by these terms to continue their relationship with KACC as KACC was a vital supplier of athletic sportswear for the South Carolina stores. TBM paid invoices dated January 1, 2019, February 1, 2019, and March 1, 2019 with certified checks on a cash-only basis.
- Beginning on April 1, 2019, TBM was unable to immediately pay via certified check to KACC for shipments of goods, so both parties agreed to resort back to the invoices payable pursuant to Net 30 Terms. On April 30, 2019, TBM made a $45,000 payment via check to KACC for an invoice dated April 1, 2019. That check was cashed by KACC on May 15, 2019. On May 1, 2019, KACC issued another invoice totaling $45,000. On May 30, 2019, TBM made a $45,000 payment via check to KACC for an invoice dated May 1, 2019. That check was cashed by KACC on June 15, 2019. On June 1, 2019, KACC issued another invoice totaling $45,000, which TBM failed to pay. On July 1, 2019, KACC issued another invoice totaling $45,000, which TBM failed to pay.
- As of the filing date, KACC had outstanding invoices in the amount of $90,000.00 dated May 1, 2019 and June 1, 2019. The last shipment of products was delivered to TBM stores in South Carolina on May 24, 2019. Another shipment is en route and set to be delivered to Delaware TBM stores in South Carolina on July 22, 2019.

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Creditor Questions

- How should KACC conduct relations with Delaware TBM post-Petition Date? Can KACC change credit terms with Delaware TBM post-Petition Date?
- Does KACC have any preference exposure? If so, how much? What defenses are applicable?
- Does KACC have any fraudulent transfer exposure? If so, how much? What defenses are applicable?
- Can KACC use the Security Deposit? If so, what steps need to be taken?

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Creditor Takeaways

- Preference defenses largely rely on maintaining detailed records of sales, deliveries, and payments. The more information a vendor is able to provide to counsel, the more likely that counsel will be able to devise strong legal theories. Vendor's counsel should urge their clients to keep detailed records of all transactions.
- Vendors, and especially financial institutions, who deal with entities engaged in suspicious activities open themselves up to fraudulent transfer liability. If a client is selling products to an entity engaged in suspicious activity, counsel should urge the client to conduct some sort of investigation into the suspicious activity in order to trigger the "good faith" defense under 11 U.S.C. § 548(c).
- Both the debtor and creditor should be aware of whether their sales relationship is governed by a contract or not. If the sales relationship is governed by a contract, the debtor has more power in the relationship as the terms of the contract must be honored until the contract is rejected or assumed. On the other hand, if there is no formal contract, then the creditor has more power in the relationship during the pendency of the bankruptcy case because the creditor is not compelled to keep supplying the debtor with products and may change credit terms at will.
- Creditors must be aware that they cannot act upon their setoff rights until they receive (1) relief from the automatic stay under 11 U.S.C. § 362; and (2) have a court order allowing them to do so. Failure to do so may be considered a violation of the automatic stay under 11 U.S.C. § 362.

Creditor – Things to Consider

- Straying away from normal business relations, such as different contract structure and terms, demanding payments, changing payment terms, threatening to cease shipments without being paid for prior invoices, or other out of the ordinary actions by the vendor may be perceived as "not ordinary" and may lead to more preference exposure.
- A vendor may be able to successfully utilize a "critical vendor defense" to a preference claim by claiming that a critical vendor order entered earlier in the bankruptcy case provides a defense to any party named as a critical vendor or those parties who have received critical vendor payments. This defense is predicated upon the belief that, had the pre-petition transfer not been made to the vendor, the vendor would nonetheless receive the payments from the debtor pursuant to the critical vendor order. Accordingly, the element under 11 U.S.C. § 547(b)(5) is not met in those circumstances.
- It is in the vendor's best interests to draft any order granting a setoff to the vendor in vague terms in order to allow the vendor to use the setoff against its oldest invoices (which will likely be general unsecured claims) and to allow the vendor to preserve its more valuable claims (such as claims under 11 U.S.C. § 503(b)(9)).

Materials for the American Bankruptcy Institute's Southeast Bankruptcy Workshop
Thursday, July 18, 2019 through Sunday, July 21, 2019

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I. General Fact Pattern

A. Delaware Toy Bargain Mart ("**Delaware TBM**"), a retail store of toys and children's clothing, based in the Midwest, Northern, and Western states, filed for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the District of Delaware on July 19, 2019 (the "**Petition Date**"), largely due to the same economic atmosphere that led to the demise of its main competitors, Toys "R" Us ("**TRU**") and Gymboree Group, Inc. ("**Gymboree**"). Increased competition from online retailers such as Amazon severely reduced sales over the past couple of years. An aggressive attempt to expand and occupy the retail vacuum left in the wake of the TRU and Gymboree bankruptcies and a U.S. Department of Justice ("**DOJ**") investigation are also credited as events leading to TBM's bankruptcy filing.

B. Delaware TBM was the surviving entity from a merger with an entity named Toy Bargain Mart ("**TBM**"). TBM was formed in March 2012 as an investment vehicle to acquire the assets of its predecessor Toy Bargain, LLC ("**TBL**") through a leveraged buyout (the "**LBO**") that closed on July 1, 2012. Through the LBO, TBL's sole shareholder, Toy Fund III, Ltd. ("**Toy Fund**") received $10 million in cash from TBM at closing.

C. TBM financed the LBO through two separate credit agreements: an ABL Facility in the amount of $7 million and a Term Loan Facility in the amount of $10 million. Bank of the South ("**BoS**") served as administrative and collateral agent for the lenders under both Credit Agreements until January 1, 2019. BoS timely filed UCC-1 financing statements on July 1, 2012, as well as the required renewal statements in 2017. On January 1, 2019, Southeast Bank, N.A. ("**SEB**") was substituted for BoS as the administrative and collateral agent under the Term Loan Facility, with BoS remaining as agent for the ABL lenders under the ABL Facility.

D. Beginning in 2014, TBM determined that it could generate larger revenues and minimize its borrowing needs by selling a significant portion of goods on a consignment basis. To implement this new strategy, TBM entered into pay by scan ("**PBS**") agreements with approximately 100 of its toy vendors, who agreed to sell their merchandise to TBM on a consignment basis. At its peak, the sale of consigned goods pursuant to these PBS agreements equaled approximately 15% of TBM's total sales.

E. Although most of these consignment vendors failed to file UCC financing statements reflecting their consignment interests, a few of them, including Smart Toy, LLC ("**Smart Toy**") filed UCC-1 statements and notified BoS of its consignment interest. Smart Toy was one of TBM's first consignment vendors, and it began selling consigned goods to TBM on May 3, 2014. Smart Toy, however, forgot to file a UCC renewal statement before May 3, 2019. Another vendor, Late Toy, Inc ("**Late Toy**") only filed its UCC-1 statement on June 15, 2019, approximately 1 month before the petition date.

F. During the first year of the TRU bankruptcy in 2018, TBM purchased several leases from old TRU stores in South Carolina, among other states in the South, in an

effort to expand by purchasing cheap, sub-market leases. Believing that TBM could aggressively expand in areas occupied by their former competitors, TBM purchased leases across the South in states it had never conducted business in before. The first TBM stores in the South opened in South Carolina on August 1, 2018.

G. To finance the acquisition of these leases, TBM amended and restated its Term Loan Facility on May 30, 2018 to increase the maximum availability to $15 million. Once again, BoS timely filed the necessary UCC statements to reflect its security interest under the amended and restated Term Loan Facility.

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J. In marketing materials throughout December 2018, TBM boasted of their sales on bicycles which were up 200% from the prior year. TBM declined to highlight that sales in nearly every other category continued to drop precipitously.

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being a new customer. One Board member mentioned that she saw Instagram posts from her friends stating that TBM was importing bikes from China tariff-free and linking those imports to TBM's incredible bike sales in Q4 of 2018. Her comments were marked on the official minutes of the Board meeting. The other Board members dismissed the comments. KACC continued shipping supplies to TBM and no other action was taken.

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M. On February 15, 2019, the DOJ filed a *qui tam* lawsuit (the "**Qui Tam Action**") after a TBM employee reported that the PRBC bikes were imported in violation of U.S. tariff laws and regulations. TBM's stock price plummeted overnight. To make matters worse, the expansion in the South was not proving to be profitable and online competition continued to eat away at TBM's already historically-low revenue.

