# The Mosquito Range:
## Avoiding Transfers and Avoiding Liability

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# Avoidance Action Pleading Requirements & Potential Attorney Liability as Initial Transferee

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# Avoidance Action Pleading Requirements

The statute of limitations for filing avoidance actions under the Bankruptcy Code requires that the action is commenced "after the earlier of - . . . 2 years after the entry of the order for relief . . . ." *See* 11 U.S.C. § 546(a). In modern practice, attorneys frequently file complaints alleging avoidance claims immediately before the expiration of the applicable statute of limitations, in part, due to the time constraints and time required to carefully review a debtor's financial records. Attorneys are often faced with the practical challenge of either filing a complaint to recover a preferential transfer and planning to amend the complaint to add a fraudulent conveyance claim after post-filing discovery, or filing a complaint asserting alternative claims for relief under Bankruptcy Code Sections 547 and 548 based upon the information available on the date of filing the complaint. The focus of this presentation is the "relation back risk" for attorneys that do not plead avoidance action claims in the alternative, and the impact of two recent U.S. Supreme Court decisions addressing avoidance action pleading standards for attorneys that plead avoidance claims in the alternative.

A. Pleading Avoidance Claims in the Alternative

When counsel files a complaint on the eve of a looming statute of limitations containing a preference claim without pleading a fraudulent conveyance claim in the alternative, counsel may rely on the right to amend the complaint upon discovery of additional information. The right to amend the complaint shall be freely granted under Fed.R.Civ.P. 15 when justice so requires. *See York ex rel. York v. Cherry Creek Sch. Dist. No. 5*, 232 F.R.D. 648, 649 (D. Colo. 2005) (citing *Aspen Orthopaedics & Sports Medicine, LLC v. Aspen Valley Hosp. Dist.*, 353 F.3d 832, 842 (10th Cir.2003). The United States Supreme Court has held that the mandate of Fed.R.Civ.P. 15(a) must be heeded. *Foman v. Davis*, 371 U.S. 178, 182, (1962) (stating "If the underlying facts or circumstances relied upon by a plaintiff may be a proper subject of relief, he ought to be afforded an opportunity to test his claim on the merits.").

Attorneys must be cautious because reliance on the right to amend a complaint is not absolute, and counsel must also be aware that any subsequent amendment to add a Section 548 claim "relates back" to the date of the original complaint. Fed.R.Civ.P. 15(c), incorporated by Fed.R.Bank.P. 7015. "Most courts addressing the issue of relation back in the context of preferential transfer and fraudulent conveyance theories have allowed a plaintiff to amend its original complaint alleging a theory of preferential transfer to add or change the theory under Section 548 if the fraudulent conveyance theory stemmed from the same basic transaction or core of operative facts." *In re Integrated Agri, Inc.*, 2007 WL 605018, *3 (C.D. Ill 2007) (internal citations omitted); *see also In re G. Survivor Corp.*, 217 B.R. 433, 438 (Bankr. S.D.N.Y. 1998). It is not uncommon for avoidance complaints to be filed close to the expiration of the statute of limitations. While a motion to dismiss may be granted with leave to file an amended complaint, amendments are not allowed where new factual allegations are needed to support the legal theories in the amended complaint. However, some courts have reached the opposite result, denying leave to amend a preference complaint to allege a fraudulent conveyance claim for the same transfer.

*See Smith v. Porter*, 416 B.R. 264, 268-69 (E.D. Va. 2009; *In re TML, Inc.*, 291 B.R. 400, 431-32 (Bankr. W.D. Mich. 2003); *In re Gantos*, 283 B.R. 649, 651 (Bankr. D. Conn 2002). Although the risk of a court denying leave to amend is small, the risk is real.

To avoid the risk that a court will deny leave to amend an avoidance complaint, attorneys often include preference and fraudulent conveyance claims for relief in the alternative as a matter of practice. A standard avoidance action complaint contains a Section 547 preference claim and a Section 548 fraudulent transfer claim. The general pleadings tend to track the statutory language and include the alternative claim for relief if it turns out that the facts support a 548 claim. Following the Supreme Court's decisions in *Twombly* and *Iqbal*, the remainder of this presentation focuses on the issue of pleading alternative avoidance claims to avoid motions to dismiss by citing statutory elements while satisfying the pleading requirements of Fed.R.Civ.P. 8.

B. *Twombly* and *Iqbal*

Rule 8 of the Federal Rules of Civil Procedure, incorporated by Fed.R.Bankr.P. 7008, requires that a complaint must contain "a short and plain statement of the claim showing the pleader is entitled to relief." Fed.R.Civ.P. 8(a)(2). In 1957, the Supreme Court established a standard to determine motions to dismiss that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 47 (1957). However, the Court recently abrogated its previous standard in *Bell Atlantic Corp. v. Twombly*, stating that to survive a motion to dismiss, a complaint's "[f]actual allegations must be enough to raise a right to relief above the speculative level." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555 (2007). In the context of an antitrust complaint, the *Twombly* Court held a complaint that merely states the statutory elements of a claim is insufficient to carry the burden set forth under Rule 8(a)(2). *Twombly*, 550 U.S. at 545 (stating that "[w]hile a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations, a plaintiff's obligation to provide the 'grounds' of his 'entitle[ment] to relief' requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do.").

