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Finding the Shoes that Fit: How Derivative is the Trustee's Power to Avoid Fraudulent Conveyances under Section 544(b) of the Bankruptcy Code

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FINDING THE SHOES THAT FIT: HOW DERIVATIVE IS THE TRUSTEE'S POWER TO AVOID FRAUDULENT CONVEYANCES UNDER SECTION 544(b) OF THE BANKRUPTCY CODE?

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ABSTRACT

Section 544(b) of the Bankruptcy Code, which enables a bankruptcy trustee to avoid transfers that an actual unsecured creditor could have avoided under state law, is a powerful tool most often used to recover assets that were fraudulently transferred several years before a debtor's bankruptcy case. This power is often described as permitting the trustee, for the benefit of the bankruptcy estate and all of the debtor's unsecured creditors, to "stand in the shoes" and assert the rights of the particular unsecured creditor. In a recent case, In re Allou Distributors, Inc., *the Bankruptcy Court for the Eastern District of New York held that a Chapter 7 trustee, acting under § 544(b), could avoid a transfer of assets, if made by an insolvent debtor for less than fair consideration, by relying on the rights of an actual unsecured creditor that held a claim both on the date of the transfer and on the date of the commencement of the bankruptcy case, even if the claim was not the same on both dates and the earlier claim had been paid in full before bankruptcy. This decision raises important questions regarding the derivative nature of § 544(b) and could have far-reaching implications with respect to the scope of a bankruptcy trustee's power to recover fraudulently conveyed assets. The court's reasoning has the potential of expanding the trustee's powers beyond the power of any actual creditor at the time of bankruptcy, thus departing from the derivative nature of § 544(b). At the same time, by not linking the trustee's powers under § 544(b) to the rights of future creditors under applicable state fraudulent conveyance statutes, the decision has the potential of narrowing the trustee's avoidance powers in certain situations. The* Allou Distributors *decision and its potential application to other cases highlight the importance of understanding the relationship of federal and state law, the derivative nature of § 544(b), and the provisions of applicable state fraudulent conveyance statutes.*

INTRODUCTION

When a bankruptcy case is commenced, the Bankruptcy Code gives the trustee certain rights and powers that enable the trustee to maximize the value of the bankruptcy estate for the benefit of the debtor's unsecured creditors. For example, the Bankruptcy Code gives the trustee the power to recover preferential payments made to creditors on the eve of bankruptcy,[1] and to avoid unperfected security interests and unrecorded real estate mortgages.[2] In a Chapter 11 case, these rights and powers may be exercised by the debtor in possession.[3]

One of the trustee's powers is based on § 544(b) of the Bankruptcy Code, which gives the trustee the power to avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable nonbankruptcy law, typically, state law, by an actual, existing creditor holding an allowable unsecured claim.[4] Consistent with the trustee's role in representing the interests of unsecured creditors, this power enables the trustee to avoid a transfer of property or an obligation that, in the absence of bankruptcy, at least one of the debtor's actual unsecured creditors with a claim allowed in the bankruptcy case could have avoided under applicable state or federal law.[5] This power is derivative; the trustee has the power to avoid a transfer or obligation under § 544(b) only if an actual creditor would have had that right outside of bankruptcy.[6] When exercising its powers under § 544(b), the trustee must identify that creditor or class of creditors on whose rights the trustee is depending, sometimes referred to as the "triggering creditor."[7]

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1 11 U.S.C. § 547 (2006).

2 11 U.S.C. § 544(a) (2006).

3 11 U.S.C. § 1107(a) (2006).

4 11 U.S.C. § 544(b) (2006); *see also* 11 U.S.C. § 502 (2006) (on the allowance of claims).

5 *See* 5 COLLIER ON BANKRUPTCY ¶ 544.02 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. 2009).

6 *Id.* at ¶ 544.02[2].

7 *See, e.g.*, MC Asset Recovery, LLC v. S. Co., No. 06-0417, 2006 WL 5112612, at *3, 2006 U.S. Dist. LEXIS 97034, at *9 (N.D. Ga. Dec. 11, 2006) ("[I]n order to maintain an avoidance action under § 544(b), a trustee must demonstrate the existence of a so-called 'golden' or 'triggering' creditor: (1) an unsecured creditor, (2) who holds an allowable unsecured claim under section 502, and (3) who could avoid the transfers at issue under applicable (i.e., state) law."); Schaps v. Bally's Park Place, Inc., 58 B.R. 581, 584 (E.D. Pa. 1986) ("[A] prerequisite to a Section 544(b) suit is the existence of an actual creditor holding an unsecured claim who could have avoided the transfer under state law."), *aff'd*, 815 F.2d 693 (3d Cir. 1987); Young v. Paramount Commc'ns Inc. (*In re* Wingspread Corp.), 178 B.R. 938, 946 (Bankr. S.D.N.Y. 1995)

In addition to § 544(b) avoidance powers, the Bankruptcy Code provides another avenue by which the trustee can recover fraudulently conveyed property or avoid a fraudulent obligation. Under § 548 of the Bankruptcy Code, the trustee may avoid a fraudulent conveyance or obligation that was made or incurred within two years before the commencement of the bankruptcy case.[8] Unlike § 544(b), to use the avoidance power under § 548, the trustee need not identify any actual creditor that could have avoided the transfer outside of bankruptcy. That is, the power to avoid a fraudulent conveyance under § 548 does not derive from the power of any particular creditor of the debtor. In fact, even if no actual creditor could have avoided the transfer outside of bankruptcy at the time the case was commenced, the trustee nonetheless can avoid the transfer under § 548.[9] However, if a transfer was made or obligation incurred more than two years before a bankruptcy filing, § 548 does not apply and the trustee has to rely on § 544(b).

A. *Section 544(b) of the Bankruptcy Code and State Fraudulent Conveyance Laws*

When the trustee relies on § 544(b) to avoid a fraudulent transfer or obligation, he or she must base the avoidance action on state or nonbankruptcy federal law that enables an unsecured creditor to avoid such a transfer or obligation.[10] Most commonly, § 544(b) is used by trustees to avoid transfers and obligations that are avoidable by creditors under the Uniform Fraudulent Transfer Act (UFTA)[11] or the Uniform

("Before a trustee is able to utilize applicable state or federal law referred to in Section 544(b), there must be an allegation and ultimately a proof of the existence of at least one unsecured creditor of the Debtor who at the time the transfer occurred, could have, under applicable local law, attacked and set aside the transfer under consideration.") (quoting *In re* Smith, 120 B.R. 588, 590 (Bankr. M.D. Fla. 1990)). Some courts have held, however, that it is not necessary for the trustee to identify the creditor by name in the complaint, although the trustee has the burden of proof to demonstrate that such a creditor exists if challenged. *See, e.g.*, Guiliano v. U.S. Nursing Corp. (*In re* Lexington Healthcare Group, Inc.), 339 B.R. 570, 576 (Bankr. D. Del. 2006).

8 11 U.S.C. § 548(a) (2006). In bankruptcy cases commenced before April 21, 2006, the applicable period is one year. This period was changed to two years by section 1402(1) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005). Section 1406(b)(2) of that act provides that the change from one to two years shall be effective only with respect to bankruptcy cases commenced more than one year after the date of enactment.

9 5 COLLIER ON BANKRUPTCY, *supra* note 5, at ¶ 548.01[1].

10 11 U.S.C. § 544(b) (2006).

11 Drafted and approved by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1984. Some states have adopted the UFTA with local variations. *See, e.g.*, CAL. CIV. CODE §§ 3439-3449 (Deering 2008); D.C. CODE ANN. §§ 28-3101-3111 (LexisNexis 2009); N.J. STAT. ANN. §§ 25:2-20-25:2-34 (West 2009); 12 PA. CONS. STAT. §§ 5101-5110 (2008); TENN. CODE ANN. §§ 66-3-301-66-3-313 (2009); PETER A. ALCES, THE LAW OF FRAUDULENT TRANSACTIONS § 1:15 (Thomson/West 2006).

