PREFERENCES AND FRAUDULENT TRANSFERS

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I.

THE NATURE AND COMMON FEATURES OF PREFERENCE AND FRAUDULENT TRANSFER AVOIDANCE ACTIONS

A. PREF ERENCES AND FRAUDULENT TRANSFERS COMPARED.

Preference actions under 11 U.S.C. § 547 and fraudulent transfer actions under 11 U.S.C. § 548 or § 544(b) are among the many tools available to a bankruptcy estate to set aside prepetition transactions. The two are often used together, and the same transfer may be subject to attack under both theories. E.g., In re Criswell, 102 F.3d 1411 (5th Cir. 1997); In re M&L Business Mach. Co., 84 F.3d 1330 (10th Cir.), cert. denied, 519 U.S. 1040 (1996); In re Hertzler Halstead Hosp., 334 B.R. 276 (Bankr. D. Kan. 2005) (transfer may be both preferential and fraudulent). The right of the bankruptcy estate to avoid preferences and fraudulent transfers is fundamental to insolvency policy, and the provision for such avoidance in a foreign nation’s insolvency laws is a critical factor for a bankruptcy court to consider in deciding whether to grant ancillary relief in aid of a foreign proceeding under the current 11 U.S.C. § 1507(b)(3), just as it was before 2005 under the former 11 U.S.C. § 304(c)(3). See In re Petition of Garcia Avila, 296 B.R. 95 (Bankr. S.D.N.Y. 2003); In re Board of Directors of Hopewell Intern. Ins. Co., 238 B.R. 25 (Bankr. S.D.N.Y. 1999), aff’d, 275 B.R. 699 (S.D.N.Y. 2002). Generally, both sorts of avoiding powers may be used only for the benefit of creditors, not for the benefit of an individual debtor or a corporate debtor’s equity holders, In re Cybergenics Corp., 226 F.3d 237 (3d Cir. 2000); In re Murphy, 331 B.R. 107 (Bankr. S.D.N.Y. 2005); In re Kmart Corp., 310 B.R. 107 (Bankr. N.D. Ill. 2004); In re Best Prods. Co., 168 B.R. 35 (Bankr. S.D.N.Y. 1994), appeal dismissed, 177 B.R. 791 (S.D.N.Y.), appeal reinstated and aff’d, 68 F.3d 26 (2d Cir. 1995), and thus normally neither sort of avoidance power may be used if the estate is solvent. Hopewell Intern., 238 B.R. at 25. Even with these similarities, there are differences between the two sorts
of theories, and they serve different policies. See Bear, Stearns Sec. Corp. v. Gredd, 275 B.R. 190 (S.D.N.Y. 2002).

Congress changed certain features of both preference and fraudulent transfer law with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), Pub. L. 109-8, 119 Stat. 23. These changes will be discussed below. Nonetheless, the basic nature of and the differences between the two sorts of actions remain.

Transfers that are designed to place the debtor’s property beyond the reach of creditors—i.e., fraudulent transfers—have been condemned at least since the Statute of 13 Elizabeth Chap. 5 (1571). This statute became part of the common law of most American jurisdictions. The common law of fraudulent transfers was codified with the promulgation of the Uniform Fraudulent Conveyance Act (“U.F.C.A.”) in 1918. This statutory scheme, in turn, was updated by the Uniform Fraudulent Transfer Act (“U.F.T.A.”), approved by the National Conference of Commissioners on Uniform State Laws in 1984 and now adopted in the majority of states. See In re Abatement Environmental Resouces, Inc., 102 Fed. Appx. 272 (4th Cir. 2004) (giving a good discussion of the history of fraudulent transfer law); Barry L. Zaretsky, Fraudulent Transfer Law As the Arbiter of Unreasonable Risk, 46 S.C. L. REV. 1165 (1995). In other words, fraudulent transfers are condemned outside the bankruptcy context, and, standing in the shoes of an unsecured creditor, the representative of the bankruptcy estate may bring a fraudulent transfer avoidance action under 11 U.S.C. § 544(b) using state law. In re Marlar, 267 F.3d 749 (8th Cir. 2001); Cybergenics, 226 F.3d at 237; In re Fordu, 201 F.3d 693 (6th Cir. 1999). Fraudulent transfers have long been condemned specifically by bankruptcy law as well. Section 67(e) of the Bankruptcy Act closely tracked the Statute of 13 Elizabeth, and 11 U.S.C. § 548 creates a federal
cause of action to set aside actually or constructively fraudulent transfers of the debtor’s property.


Preference avoidance, by contrast, is grounded on insolvency policy rather than any inherent vice in the transaction. *See Van Iderstine v. National Discount Co.*, 227 U.S. 575 (1913); Benjamin R. Norris, *Bankruptcy Preference Actions*, 121 BANKING L.J. 483 (2004) (giving a thorough discussion of the policies undergirding preference avoidance). Whereas fraudulent transfer laws are designed to enhance the total amount of distribution, preference avoidance serves to ensure the equality of distribution. *In re Issac Leaseco, Inc.*, 389 F.3d 1205
In re Fultonville Metal Prods. Co., 330 B.R. 305 (Bankr. M.D. Fla. 2005); Warsco v. Household Bank F.S.B., 272 B.R. 246 (Bankr. N.D. Ind. 2002), subsequently aff’d, 334 F.3d 638 (7th Cir.), cert. denied, 540 U.S. 1073 (2003). As a general rule, outside of bankruptcy, a debtor has every right to pay one creditor in preference to another. In most instances, disfavored creditors have no claim against the favored creditor, provided that the transfer was made to satisfy a genuine obligation owed by the debtor. E.g., B.E.L.T., Inc. v. Wachovia Corp., 403 F.3d 474 (7th Cir. 2005); In re Sharp Intern. Corp., 403 F.3d 43 (2d Cir. 2005); In re Public Access Technology.Com, Inc., 307 B.R. 500 (E.D. Va. 2004); Smith ex rel. Estates of Boston Chicken, Inc. v. Arthur Andersen, L.L.P., 175 F. Supp. 2d 1180 (D. Ariz. 2001). As Justice Story wrote 170 years ago, “In many [states], if not in all, a debtor may prefer one creditor to another, in discharging his debts, whose assets are wholly insufficient to pay all the debts.” 1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE § 12 (1836).

The uniqueness of preference actions to bankruptcy proceedings was highlighted by the decision in Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308 (1999). There, an American creditor maintained that a Mexican debtor that was on the brink of insolvency, if not already insolvent, was misusing its assets by making preferential payments to Mexican creditors. There appeared to be no allegation that the Mexican creditors were insiders of the debtor. The creditor had sought and obtained a so-called “Mareva injunction,” a preliminary injunction restraining a debtor from transferring assets pendente lite so as to avoid paying a likely judgment. Alliance Bond Fund, Inc. v. Grupo Mexicano de Desarrollo, S.A., 143 F.3d 688 (2d Cir. 1998), rev’d, 527 U.S. 308 (1999). Named for a famous decision by Lord Denning, Mareva injunctions are available in England and other common law jurisdictions even when the specific assets are not the subject matter of the litigation. Mareva Compania Naviera

A sharply divided Supreme Court reversed the decision of the lower courts. The majority opinion by Justice Scalia pointed out that, in 1789, an unsecured creditor whose claim for money damages had not been reduced to judgment had no recourse in equity to prevent the debtor from disposing of his or her assets. Because Article III tribunals are limited to equity powers that were established in 1789, the majority held, a federal court has no authority to issue a Mareva injunction. In addition to this purely traditionalist argument, a strong theme that runs through the majority opinion in Grupo Mexicano, 527 U.S. at 308, is that preferential payments are legitimate, at least outside of bankruptcy and if insiders are not being unduly favored. Only in insolvency proceedings are preferences subject to attack. Thus, because the debtor was doing nothing wrong, no preliminary injunction should issue.

Although the traditionalist aspect of the majority opinion in Grupo Mexicano may be open to question, the Court was quite correct in refusing to countenance a preliminary injunction that would prevent the defendant from paying honest debts to legitimate creditors who were not insiders, even if the refusal to enjoin the payments would mean that the defendant would prefer other creditors over the American plaintiff. If such preferences are to be set aside, it must be in an insolvency proceeding. See Ecoban Fin. Ltd. v. Grupo Acerero del Norte, S.A. de C.V., 108 F. Supp. 2d 349 (S.D.N.Y. 2000) (giving an excellent analysis of the nontraditionalist aspect of Grupo Mexicano and noting that a hierarchy of creditors should be established only in an insolvency proceeding), aff’d, 242 F.3d 364 (2d Cir.), cert. denied, 534 U.S. 814 (2001).

*It is not the purpose of a Mareva injunction to prevent a defendant acting as he would have acted in the absence of a claim against him.* Whilst a defendant who is a natural person can and should be enjoined from indulging in a spending spree undertaken with the intention of reducing or dissipating his assets before the day of judgment, he cannot be compelled to reduce his ordinary standard of living with the view to putting by sums to satisfy a judgment which may or may not be given in the future. *Equally, no defendant, whether a natural or a juridical person, can be enjoined in terms which will prevent him from carrying on his business in the ordinary way or from meeting his debts as they become due prior to the judgment being given in the action.* (Emphasis added).

There are exceptions to the general rule that preferences are not condemned outside the context of insolvency proceedings. First, a few states have statutes based on older English decisions, and, like the English Insolvency Act of 1986, they condemn transfers made by an insolvent debtor with “intent to prefer” one creditor over another. *KY. REV. STAT.* § 378.060; *N.M. STAT.* § 56-9-1; *OHIO REV. CODE* § 1313.56. Exactly what “intent to prefer” means and
whether these statutes are really designed to deal with some sort of constructive fraud has been a source of considerable debate. See In re Roberds, Inc., 313 B.R. 732 (Bankr. S.D. Ohio 2004) (holding that Ohio’s intent to prefer statute does not apply to the payment of a lawful debt in money, as opposed to other forms of property); Douglas C. Michael, The Past and Future of Kentucky’s Fraudulent Transfer and Preference Laws, 86 KY. L.J. 937 (1998). These statutes are available to individual creditors outside of bankruptcy, and, pursuant to 11 U.S.C. § 544(b), they are available to a bankruptcy estate representative. In re Rexplore Drilling Co., 971 F.2d 1219 (6th Cir. 1992). In a normal preference action under 11 U.S.C. § 547, however, intent is not an element. In re T.B. Westex Foods, Inc., 950 F.2d 1187 (5th Cir. 1992); In re AppOnline.com, Inc., 315 B.R. 259 (Bankr. E.D.N.Y. 2004).

Second, Section 5(b) of the U.F.T.A. declares that transfers made to an insider, even to satisfy an honest debt, are avoidable as fraudulent if the debtor was insolvent at the time and the insider knew or had reason to believe that the debtor was insolvent. Such transfers are deemed wrongful only as to existing creditors, however, not as to subsequent creditors, and any action to set aside such a transfer must be brought within one year. The insider preference statute will be discussed more fully in Section II.C. below. Here, however, it should be noted that even under the U.F.C.A., some courts condemned payments to insiders as constructively fraudulent because there was a lack of good faith if the insider knew or had reason to know of the debtor’s insolvency. See In re Sharp Intern., Inc., 281 B.R. 506 (Bankr. E.D.N.Y. 2002), aff’d, 302 B.R. 760 (E.D.N.Y. 2003), aff’d, 403 F.3d 43 (2d Cir. 2005). Such reasoning has now been codified in the U.F.T.A. Thus, state law has begun to incorporate preference concepts into fraudulent transfer law. See In re Youngstown Osteopathic Hosp. Ass’n, 280 B.R. 400 (Bankr. N.D. Ohio, 2002); Imageset, 299 B.R. at 709; Paul P. Daley & Mitchell Appelbaum, The Modernization of

By contrast, in collective insolvency proceedings, preferences have long been subject to attack, even though there might be nothing wrong with the transaction viewed through nonbankruptcy lenses. See Union Bank v. Wolas, 502 U.S. 151 (1991); In re RDM Sports Group, Inc., 250 B.R. 805 (Bankr. N.D. Ga. 2000). A fundamental policy of the Bankruptcy Code is to ensure that similarly situated creditors are given equal treatment. Preference actions under 11 U.S.C. § 547 help to fulfill that goal. Warsco v. Preferred Technical Group, 258 F.3d 557 (7th Cir. 2001); Coral Petro., Inc. v. Banque Paribas-London, 797 F.2d 1351 (5th Cir. 1986); In re Furrs Supermarkets, Inc., 296 B.R. 33 (Bankr. D.N.M. 2003). Closely related, preference recoveries help to deter or to remedy the prepetition dismemberment of the debtor, even if no fraud or chicanery would be or was involved in the dismemberment. Issac Leaseco, Inc., 389 F.3d at 1205; In re Criswell, 102 F.3d 1411 (5th Cir. 1997); In re Arnett, 731 F.2d 358 (6th Cir. 1984); In re Lazarus, 334 B.R. 542 (Bankr. D. Mass. 2005). In other words, preference actions counteract the debtor’s tendency to pay the most pressing creditors first. Mortensen v. National Union Fire Ins. Co. of Pittsburgh, Pa., 249 F.3d 667 (7th Cir. 2001). Finally, preference actions help to discourage and to avoid secret liens on the debtor’s property. In re Gulino, 779 F.2d 546 (9th Cir. 1985).

Although the foundations of fraudulent transfer law and preference rules differ in some respects, there are a number of features and problems common to both. These should be examined before looking to the elements of and defenses to each sort of action.
B. THE DEBTOR MUST HAVE HAD AN INTEREST IN THE PROPERTY TRANSFERRED THAT WOULD HAVE BEEN AVAILABLE TO CREDITORS.

1. Only a Prepetition Transfer of an Interest of the Debtor in Property Is Subject to Postpetition Avoidance.

Under 11 U.S.C. § 547(b), only a “transfer of an interest of the debtor in property” is subject to a preference attack. Likewise, under 11 U.S.C. § 544(b) or § 548, a fraudulent transfer action will lie only to avoid a “transfer of an interest of the debtor in property.” Nowhere, however, does the Bankruptcy Code purport to define what constitutes an “interest of the debtor in property.” The phrase has been held to be the equivalent of “property of the estate,” that is, property that would belong to the bankruptcy estate were it not for the transfer. Begier v. IRS, 496 U.S. 53 (1990); In re Cannon, 277 F.3d 838 (6th Cir. 2002); Warsco v. Preferred Technical Group, 258 F.3d 557 (7th Cir. 2001); In re PurchasePro.com, Inc., 332 B.R. 417 (Bankr D. Nev. 2005). Accordingly, courts look to nonbankruptcy law—normally, to state law—to determine whether the debtor had an interest in the relevant property. In re Simpson, 36 F.3d 450 (5th Cir. 1994) (per curiam); cf. In re Feiler, 218 F.3d 948 (9th Cir. 2000) (right to a federal tax refund is an interest of the debtor in property; right is created by federal law, however).

The basic principle is that creditors are harmed or prejudiced only by a transfer of an interest in property that actually belonged to the debtor and that would have flowed into the bankruptcy estate. In re Frank Funaro, Inc., 263 B.R. 892 (8th Cir. B.A.P. 2001); see In re Superior Stamp & Coin Co., Inc., 223 F.3d 1004 (9th Cir. 2000). A transfer or a payment made by a third party for the debtor’s benefit is generally not a transfer of an interest of the debtor in property because the third party’s property typically would not become an estate asset and would not be available to the debtor’s creditors. In re Hayes Lemmerz Intern., Inc., 329 B.R. 136 (Bankr. D. Del. 2005); In re Corporate Food Mgmt., Inc., 223 B.R. 635 (Bankr. E.D.N.Y. 1998); see In re McShane, Inc., 328 B.R. 430 (Bankr. D. Md. 2005); In re RDM Sports Group, Inc., 253
If, however, a third party purchases the debtor’s assets and then pays the debtor’s creditors, the funds used for such payments could be considered the debtor’s property if the payments were part of the consideration for the sale. *Warsco*, 258 F.3d at 557; *see In re Phelps Technologies, Inc.*, 245 B.R. 858 (Bankr. W.D. Mo. 2000). The central inquiry is whether the transfer diminished the estate. If the estate is not diminished, the transfer normally is not avoidable. *In re Maple Mortg., Inc.*, 81 F.3d 592 (5th Cir. 1996); *In re Rine & Rine Auctioneers, Inc.*, 74 F.3d 854 (8th Cir. 1996) (to be avoidable, a transfer must have placed something beyond the reach of creditors that could have been used to satisfy their claims); *In re AmeriServe Food Distrib., Inc.*, 315 B.R. 24 (Bankr. W.D. Pa. 2004); *see In re Computer Eng’g Assocs., Inc.*, 337 F.3d 38 (1st Cir. 2003) (valid assignment of contract proceeds meant that debtor had no interest in proceeds as they accrued); *In re RISCmanagement, Inc.*, 304 B.R. 566 (Bankr. D. Mass. 2004) (valid assignment of contract proceeds would deprive debtor of any interest in that property, but mere agreement to pay creditor out of contract proceeds would not).

2. **Assets That the Debtor Holds in Trust.**

Under 11 U.S.C. § 541(d), any property to which the debtor holds only bare legal title or as to which the debtor has nothing more than a possessory right would never become the property of the bankruptcy estate in the first instance. Such property would not be available to the debtor’s creditors; it would be available only to the beneficiary. *In re Cannon*, 277 F.3d 838 (6th Cir. 2002); *In re Coupon Clearing Serv., Inc.*, 113 F.3d 1091 (9th Cir. 1997). Accordingly, a prepetition transfer of any property that the debtor holds merely as an agent or in actual or constructive trust is not subject to avoidance. *In re Morris*, 260 F.3d 654 (6th Cir. 2001); *In re Zedda*, 103 F.3d 1195 (5th Cir. 1997) (where original transfer of property to debtor was a “simulation” under Louisiana civil law, debtor never held any beneficial interest, and subsequent conveyance or reconveyance could not prejudice creditors); *In re Unicom Computer Corp.*, 13
F.3d 321 (9th Cir. 1994) (funds that were mistakenly deposited to debtor’s account and that debtor remitted to proper party could not be made part of bankruptcy estate because, under state law, debtor had no equitable interest in such funds; transfer was not subject to avoidance); *In re UDI Corp.*, 301 B.R. 104 (Bankr. D. Mass. 2003) (rebates that debtor collected and disbursed as agent for consolidated pool of buyers would not have become estate property; debtor had no beneficial interest in rebates); see *MidWestOne Bank & Trust v. Commercial Fed. Bank*, 331 B.R. 802 (S.D. Iowa 2005) (property held by debtor as a bailee cannot be the subject of a preference action); *In re World Parts, LLC*, 332 B.R. 37 (Bankr. W.D.N.Y. 2005) (property that debtor had converted and then sold could not be the subject of an avoidance action because debtor had no beneficial interest in it); *In re Victoria Alloys, Inc.*, 261 B.R. 424 (Bankr. N.D. Ohio 2001) (estate would not include property that debtor was obliged to return to its rightful owner). Both express and constructive trust doctrines have been used with particular frequency in cases involving attorneys. *In re Kennedy*, 279 B.R. 455 (Bankr. D. Conn. 2002) (client trust funds that debtor-attorney had misappropriated and transferred to his wife could not be recovered for benefit of estate; debtor had no beneficial interest in funds, and they could be recovered only by wronged clients; outside of bankruptcy, funds would not have been available to attorney’s general creditors); *In re Brady*, 234 B.R. 652 (Bankr. E.D. Pa. 1999) (property that debtor-attorney had misappropriated from client’s probate estate was held in constructive trust); see also *In re Dayton Title Agency, Inc.*, 292 B.R. 857 (Bankr. S.D. Ohio 2003) (funds that debtor title agency had held in its trust account to apply to specified real estate transactions for its clients were held in express trust and did not constitute an interest of the debtor in property). Property that the debtor holds in a resulting trust is likewise unavailable to the bankruptcy estate.
Similarly, payments of trust fund taxes are not subject to avoidance because the debtor is not deemed to have held any beneficial interest in the monies paid to federal or state taxing authorities. In re AAPEX Sys., Inc., 273 B.R. 35 (Bankr. W.D.N.Y. 2002), aff’d, 288 B.R. 663 (W.D.N.Y. 2003); In re Wellington Foods, Inc., 165 B.R. 719 (Bankr. S.D. Ga. 1994); In re Front Office Assocs., Inc., 142 B.R. 24 (Bankr. D.R.I. 1992); see In re Megafoods Stores, Inc., 210 B.R. 351 (9th Cir. B.A.P. 1997) (state sales tax receipts were held in trust). Likewise, in some states, statutes establish that a contractor holds contract proceeds in trust for subcontractors and materialmen. In such states, statutory trust funds are not available to the contractor’s general creditors, and they do not become the property of the bankruptcy estate. Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters., Inc., 960 F.2d 366 (3d Cir. 1992). The prepetition use of such funds to pay subcontractors or materialmen is therefore not avoidable. In re IT Group, Inc., 326 B.R. 270 (Bankr. D. Del. 2005); In re Trans-End Technology, Inc., 228 B.R. 181 (Bankr. N.D. Ohio 1998). If the debtor-contractor has misapplied the funds, the beneficiary may pursue the transferee outside of bankruptcy. The trust fund would never have become estate property, and hence the estate has no interest in it. In re Valerino Const., Inc., 250 B.R. 39 (Bankr. W.D.N.Y. 2000); see In re McCann, Inc., 318 B.R. 276 (Bankr S.D.N.Y. 2004). On the other hand, if state law does not require the debtor-contractor to segregate the contract proceeds for the benefit of subcontractors and materialmen, and if the debtor-contractor has commingled those funds, at least one court has held that no true trust relationship arises. In re ML & Assocs, Inc., 301 B.R. 195 (Bankr. N.D. Tex. 2003). Carrying the hostility to such trust fund statutes to extremes, one court, using reasoning that can only be described as circular, has held that Michigan’s

Even if the debtor is a trustee of an express trust, the corpus may be deemed the debtor’s property to the extent that the debtor had a beneficial interest in the trust assets. In In re Hixon, 295 B.R. 866 (8th Cir. B.A.P. 2003), aff’d, 387 F.3d 695 (8th Cir. 2004), the debtor had received a third party’s property in trust as part of a scheme to hinder, delay, or defraud the third party’s creditors. Under the trust agreement, the debtor held a general power of appointment as well as the usual rights of a trustee. The court held that, because the debtor could have distributed the trust property to herself or her creditors, she had a beneficial interest in the corpus so that the reconveyance or distribution of the assets back to the third party could be attacked as a fraudulent transfer. Had the transfer not been made, the Chapter 7 trustee could have exercised the general power of appointment for the benefit of the debtor’s creditors.