The U.S. Supreme Court later confirmed that the *Twombly* plausibility standard is not just limited to antitrust complaints, but rather applies to "all civil actions." *See Ashcroft v. Iqbal*, 556 U.S. 662, 129 S.Ct. 1937, 1953 (2009). The *Iqbal* Court following its previous decision in *Twombly* articulated a more demanding two-pronged test to determine whether a complaint should survive a motion to dismiss. *See Twombly*, 550 U.S. 544; *Iqbal*, 129 S.Ct. 1937. The Supreme Court explained as follows:

> Two working principles underlie our decision in *Twombly*. First, the tenet that a court must accept as true all of the allegations contained in a complaint is inapplicable to legal conclusions. Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice. . . . Rule 8 marks a notable and generous departure from the hypertechnical, code-pleading regime of a prior era, but it does not unlock the doors of discovery for a plaintiff armed with nothing more than conclusions. Second, only a complaint that states a plausible claim for relief survives a motion to dismiss. . . . But where the well pleaded facts

> do not permit the court to infer more than the mere possibility of misconduct, the complaint has alleged-but it has not "show[n]"-"that the pleader is entitled to relief." Fed. Rule Civ. Proc. 8(a)(2).

*Iqbal*, 129 S.Ct. at 1949-50 (internal citations omitted). In other words, the court's first step is to identify "the allegations in the complaint that are not entitled to the assumption of truth." *Iqbal*, 129 S.Ct. 1951. Although a court must accept as true all allegations in the complaint, the court must not accept as true mere legal conclusions or conclusory statements. The second step is for the court to evaluate whether "the factual allegations in respondent's complaint to determine if they plausibly suggest an entitlement to relief." *Id.* This second step is often called the "plausibility standard" and refers to the concept that a complaint must state a plausible, not merely possible or conceivable, claim for relief.

Application of the *Twombly-Iqbal* test has generated a number of decisions concerning the sufficiency of pleadings in adversary proceedings. As applied to the bankruptcy avoidance action context, cases where courts have granted motions to dismiss suggest that pleading Section 547 and Section 548 claims in the alternative run afoul the well plead complaint rule set forth in Rule 8. *See In re Pillowtex Corp.*, 427 B.R. 301, 302-07 (Bankr. D. Del. 2010); *In re Hydrogen, LLC*, 431 B.R. 337, 352-54 (Bankr. S.D.N.Y. 2010); *Charys Liquidating Trust v. Hades Advisors, LLC (In re Charys Holding Co.)*, Adv. No. 10-50211, 2010 WL 2788152, *3-5 (Bankr. D. Del. July 14, 2010); *In re Caremerica, Inc.*, 409 B.R. 737 (Bankr. E.D. N.C. 2009) (finding lack of specificity with respect to a preference claim, but nonetheless holding the complaint was sufficient on an intentional fraudulent transfer claim where the plaintiff merely alleged that the debtor transferred funds into the name of a non-debtor entity for the purpose of hindering creditors from attaching the debtor's bank accounts). Courts in the Tenth Circuit have applied the *Twombly-Iqbal* test in a number of disputes centered on a motion to dismiss a complaint. However, the Tenth Circuit application of the *Twombly-Iqbal* standard to avoidance actions has not yet been discussed in any published decision. *Compare In re McJunkin*, Adversary Proceeding No. 11–01331 EEB, 2011 WL 3880497 (Bankr. D. Colo. Sept. 2, 2011) (denying a motion to dismiss to a complaint pleading 523 and 727 claims in the alternative by applying the plausibility standard).

C. Practical Issues

Regardless of whether an attorney chooses to file a complaint with alternative avoidance claims or one claim relying on the right to amend claims, ultimately the safest approach for attorneys is to conduct a thorough pre-filing investigation before filing a complaint. With a firm understanding of the facts, counsel will have the ability to file a complaint containing the required factual support that ties the known facts to the stated elements of each asserted claim. Without sufficient factual support, attorneys run the risk of potentially facing dismissal of claims that may be barred by the statute of limitations. In that instance, the attorney may be subject to court imposed sanctions pursuant to Fed.R.Civ.P. 11 in cases where the plaintiff fails to conduct a reasonable pre-filing investigation into the factual and legal basis of their claims. *See, e.g. White v. General Motors Corp., Inc.*, 908 F.2d 675 (10th Cir. 1990).

You may not have the factual basis for more than a 547 case but may pick it up in discovery. Examples include credit card or debt in one person's name or entity but paid by another. Husband pays debt of wife or the parent corporation paid the debt of the subsidiary. This assumes that you have already named as a Defendant the correct party. This argument may or may not be viable if the 10th circuit follow the recent case of In Re Renaissance Hospital, 2011 WL 5240265 ( Bankr, N.D. Texas 2011), which treated a parent and subsidiary as a single economic unit for 548 reasonably equivalent value purposes. In discovery, you may also pick up the fact that some of the material was not delivered or was defective. In business cases, especially converted Chapter 11 cases, you only have the books and records, a statute of limitation approaching and a nonexistent or uncooperative principal.