Fraudulent Conveyance Act (UFCA),[12] which are uniform statutes proposed by the National Conference of Commissioners on Uniform State Laws and recommended for state adoption. The majority of states have enacted the UFTA.[13] A minority of states, including New York[14] and Maryland,[15] still follow the older UFCA, and a few states have non-uniform statutes.[16] Both the UFTA and the UFCA recognize two types of fraudulent conveyances: actual fraud and constructive fraud.[17]

Under the actual fraud prong of the UFTA and the UFCA, a transfer or obligation is fraudulent when it is made or incurred with "actual intent" to "hinder, delay or defraud" creditors of the debtor.[18] The debtor's state of mind must be examined to determine the motivation for the transfer. Though it may be relevant to the debtor's motivation, the debtor's solvency at the time of the transfer is not a defense.[19] An example of a fraudulent conveyance with actual intent to hinder, delay, or defraud creditors is when a debtor, while unable to pay debts as they mature and worried about financial difficulties, gives assets to friends and relatives for the purpose of putting them out of the reach of creditors. Section 4 of the UFTA lists a number of factors or "badges of fraud," as they are commonly referred to by the courts, that may be considered in determining actual intent to defraud creditors.[20] Such considerations include whether:

(1) the transfer or obligation was to an insider;

(2) the debtor retained possession or control of the property transferred after the transfer;

(3) the transfer or obligation was disclosed or concealed;

(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

(5) the transfer was of substantially all the debtor's assets;

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12 The Uniform Fraudulent Conveyance Act was approved by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in 1918. Some states have adopted the UFCA with local variations. *See, e.g.*, MD. CODE ANN., COM. LAW §§ 15:201-214 (West 2008); N.Y. C.P.L.R. 270-281 (McKinney Supp. 2009); S.C. CODE ANN. §§ 27-23-10-27-23-40 (2007); V.I. CODE ANN. tit. 28, §§ 201-212 (2009); ALCES, *supra* note 11, at § 1:14.

13 Forty-three states and the District of Columbia have adopted the UFTA. *See A Few Facts About the... Uniform Fraudulent Transfer Act*, UNIFORM LAW COMMISSIONERS: THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ufta.asp.

14 N.Y. C.P.L.R. 270-281 (McKinney Supp. 2009).

15 MD. CODE ANN., COM. LAW §§ 15:201-214 (West 2008).

16 *See* VA. CODE ANN. § 55-80 (West 2009); S.C. CODE ANN. § 27-23-40 (2007).

17 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 548.01[2]-[4].

18 *See* U.F.T.A. § 4 (1984); U.F.C.A. § 7 (1918).

19 United States v. Green, 201 F.3d. 251, 256 (3d Cir. 2000); Nisselson v. Ford Motor Co. (*In re* Monahan Ford Corp. of Flushing), 340 B.R. 1, 38 (Bankr. E.D.N.Y. 2006).

20 U.F.T.A. § 4(b) and cmt. 5 (1984); *see also* Sullivan v. Messer (*In re* Corcoran), 246 B.R. 152, 161 (E.D.N.Y 2000).

(6) the debtor absconded;

(7) the debtor removed or concealed assets;

(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.[21]

A constructive fraudulent conveyance is one that is not predicated on the debtor's intentions or motivations, but is based on the debtor's transfer of assets for less than reasonably equivalent value while experiencing a poor financial condition. In particular, under the UFTA, a transfer for less than reasonably equivalent value is a fraudulent conveyance if (a) the debtor was insolvent at the time of the transfer, (b) the debtor was engaged or was about to engage in a business or transaction for which the remaining assets were unreasonably small in relation to the business or transaction, or (c) the debtor intended to incur, or believed or reasonably should have believed that it would incur, debts beyond its ability to pay as such debts become due.[22] The UFCA has similar provisions with respect to constructive fraudulent conveyances.[23]

B. *Fraudulent Conveyances as Against Present and Future Creditors*

State law distinguishes between those transfers and obligations that are fraudulent as to present creditors only, and those that are fraudulent as to present and future creditors. Under both the UFTA and the UFCA, a transfer made with actual intent to hinder, delay, or defraud any creditor of the debtor is a fraud on both present and future creditors.[24] Therefore, if a debtor makes a transfer with the intent of putting assets out of the reach of creditors, a future creditor whose claim did not exist when the transfer was made would have standing to bring a fraudulent

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[21] U.F.T.A. § 4(b) and cmt. 5 (1984).

[22] U.F.T.A. §§ 4(a)(2), 5(a) (1984).

[23] U.F.C.A. §§ 4, 5 (1918). Instead of using the phrase "reasonably equivalent value," as is used in the UFTA and § 548 of the Bankruptcy Code, the UFCA uses the phrase "fair consideration," which is defined in section 3 of the UFCA to mean, in the context of an exchange for property or an obligation, "a fair equivalent thereof, and in good faith . . . ."

[24] U.F.T.A. § 4 (1984); U.F.C.A. §§ 5, 6 (1918).

conveyance action to avoid the transfer and recover the assets from the transferee.[25]

The UFTA and UFCA also give future creditors standing to avoid a constructive fraudulent conveyance, but only if the action is based on the debtor's receipt of less than reasonably equivalent value for the transferred property when the debtor was left with unreasonably small capital or when the debtor intended or believed it would incur debts beyond its ability to pay as they mature.[26] If the claim of constructive fraudulent conveyance is based on the insolvency of the debtor, it is a fraud only against existing creditors. A future creditor does not have the right to bring a fraudulent conveyance claim based on the allegation that the debtor received less than reasonably equivalent value in connection with the transfer and was insolvent or rendered insolvent by the transfer.

The distinction between those transfers and obligations that are fraudulent as to only present creditors, and those that are fraudulent as to both present and future creditors, is also significant with respect to the application of § 544(b) of the Bankruptcy Code. If the basis for a constructive fraudulent conveyance is that the debtor had unreasonably small capital when it transferred property for less than reasonably equivalent value, it would be relatively easy for the trustee to identify an actual creditor with an allowable unsecured claim who could avoid the transfer under state law. Any unsecured creditor with an allowable claim in the bankruptcy case that existed at the time of the bankruptcy filing could be the triggering creditor because the transfer was a fraud on both present and future creditors. It would not be necessary for the claim of the triggering creditor to have been in existence at the time of the fraudulent transfer. But if the basis for the fraudulent conveyance claim is that the debtor was insolvent when it transferred property for

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[25] *Shelly v. Doe*, 660 N.Y.S.2d 937, 943, 173 Misc. 2d 200, 208 (St. Lawrence County Ct. 1997) ("[A] creditor has standing to maintain an action to set aside a fraudulent transfer . . . even though his debt may not have been in existence at the time of the transfer."), *aff'd*, 671 N.Y.S. 2d 803, 249 A.D. 2d 756 (App. Div. 3d Dep't 1998). Section 7 of the UFTA lists remedies available to creditors. Under section 7, a creditor can obtain (a) avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim; (b) an attachment or other provisional remedy against the asset transferred or other property of the transferee in accordance with the procedure described by relevant statute; (c) an injunction against further disposition by the debtor or a transferee, or both, of the asset transferred or of other property; (d) appointment of a receiver to take charge of the asset transferred or of other property of the transferee; or (e) any other relief the circumstances may require. Section 7 of the UFTA derives from sections 9 and 10 of the UFCA which provides for substantially the same remedies but splits them up in remedies of holders or matured claims and remedies of holders of unmatured claims. A creditor holding an unmatured claim may be denied the right to receive payment for the proceeds of a sale on execution until its claim has matured, but the proceeds may be deposited in court or in an interest bearing account pending the maturity of the claim.

