Secret Extensions
Preference Actions Avoiding the Statute of Limitations

BY JEFFREY A. WURST, ESQ. AND MICHAEL T. ROZEA, ESQ.

While it is rare that one sees issues regarding the two-year statute of limitations for the commencement of preference actions, such issues can wreak havoc in larger, more complex Chapter 11 bankruptcies where a plan of reorganization has yet to be confirmed prior to the running of the two-year anniversary of the case.

JEFFREY A. WURST, ESQ.
Senior Partner, Chair, Financial Services, Banking & Bankruptcy Department, Ruskin Moscou Faltischek, P.C.

MICHAEL T. ROZEA, ESQ.
Associate, Financial Services, Banking & Bankruptcy Department, Ruskin Moscou Faltischek, P.C.

Readers of this publication are aware of the workings of preference recovery actions under the Bankruptcy Code, which are intended to neutralize any disparity in the treatment among creditors during a debtor's slide into bankruptcy. One such case is *In re DPH Holdings Corp., et al.*[1]

When drafting the Bankruptcy Code, Congress did not intend to provide debtors or trustees with an infinite amount of time to recover these payments and accordingly incorporated a two-year statute of limitations. The purpose of a statute of limitations is to establish a reasonable time period in which a lawsuit may be brought while allowing potential defendants assurance that once that period has passed they will no longer be subjected to the risk of defending themselves. Amendments in recent years significantly reduced the *second bite of the apple* that would occur when a debtor remained in Chapter 11 for a period of time and subsequently had its Chapter 11 case converted to one under Chapter 7, giving the debtor or trustee a new two-year statute of limitations.

It is rare that we see issues regarding the two-year statute of limitations for the commencement of preference actions. Typically, long before the running of the two-year period to commence an action, a debtor has 1.) successfully reorganized and emerged from Chapter 11 protection, 2.) sold all or substantially all of its assets, 3.) confirmed a Chapter 11 plan of reorganization or liquidation, and/or 4.) commenced its preference actions. In such cases, the prosecution of preference claims generally follows the principal reorganization or liquidation efforts. However, the two-year statute of limitations can create significant issues for larger, more complex Chapter 11 bankruptcies where a plan of reorganization has yet to be confirmed prior to the running of the two-year anniversary of the case. For example, the case of *In re DPH Holdings Corp., et al.*

On October 8, 2005, Delphi Corporation and certain of its affiliates (collectively, Delphi or debtor) filed voluntary petitions for relief under Chapter 11 of Title 11 of the U.S. Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York. In August 2007, with the two-year statute of limitations set to expire on October 8, 2007, Delphi filed an *ex parte* motion (the First Extension Motion) seeking the court's permission to file 742 preference complaints *under seal*. These "sealed" complaints would be filed with numbers in place of defendants' (the preference defendants) names, thereby depriving the preference defendants of any notice that an action had been filed against them. These actions would remain sealed until Delphi "unsealed" them. That occurred over two and a half years after the statute of limitations had expired in March and April 2010.

Essentially, Delphi argued that it was justified in concealing a potential lawsuit against the preference defendants and that this was somehow beneficial to these defendants because it saved them the costs of retaining counsel and prosecuting the adversary proceedings.

Under Federal Rule of Civil Procedure 4(m) (Rule 4(m)), which is made applicable to bankruptcy proceedings by Federal Rule of Bankruptcy Procedure 7004, a plaintiff must serve a summons within 120 days of the filing of a lawsuit, unless, for good cause shown, the court extends the time period. On August 17, 2007, the court issued an order (the First Extension Order) granting Delphi 1.) authority to file preference complaints under seal, 2.) an extension of the 120-day period to serve summons and complaints, and 3.) a stay of the adversary proceedings until service of process was effected.

