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Collier Family Law and the Bankruptcy Code

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CHAPTER 7 Lien and Transfer Avoidance in Connection With Marital or Family Obligations

*1-7 Collier Family Law and the Bankruptcy Code P 7.02*

**P 7.02 General Principles Governing the Trustee's Avoiding Powers Under Sections 544-553.**

**[1] Parties Who May Exercise Trustee's Avoiding Powers.**

Although they are customarily denominated as the "trustee's avoiding powers," the avoiding powers granted in sections 544-553<sup>n1</sup> may be exercised by a number of different parties besides a trustee, depending on the circumstances. (The trustee in a bankruptcy case under any chapter may, of course, always exercise them when they are applicable.)<sup>n2</sup>

In a chapter 7 case, the trustee appointed by the United States trustee, or thereafter elected by creditors,<sup>n3</sup> and normally only that trustee, exercises these powers.

In a chapter 11 case, in which usually no trustee is present, the avoiding powers may be exercised by the debtor in possession.<sup>n4</sup> Therefore, the chapter 11 debtor in possession typically controls the initiation of avoidance proceedings. However, if a trustee is appointed or elected in a chapter 11 case,<sup>n5</sup> the power to commence such proceedings shifts to the trustee.<sup>n6</sup>

When a chapter 11 debtor in possession or a trustee under any chapter fails to bring an avoidance proceeding that other parties believe to have merit, those other parties may seek leave from the court to bring that proceeding on behalf of the estate.<sup>n7</sup> This might occur, for example, when the transferee was a party with close ties to the debtor, such as an officer or relative of the debtor. Usually, the party that would take such a step would be one of the committees appointed in a chapter 11 case, such as the committee of unsecured creditors.<sup>n8</sup>

In chapter 12 cases, a trustee is always appointed,<sup>n9</sup> but the debtor is also normally given the status of a debtor in possession with the same avoidance powers as a chapter 11 debtor in possession.<sup>n10</sup> The debtor may lose the status of debtor in possession during the case,<sup>n11</sup> in which event only the trustee could exercise the avoiding powers.

Similarly, in chapter 13 a trustee is always appointed,<sup>n12</sup> and that trustee clearly has the right to exercise the avoiding powers.<sup>n13</sup> It is far less clear whether the debtor can exercise them in every instance where the trustee does not. Some courts, recognizing that the chapter 13 trustee is much more of a disbursing agent and monitor of the process than anything else,<sup>n14</sup> have looked to certain legislative history to find that the chapter 13 debtor is a type of debtor in possession who may exercise the avoiding powers in place of the trustee.<sup>n15</sup> Most others, however, have held to the contrary, based upon the absence of any explicit authority in the statute itself.<sup>n16</sup>

Finally, as discussed below,<sup>n17</sup> individual debtors under all chapters have the right to utilize the trustee's avoiding

powers to invalidate certain transfers of property which would otherwise be exempt in the bankruptcy case.

## **[2] Procedure for Exercising Trustee's Avoiding Powers.**

Under *Bankruptcy Rule 7001*<sup>18</sup> a proceeding that asserts one or more of the trustee's avoiding powers must be brought as an adversary proceeding, commenced by a complaint,<sup>19</sup> because such a proceeding will seek either to recover money or property or to determine the validity, priority or extent of a lien. Once the complaint is filed, the remainder of the adversary proceeding rules, which are extremely similar to the Federal Rules of Civil Procedure, will apply.<sup>20</sup>

It is important to note that lien and transfer avoidance does not occur automatically upon the filing of a bankruptcy case. A motion or adversary proceeding resulting in a court order avoiding the lien or transfer is necessary. If no timely proceeding is brought, a transfer which could be avoided is normally unaffected by the bankruptcy.<sup>21</sup>

## **[3] Time Limits for Assertion of Trustee's Avoiding Powers.**

Section 546(a)<sup>22</sup><sup>23</sup><sup>24</sup><sup>25</sup> sets a statute of limitations for the exercise of the trustee's avoiding powers. That section, as amended by the Bankruptcy Reform Act of 1994,<sup>26</sup> provides that the avoidance action must be brought within two years of the order for relief unless the first trustee is appointed or elected in the second of those two years, in which case the deadline is one year after such appointment or election.<sup>27</sup>

This statute of limitations is distinct from the various time periods set forth in the different avoiding powers provisions, such as the 90 day or one year preference periods in section 547.<sup>28</sup> Those provisions refer to times prior to the bankruptcy filing within which the transfer must have occurred, while section 546 refers to the time period after the bankruptcy filing (or appointment of a trustee) within which an avoidance action must be commenced.

