

AMPAD Decision Affects Trustee's Ability to Avoid Preferences

By Joshua T. Klein

Ruling affects statute of limitations for avoiding preferences.

A distressed company can find itself in a Chapter 7 bankruptcy liquidation in one of three ways. First, the company can file a Chapter 7 bankruptcy petition, which is very rare. Second, the company may file for Chapter 11 but the reorganization fails and is then converted to a Chapter 7 liquidation. Third, the company may file for Chapter 11 and sell substantially all of its assets. Then, the Chapter 11 is converted to a Chapter 7 case. Recently, the third way has been the most prevalent in corporate bankruptcies. After a case is converted to Chapter 7, a trustee is appointed and has the duty to liquidate any remaining assets for the benefit of the company's creditors and distribute the proceeds to the company's creditors, according to the priorities set forth in the U.S. Bankruptcy Code ("Code").¹

By and large, the most valuable asset of a company in Chapter 7 consists of certain causes of action provided by the Code. These causes of action include avoidance and recovery of preferential transfers, which are typically payments made by the company to creditors preceding bankruptcy that "prefer" these creditors in some way, such as being out of the ordinary course of business.² The policy behind such actions is to promote equality of distribution among creditors and to dissuade creditors from pressuring a company to pay outstanding debts when the company is in a distressed situation. However, as with most statutory causes of action, Section 546 of the Code provides a two-year statute of limitations period under which a debtor-in-possession (DIP) or Chapter 7 trustee is restricted as to pursuit of avoidance actions. This time period can be extended by one year if certain requirements are met, which are particularly applicable in cases that are converted from Chapter 11 to Chapter 7.

Recently, the United States Court of Appeals for the Third Circuit issued a decision on the statute of limitations period that may have significant impact on bankruptcy estates and their creditors, *In re American Pad & Paper Co.*³ This article discusses the opinion and the court's decision; provides an analysis of the decision, including its potential impact on bankruptcy cases going forward; and suggests ways for parties to try to protect themselves from the outcome provided by this decision.

American Pad & Paper

On January 10, 2000, several creditors of American Pad & Paper Company and six related entities (AMPAD) filed involuntary Chapter 11 bankruptcy petitions against AMPAD in the U.S. Bankruptcy Court for the District of Delaware. Shortly thereafter, AMPAD filed voluntary Chapter 11 petitions seeking protection under the Code. Nearly two years later, the official committee of unsecured creditors in the cases sought to convert the cases to Chapter 7. The court entered an order converting the cases to Chapter 7 on December 21, 2001, which was effective on January 3, 2002. On that same date, January 3, the U.S. Trustee appointed Jeffrey Burtch as interim Chapter 7 trustee under Section 701 of the Code.

Section 701 of the Code provides that an interim trustee shall be appointed promptly after the order for relief or conversion of a case to Chapter 7. However, Section 701 further provides that "[t]he service of an interim trustee under this section terminates when a trustee [is] elected or designated under sec-

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tion 702 of this title [as permanent trustee] to serve as trustee in the case” The U.S. Trustee then scheduled the meeting of creditors under Section 341 of the Code for February 13, 2002. In the meantime, the statute of limitations to seek the avoidance of certain transfers, such as preferential transfers, provided by Section 546(a) expired on January 14, 2002 (two years after the order for relief). At the meeting of creditors, certain creditors requested the election of a trustee under Section 702(b) of the Code and elected Steven Singer to serve as the permanent Chapter 7 trustee. Section 702(b) provides that creditors may request the election of a trustee so long as such request is from creditors holding at least 20 percent in the amount of unsecured claims.

Due to the significant effort needed for creditors to meet the requirements of Section 702(b), trustees are rarely elected. The normal course of events is that the interim trustee automatically becomes the permanent trustee under Section 702(d) if there is no election. Unfortunately, that section does not refer to a date when the interim trustee is treated as the permanent trustee. For example, is the date of appointment as the interim trustee the effective date of appointment as the permanent trustee? Or does the effective date as permanent trustee have to occur later, when there is no election at the meeting of creditors? More on these issues later.

