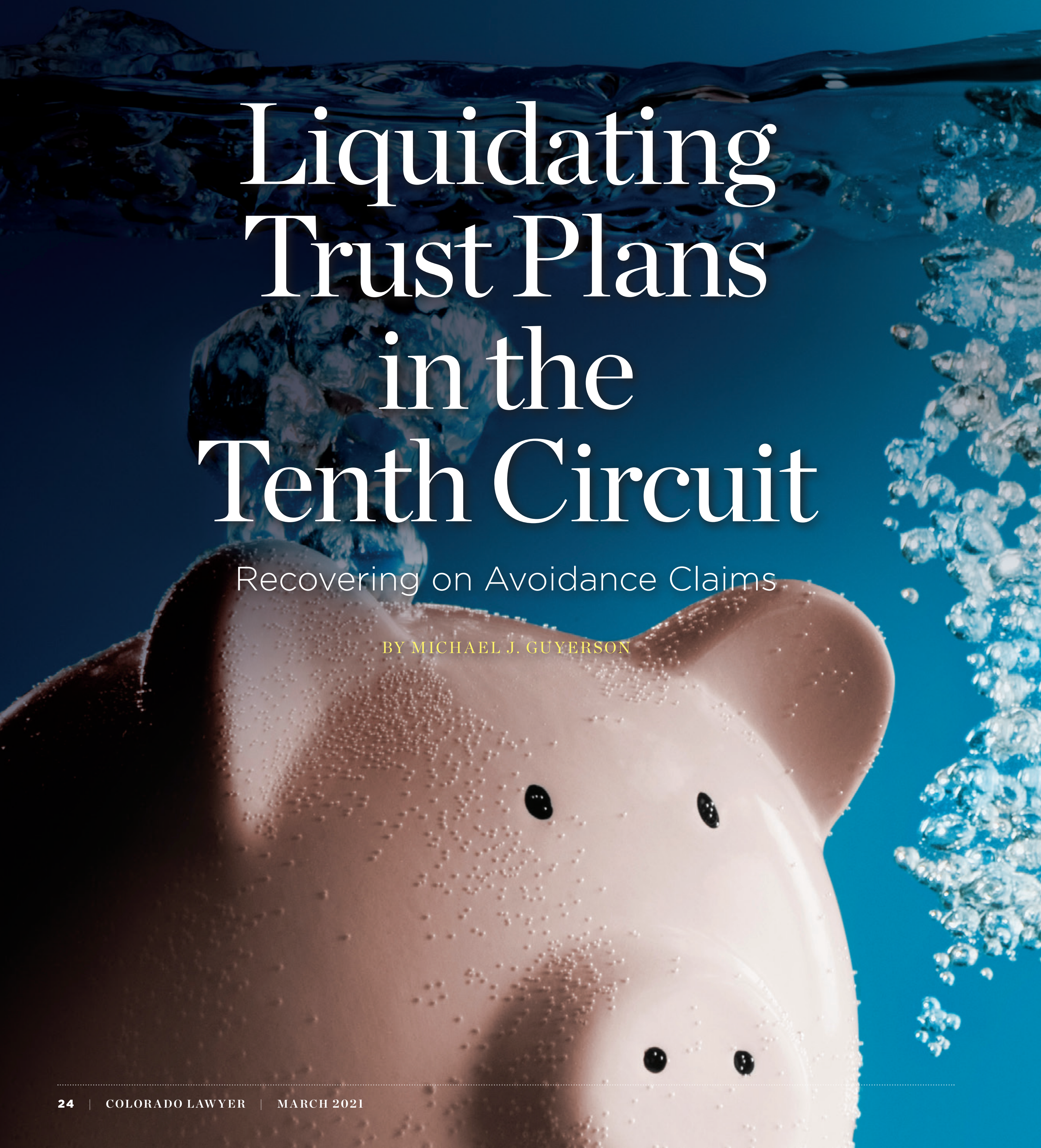

Liquidating Trust Plans in the Tenth Circuit

Recovering on Avoidance Claims

BY MICHAEL J. GUYERSON

This article discusses liquidating trust plans in Tenth Circuit chapter 11 reorganization plans, with a focus on maximizing the recovery of avoidable transfers. It uses the Atna Liquidating Trust as an example for the analysis.

