Fraudulent Transfers and Preferences

Concurrent Session

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PREFERENTIAL TRANSFERS AND FRAUDULENT CONVEYANCES

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I. Introduction

The recovery of preferential transfers and fraudulent conveyances are two of the tools in the trustee (or debtor in possession)'s tool kit for enhancing the assets available for distribution for creditors. Preferences are the subject of section 547 of the Bankruptcy Code, while Fraudulent transfers and obligations are defined by section 548 of the Bankruptcy Code and applicable state law. The recovery of avoided transfers is the subject of section 550.

II. Preferences

A. Definition. The heart of section 547 is subsection (b), which tells what transactions may be avoided as preferential transfers. "That section serves two purposes: First it fosters equality of distribution among creditors. . . .Second, it 'discourages "secret liens" upon the debtor's collateral which are not perfected until just before the debtor files for bankruptcy." *In re Lee,* 530 F.3d 458, 463 (6th Cir. 2008). A well-drafted complaint will address each of the elements of subsection (b). That subsection provides:

> **(b) Except as provided in subsections (c) and (I) of this section, the trustee may avoid any transfer of an interest of the debtor in property–**
>
> > **(1) to or for the benefit of a creditor;**
> >
> > **(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;**
> >
> > **(3) made while the debtor was insolvent;**
> >
> > **(4) made–**
> >
> > > **(A) on or within 90 days before the date of the filing of the petition; or**
> > >
> > > **(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such creditor an insider; and**
> >
> > **(5) that enables such creditor to receive more than such creditor would receive if –**

(A) the case were a case under Chapter 7 of this title;

(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

B. Transfer of an interest of the debtor in property. There can be no preference unless there is a transfer of an interest of the debtor in property.

(1) Transfer. The term "transfer" is defined at section 101(54).

The term 'transfer' means--

(A) the creation of a lien;

(B) the retention of title as a security interest;

(C) the foreclosure of a debtor's equity of redemption; or

(D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with–

(i) property; or

(ii) an interest in property.

The definition at section 101(54) is supplemented at section 547(e), which provides:

(e)(1) For purposes of this section–

(A) a transfer of real property other than fixtures, but including the interest of a seller or purchaser under a contract for the sale of real property, is perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee; and

(B) a transfer of a fixture or property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee.

(2) For the purposes of this section, except as provided in paragraph (3) of this subsection, a transfer is made–

> (A) at the time such transfer takes effect between the transferor and transferee, if such transfer it perfected at, or within 30 days after, such time, except as provided in subsection (c)(3)(B);
>
> (B) at the time such transfer is perfected, if such transfer is perfected after such 30 days; or
>
> (C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of–
>
> > (i) the commencement of the case; or
> >
> > (ii) 30 days after such transfer takes effect between the transferor and the transferee.

(3) For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred.

(2) Cases concerning transfer

Barnhill v. Johnson, 503 U.S. 393, 397, 112 S.Ct. 1386 (1992). What constitutes a transfer and when it is complete is a matter of federal law since the statute itself provides a definition of transfer.

In re Lee, 530 F.3d 458 (6th Cir. 2008). Refinancing consist of two transfers: a transfer of funds to pay off the old mortgage, and the granting of the new mortgage.

In re Laughlin, 602 F.3d 417 (5th Cir. 2010). Debtor's renunciation of inheritance did not effect transfer of any interest of debtor in property.

In re Phoenix Assoc. Land Syndicate, Inc., Slip Op. 2011 WL 1337294 (Banks. E.D. La. 2011). The establishment of a judicial lien constitutes a transfer for purposes of § 547(b) (citing *Cullen Ctr. Bank & Trust v. Hensley (In re Criswell),* 102 F.3d 1411, 1415 (5th Cir. 1997)).

(3) Interest of the debtor in property

Meoli v. MBNA America Bank (In re Wells), 382 B.R. 355 (6th Cir. BAP 2008). Use of convenience checks from one credit card issuer to pay off debt owed to another constitutes a transfer of an interest of the debtor in property.