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O. On July 2, 2019, in a blatant effort to obtain venue in Delaware in the event of a possible bankruptcy filing, TBM underwent a merger with a newly-formed corporate entity, Delaware TBM. Delaware TBM acquired all assets and liabilities of TBM. Delaware TBM was the surviving entity of the merger. TBM was dissolved.

P. Faced with continued declining sales and an unexpected adverse ruling from a U.S. District Court on a Motion to Dismiss filed in the Qui Tam Action, Delaware TBM filed for Chapter 11 bankruptcy on July 19, 2019 in the U.S. Bankruptcy Court for the District of Delaware.

Q. As of the filing date, KACC had outstanding invoices in the amount of $90,000.00 dated May 1, 2019 and June 1, 2019. The last shipment of products was delivered to TBM stores in South Carolina on May 24, 2019. Another shipment is en route and set to be delivered to Delaware TBM stores in South Carolina on July 22, 2019.

II. Consignments

A. Questions

1. Does Smart Toy have priority over BoS and/or SEB with respect to its consignment goods?

2. Did Smart Toy's failure to file a renewal statement in 2019 affect its priority with respect to BoS and/or SEB?

3. Does Late Toy have priority over BoS and/or SEB as a result of its UCC-1 filing in June 2019? If so, when did that priority arise? Is the filing of the UCC-1 avoidable as a preference?

B. Consignments Generally

1. Section 9-102 of the UCC defines "consignment" as a "transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and: (A) the merchant: (i) deals in goods of that kind under a name other than the name of the person making delivery; (ii) is not an auctioneer; and (iii) is not generally known by its creditors to be substantially engaged in selling the goods of others . . . UCC § 9-102(a)(20)(A)." If, and only if, this definition is satisfied do the other provisions of Article 9 apply. *In re Valley Media, Inc.*, 279 B.R. 105, 124 n.33 (Bankr. D. Del. 2002) ("[I]f the consignee is not a merchant, then the relationship is not a consignment and [section 9-319] does not apply.").

2. Section 9-102(20) is the successor to old UCC section 2-326(3). U.C.C. § 2-326. cmt 4. Despite differences in wording, no substantive change was intended by the drafters of revised section 9-102(20). See U.C.C. § 9-319, cmt. 2 ("Insofar as creditors of the consignee are concerned, this Article to a considerable extent reformulates the former law, which appeared in former Sections 2-326 and 9-114, without changing the results."). UCC section 2-326(3) provided three exceptions to its application: (1) where the consignor complied with an applicable sign law; (2) where the debtor is "generally known by his creditors to be substantially engaged in selling the good of others"; or (3) when the consignor complies with the filing provisions of UCC Article 9. U.C.C. § 2-326(3)(a)-(c) (2002). Thus, section 9-102(20) does not apply—meaning the transaction is not a consignment for purposes of the UCC—if any of these exceptions apply. *Valley Media*, 279 B.R. at 124 n.33 (discussing the technical differences in how a transaction would not constitute a consignment under old UCC section 2-326 and new UCC section 9-102(a)(20)).

3. If none of the foregoing exceptions apply, the priority of a consignment vendor's interest in its consigned goods will be governed by the UCC. UCC section 9-103(d) provides that a consignment vendor's security interest in its consigned goods is treated as "a purchase-money security interest in inventory." U.C.C. § 9-103(d). Accordingly, the priority of a consignment vendor's interest in its consigned goods vis-à-vis other creditors of the debtor is governed by UCC section 9-324(b). Pursuant to UCC section 9-324(b), a purchase money security interest ("PMSI") in inventory will have priority over a conflicting security interest if 4 requirements are met.

a) The PMSI is perfected when the debtor receives possession of the inventory;

b) the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;

c) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and

d) the notification states that the person sending the notification has or expects to acquire a PMSI in inventory of the debtor and describes the inventory.

4. Likewise, for purposes of determining a competing creditor's rights in the consigned goods, the debtor is "deemed to have rights and title to the goods identical to those the consignor had or had the power to transfer." *Id.* § 9-319(a). Once again, the rights provided to other creditors of a debtor under this section of the UCC are similar to the rights provided under the earlier version of the UCC, including sections 2-326 and 9-114. *Id.* §9-319(a), at cmt. 2.

C. The General Knowledge Exception

1. "General Knowledge," is used as a term of art when referring to consignment relationships. Judge Walsh explained in *In re Valley Media, Inc.*, that a consignor can avoid the application of the UCC if it can demonstrate "(1) that the consignee is substantially engaged in selling the goods of others, and (2) that it is generally known by creditors of the consignee that this is the case." 279 B.R. 105, 124 (Bankr. D. Del. 2002). Courts have identified 20% as the minimum value inventory that must be held on a consignment basis before a merchant may be considered to be "substantially engaged" in the selling of goods of others. See Memorandum Opinion, *TSA Stores, Inc. v. Performance Apparel Corp.*, Adv. No. 16-50317 (Bankr. D. Del. Mar. 7, 2017), D.I. 37, at 12 ("That threshold [for establishing that a consignee is substantially engaged in selling the goods of others] is met if consigned goods make up 20% or more of the value of the consignee's inventory."); *In re Valley Media, Inc.*, 279 B.R. at 125; *Multibank Nat'l of W. Mass., N.A. v. State St. Auto Sales, Inc*. (In re State St. Auto Sales, Inc.), 81 B.R. 215, 216, 218 (Bankr. D. Mass. 1988).

a) While not expressly listed in the statute, most courts that have interpreted section 9-102(20) and its predecessor have found that a creditor's actual knowledge of another creditor's consignment interest satisfies the "general knowledge" exception. *See Fariba v. Dealer Servs. Corp.*, 100 Cal. Rptr. 3d 219, 229 (Cal. Ct. App. 2009) ("[C]onstruing the knowledge exception to include constructive knowledge, but not actual knowledge, would lead to absurd results and we shall not interpret our Commercial Code in such a manner."); *id.* (reasoning that such an exception "gives full effect to the purpose of the statute as explained in the official comments. It does not burden creditors with 'secret liens' while providing limited protection to

consignors who never intended to lose title to their property. It also avoids the result of giving greater weight to imputed knowledge than actual knowledge"); *Eurpac Serv. v. Repub. Acceptance Corp.,* 37 P.3d 447, 450-51 (Colo. Ct. App. 2000) (finding actual knowledge operates as an exception to the UCC); *Belmont Int'l, Inc., v. Am. Int'l Shoe Co.,* 831 P.2d 15, 19 (Ore. 1992) ("The assumption is that, 'where a secured creditor has knowledge of consignments, he will certainly not advance funds to the consignee based on the consignee's possession of the consigned property.'") (citation omitted); *In re High-Line Aviation, Inc.*, 149 B.R. 730, 737 (Bankr. N.D. Ga. 1992) ("[I]f a creditor knows that goods in a debtor's place of business are on consignment, the creditor is not misled by the presence of the consigned goods and its lien should not extend to them."); *In re Key Brook Serv., Inc.*, 103 B.R. 39, 43 (Bankr. D. Conn. 1989) (finding that the exceptions are designed to protect creditors who have been misled by secret liens, not secured creditors with knowledge of the consignment relationship); *First National Bank v. Olsen*, 403 N.W.2d 661, 665 (Minn. Ct. App. 1987) ("[T]he case law interpreting § 2-326 creates a broader interpretation of the exceptions and establishes an exemption if the secure creditor had actual knowledge of the consignment."); *GBS Meat Indus. Pty. Ltd. v. Kress-Dobkin Co.*, 474 F. Supp. 1357, 1363 (W.D. Pa. 1979*), aff'd without opinion* at 622 F.2d 578 (3d Cir. 1980) ("[W]here a secured creditor knows that the proceeds rightfully belong to a consignor, the consignor must have priority. Any other construction of 2-326 would contravene the intent of that section and would sanction intentional conversions of goods or proceeds.").

2. Only two published decisions have outright rejected the actual knowledge exception. *See Russell v. Mountain Nat'l Bank (In re Russell)*, 254 B.R. 138, 141 (Bankr. W.D. Va. 2000) (reasoning that a bank's knowledge of a consignment does not preclude it from asserting rights under the UCC when the bank did not engage "in any affirmative conduct to promote those arrangements or lull the consignors to fail to protect themselves"); *In re State St. Auto Sales*, 81 B.R. 215 (Bankr. D. Mass. 1988) (determining that a secured creditor was not equitably estopped from asserting its interest in consigned goods even though it had actual knowledge of the debtor's consignment arrangements).