The US Bankruptcy Code (Code)[1] provides for the use of a liquidating trust under § 1123(b)(3) to enforce a bankruptcy estate's claims and interests. A liquidating trust allows a debtor to transfer causes of action and other assets to the trust for future liquidation and distribution to the debtor's creditors, who are the trust beneficiaries. The liquidating trust is a tool commonly used by bankruptcy practitioners to recover avoidable transfers.

This article discusses liquidating trusts in chapter 11 reorganization cases in the Tenth Circuit and explores methods for maximizing the recovery of avoidable transfers in bankruptcy. It uses *In re Atna Resources Inc.*[2] as an example for analyzing the issues.

Liquidating Trusts in Chapter 11 Cases

Many companies that file for chapter 11 bankruptcy relief ultimately liquidate their assets and claims. These chapter 11 plans typically provide for the controlled liquidation of assets and the pursuit of avoidance claims, such as preference or fraudulent conveyance claims under article V of the Code. The *Atna* case is a good example of how this approach works.

In 2015, Atna Resources Inc. and its six affiliates filed separate voluntary petitions for relief under chapter 11 in the US Bankruptcy Court for the District of Colorado. The seven Atna entities, each a standalone company, had a complicated ownership structure. The common element among them was their use of a centralized cash management system through which all deposits were swept into a centralized account, regardless of which separate entity created the income. Funds were then redistributed from the centralized account to individual accounts for each entity. Each entity then paid its own bills, but given the centralized account, income from one entity was routinely used to pay the debts of another.

The use of a centralized account is common and may be acceptable when the involved entities are solvent and cash is flowing. However, when some or all of the subsidiary companies are insolvent, using funds from one entity to pay another's debts becomes a potential fraudulent conveyance.

The chapter 11 plan for Atna and its affiliated entities was confirmed by the court. The plan created the Atna Liquidating Trust (the Trust) as a standalone liquidating grantor trust entity in accordance with US Treas. Reg. 301.7701-4(d). The Trust was designed to operate without court supervision with a trustee empowered to bring Code article V avoidance actions, such as those for preferential payments and fraudulent conveyances.

The Trust was typical of those used in Colorado and nationally. Virtually the same liquidating plan provisions and trust agreement were successfully used in other Tenth Circuit confirmed chapter 11 liquidating plans.[3] Most debtors under such plans have multiple subsidiary operations and use some form of centralized bank account or cash management account system. Transfers are made from one account to the other, or are swept into a centralized account and then redistributed to separate accounts from which payments are finally made to creditors or other parties. But debtors and trustees of liquidating trusts trying to recover these payments face unique challenges in the Tenth Circuit. One such obstacle is what has become known as the *Slack-Horner* doctrine.

Slack-Horner and § 548 Claims

Title 11 USC § 550(a) permits the trustee to recover avoided transfers, such as fraudulent conveyances under Code § 548, from either the initial transferee or a subsequent transferee. A transfer occurs each time a payment or transfer is made from one account to another of a related company or affiliate. The *Slack-Horner* doctrine, in a nutshell, requires that each movement of funds from one entity to another is a transfer that must be avoided before the end transfer can be recovered. This Tenth Circuit doctrine arguably glosses over what happens when all such transfers are controlled by one group of companies or individuals. In practical terms, the rule makes it more difficult to recover fraudulently transferred property for the benefit of the estate in situations where multiple debtors transferred funds to and among each other via a centralized cash management system.

