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From the Bankruptcy Courts

*Benjamin Weintraub** and *Alan N. Resnick***

A SECURED CREDITOR'S RIGHT TO FUNDS RECEIVED BY A TRUSTEE IN SETTLEMENT OF AN ACTION TO AVOID A FRAUDULENT TRANSFER OF COLLATERAL

One of the primary duties of a trustee in a chapter 7 liquidation case is to "collect and reduce to money the property of the estate for which such trustee serves."¹ This function may be comparatively easy when the trustee comes into possession of *tangible* property that the debtor owned when the petition was filed. However, although the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case,"² the scope of the estate goes beyond these property interests. The United States Code also includes, in the estate, property recovered

by the trustee pursuant to one of the so-called avoiding powers.³ These powers enable the trustee to avoid certain transfers and to set aside certain liens.⁴

Fraudulent Transfer of Encumbered Assets

In the trustee's effort to recover property using one of the avoiding powers (such as when the trustee attempts to avoid a preference⁵ or fraudulent transfer⁶), it is common for the adversary proceeding against the transferee to be settled with court approval. The result of this settlement is that the transferee retains the property transferred but pays part of its value to the trustee in cash. Another common situation is where the property that was fraudulently conveyed prior to bankruptcy is subject to a perfected security interest or other lien in an amount that is less than the value of the property transferred. If the trustee receives a cash settlement in a fraudulent-conveyance action

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¹ 11 U.S.C. § 704(1).

² 11 U.S.C. § 541(a)(1).

³ See 11 U.S.C. § 541(a)(3).

⁴ See B. Weintraub & A. Resnick, *Bankruptcy Law Manual* ch. 7 ("The Trustee's Powers") (rev. ed. 1986).

⁵ See 11 U.S.C. § 547.

⁶ See 11 U.S.C. § 548.

involving the fraudulent transfer of assets that are encumbered by a secured creditor's lien, does the lien attach to the settlement proceeds? The answer to this question is found in the recent case of *In re Figearo*,⁷ in which a secured creditor sought a determination of the nature and extent of a lien on money in the possession of the chapter 7 trustee. The money represented the amount received by the trustee from the compromise of a fraudulent-conveyance action involving a prepetition transfer of the debtor's inventory.

In re Figearo

The debtor operated a jewelry business and granted a security interest in his jewelry inventory to a creditor, Steven Haley, on January 17, 1985. The security agreement contained a broad after-acquired property clause and included as collateral all proceeds of the inventory. Subsequently, but prior to filing a bankruptcy petition, the debtor transferred a significant portion of his inventory to Pacific Pawnbrokers, Inc.

In the debtor's chapter 7 case, the trustee commenced an adversary proceeding against Pacific, alleging that the transfer of inventory was a fraudulent conveyance avoidable under Section 548 of the Bankruptcy Code. Specifically,

the trustee claimed that, within one year prior to bankruptcy, the debtor transferred property worth \$20,000 to Pacific but received only \$1,200 as consideration. The suit was settled for \$2,500, and the compromise was approved by the court.

Haley, who held the security interest in the debtor's inventory and filed a proof of claim in the amount of \$7,342, claimed that the \$2,500 received by the trustee in settlement of the fraudulent-conveyance action was subject to his security interest because it constituted proceeds from the sale or other disposition of the collateral. The trustee took the position that the money was derived from the compromise and did not constitute property or proceeds to which Haley's security interest could attach.

Haley argued that the transfer to Pacific was a violation of Article 6 of the Uniform Commercial Code governing bulk sales, as well as a violation of the Uniform Fraudulent Conveyance Act adopted in the state of Nevada. Thus, under state law Haley could have avoided the transfer of inventory. Haley concluded that since he could have obtained this remedy under state law but was precluded from doing so postpetition because of the automatic stay,⁸ any recovery by the trustee

⁷ 79 Bankr. 914 (Bankr. D. Nev. 1987).

⁸ Any recovery by the trustee would have been property of the state under

in a similar action should accrue to his benefit.

Analyzing several cases that had addressed the issue whether the recovery of property by the estate through the trustee's avoiding powers remained subject to a prepetition security interest, the court found that the majority of cases held in favor of the secured creditor. Among the cases cited, *In re Mid-Atlantic Piping of Charlotte*⁹ held that since the creditor's security interest extended to the property preferentially transferred by the debtor, any recovery by the trustee in the preference litigation would be subject to the security interest. However, at least one court has held against the secured creditor. In *In re Integrated Testing Products Corp.*,¹⁰ the court held that since the secured creditor did not have any security interest in the trustee's right to recover preferences under state law, it had no security interest in the funds recovered by the trustee in the preference litigation.