D. The Sports Authority Opinions

1. In a series of opinions in three separate adversary proceedings involving disputes over the priority of the proceeds of consignments goods in the Sports Authority Bankruptcy, Judge Walrath established a comprehensive guide to analyzing consignment priority issues.

2. *WSFS v. Performance Apparel Corp*, Adv. No. 16-50317 (MFW) – 11/26/18, Docket No. 118.

a) After setting forth the general UCC rules regarding consignment, Judge Walrath agreed with the majority view in finding that a lender's actual knowledge of a consignment relationship takes the relationship outside the operation of the UCC. She found the few cases to the contrary non-persuasive. She further found that it would be absurd to bind a secured lender to the constructive knowledge acquired through a UCC-1 filing but to not bind it by actual knowledge of the consignment itself. Regardless of whether the term loan agent's knowledge could be imputed to the term loan lenders or not, the term loan lenders were parties to the term loan agreement, and "parties to a contract are conclusively presumed to know its contents and are bound by its terms." Slip Op at 17 (citing *Level Export Corp. v. Wolz, Aiken & Co.*, 111 N.E.2d 218, 221 (N.Y. 1953)). Because the defendant's consignment interest was noted on a schedule to the term loan agreement at the time it was executed, the term loan lenders had actual knowledge of the consignment relationship and cannot take priority in the consigned goods. Thus, defendant's interests in the consigned goods is superior to the blanket security interests of the term loan lenders.

3. *WSFS v. M.J. Soffe, LLC*, Adv. No. 16-50364 (MFW) – 11/26/18, Docket No. 179.

a) Judge Walrath found that Soffe had failed to establish that the term loan lenders or WSFS had actual knowledge of Soffe's consignment relationship. While a representative of the prior term loan agent knew that Soffe was selling goods on consignment, he did not know that some of those goods were being sold to the Debtors. Moreover, even if he did know, he was duty bound to keep the information he received confidential and he was not authorized to share it with the separate division of BOA that was administering the Debtors' term loan. Finally, Judge Walrath determined that even if the prior term loan agent had actual knowledge of Soffe's consignment relationship that was not confidential, that information could not be imputed to the term loan lenders because of the limitations on the agency relationship set forth in the Term Loan Agreement.

b) Despite the foregoing, Judge Walrath determined that based on the parties' concessions, WSFS only had priority in the consigned goods delivered before January 4, 2016 when Soffe filed its UCC-1 perfecting its security interest. She also found that the filing of the UCC-1 could not be avoided based on Soffe's concession that it was only intended to grant a PMSI to goods delivered after that date, and thus was not a transfer on account of an antecedent debt.

4. *WSFS v. Sport Dimension Inc.*, Adv. No. 16-50368 (MFW) – 4/12/19

a) Reaching a different conclusion than she did in *Soffe*, Judge Walrath found that knowledge of competing interests in collateral clearly falls within the scope of the agent's duties and thus if WSFS had actual knowledge of Sport

Dimension's consignment interest, that knowledge would be imputed to the term loan lenders.

b) Nevertheless, Judge Walrath ultimately concluded that WSFS did not have such knowledge. She rejected Sport Dimension's argument that the 20% test was "a general rule of thumb" and instead found it to be a bright line rule for purposes of determining general knowledge. Moreover, even if the Debtors' admissions could establish "substantial engagement," that did not establish WSFS's knowledge of this fact at the time the loan was extended. She likewise rejected Sport Dimension's argument that actual knowledge of some consignment relationship was sufficient, finding that it must show that WSFS or the term loan lenders had actual knowledge of Sport Dimension's specific consignment relationship.

c) With respect to the UCC-1 statement Sport Dimension filed in January, Judge Walrath found that because they did not send notice of the consignment relationship to WSFS (instead it sent it to its predecessor BOA), it did not satisfy the PMSI requirements of 9-324(b) and Sport Dimension was required to disgorge any proceeds it recevied after the filing of the UCC-1 statement as well.

5. Key Takeaways from the Sports Authority Trilogy

a) Delaware joined most other courts that have considered the issue in holding that a lender's actual knowledge of a consignment relationship will provide the consignment vendor with a superior claim to the consigned goods and the proceeds thereof whether a UCC-1 statement was filed or not.

b) To demonstrate actual knowledge, the consignment vendor must show that the other creditor actually knew that the consignee sold the goods of the specific consignment vendor in dispute.

c) Actual knowledge falls within the "general knowledge" exception provided by section 9-102(a)(20)(A)(iii) of the UCC, which is also satisfied if the competing creditor knew that the debtor was selling 20% or more of its inventory on consignment.

d) An agent's knowledge of a competing consignment interest will be imputed to the participating lenders.

e) Providing notice to a predecessor agent is not sufficient to satisfy the PMSI requirements under section 9-324(b) of the UCC.

f) If a consignment interest is identified on the schedules to a loan agreement, the lenders under that agreement will be charged with actual knowledge of the consignment relationship regardless of whether the consignment vendor subsequently files a UCC renewal statement.

g) Actual knowledge is a highly factual issue that varies from case to case.

III. Discovery Obligations of Successor Agent

A. Question

1. If SEB pursues litigation against Smart Toy, or any other consignment vendor, seeking to establish its priority in the consigned goods, is SEB responsible for collecting and producing documents in the possession of its predecessor agent, BoS?

B. It is black letter law that a party who acquires its position through assignment and pursues claims as a Plaintiff based on its acquired position is responsible for producing responsive documents that are in the possession and control of its predecessor. *See* 7 Moore's Federal Practice, § 34.14[2][c], at 34-86 (Matthew Bender 3d ed. 2016) ("The assignee of a claim in litigation has a duty to obtain and produce the same documents and information to which the opposing parties would have been entitled had the assignors brought the claim themselves.").

C. Many courts, especially in the Southern District of New York, have applied this rationale in recent years. *See Royal Park Invs. Sa/NV v. Deutsche Bank Nat'l Trust Co.*, 314 F.R.D. 341 (S.D.N.Y. 2016) (ordering plaintiff assignee to "produce otherwise-discoverable documents and things (including electronically stored information) held by BNP Paribas to the same extent it is required to produce documents from its own files"); *In re Skelaxin (Metaxalone) Antitrust Litig.*, 2014 WL 129814, at *2 (E.D. Tenn. Jan. 10, 2014) ("[I]t would be wholly unfair for Plaintiffs to step into the shoes of the assignors for the purposes of bringing their claims and not also assume a claimant's attendant discovery obligations."); *Travelers Indem. Co. of Am. v. Kendrick Bros. Roofing, Inc.*, 2013 WL 6681240, at *2 (D. Idaho Dec. 18, 2013) ("As the assignee of Okland's claims, Travelers therefore steps into Okland's shoes—where it takes on both the potential benefits and obligations of an allegedly wronged party bringing a lawsuit."); *J.P. Morgan Chase Bank, N.A. v. KB Home*, 2010 WL 1994787, at *6 (D. Nev. May 18, 2010) ("It would be unfair to allow JPMorgan and the current debt holders to stand in the shoes of the original lenders in order to pursue this action without requiring them to produce discovery that the original lenders would be required to produce if they had brought the action themselves."); *J.P Morgan Chase v. Winnick*, 228 F.R.D. 505, 506 (S.D.N.Y. 2005) ("It is both logically inconsistent and unfair to allow the right to sue to be transferred to assignees of a debt free of the obligations that go with litigating a claim."); *Bank of New York v. Meridien BIAO Bank Tanzania Ltd.*, 171 F.R.D. 135, 149 (S.D.N.Y. 1997) (finding that it would be "patently unfair" to permit a counterclaim plaintiff assignee to continue discovery from counterclaim defendant while forcing counterclaim defendant to seek discovery from counterclaim plaintiff's assignor as a third party). *See also Firemen's Mutual Ins. Co. v. Erie-Lackawanna RR. Co.*, 35 F.R.D. 297, (N.D. Ohio 1964) (requiring an assignee plaintiff to obtain information from its assignor for purposes of responding to interrogatories).

D. This rationale also extends to administrative agents who are pursuing claims on behalf of claims assigned by predecessor agents.

