

Supreme Court Decision Limits Trustees' Ability to Pursue Fraudulent Transfer Actions

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The Supreme Court recently issued an opinion, resolving a circuit split, narrowing the sovereign immunity exception by limiting a trustee's ability to pursue avoidance actions against the government when such action invokes the rights of a creditor holding an unsecured claim to set aside a transfer that is "voidable under applicable law." The effect of this decision is to limit the ability of a trustee, to the detriment of creditors, to recover transfers from the government since sovereign immunity applies with respect to state law claims.

Bankruptcy Code Section 544 grants a trustee the power to avoid certain transfers for the benefit of creditors of the bankruptcy estate made before the bankruptcy filing when the debtor was insolvent without receiving reasonably equivalent value. To maximize recovery for creditors, Section 106(a)(1) provides for a waiver of sovereign immunity with respect to several Bankruptcy Code provisions, including Section 544.

At issue was the interplay between Sections 544(b) and 106(a)(1) of the Bankruptcy Code. Under Section 544(b), a trustee may invoke the rights of a creditor to avoid a transfer of an interest of the debtor "that is voidable under applicable law."

The Court considered whether the waiver of sovereign immunity under Section 106(a)(1) applies to actions commenced under Section 544(b) where the trustee is commencing the action in the name of a creditor, as opposed to asserting a cause of action granted under the Bankruptcy Code to which the waiver of sovereign immunity would apply under Section 106(a)(1).

Since the federal government is immune from liability if a creditor commenced the avoidance action directly, the question presented was whether sovereign immunity was waived when the trustee brings the same action on behalf of the bankruptcy estate. The Court ruled that the result should be the same since the waiver of sovereign immunity under Section 106(a)(1) did not create an independent cause of action against the federal government but is merely jurisdictional.

In *United States v. Miller*, the trustee in a Chapter 7 bankruptcy proceeding commenced an adversary proceeding against the federal government pursuant to Section 544(b), under the Utah fraudulent conveyance statute, to recover personal tax debts paid by a corporation on behalf of its principals before the bankruptcy filing. The Court's analysis turned on whether the

trustee satisfied the actual "creditor" requirement of Section 544(b)(1) for which sovereign immunity would apply and therefore preclude such an action since the creditor could not bring the same action under the Utah statute based on sovereign immunity.

In the 8-1 ruling, Justice Jackson delivered the opinion of the Court with Justice Gorsuch authoring the sole dissenting opinion. The Court noted that to prevail under Section 544(b), the trustee must identify an "actual creditor" who could have voided the transaction outside of the bankruptcy proceeding. Notwithstanding Section 106(a), since any actual creditor would have been barred based on sovereign immunity, the trustee could not be in a better position than the creditor would be to recover the transfer. The Court also noted that Section 106(a)(5) expressly provides that nothing in the section shall create any substantive claim for relief or cause of action not otherwise existing under the Bankruptcy Code, Federal Rules of Civil Procedure or non-bankruptcy law and that since the statute is jurisdictional it does not grant any substantive rights against the government. The reasoning of the majority was that Section 106(a) operates as a jurisdic-



tional provision but did not grant a substantive claim or right to a bankruptcy estate, even if that denies a trustee the right to pursue avoidance actions where the recovery would enhance the distribution to creditors of the bankruptcy estate.

The Court acknowledged that Section 106(a)'s language unmistakably waives sovereign immunity for federal causes of action created by Section 544(b) but does not waive sovereign immunity for state law claims nested within Section 544(b)'s "applicable law" clause.

The Court held that the trustee could not recover the transfer, even though the fraudulent transfer was undisputed, since the government's sovereign immunity defense insulates it under state law and the Bankruptcy Code does not grant the trustee any greater rights than a creditor to bring the action under state law. The Court ruled that if the federal government is immune under state law, then it should enjoy the same sovereign immunity even if the action is commenced by a trustee under the Bankruptcy Code.

Justice Gorsuch delineated the majority opinion by highlighting the divergence between state and federal bankruptcy proceedings, since it deprives the bankruptcy

estate of the cause of action granted under Section 544 against the recipient of the fraudulent transfer. The dissent contends that even if the federal government can defeat a claim brought by a private creditor in state court pursuant to sovereign immunity, the same claim brought by a trustee in federal court should not be barred by the sovereign immunity defense since, by enacting Section 106(a), Congress chose to waive the affirmative defense of sovereign immunity to an otherwise valid claim. While the federal government can defeat the claim pursued by a creditor in state court based on sovereign immunity, the dissent argued that the federal government should not defeat the same claim brought by a trustee in the Bankruptcy Court by virtue of Section 106(a)(1). Needless to say, since Judge Gorsuch was the sole dissent, the trustee did not prevail.

This marks a stark distinction between state law claims nested within a Section 544(b) claim and the Section 544(b) claim itself. Hence, as for the latter, Section 106(a) bars the federal government from asserting a sovereign immunity defense. As to the former, a claim asserted by a trustee in the name of a creditor pursuing the same relief in state court can be defeated by a sov-

ereign immunity defense.

The *Miller* decision clarifies that the Bankruptcy Code's waiver of sovereign immunity with respect to Section 544(b) does not apply to state law causes of action where the trustee steps into the shoes of the creditor, even if the sovereign immunity defense diminishes potential creditor recoveries.



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