Subsequent to the election and appointment of Singer as trustee, Singer filed approximately 150 avoidance actions under Section 547 of the Code seeking to avoid and recover prepetition transfers by AMPAD as preferential transfers. Section 547 allows a debtor or the trustee to recover such transfers in order to prevent a debtor from paying favored creditors with assets that otherwise would be available to be apportioned among all creditors according to the priorities of the Code.⁴ For example, recipients of preferential transfers tend to be trade vendors with unsecured claims that pressure the debtor to pay past-due invoices. The receipt of payment by such vendors in effect favors them over creditors with more senior claims against the estate, such as a prepetition secured lender. Several of the defendants named in the actions filed by Singer moved in the bankruptcy court to dismiss the claims on the basis that they were filed beyond the two-year statute of limitations contained in Section 546(a). The bankruptcy court agreed with the defendants

and dismissed the actions. The U.S. District Court for the District of Delaware affirmed that decision, which was appealed by Singer to the U.S. Court of Appeals for the Third Circuit.

The Third Circuit began its analysis with direct reference to Section 546(a) of the Code. Section 546(a) provides in part as follows:

Limitations on avoiding powers:

- (a) An action or proceeding under section ... 547 may not be commenced after ...
 - 1) the later of—
 - (A) 2 years after the entry of the order for relief; or
 - (B) 1 year after the appointment or election of the first trustee under Section 702 ... of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A).

Accordingly, the two-year limitations period may be extended for an additional year if a trustee is elected or appointed prior to the expiration of the two-year period.

The court applied the limitations period to the AMPAD timeline and found that the two-year period expired on January 14, 2002—two years after the orders for relief were entered by the bankruptcy court. Singer was elected on February 13, 2002, and began filing his actions in August 2002, which was almost seven months beyond January 14, 2002. The court looked to the common statutory interpretation method under which the courts are to enforce a statute according to its terms when the language of the statute is plain and the only exception is when application of its terms would lead to an absurd result.⁵ In this case, the court determined that applying the plain language of the statute led to the conclusion that the actions brought by Singer were barred by the two-year time period because they were filed after its expiration.

Notwithstanding what the court described as actions that were plainly barred by the statute of limitations, Singer pointed to Burtch’s appointment date of January 3, 2002. Singer argued that because the interim trustee under Section 701 was appointed prior to the expiration of the initial two-year period he, as permanent trustee, should have

received the additional one-year period to file actions. In support of this argument, Singer relied on a subsequently overruled bankruptcy court decision that held that the one-year extension period began to run upon the appointment of the interim trustee under Section 701.⁶

In *Allied Digital*, the order for relief was entered by the court on October 25, 2000, and the first interim trustee was appointed on July 10, 2002, with a successor interim trustee appointed on July 25, 2002. However, the Section 341 meeting of creditors did not occur until March 5, 2003—more than four months after the expiration of the two-year period. The bankruptcy court determined that Section 701 should be read into the section concerning the one-year extension, because there is no practical difference between the powers of an interim trustee and those of a permanent trustee. The district court, in reversing the bankruptcy court, highlighted the fact that similarities in function between interim and permanent trustees do not warrant interposing Section 701 into the statute where it does not appear. The district court held that where the meaning of a statute is clear, a court's analysis of it must end, and because Section 701 does not appear in the one-year extension section, the appointment of an interim trustee cannot trigger its application to extend the two-year period. The Third Circuit pointed out that even the bankruptcy court in *Allied Digital* stated that it was not passing on whether a new one-year period is barred if the election occurs outside of the initial two years but an interim trustee was appointed within two years.

The Third Circuit wholeheartedly agreed with the district court's decision in *Allied Digital* and found the *AMPAD* facts in an even greater conflict with the clear language of the Code. This was because the election of the permanent trustee was clearly provided for in the extension language of Section 546(a), and the election in *AMPAD* occurred outside of the two-year time period. Even so, the Third Circuit went through an analysis to determine if there was an ambiguity in Section 546(a) that would allow it to interpret it differently and possibly "read in" Section 701.

