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The IRS As "Golden Creditor:" The Past Isn't Dead (It Isn't Even Past)

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To paraphrase two out of fashion economic observers: There is a spectre haunting the market—the spectre of recession. And inasmuch as inflation was "transitory" until it wasn't, perhaps the ghostbusters at the Fed will speak of a "soft landing" until they don't.

With that chilling background in mind, we here at Ropes & Gray call your attention to another ghostly hand that may soon be haunting borrowers, creditors, and sponsors more and more: the so-called "IRS as golden creditor" theory. To wit: the combination of the Bankruptcy Code's strong arm powers and the collection period available to the Internal Revenue Service ("IRS") under 26 U.S.C. § 6502 effectively creates a ***ten year*** statute of limitations for fraudulent transfers. *See also United States v. Summerlin*, 310 U.S. 414, 416 (1940) ("It is well settled that the United States is not bound by state statutes of limitation or subject to the defense of laches in enforcing its rights.").

While this practically limitless period of review seems at odds with traditional (not to say "statutory") views on statutes of limitations in bankruptcy, a recent and otherwise unexceptional opinion from a Kansas bankruptcy court, *Williamson v. Smith (In re Smith)*, Case No. 19-40964, 2022 WL 1814415 (Bankr. D. Kan. June 2, 2022) (Somers, D.), shows how the golden creditor may haunt future bankruptcies for some time to come.

- *Smith* held that a trustee pursuing state law fraudulent transfer claims could, via Section 544 of the Bankruptcy Code, utilize the ten year lookback found in the Internal Revenue Code (the "IRC")[1] if the IRS holds an allowable claim against a debtor.

- The facts giving rise to the "IRS as golden creditor" theory in *Smith* are commonplace—namely, the IRS holds allowable claims against many, many debtors.

- Application of this theory may then give rise to another set of potential horrors as the claims that can be asserted by the hypothetical trustee are **not** capped at the size of the golden creditor's claim. For instance, a de minimis tax claim in favor of the IRS may allow for the pursuit of substantially larger claims against putative defendants.

- As we may approach a cycle of potential distress, market participants may need to look over their shoulder for a very long time.

- Potential litigation around nearly decade-old claims further presents a number of practical issues: memories fade, document retention policies may not look back into the early teens, investment vehicles may have dissolved, and personnel may be long gone.

The "IRS as Golden Creditor" Theory

Section 544(b)(1) of the Bankruptcy Code vests a trustee or debtor in possession with avoidance powers arising under "applicable law" that are available to *any* creditor holding an allowable claim against the debtor, provided that the trustee can demonstrate the existence of such a creditor (often referred to as the "golden creditor" or the "triggering creditor").

The debtor in possession, or its surrogate, may then "step into the shoes" of the triggering creditor in the sense that the rights available to the debtor in possession are defined by the rights of the triggering creditor. Importantly, however, the

[1] *See* 26 U.S.C. § 6502.

rights to recover are not limited to the size of the golden creditor's actual claim; thus a relatively small claim may give rise to a very large recovery. Said differently, the entirety of a fraudulent transfer may be avoided and recovered from the transferee for the benefit of the bankruptcy estate, regardless of the size of the triggering claim. *In re Tronox Inc.*, 464 B.R. 606, 616 (Bankr. S.D.N.Y. 2021) ("[A] trustee [may] avoid a fraudulent transfer without regard to the size of the claim of the creditor whose rights and powers the trustee [i]s asserting . . . .").

IRC Section 6502 and the IRS as Golden Creditor

Pursuant to Section 6502 of the IRC, the IRS may collect a tax assessment (typically via levy or lawsuit) within ten years of the assessment in question. *See* 26 U.S.C. § 6502.

There is limited authority preventing Section 6502 from expanding traditional statutes of limitations in bankruptcy. The New Mexico bankruptcy court in *In re Vaughan Co.*[2] rejected the "IRS as golden creditor" theory under the dual theory that a trustee is pursuing private interests (as opposed to the public interests of the IRS), and allowing for the trustee to enjoy a ten year lookback period wherever there is a tax claim would eviscerate the four-year lookback period in most bankruptcy cases.[3]

Conversely, the substantial majority of courts taking a 'plain meaning' approach to Section 544 have accepted the "IRS as golden creditor" approach, while also noting *Vaughan*'s policy-based concerns.[4] To date, no Federal Circuit Courts of Appeal have addressed the "IRS as golden creditor" theory directly, and therefore the law remains ultimately undecided.