One approach would be to request documents from the creditor and make demand early in the administration, i.e. right after the 341 meeting. Follow up with a 2004 examination or file the adversary during a time period where you still have time to amend within the statute of limitation. Since it is not unusual that targets of 547 and 548 claims may be less than cooperative in providing information until you file a law suit, you may want to calendar to file any action six months before the statute of limitation is reached rather than at the last minute. An approach that sometimes work to expedite the response from the potential Defendant is to attach a draft of the complaint to the second demand letter.

# Potential Attorney Liability as Initial Transferee

A. Section 550 Initial Transferees

Section 550 of the bankruptcy code provides that to the extent a trustee has avoided a transfer, the trustee may recover the property transferred, "or, if the court so orders, the value of such property, from-- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee." 11 U.S.C. § 550(a). The time at which the property transferred is valued for this purpose "depends on the circumstances of the case." *In re Integra Realty Resources, Inc.*, 354 F.3d 1246 (10th Cir. 2004). Although a trustee may recover a transfer from more than one party, the trustee "is entitled to only a single satisfaction under [Section 550(a)]." 11 U.S.C.A. § 550(d).

The term "initial transferee" is not defined in the Bankruptcy Code. "This absence and 'the harsh result of an overly literal approach to' § 550 has given rise to the conduit theory." *In re Brooke Corp.*, Bankr. Case No. 08–22786, 2011 WL 4543484, *2 (Bankr. D. Kan. Sept. 28, 2011). Under the conduit theory adopted in the Tenth Circuit from the Seventh Circuit, "the minimum requirement of status as a 'transferee' is dominion over the money or other asset, the right to put the money to one's own purposes." *Id.* (citing *Malloy v. Citizens Bank of Sapulpa (In re First Security Mortg. Co.)*, 33 F.3d 42, 43-44 (10th Cir.1994), quoting *Bonded Fin. Serv., Inc. v. European Amer. Bank*, 838 F.2d 890, 893 (7th Cir.1988)). In *Bonded*, the Seventh Circuit rejected the idea that mere-conduit status was an exception to initial transferee liability and thereby rejected the idea of good faith as a requirement. *Bonded*, 838 F.2d at 894. Instead, the court

discussed that a good faith analysis was an unnecessary step, and ruled that one who lacks dominion over assets fraudulently received can never be an initial transferee because the term "transferee" denotes something more than merely a recipient. *Id.*

"This approach recognizes that the term "transferee" must mean something different from anyone who simply touches the money, such as a "'possessor' or 'holder' or 'agent,'" and provides a basis to hold that "those who act as mere 'financial intermediaries,' 'conduits' or 'couriers' are not initial transferees under § 550." *Id.* (citing *Bailey v. Big Sky Motors, Ltd. (In re Ogden)*, 314 F.3d 1190, 1202 (10th Cir. 2002), quoting *Rupp v. Markgraf*, 95 F.3d 936, 941 (10th Cir. 1996)). "The Seventh Circuit has recently characterized the *Bonded* definition as an approach that tracks the function of the bankruptcy trustee's avoiding powers: to recoup money from the real recipient of preferential transfers. Whether a transferee is an initial transferee or conduit is a fact intensive inquiry." *Id.* (internal quotations omitted).

Courts disagree as to whether a trustee is required under Section 550 to first sue the initial transferee to avoid the transfer prior to seeking avoidance and recovery from a subsequent transferee. *See In re International Administrative Services, Inc.*, 408 F.3d 689 (11th Cir. 2005) (holding it is unnecessary to sue the initial transferee before pursuing action to avoid and recover transfer against the subsequent transferee); *In re AVI, Inc.*, 389 B.R. 721 (B.A.P. 9th Cir. 2008) (finding the trustee is not required to avoid the initial transfer from the initial transferee before seeking recovery from subsequent transferees under § 550(a)(2)); *In re Connolly North America, LLC*, 340 B.R. 829 (Bankr. E.D. Mich. 2006); *In re National Audit Defense Network*, 332 B.R. 896 (Bankr. D. Nev. 2005). *But see Weinman v. Simons (In re Slack–Horner Foundries Co.)*, 971 F.2d 577 (10th Cir. 1992); *In re Enron Corp.*, 343 B.R. 75 (Bankr. S.D. N.Y. 2006), *rev'd and remanded*, 388 B.R. 489 (S.D. N.Y. 2008) (transfer cannot be avoided and recovered from subsequent transferee without participation of the initial transferee in the action). This split authority coupled with the lack of a firm definition for "initial transferee" in the Bankruptcy Code, has given rise to new avoidance litigation where trustees are now targeting attorneys as initial transferees in avoidance actions.