In a similar vein, most courts are reluctant to impress a constructive trust on the debtor’s property. See, e.g., In re Advent Management Corp., 104 F.3d 293 (9th Cir. 1997); In re Rine & Rine Auctioneers, Inc., 74 F.3d 854 (8th Cir. 1996); In re Cox, 247 B.R. 556 (Bankr. D. Mass. 2000). Encumbering property with a constructive trust interferes with the priority system of the Bankruptcy Code and diminishes the estate. A creditor or transferee claiming that the debtor holds the relevant property in constructive trust bears a heavy burden of showing that a constructive trust has arisen under state law, and an even heavier burden of identifying the specific property constituting the trust corpus. In re Southmark Corp., 49 F.3d 1111 (5th Cir.)
1995); In re Omegas Group, Inc., 16 F.3d 1443 (6th Cir. 1994); Cadle Co. v. Mangan, 316 B.R. 11 (D. Conn. 2004) (judgment creditor’s claim that it could have levied on stock that debtor had allegedly concealed did not give judgment creditor a sufficient interest in the stock to impress it with a constructive trust); see In re Dameron, 206 B.R. 294 (Bankr. E.D. Va. 1997) (constructive trust imposed only to the extent that funds were traceable). Even if the debtor has acquired property dishonestly, this does not mean that the debtor has no interest in it. The debtor holds at least voidable title. In re Ogden, 314 F.3d 1190 (10th Cir. 2002); see Morin v. Frontier Business Technologies, 288 B.R. 663 (W.D.N.Y 2003). If the funds have been commingled and no res can be identified, the claimant is simply an unsecured creditor. In re Graphics Technology, Inc., 306 B.R. 630 (8th Cir. B.A.P.), aff’d, 113 Fed. Appx. 734 (8th Cir. 2004); In re Safety-Kleen Corp., 331 B.R. 591 (Bankr. D. Del. 2005); In re Nation-Wide Exch. Servs., Inc., 291 B.R. 131 (Bankr. D. Minn. 2003).

On the other hand, when a prepetition judgment has already declared that the debtor holds certain property as a trustee ex maleficio, any concerns about disturbing the scheme of priorities in bankruptcy is misplaced, and the prepetition judgment must be recognized. In re Aultman, 223 B.R. 481 (Bankr. W.D. Pa. 1998). Furthermore, if the property alleged to be subject to a constructive trust or equitable lien is exempt, a bankruptcy court may be less reticent about granting such an equitable remedy. Imposing an equitable lien or a constructive trust on exempt property will not prejudice the general body of creditors or interfere with the distribution scheme. In re Linsey, 296 B.R. 582 (Bankr. D. Mass. 2003).

Likewise, as a general rule, funds that the debtor holds as an escrowee are not estate property because the debtor has no beneficial interest in such funds under state law. Cannon, 277 F.3d at 838; In re Maple Mortg., Inc., 81 F.3d 592 (5th Cir. 1996); see also In re
AppOnline.com, Inc., 315 B.R. 259 (Bankr. E.D.N.Y. 2004) (funds held in escrow would not come into bankruptcy estate, but claimant failed to show what funds were so held). Outside the bankruptcy context, the debtor’s creditors would have no right to reach this sort of property. In re Portjeff Dev. Corp., 128 B.R. 38 (Bankr. E.D.N.Y. 1991); In re Cedar Rapids Meats, Inc., 121 B.R. 562 (Bankr. N.D. Iowa 1990). Consequently, a transfer of such funds is not subject to avoidance. In re TTS, Inc., 158 B.R. 583 (D. Del. 1993).

3. The Earmarking Doctrine.

The so-called earmarking doctrine is likewise based on the premise that no property interest of the debtor was involved in the challenged transfer. In re Lazarus, 334 B.R. 542 (Bankr. D. Mass. 2005). Earmarking grew out of Bankruptcy Act cases in which a debtor’s guarantor had paid a debt and then stepped into the creditor’s shoes. Clearly, any payment made by a third party with its own funds would not be avoidable, and to compel the guarantor to repay the bankruptcy estate would amount to forcing that party to pay the same debt twice. See National Bank of Newport v. National Herkimer County Bank, 225 U.S. 178 (1912); Grubb v. General Contract Purchase Corp., 94 F.2d 70 (2d Cir. 1938). In principle, the result should be no different if the third party channels the payment through the debtor rather than paying the antecedent creditor directly. See In re Computrex, Inc., 403 F.3d 807 (6th Cir. 2005); In re Kelton Motors, Inc., 97 F.3d 22 (2d Cir. 1996); In re Smith, 966 F.2d 1527 (7th Cir.), cert. dismissed, 506 U.S. 1030 (1992).

Some courts do not wish to extend the earmarking doctrine beyond cases involving payments by sureties, guarantors, or codebtors, see In re Moses, 256 B.R. 641 (10th Cir. B.A.P. 2000), but most courts take a broader view. The earmarking doctrine in its typical form is based upon a determination that no property in which the debtor had a beneficial interest was transferred. Computrex, 403 F.3d at 807; In re Superior Stamp & Coin Co., Inc., 223 F.3d 1004
(9th Cir. 2000); *In reKalmar*, 276 B.R. 214 (Bankr. S.D. Ohio 2002); see Hon. Mary Davies Scott & Kimberly Forseth Woodyard, *Earmarking: Not Strictly an Affirmative Defense to a Preference Action*, SC78 ALI-ABA 391 (1998). Many courts employ a three-part test to determine whether the earmarking doctrine applies: (a) there must have been an agreement between the debtor and the third party that the funds advanced by the third party would be used to pay a specific antecedent debt; (b) the debtor must have performed the agreement according to its terms; and (c) the transaction as a whole must not have resulted in any diminution of the estate or prejudice to other creditors. *In re Bohlen Enters., Ltd.*, 859 F.2d 561 (8th Cir. 1988); *Cadle Co. v. Mangan*, 316 B.R. 11 (D. Conn. 2004); *In re Adams*, 240 B.R. 807 (Bankr. D. Me. 1999). In addition, or in the alternative, some courts add the requirement that the debtor must not have exercised dispositive control over the funds. *In re Golfview Developmental Ctr., Inc.*, 309 B.R. 758 (Bankr. N.D. Ill. 2004); *In re Crystal Med. Prods., Inc.*, 240 B.R. 290 (Bankr. N.D. Ill. 1999). This, however, seems to be a conclusory criterion that adds little to the analysis. *In re Libby Intern. Inc.*, 240 B.R. 375 (Bankr. W.D. Mo. 1999), aff’d, 247 B.R. 463 (8th Cir. B.A.P. 2000). If the earmarking doctrine applies, the transaction simply involved a new creditor using its own funds to step into the shoes of a former creditor with no net impact on the estate. The result would be the same as though the new creditor had paid the old creditor directly to acquire the old creditor’s rights, and hence, properly speaking, no property of the debtor actually changed hands. *In re Rounds*, 328 B.R. 132 (Bankr. N.D. Iowa 2005); *In re AmeriServe Food Distrib., Inc.*, 315 B.R. 24 (Bankr. W.D. Pa. 2004); *In re Messamore*, 250 B.R. 913 (Bankr. S.D. Ill. 2000); see David Gray Carlson & William H. Widen, *The Earmarking Defense to Voidable Preference Liability: A Reconceptualization*, 73 AM. BANKR. L.J. 591 (1999).
All of the criteria must be satisfied, however. If the debtor borrows money to pay an antecedent debt of the debtor’s own choosing, there is no earmarking because the new creditor did not dictate how the funds would be used. The debtor exercised control, and there was no agreement with the new creditor to discharge a specific antecedent debt. *In re Neponset River Paper Co.*, 231 B.R. 829 (1st Cir. B.A.P. 1999); *In re Anderson*, 275 B.R. 264 (Bankr. W.D. Ky. 2002); see *In re Phelps Technologies, Inc.*, 245 B.R. 858 (Bankr. W.D. Mo. 2000). Likewise, there must be no net diminution of the estate. *In re Prindle*, 270 B.R. 743 (Bankr. W.D. Mo. 2001). A mere change in the method of transmitting funds to a creditor has no earmarking implications. *In re Libby Intern., Inc.*, 247 B.R. 463 (8th Cir. B.A.P. 2000). Similarly, while the earmarking doctrine may apply if the new creditor steps into the same secured position occupied by the former creditor, *In re Heitkamp*, 137 F.3d 1087 (8th Cir. 1998); see *In re Nation-Wide Exch. Servs., Inc.*, 291 B.R. 131 (Bankr. D. Minn. 2003), there is no earmarking where secured debt replaces unsecured debt. In that case, there has been a net diminution in the property available to unsecured creditors. *In re Flanagan*, 293 B.R. 102 (Bankr. D. Conn. 2003), aff’d, 316 B.R. 11 (D. Conn. 2004); *Messamore*, 250 B.R. at 913; see *Cadle Co.*, 316 B.R. at 11 (where previous creditor was secured and new creditor was given greater security, earmarking doctrine applied only pro tanto).

There has been a split of authority as to how or to what extent the earmarking doctrine applies to refinancing situations when one secured creditor steps into the shoes of another and takes a security interest in the same collateral. *See Lazarus*, 334 B.R. at 542 (discussing the divergent views). All courts agree that, if the elements of the earmarking doctrine are otherwise satisfied, then the payment of funds to discharge the debt owed to the original creditor did not involve an interest of the debtor in property. There is a different of opinion, however, as to how
to treat the perfection of the new creditor’s lien. In the view of some courts, this is a transaction that is distinct from the payment of the original debt. If the earmarking doctrine applies at all, then, in a preference action, these courts reason that the perfection of the new creditor’s security interest must be contemporaneous with the advancement of the funds. Otherwise, the new creditor would have been unperfected for a time, and the later perfection of a lien would itself be an avoidable transfer. Thus, in a preference action, if earmarking applies to the new creditor’s lien, that lien must be perfected within the time that 11 U.S.C. § 547(e)(2) specifies for relation back or for the perfection of a security interest to be considered contemporaneous with the underlying transaction. Any delay means that the new creditor’s lien may be avoided and the creditor left unsecured. The leading case espousing this analysis is Messamore, 250 B.R. at 913. Other courts have agreed with this approach. In re Lee, 326 B.R. 704 (Bankr. E.D. Mich. 2005); In re Schmiel, 319 B.R. 520 (Bankr. E.D. Mich. 2005); In re Morei, 300 B.R. 326 (Bankr. E.D. Wis. 2003); In re Shreves, 272 B.R. 614 (Bankr. N.D. W. Va. 2001).

In this respect, BAPCPA offered greater protection for creditors. Formerly, 11 U.S.C. § 547(e)(2) required perfection within 10 days of the underlying transaction in order for relation back to apply. Section 403 of BAPCPA, significantly styled “Protection of Refinance Security Interests,” lengthened that period to 30 days. Thus, in jurisdictions that follow the reasoning of the cases just discussed, a refinancing creditor who waits up to 30 days to perfect its mortgage or security interest may be able to claim the protection of the earmarking doctrine for its lien.

In other jurisdictions, however, this change in Section 547(e)(2) should matter little. Some courts have viewed a refinancing arrangement involving the substitution of one secured creditor for another as a single, unitary transaction, not as the payment of the original debt followed by the granting of a security interest to the new creditor. So long as the intention of the
parties was clearly to substitute one creditor holding a security interest in the same collateral for another creditor, and so long as other creditors are not prejudiced, then the earmarking doctrine will apply to the entire transaction, including the channeling of funds to pay the original debt and the securing of the new lender. The new creditor, in effect, is regarded as receiving the old creditor’s security, not as receiving a new security interest from the debtor. The leading case expounding this view is the Eighth Circuit’s decision in Heitkamp, 137 F.3d at 1087 (lapse of several months in perfection), and obviously this approach has been used by lower courts in the Eighth Circuit. In re Ward, 230 B.R. 115 (8th Cir. B.A.P. 1999) (delay of at least 39 days in perfection); Rounds, 328 B.R. at 132. Courts in other jurisdictions have also followed this approach, concentrating their focus on whether the estate was diminished and on the policies underlying avoidance statutes rather than on a strict distinction between paying the debt to the original creditor and the refinancing creditor’s security interest. Lazarus, 334 B.R. at 542; In re Davis, 318 B.R. 119 (Bankr. E.D. Mich. 2004), reconsideration denied, 319 B.R. 532 (Bankr. E.D. Mich. 2005); see also In re Biggers, 249 B.R. 873 (Bankr. M.D. Tenn. 2000).

4. **Draws Under a Letter of Credit When the Debtor Is the Applicant (Account Party).**

It is well established that, in a trilateral letter of credit arrangement, the contracts between the applicant (formerly known as the “account party”) and the beneficiary, between the beneficiary and the applicant, and between the applicant and the issuer, are independent of one another. In re Compton Corp., 831 F.2d 854 (5th Cir. 1987); In re Keene Corp., 162 B.R. 935 (Bankr. S.D.N.Y. 1995). It is equally well settled that, notwithstanding the applicant’s obligation to reimburse the issuer, the issuer disburses its own funds when it honors a letter of credit. A beneficiary’s draw on a letter of credit does not involve any property interest of the applicant; only the issuer’s property is involved. In re Air Conditioning, Inc. of Stuart, 845 F.2d 293 (11th
Cir.), cert. denied, 488 U.S. 993 (1988); In re ITXS, Inc., 318 B.R. 85 (Bankr. W.D. Pa. 2004); see In re Dairy Mart Convenience Stores, Inc., 351 F.3d 86 (2d Cir. 2003) (beneficiary of a letter of credit has no interest in debtor-applicant’s property, and, postpetition, beneficiary is not entitled to adequate protection). It follows that a prepetition draw under a letter of credit is not avoidable because there is no transfer of an interest of the debtor in property. The issuer transfers its own assets to the beneficiary, not the debtor’s assets. ITXS, 318 B.R. at 85; accord Compton Corp., 831 F.2d at 586; In re Baja Boats, Inc., 203 B.R. 71 (Bankr. N.D. Ohio 1996); In re Metro Communications, Inc., 115 B.R. 849 (Bankr. W.D. Pa. 1990).

Similarly, when the applicant is a debtor in bankruptcy, postpetition draws under a letter of credit are not subject to the automatic stay because no property of the debtor or of the estate is at issue. Willis v. Celotex Corp., 978 F.2d 146 (4th Cir. 1992), cert. denied, 507 U.S. 1030 (1993); In re War Eagle Cost. Co., 283 B.R. 193 (S.D.W. Va. 2002) (noting that, unlike a surety bond, a letter of credit is not estate property); In re Farm Fresh Supermarkets of Maryland, Inc., 257 B.R. 770 (Bankr. D. Md. 2001) (a postpetition draw under a letter of credit does not violate the stay and is not subject to avoidance under 11 U.S.C. § 549); In re Skylark Travel, Inc., 120 B.R. 350 (Bankr. S.D.N.Y. 1990); see Dairy Mart Convenience Stores, 351 F.3d at 91.

If the debtor-applicant grants a security interest to collateralize the reimbursement obligation to the issuer, however, then clearly there has been a transfer of an interest of the debtor in property. In re Lease-A-Fleet, Inc., 141 B.R. 853 (Bankr. E.D. Pa. 1992); see Baja Boats, 203 B.R. at 71. If the security interest is granted within the preference period at the same time that the letter of credit is issued, most courts hold that the value of the collateral may be recovered from the beneficiary because the transfer was primarily for the beneficiary’s benefit if the net effect was to replace unsecured debt with secured debt, thus diminishing the assets
available to unsecured creditors. *Air Conditioning, Inc. of Stuart*, 845 F.2d at 293; *Compton Corp.*, 831 F.2d at 856; *see also ITXS*, 318 B.R. at 85. Under this indirect preference analysis, the issuer would not be liable because the issuer gave new value (the letter of credit) at the same time that the security interest was granted; because the issuer might be regarded as a “mere conduit” through whom the transfer flowed; or because letters of credit are vital instruments of commerce, and it would disturb the sanctity of the independence principle to proceed against the issuer rather than the beneficiary. *See Air Conditioning, Inc. of Stuart*, 845 F.2d at 293; *Compton Corp.*, 831 F.2d at 856. Furthermore, under this analysis, there would be no preference at all if the letter of credit were issued and the security interest were granted as part of a transaction involving a new extension of credit by the beneficiary rather than an antecedent debt. *See Compton Corp.*, 831 F.2d at 586.

On the other hand, one may question whether the sanctity of the independence principle or any other consideration will always prevent the bankruptcy estate from proceeding against the issuer. *See In re Security Serv., Inc.*, 132 B.R. 411 (Bankr. W.D. Mo. 1991). If the issuer perfects a security interest within the preference period to secure an *antecedent* contingent reimbursement obligation by the debtor-applicant that had previously been unsecured, then there has been a transfer of an interest of the debtor in property that changed the issuer from an unsecured contingent creditor to a secured contingent creditor, thereby prejudicing the rights of unsecured creditors generally. If the issuer later honors the letter of credit and then proceeds to foreclose on the collateral, both the security interest and the foreclosure may be avoided, and there may be recovery against the issuer. *In re P.A. Bergner & Co.*, 140 F.3d 1111 (7th Cir.), *cert. denied*, 525 U.S. 964 (1998). In the same manner, even though there is no violation of the automatic stay if the issuer honors a letter of credit postpetition, the automatic stay will prevent
the issuer from exercising its rights in the collateral or otherwise enforcing its right to reimbursement against the debtor-applicant. *Keene Corp.*, 162 B.R. at 935.