## **[4] Effect of Avoiding Powers on Recipients of Avoided Transfers.**

The effect of the avoidance of a transfer by the trustee upon the entity which received the transfer depends upon several factors. Generally, section 550 provides that the property transferred (or in some cases its value) may be recovered from either an initial transferee or a subsequent transferee.<sup>29</sup> Any separate action to recover property from a transferee after a transfer is avoided must be commenced within one year after the avoidance or, if the case is closed or dismissed within a year after the avoidance, before the bankruptcy case is closed or dismissed.<sup>30</sup>

However, the trustee (or debtor) may not recover from a transferee subsequent to the initial transferee if the subsequent transferee has either taken for value in good faith without knowledge of the voidability of the transfer or taken from a prior transferee who has taken in good faith without such knowledge.<sup>31</sup> When the property is in the hands of a subsequent transferee from whom recovery cannot be obtained, the only recovery possible is recovery of the value of the property from the initial transferee.

In addition, under a 2005 amendment to the Code, if a transfer avoided as a preference to an insider<sup>32</sup> occurred between 90 days and one year prior to the bankruptcy, the trustee may avoid the transfer with respect to and recover only from a transferee that was an insider.<sup>33</sup>

Normally, a party who is required to disgorge money or property as a result of an avoidance proceeding is left with only an unsecured claim for the debt, if any, which gave rise to the transfer.<sup>34</sup> In addition, to the extent that a good faith transferee improved the property transferred or paid liens or taxes on the property, that party is given a lien in the amount of the costs of the improvements or the increase in value resulting from the improvements.<sup>35</sup> In certain cases, a good faith transferee in a transfer avoided under sections 548 and 549 is also given a lien to the extent that the transferee gave value for the transfer.<sup>36</sup>

## **[5] Preservation of Avoided Transfers.**

Section 551 provides that any transfer, including any lien, avoided under the trustee's avoiding powers is preserved for the benefit of the bankruptcy estate.<sup>n37</sup> What this means is that the estate steps into the shoes of the transferee and maintains the benefits of the transfer, such as lien priority that the transferee had.

For example, if the trustee avoids an execution lien that came prior in time to the perfection date of an unavoidable security interest, the trustee retains the lien priority of the execution lienholder over the holder of the security interest. The preservation of avoided liens prevents the holders of junior liens, who may be wholly or partially undersecured and therefore treated as unsecured for all or part of their claims in the bankruptcy,<sup>n38</sup> from moving up to a more secured position as they would have done if the avoided lien were simply eliminated.

**[6] Nondischargeability of Debt Not a Defense.**

Because the trustee represents the debtor's unsecured creditors and not the debtor, the fact that the debtor might not be entitled to a discharge from the debt underlying an avoidable transfer generally has not been considered a valid defense to the avoidance proceeding. The processes of gathering the debtor's property and distributing it to creditors, on the one hand, and the debtor obtaining a discharge, on the other, are separate and distinct. The former goes on even when the debtor does not obtain a discharge.

The policies underlying the trustee's avoiding powers center on fairness among creditors rather than equities between the debtor and a particular creditor. Those equities are taken into consideration in the dischargeability provisions of the Code,<sup>n39</sup> which may leave a creditor free to pursue a debtor after the bankruptcy, but they are not generally considered in the gathering up and distribution of the bankruptcy estate to other creditors who are usually innocent of any wrongdoing attributable to the debtor. Any special treatment intended by Congress in that process is carried out by the provisions of the Code setting priorities among creditors,<sup>n40</sup> and detailing the order of distribution.<sup>n41</sup>

Consequently, it is possible that prebankruptcy transfers made by the debtor to a former spouse may be avoided as preferences<sup>n42</sup> or under some other avoiding power, notwithstanding the fact that the debts which were paid were nondischargeable in the bankruptcy case. As discussed below,<sup>n43</sup> Congress carved out a narrow exception to this general principle for the first time in the Bankruptcy Reform Act of 1994,<sup>n44</sup> which created an exception to the preference avoiding power for payments on debts in the nature of alimony, maintenance, or support.<sup>n45</sup> This exception was broadened by the 2005 amendments to the Bankruptcy Code,<sup>n46</sup> which made it applicable to all domestic support obligations.<sup>n47</sup> In any case, even if a transfer is avoided, it is important to note, that only the transfer is avoided, and not the underlying debt that gave rise to the transfer. At least one court has held that if a nondischargeable debt is paid by a debtor and that payment is subsequently avoided, the debt that results from the avoidance retains its nondischargeability.<sup>n48</sup>