C. To or for the benefit of a creditor

In re Silverman, 616 F.3d 1001 (9th Cir. 2010). Criminal restitution payments are made to or on for the benefit of a creditor even though they may also benefit society.

D. For or on account of an antecedent debt owed by the debtor before such transfer was made

Wells Fargo Home Mtg., Inc. v. Lindquist, 592 F.3d 838 (8th Cir. 2010). Lender who failed to record mortgage for two years after loan was made resulted in transfer on account of an antecedent debt.

Strange v. Cage, Slip Op. WL 1337130 (S.D. Tex. 2011). Assignment of retail installment contracts to "Pool Investors" constituted transfer of property on account of an antecedent debt.

E. Made while the debtor was insolvent

***See* § 547(f) which provides:** "For the purposes of this section, the debtor is presumed to be insolvent on and during the 90 days immediately preceding the date of the filing of the petition."

F. Made–

> **(A) on or within 90 days before the date of the filing of the petition; or**
>
> **(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such creditor an insider**

In re TransTexas Gas Corp., 597 F.3d 298 (5th Cir. 2010. Debtor's chief executive officer was an insider when parties entered into an agreement to make severance payments to him, and "insider" element of Bankruptcy Code is satisfied even though CEO had left the company by the time actual payments were made.

Longview Aluminum, L.L.C. v. Brandt, 431 B.R. 193 (N.D. Ill. 2010). A manager or member of a limited liability company is an "insider" for purposes of preference analysis. *See also In re Krehl*, 86 F.3d 737, 741-42 (7th Cir. 1996). Fact that transfer was for legitimate purposes and did not involve self-dealing is irrelevant for purposes of preference analysis.

In re Piccinini, 439 B.R. 100 (E.D. Mich. 2010). A creditor may be treated as a non-statutory insider when there is a close relationship between to the debtor and creditor or anything else to suggest that any transactions were not conducted at arms' length. *See also In re Winstar Communications, Inc.,* 554 F.3d 382 (3rd Cir. 2009).

G. That enables such creditor to receive more than such creditor would receive if –

(A) the case were a case under Chapter 7 of this title;

(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

United Rentals, Inc., 592 F.3d 525 (4th Cir. 2010). The § 547(b)(5) inquiry focuses "not on whether a creditor may have recovered all the monies owed by the debtor *from any source whatsoever*, but instead upon whether the creditor would have received less than 100% payout" from the bankruptcy estate." 592 F.3d at 531 quoting *Smith v. Creative-Financial Mgmt., Inc., (In re Virginia-Carolina Fin. Corp.),* 954 F.2d 193, 199 (4th Cir. 1992).

Wells Fargo Home Mtge, Inc. v. Lindquist, 592 F.3d 838, 844-45 (8th Cir. 2010). Late transfer of mortgage to creditor diminished the bankruptcy estate and enabled the mortgage creditor to receive more than it would have in a hypothetical Chapter 7 liquidation.

In re Phoenix Assocs. Land Syndicate, Inc., Slip Op. 2011 WL 1337294 (Bankr. E.D. La. 2011). As long as the distribution to unsecured creditors is less than 100%, an unsecured creditor who receives any distribution during the preference period enables the creditor to receive more than he would receive in a hypothetical liquidation. Thus, a creditor who recorded a mortgage during the preference period changed his status from unsecured to secured, receiving more than the *pro rata* share he otherwise would have been entitled to.

III. Preference Defenses. There are nine affirmative defenses available to the preference defendant in § 547(c). Summarized, these exceptions to the preference rules are as follows:

(1) The Contemporaneous Exchange for New Value Exception
(2) The Ordinary Course of Business Exception
(3) The Purchase Money Exception
(4) The Enabling Loan Exception
(5) The Floating Lien Exception
(6) The Statutory Lien Exception
(7) The Domestic Support Obligation Exception
(8) The Small Transfer Exception for Consumer Debtors (less than $600)
(9) The Small Transfer Exception for Commercial Debtors (less than $5,850)

A. The Contemporaneous Exchange for New Value Exception. Exchanges that are intended to be and are in fact substantially contemporaneous are excepted from the reach of the preference rules. Section 547(c)(1) provides:

(c) The trustee may not avoid under this section a transfer –

(1) to the extent that such transfer was –

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange.

