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Can Your Lien Be Avoided if Only the Debtor Will Benefit? The Courts are Split.

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The United States Bankruptcy Court for the District of New Mexico added its voice to the split in judicial authority on whether a lien or similar transfer can be avoided under sections 544, 547, 548 and 549 of the Bankruptcy Code where only the debtor itself may benefit from the avoidance. Judge Thuma in his recent decision in *U.S. Glove, Inc. v. Jacobs (In re U.S. Glove, Inc.)*, AP No. 21-1009, 2021 WL 2405399 (Bankr. D. N.M. June 11, 2021), held that notwithstanding the lack of a "benefit to the estate" requirement in section 547 of the Bankruptcy Code, an action to avoid a lien belatedly perfected during the preference period could only proceed if avoidance of the lien would benefit the estate (i.e., creditors) and not just the debtor.

Sections 544, 547, 548 and 549 of the Bankruptcy Code empower the debtor or a trustee in a chapter 11 or chapter 7 bankruptcy, respectively, to sue creditors to avoid certain transfers. The most common type are payments received in the 90 days prior to the bankruptcy filing (or 1 year for insiders), often referred to as the preference period, but the term transfer is broadly defined by the Bankruptcy Code and can include the grant and perfection of liens.[1] Where the transfer is of money or property that must be recovered for the estate, this action will include a claim for recovery of the property transferred pursuant to section 550(a) of the Bankruptcy Code. Section 550(a) contains a limit that property may only be recovered for the benefit of the estate.[2] However, in an action to avoid a lien or the perfection of a lien, as was the case in the *U.S. Glove* decision, section 550(a) may not be asserted and its limitation of benefit to the estate may not be not applicable.[3] Sections 544, 547, 548 and 549 of the Bankruptcy Code do not explicitly limit their avoiding power to situations that will benefit the estate.[4] As recognized by Judge Thuma, courts are split on whether avoidance actions that do not raise section 550 require that there be some "benefit of the estate/benefit of creditors."

In *U.S. Glove, Inc.*, the debtor sued the defendant – who was also the debtor's only allowed unsecured creditor – to avoid a lien that the defendant perfected more than 20 months after the grant of his security interest in the collateral securing his loan to the debtor. *Id.* at *1-2. The defendant's delayed perfection was within the preference period and the debtor sued the defendant to avoid the lien pursuant to section 547 of the Bankruptcy Code. *Id.* The plaintiff filed a motion seeking summary judgment and the defendant objected to the motion on the sole issue of whether the action could proceed without a benefit to unsecured creditors (i.e, the defendant). [5] *Id.* at *4. The defendant asserted that the avoidance powers of section 547 were inapplicable unless creditors benefit. *Id.*

Judge Thuma discussed the history of the Bankruptcy Act and the split among the courts regarding whether a "benefit to the estate" requirement is imposed when not explicitly provided for in the statute. *Id.* at *6-9. In siding with the courts requiring a benefit to the estate, Judge Thuma detailed six bases for his decision:

- Under the Bankruptcy Act, a trustee or debtor in possession had to demonstrate a benefit to the estate before she could use her avoidance powers.
- The language and legislative history of the Bankruptcy Code's avoidance and recovery sections do not evidence a desire to eliminate the "benefit of the estate" rule developed under the Bankruptcy Act, and the Supreme Court has repeatedly held that a clear indication is required before concluding that Congress intended to depart from the past.
- It makes no sense to have a "benefit of the estate" limitation for some avoidable transfers but not others.
- It seems likely that Congress intended the "benefit of the estate" limitation in section 550 to apply to all avoided transactions, and that Congress simply overlooked the situation in which section 550 need not be pled, like the lien avoidance action at issue.
- Granting a security interest actually is a transfer of property, so section 550 should apply.
- Requiring a benefit to the estate is consistent with the purposes of the Bankruptcy Code and the avoidance action provisions which were intended to create equality of distribution among similarly situated creditors and not to be used to generate windfalls for debtors.

Judge Thuma denied summary judgment and notwithstanding his decision in favor of the defendant on the legal issue, held that evidence and briefing on the legal standard was needed regarding whether avoidance of the lien would benefit the estate. The Court held that, "[w]hether a particular action provides a windfall for the debtor or a benefit for the estate 'depends on a case-by-case, fact-specific analysis'" and would require evidence. *Id.* at *9 (citation omitted). The Court noted that cases run the gamut from allowing avoidance so long as there is some benefit, to requiring that all proceeds recovered be paid directly to creditors. *Id*. *See also Rushton v. Hiawatha Coal Co. Inc. (In re C.W. Min. Co.)*, 477 B.R. 176, 189 (B.A.P. 10th Cir. 2012) ("There is also split of authority concerning how broadly to interpret 'for the benefit of the estate.'").

In cases where the benefits of avoidance will not run to the creditors, this decision and the others that precede it provide another basis for creditors to defend avoidance actions in addition to the traditional defenses.

Footnotes

[1] 11 U.S.C. §101(54).

[2] 11 U.S.C. §550(a).

[3] Historically, under the Bankruptcy Act of 1898 (the "Bankruptcy Act") the avoidance and recovery provisions were contained within the same provision and courts uniformly held that avoidance powers were intended to benefit unsecured creditors and could not be used when the only beneficiary was the debtor. *U.S. Glove*, 2021 WL 2405399, at *5, citing 11 U.S.C. §§ 67 et seq. (repealed) and *In Whiteford Plastics Co. v. Chase Nat'l Bank of New York City*, 179 F.2d 582 (2d Cir. 1950).

[4] 11 U.S.C. §§544, 547, 548 and 549.

[5] Generally, under section 547, the trustee may avoid any transfer of an interest of the debtor in property to or for the benefit of a creditor, for or on account of an antecedent debt owed by the debtor before the transfer was made, while the debtor was insolvent, within 90 days before the date of the bankruptcy petition or between 90 days and one year before the petition date if the creditor of such transfer was an insider, if it permits the creditor to get more than it would get in chapter 7. *Id.* at *2. The Court found that defendant more or less conceded the debtor's prima facie case and focused on its argument that the debtor lacks standing to assert the claim because avoiding defendant's lien would not benefit creditors. *Id.* at *1.

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