1. The seminal case on this issue is *Winnick*. In *Winnick*, JPMorgan, in its capacity as administrative agent under a credit agreement brought suit against officers, directors and employees of its borrower in connection with loans under a credit agreement. *Winnick*, 228 F.R.D. at 506. The defendants served discovery on JPMorgan, seeking documents and witnesses in the lender banks' possession, custody or control. *Id.* JPMorgan asserted, among other things: (a) that the documents sought were not in its custody, possession or control; (b) that it did not have the right to demand such documents under its agency agreement; (c) that the lender banks were not parties to the case; and (d) that defendants were in a better position than JPMorgan to enforce disputed discovery from any unwilling bank. *Id.* The court found that "[v]iewed from any angle, [JPMorgan]'s position cannot be correct." *Id.*

2. Efforts to distinguish *Winnick* or limit it to its facts have failed. *See generally Royal Park*, 314 F.R.D.; *see also Skelaxin*, 2014 WL 129814, at *1 (finding that *Winnick* was not limited to parties not subject to service of process); *KB Home*, 2010 WL 1994787, at *5-*6 (finding that *Winnick* expressly considered the burden on the assignee to obtain the requested discovery).

3. The most recent ruling to apply *Winnick* occurred in an adversary proceeding filed by Wilmington Savings Fund Society ("WSFS") against M.J. Soffe, LLC in an adversary proceeding in the Sports Authority chapter 11 cases. WSFS was the successor term loan agent, replacing Bank of America, N.A, in that capacity. WSFS asserted four arguments in its effort to distinguish *Winnick* and its progeny.

a) First, WSFS insisted that BOA, despite not being a party to the adversary proceeding, had submitted itself to the jurisdiction of the court, making third-party discovery much easier than in *Winnick* and the other cited cases.

b) Second, WSFS argued that BOA was not its assignor; rather, BOA's resignation resulted in WSFS's appointment as successor agent.

c) Third, WSFS argued that even if BOA was its assignor, the claims at issue only arose after WSFS's appointment as successor agent.

d) Finally, WSFS asserted that *Winnick* only applies to the relationship between an agent and its lenders, not the relationship between a predecessor agent and its successor.

4. Judge Walrath rejected each of these arguments following oral argument on June 23, 2017.

a) Regardless of how WSFS obtained the role of successor agent, it was BOA's assignee for purposes of the court's analysis. More importantly, Judge Walrath found that the claims at issue arose well before the assignment occurred.

Ultimately, while Judge Walrath avoided the question of whether WSFS must collect documents from BOA in its capacity as a term loan lender, she found that WSFS must produce documents from BOA in its role as administrative agent under the Debtors' term loan facility. Moreover, consistent with *KB Home*, Judge Walrath found that any practical difficulties arising from the collection of those documents should be borne by WSFS, who could have dealt with those issues at the time of the assignment. *See KB Home*, 2010 WL 1994787, at *5. The fact that BOA had arguably submitted to jurisdiction and that the defendant could have served BOA with a subpoena seeking the same documents was irrelevant.

E. Key Takeaways

1. These decisions should serve as a reminder to successor administrative agents, and their counsel, to ensure that they negotiate rights to access any documents, including ESI, related to any potential claims that may be pursued by the successor agent.

2. While these cases have thus far been limited to situations involving claims asserted by an assignee as Plaintiff, the notions of fundamental fairness relied upon in these cases could also be expanded to apply to any situation involving the possibility of separating a litigation right, including any affirmative defenses, from related litigation obligations.

IV. Prepetition Pitfalls for a Trade Creditor/Vendor

A. Questions

1. How should KACC conduct relations with Delaware TBM post-Petition Date? Can KACC change credit terms with Delaware post-Petition Date?

2. Does KACC have any preference exposure? If so, how much? What defenses are applicable?

3. Does the merger between TBM and Delaware TBM affect KACC's preference exposure? Can Delaware TBM avoid as preferences any transfers made by TBM to KACC?

4. Does KACC have any fraudulent transfer exposure? If so, how much? What defenses are applicable?

5. Can KACC use the Security Deposit? If so, what steps need to be taken?

B. Preference Exposure

1. Payments made by the Debtor to a creditor on or within the 90 days before the date of a bankruptcy filing may be subject to clawback under a preference theory pursuant to 11 U.S.C. § 547.

2. Vendors should strive to continue operations with the Debtor according to the ordinary course of business between the two parties, or according to normal business

practices in the relevant industry. The Bankruptcy Code provides vendors with an "ordinary course of business defense" under 11 U.S.C. § 547(c)(2). Recently amended in 2005, the ordinary course of business defense applies if the debtor incurred the debt in the ordinary course of business and financial affairs, and the transfers was either made in the ordinary course of business between the debtor and vendor (the subjective prong) or the transfers were made according to ordinary business terms (the objective prong).

a) Congress intended that this absolute defense was codified to "leave undisturbed normal financial relations." H.R. Rep. No. 95-595, at 373, U.S.C.C.A.N. 1978, p. 6329. So, as long as the vendor and debtor were abiding to normal relations during the preference period, 11 U.S.C. § 547(c)(2) provides an absolute defense.

b) Straying away from normal business relations, such as different contract structure and terms, demanding payments, changing payment terms, threatening to cease shipments without being paid for prior invoices, or other out of the ordinary actions by the vendor may be perceived as "not ordinary" and may lead to more preference exposure.

3. A vendor who continues to provide new value to the debtor may have a "new value" or "subsequent advance" defense under 11 U.S.C. § 547(c)(4). *See In re Jet Fla. Sys.*, 841 F.2d 1082, 1083 (11th Cir. 1988) ("This section [11 U.S.C. § 547(c)(4)] has generally been read to require: (1) that the creditor must have extended the new value after receiving the challenged payments, (2) that the new value must have been unsecured, and (3) that the new value must remain unpaid."); *In re Prescott*, 805 F.2d 719, 731 (7th Cir. 1986) ("The creditor that raises a 'subsequent advance' defense has the burden of establishing that new value was extended, which remains unsecured and unpaid after the preferential transfer.").

a) Courts differ on whether the new value defense applies to value provided to the debtor that was paid by the debtor postpetition. *See Friedman's Liquidating Trust v. Roth Staffing Cos. LP* (*In re Friedman's Inc.*), 738 F.3d 547 (3d Cir. 2013) (post-petition payments by a debtor did not affect a creditor's new value defense under § 547(c)(4)); *but see Siegel v. Sony Elecs., Inc.* (*In re Circuit City Stores, Inc.*), 515 B.R. 302 (Bankr. E.D. Va. 2014) (satisfaction of the creditor's administrative claim for the cost of goods sold to the bankruptcy debtor was an unavoidable transfer, so the creditor was precluded from also asserting the claim as new value as a defense to preferential transfers); *Circuit City Stores, Inc. v. Mitsubishi Digital Electronics America, Inc.* (*In re Circuit City Stores, Inc.*), No. 10-03068-KRH, 2010 Bankr. LEXIS 4398, 2010 WL 4956022 (Bankr. E.D. Va., Dec. 1, 2010) (finding same).

4. Requiring payment on a cash-only basis can help a vendor avoid preference exposure as such a transaction will be considered a contemporaneous exchange for new value protected under 11 U.S.C. § 547(c)(1).

a) Accepting checks or other payment methods, on the other hand, may not constitute a "contemporaneous exchange." Whether the delay between date of delivery of goods and the date payment is received is considered a "contemporaneous exchange" largely depends on the reviewing court. *See Pine Top Ins. Co. v. Bank of America Nat. Trust & Sav. Ass'n*, 969 F.2d 321, 328 (7th Cir. 1992) (delay of two to three weeks was a contemporaneous exchange); *In re Payless Cashways, Inc.*, 306 B.R. 243, 252 (8th Cir. B.A.P. 2004) (payment for goods by EFT within 15 days of delivery was a contemporaneous exchange); *but see In re Interstate Bakeries Corp.*, No. 04-45814, 2012 Bankr. LEXIS 5823, 2012 WL 6614969, at *5 (Bankr. W.D. Mo. Dec. 19, 2012) (average delay of 31 days not a contemporaneous exchange); *In re Messamore*, 250 B.R. 913 (Bankr. S.D. Ill. 2000) (delay of 50 days was not a contemporaneous exchange); *In re Freestate Management Services, Inc.*, 153 B.R. 972, 984 (Bankr. D. Md. 1993) (delay of 24 days was not a contemporaneous exchange); *Gold v. Myers Controlled Power, LLC* (*In re Truland Grp., Inc.*), 2018 Bankr. LEXIS 42 (Bankr. E.D. Va. Jan. 8, 2018) (delay of 23 and 44 days was not a contemporaneous exchange).