5. **Prepetition Disclaimers of Bequests, Devises, or Inheritances.**

Under the law of most states, the beneficial rights to a bequest, devise, or inheritance vest in the beneficiary immediately upon the decedent’s death. Thus, as soon as the decedent dies, such property normally would be available to the beneficiary’s creditors, subject to the claims of the decedent’s creditors and the creditors of the decedent’s estate. Many states, however, have enacted statutes that permit a beneficiary to disclaim a bequest, devise, or inheritance. Under these statutes, the disclaimer is deemed to relate back to the time immediately before the decedent’s death. Thus, a party who makes a valid and timely disclaimer is treated under the laws of these states as though he or she never had any interest in the property. The property passes under the will or the laws of interstate succession as though the beneficiary had predeceased the decedent. *E.g.*, ARIZ. REV. STAT. § 14-2801(A), (D); CAL. PROB. CODE §§ 275, 282(a); COLO REV. STAT. § 15-11-801; DEL. CODE tit. 12, §§ 601, 604(a); 755 ILL. COMP. STAT. 5/2-7; MD. EST. & TRUSTS CODE §§ 9-201(a), 9-204(a)(1); NEB. REV. STAT. §§ 30-2352(a)(1), 30-2352(c); N.Y. EST. POWERS & TRUSTS LAW § 2-1.11(b), (d); PA. CONS. STAT. §§ 6201, 6205(a); TEX. PROB. CODE § 37A.

The upshot is that courts in states that have such statutes have held that a valid disclaimer cannot be attacked as a fraudulent transfer by the creditors of the disclaimant. The disclaiming beneficiary is deemed to have had no interest in the property, and thus nothing was placed beyond the reach of creditors that they could have reached in any event. *E.g.*, *Tompkins State Bank v. Niles*, 537 N.E.2d 274 (Ill. 1989); *National City Bank of Evansville v. Oldham*, 537 N.E.2d 1193 (Ind. App. Ct. 1989); *Essen v. Gilmore*, 607 N.W.2d 829 (Neb. 2000); *Dyer v. Eckols*, 808 S.W.2d 531 (Tex. App.—Houston [14th Dist.] 1991, writ dism’d by agr.); *In re
Estate of Goldammer, 405 N.W.2d 693 (Wis. Ct. App. 1987); see Sara L. Johnson, Annotation, Creditor’s Right to Prevent Debtor’s Renunciation of Benefit Under Will or Debtor’s Election to Take Under a Will, 39 A.L.R. 4th 633 (1985). In California, the Legislature has expressly provided that a “disclaimer is not a fraudulent transfer by the beneficiary.” CAL. PROB. CODE § 283. In enacting this statute, the California Legislature overruled the decision of the California Supreme Court in In re Kalt’s Estate, 108 P.2d 401 (Cal. 1940). The Texas Legislature has enacted a similar provision as part of that state’s Uniform Fraudulent Transfer Act. TEX. BUS. & COM. CODE § 24.002(12) (for fraudulent transfer purposes, a disclaimer is not considered a transfer).

At least part of the rationale behind the rule that a valid disclaimer is not a fraudulent transfer and that no property interest of the debtor was involved is that a bequest, devise, or inheritance is a gift. No one may be forced to accept a gift, even if the refusal would harm the donee’s creditors. Because the beneficiary’s rights vest upon the decedent’s death, the beneficiary would become an involuntary donee and the property would be available to creditors if it were not for the right to disclaim and the relation back doctrine. In re Scrivani, 455 N.Y.S.2d 505 (N.Y. Sup. Ct. 1982); Lynch v. Lynch, 21 S.E.2d 569 (S.C. 1942); see Essen, 607 N.W.2d at 829; Dyer, 808 S.W.2d at 531.

By contrast, a few states have enacted statutes that expressly limit or nullify a beneficiary’s right to disclaim when the beneficiary is insolvent or, in some instances, when a renunciation of a bequest, devise, or inheritance would otherwise prejudice the beneficiary’s creditors. See ALA CODE § 43-8-295; FLA. STAT. ANN. § 732.801(6); MINN. STAT. ANN. § 525.532(6); N.J. REV. STAT. § 3B:9-9. In these states, a beneficiary’s creditors might attack a disclaimer as a fraudulent transfer or otherwise seek to avoid the renunciation. See Pennington

For bankruptcy preference and fraudulent transfer purposes, whether a transfer of an interest of the debtor in property occurred is normally determined by reference to state law. Every federal court of appeals that has addressed the issue has held that, if the debtor has made a valid prepetition disclaimer of a bequest, devise, or inheritance, then the transfer cannot be attacked as fraudulent under 11 U.S.C. § 548 (or, presumably, as preferential under 11 U.S.C. § 547). Unless there is state statutory authority to the contrary, the creditors of the debtor would have had no right to reach the property, and, for relevant purposes, the Bankruptcy Code does not give creditors any greater rights. In re Simpson, 36 F.3d 450 (5th Cir. 1994) (debtor executed valid disclaimer one day before filing bankruptcy petition; disclaimer was not subject to attack as a fraudulent transfer because, under Texas law, debtor would be deemed never to have held any interest in the property); In re Atchison, 925 F.2d 709 (7th Cir.) (same result applying Illinois law), cert. denied, 502 U.S. 860 (1991); accord Hoecker v. United Bank of Boulder, 476 F.2d 838 (10th Cir. 1973) (same result under the Bankruptcy Act applying Colorado law). The Ninth Circuit Bankruptcy Appellate Panel has reached the same conclusion in a particularly well reasoned decision. In re Bright, 241 B.R. 664 (9th Cir. B.A.P. 1999). Similarly, if the bankruptcy estate representative brings a state law fraudulent transfer action under 11 U.S.C. § 544(b) rather than a federal fraudulent transfer action under 11 U.S.C. § 548, a prepetition disclaimer cannot be avoided if applicable state law would not allow creditors to set aside the disclaimer. In re Popkin & Stern, 223 F.3d 764 (8th Cir. 2000) (prepetition disclaimer would not be deemed a fraudulent transfer under Missouri law and could not be set aside under 11 U.S.C. § 544(b)).
Some lower court decisions have reached a contrary result, reasoning that the debtor must have had an interest in the property; otherwise, there would have been nothing to disclaim. In the eyes of these courts, the relation back doctrine is nothing but a dubious legal fiction, and federal bankruptcy policy must override whatever state law rights the debtor had. *In re Brajovik,* 151 B.R. 402 (Bankr. W.D. Tex. 1993), *overruled by In re Simpson,* 36 F.3d 450 (5th Cir. 1994); *In re Peery,* 40 B.R. 811 (Bankr. M.D. Tenn. 1984); see Gregory M. McCoskey, *Death and Debtors: What Every Probate Lawyer Should Know About Bankruptcy,* 34 REAL PROP. PROB. & TR. J. 669 (2000). In fact, the relation back doctrine is not far-fetched, and it arises in other contexts without causing any concern. *E.g., In re Rashid,* 210 F.3d 201 (3d Cir. 2000) (under criminal forfeiture statutes, forfeiture is deemed to relate back to time of crime; because debtor never had any interest in the property, forfeiture could not be attacked as a fraudulent transfer); *In re Cox,* 247 B.R. 556 (Bankr. D. Mass. 2000) (when state appellate court reversed lower court ruling that debtor had an interest in her former husband’s pension, appellate decision related back and amounted to a defeasance *ab initio;* bankruptcy estate could claim no rights in or to the pension).

In 2000, one lower court revived the hostility to prepetition disclaimers and held that such a disclaimer may be set aside as constructively fraudulent under 11 U.S.C. § 548. *In re Kloubec,* 247 B.R. 246 (Bankr. N.D. Iowa 2000), *aff’d,* 268 B.R. 173 (N.D. Iowa 2001). The *Kloubec* court placed great reliance on the decision in *Drye v. U.S.,* 528 U.S. 49 (1999), *aff’m’g,* 152 F.3d 892 (8th Cir. 1998). In *Drye,* the Supreme Court held that a state law right to disclaim and the relation back doctrine would not defeat a federal tax lien established by I.R.C. § 6321. The tax lien attached as soon as the taxpayer acquired rights in the property, — *i.e.,* upon the decedent’s death—and a state law right to disclaim could not overcome the government’s rights.
created by a federal statute. The Kloubec court reasoned that 11 U.S.C. § 548 is likewise a federal statute, and hence a state law right to disclaim must yield to the bankruptcy estate representative’s right to avoid the transfer as fraudulent. See McCoskey, Death and Debtors, 34 Real Prop. Prob. & Tr. J. at 669.

The Kloubec court appears to have been mistaken for at least four reasons. First, the analysis in Drye, 528 U.S. at 49, is inapposite in the relevant context. The Drye decision dealt with a statute, I.R.C. § 6321, that creates a lien in favor of the government, and that lien attaches as soon as the debtor acquires “property” or “rights to property.” By contrast, 11 U.S.C. § 548 does not create a lien on any particular property, and it certainly does not create a lien in favor of any particular creditor, or even in favor of creditors as a group. Furthermore, 11 U.S.C. § 548 does not take effect when the debtor first acquires the property; it takes effect when a bankruptcy petition is filed. To recognize a state law right to disclaim in the tax lien context would be to allow state law to trump the federal government’s lien rights in specific property created by a federal statute. No such result would follow with respect to recognizing a state law right to disclaim in the context of 11 U.S.C. § 548. A bankruptcy court in Oklahoma has used this reasoning to reject the Kloubec decision. In re Faulk, 281 B.R. 15 (Bankr. W.D. Okla. 2002).

Second, the method of and applicable law for determining the relevant party’s property rights is not the same for tax purposes as it is for bankruptcy purposes. Under I.R.C. § 6321, a federal tax lien attaches to the taxpayer’s “property” or “rights to property.” While state law determines what rights the taxpayer has, federal law determines whether those rights constitute “property” or “rights to property” for tax lien purposes, and Congress specifically intended to give those terms the widest possible scope. Drye, 528 U.S. at 49; accord U.S. v. National Bank of Commerce, 472 U.S. 713 (1985). By contrast, what constitutes an “interest of the debtor in
property” for preference and fraudulent transfer purposes is determined by reference to state law. *In re Kemp Pac. Fisheries, Inc.*, 16 F.3d 334 (9th Cir. 1994); *Bright*, 241 B.R. at 664; see *Barnhill v. Johnson*, 503 U.S. 393 (1992). Thus, if state law would hold that the debtor had no interest in a bequest, devise, or inheritance that was properly disclaimed prepetition, the same must be true under bankruptcy statutes. This result does not follow for tax lien purposes, however.

Third, holding that 11 U.S.C. § 548 (or § 547) overrides a state law right to disclaim would lead to the anomalous result that a trustee or debtor-in-possession could avoid a prepetition disclaimer under 11 U.S.C. § 548 (or § 547) but could not do so by using state fraudulent transfer law under 11 U.S.C. § 544(b). See *Popkin & Stern*, 223 F.3d at 764. In *Popkin & Stern*, the Eighth Circuit purported to distinguish *Kloubec*, 247 B.R. at 246, on the ground that *Kloubec* was decided under 11 U.S.C. § 548, while *Popkin & Stern* involved state fraudulent transfer law as incorporated by 11 U.S.C. § 544(b). Nonetheless, it was clear that the Eighth Circuit did not find *Kloubec* cogent or persuasive. There is no reason to believe that Congress meant for 11 U.S.C. § 548 to set aside disclaimers that would be regarded as perfectly legitimate outside of bankruptcy.

Fourth, the Supreme Court itself has recognized that “state property transfer rules do not translate into federal taxation rules.” *U.S. v. Irvine*, 511 U.S. 224 (1994). A major policy behind state disclaimer law is to allow a bequest, devise, or inheritance to be placed beyond the reach of a beneficiary’s creditors. There is, however, no legitimate reason to allow a disclaimer to be used so as to permit a taxpayer to evade his or her federal tax liability. This was hardly the purpose for enacting the disclaimer statutes, and, even if there were any state policy to this effect, it would have to yield to federal law. *Id.* Thus, for federal gift tax purposes, a disclaimant
is regarded as the donor, even though state law might say that the disclaimant never had any interest in the property. *Jewett v. C.I.R.*, 455 U.S. 305 (1982). In this respect, *Drye*, 528 U.S. at 49, was simply an extension of *Jewett*. By contrast, no such policy concerns apply to preference and fraudulent transfer statutes. *Bright*, 241 B.R. at 664.

This difference between tax law and bankruptcy law is evident in other areas. For example, a debtor’s interest in a valid spendthrift trust is beyond the reach of creditors under state law, and such an interest does not become an asset of the bankruptcy estate. 11 U.S.C. § 541(c)(2). By contrast, a federal tax lien attaches to a taxpayer’s interest in a spendthrift trust, and the government may reach trust assets to satisfy tax liability. *In re Orr*, 180 F.3d 656 (5th Cir. 1999), *cert. denied*, 529 U.S. 656 (2000); *Bank One Ohio Trust Co., N.A. v. U.S.*, 80 F.3d 173 (6th Cir. 1996). Similarly, in some states, a debtor spouse’s interest in property held in tenancy by the entirety is beyond the reach of the debtor spouse’s separate creditors, and many courts hold that if this is the rule in the relevant state, then only joint creditors have any rights in entireties property when one spouse files a bankruptcy petition. *Sumy v. Schlossberg*, 777 F.2d 921 (4th Cir. 1985); *In re Chandler*, 148 B.R. 13 (Bankr. E.D.N.C. 1992); *In re Hunter*, 122 B.R. 349 (Bankr. N.D. Ind. 1990), *subsequently aff’d*, 970 F.2d 299 (7th Cir. 1992); see *In re Kelly*, 289 B.R. 38 (Bankr. D. Del. 2003), *aff’d*, 316 B.R. 629 (D. Del. 2004). Nonetheless, the government may reach the interest of one taxpayer spouse in entireties property, even though that interest could not be touched by separate creditors under state law. *U.S. v. Craft*, 534 U.S. 274 (2002); see *Hatchett v. U.S.*, 330 F.3d 875 (6th Cir. 2003).

Since 2001, several decisions rejected *Kloubec*, 247 B.R. at 246, relying on some of the arguments discussed above. In *Faulk*, 281 B.R. at 15, the court noted that a tax lien attaches to the beneficiary’s interest in a decedent’s property as soon as the decedent dies. No state or
bankruptcy fraudulent transfer statute creates a lien in favor of creditors. The court in *In re Nistler*, 259 B.R. 723 (Bankr. D. Or. 2001) used similar reasoning to reject *Kloubec* and held that a prepetition disclaimer that was valid under North Dakota law could not be set aside in bankruptcy because no interest of the debtor in property was involved. In *In re Womble*, 289 B.R. 836 (Bankr. N.D. Tex.), *aff’d*, 299 B.R. 810 (N.D. Tex. 2003), *aff’d*, 108 Fed. Appx. 993 (5th Cir. 2004), the court rejected *Kloubec*’s reasoning without citing *Kloubec*. The *Womble* court held that a valid prepetition disclaimer could not be used as a basis for denying the debtor a discharge on fraudulent transfer grounds under 11 U.S.C. § 727(a)(2). The *Womble* court further held that the disclaimer could not be deemed invalid because the debtor had exercised control over the decedent’s property in a purely fiduciary capacity as the executor of the estate. It appears that *Kloubec* is likely to be something of an anomaly. A prepetition disclaimer of a bequest, devise, or inheritance that is valid under state law should not be avoidable in bankruptcy.

These prepetition disclaimer cases should be carefully distinguished from attempts by a debtor to disclaim a bequest, devise, or inheritance postpetition. Under 11 U.S.C. § 541(a)(5)(A), a bequest, devise, or inheritance in which the debtor acquires an interest within 180 days after the filing of the petition becomes the property of the estate. *See Faulk*, 281 B.R. at 15 (distinguishing between prepetition and postpetition disclaimers); Steve R. Akers, *Estate Administration—A Summary of Practical Tax-Planning Ideas*, SC12 ALI-ABA 661 (1997); *see also In re Gilroy*, 235 B.R. 512 (Bankr. D. Mass. 1999). This statute overrides any state law right to disclaim, and a disclaimer made within 180 days after the filing of a bankruptcy petition is void. *In re Chenworth*, 3 F.3d 1111 (7th Cir. 1993); *see In re Cornell*, 95 B.R. 219 (Bankr. W.D. Okla. 1989); *In re Lewis*, 45 B.R. 27 (Bankr. W.D. Mo. 1984); *see also In re Detlefsen*, © International Insolvency Institute - www.iiiglobal.org
610 F.2d 512 (8th Cir. 1979) (holding that, under the Bankruptcy Act, a debtor could validly disclaim a bequest both prepetition and postpetition, and, under the state law relation back doctrine, the debtor would be treated as having never had any interest in the property, but noting that the result would be different for postpetition disclaimers under Section 541(a)(5)(A) of the Bankruptcy Code). Property that the debtor receives within 180 days of the date of the petition as the result of a third party’s death is clearly estate property. See In re Hunter, 261 B.R. 789 (Bankr. M.D. Fla. 2001); In re McCullough, 259 B.R. 509 (Bankr. D.R.I. 2001). Any attempt by the debtor to exercise control over such property for his or her own benefit — or to disclaim — would be prohibited. See In re Lickman, 297 B.R. 162 (Bankr. M.D. Fla. 2003). On the other hand, if the decedent dies more than 180 days postpetition, Section 541(a)(5)(A) does not apply, and any bequest, devise, or inheritance that the debtor receives cannot be considered estate property. In re Winstead Mem. Hosp., 249 B.R. 588 (Bankr. D. Conn. 2000).

Although the debtor may not disclaim for 180 days postpetition, there is nothing to prevent a testator or testatrix from changing his or her will postpetition so as to effectively disinherit the debtor. In In re McGuire, 209 B.R. 580 (Bankr. D. Mass. 1997), the debtor’s mother had altered her will after the bankruptcy petition had been filed so as to exclude the debtor—and hence the debtor’s creditors—from any distribution of her property. The mother died shortly thereafter. The court disagreed with the argument that the change in the will was invalid because of an overriding federal bankruptcy policy, and that the mother’s property designated for the debtor under the previous will should pass to the bankruptcy estate under 11 U.S.C. § 541(a)(5)(A). All that the debtor had held when the petition was filed was an unmatured expectancy under the previous will, and whatever remote property interest this may have given the debtor, that interest was subordinate to the mother’s absolute state law right to
leave her property to whomever she pleased. See In re Fashion Accessories, Ltd., 308 B.R. 592 (Bankr. N.D. Ga. 2004) (noting that a debtor’s expectancy of inheritance is too remote and tenuous to become an estate asset; court analogized debtor’s interest as a revocable beneficiary under an unmatured life insurance policy to an expectancy). The McGuire court rightly rejected the suggestion that a bankruptcy court has the authority to tell any and all nondebtor parties from whom the debtor may receive a postpetition bequest, devise, or inheritance not to make a new will once a petition has been filed, or that the right of a nondebtor party to make a new will is somehow subject to the automatic stay. See McCoskey, Death and Debtors, 34 REAL PROP. PROB. & TR. J. at 669.


As a general rule, corporate forms are observed in bankruptcy unless there are clear state law grounds for piercing the corporate veil. See In re Foxmeyer Corp., 290 B.R. 229 (Bankr. D. Del. 2003); In re KZK Livestock, Inc., 221 BR. 471 (Bankr. C.D. Ill. 1998); see also In re Altman, 230 B.R. 6 (Bankr. D. Conn. 1999). Consequently, courts have held that a preferential or fraudulent transfer of a corporation’s assets may not be recovered for the benefit of a shareholder or the shareholder’s estate, In re Cassis, 220 B.R. 979 (Bankr. N.D. Iowa 1998); In re Spring Grove Livestock Exch., Inc., 205 B.R. 149 (Bankr. D. Minn. 1997); see In re BCP Mgmt., Inc., 320 B.R. 265 (Bankr. D. Del. 2005) (bankruptcy estate of general partner could not bring an action in its own right to avoid transfers of funds of limited partnership), and a transfer of a subsidiary’s assets may not be recovered for the benefit of the parent corporation or of the parent’s estate. In re Regency Holdings (Cayman), Inc., 216 B.R. 371 (Bankr. S.D.N.Y. 1998); accord In re Blackwell ex rel. Estate of I.G. Servs., Ltd., 267 B.R. 732 (Bankr. W.D. Tex. 2001); see In re W.T. Mayfield Sons Trucking Co., Inc., 225 B.R. 818 (Bankr. N.D. Ga. 1998).
Conversely, transfers of a parent corporation’s assets generally may not be recovered for the benefit of a subsidiary’s creditors, *Lippe v. Bairnco Corp.*, 230 B.R. 906 (S.D.N.Y. 1999), and transfers of a shareholder’s assets may not be set aside for the benefit of the corporation’s bankruptcy estate. *In re Frank Funaro, Inc.*, 263 B.R. 892 (8th Cir. B.A.P. 2001); *In re Harrold*, 296 B.R. 868 (Bankr. M.D. Fla. 2003). The property rights of the shareholder or the parent are the rights represented by the stock; the specific assets are the property of the corporation or the subsidiary. *Cassis*, 220 B.R. at 979. If prepetition transfers of a corporation’s assets may be recovered for the benefit of anyone, it is for the creditors of the corporation itself, not the creditors of the equity owner. *Regency Holdings*, 216 B.R. at 371; see *In re Foxmeyer Corp.*, 296 B.R. 327 (Bankr. D. Del. 2003).