Postpetition Effect of Security Interest

Following the approach taken in *Integrated Testing*, the bankruptcy court in *Figeafo* began its analysis with Section 552 of the Bankruptcy Code, which governs the postpetition effect of a security interest. Section 552(a) contains the general rule that "property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case."¹¹ This provision is designed to limit the effect of after-acquired property clauses in prepetition security agreements so that property acquired postpetition may be obtained free of the lien. Section 552(b) contains an important exception, however, that continues the security interest in postpetition "proceeds, product, offspring, rents, or profits" of prepetition collateral to the extent provided in the security agreement and by applicable nonbankruptcy law, "except to any extent that the court, after notice and a hearing based on the equities of the case, orders otherwise."¹²

§ 541(a)(3). Therefore, any postpetition attempt by Haley to set aside the transfer or foreclose on the property was automatically stayed when the debtor filed a bankruptcy petition. See 11 U.S.C. §§ 362(a)(3) 362(a)(4).

⁹ 24 Bankr. 314 (Bankr. W.D.N.C. 1982); *In re Cambria Clover Mercantile Co.*, 51 Bankr. 983, 986 (Bankr. E.D. Pa. 1985); *In re Lively*, 74 Bankr. 238 (Bankr. S.D. Ga. 1987).

¹⁰ 69 Bankr. 901 (Bankr. D.N.J. 1987).

¹¹ 11 U.S.C. § 552(a).

¹² 11 U.S.C. § 552(b).

Does Right to Avoid Constitute "Proceeds"?

Applying Section 552 to the facts of the case, the court focused on two legal issues. The first issue was whether the trustee's right to avoid the transfer under the trustee's avoiding powers constitutes "proceeds" of the inventory as provided in the security agreement and applicable nonbankruptcy law. Consistent with the holding in *Integrated Testing*, the court in *Figearo* held that the trustee's right of recovery in the fraudulent-conveyance action was not "proceeds" of the inventory so that Section 552(b) did not help the secured creditor's position. "Proceeds" are defined in the Uniform Commercial Code as "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds."¹³ The UCC divides proceeds into two categories: Money, checks, deposit accounts, etc., are "cash proceeds," and all other forms are "noncash proceeds."

Although it is arguable that the trustee's right to avoid the transfer to Pacific constituted noncash proceeds, the court held that the trustee's cause of action was not proceeds at all. The court reasoned that the trustee's right to set aside the transfer was first created on the filing of the bank-

ruptcy petition, not at the time of the prepetition transfer of inventory to Pacific. Moreover, the trustee is generally the only party in interest with standing to pursue these rights. The court stated: "Although the trustee's rights are dependent on the nature of the transfer, they are not received upon the sale, exchange, collection or other disposition of collateral or proceeds."¹⁴ Accordingly, the trustee's right to set aside the fraudulent conveyance could not be considered proceeds of the inventory, and Section 552(b) did not extend Haley's lien to the right to set aside and recover property based on the trustee's avoiding powers.

Was Recovered Property Subject to Security Interest?

The second issue facing the court was whether any property recovered by the trustee under the avoiding powers remained subject to a security interest that was enforceable against the transferee of the avoided transfer. The court recognized that Haley's lien continued in the inventory items after the transfer to Pacific pursuant to Article 9 (secured transactions) as well as Article 6 (bulk transfers) of the Uniform Commercial Code.¹⁵

¹⁴ 79 Bankr. at 917.

¹⁵ See U.S.C. §§ 6-104, 9-306(2), 9-307. The security agreement contained restrictions on the sale or disposition of the collateral, and the sale to Pacific was not in the ordinary course of business.

¹³ The court quoted from Nev. Rev. Stat. § 104-.9306(1).

