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Problems in the Code

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Let's Rethink *Moore v. Bay*

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Amidst ongoing discussion about problems in the Bankruptcy Code, most notably by the ABI Commission to Study the Reform of Chapter 11,[1] the doctrine of *Moore v. Bay*[2] has received little attention. The case holds that when a transfer is subject to avoidance, the transfer may be avoided in its entirety and the recovery shall be shared by all unsecured creditors, including creditors who could not themselves avoid the transfer under state law.

Moore v. Bay leads to extraordinary results. In some cases, it allows an estate representative to unwind a transfer for the benefit of creditors who themselves funded the transfer with full knowledge of the facts. For example, in cases involving leveraged buyouts (LBOs), holders of post-LBO debt, including high-yield debt issued to finance the buyout, can share fully in recoveries from other participants in the deal.

Moore v. Bay has been subject to intense criticism; one scholar even called the decision "one of the most glaring misconstructions to be encountered in the history of Anglo-American law."[3] More recently, an article in the *ABI Journal* derided the application of the doctrine "without regard to its real-world effects."[4] Nonetheless, efforts to repeal the decision appear to be dormant; for example, the ABI Commission's Report did not address *Moore v. Bay*.

This article proposes that § 550 of the Bankruptcy Code be amended to provide that when an estate representative challenges a transfer under § 544(b) of the Code, there is merely a *rebuttable presumption* that the entire transfer may be avoided and shared by all creditors. However, the defendant would be able to overcome that presumption by showing that particular creditors could not avoid the challenged transfer under applicable state law. Under this approach, the bankruptcy estate could still pursue actions under § 544(b) without identifying all creditors with viable claims. At the same time, defendants would maintain their defenses to claims of allegedly "tainted" creditors, both for their own benefit and for the benefit of "innocent" creditors whose recoveries would otherwise be diluted.

State Law Background

Outside of bankruptcy, fraudulent transfer claims belong to creditors. State law, however, places limits on who can bring a fraudulent transfer claim and for how much. *First*, under state law, a creditor cannot recover more than it is owed: the Uniform Fraudulent Transfer Act (UFTA) provides that when a transfer is avoidable, a creditor may not recover more than "the amount necessary to satisfy the creditor's claim."[5]

Second, not all creditors are eligible to sue and recover. For example, under the uniform acts, only pre-transfer creditors may avoid transfers that render the debtor insolvent.[6] State fraudulent transfer law also incorporates doctrines such as estoppel and ratification.[7] Thus, even when creditors have standing to bring fraudulent transfer claims, those claims can be subject to defenses predicated on the creditors' conduct or knowledge.

Based on principles of estoppel and ratification, numerous decisions have held that creditors who participate in or otherwise ratify a transaction may not subsequently avoid the transaction.[8] As explained in a widely cited treatise, "the subsequent creditor who complains of a fraudulent conveyance should state the circumstances under which

1 For more about the Commission's work, including its Final Report and Recommendations published in December 2014, visit commission.abi.org.
2 *Moore v. Bay*, 284 U.S. 4 (1931).
3 James MacLachlan, *Bankruptcy* 331 (1956).
4 Gerard G. Pecht and Bob B. Bruner, "Limiting Fraudulent-Transfer Damages to the Amount of 'Innocent' Creditor Claims," XXXIII *ABI Journal* 3, 56-57, March 2014, *available at* abi.org/abi-journal.
5 UFTA § 8(b) (1984). The Uniform Fraudulent Conveyance Act (UFCA) likewise states that a creditor may set aside a fraudulent transfer "to the extent necessary to satisfy his claim." UFCA § 9(1)(a).
6 UFTA § 5; *accord* UFCA § 4.
7 UFTA § 10; UFCA § 11.
8 *See, e.g., In re Lyondell Chem. Co.*, 503 B.R. 348, 383- 84 (Bankr. S.D.N.Y. 2014); *In re Best Prods. Co.*, 168 B.R. 35, 57 (Bankr. S.D.N.Y. 1994).

he extended credit, so as to show that, if he did so after the transfer was made, he was not aware of the fact at the time."[9] These principles have been invoked to prevent creditors that finance LBOs and other corporate transactions from themselves suing to unwind those transactions after the fact.[10]

The ratification and estoppel defenses have been the subject of controversy. While some cases suggest that creditors with notice of a transaction are barred from challenging it, other cases have focused on the level of the creditor's sophistication; still other cases have questioned the viability of the defenses in situations where the statute authorizes suits by post-transfer creditors.[11] For purposes of this article, the precise scope of the state law defenses is not important; the critical point is that they are ineffectual in bankruptcy due to *Moore v. Bay*.

Moore v. Bay Overrides State Law

The Bankruptcy Act of 1898, which governed when *Moore v. Bay* was decided, did not clearly address whether (1) the trustee, in bringing an avoidance action, was limited to recovering what creditors could recover under state law, or (2) creditors not eligible to avoid a transfer under state law could share in the trustee's recovery. *Moore v. Bay*, a two-paragraph decision by Justice Oliver Wendell Holmes, resolved those questions.