B. *Slack-Horner* and Indispensible Parties

In avoidance actions in the Tenth Circuit, the plaintiff is required to include the initial transferee as an indispensible party pursuant to Fed.R.Civ.P. 19. *See Weinman v. Simons (In re Slack–Horner Foundries Co.)*, 971 F.2d 577 (10th Cir. 1992). Rule 19(a) requires that "[a] person who is subject to service of process and whose joinder will not deprive the court of subject-matter jurisdiction must be joined as a party if: (A) in that person's absence, the court cannot accord complete relief among existing parties; or (B) that person claims an interest relating to the subject of the action and is so situated that disposing of the action in the person's absence may: (i) as a practical matter impair or impede the person's ability to protect the interest; or (ii) leave an existing party subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations because of the interest." Fed.R.Civ.P. 19(a).

Under *Slack-Horner,* the Tenth Circuit "requires that the avoidability of the initial transfer be determined in litigation brought against the initial transferee." *In re Brooke Corp.*, 443 B.R.

847, 852 (Bankr. D. Kan. 2010) (citing *Slack–Horner*, 971 F.2d 577). To provide some background:

> In *Slack–Horner,* the debtor's interest in real property was transferred to the state prepetition in a tax lien sale at which Simons purchased the property. After the expiration of the redemption period and within one year prior to debtor's filing for bankruptcy relief, a deed was issued to Simons. The trustee alleged that the transfer to Simons was fraudulent under § 548 and sought to recover the value of the property from Simons. The bankruptcy court and the district court denied relief, finding that no interest of the debtor in property was transferred to Simons when the deed was recorded. The Tenth Circuit affirmed, but on different grounds, finding that the crucial event was the transfer by the debtor to the state in the foreclosure action, and that Simons was a subsequent transferee from the state. The trustee had not made any attempt to have the transfer from the debtor to the state avoided under § 548, either in the action against Simons or in a separate proceeding. The Tenth Circuit held that in the absence of such a determination of avoidance, the trustee could not recover the property or its value from Simons, the immediate transferee of the state, under § 550. The court relied upon the phrase in § 550(a) "to the extent that a transfer is avoided under section . . . 548 . . . the trustee may recover . . . the value of such property" from the initial transferee or any immediate transferee of such initial transferee. The court stated in a footnote, "[T]he trustee may not set aside such a transfer of property by the state as fraudulent without bringing the state into the action.

*In re Brooke Corp.*, 443 B.R. at 852 (quoting *Slack–Horner*, 971 F.2d at 580, n. 1).

The *Slack-Horner* decision remains binding precedent in the Tenth Circuit interpreting Section 550 "to require a successful avoidance action against the initial transferee before recovery may be had from a subsequent transferee." *Brooke Corp.*, 443 B.R. at 852-53 (quoting *5 Collier on Bankruptcy*, ¶ 550.02[1] (Alan N. Resnick & Henry J. Sommer, eds.-in-chief, 16th ed. 2010)). The United States Bankruptcy Court for the District of Kansas discussed the precedential value of *Slack-Horner*:

> Under the Tenth Circuit opinion, the Trustee cannot prevail . . . even though the Complaint clearly alleges that the transfer from the Debtor is avoidable. *Slack–Horner* has been consistently construed to require that the avoidability of the initial transfer be determined in litigation brought against the initial transferee. Circuit Judge Seymour, when dissenting from the majority decision in *Slack–Horner*, interpreted the majority as holding "that because Simons received the property from the state rather than directly from the debtor, the trustee must seek recovery only from the state and cannot proceed against Simons even if the transfer is avoidable under 11 U.S.C. § 548 (1988)."

*Id.* at 852 (quoting *Slack-Horner*, 971 F.2d at 581 (Seymore, J., dissenting)). Although the court acknowledged that the *Slack-Horner* decision was binding, the court added that:

> Courts are divided on the question whether the trustee must first avoid the transfer between the initial transferor and transferee before he can recover from a subsequent transferee. Collier states:
>
> > Recovery "to the extent that" a transfer is avoided has been interpreted to require a successful avoidance action against the initial transferee before recovery may be had from a subsequent transferee. The better view, adopted by the majority of courts, is that a transfer may be found avoidable and a recovery may be had from a subsequent transferee without suing the initial transferee.

*Id.* at 853 (citing *5 Collier on Bankruptcy* ¶ 550.02). "Collier's 'better view,' which is contrary to SlackHorner, is illustrated by the Eleventh Circuit's opinion in International Administrative Services. *Id.* (citing *IBT Intern., Inc. v. Northern (In re Int'l Admin. Servs., Inc,)*, 408 F.3d 689 (11th Cir. 2005). Ultimately, the U.S. Bankruptcy Court for the District of Kansas begrudgingly followed the *Slack-Horner* precedent, despite its recognizing that the decision represents the minority position.

If the Tenth Circuit adopted the *Harwell* analysis (discussed below) expanding the term "initial transferee" to include a debtor's attorney, the *Slack-Horner* case would conceivably require the trustee to name the debtor's attorney as a defendant in every avoidance action where the attorney held any of the debtor's avoidable funds pursuant to Rule 19.

