UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In re:	)	Chapter 11
	)	
DBSI, INC., et al.	)	Case No. 08-12687(PJW)
	)	
Debtors.	)	Jointly Administered
	)	
JAMES R. ZAZZALI, as Trustee of the DBSI Estate Litigation Trust created by operation of the Second Amended Joint Chapter 11 Plan of Liquidation,	)	
	)	
Plaintiff,	)	
	)	
v.	)	Adv. Proc. No. 10-54649(PJW)
	)	
DOUGLAS L. SWENSON, et al.,	)	
	)	
Defendants.	)	

MEMORANDUM OPINION

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Dated: February 11, 2011

WALSH, J

This opinion is with respect to the amended motion to dismiss the third through sixth counts of the Complaint. (Doc. # 5.) The motion to dismiss is filed by the United States, pursuant to Federal Rule of Civil Procedure 12(b)(6). These counts seek to recover allegedly fraudulent transfers from the Internal Revenue Service ("IRS") under § 544(b)(1) of the Bankruptcy Code, 11 U.S.C. §§ 101 et seq., incorporating applicable provisions of Idaho law. The principal question presented here is to what extent did Congress abrogate sovereign immunity for suits under § 544(b)(1) that apply state law causes of action. For the reasons discussed below, I find that Congress has fully abrogated sovereign immunity and therefore I will deny the motion on this issue. In addition to the sovereign immunity issue, the motion also asserts that the third, fifth and sixth counts fail to state a claim under § 544(b)(1) because the plaintiff failed to identify or allege an actual unsecured creditor that could sue the United States under Idaho state law. As to that issue, I will grant the motion without prejudice.

Background

DBSI, Inc. and certain of its affiliates filed bankruptcy petitions under Chapter 11 of the Bankruptcy Code on November 6, 2008. A plan of liquidation was confirmed on October 26, 2010, resulting in the appointment of James R. Zazzali as trustee

("Trustee") to administer the DBSI Estate Liquidation Trust. As that confirmation order sets forth in greater detail, DBSI, Inc. and its affiliates were operated as a single enterprise under the control of a small group of insiders. (Case No. 08-12687, Doc. # 5924, ¶ 27.) Trustee has commenced this adversary proceeding to recover allegedly fraudulent transfers made to these insiders as well as transfers made on behalf of the insiders to the IRS and the taxing authorities of 25 states. Trustee seeks to recover transfers made in the two years prior to the petition date pursuant to § 548, and he seeks to recover transfers made in the four years prior to the petition date under § 544(b)(1), applying Idaho fraudulent transfer statutes, Idaho Code Ann. §§ 55-906, 55-913, 55-914, 55-916, and 55-917 .

The United States has moved to dismiss the § 544(b)(1) counts against the IRS under Federal Rule of Civil Procedure 12(b)(6), as applicable here under Federal Rules of Bankruptcy Procedure 7012(b). The United States advances two arguments for dismissal. The first is that Congress has not abrogated sovereign immunity as to the § 544(b)(1) underlying state law causes of action. The second is that, as to counts three, five, and six, Trustee has failed to plead a cause of action under § 544(b)(1) because those counts do not allege the existence of an actual unsecured creditor who could have brought the state law action.

Trustee contends that Congress abrogated sovereign immunity in § 106(a)(1). Alternatively, Trustee contends that the United States has waived sovereign immunity under § 106(b) by filing a proof of claim in the bankruptcy case. As regards any pleading deficiency, Trustee contends there is no requirement to plead the existence of an actual unsecured creditor. In the alternative, Trustee answers that, if given leave to amend, it could cure this deficiency.

Discussion

Standard of Review

In considering a motion to dismiss, I must accept all factual allegations as true, construe the Complaint in the light most favorable to Trustee, and determine whether, under any reasonable reading of the Complaint, Trustee may be entitled to relief. Rea v. Federated Investors, 627 F.3d 937, 940 (3d Cir. 2010).

The central question presented in this motion to dismiss is whether Congress, through § 106(a)(1), abrogated sovereign immunity for state law fraudulent transfer actions brought under § 544(b)(1).