5. A deposit or prepayment is **not considered a preference** because such a payment is not a payment on an antecedent debt. Accordingly, the "antecedent debt" element of 11 U.S.C. § 547(b)(2) is not met and a preference for a deposit or prepayment is not actionable.

6. Detailed records are crucial for vendors to prove preference defenses. Vendors should keep track of when funds are received, when the funds are cleared by the bank, when goods are delivered, by whom it is delivered, and when delivery is accepted. If that information is not saved, the vendor may "lose" some of its preference defenses by virtue of its failure to identify when a transfer was received or when goods were delivered.

7. A vendor may be able to successfully utilize a "critical vendor defense" by claiming that a critical vendor order entered earlier in the bankruptcy case provides a defense to any party named as a critical vendor or those parties who have received critical vendor payments. This defense is predicated upon the belief that, had the pre-petition transfer not been made to the vendor, the vendor would nonetheless receive the payments from the debtor pursuant to the critical vendor order. Accordingly, the element under 11 U.S.C. § 547(b)(5) is not met in those circumstances.

a) Case law suggests that this defense is only applicable when the critical vendor order mandates payment to a specific named creditor. *See, e.g.*, *Official Comm. of Unsecured Creditors v. Medical Mutual of Ohio* (*In re Primary Health Systems, Inc.*), 275 B.R. 709, 712 (Bankr. D. Del 2002), *aff'd*, C.A. No. 02-301 (D. Del. Feb. 27, 2003) (applying a critical vendor defense to a preference claim); *but see Zenith Indus. Corp. v. Longwood Elastomers, Inc.* (*In re Zenith Indus. Corp.*) 319 B.R. 810 (Bankr. D. Del. 2005) (rejecting a critical vendor defense to

a preference claim); *HLI Creditor Trust Corp. v. Export Corp.* (*In re Hayes Lemmerz Int'l, Inc.*), 313 B.R. 189 (Bankr. D. Del. 2004) (rejecting a critical vendor defense to a preference claim).

8. The Supreme Court has made clear that a "transfer" of a check for preference purposes occurs on the date that the drawee's bank honors the check. However, many courts have held that, for preference defenses under 11 U.S.C. § 547(c), the date of delivery of the check is the "date of transfer." *See, e.g.*, *Barnhill v. Johnson*, 503 U.S. 393 (1992) (holding that a transfer made by check should be deemed to occur on the date the drawee bank honors it); *Nat'l Enters. v. Tee-Lok Corp.* (*In re Nat'l Enters.*), 174 B.R. 429, 432 (Bankr E.D. Va. 1994) ("The law in the Fourth Circuit and the Eastern District of Virginia seems clear that for the purposes of the § 547(c) exceptions to avoidance, the date of delivery of a check is the date of transfer.").

C. Fraudulent Transfer Exposure

1. Trade creditors and vendors are at risk of fraudulent transfer litigation for certain transactions occurring within the two years prior to the bankruptcy filing. Fraudulent transfers under the Bankruptcy Code fall into three groups (1) "actual" fraudulent transfers under 11 U.S.C. § 548(a)(1)(A); (2) "constructive" fraudulent transfers under 11 U.S.C. § 548(a)(1)(B); and (3) state law fraudulent transfers made applicable through 11 U.S.C. § 544.

2. Under 11 U.S.C. § 548(a)(1)(A), a debtor may avoid a transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily made such transfer or incurred such obligation with the actual intent to hinder, delay, or defraud any creditor. Such claims usually arise when the debtor was engaging in illegal activity prior to the bankruptcy filing and the vendor had reason to be aware, or was actually aware, of such illicit activity.

3. Vendors should be weary of debtors who engage in suspicious activities as claims under 11 U.S.C. § 548(a)(1)(A) are valid even if the vendor provided value to the debtor. If the vendor has reason to believe that the debtor was engaging in suspicious and/or illegal activity prior to a bankruptcy filing, counsel should be alerted to determine whether the vendor should cease activity with the debtor. "Value" provided by the vendor to the debtor is irrelevant, so long as the elements of the claim under 11 U.S.C. § 548(a)(1)(A) are met. The proper focus is on the intent of the debtor. *See Bank of Am., N.A. v. Veluchamy (In re Veluchamy)*, 2014 Bankr. LEXIS 5091 at *17 (Bankr. N.D. Ill. Dec. 17, 2014) ("§ 548(c) provides that only a good faith transferee can receive credit for any value given to the transferor. So knowing participants in a fraudulent transfer—those not acting in good faith—are penalized for their involvement in the scheme by denying them a reduction in liability on account of any payment they make for the transferred property. For example, if A transfers a car to B, and B pays A $1,000 for the car, knowing that the transfer is intended to defraud creditors, B is liable for the value of the car, with no reduction for the $1,000

payment, even though this allows the estate to recover more than the value of the transferred car."); *Tavenner v. Smoot*, 257 F.3d 401, 407 (4th Cir. 2001) ("Nothing in § 548 indicates that a trustee must establish that a fraudulent conveyance actually harmed a creditor. Nor does § 548 exclude from its scope transfers of exempt property. *See* 11 U.S.C. § 548(a)(1)(A). Rather, § 548 states that "the trustee may avoid any transfer of an interest of the debtor in property" if the transfer or obligation is entered into with the requisite intent. 11 U.S.C. § 548(a)(1)(A). Section 548 properly focuses on the intent of the debtor, for if a debtor enters into a transaction with the express purpose of defrauding his creditors, his behavior should not be excused simply because, despite the debtor's best efforts, the transaction failed to harm any creditor."); *Davis v. Davis* (*In re Davis*), 911 F.2d 560, 562 (11th Cir. 1990) ("To hold now that there occurred no transfer of property with the intent to hinder creditors merely because the debts on the residence exceeded its . . . value would be to reward appellant for his wrongdoing, which this court refuses to do.") (quoting *Future Time, Inc. v. Yates*, 26 B.R. 1006, 1009 (M.D. Ga. 1983)).

4. Under 11 U.S.C. § 548(a)(1)(B), a court may set aside a sale of an insolvent debtor's property as fraudulent if it was made for "less than reasonably equivalent value." The term "reasonably equivalent value" is a highly fact-intensive inquiry. *See BFP v. Resolution Trust Corp.*, 511 U.S. 531, 548 (1994) ("As we have emphasized, the inquiry under § 548(a)(2)(A) – whether the debtor has received value that is substantially comparable to the worth of the transferred property – is the same for all transfers.").

5. When faced with a fraudulent transfer claim, 11 U.S.C. § 548(c) provides an absolute defense if the vendor took for value in good faith **and** exchanged value to the Debtor. Several courts have adopted somewhat different standards to govern the "good faith defense" under 11 U.S.C. § 548(c). *See Gold v. First Tenn. Bank Nat'l Ass'n* (*In re Taneja*), 743 F.3d 423, 430 (4th Cir. 2014) ("[I]n evaluating whether a transferee has established an affirmative defense under Section 548(c), a court is required to consider whether the transferee actually was aware **or** should have been aware, at the time of the transfers and in accordance with routine business practices, that the transferor-debtor intended to "hinder, delay, or defraud any entity to which the debtor was or became . . . indebted.") (emphasis added to demonstrate that the Fourth Circuit has adopted both a subjective and objective standard); *Perkins v. Lehman Bros.* (*In re Int'l Mgmt. Assocs., LLC*), 563 B.R. 393, 430 (Bankr. N.D. Ga. 2017) ("The Court concludes that a transferee acts in good faith for purposes of the affirmative defense of § 548(c) applies when transfers are to an unaffiliated third-party in arm's length transactions under ordinary business terms and the debtor received contemporaneous and exactly value for the transfers in the absence of actual knowledge of the debtor's insolvency or the existence of a Ponzi scheme."); *Meoli v. The Huntington National Bank* (*In re Teleservices Group, Inc.*), 444 B.R. 767 (Bankr. W. D. Mich. 2011), *aff'd* 848 F.3d 716 (6th Cir. 2017) (providing a subjective standard under 11 U.S.C. § 547 whereby "it is the recipient's own honesty and

integrity – i.e., his good or bad faith – that will determine how he will fare with the estate.").

6. State law fraudulent transfer statutes largely mirror the elements of the Bankruptcy Code fraudulent transfer provisions with slight variations depending on the state. By and large, 11 U.S.C. § 548 sets a lower bar than most fraudulent transfer claims under state law, but the lookback period under state law is usually longer.