Smith

Smith's facts are as unexceptional as its name. After filing for chapter 7 in August 2019, the chapter 7 trustee (the "Trustee") filed an adversary proceeding seeking, among other things, to avoid numerous transfers to the debtor's wife and their shared LLC as fraudulent transactions. *Smith*, 2022 WL 1814415, at *1, 5–6. The IRS held an allowable unsecured claim for 2018 federal income taxes in the amount of $20,574.08, plus a penalty of $797.20.14.[5]

The sole issue before the *Smith* court was whether certain of the Trustee's fraudulent transfer claims should be dismissed on the grounds that the applicable four-year statute of limitations had passed. *Id.* at *2. The Trustee asserted that the transfers were avoidable under Section 544(b) of the Bankruptcy Code, and that the Trustee could "step into the shoes" of the IRS and exercise the lookback period provided under IRC Section 6502.

Ultimately, the *Smith* court sided with the substantial majority of courts to have addressed this issue. The *Smith* court adopted the majority's reasoning, finding that Section 544(b)'s plain meaning imposes no limitations on the Trustee's rights when standing in the shoes of the IRS versus state avoidance law. *Smith*, at *20–21, 24.[6]

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[2] *Wagner v. Ultima Homes, Inc. (In re Vaughan Co.)*, 498 B.R. 297 (Bankr. D.N.M. 2013).
[3] *Id*. at 304–05.
[4] *See In re Gaither*, 595 B.R. 201, 208 (Bankr. D.S.C. 2018) ("The majority of courts [that] have addressed the same issue [have] concluded that § 544(b) . . . permit[s] a trustee to step into the shoes of the IRS and avail herself of federal law.") (citations omitted).
[5] Note that the Proof of Claim filed by the IRS, Proof of Claim No. 4, states that the taxes were assessed on November 18, 2021 – *after* the date that the debtor filed its bankruptcy petitions.
[6] Note that *Smith* only addressed the specific issue of which statute of limitations applied on a motion to dismiss, where the court accepted the Trustee's assertions on the merits of the alleged fraudulent transfer claim as true and in the light most favorable to the Trustee. The defendants in *Smith* will still have an opportunity to have the merits of the alleged fraudulent transfer claims adjudicated by a trier of fact.

Takeaways from *Smith*

The key fact underlying the *Smith* decision is, by its very nature, routine: many debtors will have allowable claims held by the IRS as of their bankruptcy filing. Accordingly, market participants should note that, when assessing stressed or distressed situations, the typical temporal parameters to litigation risk may not necessarily apply as a ten year lookback period opens up a large universe of potential claims.

While the legal implications may be fairly simple—i.e., the lookback period for claims may be up to ten years—the practical implications are likely more complex and far reaching. At the most basic level, litigating claims that are nearly a decade old presents informational challenges. Documents, memories, employees, or other transaction participants may no longer be available. To be sure, the justifications for the "IRS as golden creditor" theory are, at best, shaky,[7] and clearly at odds with long-settled views on how statutes of limitations are intended to work.

But it is worth bearing in mind that many years after a given transaction, an investor may have exited its investment, closed the investing funds, and returned capital to its partners, and fiduciary liability insurance policies (or their respective tail periods) may have expired. A financial sponsor may have left its portfolio company on perfectly sound footing when exiting its investment, but, under the ownership of another party, the portfolio company ends up in bankruptcy court and the previous sponsor is then sued for seven, eight, or nine-year-old claims. As with any ghost, then, *Smith* serves as a timely but perhaps unwelcome reminder that things long past may be relevant for a long time to come.

That being said, defenses may still be available with respect to application of Section 6502 in the "IRS as golden creditor" theory—above and beyond policy arguments challenging the wisdom of a practically endless statute of limitations. Moreover, the best time to mitigate risk is oftentimes prior to any transfer, and strategies exist to proactively address potential liability, such as utilizing the safe harbor for securities transactions discussed here. But careful analysis is required, and we encourage you to contact your Ropes & Gray team to discuss these matters more fully.

[7] *In re Kipnis*, 555 B.R. 877, 883 (S.D. Fla 2016) ("The IRS is a creditor in a significant percentage of bankruptcy cases. The paucity of decisions on the issue may simply be because bankruptcy trustees have not generally realized that this longer reach-back weapon is in their arsenal. If so, widespread use of § 544(b) to avoid state statutes of limitations may occur and this would be a major change in existing practice.").