It follows that the representative of the bankruptcy estate of a shareholder or parent has no standing to seek to avoid prepetition transfers of the property of the corporation or the subsidiary. *In re Summers*, 320 B.R. 630 (Bankr. E.D. Mich. 2005); *Blackwell*, 267 B.R. at 732; *Spring Grove Livestock Exch.*, 205 BR. at 149; see *Foxmeyer*, 296 B.R. at 327. Similarly, a debtor corporation generally lacks standing to avoid a transfer of the assets of its parent or shareholders. See *Frank Funaro*, 263 B.R. at 892; *Harrold*, 296 B.R. at 868; *In re Trinity Gas Corp. (Reorganized)*, 242 B.R. 344 (Bankr. N.D. Tex. 1999); cf. *APS Sports Collectibles, Inc. v. Sports Time, Inc.*, 299 F.3d 624 (7th Cir. 2002) (principals of corporation who were not themselves transferees could not be held personally liable under a fraudulent transfer theory for corporation’s transfer of its assets).

Matters may be different when there are state law grounds for disregarding the corporate form. A debtor may not create a business entity that is merely an extension of the debtor and that has no purpose except to shield the debtor’s assets and then cause that entity to make fraudulent...
or preferential transfers.  See Fleet Credit Corp. v. TML Bus. Sales, Inc., 65 F.3d 119 (9th Cir. 1995). In such a case, courts will pierce the veil and regard the property transferred as the debtor’s own assets. The property or its value may then be recovered for the benefit of the debtor’s estate. In re Turner, 335 B.R. 140 (Bankr. N.D. Cal. 2005); In re Lindell, 334 B.R. 249 (Bankr. D. Minn. 2005).

C. There Must Have Been a Transfer.

In both fraudulent transfer actions under 11 U.S.C. § 548 or § 544(b) and preference actions under 11 U.S.C. § 547, there must have been a transfer of some interest of the debtor in property. Although the question whether the debtor had an interest in the relevant property (and whether that interest would have been available to creditors) generally turns on state law, the question whether there has been a transfer is governed by federal law in actions under Section 547 or Section 548. Barnhill v. Johnson, 503 U.S. 393 (1992); In re Morehead, 249 F.3d 445 (6th Cir. 2001); In re Pepmeyer, 275 B.R. 539 (Bankr. N.D. Iowa 2002). As amended by Section 1201(6) of BAPCPA, 11 U.S.C. § 101(54)(D) defines “transfer” as including “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.” In addition, the creation of a lien, the retention of title as security, and the foreclosure of debtor’s equity of redemption are all expressly listed in the definition. 11 U.S.C. § 101(54)(A), (B), (C). Even before the enactment of BAPCPA in 2005, the definition of “transfer” in 11 U.S.C. § 101(54) was extremely broad, and it does not appear that Congress wished to make any substantive changes. See H.R. Rep. No. 31, 109th Cong., 1st Sess., pt. 1, 141 (2005). The definition of “transfer” under the Uniform Fraudulent Transfer Act is likewise very broad. U.F.T.A. § 1(12). See In re PurchasePro.com, Inc., 332 B.R. 417 (Bankr. D. Nev. 2005) (noting that the U.F.T.A. definition of “transfer” is based on the definition contained in the 1978 version of the Bankruptcy Code).

By its plain terms, 11 U.S.C. § 101(54) includes involuntary as well as voluntary transactions. *In re Jones*, 226 F.3d 917 (7th Cir. 2000); *In re White*, 258 B.R. 129 (Bankr. D.N.J. 2001). Thus, obtaining a judgment lien against the debtor’s property is a transfer just as much as obtaining a consensual lien or security interest. *In re XYZ Options, Inc.*, 154 F.3d 1276 (11th Cir. 1998); *In re Lively*, 74 B.R. 238 (S.D. Ga. 1987), aff’d, 851 F.2d 363 (11th Cir. 1988); *In re Hoffinger Indus., Inc.*, 313 B.R. 812 (Bankr. E.D. Ark. 2004); *In re McGuane*, 305 B.R. 695 (Bankr. N.D. Ill. 2004). Likewise, obtaining a garnishment or attachment lien is a transfer. *Morehead*, 249 F.3d at 445; *In re Conner*, 733 F.2d 1560 (11th Cir. 1984); *In re Merrimac Paper Co., Inc.*, 317 B.R. 215 (D. Mass. 2004); *In re Rose Marine, Inc.*, 203 B.R. 511 (Bankr. S.D. Ga. 1996). So also the attachment of a tax lien is a transfer. *In re America West Airlines, Inc.*, 217 F.3d 1161 (9th Cir. 2000). Moreover, ever since 1984, the Bankruptcy Code has expressly provided that foreclosure of the debtor’s equity of redemption constitutes a transfer. *In re Cottrell*, 213 B.R. 33 (M.D. Ala. 1997); see *In re Carter*, 209 B.R. 732 (Bankr. D. Or. 1997) (debtor’s loss of right to redeem from pawnbroker was a transfer because it was analogous to a loss of the equity of redemption).

Even if the property is exempt or potentially exempt, or even though it might be beyond the reach of creditors outside of bankruptcy, most courts hold that an avoidable transfer within the purview of the Bankruptcy Code may nonetheless occur if a third party or the debtor has taken some action with respect to the debtor’s interest. *Tavenner v. Smoot*, 257 F.3d 401 (4th Cir. 2001) (holding that a transfer of potentially exempt property is nonetheless a transfer and that it may be avoided, and noting that this is the majority rule), *cert. denied*, 534 U.S. 1116 (2002); *In re Wickstrom*, 113 B.R. 339 (Bankr. W.D. Mich. 1990); *In re Kewin*, 24 B.R. 158 (Bankr. E.D. Mich. 1982) (payment with potentially exempt insurance proceeds held a transfer).
But see In re Treiber, 92 B.R. 930 (Bankr. N.D. Okla. 1988). By contrast, under the U.F.T.A., a transfer of exempt property is not deemed a transfer of an asset because it does not remove anything on which a general creditor could levy. In re Schaefer, 331 B.R. 401 (Bankr. N.D. Iowa 2005); In re Porras, 312 B.R. 81 (Bankr. W.D. Tex. 2004); see In re Dolata, 306 B.R. 97 (Bankr. W.D. Pa. 2004) (transfer of property held in tenancy by the entirety cannot be fraudulent as to separate creditors under Pennsylvania’s U.F.T.A.). For the same reason, the transfer of fully encumbered property is not deemed a transfer of an asset under the U.F.T.A. See In re Valente, 360 F.3d 256 (1st Cir. 2004); Commercial Technology, 354 F.3d at 378.

If the transaction does not diminish the quantum of the debtor’s preexisting interest in the property, then usually no transfer has occurred. For example, the renewal of an already existing lien or security interest is not a transfer within the meaning of 11 U.S.C. § 101(54) or of U.F.T.A. § 1(12). In re Wind Power Sys., Inc., 841 F.2d 288 (9th Cir. 1988); In re Advance Insulation & Supply, Inc., 176 B.R. 390 (Bankr. D. Md. 1994), aff’d, 176 B.R. 401 (D. Md. 1995); see In re Cosper, 106 B.R. 377 (Bankr. M.D. Pa. 1989). This result is impelled not so much by the statutory definition of “transfer” as by the fact that such a renewal does not diminish the assets available to unsecured creditors. In re Biggers, 249 B.R. 873 (Bankr. M.D. Tenn. 2000); see In re Lowe, 92 Fed. Appx. 129 (6th Cir. 2003). Similarly, a judicial annullment of a mistaken release of a lien is not a transfer. There was never a valid release in the first place, so that reinstating the lien is tantamount to an undisturbed continuation of the original status quo. In re Burkett, 295 B.R. 776 (Bankr. W.D. Pa. 2003). Likewise, the passing of a net operating loss (NOL) or other tax consequences from a Subchapter S corporation to its principals is not a transfer. The pass-through occurs by operation of law, not by any act on the part of the corporation or its principals. In re Forman Enters., Inc., 281 B.R. 600 (Bankr. W.D. Pa. 2002);
see In re Marvel Entertainment Group, Inc., 273 B.R. 58 (Bankr. D. Del 2002) (when a corporate group files a single tax return through the parent, no individual member has an interest in an NOL; hence, an individual group member does not transfer an NOL to the parent in such a situation). In the same vein, the consolidation of two credit card accounts involving the same issuer is not a transfer. The transaction in no way diminishes the debtor’s property. In re Ratner, 322 B.R. 604 (Bankr. W.D. Mo. 2005).


There has been a difference of opinion as to whether the noncollusive termination of a commercial lease because of the debtor’s default constitutes a transfer of an interest of the debtor in property. Nancy A. Connery, Current Issues: Impact of Bankruptcy on Commercial Leases, 427 PLI/REAL 417 (1998); Marvin Garfinkel, Lease Terminations, Assignments, and Subleases as Fraudulent Conveyances, SA81 ALI-ABA 435 (1996). Some heavily criticized decisions held that such a noncollusive termination is indeed a transfer, and hence the termination is
subject to avoidance as a constructively fraudulent, or, conceivably, as preferential. *In re Edward Harvey Co.*, 68 B.R. 851 (Bankr. D. Mass. 1987); *In re Queen City Grain, Inc.*, 51 B.R. 722 (Bankr. S.D. Ohio 1985); see Robert E. Goodman, Jr., *Avoidance of Lease Termination as Fraudulent Transfers*, 43 Bus. Law. 897 (1988). Recoiling from the commercial implications of these decisions, other courts have held that a noncollusive termination of a lease is not a transfer at all in the relevant sense, and hence such a transaction simply cannot be a preference or a fraudulent transfer. *In re Egyptian Bros. Donut, Inc.*, 190 B.R. 26 (Bankr. D.N.J. 1995); *In re Haines*, 178 B.R. 471 (Bankr. W.D. Mo. 1995); see *In re Jermoo’s, Inc.*, 38 B.R. 197 (Bankr. W.D. Wis. 1984). Furthermore, under Section 8(e)(1) of the Uniform Fraudulent Transfer Act, the lawful termination of a lease because of the debtor’s default is not avoidable.

The most perceptive analyses of this question have concluded that lawful lease terminations are not subject to avoidance as preferences or fraudulent transfers, even though these transactions may be transfers in a strict sense. Undoubtedly the loss of a leasehold estate means parting with an interest in property held by the prepetition debtor. *Cf. In re Robotic Vision Sys., Inc.*, 322 B.R. 502 (Bankr. D.N.H. 2005) (debtor’s surrender of rights in patented technology following default was a transfer). Such property, however, would not be available to creditors of the estate. Under 11 U.S.C. § 365(c)(3), the bankruptcy estate may not assume any executory contract or nonresidential lease that has been legitimately terminated prepetition. The estate would never have had any interest in the lease. If an “interest of the debtor in property” is synonymous with “property of the estate,” then the correct approach is that noncollusive prepetition lease terminations cannot be preferential or fraudulent, not because they are not transfers, but rather because they do not involve a property interest of the debtor that would be available to the bankruptcy estate. *In re Durso Supermarkets, Inc.*, 193 B.R. 682 (Bankr.
D. STANDING TO BRING A FRAUDULENT TRANSFER OR PREFERENCE ACTION.


11 U.S.C. §§ 544(b), 547, and 548 all speak of the “trustee” as having the right to bring an action to avoid a prepetition transaction. In a liquidation case under the Securities Investor Protection Act (SIPA), the Securities Investor Protection Corporation (SIPC) functions as the trustee and thus may exercise a trustee’s avoidance powers. In re Cambridge Capital, LLC, 331 B.R. 47 (Bankr. E.D.N.Y. 2005); Securities Inv. Protection Corp. v. R.D. Kushnir & Co., 274 B.R. 768 (Bankr. N.D. Ill. 2002); see 15 U.S.C. § 78eee(b). Under 11 U.S.C. § 1107(a), a debtor-in-possession has most of the powers of a trustee, and a debtor-in-possession, like a trustee, may bring a fraudulent transfer or a preference action on behalf of the estate. In re Coleman, 426 F.3d 719 (4th Cir. 2005); In re Hughes, 704 F.2d 820 (5th Cir. 1983); In re G-I Holdings, Inc., 313 B.R. 612 (Bankr. D.N.J. 2004); In re Logan Square East, 254 B.R. 850 (Bankr. E.D. Pa. 2000); In re Quality Botanical Ingredients, Inc., 249 B.R. 619 (Bankr. D.N.J. 2000). In Chapter 13 cases, a minority of courts have held that the debtor may bring avoidance actions in the same manner and to the same extent as the trustee. In re Thacker, 256 B.R. 724 (W.D. Ky. 2000); In re Cohen, 305 B.R. 886 (9th Cir. B.A.P. 2003); In re Weaver, 69 B.R. 554 (Bankr. W.D. Ky. 1987); In re Einoder, 55 B.R. 319 (Bankr. N.D. Ill. 1985). A growing majority, however, hold that an avoidance action for the benefit of the estate may only be brought by the Chapter 13 trustee. In re Hamilton, 125 F.3d 292 (5th Cir. 1997); In re Hansen, 332 B.R. 8 (10th Cir. B.A.P. 2005); In re Merrifield, 214 B.R. 362 (8th Cir. B.A.P. 1997); In re Ryker, 315 B.R. 664 (Bankr. D.N.J. 2004); In re Richardson, 311 B.R. 302 (Bankr. S.D. Fla.
Generally, only a representative of the estate may bring an avoidance action. *Angell v. Kelly*, 336 F. Supp. 2d 540 (M.D.N.C. 2004); *In re Veterans Choice Mortg.*, 291 B.R. 894 (Bankr. S.D. Ga. 2003); *In re Johnson*, 262 B.R. 831 (Bankr. D. Idaho 2001). Under limited circumstances, however, an individual debtor may bring an avoidance action for his or her own benefit, as opposed to an action for the benefit of the estate. 11 U.S.C. § 522(h) provides that, if the trustee fails or refuses to avoid a prepetition transfer of property that would be subject to exemption from the claims of creditors, then the debtor personally may do so. *Hamilton*, 125 F.3d at 292; *In re James*, 257 B.R. 673 (8th Cir. B.A.P. 2001); *see In re Wood*, 301 B.R. 558 (Bankr. W.D. Mo. 2003) (individual debtor lacked standing where property in question was not subject to exemption); *In re Montoya*, 285 B.R. 490 (Bankr. D.N.M. 2002) (same). Under 11 U.S.C. § 522(g), (h), an individual debtor must meet five criteria in order to bring an avoidance action on his or her own behalf: (a) the transfer could have been avoided by the trustee; (b) the debtor could have exempted the property in question; (c) the trustee cannot or will not seek to avoid the transfer; (d) the debtor did not transfer the property voluntarily; and (e) the debtor did not conceal the property. *Hamilton*, 125 F.3d at 292; *In re DeMarch*, 62 F.3d 1248 (9th Cir. 1995); *In re Smith*, 333 B.R. 739 (Bankr. D. Md. 2005); *Ryker*, 315 B.R. at 664. If the property in question may not be exempted, then the individual debtor may not bring an avoidance action, even if the trustee has failed or refused to act. *In re Humphrey*, 165 B.R. 578 (Bankr. D. Md. 1993); *see Merrifield*, 214 B.R. at 362; *In re Quisenberry*, 295 B.R. 855 (Bankr. N.D. Tex. 2003) (debtor individually had standing to pursue avoidance action only to the extent that value of property in question was subject to exemption). The debtor may claim no exemption if he or she

2. **Granting Derivative Standing to a Committee or Individual Creditors.**

The literal language of the relevant statutes would indicate that only a trustee (including the SIPC in a SIPA case), a debtor-in-possession, or, in limited circumstances involving property subject to exemption, an individual debtor, may bring a preference or a fraudulent transfer action. A panel of the Third Circuit actually adopted such a literal interpretation and held that a creditors’ committee and individual creditors can never have and can never be granted standing to pursue an avoidance action derivatively for the benefit of the bankruptcy estate, even if the debtor-in-possession or the trustee fails or refuses to act. In such a case, the only remedy is to seek the appointment of a trustee if one has not already been appointed, to demand the replacement of an existing trustee, or to seek conversion or dismissal. *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 304 F.3d 316 (3d Cir.), vacated pending rehe’g en banc, 310 F.3d 785 (3d Cir. 2002), rev’d on en banc rehe’g, 330 F.3d 548 (3d Cir.), cert. dismissed, 540 U.S. 1002 (2003). This opinion is contrary to the great weight of authority, however, and it met with astonishment and protest, even among lower courts within the Third Circuit. *In re W.R. Grace & Co.*, 285 B.R. 148 (Bankr. D. Del. 2002); see *In re The V Cos.*, 292 B.R. 290 (6th Cir. B.A.P. 2003); *In re Stanwich Fin. Servs. Corp.*, 288 B.R. 24 (Bankr. D. Conn. 2002). The Third Circuit quickly granted an en banc rehearing and vacated the panel opinion until the full court could decide the issue. On rehearing en banc, the Third Circuit retreated from the panel decision and held that, under appropriate circumstances, a creditors’ committee may be

The en banc Cybergenics opinion placed the Third Circuit in line with the rule followed by the great majority of courts that creditors or a creditors’ committee may be granted derivative standing to prosecute a preference or fraudulent transfer action when the trustee or debtor-in-possession cannot or will not do so, or when the debtor-in-possession is unlikely to act. E.g., In re Gibson Group, Inc., 66 F.3d 1436 (6th Cir. 1995); In re Suffola, 2 F.3d 977 (9th Cir. 1993); In re Together Dev. Corp., 262 B.R. 586 (Bankr. D. Mass. 2001) (noting that granting standing to a creditors’ committee is especially important when the defendant in an avoidance action is a principal of a corporate debtor-in-possession). But see Sun N Surf Apts., Inc. v. Dempsey, 253 B.R. 490 (M.D. Fla. 1999) (espousing a position much like that later adopted by the Cybergenics panel); In re Fox, 305 B.R. 912 (10th Cir. B.A.P. 2004) (rejecting the Third Circuit’s en banc decision in Cybergenics and adopting the reasoning of the original Cybergenics panel). Many courts have found at least implied authority for granting standing to a committee under 11 U.S.C. §§ 1103(c)(5), 1109(b). See Cybergenics, 330 F.3d at 548. As expounded by the Second Circuit, a creditors’ committee should be allowed to prosecute an avoidance action if there is a viable claim and if the trustee or debtor-in-possession unjustifiably fails or refuses to pursue it, or if the estate representative consents to such derivative standing and the bankruptcy court determines that such a step would be in the best interest of the estate and necessary and beneficial to the fair and efficient resolution of the bankruptcy proceeding. In re Housecraft Indus. USA, Inc., 310 F.3d 64 (2d Cir. 2002); see In re Commodore Intern., Ltd., 262 F.3d 96 (2d
Cir. 2001); In re STN Enters., 779 F.2d 901 (2d Cir. 1985). Other courts, using slightly different phrasing, have held that a party seeking derivative standing must show that there is a colorable claim and that demand has been made on the estate representative to prosecute the claim, which demand was unjustifiably refused, or, alternatively, that demand would be futile. Gibson Group, 66 F.3d at 1436; In re Enron Corp., 319 B.R. 128 (Bankr. S.D. Tex. 2004); In re G-I Holdings, Inc., 313 B.R. 612 (Bankr. D.N.J. 2004). In addition, the committee must obtain court approval before it assumes the functions of a trustee or a debtor-in-possession and prosecutes an avoidance action on behalf of the estate. Coral Petro., Inc. v. Banque Paribas-London, 797 F.2d 1351 (5th Cir. 1986); STN Enters., 779 F.2d at 901; In re Yes! Entertainment Corp., 316 B.R. 141 (D. Del. 2004) (holding that standing could be granted nunc pro tunc); In re National Forge Co., 304 B.R. 214 (Bankr. W.D. Pa. 2004) (derivative standing may be granted nunc pro tunc when dismissal would be inefficient); see also In re Morad, 328 B.R. 264 (1st Cir. B.A.P. 2005).