The court noted that the current version of Section 546(a) was the result of congressional amendments in 1994. The prerevision version led to extensive litigation and differing decisions by courts around the country due to confusion over its language. Primarily, the first version did not refer to the order for relief but only stated that the two-year period begins to run with the appointment of a trustee under Section 702. Therefore, some courts held that there was no statute of limitations for a DIP to file avoidance actions. Some courts even held that the two-year period began to start over when there was a subsequent trustee appointed. Due to this confusion, Congress amended Section 546(a) to its current form. Floor statements following the passage of the 1994 amendment reflect that the reason for the amend-

ment was to provide a needed period of time for a later-appointed estate representative, such as a Chapter 7 trustee, to investigate and institute actions. Further statements also show that the amendment was intended

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to prevent prejudice against defendants from having to defend stale actions and should encourage estate representatives to investigate and resolve actions earlier in a bankruptcy case. The court continued and stated that in spite of the amendment and the focus on the limitations period, Congress did not include Section 701 in Section 546. The court found this very persuasive because there are other sections of the Code where interim trustees are included in grants of rights or powers by specific reference to Section 701.⁷ It is important that the court found that Section 701 cannot be applied to extend the period when the interim trustee (and not permanent trustee) is appointed. However, implied in this finding is the court's determination that an interim trustee becomes the permanent trustee at the time of the meeting of creditors under Section 341 once there is no election at the meeting, although the court referred to no decisional case law on this point.

Finally, the court addressed Singer's last argument that the statute as written produces absurd results and presents a due-process problem because the statute of limitations provides no notice as to when avoidance actions must be commenced

nor time in which to bring such actions. The court, while sympathetic to the time constraints involved, found little merit in this argument. The court stated that other parties in interest have the power to bring avoidance actions before the expiration of the two-year period.⁸ Likewise, the court found little merit in the argument that Singer's claims, as the permanent Section 702 trustee, were already barred at the moment of his election in February 2002, thus making the results of the application of the statute absurd. Without commenting on whether or not such results are absurd, the court simply dismissed this policy-based argument by stating that the natural reading of the statute produces the correct result and that any better policy outcome should come from Congress, not the courts. In other words, if you don't like the results, then complain to Congress.

The court clearly was not willing to stray from the strict reading of the statute and apply it other than as provided by Congress. The result probably is absurd, but the facts of this case are not very conducive to being able to make the policy argument that Singer attempted to make. There would be a better set of facts if there had been no election and Burtch became the permanent trustee by operation of Section 702(d). Then it could be argued that to avoid an absurd result, the timing of the appointment should "relate back" to the initial appointment as the date to determine if the two-year period has been extended. Once again, that is still not allowed by a literal reading of Section 546(a), but it at least gets beyond something that clearly had no chance of being able to come within the gambit of a one-year extension. In addition, the stated congressional purpose of the 1994 amendment was to provide an additional year to investigate and pursue avoidance actions. However, when the interim and/or permanent trustee has no time at all to do anything, that stated purpose is frustrated by the very language that is supposed to provide the extension of time. It must also be remembered that the meeting of creditors, which the court said is the date on which an interim trustee becomes a permanent trustee if there is no election, is set by the Office of the U.S. Trustee—not the interim trustee. Therefore, the interim trustee (and the debtor's bankruptcy estate) is at the mercy of the Office of the U.S.

Trustee concerning when an appointment occurs. The purpose of a statute of limitations is to force parties to act diligently and to not delay in bringing suit. However, that purpose is destroyed when a limitations period passes before the necessary party even has authority to act.

Impact for Bankruptcy Estates and Creditors

The policy issues, though summarily dismissed by the Third Circuit, are very real and have a potentially far-reaching impact for bankruptcy estates and their creditors. As discussed above, in bankruptcy cases such as *AMPAD's*, the largest class of assets possessed by a Chapter 7 bankruptcy estate is the avoidance actions that it can pursue. Therefore, losing these precious assets on technicalities such as this statute of limitations frustrates the purpose of the Code and only serves to harm creditors. Such a result would appear to be the complete opposite of Congress's intention and the reason that avoidance actions exist—that is, to promote equality of distribution among creditors and to dissuade them from pressuring failing companies to settle their debts quickly.