[26] U.F.T.A. § 4 (1984); U.F.C.A. §§ 5, 6 (1918); *Shelly*, 660 N.Y.S.2d at 944, 173 Misc. 2d at 210 (interpreting New York's fraudulent conveyance law based on the UFCA).

less than reasonably equivalent value, and the transfer occurred more than two years before the bankruptcy filing, in order to avoid the transfer under § 544(b) and state law, the trustee would have to identify a "present" unsecured creditor whose claim existed at the time of the transfer and whose claim is also in existence and allowable at the time of the bankruptcy filing.

Because the rights of future creditors depend on the debtor's financial state—whether it was insolvent, undercapitalized, or believed it would incur debts beyond its ability to pay—it is important to understand the differences between these financial conditions.

The concept of insolvency has been defined in different ways, depending on the governing statutory authority. Insolvency is sometimes defined in a manner that compares the value of assets to the total amount of liabilities, often referred to as insolvency in the "bankruptcy sense." For example, § 101(32)(A) of the Bankruptcy Code defines "insolvency" to mean "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation . . . ."[27] Under that definition, cash flow insufficiency or inability to pay debts is irrelevant. In other statutory schemes, insolvency includes the inability to pay debts as they mature, which is commonly referred to as insolvency in the "equity sense."[28] For example, the Uniform Commercial Code provides that "a person is insolvent who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning of the federal bankruptcy law."[29]

Both the UFCA and the UFTA also define insolvency. Under the UFCA, "[a] person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."[30] Courts have characterized this definition as including both insolvency in the bankruptcy sense (deficit net worth) and in the equity sense (inability to pay debts as they mature).[31] If the debtor's assets could be sold for a sum that is sufficient to pay its debts when due, the

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[27] 11 U.S.C. § 101(32)(A) (2006). Assets excluded from this definition include exempt property under § 522 of the Bankruptcy Code and property transferred, concealed, or removed with intent to hinder, delay, or defraud creditors. In addition, separate insolvency definitions are provided in § 101(32)(A) for partnerships and municipalities.

[28] *See, e.g.*, Langham, Langston & Burnett v. Blanchard, 246 F.2d 529, 531-32 (5th Cir. 1957) (distinguishing the meaning of "insolvency" under the Bankruptcy Act from the equity test of insolvency).

[29] U.C.C. § 1-201(23) (2003).

[30] U.F.C.A. § 2(1) (1918). A separate definition of "insolvent" is provided for partnerships. *See* U.F.C.A. § 2(2) (1918).

[31] *See, e.g.*, Moody v. Sec. Pac. Bus. Credit Inc., 971 F.2d 1056, 1066 (3d Cir. 1992) (citing Larrimer v. Feeney, 192 A.2d 351, 353, 411 Pa. 604, 607 (1963)); *see also* ALCES, *supra* note 11, at § 5:59.

debtor is solvent.[32] The UFTA also defines insolvency by combining the bankruptcy and equity sense. First, it provides that "[a] debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets, at a fair valuation."[33] However, the UFTA also provides that "[a] debtor who is generally not paying his (or her) debts as they become due is presumed to be insolvent."[34]

In contrast to the definitions of "insolvency" included in the UFCA and UFTA, there is no definition for the concept of unreasonably small capital, and courts differ on what they require to meet that financial standard. Some courts require a showing of "something more than insolvency or inability to pay debts"; a transaction leaving the debtor with unreasonably small capital must place it on the "road to ruin".[35] Other courts have construed unreasonably small capital as a financial condition that is short of insolvency in both the bankruptcy and equity sense, but that is likely to lead to or result in insolvency in the near term.[36] The Court of Appeals for the Third Circuit, in *Moody v. Security Pacific Business Credit Inc.*,[37] commented that "unreasonably small capital" refers to the inability to generate sufficient profits to sustain operations. "Because an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable solvency."[38] Accordingly, the Third Circuit held that reasonable capitalization is determined by the reasonable foreseeability of future profits, and that the critical test is whether, at the time of the alleged fraudulent transfer, the debtor's financial projections showing future profitability were reasonable.

In a typical case, it is easier for a trustee to pursue fraudulent transfers under the provisions of the UFTA or UFCA that require a showing of insolvency, a well-defined concept, in contrast to those provisions that require proof of undercapitalization or an intention or belief that the debtor would incur debts beyond the ability to pay.[39]

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32 For example, in *Moody*, 971 F.2d at 1066, the court found that the debtor was solvent under the UFCA definition because it could have sold its assets as a going concern for at least $26.2 million to $27.2 million, and the company's liabilities totaled $25.2 million.

33 U.F.T.A. § 2(a) (1984).

34 U.F.T.A. § 2(b) (1984).

35 Daley v. Chang (*In re* Joy Recovery Tech. Corp.), 286 B.R. 54, 76 (Bankr. N.D. Ill. 2002) ("[T]he trustee must show something more than a deteriorated balance sheet . . . or that [the debtor] had difficulty paying its trade creditors.").

36 Vadnais Lumber Supply, Inc. v. Byrne (*In re* Vadnais Lumber Supply, Inc.), 100 B.R. 127, 137 (Bankr. D. Mass. 1989).

37 *Moody*, 971 F.2d at 1070.

38 *Id.* at 1070.

39 Dan Schechter, *"Triggering Creditor" for Purposes of Trustee's Fraudulent Transfer Claim Need Not Hold Same Claim on Transfer Date and Petition Date [In re Allou Distribs., Inc. (Bankr. E.D.N.Y.)]*, 2008 COM. FIN. NEWSLETTER 76 (Sept. 8, 2008).

C. *The Derivative Nature of § 544(b) and Available Defenses Under State Law*

As discussed above, a bankruptcy trustee may use § 544(b) to avoid a fraudulent conveyance if there exists an actual unsecured creditor with an allowable claim against the bankruptcy estate, but only if that creditor, under state law, could have avoided the transfer in the absence of bankruptcy. In essence, the trustee must stand in the shoes of that actual creditor. It naturally follows, therefore, that if the transferee of the property would have a valid defense in a state fraudulent conveyance case brought by the actual creditor, the trustee would be subject to the same defense.[40] For example, if the triggering creditor is estopped from bringing a fraudulent conveyance claim, the trustee would be subject to the same estoppel defense.[41] Similarly, if the applicable statute of limitations had expired before the bankruptcy petition was filed, the trustee's action under § 544(b) would be subject to the same statute of limitations defense.[42] In states that have enacted the UFTA, the statute provides that any claim under the UFTA is "extinguished" unless it is brought within a specified time period, which is generally four years after the transfer was made or obligation was incurred.[43] The UFCA does not have any uniform statute of limitations or period of extinguishment of the claim, but each state governed by the UFCA has its own limitations period. In New York, that period is six years.[44]

There is one exception to the general rule that under § 544(b) the trustee has no better rights than the actual creditor on whose rights the trustee is depending. Suppose that a debtor, while insolvent, gave her brother a gift of $50,000 to help him cope with his own financial difficulties resulting from unexpected medical expenses. Also, suppose

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[40] *See, e.g.*, Davis v. Willey, 263 F. 588, 589 (N.D. Cal. 1920), *aff'd*, 273 F. 397 (9th Cir. 1921); Smith v. Am. Founders Fin. Corp., 365 B.R. 647, 659 (S.D. Tex. 2007); 5 COLLIER ON BANKRUPTCY, *supra* note 5, at ¶ 544.07[3].

[41] Harris v. Huff (*In re* Huff), 160 B.R. 256, 261 (Bankr. M.D. Ga. 1993).

[42] Heffron v. Duggins, 115 F.2d 519, 520 (9th Cir. 1940); *see also* 5 COLLIER ON BANKRUPTCY, *supra* note 5, at ¶ 544.07[3]. *But see* 11 U.S.C. § 546(a) (2006) (imposing a time limit for the trustee to commence an action to avoid a transfer or obligation under the trustee's avoiding powers, including actions brought under § 544(b)). Section 546(a) does not, however, extend the applicable statute of limitations under state fraudulent conveyance law if it had expired before the filing of the bankruptcy petition.