Many courts have allowed individual creditors, as opposed to a committee, to bring preference or fraudulent transfer actions derivatively. E.g., In re Parmatex, Inc., 199 F.3d 1029 (9th Cir. 1999); Gibson Group, 66 F.3d at 1436; Yes! Entertainment, 316 B.R. at 141; V. Cos., 292 B.R. at 290; In re Pilavis, 233 B.R. 1 (Bankr. D. Mass. 1999). Some courts, concerned that any recovery must be for the benefit of creditors as a body rather than for particular creditors, have applied more searching scrutiny and have set higher standards when a specific creditor wishes to prosecute a derivative avoidance action. In re Perkey, 194 B.R. 846 (Bankr. W.D. Mo. 1996); see Glinkra v. Abraham & Rose Co., Ltd., 199 B.R. 484 (D. Vt. 1996). Other courts, however, hold that there is no difference in the analysis that must be applied in granting derivative standing to an individual creditor than in allowing a committee to sue derivatively. Housecraft Indus., 310 F.3d at 64. If a committee already has been permitted to bring a
derivative avoidance action, however, then an individual creditor may not do so. *In re Sunbeam Corp.*, 287 B.R. 861 (S.D.N.Y. 2003).

The overwhelming majority of decisions discussing derivative standing have arisen in the context of Chapter 11 cases usually involving corporate debtors. Whether a creditor may be granted derivative standing in a Chapter 13 case is a question that has seldom arisen. Such a step may be possible, but it would require truly extraordinary circumstances. *In re Carey*, 333 B.R. 666 (S.D.N.Y. 2005) (bankruptcy court properly denied creditor derivative standing to prosecute fraudulent transfer action in Chapter 13 case; extraordinary circumstances that would support displacing the trustee did not exist, and there was little likelihood of significant recovery).

3. **Individual Creditors Seeking Avoidance on Their Own Behalf.**

Although individual creditors may be permitted to bring a preference or a fraudulent transfer action derivatively on behalf of the estate, they have no standing to prosecute such an action in their own right and for their own benefit, even if they would have had standing to do so outside of bankruptcy. *In re PWS Holding Corp.*, 303 F.3d 308 (3d Cir. 2002), *cert. denied*, 538 U.S. 924 (2003); *In re Allard*, 198 B.R. 715 (Bankr. N.D. Ill. 1996); *In re Wilson*, 77 B.R. 532 (Bankr. W.D. Va. 1987). There is some disagreement as to whether an avoidance action is estate property in a strict sense, but there is no question that such an action may be pursued only by someone acting on behalf of the bankruptcy estate, and that any action by an individual creditor to set aside a prepetition transaction for the creditor’s own benefit is barred by the automatic stay. *In re MortgageAmerica Corp.*, 714 F.2d 1266 (5th Cir. 1983); *Steffen v. Gray, Harris & Robinson, P.A.*, 283 F. Supp. 2d 1272 (M.D. Fla. 2003). Moreover, once a bankruptcy petition is filed, a state court receiver, an assignee for the benefit of creditors, or any similar party authorized to act on behalf or creditors under state law loses any right to pursue an avoidance
action; such an action may only be pursued by a representative of the bankruptcy estate. *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198 (9th Cir. 2005).

If the right to bring a fraudulent transfer or a preference claim is estate property, it may be abandoned. *See In re Blumberg*, 263 B.R. 704 (Bankr. E.D.N.Y. 2001). In that event, an individual creditor’s right to pursue a fraudulent transfer action for his or her own benefit would spring back to life. An interesting variation on this analysis occurred in *National Am. Ins. Co. v. Ruppert Landscape Co.*, 122 F. Supp. 2d 670 (E.D.Va. 2000). There, the trustee had purported to sell certain claims, including a fraudulent transfer action, to various unsecured creditors. The trustee had concluded that the avoidance claim was worthless because it was time-barred under 11 U.S.C. § 546(a). The district court treated the transaction as a form of abandonment rather than a sale. While perhaps not a true abandonment under 11 U.S.C. § 554, the trustee’s action, taken with court approval, meant that no one acting on behalf of the estate would or could pursue the claim. The upshot, in the *Ruppert Landscape* court’s view, was to restore standing to the “purchasing” creditors. But for the bankruptcy, they would have had standing to pursue a state law fraudulent transfer action in their own right. So long as the bankruptcy was pending, their right was subject to the stay, and their standing was superseded by the trustee’s. In the court’s analysis, the transaction in question had not really given the creditors the trustee’s fraudulent transfer claim, which would have been time-barred by the postpetition limitations statute, 11 U.S.C. § 546(a), in any case. Rather, the so-called sale had actually restored to the creditors their standing to pursue their own state law fraudulent transfer claims. 11 U.S.C. § 546(a) did not apply because the creditors were now acting in their own right, and they could prosecute their lawsuit so long as the state law limitations period for their fraudulent transfer action had not run.
Conversely, if the bankruptcy estate settles or releases an avoidance action, the action is extinguished. Thus, it cannot vest in individual creditors even if they could have pursued such an action in their own right before the petition was filed. *In re Stein*, 314 B.R. 306 (D.N.J. 2004); *In re Gentek, Inc.*, 328 B.R. 423 (Bankr. D. Del. 2005).

4. Assignment of and Succession to Avoidance Actions.

The bankruptcy estate’s avoidance actions are generally deemed to be non-assignable. Most courts hold that, while creditors may be given derivative standing to prosecute such actions for the benefit of the estate, the bankruptcy estate’s preference or fraudulent transfer action as such may not be transferred to a third party so that he or she may pursue it for his or her own benefit. *In re Pro Greens, Inc.*, 297 B.R. 850 (Bankr. M.D. Fla. 2003); *In re Bargdill*, 238 B.R. 711 (Bankr. N.D. Ohio 1999); *In re Allegheny Health, Educ. & Research Found.*, 233 B.R. 671 (Bankr. W.D. Pa. 1999); see *In re Cybergenics Corp.*, 226 F.3d 237 (3d Cir. 2000) (strictly speaking, avoidance action may not be estate property, and it is certainly not the debtor’s property; party that purchased debtor’s property did not acquire right to bring avoidance action); *Belding-Hall Mfg. Co. v. Mercer & Ferdon Lumber Co.*, 175 F. 335 (6th Cir. 1909) (under Bankruptcy Act, avoidance action was not assignable). Nonetheless, even if the cause of action is not assignable, there is no reason why the proceeds may not be assigned or granted as collateral to a postpetition lender or some other claimant. In such an instance, recovery is still for the benefit of the estate, as 11 U.S.C. § 550(a) requires. The proceeds do not have to flow directly to prepetition unsecured creditors in order to benefit the estate. *In re Furrs*, 294 B.R. 763 (Bankr. D.N.M. 2003).

This sort of reasoning may lead to third parties pursuing avoidance actions, even though no assignment is involved properly speaking. *In Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004), a postpetition lender had been granted a
superpriority lien on prepetition collateral. In order to obtain the acquiescence of prepetition
secured lenders and to give them adequate protection, the prepetition lenders had been granted a
lien on postpetition property, notably any recoveries from preference actions up to $30 million.
The debtors’ assets were then sold as a going concern, and a full distribution of the proceeds was
made. The position of the prepetition lenders had deteriorated, and they began to prosecute the
preference claims. The preference defendants maintained that any recovery would not be for the
benefit of the estate as 11 U.S.C. § 550(a) requires. The Seventh Circuit disagreed. The benefit
to the estate had already been given by obtaining the prepetition lenders’ acquiescence in the
postpetition financing arrangement. There is no reason why preference recoveries could not be
granted to a particular class of creditors. The plaintiff creditors were not so much the assignees
of the estate representative as successors-in-interest by operation of law. Implicit in this
reasoning was that granting a lien on the proceeds carried with it the right to realize on the
collateral — i.e., to prosecute the cause of action. This reasoning has much to be said in its
favor. At the least, the situation was quite unlike selling the preference actions outright to a third
party. The position of the plaintiffs was closer to derivative standing with court approval than to
the alleged standing of a purchaser of the avoidance action.

5. Preserving Actions for Postconfirmation Litigation.

Normally, bankruptcy avoidance powers terminate when the case is closed or dismissed
or when a plan is confirmed. Under 11 U.S.C. § 1123(b)(3)(B), however, a Chapter 11 plan may
provide for the postconfirmation retention and enforcement of the estate’s avoidance rights. In
re P.A. Bergner & Co., 140 F.3d 1111 (7th Cir. 1998); see In re Papercraft Corp., 211 B.R. 813
(W.D. Pa. 1997) (plan gave creditors’ committee standing to pursue subordination action); In re
Connolly, 238 B.R. 475 (9th Cir. B.A.P. 1999); In re Bridgeport Holdings, Inc., 326 B.R. 312
(Bankr. D. Del. 2005). There is no explicit or separate statutory right to pursue a bankruptcy
avoidance action after confirmation, and a party wishing to do so has only such authority as the plan itself provides. *In re Teligent, Inc.*, 306 B.R. 752 (Bankr. S.D.N.Y. 2004); *aff’d*, 326 B.R. 219 (S.D.N.Y. 2005); *see In re Value Music Concepts, Inc.*, 329 B.R. 111 (Bankr. N.D. Ga. 2005).

Therefore, the retention of the right to bring an avoidance action must be specified in the plan, and any recovery must be for the benefit of creditors as a group. *In re P.R.T.C., Inc.*, 177 F.3d 774 (9th Cir. 1999); *Zahn v. Yucaipa Capital Fund*, 218 B.R. 656 (D.R.I. 1998); *In re LJM2 Co-Inv., L.P.*, 327 B.R. 786 (Bankr. N.D. Tex. 2005); *see In re Ampace Corp.*, 279 B.R. 145 (Bankr. D. Del. 2002). Thus, when a party seeks to bring a postconfirmation avoidance action, that party must establish that it has been appointed by the plan and that it is acting as the representative of the estate. *Jackson Nat’l Life Ins. Co. v. Greycliff Partners, Ltd.*, 960 F. Supp. 186 (E.D. Wis. 1997) (plan clearly gave creditor right to bring avoidance action on behalf of estate); *In re Transit Group, Inc.*, 332 B.R. 45 (Bankr. M.D. Fla. 2005); *In re AmeriServe Food Distrib., Inc.*, 315 B.R. 24 (Bankr. W.D. Pa. 2004); *In re Goodman Bros. Steel Drum Co.*, 247 B.R. 604 (Bankr. E.D.N.Y. 2000) (plan clearly allowed debtor to pursue preference actions postconfirmation); *see C. Wesley Vines & Vernon O. Teofan, The Preservation and Prosecution of Avoidance Actions Post-Confirmation*, 12 Bankr. Dev. J. 735 (1996). Unless these things can be shown by reference to the plan’s plain terms, a party has no standing to pursue a postconfirmation preference or fraudulent transfer claim. *In re Mako, Inc.*, 985 F.2d 1052 (10th Cir. 1993); *see In re Texas Gen. Petro. Corp.*, 52 F.3d 1330 (5th Cir. 1995) (postconfirmation recovery must be sought for benefit of all creditors, especially unsecured creditors, and not for individual benefit of one creditor; liquidating trustee held to have standing); *In re Huntsville Small Engines, Inc.*, 228 B.R. 9 (Bankr. N.D. Ala. 1998).
Courts are divided as to the degree of specificity required to preserve a cause of action for postconfirmation litigation and whether particular claims or defendants must be identified in the plan. *In re Railworks Corp.*, 325 B.R. 709 (Bankr. D. Md. 2005) (discussing the split of authority); *In re Kmart Corp.*, 310 B.R. 107 (Bankr. N.D. Ill. 2004) (same). Some courts require a good deal of specificity on the ground that blanket language that vaguely purports to reserve all claims in fact reserves nothing. *Browning v. Levy*, 283 F.3d 761 (6th Cir. 2002); *In re G-P Plastics, Inc.*, 320 B.R. 861 (E.D. Mich. 2005); *In re Hooker Invs., Inc.*, 194 B.R. 426 (Bankr. S.D.N.Y. 1994); see *D&K Properties Crystal Lake v. Mutual Life Ins. Co. of New York*, 112 F.3d 257 (7th Cir. 1997); see also *In re Western Integrated Networks, LLC*, 322 B.R. 156 (Bankr. D. Colo. 2005).

Other courts, however, apparently a majority, hold that plan language is sufficient if it refers to types or categories of actions without naming specific transactions or specific defendants, at least if there is no conscious attempt to mislead or deceive. *In re Bankvest Capital Corp.*, 375 F.3d 51 (1st Cir. 2004); *In re P.A. Bergner & Co.*, 140 F.3d 111 (7th Cir. 1998); *Transit Group*, 332 B.R. at 45; *In re Center for Advanced Mfg. & Technology*, 331 B.R. 649 (Bankr. W.D. Pa. 2005); *In re Bridgeport Holdings, Inc.*, 326 B.R. 312 (Bankr. D. Del. 2005). The purpose of permitting the reservation of claims is precisely to allow confirmation without the cost and delay of litigating every cause of action, including avoidance actions, before the plan is confirmed. *Railworks*, 325 B.R. at 709; *Kmart*, 310 B.R. at 107. To require the estate to investigate every claim prior to confirmation and then identify in detail those that will be prosecuted would be needlessly onerous. *In re Greater Southeast Community Hosp. Corp. I*, 333 B.R. 506 (Bankr. D.D.C. 2005). According to this line of authority, the purpose of identifying in the plan the types of actions that may be pursued after confirmation is to tell creditors what
potential sources of revenue may be used to pay unsecured claims, not to give warning to
potential defendants in future preference, fraudulent transfer, or other actions. Therefore, a
listing of the types of claims will suffice. Value Music Concepts, 329 B.R. at 111; In re Ice

The current trend appears to favor allowing a general reservation of claims by type or
category rather than requiring greater specificity. Nonetheless, with the widespread use of
postconfirmation trusts or similar entities to pursue actions for the benefit of unsecured creditors
and administrative claimants, disputes on this topic are likely to continue.


There is a requirement for standing under 11 U.S.C. § 544(b) that is unique to that statute
and that does not apply to 11 U.S.C. §§ 547, 548. Section 544(b) allows the use of state law or
other applicable nonbankruptcy law to avoid a prepetition transaction if that transaction could be
avoided by a creditor holding an allowable unsecured claim. Section 544(b) thus amounts to an
incorporation of state law rather than the establishment of substantive federal standards. The
person in whose right the trustee sues must be a creditor in the bankruptcy case and not a reciver
or similar officer who could unwind transactions under state law. In re Delta Group, 300 B.R.
918 (Bankr. E.D. Wis. 2003).

In order to use Section 544(b), the trustee or other estate representative must establish
that there is in fact a creditor holding an allowable unsecured claim who, but for the bankruptcy,
could bring an action under nonbankruptcy law to set the transaction aside. In re Cybergenics
Corp., 226 F.3d 237 (3d Cir. 2000); Sender v. Simon, 84 F.3d 1299 (10th Cir. 1996); Official
Committee of Asbestos Claimants of G-I Holding, Inc. v. Heyman, 277 B.R. 20 (S.D.N.Y. 2002);
In re McCarn’s Allstate Fin., Inc., 326 B.R. 843 (Bankr M.D. Fla. 2005). Courts are divided as
to whether, as a matter of pleading requirements, the trustee must identify in the complaint the
specific creditor or creditors. See Neilson v. Union Bank of California, N.A., 290 F. Supp. 2d 1101 (C.D. Cal. 2003) (discussing the split of authority). Whatever the pleading requirements, the existence of such a creditor is jurisdictional, and the failure to show that there is such a creditor means that the trustee or debtor-in-possession lacks standing under Section 544(b). In re Marlar, 267 F.3d 749 (8th Cir. 2001); In re Wintz Cos., 230 B.R. 848 (8th Cir. B.A.P. 1999); see In re Goldberg, 235 B.R. 476 (Bankr. D. Idaho 1999).

Once the existence of the requisite creditor is shown, however, the trustee or other estate representative is not limited to recovering the amount that that creditor could recover, and any recovery is for the benefit of the estate, not for the benefit of that creditor alone. Stalnaker v. DLC, Ltd., 376 F.3d 819 (8th Cir. 2004); In re Coleman, 299 B.R. 780 (W.D. Va. 2003); In re Zeigler, 320 B.R. 362 (Bankr. N.D. Ill. 2005); see Moore v. Bay, 284 U.S. 4 (1931). On the other hand, the estate representative is subject to any defense that could be used against the predicate creditor if the predicate creditor itself had brought the action outside of bankruptcy. In re Grubbs Const. Co., 321 B.R. 346 (Bankr. M.D. Fla. 2005); In re Sheffield Steel Corp., 320 B.R. 432 (Bankr. N.D. Okla. 2005). Furthermore, under Section 544(b) the estate representative may only seek to avoid a transfer that a prepetition creditor could have avoided under nonbankruptcy law. This statute does not allow the estate representative to bring an action for damages. In re Myers, 320 B.R. 667 (Bankr. N.D. Ind. 2005); In re Teligent, Inc., 307 B.R. 744 (Bankr. S.D.N.Y. 2004); see In re Bliss Technologies, Inc., 307 B.R. 598 (Bankr. E.D. Mich. 2004).

E. TIME FOR BRINGING A PREFERENCE OR FRAUDULENT TRANSFER CLAIM.


The time within which an avoidance action must be brought is governed by 11 U.S.C. § 546(a). Formerly, that statute provided that an avoidance action had to be commenced either
within two years of the appointment of a trustee or by the time the case was closed or dismissed, whichever occurred first. This language led to a split of authority as to whether there were any time limit at all for a debtor-in-possession (as opposed to a trustee) to bring a preference or a fraudulent transfer action. Compare In re Dublin Securities, Inc., 214 F.3d 773 (6th Cir. 2000) (under version of statute in force before 1994, two-year period began to run only when trustee was appointed, not when Chapter 11 petition was filed); Gleischman Sumner Co. v. King, Weiser, Edelman & Bazar, 69 F.3d 799 (7th Cir. 1995) (statute applies only to trustees); In re Maxway Corp., 27 F.3d 980 (4th Cir.) (two-year period did not begin to run until trustee was appointed), cert. denied, 513 U.S. 1018 (1994); In re Bloch, 207 B.R. 944 (D. Colo. 1997) (where case had been converted, action was timely because it was brought within two years of appointment of trustee under pre-1994 version of statute); In re Frank Santora Equip. Corp., 231 B.R. 486 (E.D.N.Y. 1999) (same), with In re IRFM, Inc., 65 F.3d 778 (9th Cir. 1995) (two-year period did not commence anew upon appointment of trustee), cert. denied, 517 U.S. 1220 (1996); In re Century Brass Prods., Inc., 22 F.3d 37 (2d Cir. 1994) (two-year period begins to run against debtor-in-possession as soon as petition is filed); In re Coastal Group, Inc., 13 F.3d 81 (3d Cir. 1994); In re Johnson Southwest, Inc., 205 B.R. 823 (N.D. Tex. 1997) (where debtor-in-possession waited over two years to bring action, action was time-barred under pre-1994 version of statute); see In re Pugh, 158 F.3d 530 (11th Cir. 1998) (discussing the split of authority); In re Bodenstein, 248 B.R. 808 (Bankr. W.D. Ark.) (same), aff’d, 253 B.R. 46 (8th Cir. B.A.P. 2000).