In *Slack-Horner*, the debtor owned a parcel of real estate. In 1983, the county treasurer conducted a tax sale of the property for nonpayment of real property taxes. Simons was the successful bidder at the tax sale and received a tax sale certificate of purchase. Simons also paid the delinquent real property taxes for years 1982 through 1987. In December 1987, Simons obtained and recorded a treasurer's deed to the property. The debtor filed for bankruptcy in September 1988. The bankruptcy trustee sought to avoid the transfer of the debtor's interest in the property to Simons under the then-applicable version of 11 USC § 548(a)(2). The Tenth Circuit held that the debtor's interest in the property "was transferred by operation of law from the debtor to the state" when the treasurer's deed was signed.[4] The state, in turn, "transferred all interest in the property to Simons"[5] because, as the court noted, "[t]he interest in the property must have passed to the state in order for the state to issue a deed conveying the property to Simons."[6]

The Tenth Circuit noted that 11 USC § 550 permits the trustee to recover avoided transfers from "either the initial transferee or a subsequent transferee."[7] However, the court stated that "to recover from a subsequent transferee the trustee must first have the transfer of the debtor's interest to the initial transferee avoided under § 548."[8] In sum, the Tenth Circuit held that there were two separate transfers, and the first transfer to the state needed to be avoided as a precondition to avoiding the second to Simons.

Accordingly, recovery in the Tenth Circuit requires the joinder of the initial transferee in an avoidance action, even though that transferee may be a co-debtor or may no longer have an interest in the property. This complicates avoidance litigation, particularly because as long as the plaintiff in the avoidance litigation sustains the burden to show that the initial transfer is avoidable, § 550 on its face ostensibly allows recovery from a subsequent transferee.

To illustrate this dilemma, a litigant could argue under *Slack-Horner* that a fraudulent transfer may be recovered only from a party that received an interest in property from the debtor. It follows that transferees receiving property from the initial transferee would have received no property from the debtor and consequently would have no liability to the estate. Thus, a savvy initial transferee could avoid liability by simply transferring the property received from the debtor to another party. Accordingly, *Slack-Horner* may be viewed as writing the § 550 expanded scope of transferee liability out of the Code. This construction of § 550 is a minority view.

Another approach is illustrated in the Eleventh Circuit opinion *In re International Administrative Services, Inc.*,[9] which rejected defendants' argument that the Code requires the trustee to avoid transfers to the initial transferees before having a cause of action against subsequent transferees. The Eleventh Circuit found that such a strict interpretation of § 550(a) produced "a harsh and inflexible result that runs counterintuitive to the nature of avoidance actions."[10] The more "tenable result" was to allow a plaintiff, once an avoidable transfer is proven to exist, to "skip over the initial transferee and recover from those next in line."[11] The Eleventh Circuit stated that mandating actual avoidance of the initial transfer conflated the Code's "avoidance and recovery sections" and was not consistent with the legislative history of the "to the extent that a transfer is avoided" language of § 550.[12] Accordingly, it held that "[s]ection 550(a) does not mandate a plaintiff to first pursue recovery against the initial transferee and successfully avoid all prior transfers against a mediate transferee."[13]

Slack-Horner remains controlling precedent in the Tenth Circuit, though other circuits have analyzed transfer avoidance differently.[14] The resulting challenges practitioners must overcome to avoid transfers were manifest in *Atna*. There, intercompany transfers using a centralized cash management system among the separate corporate entities, while they were insolvent, inevitably led to a series of intercompany bank account transfers before the ultimate creditor was paid. Both the bankruptcy court, and the district court on de novo review, relied on *Slack-Horner* to dismiss the trustee's § 548 claims against a staffing company that was the ultimate recipient of cash funds, which had been traced by the trustee to another debtor entity that was not obligated on the debt.

