

A LITTLE SAUCE FOR THE GANDER: THE NINTH CIRCUIT HOLDS THAT A BANKRUPTCY TRUSTEE CAN RECOUP TAX PAYMENTS FROM THE IRS AS FRAUDULENT TRANSFERS UNDER APPLICABLE STATE LAW

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Most states have a version of the Uniform Fraudulent Transfer Act, or its predecessor, the Uniform Fraudulent Conveyance Act; these statutes permit creditors to set aside a variety of transfers made by debtors, including transfers made with an intent to hinder, delay or defraud creditors and transferees, as well as transfers made for less than fair value while the debtor was insolvent. The IRS is a frequent and enthusiastic litigant under these state statutes, which it relies upon to collect delinquent taxes from third parties who received a taxpayer's property.

On August 31st, the Ninth Circuit ruled that the IRS is also subject to these laws, holding that a bankruptcy trustee could rely on state law to recoup tax payments made to the IRS. [Zazzali v. United States](#), No. 16-35597, 2017 U.S. App. LEXIS 16817 (9th Cir. Aug. 31, 2017).

Zazzali arose out of the bankruptcy case of DBSI, Inc., which had apparently operated a Ponzi scheme. 2017 U.S. App. LEXIS 16817 at *4. DBSI elected to be treated as an S Corporation, and it made \$17 million in tax payments on behalf of its shareholders between 2005 and 2008. *Id.* at *4-*5. The shareholders received refunds of \$3.6 million from the IRS that were derived from these payments. *Id.* at *5. After DBSI's liquidating plan was approved, Mr. Zazzali, as its liquidating trustee, sought to recoup DBSI's tax payments in an adversary proceeding before the bankruptcy court.

The trustee relied upon two different provisions of the Bankruptcy Code, section 548, which provides a bankruptcy trustee with authority to recoup fraudulent transfers made within two years of the bankruptcy filing, and section 544(b), which permits a trustee to step into the shoes of an actual creditor and assert any state law claim to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law." 11 U.S.C. § 544(b). The trustee's claim under section 544(b) had a four year limitations period under Idaho's Uniform Fraudulent Transfer Act that made more tax

payments subject to recovery; only \$56,000 of the \$17 million in tax payments were made within two years of the bankruptcy filing. 2017 U.S. App. LEXIS 16817 at *6.

While the Bankruptcy Code contains a provision waiving sovereign immunity, 11 U.S.C. § 106(a), the government moved to dismiss the claim under section 544(b) of the Bankruptcy Code on the theory that there was no waiver applicable to the underlying state law cause of action, which meant that no creditor could recover. *Zazzali*, 2017 U.S. App. LEXIS 16817 at *6. The bankruptcy court rejected that argument, and the district court affirmed, rejecting a Seventh Circuit opinion that supported the government's position. *Id.* at *6-*7. Ultimately, *Zazzali* was resolved in the district court on summary judgment motions, and the IRS was ordered to return \$13.4 million of transfers. *Id.* at *8-*9. The government appealed, asserting that recovery was barred by sovereign immunity.

The Ninth Circuit commenced its analysis by summarizing how section 544(b) operates, noting that it simply permits a trustee to recover in a case in which an actual creditor could invalidate a transaction. *Id.* at *10. While acknowledging that no creditor of DBSI could invalidate the tax payments outside of a bankruptcy because of sovereign immunity, the Court of Appeals observed that section 106(a)(1) of the Bankruptcy Code "unambiguously abrogates the federal government's sovereign immunity 'with respect to Section 544.'" *Id.* at *11 (quoting 11 U.S.C. § 106(a)(1)) (emphasis by the court). As a consequence, the court indicated that the abrogation of sovereign immunity necessarily reached the underlying state law claim. *Id.*