The case involved assets that were subject to a mortgage avoidable under California law by creditors with claims arising before the recording of the mortgage.[12] The issue presented was whether the trustee, upon avoiding the mortgage, should distribute the proceeds to all creditors or only those with valid state law claims. The U.S. Supreme Court concluded that "[t]he rights of the trustee by subrogation are to be enforced for the benefit of the estate" and "what thus is recovered for the benefit of the estate is to be distributed in 'dividends' of an equal *per centum* on all allowed claims."[13] Although the opinion did not explicitly discuss *how much* could be recovered, it is widely understood to hold not only that all creditors may share in an avoidance recovery, but that the trustee can avoid *entire* transfers even if eligible creditors could avoid only part.[14]

Congressional Acquiescence

The Bankruptcy Code, as enacted in 1978, confers broad avoidance powers. Section 544(b) provides that the trustee may avoid transfers that are "voidable under applicable law by a creditor holding an unsecured claim," while § 548 provides that the trustee may avoid fraudulent transfers (as defined by that section) that were made within two years of the filing. Section 550(a) further provides that a trustee may recover avoidable transfers "for the benefit of the estate."[15]

Prior to 1978, Congress was presented with various proposals to overrule *Moore v. Bay*. The Commission on the Bankruptcy Laws of the United States, among others, proposed to overrule the decision entirely.[16] In response, Prof. Vern Countryman submitted a letter urging that Congress not overrule *Moore v. Bay*. Among other things, his letter argued that if *Moore v. Bay* were overruled, the trustee would bear the burden of "locat[ing] and identify[ing] and ... prov[ing] the amount of the claims of *all* creditors who could have avoided" the debtor's transfer.[17]

The record suggests that Congress adopted Prof. Countryman's recommendation. The final Senate report proclaims that § 544(b) "gives the trustee the rights of actual unsecured creditors under applicable law to avoid transfers. It follows *Moore v. Bay*."[18] The fact that Congress included the phrase "for the benefit of the estate" in § 550(a) — the same phrase used by Justice Holmes — further supports this conclusion.

> **The results generated by *Moore v. Bay* lack sound justification. Creditors who knowingly finance a risky transaction can account for their risk by adjusting interest rates and other loan terms.**

Effects of *Moore v. Bay*

Since the enactment of the Bankruptcy Code, the significance of *Moore v. Bay* has increased. With the advent of large-scale leveraged transactions, courts have repeatedly faced situations where estate representatives, invoking the powers of a particular creditor, have sought to unwind transactions for the benefit of creditors who would not themselves have viable claims.[19] For example, in the *Verizon* case, which involved a challenge to a large spin-off transaction, the court — while agreeing that the creditors who financed the transaction lacked viable claims — permitted the suit to go forward because the plaintiff identified another creditor with a nominal claim.[20]

In some cases, estate representatives have also used *Moore v. Bay* to take advantage of rights belonging to special creditors such as the Internal Revenue Service (IRS). Under the Internal Revenue Code, the IRS has the power to invoke state fraudulent transfer law in recovering from the transferee of a taxpayer's assets.[21] In doing so, the IRS — and the IRS alone — may sue within *10 years* of the relevant tax assessment.[22] Against this backdrop, several bankruptcy courts have held that when the IRS has a claim, the trustee may seek to avoid transfers occurring up to *10 years* before the petition date, even though private creditors are limited under state law to four (or six) years.[23]

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9 1 Garrard Glenn, *Fraudulent Transfers and Preferences* § 76 (rev. ed. 1940).
10 *See, e.g., Lyondell*, 503 B.R. at 385; *Credit Managers Ass'n v. Fed. Co.*, 629 F. Supp. 175 (C.D. Cal. 1985).
11 *Compare Kupetz v. Wolf*, 845 F.2d 842, 849 (9th Cir. 1988), *with In re Integra Realty Res. Inc.*, 198 B.R. 352, 363 (Bankr. D. Col. 1996), *and Zahn v. Yucaipa Capital Fund*, 218 B.R. 656, 670 (D.R.I. 1998).
12 *See In re Sassard & Kimball Inc.*, 45 F.2d 449, 450 (9th Cir. 1930).
13 *Moore v. Bay*, 284 U.S. 4, 4 (1931).
14 *See* Thomas H. Jackson, "Avoidance Powers in Bankruptcy," 36 *Stan. L. Rev.* 725, 747 (1984).
15 11 U.S.C. §§ 544(b), 548 and 550(a) (1978).
16 *Collier on Bankruptcy* App. Pt. 4(c) (16th ed. 1996), at 4-262, 4-732.
17 Letter from Vern Countryman to Senate Committee on the Judiciary (Dec. 19, 1975), *reprinted in* Hearings on S. 235 and S. 236 Before the Subcommittee on Improvements in Judicial Machinery of the Senate Committee on the Judiciary, 94th Cong., 2d Sess., pt. III (1976), p. 8.
18 S. Rep. 95-989, 95th Cong., 2d Sess. at 85 (1978); *see* Douglas J. Whatley, "The Dangerous Doctrine of *Moore v. Bay*," 82 *Tex. L. Rev.* 73, 95 (2003) (Countryman's letter "resurrected" *Moore v. Bay*).
19 For examples of LBO-related cases wherein *Moore v. Bay* has been invoked, *see In re Healthco Int'l Inc.*, 195 B.R. 971, 980 (Bankr. D. Mass. 1996); *Crowthers McCall Pattern Inc. v. Lewis*, 129 B.R. 992, 1001-02 (S.D.N.Y. 1991).
20 *U.S. Bank Nat'l Ass'n v. Verizon Comm'ns Inc.*, 479 B.R. 405, 414 (N.D. Tex. 2012).
21 26 U.S.C. § 6901(a)(1)(A)(i) (1982); *Diebold Found. Inc. v. C.I.R.*, 736 F.3d 172, 184 (2d Cir. 2013).
22 26 U.S.C. § 6502.
23 *See, e.g., In re Kaiser*, 525 B.R. 697, 715 (Bankr. N.D. Ill. 2014); *but see In re Vaughan Co.*, 498 B.R. 297, 303-04 (Bankr. D.N.M. 2013) (rejecting trustee's use of 10-year period).