United Rentals, Inc. v. Angell, 592 F.3d 525 (4th Cir. 2010). "The purpose of the § 547(c)(1) exception is 'to encourage creditors to continue to deal with troubled debtors without fear that they will have to disgorge payments received for value given." As its legislative history demonstrates, § 547(c)(1) was designed to address the 'generic problem [that] those on the verge of bankruptcy still need to buy things ... and the fact that checks are used (with a brief gap between purchase and payment) ought not render the payment avoidable as one for an antecedent debt.'" ... Protecting contemporaneous exchanges for new value from avoidance does not harm the preference section's goal of protecting the equality of distributions among debtors [sic] because such exchanges do not diminish the size of the debtor's estate." (internal citations omitted). Release of right to file mechanic's lien on real property improved by construction is not new value for purposes of contemporary exchange exception.

In re JS & RB, Inc., ___B.R. ___, 2011 WL 671763)Bankr. W. D. Mo. 2011). Whether payment of rent due pursuant to an unexpired real property lease constitutes :new value" is a question of first impression in the 8th Circuit, but other courts have ruled that "new value" is created by a debtor's right to continue a leasehold estates in exchange for the rental payment. *See In re General Time Corp., GTC,* 328 B.R. 243, 246 (Bankr. N.D. Ga. 2005); *Brown v. Morton (IN re Workboats Northwest, Inc.),* 201 B.R. 563 (Bankr. W.D. Wash. 1996); *In re Coco,*

67 B.R. 365 (S.D.N.Y. 1986); *Armstrong v. General Growth Dev. Corp. (In re Clothes, Inc.),* 35 B.R. 489, 491 (Bankr. N.D. 1983); *Carmack v. Zell (In re Mindy's Inc.),* 17 B.R. 177, 178-9 (Bankr. S.D. Ohio 1982).

In re Interstate Bakeries Corp., Slip Op. 2011 WL 96815 (Bankr. W.D. Mo. 2011). Payments made two weeks after debtor provided goods to creditor and ceased doing business were not intended to be contemporaneous exchanges.

In re American Standard Bldg Systems, Inc., 440 B.R. 451 (Bankr. W.D. Va. 2010). Where only benefit extended to debtor is release of garnishment there is no contemporaneous exchange of new value.

B. The Ordinary Course of Business Exception. The ordinary course of business exception is designed to protect transactions in the ordinary course of the business of the parties even though these transactions would otherwise be preferential. Section 547(c)(2) provides:

(c) The trustee may not avoid under this section a transfer –

(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was –

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee, or

(B) made according to ordinary business terms.

In re FirstPay, Inc., 391 Fed.Appx. 259 (4th Cir. 2010). Failure of federal government to raise ordinary course of business defense in answer did not result in waiver of that defense where there was no unfair surprise or prejudice to plaintiff-trustee.

Rothert v. Barber, 2011 WL 1303506 (C.D. Ill. 2011). The ordinary course of business exception enables the struggling debtor to continue operating its business. The burden of proof under § 547(c)(2) rests with the creditor. 11 U.S.C. § 547(g). The ordinary course of business exception requires proof of three elements: (1) that the debt was incurred by the debtor in the ordinary course of its business and that of the transferee; (2) that the payment was made in the ordinary course of the debtor and the transferee; and (3) that the payment was made according to ordinary business terms. With respect to the second element, the 7th Circuit has established the following non-exhaustive list of factors to be considered: "1) the length of time the parties were engaged in the transaction at issue; 2) whether the amount or form of tender differed from past practices; 3)

whether the debtor or creditor engaged in any unusual collection or payment activity; and 4) whether the creditor took advantage of the debtor's deteriorating financial condition." *Kleven v. Household Bank F.S.B*., 334 F.3d 638, 642 (7th Cir.2003).

