

PUBLICATION

Sixth Circuit Clarifies Burden of Proof on Lien Validity and Confirms Availability of Defensive Avoidance Powers

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On December 17, 2013, the United States Court of Appeals for the Sixth Circuit issued an opinion in the matter of *Grant, Konvalinka & Harrison, P.C. v. C. Kenneth Still*, (Case No. 12-6374) resolving two bankruptcy issues of first impression for the Sixth Circuit. While there were several issues before the Court, the matters of first impression were (1) which party bears the burden of establishing the validity of a creditor's security interest in a proceeding for relief from the automatic stay; and (2) whether a trustee may use hypothetical lien-creditor status and avoidance powers to oppose a motion for relief from the automatic stay even after the expiration of the statute of limitations to affirmatively pursue an avoidance action.

By way of background, Steven McKenzie executed a promissory note and pledge agreement to secure fees owed to Grant, Konvalinka & Harrison, P.C. ("GKH") just weeks prior to an involuntary Chapter 7 proceeding was filed against him. The pledge agreement listed several entities in which McKenzie held an ownership interest. McKenzie subsequently filed a voluntary Chapter 11 proceeding which was consolidated with the involuntary proceeding. In February 2009, a Chapter 11 trustee was appointed. GKH, who had also filed a proof of claim, filed a motion for relief from the automatic stay. The Trustee opposed relief on the grounds that the interests pledged to GKH were preferential transfers.

GKH relied on the plain language of 11 U.S.C. § 362(g) to argue that the Court erred in requiring it to prove the validity of its security interest in addition to whether or not McKenzie had equity in the property. While the Court did not have the benefit of any circuit or district court decisions, it relied on the majority opinion of various bankruptcy courts to hold that a creditor must prove the validity of its security interest. While the plain language of the 11 U.S.C. § 362(g) does not specifically state that a creditor must prove validity, the Court found that validity and extent of security is tied up with the debtor's lack of equity - the issue for which the creditor expressly bears the burden of proof.

The Trustee asserted his avoidance powers in defense to GKH's claim for relief almost eleven months after the Trustee's ability to affirmatively seek avoidance actions had expired under 11 U.S.C. § 546(a)(1)(A). GKH argued that allowing the Trustee to use expired avoidance powers defensively would result in a procedural windfall. The Court disagreed and again found that the majority of bankruptcy courts allowed trustees to take such a position. The Court emphasized that there would be no windfall because 11 U.S.C. § 502(d) limits trustees to offsetting claims asserted by creditors. Allowing the Trustee to assert his avoidance powers defensively promoted the very purpose of bankruptcy - equality of distribution among creditors.