When the Statute of Limitations Meets Claim Objections

A tale of two sections of the Bankruptcy Code

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As with most powers, a bankruptcy trustee's avoidance powers under Chapter 5 of the Bankruptcy Code have their limits—one of the main ones being the statute of limitations embodied in 11 U.S.C. §546(a). But through use of claim objections under §502(d), trustees have successfully exercised avoidance powers even when they are clearly time-barred under §546(a).

This raises a number of questions. First, does §502(d) trump §546(a)? Second, can avoidance powers even be exercised via the claims-objection process? Can the confluence of §502(d) and §546(a) be properly comported?

Limitation of the Avoidance Powers

While a trustee's avoidance powers—found at §§544, 545, 547 and 548 of the Bankruptcy Code—are formidable, they are not automatic. Trustees must take affirmative action to use them; moreover, there is a time limit for doing so. Specifically, under §546(a), avoidance actions must be brought within the later of (1) "2 years after the entry of the order for relief" (i.e., the bankruptcy petition), or (2) "1 year after the appointment … of the first trustee … if such appointment … occurs before the expiration of the [two-year period]…."

§502(d)'s Impact on Claims Otherwise Time-Barred Under §546(a)

Although it might be appear clear that a trustee may not exercise avoidance powers after expiration of §546(a)'s limitation period, trustees have successfully employed otherwise stale avoidance powers via objections to claims under §502(d). As discussed below, there is a split of authority on this issue.

• *The Majority Approach*

The majority view is that, while §546(a)'s limitation period bars *affirmative* avoidance claims, it does not prevent *defensive* use of avoidance powers via §502(d) (just as recoupment claims may be asserted defensively after expiration of the statute of limitations). The courts following this approach generally rely on three things: (1) the specific language of §502(d) and §546(a); (2) decisions on similar sections of the prior Bankruptcy Act; and (3) policy considerations.

First, as to its specific language, §502(d) provides as follows:

> [T]he court shall disallow any claim of any entity from which property is recoverable under section … 550 … or that is a transferee of a transfer avoidable under [the avoidance sections of the Code] … unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable….

The majority-view courts note that this language contains no limitations period of its own. *See, e.g., U.S. Lines v. United States (In re*

McLean Indus.), 196 B.R. 670, 676-677 (S.D.N.Y. 1996) (stating that if Congress intended a limitations period to be applicable to §502(d), it easily could have included a reference to §502(d) in §546(a)). They also note that §502(d) does not reference §546(a), and vice versa. Thus, they conclude that nothing in the text of either section prevents trustees from using otherwise time-barred avoidance powers defensively via §502(d).

Second**,** majority-view courts also look to decisions regarding the interplay of the statutory precursors to §502(d) and §546(a) in the former Bankruptcy Act—namely, §57g and §11e. *See, In re Mid Atlantic Fund*, 60 B.R. at 609-10. The decisions most often cited are *In re Cushman Bakery,*526 F.2d 23, 34-37 (1st Cir.1975) (focusing on the lack of express textual connections between the sections, as well as the historic flexibility of the claims-allowance process, in holding that the limitations period did not apply to a claim objection); and *In re Meredosia Harbor & Fleeting Serv.,* 545 F.2d 583, 590 (7th Cir. 1976)(holding that *defensive* use of avoidance powers in response to creditors' claims is "in the nature of recoupment and therefore not barred by [the applicable statue of limitations].")

Finally, some majority-view courts reason that allowing defensive use of time-barred avoidance powers under §502(d) furthers the goal of ensuring equal distribution among creditors. *See, e.g., Comm. of Unsecured Creditors v. Commodity Credit Corp. (In re KF Dairies),* 143 B.R. 734, 737 (9th Cir. B.A.P. 1992); and *U.S. Lines v. United States (In re McLean Indus.)*, 196 B.R. 670, 677 (S.D.N.Y. 1996). According to these courts, although ideal distribution is facilitated by a trustee's timely avoiding and recovering voidable transfers, the next best approach in the event that an avoidance claim is time barred is to facilitate at least partial recovery for the estate via §502(d). *Id. See also Grant, Konvalinka & Harrison v. Still (In re Mckenzie)*, 737 F.3d 1034, 1042 (6th Cir. 2013); and *In re Cushman Bakery*, 526 F.2d 23, 36 (1st Cir. 1975).

• The Minority Approach

On the other hand, courts embracing the minority view argue §502(d)'s text and legislative history demonstrate that it cannot be used to side step §546(a)'s limitation period.

See, Hoggarth v. Kaler (In re Midwest Agri. Dev. Corp.), 387 B.R. 580, 585-586 (B.A.P. 8th Cir. 2008); *In re Mktg. Assocs. of Am.,* 122 B.R. 367 (Bankr. E.D. Mo. 1991); *Harold J. Barkley, Jr. v. West (In re West)*, 474 B.R. 191, 202-203 (Bankr. N.D. Miss. 2012); *GMAC Mortg. v. Blitz Holdings Corp. (In re IFS Fin. Corp.)*, 2008 Bankr. LEXIS 4353, at *3-5 (Bankr. S.D. Tex. 2008).

First,rather than focusing on the fact that §502(d) does not reference any limitation period or connection with §546(a), these courts rely upon the section's express language. To wit, §502(d) only requires disallowance of claims of a transferee if (1) the transfer is actually "avoidable" under the avoidance sections of the code, and (2) the transferee has not returned the property or money for which it is "liable" under such sections, they argue that no claim is "avoidable," and no transferee "liable," unless an avoidance action is first timely brought and adjudicated against the transferee. *Id.*

Second, §502(d)'s legislative history supports this view, memorializing that "disallowance of a claim … [is only proper] if the transferee has not paid … [or returned] the property received *as required under the sections under which the transferee's liability arises.*" *See, Litzler v. Cooper (In re Margaux Tex. Ventures)*, 2014 Bankr. LEXIS 2542, *35-56 (Bankr. N.D. Tex. 2014) (emphasis added).