The Third Circuit stated that parties in interest in a Chapter 11 case can pursue avoidance actions before the expiration of the two-year limitation period. However, that belief, and the apparent conflict in the statutory language itself, ignores the practicalities of most Chapter 11 bankruptcy proceedings. In most Chapter 11 proceedings, parties are not focused on pursuing avoidance actions for a number of reasons. First, the parties in interest, such as debtors, secured creditors and creditors' committees, are focused on saving and reorganizing the debtor's business rather than pursuing litigation against creditors. Second, avoidance actions usually only become a concern when the business is failing and either liquidation or conversion becomes the best option. In other words, the parties in interest tend to not care about pursuit of preferences and other avoidance actions if the business is going to succeed and emerge from bankruptcy. For obvious reasons, a debtor simply does not wish to sue the very people that are providing them with goods and services while they

are still operating. Furthermore, unsecured creditors' committees are not exactly fond of suing the members of the constituency that they represent. Finally, the crucial element underlying the Chapter 11 process is that it takes time for a debtor to either succeed or not.

The impact of this statute of limitations and the possible issue of losing avoidance actions may be immense for all creditors, in particular secured creditors. First, in a typical converted Chapter 11 case, the company's prepetition secured lender(s) will not be fully secured for a variety of reasons. Therefore, such undersecured creditors will normally have the largest and most significant unsecured claim through their deficiency claim consisting of the undersecured portion of their total claim. The greatest hope of any recovery to unsecured creditors in such cases is the proceeds of avoidance actions, of which the undersecured lender will receive the lion's share of such a distribution and have the most to lose if a trustee is barred from pursuing avoidance actions. Second, a lender providing post-bankruptcy petition Chapter 11 DIP financing may find itself in the same position. Third, several bankruptcy courts have recently been willing to approve DIP financing arrangements in which the DIP lender is given postpetition liens on a variety of assets, including the debtor's avoidance actions. Such liens will be worthless if a subsequently appointed trustee is barred from pursuing the avoidance actions.

Protections for Creditors

There are several actions that creditors—and debtors for that matter—can take to reduce the risk of an AMPAD result. First, all parties in a Chapter 11 proceeding need to be cognizant of the time period involved and the looming 546(a) limitations. If the limitations period begins to near, creditors should move to convert the case to Chapter 7 so as to preserve the extension period and ultimately

the avoidance action. This may sound drastic, but normally all parties in interest will know before the expiration of the two-year period if there is a viable opportunity for the company to reorganize or whether conversion to Chapter 7 is the only option. Second, in conversion situations, the parties in interest can become more proactive with the Office of the U.S. Trustee in timing the conversion and setting the Section 341 meeting of creditors so that it will occur before the expiration of the limitations period. Third, it is clear that in order to avoid the result in *AMPAD*, or similar results, Section 546(a) needs to be amended to include the Section 701 trustee appointment. The express inclusion of Section 701 should not be controversial and should really be viewed as a clarification. As the court stated in *AMPAD*, if you don't like the result, then complain to Congress. Therefore, Congress needs to be made aware of this issue by parties that frequently participate in bankruptcy proceedings, such as trade creditor groups, commercial leasing groups and traditional as well as nontraditional secured lenders.

Endnotes

- ¹ 11 USC §101 *et seq.*
- ² See 11 USC §547.
- ³ *In re Amer. Pad & Paper Co.*, 478 F3d 546 (3d Cir. 2007).
- ⁴ See *In re Pillowtex, Inc.*, 304 F3d 246, 252 (3d Cir. 2002).
- ⁵ See *Robert Wood Johnson Univ. Hosp. v. Thompson*, 297 F3d 273, 284 (3d Cir. 2002).
- ⁶ See *Burtch v. Georgia-Pacific Corp. (In re Allied Digital)*, 300 BR 616 (Bankr. D.Del. 2003), *rev'd*, 341 BR 171 (D.Del. 2006).
- ⁷ See 11 USC §507(a)(1)(C). Section 507 was amended by Congress in 2005 to provide that where a "trustee is appointed or elected under section 701, 702 ..." certain administrative expenses of such a trustee may be entitled to priority over other types of claims.
- ⁸ See *Offical Comm. Of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F3d 548, 550 (3d Cir. 2003) (en banc).

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