Judge Blackburn ruled:

> To recover from Elwood, a subsequent transferee of the funds in question, "the trustee must first have the transfer of the debtor's interest to the initial transferee avoided under § 548." *Slack-Horner*, 971 F.2d at 580. The Trustee has made no effort to avoid the relevant initial transfers from CR Briggs to the Canyon CCA or from Atna, Inc. to the Canyon CCA. Further, the Trustee has made no effort to avoid the relevant subsequent transfers ("immediate or mediate" transfers, to use the language of § 550) from the Canyon CCA to Atna, Inc. Under *Slack-Horner*, the fact that these prior transfers have not been avoided dooms any effort to avoid the subsequent transfers from Atna, Inc. to Elwood. Correctly, the bankruptcy court concluded that "the Trustee cannot recover the transfers [from Atna, Inc. to Elwood] without first avoiding the initial transfers from CR Briggs to Canyon and from Canyon to Atna."[15]

While such a ruling may be a dark cloud for future cases of this type in the Tenth Circuit, it is possible that *Slack-Horner* may be revisited in light of the US Supreme Court's decision in *Merit Management Group, LP v. FTI Consulting, Inc.*[16] In addressing the 11 USC § 546(e) safe harbor provisions provided to certain financial intermediaries, the Court held that the safe harbor does not protect allegedly fraudulent transfers "in which financial institutions served as mere conduits."[17] More important for other § 548 actions, the Court noted:

> If a trustee properly identifies an avoidable transfer . . . the court has no reason to examine the relevance of component parts when considering a limit to the avoiding power, where that limit is defined by reference to an otherwise avoidable transfer, as is the case with § 546(e).[18]

Perhaps this focus on the end transfer will trickle down to §§ 550 and 548.

Trustee Tools

Notwithstanding the *Slack-Horner* doctrine, trustees have other tools at their disposal to avoid transfers. Practitioners should evaluate on a case-by-case basis the availability of the collapsing doctrine, preferential claims, and the ordinary-course-of-business defense.

Collapsing Doctrine

In *Atna*, counsel argued for application of the "collapsing doctrine" to avoid the impact of *Slack-Horner*, but the bankruptcy court rejected the argument. The collapsing doctrine has been implicitly adopted in Colorado in other cases, such as *Sender v. Simon.*[19] The doctrine allows multilateral transactions between interrelated companies, including the comingling of funds in a centralized account, to be, under appropriate circumstances, "collapsed" and treated as phases of a single transaction for analysis under the Code and the Uniform Fraudulent Conveyances Act (UFCA).[20] This approach finds its most frequent application in Ponzi scheme cases and in leveraged buyouts of companies that subsequently become insolvent.[21] The Tenth Circuit has yet to review a case like *Atna* where the collapsing doctrine may be applicable.

Preference Claims

A liquidating trustee also has the ability to recover preferential transfers made to creditors or others. A preferential transfer is generally defined as any payment of money or transfer of property made by a debtor (1) to or for the benefit of a creditor, (2) for or on account of a debt that was owed before the transfer was made, and (3) while the debtor was insolvent.

In Atna, over $900,000 was recovered on § 547 preference claims. Many of the Atna demands were for amounts of $10,000 to $25,000, and the leverage of the home court was significant. At the time of the *Atna* cases, venue for an adversary proceeding was generally proper in the district court in which a bankruptcy case was pending. The one exception was for claims less than $12,850, which are required under Code § 1409(a) to be brought in the district court for the district where the defendant resides.[22]

Under the Small Business Reorganization Act of 2019 (SBRA)[23] amendments to Code title 28, which were not yet effective in 2017 when the Atna trustee began the process of identifying payments that might be avoidable, the new venue for all preference lawsuits under $25,000 is the district in which the recipient is located.[24] The new $25,000 venue limit would have clearly reduced recoveries in Atna because the small dollar amount recipients were the most likely to settle.[25] The lesson here is that practitioners should be mindful of the effects of venue when handling preference claims.

> "Notwithstanding the *Slack-Horner* doctrine, trustees have other tools at their disposal to avoid transfers. Practitioners should evaluate on a case-by-case basis the availability of the collapsing doctrine, preferential claims, and the ordinary-course-of-business defense."