Sovereign Immunity

Section 106(a)(1) abrogates sovereign immunity for certain bankruptcy causes of action. As originally enacted in the

Bankruptcy Reform Act of 1978, § 106 contained the following general waiver of sovereign immunity:

> (a) A governmental unit is deemed to have waived sovereign immunity with respect to any claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which such governmental unit's claim arose.
>
> (b) There shall be offset against an allowed claim or interest of a governmental unit any claim against such governmental unit that is property of the estate.
>
> (c) Except as provided in subsections (a) and (b) of this section and notwithstanding any assertion of sovereign immunity –
>
> (1) a provision of this title that contains "creditor," "entity," or "governmental unit" applies to governmental units; and
>
> (2) a determination by the court of an issue arising under such a provision binds governmental units.

Pub. L. No. 95-598, Title I, § 106, 92 Stat. 2549 (1978).

The Supreme Court twice found this language did not effectively abrogate sovereign immunity. Hoffman v. Conn. Dept. of Income Maint., 492 U.S. 96 (1989) and United States v. Nordic Village, Inc., 503 U.S. 30 (1992); see Collier on Bankruptcy ¶ 106.01 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed.). In response to these cases, Congress amended § 106 in the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 § 113, to include an explicit abrogation of sovereign immunity. See Collier on Bankruptcy ¶ 106.01. Section 106(a)(1) now provides that

"[n]otwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to the following," then listing 60 specific Bankruptcy Code sections, including § 544.

Section 544(b)(1) provides:

> {T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

11 U.S.C. § 544(b)(1). A trustee can use his power under § 544(b)(1) "only if there is an unsecured creditor of the debtor that actually has the requisite nonbankruptcy cause of action." Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.), 226 F.3d 237, 243 (3d Cir. 2000).

Here, the applicable nonbankruptcy law is found in Idaho's fraudulent conveyance statutes, as listed above. The United States's argument runs as follows: Trustee can bring this § 544(b)(1) action against the IRS only if an unsecured creditor could avoid such a transfer under Idaho's fraudulent transfer laws; no unsecured creditor could do so because Congress has not abrogated sovereign immunity from Idaho fraudulent transfer

actions; consequently, Trustee, in the shoes of an unsecured creditor, likewise cannot avoid the transfers under § 544(b)(1).

In its own words the United States states its position as follows:

> In short, sovereign immunity does not bar a trustee from bringing any action under 11 U.S.C. § 544. Indeed, a trustee could raise the strong-arm powers in section 544(a) because those actions do not require the existence of an actual, unsecured creditor. In contrast, because section 544(b), unlike section 544(a), requires the Trustee to identify an actual, unsecured creditor that could bring an action against the United States under the nonbankruptcy law, the Court must analyze whether that creditor's action would be barred by sovereign immunity.
>
> Here the Idaho fraudulent-transfer laws do not waive the United States' sovereign immunity, nor could they because only Congress can waive the United States' sovereign immunity. Yet Congress chose not to make an explicit sovereign-immunity waiver that would allow a creditor to use Idaho state law to avoid tax payments as fraudulent transfers. Without such an explicit waiver, there is no unsecured creditor that can raise an avoidance action against the United States.

(Doc. # 6, p. 6.)(Footnotes omitted.)

In support of this argument, the United States relies on Grubbs Construction Co. v. Florida Department of Revenue (In re Grubbs Construction Co.), 321 B.R. 346 (Bankr. M.D. Fla. 2005), and United States v. Field (In re Abatement Environmental Resources, Inc.), 301 B.R. 830 (Bankr. D. Md. 2003). In Grubbs, a debtor in possession sought to recover under § 544(b)(1) certain allegedly

fraudulent transfers from the Florida Department of Revenue. The bankruptcy court granted summary judgment for the Florida taxing authority, finding that a creditor could not have brought such an action under the Florida Uniform Fraudulent Transfer Act "because under Florida law, such an action is barred by state law sovereign immunity. Accordingly, the debtor-in-possession's action cannot be maintained under section 544(b)." Id. at 348.