C. The *Harwell* Case

The Eleventh Circuit Court of Appeals recently issued an opinion defining "initial transferee" to include debtor's counsel in the context of a trustee's avoidance action. *See Martinez v. Hutton (In re Harwell)*, 628 F.3d 1312 (11th Cir. 2010). In *Harwell*, the debtor hired counsel to negotiate a buyout of the debtor's interests in two Florida businesses. *Id.* at 1314. While negotiating this dispute, a Colorado court entered judgment against the debtor for nearly $1.4 million in favor of a creditor, who immediately began collection efforts, including domestication of the judgment in Florida. *Id.* The same attorney was hired by the debtor to defend the domestication proceedings. *Id.* While these collection efforts were ongoing, the debtor settled the buyout dispute, entitling him to receive the aggregate amount of $500,000. *Id.* The funds were deposited into the attorney's trust account, and at the debtor's direction, were immediately distributed by check to various parties, including the debtor, the debtor's wife, the debtor's father and selected creditors. *Id.*

Before the checks cleared, the Colorado court entered an order requiring the debtor to turn over any payments received from his settlement that were still within his control. *Id.* at 1315. The creditor served the attorney with a writ of garnishment for any amounts held in trust for the debtor. *Id.* Although the attorney stopped payment on two checks issued to the debtor totaling $125,000, the attorney failed to stop payment "on several other checks that had not yet cleared . . . and for which amounts still remained in his trust account." *Id.* The attorney and the debtor

moved to quash the writ of garnishment for a defective domestication on technical grounds, and the Florida court granted the request. *Id.* The same day, the attorney personally delivered the $125,000 check to the bank, and obtained seven cashier's checks in return "to make sure that the money was out of his account in case [the creditor] obtained another writ of garnishment." *Id.* The debtor subsequently filed for chapter 11 protection in Colorado, and the case was later converted to chapter 7. *Id.* The Chapter 7 trustee filed an avoidance action against the attorney, seeking to set aside the fraudulent transfers and to recover the $500,000 from the attorney as an alleged "initial transferee." *Id.* at 1316. At issue on appeal was whether the debtor's attorney was an "initial transferee" such that the trustee could recover from the debtor's attorney $500,000 that was placed into the attorney's trust account and then distributed.

The *Harwell* Court established three principles courts should use in determining who is an initial transferee under its "control" or "mere-conduit" test. *Harwell*, 628 F.3d at 1322-23. First, "a literal or rigid interpretation of the statutory term 'initial transferee' in § 550(a) means that the first recipient of the debtor's fraudulently-transferred funds is an 'initial transferee.'" *Id.* at 1322. Second, the Eleventh Circuit "carved out an equitable exception to the literal statutory language of 'initial transferee,' known as the mere conduit or control test, for initial recipients who are 'mere conduits' with no control over the fraudulently-transferred funds." *Id.* The Court explained that:

> [i]n doing so, this Court has adopted a flexible, pragmatic, equitable approach of looking beyond the particular transfer in question to the circumstances of the transaction in its entirety. The mere conduit or control test is a judicial creation that is not based in statutory language, but is an exception based on the bankruptcy courts' equitable powers. Equitable considerations play a major role in the mere conduit or control test because it would be inequitable to hold an initial recipient of the debtor's fraudulently-transferred funds liable where that recipient could not ascertain the transferor debtor's solvency, lacked any control over the funds, or lacked knowledge of the source of the funds.

*Id.* Third, courts must consider "whether the intermediary 'acts without bad faith, and is simply an innocent participant' to the fraudulent transfer." *Id.* at 1323. In concluding that good faith is a requirement under the mere conduit or control test, the Eleventh Circuit held that initial recipients asserting the mere conduit exception to Section 550(a)(1)'s statutory language must establish both "(1) that they did not have control over the assets received, i.e., that they merely served as a conduit for the assets that were under the actual control of the debtor-transferor *and* (2) that they acted in good faith and as an innocent participant in the fraudulent transfer." *Id.*

As discussed above in section A. *supra*, the Tenth Circuit has adopted the analysis from the Seventh Circuit *Bonded* opinion. While *Harwell* does not specifically address the distinction made in *Bonded* for mere-conduit status as an exception to initial transferee liability, the Eleventh Circuit seems to disagree explaining that "transfer" is defined as broadly as possible by the Bankruptcy Code. The *Harwell* progeny makes clear that the first recipient of fraudulently transferred funds is an initial transferee, meaning that a mere-conduit exception must be applied to

escape liability where an attorney knowingly participates in a debtor's fraudulent conveyances. However, the Tenth Circuit has not adopted the *Harwell* analysis, and the Supreme Court has not yet addressed the split among the circuits.

D. Practical Issues

A bank would be the initial transferee if the bank is a lender and sweeps the account, as in asset based lending. It likely would not be the initial transferee if they simply maintain a bank account for the debtor or creditor.

