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What Just Happened? How Asset Forfeiture Affects Bankruptcy Distributions

By Henry C. Kevane

Not every bankruptcy case remains within the neat confines of the Bankruptcy Code. Just as the high-tech bubble revealed conflicts between bankruptcy and intellectual property law, and the current spate of municipal Chapter 9 cases reveals conflicts between federal and state law, the recent wave of bankruptcies of the fraudsters and Ponzi schemers has revealed conflicts between the federal asset forfeiture scheme and the distributive regime of the Bankruptcy Code. Crime victims may receive distributions from forfeited assets outside of the bankruptcy case and sometimes in conflict with the bedrock policies of ratable distribution and "absolute priority" under the Bankruptcy Code.

Moreover, creditors often encounter a bankruptcy estate that is diminished due to the "nullifying" effects of a government forfeiture proceeding on the property of a debtor. A successful forfeiture can both divest the bankruptcy estate of assets available for distribution to creditors and divest property held by third parties otherwise within the reach of the estate's avoidance and turnover powers. Indeed, a debtor/criminal defendant may voluntarily turn over property or money to the government in settlement of a restitution action, fine, or penalty that is then used to compensate victims (often shareholders) ahead of or in lieu of creditors who would be senior under the bankruptcy distribution scheme. Additionally, victims often attempt to trace their investments into some form of trust that can then be carved out from the debtor's property, further diminishing an estate.

The forfeiture and bankruptcy distribution schemes are each generally intended to maximize compensation to those harmed by a debtor's conduct (whether that conduct was a crime, a tort, a contractual default, or a garden-variety business miscalculation). Yet, the divergent tools these schemes use to achieve this goal often result in fierce competition between their respective beneficiaries. A forfeiture proceeding does not typically inure to the benefit of general trade creditors and employees, while the bankruptcy paradigm typically subordinates the rights of investors and shareholders to those of creditors. Similarly, although a bankruptcy court has exclusive jurisdiction over all the property of the debtor, wherever located, the forfeiture remedies often result in the retroactive ouster of property into the hands of the government as of the date of the crime.

In those instances in which parallel criminal and bankruptcy proceedings are pending, should recoveries to injured parties vary (either in amount or eligibility) merely depending on whether a crime has been committed? Should the recoveries vary depending on what crimes are charged or, for that matter, proved? Should the government's police powers, or its ability to levy fines and penalties or order restitution against a defendant/debtor, be used to generate a competing, satellite fund for distributions to select victims, or should those recoveries be commingled with the assets of the bankruptcy case for the benefit of all affected parties?

This article examines how the fundamentals of the compensatory regime under bankruptcy law are affected by federal asset forfeiture law. Although this article focuses on the bankruptcy system, similar competition for assets occurs in the context of receivership proceedings (either under state or federal law, such as those commenced by the SEC or the CFTC), or statutory liquidations under the Securities Investor Protection Act. (A SIPA liquidation largely follows Chapter 7 and many receiverships, in fact, are modeled on the administration of estates in bankruptcy.) We will first examine the general principles under the Bankruptcy Code for marshaling and distributing assets. We then present an overview of the federal asset forfeiture rights and remedies, which nibble away at, and often deviate from, the comprehensive bankruptcy scheme. For the sake of simplicity, we have assumed that the crime at issue was perpetrated by or through an organized vehicle, such as a corporate or partnership entity. This is not to say that the issues discussed in this article are foreign to individual bankruptcy cases, but only that the scale and scope of the more celebrated cases are typically conducted through some form of organized entity.

The Bankruptcy Estate

The bankruptcy system is premised on the instantaneous creation of an "estate" upon the commencement of a bankruptcy case. The estate, in turn, is managed and maximized by the trustee (or, in a Chapter 11 reorganization case in which a trustee is not appointed, by the debtor in possession) for eventual distribution to creditors and equity holders. The estate broadly comprises "all legal or equitable interests of the debtor in property, wherever located and by whomever held" as of the commencement of the case.

In addition, the estate includes (1) any interest in property that is recovered by the estate from a third party using avoidance, turnover, offset, and related powers under the Bankruptcy Code, (2) all post-petition proceeds of property of the estate, and (3) all property that the estate acquires after the commencement of the case.

The federal district court (and, by reference, the bankruptcy court) has exclusive jurisdiction of "all the property, wherever located, of the debtor as of the commencement of the case, and of property of the estate." Virtually any party in interest has standing to appear and be heard with respect to matters affecting the disposition and distribution of property of the estate.

The formation of the estate, and the federal court's exclusive *in rem* jurisdiction over the estate, serve the essential marshaling purpose of a bankruptcy case. The bankruptcy court provides a centralized forum for (1) disclosing the debtor's financial affairs (through the schedules of assets and liabilities and other filings required of the debtor), (2) determining the validity and amount of all claims to share in the estate, (3) determining most actions against third parties to augment the estate through the trustee's turnover and avoidance powers (with certain exceptions based on the jurisdictional limits of bankruptcy courts as non-Article III courts), and (4) distributing value among parties in interest according to the distributive rankings set forth in the Bankruptcy Code.

