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R E L A T I O N S

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No Bank Lien on Rabbi Trust

A "rabbi trust" is a trust created by a corporation or other institution for the benefit of one or more of its executives. (The name arises from the original IRS ruling, involving a trust set up for a rabbi.) The executive's income tax on the corporate contributions to the rabbi trust is deferred until distribution from the trust to the executive. In order to obtain this favorable tax treatment, the executive's right to receive money from the trust must be restricted. No moneys are paid from the trust until termination of employment. Additionally, the "Model Rabbi Trust" agreement approved by the IRS requires that assets of the trust be subject to the claims of the employer's general creditors.

A federal appeals court in Chicago recently determined that a secured lender to a corporation did not have a lien on the corporate assets in a rabbi trust. After establishing the rabbi trust, the corporation borrowed and granted the bank a security interest in substantially all the corporate assets. When the corporation filed a bankruptcy petition, the bank sought to recover its collateral, including the funds in the rabbi trust.

The court reasoned that the provision of the trust agreement, making the funds subject to claims of general creditors, excluded secured creditors like the bank. Additionally, the trust agreement contained a standard provision that the corporation could not give a security interest in the trust assets. These provisions trumped the security interest in the trust assets granted by the bank's loan documents. The court's decision inverted the usual priority scheme of the Bankruptcy Code, because the unsecured creditors received the assets of the rabbi trust ahead of the secured creditor.

Bank of America v. Moglia, 330 F.3d 942 (7th Cir. 2003).

Improper Tax Payment Not Recovered

The Maryland Fraudulent Conveyance Act permits creditors or a bankruptcy trustee to recover payments made by a debtor for which the debtor did not receive equivalent value. However, a federal court has ruled that this does not apply where the recipient of the payment is a taxing authority.

The owner of a small corporation caused the corporation to use its funds to pay his personal income taxes. The corporation's Chapter 7 trustee sought to recover these tax payments from the IRS as fraudulent conveyances, arguing that the corporation received no benefit by paying the owner's taxes.

Although the bankruptcy judge agreed with the trustee, the federal district court reversed that decision, explaining that under Maryland law a voluntary tax payment, even made by mistake or illegally, may not be recovered from the taxing authority except pursuant to a specific tax refund statute. Because the fraudulent conveyance statute is a general law, rather than a tax refund statute, the trustee could not use the fraudulent conveyance statute to recover the improperly paid taxes. Unfortunately, it did not appear that the trustee could assert a refund claim, because the taxes paid were not those of the corporation.

United States v. Field (In re Abatement Environmental Resources), 2003 U.S. Dist. LEXIS 11989 (D.Md. May 27, 2003).

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This newsletter is intended to inform its readers of developments in the area of debtor/creditor relations. It is not legal advice or a legal opinion regarding any specific matter. You should consult a lawyer regarding any questions relating to your particular situation.

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