The Ordinary-Course-of-Business Defense

Every preferential transfer recipient seems to know the defense mantra "the payments were made in the ordinary course of business," as set forth in 11 USC § 547(c)(2). Indeed, the changes made to the Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) intentionally eased the burdens of the ordinary-course-of-business defense.[26]

To prove an exception to avoidance under § 547(c)(2), the defending party bears the burden of proof in establishing the exception by a preponderance of the evidence,[27] and the exception is narrowly construed.[28] In the context of preference actions, the ordinary-course-of-business defense, when raised, is evaluated by comparing the pre-preference period payment pattern with the preference period payment pattern. Items such as partial payments, sudden COD payments, or stepped up or stepped down periods between payments are clearly red flags for expenses that are not in the ordinary course of business practices. In *Atna*, the trustee examined physical checks and invoices and had computer server access to the general ledger and payment history for each vendor. This documentation was critical to rebutting the defense in that case.

One of the Atna Liquidating Trust adversary cases provides a good illustration.[29] Its facts are typical of a preference case. Before the 90-day preference period, the debtor paid 22 Cutting Edge Supply invoices issued between January 2014 and March 2015. While the invoices called for payments to be made within 30 days of the date of each invoice, the agreement was silent on payment terms. During this pre-preference period, the debtor paid every invoice in full, making payments from 43 days to 127 days after the date of the corresponding invoice.

During the preference period, the debtor made three payments. Cutting Edge Supply issued one invoice on May 28, 2015, for $34,979.40, and a second invoice on June 30, 2015, for $33,871.90. The debtor did not pay either of these invoices in full, but instead paid $17,489.70 on August 31, 2015 (95 days after the first invoice date), $17,489.70 on September 9, 2015 (104 days after the first invoice date), and $15,000 on October 9, 2015 (101 days after the second invoice date). Cutting Edge Supply did not engage in any usual collection activities related to the transfers. The court, in ruling for the trustee and rejecting the ordinary-course-of-business defense, noted the following problems with the defense:

> The amount of the payments made by the Debtor within the preference period differed markedly from the amount of the payments made by the Debtor before the preference period. The Debtor paid each invoice amount in full before the preference period. However, the Debtor's payment practices differed within the preference period. Here, two of the three payments made within the preference period were split payments in identical amounts ($17,489.50) paying one-half of the invoice amount in one case and almost one-half the invoice amount in the other case, and the third payment ($15,000) was in a round dollar amount [that] did not correspond to the amount of any of the invoices.[30]

Accordingly, practitioners and trustees should carefully analyze the payment patterns before and during the preference period.

Practice Pointers

When administering a liquidating trust, the simplest methods are usually the best. Here are a few tips:

- When looking for preferential payments, counsel should scrutinize all payments made by the debtor to creditors or others during the 90-day period before the filing (one year for insiders). Specifically, counsel should examine the invoices of each vendor and then each physical check. This method might sound old fashioned and low tech, but it is required to successfully recover preferential claims at this level of complexity.
- Email exchanges between debtors and vendors are also extremely helpful in determining the ordinary course of the parties' business dealings under § 547(c)(2)(A). In the Tenth Circuit, courts apply a "subjective" standard and examine how the parties actually conducted their business dealings.
- When evaluating multiple layers of companies and transfers between them, a forensic accountant is a necessity. Only an expert can help unravel the maze of transfers one will find. The ultimate focus is on who had actual control over the funds in an account versus mere possession as a conduit or holder of the funds.

The Future of Liquidating Trusts in the Tenth Circuit

The *Atna* cases were successfully administered in Colorado and significant amounts were recovered for creditors on preference claims, notwithstanding the *Slack-Horner* doctrine. And the Tenth Circuit will have the opportunity, when presented with the proper case, to revisit this decision. Until then, the road to success in future chapter 11 cases in Colorado where liquidating trusts are required will remain challenging. In the meantime, practitioners should employ the transfer avoidance tools discussed above.