[43] U.F.T.A. § 9 (1984). Section 9 of the UFTA includes a few exceptions to the general four-year period with respect to the extinguishment of the claim. The period for bringing claims under section 4(a)(1) (actual fraud) is four years after the transfer was made or, if later, one year after the transfer was or could reasonably be discovered by the claimant. In addition, the period for commencing an action based on the fraudulent transfer by an insider under UFTA section 5(b) is one year after the transfer was made.

[44] N.Y. C.P.L.R. 213 (McKinney Supp. 2009).

that all of her creditors are subsequently paid in full, except for one unsecured creditor owed $2,000 at the time of the gift. The gift was not made with the intent to hinder, delay, or defraud the debtor's creditors; instead, it was motivated by a desire to help the debtor's brother. But the gift was a constructive fraudulent conveyance because, while insolvent, the debtor made the gift, of course, for less than reasonably equivalent value. Under the UFTA or the UFCA, that creditor could have recovered no more than $2,000 from the debtor's brother, the transferee of the fraudulent conveyance. Clearly, state law would not, and should not, give a creditor owed only $2,000 a windfall by enabling the creditor to recover fraudulently conveyed assets worth more than the debt owed to that creditor. Moreover, if the trustee can prove the insolvency of the debtor at the time of the transfer, but cannot demonstrate that she had unreasonably small capital for any business or contemplated transaction, or that she intended to incur, or believed that she would incur, debts beyond her ability to pay as they mature, the transfer would not be avoidable by any creditors whose claims arose after the date of the making of the gift. Thus, the only creditor with the ability to avoid the gift is the one unsecured creditor owed only $2,000.

If the debtor files a bankruptcy petition three years after the gift, § 548 of the Bankruptcy Code would not be available to the trustee because the transfer occurred more than two years before bankruptcy.[45] However, if the trustee relies on § 544(b) and state law to avoid the transfer to the debtor's brother, the trustee may recover the entire $50,000 fraudulent conveyance notwithstanding that the only creditor with standing to prosecute a fraudulent conveyance action outside of bankruptcy is owed only $2,000. This doctrine, which is often referred to as the doctrine of *Moore v. Bay*[46] because of the Supreme Court decision on which it is based, permits the bankruptcy trustee to stand in the "overshoes" of the actual creditor to recover the entire fraudulent conveyance for the benefit of all creditors even though the only actual creditor who could have avoided it under state law is owed only a fraction of that amount.[47] Thus, although the trustee's power under § 544(b) derives only from the power of an actual unsecured creditor who could have avoided the transfer outside of bankruptcy, the trustee may recover far more than that creditor could have recovered.[48]

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[45] 11 U.S.C. § 548(a).

[46] Moore v. Bay, 284 U.S. 4 (1931).

[47] *Id.*; *see also* 5 COLLIER ON BANKRUPTCY, *supra* note 5, at ¶544.07[4].

[48] Acequia, Inc. v. Clinton (*In re* Acequia, Inc.), 34 F.3d 800, 809-10 (9th Cir. 1994); *see also* Abramson v. Boedeker, 379 F.2d 741, 749 n.16 (5th Cir. 1967).

I. *IN RE ALLOU DISTRIBUTORS, INC.* AND THE DERIVATIVE NATURE OF § 544(b)

Allou Distributors, Inc., and several of its affiliates were engaged in the business of distributing brand name health and beauty aid products, fragrances, and other similar items.[49] Allou was in a poor financial condition in 1999. On June 15 of that year, Allou transferred $149,945 by check to Sound Around, Inc., a wholesale supplier of televisions, audio devices, and other electronic equipment.[50] It was undisputed that, at the time of the transfer, each of the relevant Allou entities was insolvent in that the fair saleable value of its assets was less than the sum of its liabilities.[51] In addition, Allou had unreasonably small capital to carry on its business and had incurred debts beyond its ability to pay in a timely manner.[52]

Almost four years later, in April, 2003, the Allou companies became debtors under the Bankruptcy Code when voluntary petitions were filed by certain Allou entities, and involuntary petitions were filed against other Allou entities, each seeking relief under Chapter 11.[53] In September 2003, the Chapter 11 cases were converted to Chapter 7 liquidation cases, and a trustee was appointed to represent the bankruptcy estates.[54] Three months later, the bankruptcy court entered an order substantively consolidating the debtors so that they would be treated as one entity.[55]

In March 2005, the trustee commenced an action against Sound Around asserting actual and constructive fraudulent conveyance causes of action to recover the $149,945 payment made to Sound Around in 1999.[56] Because the alleged fraudulent transfer took place more than one year before the commencement of the bankruptcy case, § 548 of the Code was not available to the trustee.[57] Thus, the trustee resorted to § 544(b) of the Bankruptcy Code and to the state fraudulent conveyance

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49 Amended Complaint, Silverman v. Sound Around, Inc. (*In re* Allou Distribs., Inc.), Adv. Pro. No. 05-08219 (MLC), at 2 (Bankr. E.D.N.Y. Aug. 26, 2005) [hereinafter Amended Complaint, *In re Allou Distribs.*].

50 *Id.* at 6.

51 Silverman v. Sound Around, Inc. (*In re* Allou Distribs., Inc.), 392 B.R. 24, 28 (Bankr. E.D.N.Y. 2008); Amended Complaint, *In re Allou Distribs.*, *supra* note 49, at 8.

52 *In re Allou Distribs.*, 392 B.R. at 28.

53 *Id.* at 27.

54 *Id.*

55 *Id.*

56 *Id.*

57 11 U.S.C. § 548(a). The two-year period in § 548(a) applies only in bankruptcy cases commenced on or after April 21, 2006. In cases filed before April 21, 2006, the period is one year. *See supra* note 11.

laws of New York, which are based on the Uniform Fraudulent Conveyances Act, as the basis for its causes of action.[58]

In particular, the complaint and, later, the amended complaint, alleged that the transfer to Sound Around was for no consideration and did not serve any legitimate corporate purpose.[59] The trustee sought to recover the transferred amount from Sound Around under section 276 of the New York Debtor & Creditor Law, which provides that a transfer made with intent to "hinder, delay, or defraud" creditors is an actual fraudulent conveyance and may be recovered by the transferor's creditors.[60] The other causes of action were for constructive fraudulent conveyances under sections 273, 274, and 275 of the New York Debtor & Creditor Law.[61] The trustee alleged that Allou received less than fair consideration in exchange for the $149,945 paid to Sound Around, and that Allou (a) was insolvent or rendered insolvent by the transfer to Sound Around, (b) was engaged in a business or transaction for which the property remaining in its possession after the transfer was unreasonably small capital, and (c) at the time of the transfer the Debtors had incurred debts beyond its ability to pay as the debts matured.[62] After motions to dismiss were made early in the proceeding, the complaint was amended to remove a demand for punitive damages.[63]

Sound Around filed an answer denying many of the allegations and including an affirmative defense that Sound Around acted in good faith and provided fair consideration to Allou for any funds received.[64] The bankruptcy court tried the matter, after which the trustee withdrew with prejudice his claim based on actual intent to hinder, delay, or defraud creditors, and his requests for interest and attorneys' fees.[65] In a joint pretrial memorandum, the parties stipulated that the transfer occurred and that Allou was insolvent, had unreasonably small capital, and incurred debts beyond its ability to pay as they matured.[66]

At the close of the trustee's case at the trial, Sound Around made an oral motion for judgment dismissing the adversary proceeding on grounds that the trustee lacked standing under § 544(b).[67] The court permitted the trustee to reopen his case to introduce evidence of his standing to prosecute the fraudulent conveyance claims. The trustee

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58 N.Y. DEBT. & CRED. LAW §§ 273-275 (McKinney 2001).