An attorney who handles a case on a contingent fee or offsets his fees against the settlement funds received from the Debtor is probably an initial transferee and not a conduit. Depending upon the facts of the case, he may be able to claim he/she is a secured creditor. However, the time period of receipt of the funds, i.e. within the preference period, may make the security interest a preference.

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# AVOIDANCE ISSUES PANEL

***Statute of Limitation Issues***

***New Value Defense and Section 503(b)(9) Claims***

***BFP v. Resolution Trust Corp. – Application in Preference Cases***

***Good Faith under Section 550(b)***

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# Statute of Limitations Issues

**Issue:** Whether Section 546(a) of the Bankruptcy Code extends state-law statutes of limitation periods for Trustees to bring state-law avoidance actions?

**Cases Extending the Limitations Period Using Section 546(a):**

Picard v. Estate of Stanley Chais (In re Bernard Madoff Inv. Secs. LLC), Adv. Proc. No. 09-1172, 445 B.R. 206 (Bankr. S.D. N.Y. 2011). This case held that so long as the state-law limitations period has not run by the petition date, the Trustee may have up to two additional years under section 546(a) of the Bankruptcy Code to file state-law claims under section 544.

Finkel v. Polichuk (In re Polichuk), Adv. Proc. No. 10-0031, 2010 WL 4878789, at * 3 (Bankr. E.D.Pa. Nov. 23, 2010). The court held that "[a] trustee has two years to pursue the cause of action if the state law cause of action has not expired and a bankruptcy proceeding has been commenced. Even though the state law cause of action may expire after the filing of the petition, but before the two-year limitation in 546(a), the two-year limit in § 546(a) is applicable."

Furr v. United States (In re Pharmacy Distributor Servs., Inc.), 455 B.R. 817 (Bankr. S.D. Fla. Aug. 17, 2011) The court rejected the argument that section 546(a) acts only to limit a Trustee's time to bring avoidance action rather than to extend the statute of limitations. The court stated that such an "argument flies in the face of overwhelming case law holding that section 546 extends the time to pursue an avoidance action under section 544 so long as the underlying state law claim had not expired as of the date the bankruptcy case was filed."

# New Value Defense and Section 503(b)(9) Claims

**Issue:** Whether an administrative expense claim allowed under 11 U.S.C. § 503(b)(9) may be included in a calculation of "new value" under 11 U.S.C. § 547(c)(1)?

**Administrative Expense May Be Used As New Value:**

Commissary Operations, Inc. v. Dot Foods, Inc. et al., (In re Commissary Operations, Inc.), 421 B.R. 873 (Bankr. M.D. Tenn. 2010) (holding that a creditor may double dip administrative claims with the new value defense).

**Administrative Expense Claim Many Not be Used As New Value:**

TI Acquisition, LLC v. S. Polymer, Inc. (In re TI Acquisition, LLC), 429 B.R. 377 (Bankr. N.D. Ga. 2010) (declining to follow *Commissary Operations* and holding that a creditor may not double dip its 503(b)(9) claims with its new value defense).

Circuit City Stores, Inc. v. Mitsubishi Digital Elec. Am., Inc. et al., (In re Circuit City Stores), Adv. No. 10-03068, 2010 WL 4956022 (Bankr. E.D. Va. Dec. 1, 2010) (declining to follow *Commissary Operations* but choosing to follow *TI Acquisition*).

# BFP v. Resolution Trust Corp. – Application in Preference Cases

**Issue:** Whether the Supreme Court's ruling in BFP v. Resolution Trust Corp., 511 U.S. 531 (1994) regarding fraudulent transfers under 11 U.S.C. § 548 impacts the value analysis in preferential transfers actions brought under 11 U.S.C. § 547(b)?

**Background:** In *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), the Supreme Court held that the price received at a pre-petition foreclosure sale that is conducted in accordance with state law and without collusion equals the "reasonably equivalent value" of the property as a matter of law, and thus fraudulent transfer claims based on 11 U.S.C. § 548(a)(1)(B) must fail against creditors who foreclose on properties pre-petition in that manner.

**Cases Stating that BFP Does Not Impact Preferential Transfer Claims under § 547:**

In re Whittle Dev., Inc., 2011 WL 3268398 (Bankr. N.D. Tex. July 27, 2011). This case held that *BFP* does not govern preferential transfer cases brought under 11 U.S.C. § 547 because, unlike 11 U.S.C. § 548, § 547 requires the Court to compare actual value received against the potential value the creditor would have received under a hypothetical chapter 7 liquidation. Thus, the Court held that when an oversecured creditor forecloses on a property and then purchases the property at the foreclosure sale, the excess in value that the creditor receives from the property over what the creditor would have received under a chapter 7 liquidation is avoidable 11 U.S.C. § 547(b), even if the foreclosure proceeding complied with state law and was non-collusive.

In re Villarreal, 413 B.R. 633 (Bankr. S.D. Tex 2009). This case used reasoning similar to *Whittle*, and held that *BFP* does not govern preferential transfer cases brought under 11 U.S.C. § 547. The Court then avoided the transfer of property at a foreclosure sale where the creditor bid his $70,000 claim against the debtor and received property with a net worth to the creditor of $3,250,000.