Although the Bankruptcy Code defines what property of the debtor becomes part of the estate, non-bankruptcy law defines the scope and extent of a debtor's underlying interest in property. In other words, whether or not a debtor's property passes to the estate depends, in the first instance, on whether the debtor held cognizable title to the property under state law. Importantly, the bankruptcy estate excludes property in which the debtor holds bare legal title, such as property the debtor holds in trust for the benefit of another party. The bankruptcy court cannot control or administer the beneficial interest in such property. Consequently, third parties (such as fraud victims) often employ state law trust theories to try to defeat a debtor's interest in property and thereby thwart the estate's ability to administer the property for the benefit of all creditors.

Distribution of Estate Assets

How is property distributed in the bankruptcy case? Generally speaking, in a Chapter 7 liquidation case under the Bankruptcy Code the trustee must "collect and reduce to money" the estate (although, with the court's permission, the trustee may temporarily operate the debtor's business in order to accomplish an orderly liquidation). The proceeds of the liquidation are distributed to creditors according to strict statutory ranking and any surplus is remitted to the debtor. The trustee then files a final account of the administration of the estate, the debtor is discharged (subject to certain exceptions), and the case is closed.

In a Chapter 11 business reorganization case, the business typically remains in operation during the case, although selected assets of the estate may be sold or, under certain circumstances, if relief from the automatic stay is appropriate, returned to creditors having an interest in the property. The ultimate goal of the Chapter 11 case, and the predicate for distributions to creditors, is the confirmation of a plan of reorganization (which may, quite permissibly, provide for the debtor's eventual liquidation).

A Chapter 11 plan may propose myriad means for the disposition of the estate. For instance, the plan may provide for the retention of all or any part of the estate by the debtor (which, as a reorganized entity, could then carry on its business with its pre-bankruptcy property rights intact). Alternatively, the plan might provide for the distribution of parts of the estate to interested parties, or the merger of the debtor with another entity.

Once the liquidation is complete in a Chapter 7 case, or the plan is confirmed in a Chapter 11 case, the trustee can make distributions to creditors from property of the estate. In a Chapter 7 case, distributions follow a strict ranking—all senior claims must be paid in full before any distributions may be made to the next tier of creditors. Generally speaking, claims are ranked as follows: (1) secured claims, up to the value of the secured creditor's interest in the collateral, (2) administrative expenses, namely those costs incurred by the estate following the commencement of the case, such as professional fees, (3) priority claims, such as employee wages earned within six months before the commencement of the case, (4) all other unsecured claims, and (5) equity security interests.

The Bankruptcy Code specifically provides that a claim for a "fine, penalty or forfeiture" is payable after all unsecured claims are paid in full (including late-filed claims), but before interest is paid to unsecured creditors and before any surplus in the estate is remitted to the debtor. Forfeiture claims, thus, are contemplated by the Bankruptcy Code to be ratably paid from the estate. 11 U.S.C. § 726(a)(4). This express recognition under the Bankruptcy Code's classification scheme, however, is not viewed as an impediment to the government's ability to seek the removal of forfeited property from the estate, as discussed below.

In a Chapter 11 case, the debtor has greater flexibility under a plan with respect to distributions to creditors than otherwise required by the Chapter 7 distribution regime. Subject to certain safeguards, as long as creditors accept, some classes may be paid more than other classes, and some creditors within a class may be paid less than others. For instance, a plan may provide that, "for administrative convenience," smaller creditors may be separately classified and treated. Distribution in Chapter 11 depends, however, on creditor acceptance of the plan. Absent creditor acceptance, the only path to confirmation is compliance with the "cramdown" provisions of the Bankruptcy Code—that is, the plan must be "fair and equitable" as to each rejecting class of creditors.

Under either Chapter 7 or Chapter 11, however, unsecured creditors (whether employees, vendors, lenders, lessors or otherwise) rank senior to equity security holders (e.g., shareholders of a corporation). Moreover, the claims of creditors asserting damages arising from the purchase or sale of a security (e.g., investors) are statutorily subordinated to the claims or interests represented by the underlying security. This provision prevents an equity security holder from couching its interest as a "claim" for damages, rather than accepting treatment of the security according to its terms, in an attempt to leapfrog ahead of its cohorts.

Asset Forfeiture

In the case of a debtor facing criminal fraud charges, the government's forfeiture powers can interfere with both the scope of the estate that is otherwise subject to the jurisdiction of the Bankruptcy Court, and with the distributive priorities established under the Bankruptcy Code. Notably, the automatic stay in a bankruptcy case does not prevent the government from commencing or continuing the enforcement of its "police and regulatory power." Because forfeiture is considered punishment for a crime, not remuneration to the government, it falls within this exception. Indeed, the Supreme Court has held that the Eighth Amendment to the U.S. Constitution, barring "excessive fines," applies to forfeiture proceedings. *United States v. Bajakajian*, 524 U.S. 321 (1998).

