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# BANKRUPTCY LITIGATION: FUNDAMENTALS OF PREFERENCES AND FRAUDULENT TRANSFERS

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## Preferences: Introduction

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- Allow a debtor or bankruptcy trustee to avoid and recover certain transfers made prior to bankruptcy.
- Equalize payments to creditors so that creditors paid before bankruptcy are not treated better than others *in the same class* who were not paid (11 U.S.C. §547).
- Not widely utilized by debtors seeking to reorganize.
- Valuable source of recovery in cases where:
  - a transfer was made as a result of undue pressure by suppliers; or
  - the debtor is liquidating.

## Preferences: Elements

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- Transfer of an interest in property of the debtor;
  - “Transfer” has the broadest possible meaning (11 U.S.C. §101(54) (defining “transfer”)).
- To or for the benefit of a creditor;
- For or on account of an antecedent debt owed by the debtor;
- Made within 90 days prior to the petition date (1 year for “insiders”);
- While the debtor was insolvent;

## Preferences: Elements (cont'd)

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- That enables the creditor to receive more than it would in a Chapter 7 liquidation.
  - If the unsecured creditor received full payment on a debt within 90 days prior to the bankruptcy, but that creditor would receive less than full payment on the same debt if it were paid in a Chapter 7 liquidation, this element is satisfied.

## Preferences: Common Exceptions/Defenses

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Contemporaneous exchange for new value (11 U.S.C. §547(c)(1)).

- The defendant must show that:
  - the parties intended the transfer to be a contemporaneous exchange;
  - the exchange was actually contemporaneous; and
  - the exchange was for new value.
- Rationale: If a creditor gives new value in exchange for a payment, the estate is not diminished. New value cannot be a satisfaction of a pre-existing debt.

## Preferences: Exceptions/Defenses (cont'd)

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Ordinary course of business payments (11 U.S.C. §547(c)(2)).

- The defendant must show that the antecedent debt was incurred in the ordinary course of business **and**:
  - the antecedent debt was paid in the ordinary course of business *between the parties*; **or**
  - the payment was made according to ordinary payment terms *in the industry*.
- Rationale: Payments that are the result of ordinary commercial transactions are not avoided.

## Preferences: Exceptions/Defenses (cont'd)

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Subsequent extension of new value/open credit (11 U.S.C. §547(c)(4)).

- The defendant must show that the creditor gave “new value” on credit to the debtor **after** the alleged preference payment.
- Rationale: Encourages trade creditors to continue to do business with distressed companies and reduces exposure to the extent they replenished the debtor’s bankruptcy estate.

## Preferences: Exceptions/Defenses (cont'd)

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Purchase money security interests perfected within 30 days of credit extension (11 U.S.C. §547(c)(3)).

- Covers security interests arising from “enabling loans.”
- Not avoidable if the creditor can prove that the security interest secured new value actually given and the security agreement:
  - describes the collateral at issue;
  - is given to enable the debtor to acquire the property (and the property is acquired); and
  - is perfected within 30 days of the debtor’s receipt of the property.



## Preferences: Exceptions/Defenses (cont'd)

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Statutory liens (11 U.S.C. §547(c)(6)).

As a general matter, liens that are created by statute (such as a mechanics lien or tax lien) cannot be avoided.

## Preferences: Insolvency Presumption

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Insolvency (11 U.S.C. §101(32) (defining “insolvent”)).

- There is a presumption of insolvency during the 90-day period prior to the bankruptcy petition date (11 U.S.C. §547(f)).
- Creditors may rebut the presumption by showing some evidence of solvency.
- If the presumption is not rebutted, it can be relied on by a plaintiff from the beginning of the case through the trial.

# Preferences: The Reach of §547

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“Look-back” periods.

- 90 days for most transferees.
- One (1) year for “insiders” (11 U.S.C. §101(31)). For corporate debtors, insiders include:
  - officers and directors;
  - partnerships in which the debtor is a general partner;
  - general partners of the debtor;
  - persons in control of the debtor; and
  - relatives of a general partner, director, officer or person in control.
- There is no insolvency presumption for the 91-365 day period for preferences made to insiders.