Michael J. Guyerson is senior counsel with Buechler Law Offices, LLC in Denver. His practice includes insolvency and commercial loan restructuring; the representation of debtors, creditors' committees, trustees, and creditors in bankruptcy matters; and commercial and bankruptcy litigation. The author's firm served as counsel to the liquidating trustee of the Atna Liquidating Trust.

Coordinating Editor: Curt Todd, ctodd@templelaw.comcastbiz.net

NOTES

1. 11 USC §§ 101 to 1330.
2. *In re Atna Res. Inc.*, No. 15-22848 JGR (Bankr. D. Colo.).
3. *See, e.g.*, *In re Midway Gold USA Inc.*, No. 15-16835 MER (Bank. D. Colo.), and *In re American Eagle Energy Corp.*, No. 15-15073 HRT (Bankr. D. Colo.).
4. *In re Slack-Horner Foundries Co.*, 971 F.2d 577, 580 (10th Cir. 1992).
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.* at 580.
9. *In re Int'l Admin. Servs., Inc.*, 408 F.3d 689 (11th Cir 2005). This case has been widely followed. Most circuit courts that have considered the issue, including the Eleventh Circuit, have adopted a "control" or "conduit" test to determine whether the recipient of an avoidable transfer of assets is the initial transferee. *See id. See also Bonded Fin. Serv., Inc. v. European Am. Bank*, 838 F.2d 890, 893 (7th Cir. 1988); *In re Columbia Data Prods., Inc.*, 892 F.2d 26, 28 (4th Cir. 1989); *In re Bullion Reserve of N. Am.*, 922 F.2d 544, 548–49 (9th Cir. 1991); *In re Baker Getty Fin. Servs., Inc.*, 974 F.2d 712, 722 (6th Cir. 1992); *In re Coutee*, 984 F.2d 138, 140–41 (5th Cir. 1993); *In re First Sec. Mortgage Co.*, 33 F.3d 42, 44 (10th Cir. 1994); *In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson Casey*, 130 F.3d 52, 58 (2d Cir. 1997).

   Under this test, a recipient of an avoidable transfer is an initial transferee only if it exercises legal control over the assets received such that the recipient has the right to use the assets for its own purposes, and not if it merely served as a conduit for assets that were under the actual control of the debtor-transferor or the real initial transferee. *See Nordberg v. Societe Generale* (*In re Chase Sanborn Corp.*), 848 F.2d 1196, 1199–1200 (11th Cir. 1988); *Nordberg v. Arab Banking Corp.* (*In re Chase Sanborn Corp.*), 904 F.2d 588, 599 n.26 (11th Cir. 1990); *Bonded Fin. Serv.*, 838 F.2d at 893; *In re Ogden*, 314 F.3d 1190, 1202, 1204 (10th Cir. 2002).
10. *In re Int'l Admin. Servs., Inc.*, 408 F.3d at 704.
11. *Id.* at 707.
12. *Id.* at 706.
13. *Id.* at 708.
14. *See, e.g.*, *In re Brooke Corp.*, 443 B.R. 847, 853–55 and n.5 (Bankr. D. Kan. 2010), and *supra* note 9.
15. *Kenneth J. Buechler, Liquidating Tr. v. Elwood Staffing Services*, No. 17-cv-02363-REB, Order Dismissing Complaint (Doc. No. 22 at 10) (Bankr. D. Colo. Aug. 6, 2019).
16. *Merit Mgmt. Group, LP v. FTI Consulting, Inc.*, 138 S.Ct. 883, 895 (2018).
17. *Id.*
18. *Id.*
19. *Sender v. Simon*, 84 F.3d 1299 (10th Cir 1996).
20. *See, e.g.*, *Orr v. Kinderhill Corp.*, 991 F.2d 31, 35–36 (2d Cir. 1993).