In essence, under its forfeiture powers, the government can recover both the fruits of a crime and traceable proceeds of the crime. In addition, the government can target property used to commit, or otherwise involved in, a crime (such as a house used to manufacture drugs). A forfeiture order can be part of a criminal sentence (or a plea arrangement) against the individual fraudster or can be sought in a civil, *in rem* proceeding against the property itself, as in, for example, an action against a bank account styled as *United States v. All Funds and Interest Earned Thereon Located in Account No. 122860 at National Bank*.

Relating Back

If successful, under either the criminal or the civil path, title to the property is forfeited to the government. The government takes the position, supported by many cases, that forfeited property divests from the fraudster (or a third party, in the case of property involved in or derived from a crime), as of the date of the crime. In other words, the government's title "relates back" to the date of the offense. Under this doctrine, because a bankruptcy estate is comprised only of property of the debtor *as of the commencement of the case*, a pre-bankruptcy crime will result in forfeited property never becoming part of the estate. Moreover, when directed against third parties in possession of forfeitable assets, the estate may lose the ability to recover the property through avoidance or turnover actions.

At first blush, the relation back doctrine seems to conflict with both the bankruptcy court's exclusive jurisdiction over property of the debtor and of the estate and the provisions of the Bankruptcy Code that treat forfeiture as a "claim" against the estate. Under forfeiture rules, unless and until a judgment is entered, the property remains titled in the debtor. As a result, if the bankruptcy case is filed first, the bankruptcy court acquires exclusive jurisdiction over the property. Although the automatic stay, as discussed, would not prevent the continuation of a forfeiture proceeding, how would another court adjudicating that proceeding acquire jurisdiction over the subject property if the bankruptcy court's jurisdiction was truly "exclusive?"

The answer is not entirely pellucid—after all, the bankruptcy court can divest an admiralty court of jurisdiction over a vessel that belongs to a debtor. Why then should another court be able to exercise jurisdiction over a *res* that is within the exclusive control of a bankruptcy court? Perhaps the response is that a court adjudicating a forfeiture action does not need to exercise possession of the property in order to enter judgment, but can "arrest" and seize the property following entry. Moreover, to the extent the relation back doctrine applies (there are some exceptions), the forfeited property is deemed never to have passed into the estate. According to the Bankruptcy Appellate Panel for the Ninth Circuit, "the conflict here arises because of the relation-back doctrine and the possibility that the Property, when all is said and done, may not be property of the estate. However, if that happens, it is because that is the appropriate result under the law." *In re Chapman*, 264 B.R. 565, 573 (9th Cir. B.A.P. 2001).

Differences in Distribution Schemes

The forfeiture scheme may also be at odds with the distributive rules in bankruptcy. As noted above, in a bankruptcy case creditors are senior to shareholders and investors' damage claims are subordinated to the rank of the underlying security. In Chapter 7, the property of the estate must flow in "absolute priority" to a senior class before any residue can trickle down to a junior class. In Chapter 11, although there is greater flexibility, if a class of unsecured creditors rejects a plan no junior class can receive any value unless and until the creditors are paid in full.

Under the forfeiture process, in contrast, the government considers the rights of innocent victims (as well as the contributions of law enforcement to the discovery and prosecution of the crime). Forfeited property in the hands of the government is often used to satisfy a fraudster's obligations to his or her victims. General creditors of the fraudster are beneficiaries of forfeited property only if they qualify as victims under the crimes charged.

This result is not considered a violation of bankruptcy law because the distributive rankings under the Bankruptcy Code apply only to distributions of proceeds of the estate. Restitution to victims outside the auspices of a plan or the Bankruptcy Code do not implicate the strict rankings established under the code. Thus, in the recent *Adelphia* case, the bankruptcy court approved a settlement between the debtors and the SEC that contemplated a payment of $715 million into a victim restitution fund. The fund would then be distributed by the SEC directly to Adelphia's shareholders, before satisfaction of creditors who would be senior under the bankruptcy scheme, and outside the auspices of the bankruptcy court.

According to the court, "here equity holders and defrauded noteholders would not be sharing in assets of the estate under a plan, or in a Chapter 7 liquidation. Rather, they would be sharing in a fund to be created and owned by the Government, sharing in assets the Government would be obtaining as a consequence of . . . [its] forfeiture power . . . ." *In re Adelphia Communications Corp.,* 327 B.R. 143, 168–69 (Bankr. S.D.N.Y. 2005). On appeal, the district court affirmed noting that "if Adelphia had rejected the government's proposal and the government succeeded in forfeiting its assets, the government's interests in the assets would have been superior to those of the creditors in any case.

Conclusion

Many aspects of the interplay between the bankruptcy and asset forfeiture systems are unsettled. The federal government's forfeiture powers can profoundly affect the course of a typical bankruptcy case. Yet, these powers serve compelling interests and may alleviate enormous hardship to innocent victims that might otherwise be diluted in a bankruptcy case. When bankruptcy and forfeiture clash, the ideal outcome is a process that coordinates the proceedings from the outset, with the early identification of shared goals, in pursuit of the same end game—the maximum restoration of property to persons harmed.

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