59 Amended Complaint, *In re Allou Distribs.*, *supra* note 49, at 6, 7.

60 N.Y. DEBT. & CRED. LAW § 276 (McKinney 2001).

61 N.Y. DEBT. & CRED. LAW §§ 273-275 (McKinney 2001).

62 Amended Complaint, *In re Allou Distributors, Inc.*, *supra* note 49, at 5-6, 8.

63 Silverman v. Sound Around, Inc. (*In re* Allou Distribs., Inc.), 392 B.R. 24, 27-28 (Bankr. E.D.N.Y. 2008).

64 *Id.* at 28.

65 *Id.*

66 *Id.* at 28-29.

67 *Id.* at 28.

introduced evidence that, at the time of the $149,945 payment to Sound Around in 1999, Allou had three trade creditors with outstanding claims arising from the delivery of goods to Allou.[68] Within a month after the Sound Around transfer, the three trade creditors were paid in full. More than two years later, each of the same three trade creditors again extended credit to Allou, and those claims remained unpaid when, in 2003, Allou became a debtor in a bankruptcy case. The three trade creditors filed proofs of claim asserting general unsecured claims in the aggregate amount of $3.8 million based on transactions between 2001 and the commencement of the bankruptcy case in 2003.[69] Sound Around again moved to dismiss the proceeding,[70] alleging that, notwithstanding the three trade creditors, the trustee lacked standing to bring the fraudulent conveyance action under § 544(b) of the Code.

A. *A Matter of Standing*

The bankruptcy court in *In re Allou Distributors* characterized the issue as one of standing. Recognizing that a trustee in a Chapter 7 case is charged with the administration of the bankruptcy estate and has certain powers, including the power to avoid preferences[71] and fraudulent conveyances, the court commented that the trustee, like any other plaintiff, must establish that he or she has standing to bring the particular claim under the avoiding powers.[72] The court also noted that standing has its roots in Article III of the United States Constitution, limits the federal courts to deciding cases or controversies, and requires that the plaintiff have a personal stake in the outcome of the controversy.[73] As the Court of Appeals for the Second Circuit has written:

> [A bankruptcy trustee's standing] [c]oincides with the scope of the powers the Bankruptcy Codes gives a trustee, that is, if a trustee has no power to assert a claim because it is not one belonging to the bankrupt estate, then he also fails to meet the prudential limitation that the legal rights asserted must be his own.[74]

The court described § 544(b) as defining the "boundaries of a bankruptcy trustee's standing to bring an action to avoid a fraudulent

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68 *Id.* at 29.

69 *Id.*

70 The motion was made under Rule 52 of the Federal Rules of Civil Procedure, made applicable to adversary proceedings by Rule 7052 of the Federal Rules of Bankruptcy Procedure. *Id.* at 26.

71 *Cf.* 11 U.S.C. § 547 (2006).

72 *In re Allou Distribs.*, 392 B.R. at 30.

73 *Id.*

74 *Id.* (quoting Shearson Lehman Hutton Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991)).

transfer made by a debtor."[75] For the remainder of its opinion, the court discussed whether the requirements of § 544(b) had been met.

B. *The Court's Application of § 544(b)*

The bankruptcy court in *In re Allou Distributors* focused on the language of § 544(b)(1), which provides that a trustee may avoid any transfer of the debtor's property "that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under § 502 of [the Bankruptcy Code] . . . ."[76] The court commented that, based on this language, "[s]ection 544(b)(1) requires a trustee to 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 § 502 of this title.'"[77]

Sound Around argued that the trustee failed to demonstrate that he had standing to bring an action under § 544(b)(1) because the only three trade creditors identified as existing at the time of the payment of $149,945 were paid in full soon after the transfer and, therefore, they no longer had the right to avoid such payment at the time of Allou's bankruptcy filing.[78] Thus, the claims they had at the time of the transfer no longer existed when the bankruptcy petition was filed. Because of the payment of those claims, the three trade creditors had lost their right to bring fraudulent conveyance actions under New York fraudulent conveyance law.[79] Indeed, creditors who have been fully paid for all debts incurred prior to a transfer lack standing to avoid the transfer based on the debtor's insolvency.[80] Though the three trade creditors also had allowable claims under § 502 of the Bankruptcy Code at the time of bankruptcy, those claims were *different* claims than those held at the time of the alleged fraudulent transfer.[81] Consistent with the derivative nature of § 544(b), Sound Around asserted that, since none of the three trade creditors could bring a fraudulent conveyance action on its own, they "[did] not qualify as triggering creditors, and [did] not

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[75] *Id.* at 30-31. It is apparent that the court was referring only to fraudulent transfers that can not be avoided under § 548 of the Bankruptcy Code.

[76] 11 U.S.C. § 544(b) (2006).

[77] *In re Allou Distribs.*, 392 B.R. at 31 (emphasis added); MC Asset Recovery, LLC v. S. Co., No. 06-0417B, 2006 WL 5112612, at *3 (N.D. Ga. Dec. 11, 2006); Ries v. Wintz Props., Inc. (*In re* Wintz Cos.), 230 B.R. 848, 859 (B.A.P. 8th Cir. 1999).

[78] *In re Allou Distribs.*, 392 B.R. at 33.

[79] *Id.*

[80] Oparaji v. Madison-Queens Guy Brewer, LLC, 754 N.Y.S.2d 907, 302 A.D.2d 439, 440, (App. Div. 2d Dep't 2003); MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 931 (S.D.N.Y. 1995).

[81] *In re Allou Distribs.*, 392 B.R. at 33.

provide a basis for the Trustee's standing to bring his claims."[82]

The trustee did not dispute the fact that the three trade creditors, having been paid in full, would not have the ability to avoid the alleged fraudulent transfer when the bankruptcy case was commenced. However, the trustee's position was that it was irrelevant that the three trade creditors were no longer able to avoid the fraudulent transfer. The trustee argued that standing to prosecute the fraudulent conveyance claim under § 544(b) exists solely because (1) the three trade creditors had claims at the time of the alleged fraudulent conveyance, and (2) the same three trade creditors had unsecured claims that were allowable in the bankruptcy case.[83] "No further examination of the debtor/creditor relationship is required or warranted under Bankruptcy Code § 544(b)."[84] In particular, the trustee argued that there is no requirement that the claim held at the time of the transfer be the *same* claim that exists at the time of bankruptcy. The trustee asserted that Congress had not imposed such an "identical claim requirement" when it drafted and twice amended § 544 of the Bankruptcy Code.[85]

The bankruptcy court found the trustee's argument persuasive:

> [I]n order to satisfy the standing requirements of [§] 544, the same creditor that has an allowed unsecured claim on the Petition Date must also have been a creditor of the transferor on the Transfer Date. . . . In other words, a triggering creditor must be the same creditor on both the Transfer Date and the Petition Date, but need not hold the same claim at these two essential points in time.[86]

In agreeing with the trustee's arguments, the court pointed out that the fact that the creditors were paid in full following the pre-transfer deliveries of goods did not alter their status as creditors.[87] To illustrate that point, the court noted that "several courts have found that in the context of a series of transactions, such as an open account relationship, paying a creditor's account down to zero does not terminate its ongoing creditor status,"[88] and the court relied on three decisions dealing with ongoing business relationships where creditors were periodically paid in full. In *In re RCM Global Long Term Capital Appreciation Fund, Ltd.*, the bankruptcy court held that certain professionals who continuously provided services to the debtor could be triggering creditors for purposes of 544(b) fraudulent conveyance actions despite having been

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82 *Id.*

83 *Id.*

84 *Id.* (quoting Trustee's Memorandum of Law at 8-9, *In re* Allou Distribs., Inc., No. 05-08219 (Bankr. E.D.N.Y. Mar. 17, 2008)).