7. Assets outside of the United States may be more difficult to clawback under 11 U.S.C. § 548 due to the "presumption against extraterritoriality," which has been unevenly applied by U.S. courts. The presumption against extraterritoriality is a judicially-created test that infers a U.S. statute is not applicable extraterritorially absent clear indication from Congress. *See, e.g.*, *RJR Nabisco, Inc. v. European Community*, 136 S. Ct. 2090, 2100 (2016); *Kiobel v. Royal Dutch Petroleum Co.*, 133 S. Ct. 1659, 1664 (2013); *Morrison v. Nat'l Australian Bank Ltd.*, 561 U.S. 247, 255 (2010).

a) When dealing with 11 U.S.C. §§ 548, 550, courts have come to opposite conclusions regarding whether the those provisions apply extraterritorially. *See In re Midland Euro Exchange Inc.*, 347 B.R. 708, 720 (Bankr. C.D. Cal. 2006) ("Absent such indicia of congressional intent, the presumption against extraterritoriality bars application of [11 U.S.C. § 548] to a foreign transfer."); *but see In re Picard*, 917 F.3d 85, 99–100 (2d Cir. 2019) ("We hold that a domestic debtor's allegedly fraudulent, hindersome, or delay-causing transfer of property from the United States is domestic activity for the purposes of §§ 548(a)(1)(A) and 550(a). The presumption against extraterritoriality therefore does not prohibit that debtor's trustee from recovering such property using § 550(a), regardless of where any initial or subsequent transferee is located."); *French v. Liebmann* (*In re French*), 440 F.3d 145, 151–52 (4th Cir. 2006) (accepting the argument that § 548 applies extraterritorially); *Weisfelner v. Blavatnik* (*In re Lyondell Chem. Co.*), 543 B.R. 127, 155 (Bankr. S.D.N.Y. 2016) ("[S]ection 548 can be employed extraterritorially to claw back the December Distribution.").

D. Executory Contracts

1. If no formal contract exists as of the date of the bankruptcy filing between the vendor and debtor, there is no contractual obligation for the vendor to continue business with the debtor postpetition. Vendors should, however, seek advice of bankruptcy counsel to determine how to proceed postpetition without running afoul of the automatic stay in 11 U.S.C. § 362. If no contract is present, a vendor is free to alter the credit terms postpetition, require a postpetition deposit or prepayment, and may seek treatment as a critical vendor subject to any such order entered in the bankruptcy case if applicable. Such actions are not violations of the automatic stay so long as the vendor is not trying to collect on a prepetition debt.

2. Vendors who have existing contracts with a debtor as of the date of the bankruptcy filing must abide by the terms of such contract until the debtor rejects or accepts the contract. If the Debtor fails to abide by the terms of the contract postpetition, the creditor may seek relief under 11 U.S.C. § 365(d)(2) to request that the Debtor reject such contract for failing to cure a default under the contract.

3. A prepetition contract with the debtor may be considered an executory contract under 11 U.S.C. § 365. While the Bankruptcy Code does not define the term "executory contract," many jurisdictions follow the "Countryman Test" named after former law professor, Vern Countryman. *See BNY, Capital Funding LLC v. U.S. Airways, Inc.*, 345 B.R. 549, 553 (Bankr. E.D. Va. 2006) ("The Countryman test looks to whether the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.").

a) It is debatable whether the Supreme Court adopted a standard to govern executory contracts, or only mentioned it in dicta, in its recent opinion in *Mission Prod. Holdings, Inc., v. Tempnology, LLC*, No. 17-1656, at 2 (U.S., May 20, 2019) (citing *NLRB v. Bildisco*, 465 U.S. 513, 522 n.6 (1984) ("A contract is executory if "performance remains due to some extent on both sides. Such an agreement represents both an asset (the debtor's right to the counterparty's future performance) and a liability (the debtor's own obligations to perform).").

4. Vendors have the ability to negotiate with the debtor and request that the debtor reject burdensome contracts if both parties wish to continue under different terms. Courts defer to a debtor's business judgment in rejecting an executory contract or unexpired lease, and upon finding that a debtor has exercised its sound business judgment, will approve such rejection under Section 365(a) of the Bankruptcy Code. *See, e.g.*, *In re A.H. Robins Co.*, 68 B.R. 705, 707 (Bankr. E.D. Va. 1986) ("[Section 365] gives the trustee or the debtor-in-possession the authority to determine which contracts it wishes to assume or reject. The provision permits the debtor-in-possession to avoid contracts which are burdensome and to retain others which it believes are beneficial to the reorganization effort."); *Ryan, Inc. v. Circuit City Stores, Inc.,* 2010 U.S. Dist. LEXIS 120627 at *8 (Bankr. E.D. Va. 2010) ("[A] debtor's determination to reject an executory contract is governed by the business judgment rule."); *In re Wash. Capital Aviation & Leasing*, 156 B.R. 167, 172 (Bankr. E.D. Va. 1993) (stating that the decision to assume a contract "is part and parcel of the traditional business judgment test used to scrutinize a motion to assume an unexpired lease by a debtor in possession"); *In re Summit Land Co.*, 13 B.R. 310, 315 (Bankr. D. Utah 1981) ("In any event, court approval under Section 365(a), if required, except in extraordinary situations, should be granted as a matter of course.").

5. In a Chapter 7 case, the trustee has 60 days after the petition date to assume or reject all executory contracts. If no action is taken after that date, the executory contract is deemed rejected. *See* 11 U.S.C. § 365(d)(1).

6. In a Chapter 9, 11, 12, or 13 case, the debtor has until the confirmation of a plan to assume or reject an executory contract. *See* 11 U.S.C. § 365(d)(2).

7. A vendor cannot alter the terms of the contract, even if the plain language of the contract allows terms to be changed, based on the financial condition of the debtor or due to the bankruptcy filing as such a provision is deemed an "*ipso facto*" clause under 11 U.S.C § 365(e)(1). Importantly, any contractual provision based on the bankruptcy filing, appointment of a trustee, or the "financial condition" of the debtor is considered an ipso facto clause.

8. A vendor should not condition its refusal to provide additional goods to the debtor postpetition on the debtor's repayment of prepetition debts. In some circumstances, refusal to provide services may be considered a violation of 11 U.S.C. § 362(a)(6) if such refusal is deemed an effort to collect a prepetition debt. *See In re Olson*, 38 B.R. 515 (Bankr. N.D. Iowa 1984) (holding that a creditor's refusal to provide medical services unless all prepetition debt was paid in full constituted an effort to collect a prepetition debt); *In re Sportfame of Ohio, Inc.*, 40 B.R. 47 (Bankr. N.D. Ohio 1984) ("It seems clear from the foregoing discussion that ample authority exists for the finding that Wilson violated the automatic stay by refusing to enter into cash transactions with debtor absent payment of its prepetition debt where its sole motivation **was to collect its prepetition debt**.").

E. Security Deposits and Setoff Rights

1. Typically, a vendor must seek to lift the automatic stay under 11 U.S.C. § 362 in order to effectuate its setoff rights under 11 U.S.C. § 553.

2. The vendor must be able to prove that "cause" exists or another subsection under 11 U.S.C. § 362(d) in order to effectuate its setoff rights.

a) Under 11 U.S.C. § 362(d)(1), "[c]ause is a flexible concept and courts often conduct a fact intensive, case-by-case balancing test, examining the totality of the circumstances to determine whether sufficient cause exists to lift the stay." *In re The SCO Group, Inc.*, 395 B.R. 852, 856 (Bankr. D. Del. 2007).

3. "Whether a party has a setoff right under section 553 is a twofold inquiry." *In re Orexigen Therapeutics, Inc.*, 596 B.R. 9, 14 (Bankr. D. Del. 2018). "First, the party seeking setoff must acquire such right prepetition under applicable nonbankruptcy law." *Id.* (citing *In re Lehman Bros., Inc.*, 458 B.R. 134, 139 (Bankr. S.D.N.Y. 2011)). "Second, once a party establishes its setoff right, that party must then "meet the further code-imposed requirements and limitations set forth in [S]ection 553 [of the Bankruptcy Code].'" *Id.* (citing *In re SemCrude, L.P.*, 399 B.R. 388, 393 (Bankr. D. Del. 2009) (citing *Packaging Indus. Grp. Inc. v. Dennison Mfg. Co. Inc.* (*In re Sentinel Prod. Corp. Inc.*), 192 B.R. 41, 45 (N.D.N.Y. 1996)).