Such disputes were resolved by Section 216 of the Bankruptcy Reform Act of 1994. This statute amended 11 U.S.C. § 546(a) to provide that, in all cases filed on or after October 22, 1994, an avoidance action must be brought within two years of the time that a petition is filed.
See In re Farmland Indus., Inc., 305 B.R. 490 (Bankr. W.D. Mo. 2003) (preference action was timely when commenced within two years in the separate bankruptcy case of the transferee rather than in the case of the debtor-transferor). In other words, the two-year period does apply to debtors-in-possession as well as to trustees in cases initially filed under Chapter 7, 12, or 13. If, however, a trustee is appointed under Chapter 7, 11, 12, or 13 before the expiration of two years, then the trustee has one year from the date of appointment to file an avoidance action, even though the two-year period might otherwise have run had no trustee been appointed. In re Allied Digital Technologies Corp., 300 B.R. 616 (Bankr. D. Del. 2003); In re Universal Factoring Co., 279 B.R. 297 (Bankr. N.D. Okla. 2002). The 1994 legislation also made clear that the limitations period is not restarted with the appointment of a new or successor trustee. See Pugh, 158 F.3d at 530; In re American Pad & Paper Co., 307 B.R. 459 (Bankr. D. Del. 2004); In re American Energy Trading, Inc., 291 B.R. 159 (Bankr. W.D. Mo. 2003). It should be noted that these provisions do not apply when a trustee is appointed in a Chapter 9 case, and, in Chapter 9, the two-year period continues to run without any extension after a trustee is appointed. In re Alabama State Fair Auth., 232 B.R. 252 (N.D. Ala. 1999). In addition, the two-year limitation applies to actions by individual debtors seeking to recover exempt property for their own benefit under 11 U.S.C. § 522(h). In re Verner, 318 B.R. 775 (Bankr. W.D. Pa. 2005); In re Steck, 298 B.R. 244 (Bankr. D.N.J. 2003).

There is a possibility of some confusion as to when a Chapter 7 trustee is appointed if a case is converted, but the confusion may be more apparent than real. Section 546(a)(1)(B) speaks of the appointment or election of a trustee under Section 702 as triggering the one-year extension. One court has held that the appointment of an interim trustee under 11 U.S.C. § 701 is sufficient, so that, if an interim trustee is selected within two years of the order for relief, then
an action is timely if it is commenced within one year of the interim trustee’s appointment. *Allied Digital Technologies*, 300 B.R. at 616. This holding appears to be contrary to the plain language of Section 546(a)(1)(B), which refers to the appointment or election of a permanent trustee under 11 U.S.C. § 702, not to the appointment of an interim trustee under 11 U.S.C. § 701. A better reasoned decision has held that if an interim trustee is appointed within two years of the original petition date, but if there is no permanent trustee under Section 702 until more than two years after the petition date, then there is no one-year extension under Section 546(a)(1), and any avoidance action that the trustee may wish to bring will be time-barred. *In re American Pad & Paper*, 319 B.R. 791 (D. Del. 2005).

The growing consensus appears to reject *Allied Digital Technologies*. The key event is the selection of a permanent trustee under Section 702. Under 11 U.S.C. § 702(d), an interim trustee initially selected under Section 701 becomes permanent if no other trustee is elected by the time of the Section 341 meeting of creditors, and the election of a trustee seldom happens. Thus, if an interim trustee becomes a permanent trustee by virtue of 11 U.S.C. § 702(d) within two years of the original order for relief, Section 546(a)(1)(B) is satisfied, and the trustee has one year from the time that his or her appointment becomes permanent in which to bring an avoidance action. *In re Crowe Rope Indus., LLC*, 311 B.R. 313 (Bankr. D. Me. 2004); *accord In re U.S. Wood Prods., Inc.*, 43 B.C.D. 139 (Bankr. D. Del. 2004).

2. 11 U.S.C. § 546(a): Jurisdictional or a Mere Statute of Limitations?

In re Frascatore, 98 B.R. 710 (Bankr. E.D. Pa. 1989); In re Oro Import Co., 52 B.R. 357 (Bankr. S.D. Fla. 1985), rev’d on other grounds, 69 B.R. 6 (S.D. Fla. 1986). This position has important consequences. If Section 546(a) goes to subject matter jurisdiction, then that statute simply cannot be waived, and the time bar may be raised for the first time on appeal.

The overwhelming weight of authority, however, holds that 11 U.S.C. § 546(a) is in the nature of a statute of limitations, not a statute of repose, and that it has nothing to do with subject matter jurisdiction. In re Texas Gen. Petro. Corp., 52 F.3d 1330 (5th Cir. 1995); In re M&L Bus. Machs., Inc., 153 B.R. 308 (D. Colo. 1993); In re Randall’s Island Family Golf Ctrs., Inc., 288 B.R. 701 (Bankr. S.D.N.Y.), adhered to on reargument, 290 B.R. 55 (Bankr. S.D.N.Y. 2003); In re Day, 82 B.R. 365 (Bankr. E.D. Pa. 1988) (criticizing Sixth Circuit’s holding in Butcher), aff’d, 102 B.R. 414 (E.D. Pa. 1989). If 11 U.S.C. § 546(a) is not jurisdictional, then its provisions may be waived or tolled by a voluntary agreement. In re Outboard Marine Corp., 299 B.R. 488 (Bankr. N.D. Ill. 2003); In re Commercial Fin. Servs., Inc., 294 B.R. 164 (Bankr. N.D. Okla. 2003). Moreover, it has been held that, when the debtor and/or the defendant actively concealed the transaction, or when there has been similar misconduct, then Section 546(a), like any statute of limitations, is subject to equitable tolling. In re International Admin. Servs., Inc., 408 F.3d 689 (11th Cir. 2005); In re M&L Bus. Mach. Co., 75 F.3d 586 (10th Cir. 1996); In re United Ins. Mgmt., Inc., 14 F.3d 1380 (9th Cir. 1994); In re Porras, 312 B.R. 81 (Bankr. W.D. Tex. 2004); cf. In re Insley, 322 B.R. 272 (Bankr W.D. Pa. 2005) (although Section 546(a) is subject to equitable tolling, tolling would not be applied where trustee had failed to exercise diligence). In addition, most courts hold that, if the time limit of 11 U.S.C. § 546(a) has run after an initial complaint has been filed, a later amended complaint will relate back to the original complaint if the relation back requirements of Federal Rule of Civil Procedure 15(c) are otherwise satisfied.

Neither BAPCPA nor the Bankruptcy Reform Act of 1994 specifically addressed whether Section 546(a) is jurisdictional or merely a statute of limitations. Nonetheless, the Eleventh Circuit, in examining the legislative history of the 1994 enactment, concluded that, at least implicitly, Congress meant to confirm that Section 546(a) is a waivable statute of limitations and not a jurisdictional statute of repose. In re Pugh, 158 F.3d 530 (11th Cir. 1998); see In re Klayman, 228 B.R. 805 (Bankr. M.D. Fla. 1999). Accordingly, any defendant in an avoidance action would be well advised to raise promptly the question whether the action has been brought within the appropriate time limits. Otherwise the issue will be deemed to have been waived.

F. THE NATURE OF RECOVERY AND THE PARTIES LIABLE.

1. The Distinction Between Avoidance and Recovery.

With both fraudulent transfer and preference actions, there is a distinction between avoiding the transaction and recovering the property transferred or its value. In re Burns, 322 F.3d 421 (6th Cir. 2003); In re 360networks (USA), Inc., 316 B.R. 797 (Bankr. S.D.N.Y. 2004); In re Teligent, Inc., 307 B.R. 744 (Bankr. S.D.N.Y. 2004); In re Priest, 268 B.R. 135 (Bankr. N.D. Ohio 2000). The transaction must first be avoided as a preference under 11 U.S.C. § 547 or as a fraudulent transfer under § 544(b) or § 548. Then, and only then, may actual recovery be had under 11 U.S.C. § 550. In re Coleman, 426 F.3d 719 (4th Cir. 2005); In re H & S Transp. Co., 939 F.2d 355 (6th Cir. 1991); In re Richmond Produce Co., 195 B.R. 455 (N.D. Cal. 1996); In re DLC, Ltd., 295 B.R. 593 (8th Cir. B.A.P. 2003), aff’d, 376 F.3d 819 (8th Cir. 2004); In re Resource, Recycling & Remediation, Inc., 314 B.R. 62 (Bankr. W.D. Pa. 2004). In some cases, as when a lien is avoided, there will be no need for recovery at all. Burns, 322 F.3d at 421; see Coleman, 426 F.3d at 719.
As though to underscore this distinction, a separate statute of limitations governs a recovery action, as opposed to an avoidance action. 11 U.S.C. § 550(f) provides that a suit for recovery must be commenced within one year of the time that a transaction is avoided or by the time the case is closed or dismissed, whichever occurs first. *In re International Administrative Servs., Inc.*, 408 F.3d 689 (11th Cir. 2005); *In re Carpenter*, 266 B.R. 671 (Bankr. E.D. Tenn. 2001), *subsequently aff’d*, 79 Fed. Appx. 749 (6th Cir. 2003); *In re Phimmasone*, 249 B.R. 681 (Bankr. W.D. Va. 2000) (recovery was time-barred after case was closed; absent concealment or other grounds for equitable tolling, merely reopening the case did not restart the limitations period); *In re Serrato*, 233 B.R. 833 (Bankr. N.D. Cal. 1999) (holding that recovery action was time-barred where it was commenced more than one year after transaction had been avoided).

11 U.S.C. § 550(a) provides that the bankruptcy estate may recover the property transferred, or, if the court so orders, the value of the property may be recovered. Some courts favor a return of the property itself, if possible, if there is any room for dispute as to its value or if the property has appreciated in value after the transfer. *In re Integra Realty Resources, Inc.*, 354 F.3d 1246 (10th Cir. 2004); *In re Willaert*, 944 F.2d 463 (8th Cir. 1991); *In re McLaughlin*, 183 B.R. 171 (Bankr. W.D. Wis. 1995); *In re Vedaa*, 49 B.R. 409 (Bankr. D.N.D. 1985). A court has discretion to order a combination of a return of the property and the payment of money, particularly if the property has depreciated in the hands of the transferee. *In re American Way Serv. Corp.*, 229 B.R. 496 (Bankr. S.D. Fla. 1999); see also *In re Dolata*, 306 B.R. 97 (Bankr. W.D. Pa. 2004) (generally, the value of the property should be recovered if a partition would be necessary to recover the property itself). Recovery is limited to the property itself or its value, however. *In re Interstate Cigar Co., Inc.*, 285 B.R. 789 (Bankr. E.D.N.Y. 2002), aff’d, 42 B.C.D. 69 (E.D.N.Y. 2003); *In re Benjamin*, 210 B.R. 203 (Bankr. M.D. Fla. 1997); *In re
Farmer, 209 B.R. 1022 (Bankr. M.D. Ga. 1997). The value recoverable is the value of the property to the debtor or the estate, not its value to the transferee. Active Wear, Inc. v. Parkdale Mills, Inc., 331 B.R. 669 (W.D. Va. 2005); see In re Teligent, Inc., 325 B.R. 134 (Bankr. S.D.N.Y. 2005). Pursuing recovery when a prepetition transaction has been avoided is simply not the same thing as seeking tort damages. Teligent, 307 B.R. at 744. A contention that an avoidance action gives rise to a claim for tort relief, including a claim for punitive damages, has been held to be sanctionably frivolous. In re Casey, 173 B.R. 581 (Bankr. E.D. Tex. 1994).


Once a transaction has been avoided, 11 U.S.C. § 550(a) permits the bankruptcy estate to recover from: (a) the initial transferee; (b) the party for whose benefit the initial transfer was made; and/or (c) any subsequent transferee. In re Teligent, Inc., 307 B.R. 744 (Bankr. S.D.N.Y. 2004); In re Allegheny Health, Educ. & Research Found., 253 B.R. 157 (Bankr. W.D. Pa. 2000); Securities Inv. Prot. Corp. v. Stratton Oakmont, Inc., 234 B.R. 293 (Bankr. S.D.N.Y. 1999). That the trustee or debtor-in-possession should be allowed to recover from the initial transferee is plain enough. In re Red Dot Scenic, Inc., 293 B.R. 116 (S.D.N.Y.), aff’d, 351 F.3d 57 (2d Cir. 2003); In re Bloch, 207 B.R. 944 (D. Colo. 1997); In re Model Imperial, Inc., 250 B.R. 776 (Bankr. S.D. Fla. 2000). Likewise, unless a good faith purchaser defense is successfully raised, subsequent transferees may be liable. In re Circuit Alliance, Inc., 228 B.R. 225 (Bankr. D. Minn. 1998). There is no requirement that an action must first be brought against the initial transferee as a prerequisite to seeking recovery against other parties who may be liable. In re International Administrative Servs., Inc., 408 F.3d 689 (11th Cir. 2005); In re Richmond Produce Co., 195 B.R. 455 (N.D. Cal. 1996); In re Advanced Telecommunication Network, Inc., 321 B.R. 308 (Bankr. M.D. Fla. 2005); In re Resource, Recycling & Remediation, Inc., 314 B.R. 62 (Bankr. W.D. Pa. 2004); see In re Steele’s Mkt., Inc., 304 B.R. 447 (Bankr. D. Colo. 2004).
(by obtaining a default judgment against the initial transferee, trustee did not waive the right to pursue subsequent transferees); *Circuit Alliance*, 228 B.R. at 225 (trustee is under no duty to seek recovery from all parties who may be liable).

In order to incur liability as a transferee, a party must have exercised dominion and control over the property transferred or held some sort of beneficial right in it. *In re Paramount Citrus, Inc.*, 268 B.R. 620 (M.D. Fla. 2001); *In re Incomnet, Inc.*, 299 B.R. 574 (9th Cir. B.A.P. 2003) (one who receives money or other property merely as an agent or bailee is not a transferee); *In re Tidewater Designs, Inc.*, 276 B.R. 733 (Bankr. E.D.N.C. 2002); see *In re Doctors Hosp. of Hyde Park, Inc.*, ___ B.R. ___, 2005 WL 2650978 (Bankr. N.D. Ill. Oct. 17, 2005) (genuine issue of material fact as to whether alleged transferee had any beneficial interest in transferred property precluded summary judgment). Just as a transfer may not be avoided at all if the debtor used funds that had been earmarked by a new creditor, see § I.B.4., *supra*, so a third party may not be held liable as transferee if that party were a “mere conduit.” *In re Ogden*, 314 F.3d 1190 (10th Cir. 2002) (escrowee was a mere conduit); *In re Cohen*, 300 F.3d 1097 (9th Cir. 2002); *In re Video Depot, Ltd.*, 127 F.3d 1195 (9th Cir. 1997); *In re Bauer*, 318 B.R. 697 (Bankr. D. Minn. 2005). Even if the transaction is unquestionably avoidable under 11 U.S.C. §§ 544(b), 548 and/or 547, a recipient is immune from recovery liability under Section 550 if the funds or property in question merely passed through the recipient’s hands. *In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*, 130 F.3d 52 (2d Cir. 1997) (mere conduit is proper test for whether defendant is a transferee; debtor’s insurance broker was a mere conduit for insurance premiums and could not be held liable); *In re Reeves*, 65 F.3d 670 (8th Cir. 1995); *In re Bullion Reserve of N. Am.*, 922 F.2d 544 (9th Cir. 1991) (in order to be deemed a “transferee,” a party must have exercised dominion and control over the property); *In re Chase &
Sanborn Corp., 848 F.2d 1196 (11th Cir. 1988) (bank was a mere conduit and had no right of control over or beneficial interest in funds transferred); Bonded Fin. Servs., Inc. v. European American Bank, 838 F.2d 890 (7th Cir. 1988) (party is not a “transferee” under Section 550 unless that party has a right to exercise dominion and control over the assets or apply the assets for its own purposes); see Bauer, 318 B.R. at 697 (insurance company with which debtor maintained an IRA was merely debtor’s agent for paying debtor’s federal taxes; insurance company was a mere conduit); In re Cassandra Group, 312 B.R. 491 (Bankr. S.D.N.Y. 2004) (attorney who acted as only as an agent for a fully disclosed principal was a mere conduit). The dispositive question is whether the alleged transferee had the legal right to use the transferred property for his or her own purposes, not whether the supposed transferee could have done so through a breach of duty or whether the putative transferee did so in fact. In re Hurtado, 342 F.3d 528 (6th Cir. 2003); In re Imageset, Inc., 299 B.R. 709 (Bankr. D. Me. 2003); accord Ogden, 314 F.3d at 1190; see In re CVEO Corp., 327 B.R. 210 (Bankr D. Del. 2005); In re U.S. Interactive, Inc., 321 B.R. 388 (Bankr D. Del. 2005). A party may not bestow mere conduit status on itself by underhanded means, however. A creditor, for example, may not assign its right to payment to a third party and then purport to collect from the debtor as a “conduit” for that third party. In re Columbia Data Prods., Inc., 892 F.2d 26 (4th Cir. 1988); In re Appalachian Finishing Works, 244 B.R. 771 (Bankr. E.D. Tenn. 2000).

In addition to transferees, Section 550(a)(1) allows the bankruptcy estate to recover from any party for whose benefit the initial transfer was made. Obviously guarantors fall within that category because a transfer that reduces the debtor’s obligations also reduces the potential liability of a guarantor. In re Skywalkers, Inc., 49 F.3d 546 (9th Cir. 1995); In re Coggin, 30 F.3d 1443 (11th Cir. 1994); In re Finn, 909 F.2d 903 (6th Cir. 1990). Parties for whose benefit
the initial transfer was made, however, are by no means limited to guarantors. *In re Checkmate Stereo & Electronics, Ltd.*, 21 B.R. 402 (E.D.N.Y. 1982) (payments by debtor to defendant’s lawyer were for defendant’s benefit and could be recovered from defendant rather than from lawyer); *In re Hessco Indus., Inc.*, 295 B.R. 372 (9th Cir. B.A.P. 2003) (when transferee is a trust, beneficiaries may be liable as persons for whose benefit the transfer was made); *In re Scott Wetzel Servs., Inc.*, 278 B.R. 613 (Bankr. M.D. Fla. 2002); *In re Sanders*, 213 B.R. 324 (Bankr. M.D. Tenn. 1997); *In re Attaway, Inc.*, 180 B.R. 274 (Bankr. D. Or. 1995) (payments by debtor to factor who purchased bills of lading from debtor’s customers were for benefit of customers because factor had right of recourse against customers; payments could be recovered from customers rather than from factor). On the other hand, the party to be held liable must have received a reasonably concrete and quantifiable benefit from the transaction, not merely a remote or speculative benefit. *In re International Mgmt Assoc.*, 399 F.3d 1288 (11th Cir. 2005); *Telesphere Liquidating Trust v. Galesi*, 246 B.R. 315 (N.D. Ill. 2000); see *In re McCook Metals, L.L.C.*, 319 B.R. 570 (Bankr. N.D. Ill. 2005); see also *Imageset*, 299 B.R. 709 (benefit must arise from the transfer itself, not from the use to which the transferee puts the property). Furthermore, if a defendant is a party for whose benefit a transfer was made, liability for recovery is limited to the extent or amount of the benefit. *McCook Metals*, 319 B.R. at 570.

The bankruptcy estate representative may recover from any party or combination of parties that may be liable. *In re Princeton-New York Investors, Inc.*, 255 B.R. 376 (D.N.J. 2000). No matter how many parties the trustee or debtor-in-possession may turn to for recovery, however, 11 U.S.C. § 550(d) allows the bankruptcy estate only one satisfaction for its claim. *In re Lindell*, 334 B.R. 249 (Bankr. D. Minn. 2005) (in a recovery action, a non-settling defendant is entitled to dollar-for-dollar credit for any settlement); *Steele’s Mkt.*, 304 B.R. at 447; *In re

3. The Right to Recovery Ends with a Subsequent Good Faith Transferee for Value:

11 U.S.C. § 550(b) cuts off the right to recover property that was fraudulently or preferentially transferred when that property reaches the hands of a subsequent transferee who is a good faith purchaser or encumbrancer. 11 U.S.C. § 550(b)(1) provides that the estate may not recover the property transferred or its value from a subsequent transferee who took: (a) for value, including the satisfaction or securing of an antecedent debt; (b) in good faith; and (c) without knowledge of the avoidability of the transfer.