# Preferences: Time Limits for Commencing Suit

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Time limits (11 U.S.C. §546(a)).

- Preference actions must be commenced by the earlier of:
  - (1) The latter of:
    - two (2) years after entry of an order for relief (usually commencement of case); or
    - one (1) year after the appointment or election of the first trustee (if it occurs before the expiration of the above period).

-or-

- (2) The time the case is closed or dismissed.

## Fraudulent Transfers: Introduction

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- Like preferences, allow a bankruptcy trustee or debtor to avoid certain pre-petition transfers (11 U.S.C. §548).
- Often pleaded in the alternative to preference claims in the event a payment was not on account of an antecedent debt.
- Used to attack a wide range of transactions, from simple gifts to complex transactions such as multiparty secured loans, corporate guarantees and leveraged buy outs (LBOs).

# Fraudulent Transfers: Actual Fraud Elements

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- Transfer made or obligation incurred;
- With actual intent to hinder, delay or defraud creditors.

Plaintiffs can use “badges of fraud” to demonstrate intent, which include whether:

- The transfer was to an insider.
- The debtor retained control of the property after the transfer.
- The transfer was concealed.
- The debtor had been sued, or threatened with suit, prior to the transfer.
- The debtor transferred substantially all its assets.
- The consideration received was inadequate.

# Fraudulent Transfers: Constructive Fraud Elements

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- Transfer made or obligation incurred;
- For less than reasonably equivalent value (dollar-for-dollar value need not be given);

Focus is on value received by the *debtor* (**not** value given by the *transferee*).

Benefits/value can be direct or indirect.

Indirect benefits can come in many forms, such as securing a supply chain or corporate synergies that can enhance a debtor's value.

# Fraudulent Transfers: Constructive Fraud Elements (cont'd)

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- When the debtor was:
  - insolvent (§548(a)(1)(B)(ii)(I));
  - left with unreasonably small capital (§548(a)(1)(B)(ii)(II)); or
  - believed that it would incur debts beyond its ability to pay as they matured (§548(a)(1)(B)(ii)(III)).

Unlike 11 U.S.C. §547, there is no presumption of insolvency in the text of 11 U.S.C. §548.

The above need not be shown when certain insider employment contracts are at issue (11 U.S.C. §548(a)(1)(B)(ii)(IV)).



## Fraudulent Transfers: Limitations/Defenses

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Aside from disputing elements of a plaintiff's case-in-chief, numerous other limitations and defenses can apply, including:

- Fraudulent transfer actions are subject to the same time limitations for commencing suit as preference actions (11 U.S.C. §546(a)).
- Both actual and constructive fraudulent transfers brought pursuant to 11 U.S.C. §548 are subject to a two (2) year “look-back” period.

## Fraudulent Transfers: Good-faith Purchaser

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The good-faith purchaser defense (11 U.S.C. §548(c)) protects transferees with a lien to the extent that they both:

- Gave value.
- Acted in good faith.

Recovery governed by 11 U.S.C. §550, which provides:

- that recovery can be obtained from a transferee or subsequent transferees (11 U.S.C. §550 ); and
- a good-faith defense for subsequent transferees (11 U.S.C. §550(b)).

## Fraudulent Transfers: Mere Conduit

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The “mere conduit” defense is an equitable defense based on a defendant showing that it did not have control over the transferred property (that is, it could not use the property received for its own purposes).

# Fraudulent Transfers: Improvement

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The “Improvement” defense can be used when:

- A good faith transferee has a lien on the property recovered to the extent it has improved the property.
- The lien will secure the lesser of:
  - the cost of improvements (minus profits received by the transferee); or
  - the increase in value of the property as a result of the improvements.

# Fraudulent Transfers: Settlement Payments in connection with a Securities Transaction

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The “settlement payments in connection with a securities transaction” defense (11 U.S.C. §546(e)):

- Provides certainty to securities transactions.
- Does not protect actual fraudulent conveyances.