4. "Section 553(a) recognizes and preserves rights of set off where four conditions exist: (1) the creditor holds a 'claim' against the debtor that arose before the commencement of the case; (2) the creditor owes a 'debt' to the debtor that also arose

before the commencement of the case; (3) the claim and debt are 'mutual'; and (4) the claim and debt are each valid and enforceable." *Pardo v. Pacificare of Tex., Inc.* (*In re APF Co.*), 264 B.R. 344, 355 (Bankr. D. Del. 2001) (citing *St. Francis Physician Network, Inc. v. Rush Prudential HMO, Inc.* (*In re St. Francis Physician Network*), 213 B.R. 710, 715 (Bankr. N.D. Ill. 1997)); *see also* 11 U.S.C. § 553.

5. A vendor should carefully analyze any debtor in possession ("**DIP**") loan entered in the bankruptcy case. In some scenarios, a DIP lender may assert that its priming lien contained in the order granting its DIP loan provides the DIP lender with a priming lien pursuant to 11 U.S.C. § 364(d) in the security deposit of the debtor that would otherwise be subject to a vendor's setoff rights under 11 U.S.C. § 553.

a) While courts have not addressed this phenomenon in any reported opinion to date, a DIP lender is probably unlikely to convince a court that, even if it had a priming lien in the security interest, such lien does not extinguish the vendor's setoff rights as a "lien" is not the same as a "setoff" right. *See Folger Adam Sec., Inc. v. DeMatteis/MacGregor, J.V.*, 209 F.3d 252, 260 (3d Cir. 2000) ("It is clear from the definitions of 'lien' and 'setoff' that the term 'setoff' does not refer to the same type of interest as a 'lien.'").

6. It is in the vendor's best interests to draft any order granting a setoff in vague terms to allow the vendor to use the setoff against its oldest invoices (which will likely be general unsecured claims) and to allow the vendor to preserve its more valuable claims (such as claims under 11 U.S.C. § 503(b)(9)).

F. Key Takeaways

1. Preference defenses largely rely on maintaining detailed records of sales, deliveries, and payments. The more information a vendor is able to provide to counsel, the more likely that counsel will be able to devise strong legal theories. Vendor's counsel should urge their clients to keep detailed records of all transactions.

2. Vendors, and especially financial institutions, who deal with entities engaged in suspicious activities open themselves up to fraudulent transfer liability. If a client is selling products to an entity engaged in suspicious activity, counsel should urge the client to conduct some sort of investigation into the suspicious activity in order to trigger the "good faith" defense under 11 U.S.C. § 548(c).

3. Both the debtor and creditor should be aware of whether their sales relationship is governed by a contract or not. If the sales relationship is governed by a contract, the debtor has more power in the relationship as the terms of the contract must be honored until the contract is rejected or assumed. On the other hand, if there is no formal contract, then the creditor has more power in the relationship during the pendency of the bankruptcy case because the creditor is

not compelled to keep supplying the debtor with products and may change credit terms at will.

4. Creditors must be aware that they cannot act upon their setoff rights until they receive (1) relief from the automatic stay under 11 U.S.C. § 362; and (2) have a court order allowing them to do so. Failure to do so may be considered a violation of the automatic stay under 11 U.S.C. § 362.

V. Expanded Statute of Limitations for Fraudulent Conveyances

A. Questions

1. Can TBM seek to avoid the $10 million payment to Toy Fund in connection with the LBO as a fraudulent conveyance?

B. General Limitations

1. The Bankruptcy Code provides for a general 2 year lookback period to recover fraudulent conveyances. 11 U.S.C. § 548.

2. State law generally permits recovery of fraudulent transfers up to 4 years old, with some longer exceptions.

3. Federal Debt Collection Practices Act (FDCPA) allows the federal government to avoid transfers up to 6 years old, and may be extended for an additional two years following the date intentional fraud could have been discovered.

4. The IRS may take court action (including the filing of a fraudulent conveyance action) to recover taxes owed "within 10 years after the assessment of the tax." 26 U.S.C. § 6502(a)(1).

a) Generally, the IRS must assess taxes on a taxpayer within three years after the tax return is filed, but exceptions exist. *Id.* § 6501(a).

b) If no tax return is filed, the IRS may assess the tax at any time. *Id.* § 6501(c)(3).

c) If the taxpayer files a false or fraudulent return with intent to evade tax or to willfully attempt to evade the tax, the IRS may assess the tax at any time. *Id.* § 6501(c)(1), (2).

d) The IRS and the taxpayer may consensually agree to an extension of the assessment period. *Id.* § 6501(c)(4).

e) If the taxpayer improperly omits more than 25% of its gross income from the tax return, the IRS is granted six years to issue an assessment. *Id.* § 6501(e).

C. Federal Government Exemption

1. The United States government is not bound by state law statutes of limitations under the doctrine of *nullum tempus occurrit regi* ("no time runs against the king"). *See generally United States v. Summerlin*, 310 U.S. 414, 416 (1940) (citing cases).

2. Most courts have found that it is also exempt from state law statutes of repose. *See, e.g.*, *United States v. Evans*, 340 F. App'x 990, 993 (5th Cir. 2009) (finding that the logic of *Summerlin* applies equally to statutes of repose); *Bresson v. Comm'r*, 213 F.3d 1173, 1179 (9th Cir. 2000) ("To allow states to evade the *Summerlin* rule by the simple expedient of renaming their statutes of limitation is inconsistent with the core teaching of *Summerlin*—namely, that states 'transgress the limits of state power' when they attempt to set limitation periods on claims acquired by the United States in its governmental capacity."); United States v. Thornburg, 82 F.3d 886, 893-94 (9th Cir. 1996) (holding that *Summerlin* applies to claim-extinguishment provisions)

3. There are two functional limitations on the rule.

a) *Summerlin* only applies when (1) "the right at issue was obtained by the government through, or created by, a federal statute," and (2) "the government was proceeding in its sovereign capacity." *United States v. California*, 507 U.S. 746, 757 (1993). *See also Guaranty Trust Co. of N.Y. v. United States*, 304 U.S. 126, 141-42 (1938) (finding that a claim assigned to the United States government that had previously lapsed under an applicable statute of limitation was not revived by its assignment to the United States).

b) *Nullum tempus* also does not operate to revive a claim that has otherwise lapsed simply by assigning the claim to the United States. *Guaranty Trust*, 304 U.S. at 141-42.

D. Trustee's Exercise of Sovereign Power

1. Most courts have held that 544(b) allows the trustee to pick any creditor it wants as the "triggering creditor." *See, e.g.*, *Hillen v. City of Many Trees, LLC (In re CVAH, Inc.)*, 570 B.R. 816, 834 (Bankr. D. Idaho 2017); *Mukamal v. Citibank N.A. (In re Kipnis)*, 555 B.R. 877, 882 (Bankr. S.D. Fla. 2016); *Ebner v. Kaiser (In re Kaiser)*, 525 B.R. 697, 713 (Bankr N.D. Ill. 2014).

2. Only *In re Vaughan* has come out differently. *See Wagner v. Ultima Homes, Inc. (In re Vaughan Co.)*, 498 B.R. 297 (Bankr. D.N.M. 2013) (expressing doubt that Congress would intentionally delegate federal power to a trustee under the Code).

E. Is the Trustee expanding sovereign power?

1. Bankruptcy courts have considered whether permitting the trustee to step into the shoes of the IRS is actually expanding the sovereign power of the United States government, given that the IRS would be limited to recovering only the amount of its claim outside of bankruptcy.

2. The doctrine of *Moore v. Bay* permits the trustee to avoid the entire transfer for the benefit of all creditors of the debtor. *See Moore v. Bay*, 284 U.S. 4, 5 (1931) (holding that when a transfer is avoided, it is avoided for the benefit of all creditors, even if such creditors could not have otherwise avoided the transfer).

3. Because the IRS could be merely a general unsecured creditor in the bankruptcy case, the combination of *nullum tempus* and *Moore v. Bay* creates a situation where the IRS could recover less on its claim that it would outside of bankruptcy despite the fact that more funds were recovered from the transferor.