In Abatement, the bankruptcy trustee sought to void a transfer made to the Internal Revenue Service under § 544(b)(1), with the applicable state law being the Maryland Uniform Fraudulent Conveyance Act. Maryland law provided immunity from suit for taxing authorities, and the bankruptcy court held that this state law immunity was likewise available to the IRS. 301 B.R. at 35-36. In so holding, the court clarified that it was not deciding the issue of federal sovereign immunity: "The case at bar requires a determination of whether Maryland law recognizes a defense to a claim to avoid a 'fraudulent payment' of taxes; the issue is not whether a federal law of immunity applies under these circumstances." Id. at 835 n.6.

Neither of these cases addresses the question presented here as to whether federal sovereign immunity applies to a state cause of action under § 544(b)(1). Grubbs did not involve § 106(a)(1), as the avoidance action was brought against the Florida taxing authority. Abatement examined an avoidance action against

the Internal Revenue Service, but it did not analyze § 106(a)(1). Accordingly, neither case held that sovereign immunity bars § 544(b)(1) avoidance actions against the Internal Revenue Service.

The cases that do address this question uniformly find that § 106(a)(1) abrogates federal sovereign immunity from § 544(b)(1) suits. Liebersohn v. IRS (In re C.F. Foods, L.P.), 265 B.R. 71 (Bankr. E.D. Pa. 2001); Menotte v. United States (In re Custom Contractors, LLC), 439 B.R. 544 (Bankr. S.D. Fla. 2010), Tolz v. United States (In re Brandon Overseas, Inc.), 2010 Bankr. LEXIS 2326 (S.D. Fla. July 16, 2010), Sharp v. United States (In re SK Foods, L.P.), No. 10-2117 (Bankr. E.D. Ca. July 7, 2010). Each of these cases squarely addresses the question before the Court and finds that Congress, when it abrogated sovereign immunity as to § 544 causes of action, intended to include those state law causes of action available under § 544(b)(1). In re C.F. Foods, 265 B.R. at 85; In re Brandon Overseas, 2010 Bankr. LEXIS 2326, *10-11; In re Custom Contractors, 439 B.R. at 548-49; In re SK Foods, Case No. 09-29162, slip op. at 5.

These courts enunciated two persuasive reasons for interpreting § 106(a)(1) as applying to the state law causes of action available under § 544(b)(1). The first reason, as explained in In re C.F. Foods, is that § 544 has a long history of empowering bankruptcy trustees to bring certain state law causes of action. 265 B.R. at 85. Therefore, when Congress included § 544 in the

list set forth in § 106(a)(1), it "knowingly included state law causes of action within the category of suits to which a sovereign immunity defense could no longer be asserted." Id.

The second reason is set forth in In re Custom Contractors:

> Additionally, the Court notes that the "applicable law" referenced in § 544(b) generally contemplates state law. To require a trustee to demonstrate that the United States has waived sovereign immunity in every instance the trustee seeks to rely on state law for purposes of § 544 would render the general abrogation of sovereign immunity under § 106 almost meaningless.

439 B.R. at 549.

The United States's reply brief only addresses In re C.F. Foods. It contends that the case was wrongly decided, arguing that the ruling ran afoul of § 106(a)(5)'s limiting language: "[t]he Trustee's and Judge Carey's [in In re C.F. Foods] argument that Congress intended to waive state-law sovereign immunity by including section 544 in section 106(a)(1) is wrong because section 106(a)(5) expressly precludes any implicit waivers of sovereign immunity under nonbankruptcy law." (Doc. # 13, p. 5.) Section 106(a)(5) says no such thing.

I find the reasoning of In re C.F. Foods, In re Brandon Overseas, In re Custom Contractors, and In re SK Foods persuasive, and I find the United States's counterargument unavailing. Interpreting § 106(a)(1) to include an abrogation of the applicable

nonbankruptcy causes of action available to a trustee under § 544(b)(1) comports with the purpose and use of that provision. As stated in In re Custom Contractors, to accept the United States's argument would render § 106(a) practically meaningless. A similar sentiment was expressed by the court in In re SK Foods, L.P, No. 10-2117, p. 4-5:

> In other words, [according to the IRS], Congress' abrogation of sovereign immunity as to § 544 is only one part of the equation; according to the IRS, there must also be a waiver or abrogation of sovereign immunity with respect to the particular "applicable law" under which a bankruptcy trustee is asserting the rights of an unsecured creditor, under § 544(b)(1). However, neither the California legislature nor any state would have authority to abrogate the sovereign immunity of the United States as a defense to a creditor claim under the state's version of the Uniform Fraudulent Transfer Act or otherwise. Thus, the IRS' argument would apparently render meaningless Congress' abrogation of sovereign immunity as to § 544.