At the same time, certain trends in fraudulent transfer law have arguably mitigated the effects of *Moore v. Bay*. First, the trend in the case law toward reliance on market-based evidence of value, including evidence in the form of trading prices and the conduct of sophisticated investors,[24] has made it more difficult for plaintiffs to challenge transactions that had broad market support. Under these cases, even if the trustee can stand in the shoes of a marginal creditor in challenging a transfer, the willingness of other creditors to finance the transfer will itself bear on the court's evaluation of the debtor's financial condition, and thus on the merits of a constructive fraudulent transfer claim.

Second, in the *Crescent* case, a district court concluded that based on the language of § 550(a) directing recovery "for the benefit of the estate," it had the discretion to apply "equitable principles" in determining the trustee's recovery.[25] Thus, the court determined that it could limit recovery on the trustee's claim to those creditors who did not knowingly fund the dividend transaction at issue. *Crescent*, however, has not been tested by other courts and is open to question insofar as it interprets the language of § 550(a) (which mirrors the language used in *Moore v. Bay*) to permit departure from the result of *Moore v. Bay*.

Legislative Proposal

The results generated by *Moore v. Bay* lack sound justification. Creditors who knowingly finance a risky transaction can account for their risk by adjusting interest rates and other loan terms. Unless the debtor deceived them in some way — in which case ratification and estoppel principles would not apply — such creditors have no equitable claim to the proceeds of an avoidance action. Conversely, there are many creditors, such as involuntary tort creditors, that *cannot* adjust for the risks of a loan. Such creditors should receive the full benefit of an avoidance action without their recoveries being diluted by distributions to other creditors.

While *Moore v. Bay* conserves estate resources and because, as Prof. Countryman notes, it spares the estate the cost of identifying creditors eligible to sue, limited benefit can be preserved without retaining the doctrine as a whole. Section 550(a) of the Bankruptcy Code permits recovery of avoidable transfer "for the benefit of the estate." To address the *Moore v. Bay* problem, § 550 should be amended as follows to add a new subsection (g):

> (g)(1) In an action under section 544(b) of this title, the trustee's recovery shall be limited to the amount recoverable by creditors entitled to avoid the transfer or obligation under applicable law, and other creditors shall not share in such recovery.
>
> (2) For purposes of this section, the transferee or beneficiary from whom recovery is sought bears the burden of proving that particular creditors are not entitled to avoid the transfer or obligation under applicable law.

This amendment would curtail the effect of *Moore v. Bay*, but at the same time, it would impose on defendants the burden of reducing the estate's recovery by showing that particular creditors would not be eligible under applicable law to avoid a challenged transfer. Notably, this proposed amendment would not limit recoveries under § 548 of the Bankruptcy Code, which permits avoidance of fraudulent transfers (as defined by that section) within a two-year period before bankruptcy.[26] However, where the trustee invokes the state law claims of a creditor under § 544(b), the amendment would permit defendants to limit the estate's recovery based on defenses that are well recognized under state law. Therefore, the amendment would address the worst abuses of *Moore v. Bay*. abi

24 *See, e.g., VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007); *In re Iridium Operating LLC*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007).

25 *See Crescent Res. Ltd. Trust v. Duke Energy Corp.*, 500 B.R. 464, 477-83 (W.D. Tex. 2013).

26 *Cf. Verizon*, 479 B.R. at 415 ("Section 548 is a simple grant of power to the bankruptcy trustee to avoid transfers under certain circumstances. Verizon's ratification and estoppel arguments concerning the ... banks and bondholders are irrelevant under Section 548."). Policy arguments that support overruling *Moore v. Bay* in the context of § 544(b) also support imposing federal law limitations on recovery by the trustee in suits under § 548. Nonetheless, this article proposes a more modest fix to the Bankruptcy Code in the first instance.

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