4. Although this issue has not been addressed in a published opinion, the IRS often supports the trustee's efforts to recover the entire transfer because the automatic stay would otherwise limit the IRS's ability to avoid the transfer itself. *See Hillen v. City of Many Trees, LLC (In re CVAH, Inc.)*, 570 B.R. 816, 838 (Bankr. D. Idaho 2017) (finding that, because the IRS is barred by the automatic stay from pursuing its rights, the trustee as the statutory representative for the IRS should be permitted to exercise the same rights available to the IRS).

F. Is the IRS's Claim Allowable?

1. A transfer can only be avoided by a creditor holding a claim that is "allowable under Section 502 of this title or . . . not allowable only under section 502(e)." 11 U.S.C. § 544(b)(1).

2. Thus, a potential defendant could object to the allowance of the IRS's claim in an effort to avoid the trustee's exercise of the IRS's extended lookback period.

a) If the defendant is not a creditor, however, it may not have standing to object to the IRS's claim. *See In re FBN Food Servs., Inc.*, No. 93C6347, 1995 WL 230958, at **1, 2 (N.D. Ill. Apr. 17, 1995) (holding that a defendant in a fraudulent conveyance action who is not a creditor had no direct interest in the number or amount of claims against the bankruptcy estate); *In re E.S. Bankest, L.C.*, 321 B.R. 590, 596-98 (Bankr. S.D. Fla. 2005) (finding that such defendants are actually opposed to the interests of other creditors because they are acting in their own best interest, not the estate's best interests).

b) Even if the defendant is a creditor, it still must establish, as a factual matter, that the IRS's claim is disallowable.

3. Likewise, courts have generally held that the satisfaction of a creditor's claim does not prevent the trustee from utilizing that creditor as a triggering creditor. *MC Asset Recovery, LLC v. Commerzbank A.G. (In re Mirant Corp.)*, 675 F.3d 530, 534 (5th Cir. 2012) (finding that postpetition settlement of claims did not affect trustee's standing under § 544(b); *Stalnaker v. DLC, Ltd. (In re DLC, Ltd.)*, 295 B.R. 593, 605 (8th Cir. BAP 2003), *aff'd sub nom Stalnaker v. DLC, Ltd.*, 376 F.3d 819 (8th Cir. 2004) ("It is inconsistent with the Bankruptcy Code to allow a transferee of a fraudulent transfer to defeat the bankruptcy trustee by paying a couple of creditors. The potential for abuse is obvious."); and *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 34 F.3d 800, 807 (9th Cir. 1994) (rejecting defendant's argument that plan's payment of all claims mooted the section 544(b) action). *But see MC Asset Recovery LLC v. Commerzbank AG (In re Mirant Corp.)*, Adv. No. 05-04142, 2010 WL

8708772, at *9 (Bankr. N.D. Tex. Apr. 22, 2010). ("If Mirant's creditors have been paid in full, there is no federal jurisdiction in this adversary proceeding.").

4. The few courts to address this issue have split over the availability of a fraudulent conveyance claim where the IRS has not yet filed a claim.

a) The court in *Republic Windows* found, first, that the IRS could assert a late-filed claim and still receive a distribution, at least in a chapter 7 bankruptcy. *See Republic Windows*, 2011 WL 5975256, at *10 (citing cases). *See also IRS v. Century Boat Co. (In re Century Boat Co.)*, 986 F.2d 154, 158 (6th Cir. 1993) ("An untimely priority claim filed by the IRS may be entitled to a distribution under Section 726(a)(1) even though the claimant had notice of the bankruptcy petition in time to permit the filing of a timely proof of claim."); *See* 11 U.S.C. § 726(a)(1) (2012) (noting that estate property shall be distributed in the order of priority specified in § 507 to claims that are timely filed or late-filed on or before ten days after the mailing of the trustee's final report or the trustee's commencement of the final distribution). Second, the Court found that the debtor or trustee may file a proof of claim on behalf of a creditor pursuant to Bankruptcy Rule 3004 if the creditor fails to timely file a proof of claim. *Republic Windows*, 2011 WL 5975256, at *10. Ultimately, however, the Court held that the trustee could not pursue a fraudulent conveyance action on behalf of the IRS unless either the IRS or the trustee had filed a claim on the IRS's behalf. *See Id.* at *11.

b) The court in *In re Polichuk* disagreed with this analysis, finding "that a proof of claim is not a prerequisite to the Trustee's exercise of the § 544(b) avoidance power." *Finkel v. Polichuk (In re Polichuk)*, 506 B.R. 405, 430 (Bankr. E.D. Pa. 2014). The court relied on the distinction between the terms "allowed" and "allowable," noting that "'a creditor might fail to have an allowed claim for reasons that have nothing to do with whether it was owed money by the debtor. . . , including the failure to file.'" *Id*. at 430-31 (quoting *In re Crown Unlimited Mach., Inc.*, 2005 Bankr. LEXIS 3073, at *3 n.2 (Bankr. N.D. Ind. Nov. 4, 2005)). The court further noted that "a creditor's failure to file a proof of claim does not necessarily disrupt its standing for other purposes within the bankruptcy scheme." *Id*. at 431. Indeed, in chapter 11 and chapter 13 cases, the failure to timely file a proof of claim only eliminates the creditor's rights to a distribution; it does not extinguish the creditor's status. *Id*. (quoting *Gaudio v. Stamford Color Photo, Inc. (In re Stamford Color Photo, Inc.)*, 105 B.R. 204, 206 (Bankr. D. Conn. 1989)). As for chapter 7 cases, the court agreed with the analysis set forth in *Republic Windows* regarding the ability of the IRS to file a late claim. *Id*. at 431-32.

G. Slippery Slope Concerns

1. Bankruptcy courts have struggled with slippery slope considerations of permitting trustees to step into the shoes of the IRS given that the IRS is frequently a creditor in bankruptcy cases.

2. Because the IRS is a creditor in most cases, the default limitations period would extend from 4 years to at least 10 years.

3. This concern was expressed by the Vaughan court in denying the use of these powers by the trustee, but other courts considering this question have generally permitted the trustee to exercise the IRS's powers notwithstanding these concerns. Even in permitting the trustee to exercise the IRS's powers, however, the weight attributed to these concerns has varied. *Compare Ebner v. Kaiser (In re Kaiser)*, 525 B.R. 697, 712 (Bankr N.D. Ill. 2014) (arguing that the slippery slope argument raised by the defendants is "a logical fallacy that actual experience has disproven") *with Mukamal v. Citibank N.A. (In re Kipnis)*, 555 B.R. 877, 883 (Bankr. S.D. Fla. 2016) (positing that perhaps "bankruptcy trustees have not generally realized that this longer reach-back weapon is in their arsenal.").

4. Practical Explanations

a) Arguing that a ten-plus year old transfer rendered a company insolvent, but not yet bankrupt for another ten years or more should prove exceedingly difficult.

b) A debtor might pay its oldest taxes first to avoid the continuing accrual of interest and fees.

c) The IRS has the added ability to assert the debtor's tax debt directly against a transferee under certain circumstances, and the transferee's payment to the IRS will satisfy the debtor's debt as well. *See generally* 26 U.S.C. § 6901(a)(1)(A).

d) Many governmental creditors, including the IRS, hold claims that are secured by consensual or statutory liens. *See In re CVAH, Inc.*, 570 B.R. at 839 n. 20 ("In this Court's experience, in many bankruptcy cases, the claims of the government are secured by either consensual or statutory liens."). Section 544(b)(1) only applies to claims avoidable by unsecured creditors. *See* 11 U.S.C. § 544(b)(1) (permitting the trustee to avoid transfers that are "voidable under applicable law by a creditor holding an unsecured claim . . . .").

H. Key Takeaways

1. Where transactions would normally be safe from fraudulent transfer claims 6 years following the transaction, those transactions may be subject to transfer in a bankruptcy if the IRS is a creditor of the debtor.

2. The IRS's statute of limitations on fraudulent conveyance claims is at least 10 years, and it is potentially unlimited under certain circumstances.

3. Because the trustee's ability to step into the shoes of the IRS to assert its avoidance powers, if the debtor wishes to protect its transferees from the risk on these claims, it should ensure that the IRS is paid in full prior to the bankruptcy filing.

4. Nevertheless, the debtor's fiduciary duty to its creditors may require it to consider bringing these claims once the bankruptcy has filed.

5. Otherwise, a transferee's best defense to these claims is likely to argue that the debtor could not have been insolvent at the time of the transfer if it continued to operate outside of bankruptcy for more than 6 years.

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