85 *Id.* at 34 (citing Trustee's Memorandum of Law at 5, *In re* Allou Distribs., Inc., No. 05-08219 (Bankr. E.D.N.Y. Mar. 17, 2008)). Section 544(b) was amended in 1984 and 1998.

86 *Id.*

87 *Id.* at 34-35.

88 *Id.*

paid in full at various points between the transfer date and the petition date.[89] In *In re Bushey*, the court held that, under Ohio fraudulent conveyance law, a credit card company qualified as a "present" creditor with a claim that existed at both the time of the alleged fraudulent conveyance and the time of the bankruptcy filing, notwithstanding that the account had a zero balance at some moment between challenged transfer and filing date.[90] In *In re Aluminum Mills Corp.*, where a lender extended a revolving credit line to a borrower and the parties contemplated an ongoing indebtedness, the court held that payment of the particular debt did not terminate the ongoing debtor-creditor relationship for purposes of applying § 544(b).[91]

By treating open account creditors as existing creditors at the time of the transfer, notwithstanding zero balances after the transfer, the courts effectively deprived them of the defense of full payment. The rationale for treating open account creditors as pre-transfer creditors under state fraudulent conveyance laws, despite subsequent zero balances, was described by the court in *In re Bushey*:

> In an open account context, the "existing" creditor relationship is not defined by the balance on the account; it is the availability and continuous use of the credit facility that determines whether an appropriate creditor interest is present against which to measure the propriety of a conveyance. Every change in the balance of an open account—including a change to or from "zero"—is a "new balance," not a "new debt" for fraudulent conveyances purposes. Reduction to a zero balance of an open account, no other facts appearing, tells creditors nothing about the underlying financial condition of the borrower. . . . The continuous nature of the risk faced by the creditor in an open account relationship is the defining characteristic of an "existing" creditor, not the account balance at any moment during that relationship.[92]

The three cited cases are distinguishable from the facts of *In re Allou Distributors* because, in each of the cited cases, the creditor maintained a continuous relationship with the transferor during the period of time between the transfer and the commencement of the fraudulent transfer action. In *In re RCM Global Long Term Capital Appreciation Fund, Ltd.*, the triggering creditors were the debtor's professionals and administrators who continued to provide services,

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89 *In re* RCM Global Long Term Capital Appreciation Fund, Ltd., 200 B.R. 514, 523 (Bankr. S.D.N.Y. 1996) ("Certain of the Debtor's professionals and administrators were owed money at the time of the transfer. That they were subsequently paid for those particular services is of no consequence because they continued to provide services after the transfer for which they have still not been paid.").

90 Belfance v. Bushey (*In re* Bushey), 210 B.R. 95, 100 (B.A.P 6th Cir. 1997).

91 Aluminum Mills Corp. v. Citicorp N. Am., Inc. (*In re* Aluminum Mills Corp.), 132 B.R. 869, 890 (Bankr. N.D. Ill. 1991).

92 *In re Bushey*, 210 B.R. at 102.

apparently uninterrupted, after the transfer for which they had not been paid.[93] Similarly, the court in *In re Bushey* found that a credit card company that had an open account relationship with the transferor could satisfy that state statute's definition of "existing creditor."[94] The court in *In re Aluminum Mills Corp.* found that "[c]laims arising from open trade accounts with [the] [d]ebtor constitute preexisting claims sufficient to confer standing . . . under Illinois law."[95]

Thus, each of these cases involved distinguishable facts and circumstances that supported the relevant court's finding that there was an existing creditor relationship that spanned the time of the transfer and the time of the commencement of the fraudulent conveyance action. By contrast, there was no such finding of a continuing existing debtor-creditor relationship in *In re Allou Distributors*. Nonetheless, the court seems to have extended the holding of *In re Bushey*—that "the focus of § 544(b) is on the identity of the creditor, not on the historical relationship between the creditor's claim and the debtor"[96]—to demonstrate that the intervening full payment of the debt owed to each of the three trade creditors "does not change the fact that as of the Transfer Date, each of the Proffered Creditors was a creditor of the Debtors."[97]

More importantly, it does not appear from the decision that the court was citing the three cases to support a conclusion that, if Allou Distributors had received less than fair consideration, the three triggering creditors, *under New York fraudulent conveyance law*, could have avoided the $149,945 payment to Sound Around at the time of the bankruptcy filing. In particular, the court does not appear to go so far as to indicate that these cases should stand as authority, apart from the requirements of § 544(b), to show that a former creditor that was fully paid and that had not maintained a continuous ongoing debtor-creditor relationship with the transferor would have standing to bring a fraudulent transfer claim under New York's version of the UFCA, solely because it again became a creditor of the transferor several years after the transfer and has an allowable unsecured claim in the transferor's bankruptcy case.

To be clear, if it was the intention of the court to find that, if Allou Distributors had received less than fair consideration, the three trade creditors, applying New York constructive fraudulent conveyance law

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93 *In re RCM Global Long Term Capital Appreciation Fund*, 200 B.R. at 523. It is also important to note that Judge Brozman explained in her decision that in the *RCM Global* case no one was seeking to dismiss the fraudulent transfer action and that it remained to be seen whether proof of a qualifying creditor would conform to the statute's requirement. *Id.* at 524.

94 *In re Bushey*, 210 B.R. at 102.

95 *In re Aluminum Mills*, 132 B.R. at 890.

96 *In re Allou Distribs.*, 392 B.R. at 34 (quoting *In re* Bushey, 210 B.R. at 101).

97 *In re Allou Distribs.*, 392 B.R. at 35.

applicable to transfers by insolvent debtors, could have avoided the $149,945 payment to Sound Around on the date of the bankruptcy filing despite payment of the earlier debts, the holding of the court would have been consistent with the derivative nature of § 544(b). However, the court does not express such an intention and cites no authority under New York law that would support such a finding. Rather, the court apparently acknowledged that the three trade creditors would not have been able to avoid the $149,945 payment at the time of bankruptcy because of the payment defense, but did not consider that dispositive.

> It is surely true that where a creditor holds a claim that is satisfied in full, 'the creditor no longer has a cause of action to recover assets conveyed by the debtor or a transferee.' . . . But the payment of the claim does not somehow retroactively alter the creditor's status as a creditor at the time of the transfer.[98]

The court held, therefore, that the three trade creditors qualified as triggering creditors and supported the trustee's standing to bring the fraudulent conveyances action against Sound Around under § 544(b) and applicable state law.[99]

The reasoning in *In re Allou Distributors* appears to depart from the derivative nature of § 544(b) by not strictly adhering to state fraudulent conveyance law. As discussed above, § 544(b) gives the trustee the power to avoid transfers and obligations that are voidable by an unsecured creditor under applicable nonbankruptcy law.[100] Yet, the court seems to give only passing significance to state fraudulent conveyance law and attempts to resolve the trustee's powers by focusing primarily on the language of § 544(b). In fact, a closer analysis of New York's fraudulent conveyance laws reveals that identifying an actual creditor that held a claim at the time of the fraudulent transfer was not necessary to reach the conclusion that the trustee had standing to bring a fraudulent conveyance action against Sound Around.

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98 *Id.* at 34 (quoting MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs., Co., 910 F. Supp. 913, 931 (S.D.N.Y. 1995)).

99 *In re Allou Distribs.*, 392 B.R. at 35. On April 23, 2009, nine months after the bankruptcy court's decision holding that the trustee had standing to prosecute the fraudulent conveyance action, the court entered judgment in favor of the defendant, Sound Around, and dismissed the amended complaint with prejudice upon finding that the trustee had failed to establish at trial that Allou Distributors received less than fair consideration in exchange for the $149,950 payment to Sound Around. Silverman v. Sound Around, Inc. (*In re* Allou Distributors, Inc.), 404 B.R. 710 (Bankr. E.D.N.Y 2009).

