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Bankruptcy Ruling Highlights Longer Lookback Trend

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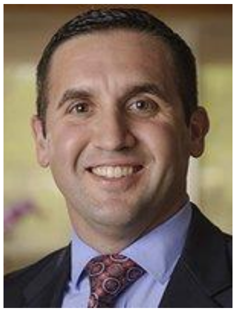
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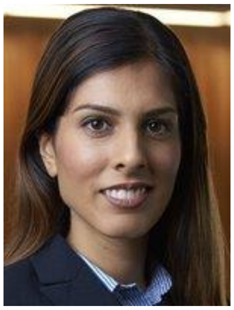
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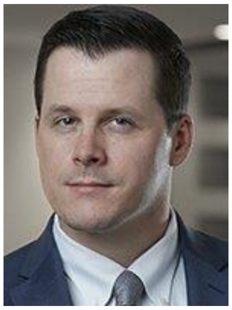
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Projections suggest over 1 million bankruptcy petitions will be filed in 2021. In preparing for those filings, counsel routinely evaluate the prospective creditor pool to determine, inter alia, the types of creditors, claim amounts and the potential exposure the debtors may face once the case commences.

Both debtors and creditors committees should be aware that the lookback period for potential claims and causes, while typically limited by both the Bankruptcy Code and corresponding state law, may be longer than expected if a governmental entity, such as the Internal Revenue Service, qualifies as a triggering creditor.

The U.S. Bankruptcy Court for the Western District of North Carolina in the case In re: Zagaroli recently joined other courts in allowing a trustee to take advantage of such a longer lookback period.[1]

While the Zagaroli decision, issued on Nov. 3, 2020, does not break new ground, it indicates an ongoing trend among bankruptcy courts to allow longer lookback periods in these types of fraudulent transfer cases, which can be a significant source of estate recovery.

It is premature to declare this the law of any circuit, given the infrequency of the decisions and the absence of direct pronouncements by the circuit courts themselves. However, bankruptcy practitioners should be aware of this mechanism.

Section 544(b) of the Bankruptcy Code, which permits a trustee to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim" under certain conditions, can be an important source of estate recovery and, in some cases, may be the only prospect for unsecured creditors to receive a recovery.[2]

It is well known among bankruptcy practitioners that bankruptcy trustees and creditors committees asserting fraudulent transfer claims on behalf of a debtor's estate are subject to a two-year lookback period under Title 11 of the U.S. Code, Section 548(a)(1). Under state fraudulent transfer statutes, the period is typically four to six years, which is applicable in bankruptcy proceedings through Title 11 of the U.S. Code, Section 544(b).

However, what may come as a surprise to some is that governmental entities holding claims often have the right to a lookback period with an even longer statute of limitations — in some cases up to 10 years. Trustees and committees may be able to invoke such creditors' rights for the benefit of an estate.

In Zagaroli, the Bankruptcy Court for the Western District of North Carolina adopted the majority approach regarding this issue, joining other bankruptcy courts in allowing a trustee to take advantage of a longer governmental lookback period.[3] There, the court permitted a trustee to step into the shoes of the IRS to avoid the prepetition transfer of real property to the defendants.[4]

Although the North Carolina Uniform Voidable Transaction Act had a statute of limitations of four years, Section 6502 of the Internal Revenue Code provided the IRS — which was exempt from the state statute of limitations — with an extended lookback period of 10 years to avoid transfers.

Because the IRS was an unsecured creditor in the case, the trustee was able to step into the IRS' shoes and challenge the transfers of real property the debtor allegedly made over six years prior to the petition date.[5]

The Zagaroli decision joins existing case law from other jurisdictions, including within the U.S. Court of Appeals for the Third Circuit.

The U.S. Bankruptcy Court for the Eastern District of Pennsylvania has previously concluded that Section 544(b) enables trustees to step into the shoes of the IRS and benefit from longer limitation periods to avoid transfers.

In In re: Polichuk, a Chapter 7 trustee asserted claims to avoid fraudulent transfers from 10 years before the petition date.[6] Although the IRS did not file a proof of claim, the trustee sought to utilize Section 544(b) to authorize the extended lookback.

The court, in the 2014 decision, rejected the defendants' argument regarding the impermissible delegation of the federal taxing power and found the trustee was not assessing or collecting taxes, but merely using the status of the IRS as a creditor that held a valid claim.[7]

The court also opined that an even longer limitations period could apply under other provisions of the Internal Revenue Code.[8]

The IRS is not the only potential governmental triggering creditor. In 2004, the U.S. Bankruptcy Court for the District of New Jersey in In re: G-I Holdings Inc. permitted the asbestos claimants' committee in a Chapter 11 case to step into the shoes of the New Jersey Department of Environmental Protection to utilize a 10-year statute of limitations applicable to fraudulent transfer actions.[9]

Like the IRS in Polichuk, the NJDEP had not filed a claim. But the claims bar date had not yet passed nor been set. As a result, the court found the NJDEP to be an existing unsecured creditor "with a potential allowable claim whose position the [c]ommittee can assume" to assert the fraudulent transfer action pursuant to Section 544(b).[10]

While the case law within the Third Circuit is fairly well established, the U.S. Court of Appeals for the

Second Circuit has yet to rule specifically on this issue. That said, cases within the Second Circuit suggest the same outcome.