Only a subsequent transferee, not the initial transferee, may avail himself or herself of 11 U.S.C. § 550(b)(1). Once a transaction is avoided, the initial transferee is strictly liable for recovery. In re Cohen, 300 F.3d 1097 (9th Cir. 2002); In re Coutee, 984 F.2d 138 (5th Cir. 1993); In re Anton Noll, Inc., 277 B.R. 875 (1st Cir. B.A.P. 2002); In re Resource, Recycling & Remediation, Inc., 314 B.R. 62 (Bankr. W.D. Pa. 2004). Congress made a conscious policy choice not to allow an initial transferee to use this defense no matter how innocent he or she might be. In re McCarn’s Allstate Fin. Co., 326 B.R. 843 (Bankr. M.D. Fla. 2005). As the party dealing directly with the debtor, the initial transferee is in the best position to detect anything suspicious about the transaction and to take appropriate steps. In re Ogden, 243 B.R. 104 (10th Cir. B.A.P. 2000); accord Perrino v. Salem, Inc., 243 B.R. 550 (D. Me. 1999). The defense of an initial transferee is to show that the transfer is not avoidable at all, either by negating an essential element of the avoidance theory or by establishing an affirmative defense to avoidance.

11 U.S.C. § 550(b)(1) provides an affirmative defense to recovery, and thus the subsequent transferee bears the burden of pleading and proving that the statute applies. In re
American Way Serv. Corp., 229 B.R. 496 (Bankr. S.D. Fla. 1999); In re Schick, 223 B.R. 661 (Bankr. S.D.N.Y. 1998). The three elements — value, good faith, and lack of knowledge of avoidability — are disjunctive, and each one must be established separately. In re Consolidated Capital Equities Corp., 175 B.R. 629 (Bankr. N.D. Tex. 1994). A subsequent transferee must first show that he or she gave value for the property. See In re Still, 963 F.2d 75 (5th Cir. 1992) (FDIC, as receiver for failed bank, did not give value, even though it may have taken in good faith); In re Stevinson, 194 B.R. 509 (D. Colo. 1996). Under 11 U.S.C. § 550(b), the focus is on the value that the subsequent transferee gave to his or her transferor, not on what the debtor received. Resource, Recycling & Remediation, 314 B.R. at 62; In re Toy King Distributors, Inc., 256 B.R. 1 (Bankr. M.D. Fla. 2000); In re KZK Livestock, Inc., 221 B.R. 464 (Bankr. C.D. Ill. 1998). That is because Section 550(b)(1) is a defense against recovery for subsequent transferees, who frequently will not have dealt with the debtor at all. Value for purposes of 11 U.S.C. § 550(b)(1) refers to reasonably equivalent value, not necessarily to fair market value, although market value is an important consideration in deciding whether the value was adequate or reasonably equivalent for purposes of this statute. In re Laguna Beach Motors, Inc., 159 B.R. 562 (Bankr. C.D. Cal. 1993).

The remaining two elements — good faith and lack of knowledge of the avoidability of the debtor’s transaction — may be conceptually distinct, but they are in fact very close. See Consolidated Capital Equities, 175 B.R. at 629. The basic question is whether the subsequent transferee had either actual knowledge of the impropriety or potential avoidability of the transaction between the debtor and the initial transferee, or else knowledge of facts sufficient to lead a prudent person to make further inquiries or to believe that the initial transfer could be avoidable. In re Bressman, 327 F.3d 229 (5th Cir. 2003); In re Fox Bean Co., Inc., 287 B.R. 270
(Bankr. D. Idaho 2002); In re Cost Reduction Servs., Inc., 284 B.R. 433 (Bankr. C.D. Ill. 2002); In re Altmeyer, 268 B.R. 349 (Bankr. W.D.N.Y. 2001) (mortgage lender who advanced money to transferee did not act in good faith; mortgagee was aware that transferee had received $60,000 in equity for a nominal price and that the transferee had a close relationship with the transferor); In re All American Petro. Corp., 259 B.R. 6 (Bankr. E.D.N.Y. 2001); see Howard N. Gorney & Lee Harrington, The Importance of Good Faith in Fraudulent Transfer Analysis, 22-Mar. Am. Bankr. Inst. J. 30 (2003). If the subsequent transferee is not aware of any impropriety or suspicious facts surrounding the debtor’s initial transfer, then the subsequent transferee is under no obligation to make any further inquiries. In re Warmus, 276 B.R. 688 (S.D. Fla. 2002); In re Erie Marine Enters., Inc., 216 B.R. 529 (Bankr. W.D. Pa. 1998); see Bressman, 327 F.3d at 229. Certainly a knowing participant in a fraudulent scheme cannot use this defense. American Tissue, Inc. v. Donaldson, Lufkin & Jenrette Securities Corp., 351 F. Supp. 2d 79 (S.D.N.Y. 2004). Moreover, a party seeking to rely on Section 550(b)(1) must not have been willfully blind. In re Model Imperial, Inc., 250 B.R. 776 (Bankr. S.D. Fla. 2000); see In re Interstate Cigar Co., Inc., 285 B.R. 789 (Bankr. E.D.N.Y. 2002) (holding that “good faith” means lack of inquiry notice), aff’d, 42 B.C.D. 69 (E.D.N.Y. 2003). If, in addition to giving value, the subsequent transferee acted without knowledge or notice of any impropriety in the debtor’s transaction, then the subsequent transferee may not be held liable for recovery, even if the debtor’s initial transfer is avoidable. Resource, Recycling & Remediation, 314 B.R. at 62; In re Mainely Payroll, Inc., 233 B.R. 591 (Bankr. D. Me. 1999); In re Food & Fibre Protection, Ltd., 168 B.R. 408 (Bankr. D. Ariz. 1994).

11 U.S.C. § 550(b)(2) also establishes a “shelter BFP rule.” Once the relevant property has passed into the hands of a good faith purchaser for value who is entitled to the protection of
Section 550(b)(1), then the bankruptcy estate may not recover from any later transferee who took in good faith, even if the later transferee did not give value. The good faith requirement for later transferees is intended to prevent a culpable party from “laundering” the property that the debtor transferred by passing it through the hands of an innocent purchaser for value. *Erie Marine*, 216 B.R. at 529; *Food & Fibre Protection*, 168 B.R. at 408; see Gorney & Harrington, *The Importance of Good Faith*, 22-Mar. AM. BANKR. INST. J. at 30.


11 U.S.C. § 550(e) establishes a degree of protection for a transferee who is otherwise liable for recovery, regardless of whether that party is an initial or a subsequent transferee. The gist of the statute is that a good faith transferee may recover its costs in preserving or improving the property. *In re American Way Serv. Corp.*, 229 B.R. 496 (Bankr. S.D. Fla. 1999). Specifically, 11 U.S.C. § 550(e)(1) provides that a good faith transferee may claim a lien on the property that the estate recovers to secure the lesser of the cost of any improvements or the amount by which such improvements may have increased the property’s value. The improvements must have been made after the transfer. *In re Zeigler*, 320 B.R. 362 (Bankr. N.D. Ill. 2005); *In re Dolata*, 306 B.R. 97 (Bankr. W.D. Pa. 2004). This statutory protection is designed to prevent the bankruptcy estate from receiving a windfall at the expense of a good faith transferee. *In re Amato*, 10 B.R. 120 (Bankr. S.D. Fla. 1981). For purposes of Section 550(e)(1), “improvements” include not only development and repairs, but also the payment of property taxes and the discharge of any lien that the estate could not avoid. 11 U.S.C. § 550(e)(2); see *In re Interstate Cigar Co., Inc.*, 285 B.R. 789 (Bankr. E.D.N.Y. 2002), aff’d, 42 B.C.D. 69 (E.D.N.Y. 2003); *In re Harcom, Inc.*, 79 B.R. 137 (Bankr. D.N.H. 1987) (transferee
liable for recovery was entitled to a lien to secure the value of repairs made and property taxes paid).

Although Section 550(e) contains no requirement that the transferee must have given value, the statute does specify that the transferee must have acted in good faith. A transferee who did not act in good faith has no right to any lien on the property that the estate recovers, regardless of what the transferee may have done to improve or preserve it. *Interstate Cigar Co.*, 285 B.R. at 789; *In re Barkley*, 263 B.R. 553 (Bankr. N.D. Ohio 2001); see *In re Jones*, 68 B.R. 483 (Bankr. W.D. Mo. 1984). For relevant purposes, good faith means that the transferee must have received the property without knowledge or inquiry notice of any infirmity in the debtor’s transaction or of the potential avoidability of the transfer. *Barkley*, 263 B.R. at 553; see *In re Blitstein*, 105 B.R. 133 (Bankr. S.D. Fla. 1989).

II.

PREFERENCE ACTIONS UNDER 11 U.S.C. § 547 AND STATE LAW

A. **ELEMENTS OF A PREFERENCE CLAIM UNDER 11 U.S.C. § 547(b).**

11 U.S.C. § 547(b) sets out five elements that must be established in order to avoid a prepetition transfer of an interest of the debtor in property as a preference. Under 11 U.S.C. § 547(g), the trustee or debtor-in-possession bears the burden of proving each of these elements by a preponderance of the evidence, and a failure to establish any one of them will defeat a preference claim. *In re Lamar Haddox Contractor, Inc.*, 40 F.3d 118 (5th Cir. 1994); *In re Bridge Info. Sys., Inc.*, 299 B.R. 567 (Bankr. E.D. Mo. 2003); *In re Zeta Consumer Prods. Corp.*, 291 B.R. 336 (Bankr. D.N.J. 2003).

1. **Transfer to or for the Benefit of a Creditor: 11 U.S.C. § 547(b)(1).**

11 U.S.C. § 547(b)(1) requires that the transfer must have been made to or for the benefit of a creditor. 11 U.S.C. § 101(10) defines “creditor” to include any entity that holds a
prepetition claim against the debtor. 11 U.S.C. § 101(5) includes contingent and unliquidated rights to payment within the definition of “claim.” In re B & B Utilities, Inc., 208 B.R. 417 (Bankr. E.D. Tenn. 1997); see In re Mowry, 263 B.R. 499 (Bankr. W.D. Pa. 2001). Consequently, guarantors or sureties are creditors because they may be called upon to pay the debtor’s obligations. If they do, they will be subrogated to the obligee, and thus they have a contingent claim against the debtor. In re Wesley Indus., Inc., 30 F.3d 1438 (11th Cir. 1994); In re Meredith Hoffman Partners, 12 F.3d 1549 (10th Cir. 1993), cert. denied, 512 U.S. 1206 (1994); In re ML & Assocs., Inc., 301 B.R. 195 (Bankr. N.D. Tex. 2003). Indeed, any party with a contingent right of recourse against the debtor—including co-obligors, endorsers or co-makers—may be deemed a creditor. See In re M2Direct, Inc., 282 B.R. 60 (Bankr. N.D. Ga. 2003); In re Ausman Jewelers, Inc., 177 B.R. 282 (Bankr. W.D. Wis. 1995); In re Herman Cantor Corp., 15 B.R. 747 (Bankr. E.D. Va. 1981).

On the other hand, a transfer to a party who simply holds an equity interest in the debtor does not satisfy this requirement. An equity interest, without more, is not a “claim” under 11 U.S.C. § 101(5), and hence the holder of such an interest generally is not a “creditor.” See Carrieri v. Jobs.com, Inc., 393 F.3d 508 (5th Cir. 2005) (preferred shareholders and stock warrant holders did not have “claims” against the debtors and were not creditors). While a distribution or payment to an equity owner may be actually or constructively fraudulent, it cannot be a preference if the equity owner did not otherwise hold a claim against the debtor. In re Hedged-Investments Assocs., Inc., 84 F.3d 1267 (10th Cir. 1996); see In re Riverside-Linden Inv. Co., 925 F.2d 320 (9th Cir. 1991). If an equity owner has a vested contractual right to payment, however, then the equity owner may be a creditor. In re IDS Holding Co., LLC, 292

A transfer may be a preference if it is made either to a creditor or for the benefit of a creditor. In re Broderick Co., 177 B.R. 430 (Bankr. D. Mass 1995). Clearly, if a creditor assigns its right to payment to one of its own creditors, the debtor’s payment to the third party, the creditor’s creditor, is for the benefit of the debtor’s own creditor, even though the third party otherwise may have no claim against the debtor directly. In re Scott Wetzel Servs., Inc., 278 B.R. 613 (Bankr. M.D. Fla. 2002); In re Phelps Technologies, Inc., 245 B.R. 858 (Bankr. W.D. Mo. 2000); In re Crafts Plus +, Inc., 220 B.R. 331 (Bankr. W.D. Tex. 1998). Such circuitous preferences were avoidable under the Bankruptcy Act, and they remain avoidable under the Bankruptcy Code. See National Bank of Newport v. National Herkimer County Bank, 225 U.S. 178 (1912); In re All-Type Printing, Inc., 274 B.R. 316 (Bankr. D. Conn. 2002) (payment on contract of which defendant was a third party beneficiary was avoidable as preferential), subsequently aff’d, 80 Fed. Appx. 700 (2d Cir. 2003). The principle involved is broader than this, however. Any transfer that reduces the contingent liability of a guarantor, surety, or co-obligor is a transfer for the benefit of that creditor, even if the transfer is made to another party. In re Robinson Bros. Drilling, Inc., 6 F.3d 701 (10th Cir. 1993), cert. denied, 510 U.S. 1214 (1994); Ausman Jewelers, 177 B.R. at 282. Consequently, a transfer that benefits such a party meets the requirements of Section 547(b)(1), regardless of whether the transfer would be avoidable if viewed solely from the perspective of the primary obligee or other entity to whom the transfer actually was made. In re Performance Communications, Inc., 126 B.R. 473 (Bankr. W.D. Pa. 1991) (transfer was preferential only as to insider guarantors and not as to obligee who
received the transfer); see *In re Marilyn Steinberg Enters., Inc.*, 141 B.R. 587 (Bankr. E.D. Pa. 1992).

2. **Transfer for or on Account of an Antecedent Debt:** 11 U.S.C. § 547(b)(2).

To meet the second requirement of a preference action, the representative of the estate must show both that the transfer was for or on account of an antecedent debt incurred before the transfer. This means that a debt was owed and that the debtor was legally obligated to pay before the transfer was made. *Laws v. United Missouri Bank of Kansas City, N.A.*, 98 F.3d 1047 (8th Cir. 1996), *cert. denied*, 520 U.S. 1168 (1997); *In re Hayes Lemmerz Intern., Inc.*, 329 B.R. 136 (Bankr D. Del. 2005). If there were no preexisting debt, then the transfer could not have been preferential. *In re CVEO Corp.*, 327 B.R. 210 (Bankr. D. Del. 2005) (if payments were reimbursements for past claims, they were on account of antecedent debts, but, if they were made to satisfy future claims, there was no antecedent debt); *In re Roberds, Inc.*, 315 B.R. 443 (Bankr. S.D. Ohio 2004); *In re Vanguard Airlines, Inc.*, 295 B.R. 329 (Bankr. W.D. Mo. 2003) (advance payments for future services were not on account of an antecedent debt); *In re Presidential Airways, Inc.*, 228 B.R. 594 (Bankr. E.D. Va. 1999) (there was no antecedent debt where debtor paid broker in advance to procure insurance); see *Stoumbos v. Kilimnik*, 988 F.2d 949 (9th Cir.) (payment to redeem stock that had already been issued in return for services rendered was not on account of an antecedent debt), *cert. denied*, 510 U.S. 867 (1993). In other words, if it were not for the transfer, a debt would have been owed, and the creditor would have had a claim against the bankruptcy estate. *In re Ogden*, 243 B.R. 104 (10th Cir. B.A.P. 2000); see *In re AppOnline.Com*, 296 B.R. 602 (Bankr. E.D.N.Y. 2003) (no antecedent debt was created where bank did not extend credit to cover debtor’s insufficient funds checks). Thus, while a gift or donation may be a fraudulent transfer, it cannot be a preference. By definition, the recipient of a gratuitous transfer has no antecedent legally enforceable claim with respect to that transfer. *In re
Galbreath, 207 B.R. 309 (Bankr. M.D. Ga. 1997). Similarly, voluntary contributions to a retirement program are not made to satisfy any antecedent debt, and thus they cannot be preferential. In re Loomer, 222 B.R. 618 (Bankr. D. Neb. 1998). On the other hand, if the transferee held a claim—liquidated or unliquidated, contingent or fixed—then there was an antecedent debt. In re Energy Co-Op., Inc., 814 F.2d 1226 (7th Cir.) (payment made in compromise of a breach of contract claim was on account of a debt), cert. denied, 484 U.S. 928 (1987); In re Phoenix Restaurant Group, Inc., 316 B.R. 671 (Bankr. M.D. Tenn. 2004) (payment in settlement of Americans with Disabilities Act claim was on account of antecedent debt); see In re Jeans, 326 B.R. 722 (Bankr. W.D. Tenn. 2005) (debt may be antecedent even if there are conditions precedent to debtor’s duty to perform).

Not only must there have been a debt; the debt must have been incurred before the transfer. In re Southmark Corp., 88 F.3d 311 (5th Cir. 1996), cert. denied, 519 U.S. 1057 (1997); In re May, 310 B.R. 405 (Bankr. E. D. Ark. 2004). Generally, a unitary or nondivisible debt is deemed to have been incurred at the time that the debtor became legally obligated to pay, not at the time that any or each installment in a series of payments on the same obligation fell due. In re First Jersey Securities, Inc., 180 F.3d 504 (3d Cir. 1999); In re Futoran, 76 F.3d 265 (9th Cir. 1996); In re Bridge Info. Sys., Inc., 311 B.R. 774 (Bankr. E.D. Mo. 2004); In re Summit Fin. Servs., Inc., 240 B.R. 105 (Bankr. N.D. Ga. 1999). On the other hand, under a lease agreement, a debt is generally deemed to be incurred when each rental installment falls due, not when the lease is executed. In re White River Corp., 799 F.2d 631 (10th Cir. 1986); In re Garrett Tool & Eng’g, Inc., 273 B.R. 123 (E.D. Mich. 2002); In re RDM Sports Group, Inc., 250 B.R. 805 (Bankr. N.D. Ga. 2000). At all events, a debt need not be past due, fixed, or liquidated in order to be antecedent. In re CCG 1355, Inc., 276 B.R. 377 (Bankr. D.N.J. 2002). Thus, a
grace period does not mean that the debtor has no obligation to pay before the grace period expires, and a payment made within the grace period is on account of an antecedent debt. In re Advance Glove Mfg. Co., 761 F.2d 249 (6th Cir. 1985); In re Bridge Info. Sys., Inc., 299 B.R. 567 (Bankr. E.D. Mo. 2003).

When the transfer in question is a mortgage or security interest, 11 U.S.C. § 547(e)(2)(A) may come into play. That statute specifies when a mortgage or security interest is deemed to have been made. Formerly, 11 U.S.C. § 547(e)(2)(A) provided that such a transfer would be considered to occur at the same time that it took effect between the parties if it were perfected within 10 days. Section 408 of BAPCPA extended this period to 30 days. A security interest is enforceable between the parties only when the creditor gives value. U.C.C. § 9-203(b)(1). Likewise, under the law of most states, if not all, a mortgage takes effect only when the mortgagee advances money, not when the mortgage documents are signed. The upshot is that if a mortgage or security interest is perfected within the requisite time — formerly 10 days, now 30 days — of the point when funds are actually advanced, the mortgage or security interest will be deemed contemporaneous with the underlying debt and not on account of an antecedent debt, even if the documents were executed much earlier. Thus, it cannot be avoided as preferential. In re Comps, 334 B.R. 235 (Bankr. E.D. Mich. 2005); see In re Crosson, 325 B.R. 787 (Bankr. W.D. Wis. 2005).

The bottom line is that if the debt were incurred before the transfer, then a major portion of Section 547(b)(2) is satisfied. In re Upstairs Gallery, Inc., 167 B.R. 915 (9th Cir. B.A.P. 1994) (lessee’s payment under lease termination contract was on account of an antecedent debt); In re Stewart, 274 B.R. 503 (Bankr. W.D. Ark.), aff’d, 282 B.R. 871 (8th Cir. B.A.P. 2002); In re Ramirez Rodriguez, 209 B.R. 424 (Bankr. S.D. Tex. 1997). On the other hand, if the debt were
incurred contemporaneously with or after the transfer, then the transfer cannot be preferential. *In re Wey*, 854 F.2d 196 (7th Cir. 1988) (downpayment on property was not on account of an antecedent debt); *In re Bridge Information Sys., Inc.*, 327 B.R. 382 (8th Cir. B.A.P. 2005) (payment to buy out lessee’s option to renew lease did not involve an antecedent debt); *In re Superior Fast Freight, Inc.*, 202 B.R. 485 (9th Cir. B.A.P. 1996) (debtor’s advance payment for future services was not on account of an antecedent debt, no matter how desperately or how quickly the debtor may have needed those services).