100 11 U.S.C. § 544(b)(1).

C. *The Rights of Future Creditors*

The trustee's complaint against Sound Around alleged that the $149,945 payment in 1999 was a constructive fraudulent conveyance voidable under sections 273, 274, and 275 of the New York Debtor & Creditor Law.[101] Most significantly, section 274 provides as follows:

> [*Section*] *274. Conveyances by persons in business.* Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors *and as to other persons who become creditors during the continuance of such business or transaction* without regard to his actual intent.[102]

Section 274 makes it clear that, if a conveyance is made for less than fair consideration, and the conveyance leaves the transferor with unreasonably small capital, the transfer is voidable by creditors with claims incurred *after*, as well as before, the transfer.[103] As mentioned in the bankruptcy court's decision in *In re Allou Distributors*, the parties stipulated in a joint pretrial memorandum that "[a]t the time of the Transfer, the Debtors were engaged in a business or transaction for which the property remaining in its possession after the conveyance was unreasonably small capital."[104] Further, Allou's business continued from the time of the payment to Sound Around in 1999 until the date of Allou's bankruptcy in 2003. Thus, under section 274, in the absence of bankruptcy, the transfer could have been avoided by *any* creditor with an allowable unsecured claim regardless of when incurred.

Similarly, section 275 of the New York Debtor & Creditor Law, provides as follows:

> [*Section*] *275. Conveyances by a person about to incur debts.* Every conveyance made and every obligation incurred without fair consideration when the person making the conveyance or entering into the obligation intends or believes that he will incur debts beyond his ability to pay as they mature, is fraudulent as to *both present and future creditors.*[105]

Again, it is clear from the plain meaning of the state statute that a

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101 *In re Allou Distribs.*, 392 B.R. at 27.

102 N.Y. DEBT. & CRED. LAW § 274 (McKinney 2001) (second emphasis added).

103 *Id.*; *see also* Julien J. Studly, Inc. v. Lefrak, 412 N.Y.S.2d 901, 905, 66 A.D.2d 208 (App. Div. 2d Dep't 1979) ("[U]nder [New York Debtor and Creditor Law] a creditor has standing to maintain an action to set aside a fraudulent transfer, though his debt may not have been in existence at the time of the transfer . . . ."), *aff'd*, 401 N.E.2d 187, 48 N.Y.2d 954, 425 N.Y.S.2d 65 (1979).

104 *In re Allou Distribs.*, 392 B.R. at 28-29.

105 N.Y. DEBT. & CRED. LAW § 275 (McKinney 2001) (second emphasis added).

constructive fraudulent conveyance under section 275 can be based on the presence of a future creditor—i.e., one who does not have a claim against the Debtor at the time of the transfer, but who has a claim subsequently. Also, as with undercapitalization, the parties stipulated in their joint pretrial memorandum that "[a]t the time of the Transfer, the Debtors had incurred debts beyond its [sic] ability to pay them as they matured."[106] However, while the parties stipulated that Allou had incurred debts beyond its ability to pay as of the time of the transfer, the parties' stipulation was not sufficient for the trustee to rely on section 275 with respect to future creditors because it did not provide that Allou intended or believed that it would in the future incur debts beyond its ability to pay as they mature.[107]

In view of the stipulations regarding Allou's financial condition at the time of the payment, and the provisions of sections 274 and 275 of the New York Debtor & Creditor Law, the result in *In re Allou Distributors* regarding the trustee's standing was correct in that the three trade creditors relied upon by the trustee as the basis for the fraudulent conveyance action were appropriate triggering creditors. Those creditors clearly had allowable unsecured claims that arose *after* the transfer and, therefore, were at least future creditors. Whether they also had claims against Allou at the time of the payment in question was irrelevant. Moreover, *any* entity with an allowable unsecured claim in the bankruptcy case that became a creditor after the transfer could have served as the triggering creditor for § 544(b) purposes.

In contrast to sections 274 and 275 of the New York Debtor & Creditor Law, section 273 provides that:

> [*Section*] *273. Conveyances by Insolvent.* Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration.[108]

Note that there is no mention of future creditors in section 273. Accordingly, if the only basis for a constructive fraudulent conveyance action is that the debtor was *insolvent* at the time of a transfer for less than fair consideration, and there is no determination that the debtor was undercapitalized or believed it would incur debts beyond its ability to pay, the trustee would have the right to avoid the transfer under § 544(b) only if he or she could find a "present" creditor with an allowed

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106 *In re Allou Distribs.*, 392 B.R. at 29.

107 *Cf.* Shelly v. Doe, 660 N.Y.S.2d 937, 943-44, 173 Misc.2d 200, 208-11 (St. Lawrence County Ct. 1997) (The court stated that section 275 applies to future creditors but ruled that the trustee failed to prove by clear and convincing evidence that the transferor intended or had knowledge that it would be unable to pay debts as they mature.), *aff'd*, 671 N.Y.S.2d 803, 249 A.D.2d 756 (App. Div. 3d Dep't 1998).

108 N.Y. DEBT. & CRED. LAW § 273 (McKinney 2001).

unsecured claim that could have avoided the conveyance in the absence of bankruptcy.

D. *Suggesting a Different Approach*

The court's focus on the language of § 544(b)(1) was an appropriate starting point for determining whether the trustee in *In re Allou Distributors* had standing to avoid the $149,945 payment to Sound Around, but the analysis was imprecise. The court's analysis was mostly textual, focusing on the words of § 544(b)(1). The court's conclusion, however, appears to be inconsistent with the tense used in the statute. Section 544(b)(1) provides that the trustee may avoid a transfer of the debtor's property "that *is* voidable" under applicable law by a creditor holding an allowable unsecured claim.[109] By holding that § 544(b) requires the existence of a creditor who held a claim at the time of the transfer, despite the defense of full payment of that claim, the court interpreted the words "is voidable" as if the words were "is or was voidable." Since the section speaks in the present tense, the better view is that the triggering creditor must be one that, at the time of bankruptcy, *has* the right to avoid the transfer under applicable nonbankruptcy law. The plain meaning of § 544(b)(1) would lead to the conclusion that the trustee must find a triggering creditor that could have avoided the transfer at the time of the bankruptcy filing.

In addition, the court, despite repeatedly stating that § 544(b) is derivative of the rights of unsecured creditors, appears to have departed from that principle in two ways. First, the court did not look sufficiently at applicable state law as the predicate for the trustee's standing under § 544(b). All rights of the trustee under § 544(b) must derive from nonbankruptcy law.[110] If the court examined applicable New York state law, it would have recognized that, for the purpose of exercising the trustee's avoidance power under § 544(b), the identification of an unsecured creditor that held a claim at the time of the fraudulent transfer was not necessary if the debtor was undercapitalized or intended or believed it would incur debts beyond its ability to pay as such debts mature.[111] All the court had to hold was that, based on the stipulation of the parties that Allou Distributors had unreasonably small capital, the payment to Sound Around was a fraud on present and *future* creditors and, therefore, *any* creditor with an allowed unsecured claim in the bankruptcy case could have served as the triggering creditor. Instead, however, the decision reasoned that §

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109 11 U.S.C. § 544(b)(1) (2006) (emphasis added).

110 11 U.S.C. § 544(b) (2006).

111 N.Y. DEBT. & CRED. LAW §§ 274-275 (McKinney 2001).

544(b) could not give the trustee standing to avoid a transfer unless it could identify a creditor that held an unsecured claim at the time of the fraudulent transfer, as well as at the time of bankruptcy. The decision did not address the rights of future creditors under applicable state fraudulent conveyance law.

The decision also departed from the derivative nature of § 544(b) by concluding that, when applicable, the required identification of a *present* creditor at the time of the fraudulent transfer may be satisfied so long as such creditor also held an allowable unsecured claim—*any* allowable unsecured claim—in the bankruptcy case, without also determining that the creditor could have avoided the transfer under state law at the time of the bankruptcy filing notwithstanding full payment of the earlier debt.