Delphi contended that it was on the verge of confirming a plan of reorganization, which would pay each creditor in full but that it was necessary to file the complaints under seal only as a "precautionary measure." Delphi also suggested that filing under seal would avoid disrupting Delphi's "existing business relationships" with the preference defendants. The debtor expressed its concern that if the preference defendants learned of the pending actions, some might not be willing to continue to do business with the debtor as it tried to emerge from Chapter 11. Essentially, Delphi argued that it was justified in concealing a potential lawsuit against the preference defendants and that this was somehow beneficial to these defendants because it saved them the costs of retaining counsel and prosecuting the adversary proceedings.

Of course, by filing the complaints under seal, the preference defendants did not even know that they were parties to any lawsuits and, as a result, did not oppose the First Extension Motion. While some of the preference defendants did have *constructive* notice of the First Extension Motion by virtue of having filed notices of appearance and their receipt of electronic notice of the more than 20,000 documents filed in the case, others had no reason to appear in the case and had no notice whatsoever that preference actions were commenced, let alone commenced under seal.

Delphi's *ex parte* First Extension Motion envisioned that the preference defendants would enter into tolling stipulations[2] with Delphi that would toll the time in which the debtor would be required to serve the summonses and complaints. Despite attaching the proposed tolling stipulation to the First Extension Order, the preference defendants were never invited to enter into the tolling stipulations, nor did they agree or otherwise consent to any extension of time in which Delphi could commence or serve the defendants with the complaints in these actions.

After entering the First Extension Order and failing to enter into the tolling stipulations, Delphi's first plan of reorganization (which envisioned satisfaction in "full" of all creditors' claims) unsurprisingly failed to become effective. Thereafter, through a series of three additional *ex parte* extension orders (together with the First Extension Order, the Extension Orders), the preference defendants finally received notice of the action when they were served with complaints in March and April. Like the First Extension Order, the Extension Orders were entered without notice to the preference defendants.

Obviously, many of the preference defendants were befuddled in March and April 2010 when they were first served with complaints for preference actions relating to transactions that occurred some four and a half years earlier, in or around October 2005. These defendants had taken no steps to 1.) preserve and retain their records or 2.) assure that they retained access to those individuals who could provide litigation information as (they believed) the statute of limitations had expired in October 2007. During the four-and-a-half year period before the complaints were unsealed, some of the preference defendants went out of business, sold their claims to other parties or otherwise continued to operate under the false assumption that they would not be subjected to the need to defend themselves in a lawsuit. Moreover, Delphi received the benefit of a more favorable negotiating position with its creditors as those creditors were unaware that the secret preference actions were filed against them.

While an extension of the 120-day period to serve the summons and complaint is not common, courts may extend such period "for cause" under Federal Rule 4(m). Typically the time is extended where the plaintiff is unable to locate or effect service upon the defendant or where the debtor provided notice to its defendant that it was seeking an extension. In the case *In re Safety-Kleen Corp., at al.*[3] the court granted the debtors an extension, but only after the debtors notified the defendants of any pending actions by letter. Similarly, in the case *In re Interstate Bakeries Corp.*,[4] the debtors sought an extension and the court granted the extension only after the debtors served a copy of the draft complaint on all parties listed as a potential preference defendant. Inasmuch as those preference defendants received notice of the actions before the extension was granted, they were afforded their due process rights and accordingly, were properly provided an opportunity to oppose the extension. The preference defendants in the Delphi case were not provided a similar opportunity to oppose the extension as Delphi had filed the complaints under seal with no notice to the preference defendants.

Dismissing the case under *Twombly* and *Iqbal*, although justified, remains the safe and *easy* escape in this dilemma. However, that would avoid the opportunity to correct what many see as an abuse of a Rule 4(m) extension and the improper filing of actions under seal.

In May 2010, 83 of the defendants[5] filed motions to dismiss the complaint. These defendants raised a number of substantive and procedural objections to the complaint, asserting that 1.) the complaints were defective and were not sufficiently pled under the heightened pleading standards of *Twombly*[6] and *Iqbal*,[7] 2.) the preference defendants were denied their due process rights existing under the Fifth Amendment and 3.) Delphi failed to demonstrate "cause" for an extension under Rule 4(m).