• Questions Raised By the Majority Approach

Although New Jersey courts have yet to weigh in on the authoritative split concerning the

relationship between §546(a) and §502(d), the majority approach raises two main questions that must be considered in analyzing any interaction of those sections.

First, can avoidance powers even be exercised via the claims-objection process? Because Bankruptcy Rule 7001 requires that avoidance actions be brought as adversary proceedings, an argument may be made that they cannot.

Previously, this argument could be easily refuted because a prior version of Rule 3007—which governs the claims-objection process—provided that if an objection included Rule 7001 demands (such as avoidance demands), "it bec[a]me an adversary proceeding." Thus, courts faced with arguments that avoidance powers had to be asserted via adversary proceedings (subject to §546(a)) were able to rely on this rule as expressly allowing avoidance demands to be asserted via a §502(d) objections—such demands would simply "become" an adversary proceeding. *See, In re Metiom*, 301 B.R. 634, 639 (Bankr. S.D.N.Y. 2003).

Rule 3007 was amended in 2007, however, and now provides that objections "shall not include a demand for relief" required to be brought as an adversary proceeding under Rule 7001. And, given that the rule has been changed and avoidance demands may only be brought in an adversary proceeding, a persuasive argument may be made that §502(d)'s back-door approach to asserting avoidance demands is now closed. *See, In re Carter*, 2013 Bankr. LEXIS 2577, *1-3 (Bankr. D. Colo. June 25, 2013).

In further support of this argument, a number of courts (including courts in the Third Circuit) have held that disallowance of a claim under §502(d) first requires a judicial determination, via an adversary proceeding, that the claimant is liable. *See, e.g., In re Lids Corp.*, 260 B.R. 680, 684 (Bankr. D. Del. 2001); *In re AgFeed USA,* 2015 Bankr. Lexis 1403 (Bankr. D. Del. 2015); *In re Marketing Resources Int'l Corp.,* 35 B.R. 353, 356 (Bankr. E.D. Pa. 1984).

If that is the case, and a §502(d) objection no longer "becomes an adversary proceeding" under the current version of Rule 3007, it would seem that a strong argument may be made that §502(d) no longer provides an end-around §546(a)'s limitation period. Indeed, if an adversary action is needed for a liability determination, and a liability determination is a precondition to disallowance of a claim under §502(d), it seems to logically follow that a timely adversary action is necessary for use of §502(d).

Second, assuming the equitable doctrine of recoupment is one of the main underpinnings of the majority-view approach that time-barred avoidance powers may be wielded defensively via §502(d), does recoupment even apply in most §502(d) scenarios?

According to both the Third Circuit and the New Jersey courts, although recoupment allows defensive use of otherwise time-barred claims, the defensively-asserted claim "must arise from the 'same transaction'" as the claim to which it responds. *See, Frescati Shipping Co. v. Citco Asphalt Ref. Co.,* 718, F.3d 184, 214 (3rd Cir. 2013); *Triboro v. Siren,* 2006 U.S. Dist. LEXIS 7522 (D.N.J. 2006). To this end, "a mere logical relationship [between the claims] is not enough[.]" *In re Enright*, 2015 Bankr. LEXIS 2728, *10 (citing *Lee v. Schweiker*, 739 F.2d 870, 875 (3rd Cir. 1984)). Rather, both claims "must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of the transactions without also meeting its obligations." *Id.*

In most §502(d) situations, however, it would seem that this standard is not met. Indeed, whether a creditor received a payment within 90 days of bankruptcy that might be avoidable as a preference under §547 could very well

have nothing to do with transactions out of which that creditor's proof of claim arise. Similarly, in many cases, the basis for a creditor's proof of claim would seem to have no connection with whether a transfer to such creditor could be avoidable as a fraudulent transfer under §544 or §548. Likewise, the circumstances giving rise to a trustee's strong-arm powers to avoid liens as a hypothetical creditor may not necessarily arise out of the same transaction in which the lien itself was created (as opposed to the fact that the lien was not adequately perfected for purposes of determining priority against competing creditors).

So if recoupment does not apply, does that mean that §502(d) cannot be used to assert stale avoidance powers? The majority-view courts do not address this.

Alternative Approach that NJ Courts Should Consider

Again, New Jersey bankruptcy courts have yet to side with either the majority or minority view. But there is, perhaps, an alternative, middle-ground approach that should be considered. That is as follows: require that avoidance powers may only be asserted via adversary proceedings subject to §546(a)'s time limits, with a liability adjudication being a necessary precondition to disallowance of a claim under §502(d); *but* allow §546(a)'s limitation period to be "avoided" in the following circumstances: (1) if otherwise applicable tolling doctrines apply; or (2) if a §502(d) objection falls within the limited confines of the recoupment doctrine, such that the avoidance claim(s) arise out of the same transaction that gives rise to the creditor's proof of claim. This approach seems to meld both the recoupment-based underpinning of the majority view, and the rules and case law that require a successfully adjudicated adversary proceeding as a precondition to a §502(d) objection.

Regardless of the approach, however, absent legislative intervention, it is likely that New Jersey courts will ultimately have to navigate the intersection of §546(a) and §502(d).

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