**FOOTNOTES:**

(n1)Footnote 1. *11 U.S.C. §§ 544-553.*

(n2)Footnote 2. *11 U.S.C. § 103(a). See 2 Collier on Bankruptcy, P 103.02 (Matthew Bender 15th Ed. Revised).*

(n3)Footnote 3. *11 U.S.C. §§ 701 and 702. See 6 Collier on Bankruptcy, chs. 701 and 702 (Matthew Bender 15th Ed. Revised).*

(n4)Footnote 4. *11 U.S.C. § 1107(a). See 7 Collier on Bankruptcy, P 1107.03[4] (Matthew Bender 15th Ed. Revised).*

(n5)Footnote 5. *11 U.S.C. § 1104(a), (b).* Section 1104(b), permitting election of a chapter 11 trustee, was enacted by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (effective with respect to cases commenced on or after October 22, 1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised). *See 7*

*Collier on Bankruptcy*, P 1104.02 (Matthew Bender 15th Ed. Revised).

(n6)Footnote 6. *11 U.S.C. § 1101(1)*. See 7 *Collier on Bankruptcy*, P 1101.01[1] (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. See 7 *Collier on Bankruptcy*, P 1103.05[5] (Matthew Bender 15th Ed. Revised). See also, e.g., *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351 (5th Cir. 1986) .

(n8)Footnote 8. See P 1.03[3][b] *supra*.

(n9)Footnote 9. *11 U.S.C. § 1202*. See 8 *Collier on Bankruptcy*, P 1202.02 (Matthew Bender 15th Ed. Revised).

(n10)Footnote 10. *11 U.S.C. § 1203*. See 8 *Collier on Bankruptcy*, P 1203.02[1] (Matthew Bender 15th Ed. Revised).

(n11)Footnote 11. *11 U.S.C. § 1204(a)*. See 8 *Collier on Bankruptcy*, P 1204.01 (Matthew Bender 15th Ed. Revised).

(n12)Footnote 12. *11 U.S.C. § 1302(a)*. See 8 *Collier on Bankruptcy*, P 1302.02 (Matthew Bender 15th Ed. Revised).

(n13)Footnote 13. *11 U.S.C. § 103(a)*. See 2 *Collier on Bankruptcy*, P 103.02 (Matthew Bender 15th Ed. Revised).

(n14)Footnote 14. See P 1.03[3][d] *supra* and P 8.01[1] *infra* .

(n15)Footnote 15. E.g., *In re Cohen*, 305 B.R. 886 (B.A.P. 9th Cir. 2004) ; *In re Freeman*, 72 B.R. 850 (Bankr. E.D. Va. 1987) ; *In re Ottaviano*, 68 B.R. 238 (Bankr. D. Conn. 1986) .

(n16)Footnote 16. E.g., *In re Mast*, 79 B.R. 981 (Bankr. W.D. Mich. 1987) ; *In re Driscoll*, 14 C.B.C.2d 146, 57 B.R. 322 (Bankr. W.D. Wis. 1986) .

(n17)Footnote 17. See P 7.03[3] *infra*.

(n18)Footnote 18. *Fed. R. Bankr. P. 7001*. See 10 *Collier on Bankruptcy*, PP 7001.02., 03 (Matthew Bender 15th Ed. Revised).

(n19)Footnote 19. *Fed. R. Bankr. P. 7003*. See 10 *Collier on Bankruptcy*, P 7003.04 (Matthew Bender 15th Ed. Revised).

(n20)Footnote 20. *Fed. R. Bankr. P. 7001-7087*. See 10 *Collier on Bankruptcy*, chs. 7001- 7087 (Matthew Bender 15th Ed. Revised).

(n21)Footnote 21. See *Fed. Deposit Ins. Corp. v. Davis*, 733 F.2d 1083, 10 C.B.C.2d 1413 (4th Cir. 1984) . One exception to this rule would be a postpetition transfer avoidable under section 549, which might also be deemed void *ab initio* because it is in violation of the automatic stay. See P 5.05[1] *supra*.