In re Landreth Lumber Co., Slip Op. 2010 WL 4457451 (S.D. Ill. 2010). The ordinary course of business exception 'is designed to protect recurring customary credit transactions that are received and paid in the ordinary course of the business of the debtor and the debtor's transferee.' quoting *In the Matter of Midway Airlines, Inc.,* 69 F.3d 792, 797 (7th Cir. 1995). In order to meet the burden under the ordinary course of business defense, a party must show that a 'transfer was in payment of a debt incurred by the debtor in the ordinary course of business ... and such transfer was - (A) made in the ordinary course of business or financial affairs of the debtor and transferee; or (B) made according to ordinary business terms.' quoting 11 U.S.C. § 547(c)(2).

C. **The Enabling Loan Exception**. The Enabling Loan (or New Value) Exception provides special treatment to purchase-money creditors, similar to that provided under the UCC. Section 547(c)(3) provides:

(c) The trustee may not avoid under this section a transfer—

3) that creates a security interest in property acquired by the debtor—

(A) to the extent such security interest secures new value that was—

(i) given at or after the signing of a security agreement that contains a description of such property as collateral;
(ii) given by or on behalf of the secured party under such agreement;
(iii) given to enable the debtor to acquire such property; and
(iv) in fact used by the debtor to acquire such property; and

(B) that is perfected on or before 30 days after the debtor receives possession of such property.

In re Penrod, 611 F?3d 1158 (9th Cir. 2010). Creditor does not have purchase money security interest in "negative equity" of trade-in used in purchase of automobile.

In re Johnson, 611 F.3d 313 (6th Cir. 2010). Upon certification of the question to the Kentucky Supreme Court, that court held that, "under

Kentucky law, final perfection of a vehicle lien does not occur until the physical notation is made on the title ... and, accordingly, perfection is not accomplished as and when the required paperwork and fee are submitted to the county clerk." *Johnson v. Branch Banking & Trust Co.,* 313 S.W.3d 557, 558 , 2010 WL 2470849, at *1 (Ky. 2010). Accordingly, enabling loan exception did not apply where creditor timely submitted paper work, but county clerk did not lien certificate of title until two weeks later.

In re Taylor, 599 F.3d 880 (9th Cir. 2010). Creditor who completed steps to perfect security interest in automobile on the 21st day after debtor took possession of automobile did not enjoy protection of enabling loan exception even though state law provided 30 days to perfect. (N.B.: Federal law has since been amended to provide 30 days to perfect.).

(D) **The Floating Lien Exception.** The Floating Lien Exception protects financiers of inventory and accounts. It provides:

(c) The trustee may not avoid under this section a transfer—

(5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of—

(A)

(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or (B) the date on which new value was first given under the security agreement creating such security interest;

In re Qualia Clinical Service, Inc., 441 B.R. 325 (8th Cir. BAP 2011). Chpater 7 trustee brought adversary proceed to avoid security interest in accounts. BAP held that purported contract for purchase and sale of accounts was actually a disguised financing agreement. Creditor perfected security interest in accounts not when it filed financing statement with Secretary of State in state in which debtor did business, but only when it filed second financing statement in state in which debtor was incorporated - within the 90-day preference period.