E. *Potential Consequences of the* In re Allou Distributors *Decision*

The court's conclusions—that "in order to satisfy the standing requirements of § 544, the same creditor that has an allowed unsecured claim on the Petition Date must also have been a creditor of the transferor on the Transfer Date," but "need not hold the *same claim* at these two essential points in time,"[112] and that the transferee's complete defense under state law based on the full payment of its original claim is not a bar to the trustee's avoidance under § 544(b)—could lead to both the narrowing as well as the expansion of the trustee's powers.

For an illustration of the narrowing effect of the court's holding on the trustee's powers under § 544(b), suppose a situation in which the debtor had transferred assets for less than reasonably equivalent value while undercapitalized, as well as while insolvent. Subsequently, all existing creditors are paid in full. Suppose further that three years later the debtor files for bankruptcy and that none of the creditors that existed at the time of the fraudulent transfer have allowed unsecured claims in the bankruptcy case. Could the trustee use § 544(b) to avoid the transfer, assuming at least one allowed unsecured claim in the bankruptcy case? In either a UFTA or UFCA jurisdiction, the answer should be "yes" because *any* creditor with an allowed unsecured claim would be a *future* creditor under state fraudulent conveyance law and the presence of a future creditor should be sufficient to give the trustee the power to avoid the transfer. However, the court in *Allou Distributors* made no such distinction based on state law and apparently held that a trustee has standing to bring a § 544(b) avoidance action only if at least one of the holders of an allowable unsecured claim in the

112 *In re Allou Distribs.*, 392 B.R. at 34.

bankruptcy case also held a claim—*any* claim—at the time of the fraudulent conveyance.[113]

To demonstrate how the holding in *In re Allou Distributors* also broadens the trustee's powers under § 544(b), assume the same facts as those in *In re Allou Distributors*, except that the trustee is able to prove that the debtor received less than fair consideration and was insolvent at the time of the transfer, but could not demonstrate that the debtor had unreasonably small capital or that the debtor believed or intended that it would not be able to pay its debts as they mature. Also suppose that the trustee is unable to identify any creditor existing at the time of bankruptcy that could have avoided the transfer under state law at the time of bankruptcy, but could identify creditors that had claims at the time of the transfer and also have different unsecured claims that have been allowed in the bankruptcy case. Arguably, under the apparent rationale of *In re Allou Distributors*, the trustee could avoid the transfer despite the fact that no existing creditor has such power under state law. This result would give the trustee powers that no actual creditor possesses and, therefore, goes well beyond the derivative nature of § 544(b).

F. *Potential Effect of the Decision on the Statute of Limitations*

Taking the reasoning of *In re Allou Distributors* another step further, suppose that seven years before it files a bankruptcy petition, a company transfers assets for less than reasonably equivalent value while insolvent (but not undercapitalized or under the belief or intention that it will not be able to pay its debts as they mature), and that, as in New York, applicable state law has a six-year statute of limitations for fraudulent conveyances. Suppose further that the trustee identifies a creditor that had an unsecured claim at the time of the fraudulent conveyance that had been fully paid. Suppose further that the same creditor holds an unrelated allowable unsecured claim when the bankruptcy petition was filed. Clearly, the creditor would not be able to avoid the transfer under state law because of the statute of limitations defense.[114] But is that materially different than the situation in *In re Allou Distributors*, in which the triggering creditors had lost their right to sue Sound Around to avoid the transfer under state law because they had been paid in full? Is the defense of the statute of limitations different than the defense of full payment for the purpose of enforcing the trustee's avoiding powers under § 544(b)? If, as the court

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113 *In re Allou Distribs.*, 392 B.R. at 34-35.

114 5 COLLIER ON BANKRUPTCY, *supra* note 5, at ¶ 544.07[3].

apparently held in *In re Allou Distributors*, the trustee has standing to recover under § 544(b) so long as the trustee can identify a creditor that had a pre-transfer claim and also has an allowed unsecured claim in the bankruptcy case, regardless of whether the transferee would have a complete defense against the triggering creditor under state law, it appears that a court that follows the reasoning of *In re Allou Distributors* could hold that the trustee would be able to avoid the transfer under § 544(b) despite the statute of limitations defense.

Such an abrogation of state statutes of limitations with respect to fraudulent conveyance actions brought under § 544(b), though a logical extension of *In re Allou Distributors*, would be a drastic departure from prevailing law. Courts have uniformly held that a trustee may not bring an avoidance action under § 544(b) if the applicable state statute of limitations would bar any and all creditors from bringing a fraudulent conveyance action under state law.[115] Otherwise, there would be no time limits on the avoidance of fraudulent conveyances if the transferor becomes a debtor in a bankruptcy case.[116] It is doubtful that the court in *In re Allou Distributors* intended that its holding would lead to such an abrogation of state statutes of limitations in the context of a § 544(b) avoidance action.

Arguably, the concern that the reasoning of *In re Allou Distributors* would allow a trustee to side-step around a state statute of limitations and subject transfers to fraudulent conveyance attack for an indefinite period is less of a danger in most states because the UFTA, applicable in a majority of the states, has a statute of extinguishment instead of a statute of limitations. The UFTA provides that a claim for relief or cause of action with respect to a fraudulent transfer or obligation under that act "is extinguished" unless an action is brought within the relevant time period, which in most situations involving constructive fraud is four years.[117] The official comment to the UFTA explains that the purpose of the section "is to make clear that lapse of the statutory periods prescribed by the section bars the right and not merely the remedy."[118] Courts are not likely to go so far as to permit

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115 See *supra* note 42 and accompanying text for a discussion of the statute of limitations defense.

116 In this regard, it should be noted that § 546(a) of the Bankruptcy Code imposes a statute of limitations on the trustee's exercise of the avoiding powers. Such actions must be commenced by the trustee before the later of two years after the commencement of the bankruptcy case, or one year after the appointment or election of the first trustee in the case if such appointment or election takes place within two years after the commencement of the case. However, if the trustee seeks to avoid a fraudulent conveyance under § 544(b) and applicable state law, the limitations period in § 546(a) does not extend the state statute of limitations or revive the cause of action if the state statute of limitations expires before the bankruptcy case is commenced. 11 U.S.C. § 546(a).

117 U.F.T.A. § 9 (1984).

118 U.F.T.A. § 9 cmt. 1 (1984).

the trustee to resurrect an extinguished cause of action under § 544(b). Nonetheless, an extension of the reasoning of *In re Allou Distributors*—permitting the trustee to avoid a fraudulent transfer even when the triggering creditor would be subject to a complete defense under state law—arguably could be used to avoid the effect of the extinguishment of the claim under the UFTA.

CONCLUSION

The theory underlying § 544(b) of the Bankruptcy Code is that a trustee, as the representative of the bankruptcy estate, should have the same rights and powers that unsecured creditors have under state law to avoid transfers made and obligations incurred by the debtor. That power must derive from actual creditors. The bankruptcy court's decision on the trustee's standing in *In re Allou Distributors* demonstrates how the trustee's powers can be unduly limited or expanded when a court does not strictly follow the derivative nature of § 544(b). Ironically, a consideration of the rights of future creditors under applicable state fraudulent conveyance laws would have led to the same conclusion on the trustee's standing as that reached by the court. The stipulated facts established that the debtor had unreasonably small capital at the time that it made the transfer to the defendant so that any creditor holding a claim arising before the bankruptcy filing could have served as the triggering creditor under § 544(b). However, the decision did not follow that path. Unfortunately, the decision also appears to have left the door open for a trustee, under § 544(b), to recover a fraudulent conveyance made by an insolvent debtor when the triggering creditor, because of a valid defense, would not have had the ability to avoid the transfer at the time of the bankruptcy case.