(n22)Footnote 22. *11 U.S.C. § 546(a)*. See 4 *Collier on Bankruptcy*, P 546.02 (Matthew Bender 15th Ed. Revised).

(n23)Footnote 23. [Reserved]

(n24)Footnote 24. [Reserved]

(n25)Footnote 25. [Reserved]

(n26)Footnote 26. Pub. L. No. 103-394 (effective with respect to cases commenced on or after October 22, 1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n27)Footnote 27. *11 U.S.C. § 546(a)(1)*, as amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (effective with respect to cases commenced on or after October 22, 1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n28)Footnote 28. *See P 7.08 infra*.

(n29)Footnote 29. *11 U.S.C. § 550(a)*. *See 5 Collier on Bankruptcy, P 550.02* (Matthew Bender 15th Ed. Revised).

(n30)Footnote 30. *11 U.S.C. § 550(f)*(formerly § 550(e) and redesignated by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (effective with respect to cases commenced on or after October 22, 1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised)). *See 5 Collier on Bankruptcy, P 550.07* (Matthew Bender 15th Ed. Revised).

(n31)Footnote 31. *11 U.S.C. § 550(b)*. *See 5 Collier on Bankruptcy, P 550.03* (Matthew Bender 15th Ed. Revised).

(n32)Footnote 32. "Insider" is defined at *11 U.S.C. § 101* to include various types of parties, including relatives, who have a close relation with the debtor.

(n33)Footnote 33. *11 U.S.C. § 547(i)*, as enacted by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. *11 U.S.C. § 550(c)*, as enacted by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (effective with respect to cases commenced on or after October 22, 1994), *reprinted in* Vol E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised). This overrules the *Diprezio* rule for all preference transfers that might affect the rights of a noninsider, named after *Levitt v. Ingersoll Rand Financial Corp (In re Diprizio)*, 874 F.2d 1186 (7th Cir. 1989) . *See 5 Collier on Bankruptcy P 547.03[3][a]*.

(n34)Footnote 34. *11 U.S.C. § 502(h)*. *See 4 Collier on Bankruptcy, P 502.09* (Matthew Bender 15th Ed. Revised)

(n35)Footnote 35. *11 U.S.C. § 550(e)*(formerly § 550(d) and redesignated by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (effective with respect to cases commenced on or after October 22, 1994, *reprinted in* Vol E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised)). *See 5 Collier on Bankruptcy, P 550.06* (Matthew Bender 15th Ed. Revised).

(n36)Footnote 36. *11 U.S.C. §§ 548(c) and 549(c)*. *See 5 Collier on Bankruptcy, PP 548.07[2][a], [2][c] and 549.06* (Matthew Bender 15th Ed. Revised).

(n37)Footnote 37. *11 U.S.C. § 551*. *See 5 Collier on Bankruptcy, P 551.01* (Matthew Bender 15th Ed. Revised).

(n38)Footnote 38. *See P 7.12 infra*.

(n39)Footnote 39. *See Chapter 6 supra*.

(n40)Footnote 40. *11 U.S.C. § 507*. *See 5 Collier on Bankruptcy, ch. 507* (Matthew Bender 15th Ed. Revised).

(n41)Footnote 41. *11 U.S.C. § 726*. *See 6 Collier on Bankruptcy, ch. 726* (Matthew Bender 15th Ed. Revised).

(n42)Footnote 42. *See P 7.08 infra*.

(n43)Footnote 43. *See text at P 7.08[4] infra* .

(n44)Footnote 44. Pub. L. No. 103-394 (effective with respect to cases commenced on or after October 22, 1994),

*reprinted in Vol E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).*

(n45)Footnote 45. *11 U.S.C. § 547(c)(7)*, enacted by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (effective with respect to cases commenced on or after October 22, 1994), *reprinted in Vol E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).*

(n46)Footnote 46. Pub. L. No. 109-8 (2005), effective with respect to cases filed on or after October 17, 2005.

(n47)Footnote 47. "Domestic support obligation" is defined in *11 U.S.C. § 101*, as amended by Pub. L. No. 109-8 (2005), effective with respect to cases filed on or after October 17, 2005. *See P 6.03[1] supra.*

(n48)Footnote 48. *Anderson v. Wendt (In re Wendt)*, 381 B.R. 217 (S.D. Tex. 2007) (alimony payments avoided as preferences resulted in new claim that was for alimony; court did not discuss fact that claim for property recovered under avoiding powers arises under § 502(h) or the wording of that provision).