Section 106(a) of the Bankruptcy Code abrogates sovereign immunity of any governmental unit for purposes of *fifty-nine* different provisions of the Bankruptcy Code, including section 544. See 11 U.S.C. § 106(a)(1). It then specifically authorizes the entry of "an order, process, or judgment under such sections or the Federal Rules of Bankruptcy Procedure, including an order or judgment awarding a money recovery, but not including an award of punitive damages." 11 U.S.C. § 106(a)(3). In the Ninth Circuit's view, the substantive requirement of section 544(b) that a creditor be able to recover under applicable law had to be read in view of the broad waiver of sovereign immunity contained in section 106(a)(1). *Zazzali*, 2017 U.S. App. LEXIS 16817 at *11-*12. The Court of Appeals concluded that section 544(b), read in light of section 106(a)(1), meant that "a trustee need only identify an unsecured creditor, who, but for sovereign immunity, could bring an avoidance action against the IRS." *Id.*

The Ninth Circuit observed that its conclusion was reinforced by the order in which the section 106(a)(1) and section 544(b) had been enacted. The current version of section 106(a)(1) was enacted in 1994. *Id.* at *12, n.8. As a consequence, when Congress passed that statute, it was well aware that section 544(b) allowed a trustee or debtor-in-possession to bring claims derived from applicable state law, as that power had been included when the Bankruptcy Code was enacted in 1978, and had existed under the Bankruptcy Act of 1898. *Id.* at *13. Since Congress is presumed to understand the state of existing law when it legislates, the Ninth Circuit concluded that when Congress included section 544 among the Bankruptcy Code sections for which sovereign immunity was abrogated, it meant to include the underlying state law claims as well. *Id.*

The court also reasoned that a contrary reading of section 106(a)(1) would treat the reference to section 544 in that statute as a nullity. *Id.* at *13-*14. As a consequence, the Ninth Circuit explicitly held that the text of section 106(a)(1) abrogated sovereign immunity for claims under section 544(b) of the Bankruptcy Code, "including the underlying state law cause of action." *Id.* at *16. While recognizing that it was required to adopt a plausible construction that would preserve sovereign immunity, the Court of Appeals indicated that there was no plausible construction that would do so. *Id.*

The Ninth Circuit then addressed the contrary Seventh Circuit opinion, *In re Equipment Acquisition Resources, Inc.*, 742 F.3d 743 (7th Cir. 2014) ("EAR"). At the outset, the Ninth Circuit noted that a number of

bankruptcy and district courts had rejected the Seventh Circuit's holding in *EAR*. *Id.* at *17, n.11. The Ninth Circuit then noted that *EAR* had followed an appropriate mode of analysis derived from *FDIC v. Meyer*, 510 U.S. 471 (1994) by asking first whether there was a waiver of sovereign immunity and then whether the relevant substantive law offered a basis to provide relief. *Zazzali*, 2017 U.S. App. LEXIS 16817 at *17. In the Ninth Circuit's view, the court in *EAR* erred in analyzing whether the relevant substantive law provided relief, noting that Congress would not have bothered to waive sovereign immunity for a claim that could not be brought. *Id.* at *18-*19. Instead, the Ninth Circuit indicated that Congress plainly intended its abrogation of sovereign immunity to apply to the underlying state law claim that was to be brought pursuant to section 544(b). The Ninth Circuit also observed that the statutory definitions under both the Bankruptcy Code and under Idaho's Uniform Fraudulent Transfer Act contemplated governmental entities as defendants, and both section 544(b) and the relevant provisions of Idaho law provided an avenue for potential relief within the meaning of *FDIC v. Meyer*. *Id.* at *19.

The Ninth Circuit also rejected the Seventh Circuit's conclusion in *EAR* that both the Appropriations Clause and the Supremacy Clause supported its conclusion that sovereign immunity barred relief. As to the Appropriations Clause, the Ninth Circuit reasoned that federal law gave rise to the relief, making the Appropriations Clause irrelevant. *Id.* at *20-*21. For the same reason, the court indicated that "we fail to see any Supremacy Clause issue here." *Id.* at *21.

The Ninth Circuit closed its analysis by indicating that its disposition was also consistent with the equitable principles that form the backbone of the Bankruptcy Code, noting that Congress permitted transfers to the IRS to be avoided so that it would be on the same footing as other creditors. This solidly-reasoned opinion also comports with another equitable principle: What's sauce for the goose is sauce for the gander.



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