“Settlement payment” is broadly construed and generally refers to any sort of payment that completes a securities transaction.

The precise scope of protections provided by 11 U.S.C. §546(e) is still being defined.

# Fraudulent Transfer: § 546(e) and the LBO

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11 U.S.C. §546(e) and the scope of the “safe harbor” for LBOs:

- In most LBOs, the assets of the target are pledged as collateral for the loans issued to fund the transaction.
- Loan proceeds are typically used to pay existing bank debt and to “cash-out” shareholders.
- If a bankruptcy follows, that LBO may be challenged as a fraudulent transfer. This can mean suing the bank that provided the secured financing (to avoid the lien) and shareholders for the payout they received.

## Current Issues: §546(e) and the LBO (cont'd)

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Several recent fraudulent transfer cases discuss whether the safe harbor protection:

- Applies to state law claims brought by creditors or on their behalf.
  - *Tribune* and *Lyondell* reject the argument that 11 U.S.C. §546(e) applies to such creditor claims brought only under state law.
- Preempts state law fraudulent conveyance actions.
  - *Tribune* and *Lyondell* reject the pre-emption argument for solely state law claims.

# Fraudulent Conveyances: State Law Claims

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State fraudulent conveyance statutes are applicable to bankruptcy cases pursuant to 11 U.S.C. §544(b):

- The debtor/trustee is given state law avoidance rights of unsecured creditors.
- A benefit is that a longer “look-back” period applies (for example, New York is six years instead of the 2 years provided under 11 U.S.C. §548).
- A drawback is that the creditor must have an allowed unsecured claim that could itself avoid the challenged transfer under state law.



## Current Issues: §546(e) and *Madoff*

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- The trustee in *Madoff* sued certain Madoff clients for payments they received from the Madoff firm based on constructive fraudulent conveyance claims under 11 U.S.C. §548 and state law.
- The S.D.N.Y. district court dismissed all constructive fraudulent conveyance claims against the clients, based on §546(e).
- A principal issue before the Second Circuit was whether a “Ponzi-scheme exception” to §546(e) should be created because no securities were traded by Madoff.
- The Second Circuit decided in December that §546(e) protection applies even though no securities were actually traded.

# Current Issues: §548 and Judicially-created Insolvency Presumption

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- S.D.N.Y. courts are starting to presume insolvency for certain 11 U.S.C. §548 constructive fraud claims.
- This presumption is being used in cases alleging “giveaways” by debtors (that is, cases where the debtor allegedly received no consideration for the transfer at issue).
- The S.D.N.Y.’s extension of the presumption to constructive fraud claims is based on New York state law.
- This extension is debatable given that Congress chose to include a presumption in the text of 11 U.S.C. §547 but declined to include a presumption in the text of 11 U.S.C. §548.

## Current Issues: §548 and Judicially-created Insolvency Presumption (cont'd)

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This issue is important because the insolvency presumption:

- Makes it harder for defendants to dismiss constructive fraudulent conveyance claims.
- Can relieve the plaintiff of having to prove what is often the most expensive aspect of its case.
- Is costly and difficult to rebut, especially when the financial affairs of a debtor are complex or poorly documented.

## Practice Tips

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- Consider the adequacy of any proposed special procedures governing discovery in cases where preference actions are filed *en masse*.
- Since fraudulent transfer claims are often pled in the alternative to preference claims, consider stipulating to the existence of an antecedent debt in exchange for dismissal of the “back up” fraudulent conveyance claim.
- Be careful not to overlook other forms of settlement currency, such as potential offsets.

# Relevant Practical Law Resources

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- Practice Note, Bankruptcy Litigation: Preferences and Fraudulent Transfers
- Practice Note, Bankruptcy Basics: What Commercial Litigators Need to Know
- Practice Note, Finance Fundamentals: Preferences v. Fraudulent Conveyances
- Practice Note, Fraudulent Conveyances in Bankruptcy: Overview
- Practice Note, Preferential Transfers: Overview and Strategies for Lenders and Other Creditors

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# Questions