On July 22, 2010, the U.S. Bankruptcy Court for the Southern District of New York heard argument on the motions to dismiss and analyzed whether the preference actions were sufficiently pled under *Twombly* and *Iqbal*, without addressing the due process and Rule 4(m) issues. The court ultimately ruled that under *Twombly* and *Iqbal*, the complaints should be dismissed, but authorized Delphi to file a motion for leave to amend the complaints within 45 days and further ruled that those complaints that were not amended would be dismissed. By the time that Delphi filed its motion to amend on September 7, 2010, over five years had passed since the alleged preferential transfers. The preference defendants filed opposition to the motion to amend on November 24, 2010 and are awaiting a hearing on this motion.[8]

The judge, a well regarded and talented jurist, must now determine whether these actions may continue. If the court grants the motion to amend, Delphi will be permitted to refile and serve the complaints and the actions will continue, forcing the preference defendants to defend themselves in actions based upon aged facts. However, the precedent will be overwhelming — effectively opening the door to allow debtors unlimited time in which to prosecute actions otherwise subject to a two-year statute of limitations.

Dismissing the case under *Twombly* and *Iqbal*, although justified, remains the safe and *easy* escape in this dilemma. However, that would avoid the opportunity to correct what many see as an abuse of a Rule 4(m) extension and the improper filing of actions under seal. To address these issues, the judge would need to revisit his own rulings — rulings that were perhaps made based upon motion papers that were somewhat less than forthright in advising the court that the debtor may (but not shall) enter into tolling stipulations with the preference defendants.

Certainly, had any preference defendant entered into the proposed stipulation that defendant would have no basis to object to the delay in the service of the complaint. However, absent consent of the preference defendants, Delphi abused the process to receive a Rule 4(m) extension. Dismissing the cases without revisiting the Rule 4(m) orders will deprive the litigants of an adjudication of the creative legal vehicle that enabled Delphi to avoid the restrictions of the statute of limitations.

Given the impact that the court's decision will have on merchants and lenders, readers would be wise to monitor the outcome of these cases as the court's decision will greatly affect how preference actions are filed and served in the future. If the court grants the motion to amend and allows these cases to proceed, it will undoubtedly result in greater uncertainty for creditors going forward as debtors will now have a vehicle to secretly extend the statute of limitations. Such a result flies in the face of Congress's intent when enacting the statute of limitations under 546 of the Bankruptcy Code. Justice requires not only that the motion to amend be denied — it requires that the integrity of Rule 4(m) and the statue of limitations be upheld herein.

Stay tuned for the court's decision. abfj

JEFFREY A. WURST, ESQ. is a senior partner and the chair of the Financial Services, Banking and Bankruptcy Department, and **MICHAEL T. ROZEA, ESQ.** is an associate in the same department at Ruskin Moscou Faltischek, P.C. in Uniondale, NY. Wurst can be reached at 516-663-6535 or jwurst@rmfpc.com.

FOOTNOTES:

1 Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 8, 2005).

2 A tolling agreement is typically a contract between parties where the defendant agrees that any statute of limitations that may be applicable to the claim (for instance, the two-year limitation applicable to preference actions) is tolled and the defendant waives its right to raise the statute of limitations as an affirmative defense in the event a lawsuit is eventually filed against the defendant.

3 2007 WL 2248074 (Bankr. D. Del. May 7, 2002).

4 Case No. 04-45814 (Bankr. D. Mo. Sept. 22, 2004).

5 The authors are representing one such defendant.

6 550 U.S. 544 (2007).

7 129 S.Ct. 1937 (2009).

8 As of this writing, a date for the hearing has not been set due to scheduling. The dates most recently proposed by the court are not until May 2011.

Jeffrey A. Wurst is a partner at Ruskin Moscou Faltischek in Uniondale, NY, where he chairs the law firm's Financial Services, Banking and Bankruptcy Department. He can be reached at (516) 663-6535 or jwurst@rmfpc.com.

Michael T. Rozea is an associate at Ruskin Moscou Faltischek. He can be reached at (516) 663-6686 or mrozea@rmfpc.com.