III. Fraudulent Conveyance

A. Sources of Law. There are two sources of law for the avoidance of fraudulent conveyance in bankruptcy. The first in 11 U.S.C. § 544(b), which permits a trustee to step into the shoes of an unsecured creditor who might have avoided a transfer of the debtor's property but for the filing of the bankruptcy case. The recovery will be for the benefit of all creditors, rather than the specific unsecured creditor that gives rise to the trustee's right to recover. The second source of law for the avoidance of fraudulent conveyances in bankruptcy is 11 U.S.C. § 548(a), which provides:

> **(a) (1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—**
>
> > **(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or**
> >
> > **(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and**
> >
> > **(ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;**
> > **(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;**
> > **(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or**
> > **(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.**

Attorney who participates in fraud may not escape liability as mere conduit. *In re Harwell*, 628 F.3d 1312 (11th Cir. 2010). Chapter 7 trustee brought adversary proceeding against attorney and his law firm who had represented debtor prepetition seeking to recover settlement proceeds that passed through the attorney's trust account before being distributed to debtor and debtor's family member and selected creditors. The court of appeals affirmed that the attorney

was the initial transferee (*see* 11 U.S.C. § 550(a)(1)) of the settlement proceeds, but remanded for a determination of whether attorney participated in the fraud, and therefore could not escape liability as a "mere conduit" of the funds.

Transfer by tax sale perfected upon recording of tax deed. *In re Smith*, 614 F.3d 654 (7th Cir. 2010). Debtors initiated adversary proceeding to avoid tax deed on their home as fraudulent transfer. The bankruptcy and district courts held that the debtors right to recover their property ended with the redemption period. The debtor argued that the tax sale was not perfected, and their rights not cut off, until the sale was "perfected" by the issuance and recording of the tax deed (which occurred within two years before the filing of the bankruptcy petition). The court of appeals agreed and REVERSED the decision of the bankruptcy court. Since the recording of the tax deed occurred within two years before the filing of the bankruptcy petition, the debtors had sufficiently pleaded the two-year look-back element of their fraudulent conveyance claim.

Renunciation of inheritance is not a transfer of an interest of the debtor in property. *In re Laughlin*, 602 F.3d 417 (5th Cir. 2010). Debtor's renunciation of inheritance did not effect a transfer of any interest of the debtor in property; therefore denial of debtor's discharge could not be predicated upon this act as a fraudulent conveyance (reversing decision of bankruptcy court). *See also In re Costas*, 555 F.3d 790 (9th Cir. 2009).

Transfer between spouses and trust not intended to defraud creditors. *In re Richmond*, 338 Fed, Appx. 197 (3rd. Cir. 2009). Debtor transferred his interest in their marital home to his wife for $1.00. The wife gave a mortgage on the home to her family trust, the trust deposited $200,000 to a joint account held by the debtor and his wife, and the debtor paid off a prior debt. The bankruptcy court held that the facts surrounding the transfer supported by the fact that the debtor was not rendered insolvent as a result of the transfer, did not evidence an intent to defraud, delay, or hinder creditors, despite heightened scrutiny applied to transactions between spouses. The district court and the court of appeals affirmed, concluding that the factual findings of the bankruptcy court were not clearly erroneous.

Transfer pursuant to divorce decree not a fraudulent conveyance. *In re Bledsoe*, 569 F.3d 1106 (9th Cir 2009). Trustee attempted attack on marital dissolution agreement as fraudulent conveyance. The court of appeals affirmed the decision of the bankruptcy court in favor of the debtor's ex-husband. A collateral attack on a marital dissolution judgement must plead and prove extrinsic fraud, and a dissolution judgment that results from a regularly conducted, contested divorce proceeding conclusively establishes "reasonably equivalent value" in the absence of fraud.

Purchase of annuity on eve of bankruptcy is a fraudulent conveyance. *In re Bossart*, 296 Fed. Appx. 398 (5th Cir. 2008). Debtors' purchase of annuity following liquidation of nonexempt assets two days before filing bankruptcy petition held to be fraudulent transfer.

Transfers by debtor to domestic partner to pay expenses of combined household not fraudulent conveyances. *In re Fisher*, 296 Fed. Appx. 494 (6th Cir. 2008). Transfers between domestic partners could be netted for purposes of determining whether there was a fraudulent conveyance, and monetary transfers to pay debtor's share of ongoing expenses of combined household were not made with actual intent to hinder, delay, or defraud creditors.