In re Rambo, 297 B.R. 418 (Bankr. E.D. Penn. 2003). This case also used reasoning similar to *Whittle*, and held that *BFP* does not govern preferential transfer cases brought under 11 U.S.C. § 547. In this case, however, the Court ultimately decided that the creditor did not receive more value through foreclosure than it would have received through a liquidation under chapter 7 of the Bankruptcy Code, and thus it declined to avoid the transfer at issue.

**Cases Stating that BFP Does Impact Preferential Transfer Claims under § 547:**

In re Pulcini, 261 B.R. 836 (Bankr. W.D. Penn. 2001). Held that *BFP*'s analysis of 11 U.S.C. § 548 applies with equal force to § 547 and that lien creditors do not receive more, even if oversecured, than they would under a chapter 7 liquidation because the amount actually received at the foreclosure sale constitutes the value as a matter of law.

In re FIBSA Forwarding, Inc., 230 B.R. 334 (Bankr. S.D. Texas 1999). Held that the *BFP* analysis governs 11 U.S.C. § 547 because in *BFP*, "the Supreme Court decided to prefer state

title interests over the 'basic principle' of bankruptcy law" to equitably apportion estate assets among creditors. *Id*. at 341. The court noted that the "apparent lesson of *BFP* is that if a creditor is oversecured, the Debtor must file a bankruptcy petition (or creditors must file an involuntary petition) before foreclosure to prevent the secured creditor from reaping a windfall at the expense of the other creditors." *Id*.

Cottrell v. U.S., 213 B.R. 378 (Bankr. M.D. Ala. 1996). Held that *BFP* governed the preference action at issue because the "forced sale" price obtained at the foreclosure proceeding "would undoubtedly be duplicated by a trustee in a 'forced sale' in bankruptcy," and thus the creditor did not receive more through foreclosure than it would have received under a chapter 7 liquidation.

Ehring v. Western Community Moneycenter (In re Ehring), 900 F.2d 184 (9th Cir. 1990). This is a pre-*BFP* decision holding that a creditor who bids and purchases at a foreclosure sale does not receive more than it would under a chapter 7 liquidation because (a) there is no reason to treat a creditor who purchases at a foreclosure sale different than a third party, simply because one or the other was the highest bidder at the foreclosure sale, and (b) the likely outcomes at a liquidation and at a foreclosure sale are essentially the same, since a creditor may bid at either, and both are forced sales.

# Good Faith Under Section 550(b)

**Issue:** Whether the good faith requirement of section 550(b) is based purely on an objective standard or whether it contains a subjective component as well.

**Background:** Section 550(b) of the Bankruptcy Code provides a defense for mediate transferees of fraudulent transfers, but only if such mediate transferee "takes for value, … in good faith, and without knowledge of the voidability of the transfer avoided."

**Good Faith is Measured Objectively:**

Hayes v. Palm Seedlings Partners—A (In re Agricultural Research and Technology Group, Inc.), 916 F.2d 528 (9th Cir. 1990). The court applied a purely objective standard to determine whether the defendant demonstrated good faith.

Brown v. Third National Bank (In re Sherman), 67 F.3d 1348 (8th Cir. 1995). In this case, the court purported to apply the purely objective good-faith test of *Agricultural Research*, but then applied a test with a subjective component, as evidenced by its statement that "a transferee does not act in good faith when *he* has sufficient knowledge to place *him* on inquiry notice of the debtor's possible insolvency." (emphasis added).

**Good Faith has both a Subjective and Objective Component:**

Goldman v. Capital City Mortgage Corp. (In re Nieves), 648 F.3d 232 (4th Cir. 2011). Regarding the "knowledge" prong of the defense, the *Nieves* court said that "actual notice" is required, but "is satisfied if the transferee knew facts that would lead a reasonable person to believe that the property transferred was recoverable." (internal quotations omitted). The test is a subjective test that looks at the actual knowledge of the defendant.

Regarding the "good faith" prong of the defense, the *Nieves* court applied a test with both a subjective and objective component. "Under the subjective prong, a court looks to the 'honesty' and 'state of mind' of the party acquiring the property. Under the objective prong, a party acts without good faith by failing to abide by routine business practices." *Id.* at 239 (internal citations omitted). The objective portion of the test, however, depends on what the defendant actually knew "and not what it was charged with knowing on a theory of constructive notice." Thus, although transferees do not have a duty to investigate—unless the customary business practices of the industry so require—and they cannot take in good faith if "they remain willfully ignorant in the face of facts which cry for investigation." *Id.*

Gowan v. Patriot Group, LLC (In re Dreier LLP), 452 B.R. 391 (Bankr. S.D.N.Y. 2011). This court noted and appeared to embrace the *Nieves* formulation of the good faith defense, but

ultimately determined that the Second Circuit has not determined the proper legal standard of the good faith defense.