In addition to holding inventory subject to Haley's security interest, however, Pacific also was liable to the trustee as the initial transferee of fraudulently conveyed assets. Section 550(a) provides that the trustee may recover "for the benefit of the estate," the property transferred or, if the court so orders, the value of this property from the initial transferee.¹⁶

The key language in Section 550(a), "for the benefit of the estate," derives from the Supreme Court's decision in *Moore v. Bay*.¹⁷ As the court in *Figearo* observed:

The law established in *Moore* is well settled, and has been clearly incorporated into the Bankruptcy Code. Without question, any property recovered by the trustee as a result of an avoided transfer must be distributed to creditors in their order of priority to the extent the estate has equity in the property recovered.¹⁸

The court found that the trustee's recovery under Section 550(a) did not extinguish Haley's security interest in the collateral in Pacific's possession. But does the lien attach to the money received by the trustee in settlement

of the fraudulent conveyance action? The court examined the letter and spirit of Section 552(a) to find the answer to this problem:

As previously stated, the purpose of 11 U.S.C. § 552(a) is to avoid the postpetition application of an otherwise valid after-acquired property clause in a security agreement. The statute allows the estate to acquire new property with estate assets free of the security interest. Applying § 552(a) to avoid a security interest in property recovered through the trustee's avoiding powers appears to go beyond what the statute was designed to accomplish. In any event, the crucial question is whether the avoidance of a fraudulent transfer under 11 U.S.C. § 548 and recovery of the property under 11 U.S.C. § 550 constitutes an acquisition of property by the estate within the meaning of 11 U.S.C. § 552(a).¹⁹

The court concluded that the avoidance and recovery by the trustee was not a postpetition acquisition of property within the meaning of Section 552(a). Instead, the estate's interest in the transferred inventory existed immediately on the filing of the bankruptcy petition. Pacific merely held voidable title, and the trustee's exercise of the avoiding power under Section 548 caused the transfer to become void. Moreover, any property recovered by the trustee was subject to

¹⁶ 11 U.S.C. § 550(a).

¹⁷ 284 U.S. 4 (1931); see Weintraub & Resnick, note 4 *supra*, ¶ 7.03, at 7-10 ("[T]he transfer is avoided by the trustee for the benefit of the estate—not of the actual creditor.").

¹⁸ 79 Bankr. at 918.

¹⁹ *Id.*

Haley's lien both before and after the fraudulent conveyance to Pacific. The court stated: "Were the trustee to recover the property from Pacific free of any prepetition encumbrances, he would recover a greater interest in the property than that held by Pacific or the debtor prior to the transfer."²⁰ Therefore, based on the interpretation of Sections 550 and 552, the court held in favor of the secured creditor:

Having found that Haley's security interest does not attach to the trustee's right to set aside a fraudulent transfer but does attach to the recovered property, the court concludes that the funds held by the trustee as a result of the compromise of the fraudulent conveyance litigation is subject to Haley's security interest.²¹

Conclusion

The method of analysis and result reached in *Figearo* are consistent with the Code's general policy of recognizing the validity of prepetition security interests in collateral owned by the debtor prior to bankruptcy.²² Clearly, Haley's lien continued in the inventory after it was transferred to Pacific. If the same inventory was recovered by the trustee postpetition, there would be no justifica-

tion for depriving Haley of its security interest in that collateral. In fact, Haley's security interest was not avoidable under any of the trustee's powers. In *Figearo*, however, the trustee did not recover the inventory but instead received a money settlement. Although, technically, these funds did not constitute "proceeds" of the inventory within the meaning of Section 552(b), it was important to treat such money as if it were merely a substitute for the inventory; otherwise, it would allow a trustee to defeat the rights of a secured creditor by accepting a monetary settlement in lieu of recovering the actual collateral.

Despite the soundness of the decision, a problem ignored in the case is worthy of comment. The trustee incurred counsel fees in suing Pacific and obtaining the compromise. Yet, no mention of reimbursement of these expenses appeared in the decision. Should these expenses not have been charged against the settlement, since obviously the action and settlement inured to the benefit of the secured creditor? Because of the security interest, the trustee could have sought abandonment of the lawsuit, since the recovery was inconsequential to the estate.²³ Absent this suit by the trustee, the

²⁰ *Id.*

²¹ *Id.*

²² See, e.g., 11 U.S.C. § 506(a).

²³ See 11 U.S.C. § 554, which authorizes the abandonment of "any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate."

secured creditor would be left to his own resources (i.e., seeking permission from the court to modify the automatic stay to allow Haley to sue Pacific and then the institution of a foreclosure action in a federal or state court). In view of the Code's policy of allowing the trustee to recover expenses

incurred in preserving collateral for the benefit of a secured creditor, as expressed in Section 506(c), the trustee should recover legal expenses from the settlement funds.²⁴

²⁴ 11 U.S.C. § 506(c).