Bankruptcy courts in the Southern and Eastern districts of New York have held that the avoidance power of a trustee depends on whether there is a legitimate creditor to benefit from the recovery.[11] The trustee must show "both that there is an actual creditor as to whom the transfer is 'voidable under applicable law,' and that the creditor 'hold[s] an unsecured claim that is allowable under section 502 of this title.'"[12]

These courts have not read additional limitations into these requirements. In fact, the courts have held that Section 544(b) confers standing upon the trustee even if the triggering creditor's claim at the time of the transfer to be avoided is not the same claim the triggering creditor holds on the petition date.[13] Therefore, a trustee should be able to stand in the shoes of a governmental entity even if a claim had been satisfied, so long as a claim existed at those two essential times.

Furthermore, the amount of the triggering creditor's claim is irrelevant; a single triggering creditor provides a trustee with standing; and the entire transfer may be set aside for the benefit of the estate.[14] Courts within the Second Circuit have not placed any restrictions on the identity of a triggering debtor or the source of applicable law that would prevent a trustee from stepping into the shoes of a governmental entity.

Given this trend among the bankruptcy courts, both debtors and creditors committees should carefully consider whether a governmental creditor exists, and if so, whether that creditor could be used to obtain a longer lookback period for fraudulent transfer and other types of claims. This could be an important source of recovery where a claim would otherwise be time-barred and would usually be disregarded.

Parties making these considerations should think broadly about the entities, certainly beyond just the IRS. If such a governmental creditor is present in the case, claims beyond the usual four-year statute of limitations will need to be included in any analysis of the estate's possible claims and assets.

Committees conducting discovery or Rule 2004 investigations regarding prepetition transactions should be particularly cognizant of the possibility of taking advantage of a longer lookback period and should not — as is often done — limit discovery to the time period of four to six years prior to the petition date. Any valuation or analysis of estate claims should include claims within the 10-year lookback period if a governmental creditor exists.

In the absence of clear precedent, the viability of such claims is unpredictable. That said, professionals on all sides of a bankruptcy need to be cognizant of the existence of extended lookback claims and take appropriate steps to ensure that they are evaluated and addressed.

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Disclosure: Lowenstein Sandler represented the official committee of asbestos claimants in the case of In re: G-I Holdings Inc., discussed above.

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[1] In re Zagaroli, No. AP 20-05000, 2020 WL 6495156 (Bankr. W.D.N.C. Nov. 3, 2020).

[2] 11 U.S.C. § 544(b).

[3] See,e.g., In re Kaiser, 525 B.R. 697, 711–12 (Bankr. N.D. Ill. 2004); In re Polichuk, 506 B.R. 405, 427 (Bankr. E.D. Pa. 2014); In re Greater Se. Cmty. Hosp. Corp. I, 365 B.R. 293, 299–306 (Bankr. D.D.C. 2006); In re Emergency Monitoring Tech, Inc., 347 B.R. 17, 19 (Bankr. W.D. Pa. 2006); In re Porras, 312 B.R. 81, 97 (Bankr. W.D. Tex. 2004).

[4] In re Zagaroli, No. AP 20-05000, 2020 WL 6495156, at *3 (Bankr. W.D.N.C. Nov. 3, 2020).

[5] Id. at *1.

[6] In re: Polichuk, 506 B.R. 405 (Bankr. E.D. Pa. 2014).

[7] Id. at 427.

[8] Id. at 429 (observing that sections 6501(c)(1) and (2) of the IRC have unlimited statutes of limitations).

[9] In re G-I Holdings Inc., 313 B.R. 612, 636 (Bankr. D.N.J. 2004).

[10] Id.

[11] See In re Wingspread Corp., 178 B.R. 938, 945 (Bankr. S.D.N.Y. 1995); In re Liggett, 118 B.R. 219, 222 (Bankr. S.D.N.Y. 1990).

[12] In re Allou Distribs., Inc., 392 B.R. 24, 31 (Bankr. E.D.N.Y. 2008) (quoting 11 U.S.C. § 544(b)(1)).

[13] Id. at 34 (citing In re RCM Glob. Long Term Cap. Appreciation Fund, Ltd., 200 B.R. 514, 523 (Bankr. S.D.N.Y. 1996)).

[14] See In re Tronox Inc., 464 B.R. 606, 614–18 (Bankr. S.D.N.Y. 2012).