I adopt the position of the courts in In re Custom Contractors and In re SK Foods, L.P.

As to the United States's counterargument, § 106(a)(5) states that "[n]othing in this section shall create any substantive claim for relief or cause of action not otherwise existing under this title, the Federal Rules of Bankruptcy Procedure, or nonbankruptcy law." Adopting the interpretation of In re C.F. Foods, et al., does not create a new substantive cause of action that did not already exist under this title. Rather, this

interpretation recognizes the deep-rooted power of a trustee to bring certain state law causes of action. See In re C.F. Foods, 265 B.R. at 85-86 (citing 3 NORTON BANK. L. & PRAC. 2d. § 54:6 (1997)). This power existed under section 70(e) of the Bankruptcy Act of 1898, see, e.g. Moore v. Bay, 284 U.S. 4 (1931), and was adopted into the Bankruptcy Code under § 544(b) in 1978. Interpreting § 106(a)(1) as including § 544(b)(1)'s underlying state law causes of action recognizes this long-held power. It does not create any new substantive cause of action and in no way runs afoul of § 106(a)(5).

Because I find that by § 106(a) Congress abrogated the federal sovereign immunity defense implicated by a § 544(b)(1) action, it is not necessary to address the issue of whether the government, by filing a proof of claim in the bankruptcy case, waived sovereign immunity under § 106(b).

Pleading Requirements for a § 544(b)(1) Cause of Action

The final issue is whether Trustee has adequately pleaded a cause of action under § 544(b)(1). It is well settled that "a trustee or debtor in possession can use this power only if there is an unsecured creditor of the debtor that actually has the requisite nonbankruptcy cause of action." In re Cybergenics, 226 F.3d at 243. While a trustee at this stage of the litigation need not "plead the existence of an unsecured creditor by name," he "must ultimately prove such a creditor exists." In re APF Co., 274 B.R.

634, 639 (Bankr. D. Del. 2001).

Because Trustee has failed to even allege in counts three, five and six the existence of an actual unsecured creditor who could bring such a cause of action against the IRS, I will grant the IRS's motion to dismiss without prejudice, thus giving Trustee the opportunity to amend the Complaint.[1]

Conclusion

I conclude that Congress abrogated federal sovereign immunity defense implicated by a § 544(b)(1) action and that Trustee, therefore, may bring this cause of action against the Internal Revenue Service. However, because Trustee has not properly plead the existence of an actual unsecured creditor in counts three, five and six, I will grant the motion to dismiss as to those counts. I do so without prejudice to Trustee's right to amend the Complaint.

[1] Rule 15 permits a party to amend his pleading by leave of the court, and "leave shall be freely given when justice so requires." Fed. R. Civ. P. 15(a). An amendment "relates back to the date of the original pleading when the claim . . . asserted in the amended pleading arose out of the conduct, transaction or occurrence set forth or attempted to be set forth in the original pleading." Fed. R. Civ. P. 15(c).

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JAMES R. ZAZZALI, as Trustee of the DBSI Estate Litigation Trust created by operation of the Second Amended Joint Chapter 11 Plan of Liquidation,	)	
	)	
Plaintiff,	)	
	)	
v.	)	Adv. Proc. No. 10-54649(PJW)
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DOUGLAS L. SWENSON, et al.,	)	
	)	
Defendants.	)	

ORDER

For the reasons set forth in the Court's memorandum opinion of this date, the United States' amended motion (Doc. # 5) to dismiss the third through sixth counts of the Complaint is **denied**, except as to counts three, five and six as to which it is **granted** without prejudice to Trustee's right to amend the Complaint to allege the existence of an unsecured creditor.

Judge Peter J. Walsh
United States Bankruptcy Judge

Dated: February 11, 2011