21. *See United States v. Gleneagles Inv. Co.*, 565 F.Supp. 556 (M.D.Pa. 1983) (PA UFCA), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986); *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992, 998 (Bankr. S.D.N.Y. 1991) (NY UFCA); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 500–04 (Bankr. N.D.Ill. 1988) (IL UFCA); and *In re Best Products Co.*, 168 B.R. 35, 56–57 (Bankr. S.D.N.Y. 1994) (NY UFCA).

22. The omission of proceedings "arising under" from the small-dollar venue exception, and whether such omission was intentional or inadvertent, has created judicial uncertainty about the application of the exception to preference cases. Some courts have concluded that the omission of the term "arising under" in the language of § 1409(b) was intentional and that, as a result, the small-dollar venue exception does not apply to preference actions. *See generally Redmond v. Gulf City Body & Trailer Works Inc.* (*In re Sunbridge Capital Inc.*), 2011 Bankr. LEXIS 2856 (Bankr. D. Kan. July 20, 2011). However, other courts have looked beyond the text of the statute to protect small-dollar preference defendants from the coercion and unfairness of litigating in the debtor's home court (i.e., *DynAmerica Mfg. LLC v. Johnson Oil Co. LLC* (*In re DynAmerica Mfg. LLC*), 2010 Bankr. LEXIS 1384 (Bankr. D. Del. May 10, 2010)). The SBRA has now perhaps leveled the playing field.

23. Pub. L. No. 116-54, 133 Stat. 1079.

24. 28 USC § 1409(b) was amended by striking "$10,000" and inserting "$25,000."

25. As of late April 2018, 26 of the filed preference adversary cases had been resolved and payments had been obtained, almost all before the need for an answer to be filed and with minimal, if any, court time or involvement. As a result of these settlements, more than $820,672.84 was collected for the Atna Liquidating Trust over a relatively short period of time and with minimal court time.

26. *See Weinman v. New Penn Motor Express* (*In re Office Source Inc.*), 2013 WL 6507186 (Bankr. D. Colo. 2013).

27. *See* 11 USC § 547(g). In the Tenth Circuit, the controlling case law is *Jubber v. SMC Elec. Prods., Inc.* (*In re C.W. Mining Co.*), 798 F.3d 983, 987 (10th Cir. 2015).

28. The defense must be narrowly construed. *Jobin v. McKay* (*In re M & L Bus. Mach. Co.*), 84 F.3d 1330, 1339 (10th Cir. 1996). When determining the ordinary course of the parties' business dealings under § 547(c)(2)(A), courts apply a "subjective" standard, looking to how the parties conducted their business dealings. *Lovett v. St. Johnsbury Trucking*, 931 F.2d 494, 497 (8th Cir. 1991); *Tulsa Litho Co. v. BRW Paper Co.* (*In re Tulsa Litho Co.*), 229 B.R. 806, 809–10 (B.A.P. 10th Cir. 1999).

29. *Kenneth J. Buechler, Liquidating Tr. v. Black Diamond Blade Co., d/b/a Cutting Edge Supply*, No. 17-1156 JGR, Order Granting Plaintiff's Motion for Cross Summary Judgment at 5 (Bankr. D. Colo. Mar. 23, 2018).

30. *Id.*

COLORADO
LAWYER

IS ON **CASEMAKER**

All past issues of *Colorado Lawyer* are available to CBA members via Casemaker. Once logged into the CBA website, follow these steps:

1. Visit www.cobar.org/Casemaker.
2. Select "Click here to Enter Casemaker."
3. Select "Colorado."
4. Select "The Colorado Lawyer."
5. Browse issues by date, or select "Advanced Search" to search by keyword, title, or author.

Questions? Contact Susie Klein, sklein@cobar.org, or Jodi Jennings, jjennings@cobar.org.

©2021 Colorado Bar Association. All rights reserved