Bonded Financial Services, Inc. v. European American Bank, 838 F.2d 890 (7th Cir. 1988). Although some courts have cited to the *Bonded Financial Services* case to support their formulation of the good-faith test, *Bonded Financial Services* did not analyze good faith but instead focused on the knowledge portion of the test. Concerning knowledge, the court held that the only time knowledge may be imputed is where there are facts and information of which the transferee is aware that would "support an inference of knowledge" by the transferee, and not merely put the transferee on inquiry notice. This formulation of the test thus includes a subjective component as well.

**CONSUMER WORKSHOP IV**
**THE MOSQUITO RANGE: AVOIDING TRANSFERS AND AVOIDING LIABILITY**

# AVOIDING THE DEFECTIVE MORTGAGE

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## A. Introduction.

From a lender's (and possibly an individual debtor's perspective), one of the many fallouts from the mortgage crisis is renewed focus on the mortgages encumbering debtor's real property. With mortgage companies springing up everywhere five to ten years ago and the frenzied refinancing seen in the recent past, trustees are increasing scrutinizing the mortgages for defects to provide a source of recover for the unsecured creditors.

While certainly not immune from problems, experience is showing that the lending put in place when debtors originally purchased the home usually is properly documented and recorded. The same cannot be said of the documentation and recording that occurred when the house was refinanced, or re-refinanced, or re-re-refinanced, or . . . In the frenzied refinancing environment of the 2004 to 2006, many non-traditional lenders simply failed to follow the statutory requirements in the jurisdiction in which the real property was located and/or failed to adequately train their personnel. As a consequence, trustees are finding numerous opportunities to recover funds for the unsecured creditors.

## B. Bankruptcy Code Authority.

The primary basis for the trustee's challenge is 11 U.S.C. § 544(a) which provides:

> **(a)** The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any

> creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
>
> **(1)** a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
>
> **(2)** a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or
>
> **(3)** a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

While 11 U.S.C. § 544(a)(3) provides a trustee with rights of either a creditor or a bona fide purchaser of real property, whether such a creditor or bona fide purchaser of real property may successfully challenge a mortgage will be determined by state law. It is important to note that the applicable law is the state law in which the real property is located, *not* the state law of the jurisdiction within which the bankruptcy case is pending.

### C. Trustee's (and Debtor's Counsel's) Review.

A trustee's examination on real estate issues will typically consist of reviewing the lending documents, particularly the executed and filed documents, as well as questioning of debtors regarding the closing. These documents include the deed, the mortgage, the mortgage note, and the assignments of the mortgages. Generally, a trustee may focus on the following questions and issues:

a. Who are the parties to the original lending transaction or refinancing transaction and who are the parties executing the documents?
b. Were the lending documents executed by both husband and wife or is only one of the parties obligated by the underlying debt?

c. If the real property was purchased by a debtor who subsequently gets married, are there dower or curtesy issues.
d. Who is the borrower under the mortgage? Is it only one of the parties or is it both the husband and wife?
e. Who is defined as the borrower under the lending documents?
f. What is the effect of a signature of a non-owner/non-borrower spouse?
g. If there was a refinance, did the refinance fall within the terms of the original mortgage?
h. Is the legal description complete and accurate?
i. If there are multiple parcels, are all of the parcels being pledged?
j. If not, are the lending documents consistent regarding which parcels are being pledged?
k. Are interests in mineral rights properly included in the lending documents?
l. Are the attestations proper under state law?
m. Was the notary present and did he or she actually witness the execution of the documents or were the signatures later acknowledged before the notary?
n. If witnesses are required, were the lending documents signed in their presence?
o. Are the witnesses properly identified under state law?
p. Is the notarization proper under state law?
q. Where did the closing occur?
r. If the closing occurred in the debtor's home, who was present?

Failure to follow the specific requirements of state law may render a mortgage defective and open the door for a challenge by the trustee.

In addition to reviewing the lending documents and the circumstances surrounding the closing of the loan, a trustee will review the filing of the mortgage. This inquiry will include:

a. Was the mortgage properly filed?
b. When was the mortgage filed in relationship to the borrowing and in relationship to the bankruptcy filing?
c. Was the mortgage filed in the property location?
d. If the property is located in more than one county, was it properly filed everywhere it should be filed?

e. Are there any special filing requirements and were these filing requirements met?

f. If a refinance has occurred, are the terms of the refinancing consistent with any limitations set forth in the original mortgage?

Failure to meet the recording requirements provides another avenue for a trustee to avoid the mortgage. If the debtor is in default under the mortgage, it may make sense to double check when the mortgage was recorded as lenders will often attempt to fix defects prior to instituting a foreclosure proceeding.

As hinted at above, if there is time, debtor's counsel should conduct a similar review before the bankruptcy filing to determine if there are possible defects. If possible, counsel should review both the original lending documents as well as the documents relating to any subsequent refinancing. Debtor's counsel will likely want to review in detail with the debtor the circumstances of any closings occurring in the debtor's home as the specific statutory requirements tend to be overlooked opening the door for challenges to the lien.