Even if an antecedent debt existed, the estate representative must also show that the transfer was made for or on account of that debt. *In re Enron Corp.*, 318 B.R. 655 (Bankr. S.D. Tex. 2004). The mere fact that there was a preexisting debt does not mean that a particular transfer was made to satisfy it. *In re Coast Grain Co.*, 317 B.R. 796 (Bankr. E.D. Cal. 2005); see *Warsco v. Preferred Technical Group*, 258 F.3d 557 (7th Cir. 2001) (fact question existed as to whether payment that purchaser of debtor’s assets had made to one of debtor’s creditors was for or on account of an antecedent debt that the debtor owed). The transfer may have been for new value, at least in part. *In re Amick*, 163 B.R. 589 (Bankr. D. Idaho 1994). Moreover, if the transfer created an account receivable or equivalent contract right against the transferee, it cannot be deemed to have been made for or on account of an antecedent debt. *In re Southern Indus. Banking Corp.*, 48 B.R. 306 (Bankr. E.D. Tenn. 1985). Such a transfer may have been used by the creditor to create a right of setoff, and, if so, it may be subject to attack under the setoff statute, 11 U.S.C. § 553, but it cannot be a preference. *Coast Grain*, 317 B.R. at 796.

3. **Transfer Made While the Debtor Was Insolvent:** 11 U.S.C. § 547(b)(3).

The third requirement of a preference claim is that the debtor must have been insolvent when the transfer was made. 11 U.S.C. § 101(32) establishes a balance sheet definition of insolvency for business organizations and individuals, although a cash flow or equitable
insolvency definition applies to municipalities. A business organization or an individual debtor is “insolvent” if the debtor’s liabilities as of the date of the transfer were greater than the debtor’s assets, exclusive of fraudulently transferred and exempt property. In re Smith, 236 B.R. 91 (Bankr. M.D. Ga. 1999); see In re Forman Enters., Inc., 293 B.R. 848 (Bankr. W.D. Pa. 2003). Thus, except in the case of a municipality, demonstrating that the debtor was unable to pay its debts as they accrued is not necessarily proof of insolvency for preference purpose. In re Koubourlis, 869 F.2d 1319 (9th Cir. 1989); see In re Taxman Clothing Co., 905 F.2d 166 (7th Cir. 1990).

The debtor’s assets must be given a “fair valuation” as of the date of the transfer. This normally means that they must be given their fair market value. In re Pembroke Dev. Corp., 124 B.R. 398 (Bankr. S.D. Fla. 1991) (court must be able to estimate what the debtor’s assets would have brought if sold “in a prudent manner under current market conditions” as of the date of the transfer); accord Briden v. Foley, 776 F.2d 379 (1st Cir. 1985); In re Heilig-Meyers Co., 319 B.R. 447 (Bankr. E.D. Va. 2004), aff’d, 328 B.R. 471 (E.D. Va. 2005); In re Zeta Consumer Prods. Corp., 291 B.R. 336 (Bankr. D.N.J. 2003). A reasonable time should be assumed for the sale of the assets in order to arrive at a fair market value. In re Trans World Airlines, Inc., 134 F.3d 188 (3d Cir.), cert. denied, 523 U.S. 1138 (1998). Thus, the book value of the debtor’s property may not necessarily be an accurate criterion for determining insolvency, especially if the assets have been substantially depreciated for tax purposes. In re Lamar Haddox Contractor, Inc., 40 F.3d 118 (5th Cir. 1994); In re Hoffinger Indus., Inc., 313 B.R. 812 (Bankr. E.D. Ark. 2004); see Peltz v. Hatten, 279 B.R. 710 (D. Del. 2002), aff’d, 60 Fed. Appx. 401 (3d Cir. 2003); In re Waccamaw’s Homeplace, 325 B.R. 524 (Bankr D. Del. 2005). The determination of the value of the debtor’s assets and liabilities at the time of the transfer is highly fact-specific, and
expert testimony is frequently required. *In re Kaypro*, 218 F.3d 1070 (9th Cir. 2000); *Gasmark Ltd. Liquidating Trust v. Louis Dreyfus Natural Gas Corp.*, 158 F.3d 312 (5th Cir. 1998); *In re Roblin Indus., Inc.*, 78 F.3d 30 (2d Cir. 1996); *In re Heilig-Meyers Co.*, 328 B.R. 471 (E.D. Va. 2005). Typically the debtor’s assets should be given their going concern value, and liquidation value should be used only if the debtor were financially moribund at the time of the transfer. *In re PWS Holding Corp.*, 228 F.3d 224 (3d Cir. 2000); *Jones Truck Lines, Inc. v. Full Serv. Leasing Corp.*, 83 F.3d 253 (8th Cir. 1996); *Heilig-Meyers*, 328 B.R. at 471; *In re Payless Cashways, Inc.*, 290 B.R. 689 (Bankr. W.D. Mo. 2003); *In re Lids Corp.*, 281 B.R. 535 (Bankr. D. Del. 2002). If the debtor is considered a going concern at the time of the transfer, its publicly traded debt, if any, should be given its face value. *Trans World Airlines*, 134 F.3d at 188. Contingent debts should be discounted by the probability, at the time of the transfer, that the contingency would accrue. *Hoffinger Indus.*, 313 B.R. at 812; *Lids Corp.*, 281 B.R. at 535.

The representative of the estate may be aided by the statutory presumption that the debtor was insolvent during the 90 days preceding the filing of the petition. 11 U.S.C. § 547(f); see *In re Keplinger*, 284 B.R. 344 (N.D.N.Y. 2002); *In re Siemens*, 249 B.R. 205 (Bankr. D. Neb. 2000). The opposing party, however, may overcome the presumption with any evidence sufficient to call the presumption into doubt. *Gasmark*, 158 F.3d at 312; *Jones Truck Lines*, 83 F.3d at 253; *In re Enron Corp.*, 318 B.R. 655 (Bankr. S.D. Tex. 2004); *In re McGuane*, 305 B.R. 695 (Bankr. N.D. Ill. 2004); *In re Brothers Gourmet Coffees, Inc.*, 271 B.R. 456 (Bankr. D. Del. 2002); see Fed. R. Evid. 301. The presumption cannot be overcome by mere speculation that the debtor may have been solvent, however. *In re Emerald Oil Co.*, 695 F.2d 833 (5th Cir. 1983); *In re CVEO Corp.*, 327 B.R. 724 (Bankr D. Del. 2005); *In re J. Allen Steel Co.*, 321 B.R. 764 (Bankr S.D. Tex. 2005). Moreover, the ultimate burden of persuasion always rests on the party
seeking to avoid the transfer. McGuane, 305 B.R. at 695; Payless Cashways, 290 B.R. at 689; In re J.R. Deans Co., Inc., 249 B.R. 121 (Bankr. D.S.C. 2000); In re Artha Mgmt., Inc., 174 B.R. 671 (Bankr. S.D.N.Y. 1994). Of course, there is no presumption that the debtor was insolvent more than 90 days prepetition. If the transfer took place before that time, the statutory presumption is of no benefit, and the representative of the estate bears the full burden of pleading and proving the debtor’s insolvency. Larmar Haddox, 40 F.3d at 118; Artha Mgmt., Inc., 174 B.R. at 671.


11 U.S.C. § 547(b)(4) establishes two distinct time periods for preference avoidance. In re Frank Santora Equip. Corp., 231 B.R. 486 (E.D.N.Y. 1999). Normally, only transfers made within 90 days of the filing of the petition are subject to a preference attack. 11 U.S.C. § 547(b)(4)(A); see In re Tops Appliance City, Inc., 372 F.3d 510 (3d Cir. 2004); In re Organic Conversion Corp., 259 B.R. 350 (Bankr. D. Minn. 2001); In re Stewart, 256 B.R. 259 (Bankr. S.D. Ohio 2000); see also In re Green, 223 F.3d 1064 (9th Cir. 2000) (90-day period is not extended if last day falls on a Saturday, Sunday, or legal holiday); In re Boyer, 212 B.R. 975 (Bankr. D. Or. 1997) (same). If, however, the transfer were made to an “insider,” then the reachback period extends to one year. 11 U.S.C. § 547(b)(4)(B); see General Trading, Inc. v. Yale Materials Handling Corp., 119 F.3d 1485 (11th Cir. 1997). The purpose of the distinction is to prevent those with inside knowledge of the debtor’s financial condition from satisfying their own claims before outside creditors have an opportunity to learn of the debtor’s difficulties. In re Frank Santora Equip. Corp., 213 B.R. 420 (E.D.N.Y. 1997). Any transfer made more than one year prepetition cannot be avoided as preferential. In re Bame, 252 B.R. 148 (Bankr. D. Minn. 2000). If a case is converted, the reachback period is measured from the date of the
original petition rather than from the date of conversion. See Vogel v. Russell Transfer, Inc., 852 F.2d 797 (4th Cir. 1988).

11 U.S.C. § 101(31) gives an extensive but nonexclusive list of persons who are considered “insiders” of the debtor. In re Enterprise Acquisition Partners, Inc., 319 B.R. 626 (9th Cir. B.A.P. 2005) (statutory list of insiders is nonexclusive); In re J.R. Deans Co., Inc., 249 B.R. 121 (Bankr. D.S.C. 2000) (same). Generally, any party who had a close relationship with the debtor or the ability to control the debtor may be considered an insider, especially if the transfer does not bear the hallmarks of an arm’s-length bargain. In re Holloway, 955 F.2d 1008 (5th Cir. 1992) (debtor’s former wife was an insider when the parties continued their close personal and business relationship despite their divorce); In re Broumas, 203 B.R. 385 (D. Md. 1996) (attorney with whom debtor had had a very close relationship for more than 15 years was an insider); In re Kunz, 335 B.R. 170 (10th Cir. B.A.P. 2005) (fact question existed as to whether debtor who was “director emeritus” of bank exercised sufficient control or was in such authority as to make bank an insider); In re Phongsavath, 328 B.R. 895 (Bankr. N.D. Ga. 2005) (fact issue existed as to whether friend and housemate of debtor was an insider); In re Carrozzella & Richardson, 302 B.R. 415 (Bankr. D. Conn. 2003) (wife of one of debtor’s principals was an insider); In re A. Tarricone, Inc., 286 B.R. 256 (Bankr. S.D.N.Y. 2002) (golfing buddy of person in de facto control of debtor corporation was an insider); In re Demko, 264 B.R. 404 (Bankr. W.D. Pa. 2001) (man with whom debtor was cohabiting was an insider); In re Craig Sys. Corp., 244 B.R. 529 (Bankr. D. Mass. 2000) (discussing eleven factors that have been used to determine insider status); In re Emerson, 244 B.R. 41 (Bankr. D.N.H. 2000) (close personal friend of debtor and friend’s son were insiders); In re Liberty Livestock Co., 198 B.R. 365 (Bankr. D. Kan. 1996) (sibling corporation was an insider of the debtor corporation; both were owned and controlled by
the same married couple). On the other hand, an adversarial or arm’s-length relationship will generally preclude a finding of insider status. *Gray v. Giant Wholesale Corp.*, 758 F.2d 1000 (4th Cir. 1985) (creditor who controlled disbursement of debtor’s checks was not automatically an insider); *In re Kong*, 196 B.R. 167 (N.D. Cal. 1996) (bank was not an insider where it exercised no more control over the debtor than the pressures typical of debtor/creditor relationships); *In re Fox*, 277 B.R. 740 (Bankr. N.D. Ohio 2002) (judgment lien creditor was not acting as an insider; even though debtor and creditor had been personal friends, their friendship had deteriorated, and transfer in question was involuntary); *In re Busconi*, 177 B.R. 153 (Bankr. D. Mass 1995) (debtor’s former wife was not an insider, even before divorce decree became final, where divorce was particularly acrimonious and transfers in question were coerced).

Whether the creditor to whom or for whose benefit the transfer was made is an insider must be determined as of the date of the transfer. A party who was formerly an insider but who was no longer so at the time of the transfer, or a party who became an insider only after the transfer was made, cannot be subject to the one-year reachback period. *In re Optical Technologies, Inc.*, 246 F.3d 1332 (11th Cir. 2001); *Butler v. David Shaw, Inc.*, 72 F.3d 437 (4th Cir. 1996); see Benjamin R. Norris, *Bankruptcy Preference Actions*, 121 BANKING L.J. 483 (2004).

Because of the reachback periods of Section 547(b), the timing of a transfer may be critical in a preference action. See *In re North*, 310 B.R. 152 (Bankr. D. Ariz. 2004). 11 U.S.C. § 547(e) establishes when a transfer is deemed to have been made in a preference action. For purposes of avoidance under 11 U.S.C. § 547(b), a payment by check is considered to have been made when the drawee bank honors the check, not when the payee receives it. *Barnhill v. Johnson*, 503 U.S. 393 (1992); see *In re Watkins*, 325 B.R. 277 (Bankr. E.D. Mo. 2005); *In re
MGroup, Inc., 308 B.R. 697 (Bankr. D. Del. 2004); In re H.L. Hansen Lumber Co. of Galesburg, Inc., 270 B.R. 273 (Bankr. C.D. Ill. 2001). Under 11 U.S.C. § 547(e)(2), a transfer of real property or the granting of a lien is deemed to occur upon perfection. If perfection occurs within 30 days of the underlying transaction, however, the perfection will relate back to the underlying transaction. In re Lewis, 398 F.3d 735 (6th Cir. 2005); In re Jrosz, 332 B.R. 662 (Bankr. E.D. Wis. 2005); see In re Dorton, 327 B.R. 14 (Bankr. D.D.C. 2005). The 30-day relation back period was added by Section 403 of BAPCPA in 2005. Prior to BAPCPA, the grace or relation back period was 10 days.

One area of controversy in this respect has been the timing of a garnishment of a debtor’s wages. Three older decisions at the court of appeals level held that the transfer is deemed to occur at the time that the writ of garnishment is served. According to these courts, the writ divests the debtor of any interest in future wages subject to the garnishment. Thus, if the writ of garnishment is served more than 90 days prepetition, and if the creditor is not an insider, the garnishment cannot be avoided as a preference, even if the wages were earned and otherwise would have been payable to the debtor within the 90-day period. In re Conner, 733 F.2d 1560 (11th Cir. 1984); In re Coppie, 728 F.2d 951 (7th Cir. 1984), cert. denied, 469 U.S. 1105 (1985); In re Riddervold, 647 F.2d 342 (2d Cir. 1981).

The Sixth Circuit, however, has rejected this position. 11 U.S.C. § 547(e)(3) says very plainly that a transfer does not occur until the debtor acquires rights in the property. A debtor has no right to wages until they are earned. Thus, for preference purposes, a transfer under a garnishment occurs when wages are earned and payable, not when the writ is served. If the wages were earned within the preference period, then the transfer may be avoided, even if the garnishment order was served outside the preference period. In re Morehead, 249 F.3d 445 (6th
Cir. 2001); accord In re James, 257 B.R. 673 (8th Cir. B.A.P. 2001); cf. Tops Appliance City, 372 F.3d at 510 (accepting the proposition that, in a garnishment, no transfer occurs until the wages are earned and contrasting that with the transfer of the proceeds of the debtor’s leases, which occurred upon closing, not when the debtor actually vacated the premises). This reasoning appears to be more accurate. The majority of bankruptcy court decisions, particularly recent ones, support the position that no garnishment transfer occurs until the wages are earned and payable. In re Casias, 332 B.R. 357 (Bankr. C.D. Ill. 2005); In re Price, 272 B.R. 828 (Bankr. W.D.N.Y. 2002) (holding that the Second Circuit’s Riddervold decision is no longer good law in light of Barnhill v. Johnson, 503 U.S. 393 (1992)); In re White, 258 B.R. 129 (Bankr. D.N.J. 2001); In re Chavez, 257 B.R. 341 (Bankr. D.N.M. 2001); In re Kaufman, 187 B.R. 167 (Bankr. E.D. La. 1995). Some courts, however, adhere to the older view on the rationale that a writ of garnishment cuts off the debtor’s rights in future wages and thus amounts to a present attachment when the writ is served. In re Flanagan, 296 B.R. 293 (Bankr. D. Conn. 2003).

5. The Creditor Must Have Received More Than It Would Have Received in a Chapter 7 Liquidation: 11 U.S.C. § 547(b)(5).

The final requirement for a preference action is that the creditor to or for whose benefit the transfer was made must have recovered a greater share of its claim on account of the transfer than the creditor would have received in a Chapter 7 liquidation, assuming that the transfer had not been made. 11 U.S.C. § 547(b)(5). This means that payments made to a fully secured creditor cannot be preferential as to that creditor. But see § III.F.6., infra. Such payments do not prejudice other creditors or diminish the estate; they merely serve to reduce the amount of the secured claim. In re Smith’s Home Furnishings, Inc., 265 F.3d 959 (9th Cir. 2001); In re Hagen, 922 F.2d 742 (11th Cir. 1991) (“A transfer to a secured creditor in the amount of its lien during
the preference period does not constitute an avoidable preference.”); In re Missionary Baptist Found. of Am., Inc., 796 F.2d 752 (5th Cir. 1986) (“It is commonplace that preference law exempts fully secured creditors from its grasp.”); In re Davis, 281 B.R. 626 (Bankr. W.D. Pa. 2002). So also the payment of a debt that is fully bonded by a solvent surety is not preferential. In re ML & Assocs., Inc., 301 B.R. 195 (Bankr. N.D. Tex. 2003). As a caveat, however, the secured creditor’s lien must be perfected. If it is not, the lien could be avoided in a hypothetical Chapter 7 case, and the creditor would be deemed unsecured. Thus, a payment to a creditor with an unperfected lien generally enables that creditor to receive more than it would in a Chapter 7 liquidation. In re Jones, 226 F.3d 917 (7th Cir. 2000).

Sometimes creditors may claim to be fully secured on the basis of rather unusual liens. If these liens are not avoidable by the estate, however, then a transfer to or for the benefit of such a creditor is immune from preference attack. In re Merchants Grain, Inc., 93 F.3d 1347 (7th Cir. 1996) (farmers held lien on grain in possession of debtor-elevator under Ohio statute, and lien was not avoidable; payment to farmers could not be preferential), cert. denied, 519 U.S. 1111 (1997); In re Korniczky, 308 B.R. 153 (Bankr. W.D.N.Y. 2004) (cotenant’s equitable charge on debtor’s interest for payment of taxes and expenses). Likewise, although a right of setoff is not a security interest under state law, it is treated as such for bankruptcy purposes. 11 U.S.C. § 506(a)(1); see id. § 553. Thus the transforee’s setoff rights must be taken into account for purposes of 11 U.S.C. § 547(b)(5). Braniff Airways, Inc. v. Exxon Co., U.S.A., 814 F.2d 1030 (5th Cir. 1987); In re Comptronix Corp., 239 B.R. 357 (Bankr. M.D. Tenn. 1999).

However a fully secured or oversecured creditor may claim that status, any transfers made to or for the benefit of that creditor cannot be preferential. In re Cannon, 237 F.3d 716 (6th Cir. 2001) (bank’s security interests in deposited check under Article 4 of the U.C.C.); In re

In the case of undersecured creditors, transfers from the debtor’s general funds are conclusively presumed to have been applied first to the unsecured debt, thus making the payments preferential to that extent. Drabkin v. A.I. Credit Corp., 800 F.2d 1153 (D.C. Cir. 1986); In re Alper-Richman Furs, Ltd., 147 B.R. 140 (Bankr. N.D. Ill. 1992); see In re Schwinn Bicycle Co., 182 B.R. 514 (Bankr. N.D. Ill. 1995) (noting that a transfer is preferential only to the extent that the creditor is undersecured); In re Lease-A-Fleet, Inc., 151 B.R. 341 (Bankr. E.D. Pa. 1993) (payment is preferential only to the extent that the payment exceeds the value of the undersecured creditor’s collateral). If, however, the undersecured creditor has merely received its own collateral or the proceeds of its collateral, then the creditor has not received more than it would have obtained in a Chapter 7 liquidation. Consequently, the transfer is not avoidable. In re El Paso Refinery, LP, 171 F.3d 249 (5th Cir. 1999); In re Telesphere Communications, Inc.,

Even though security interests are not necessarily involved, most courts hold that, if a debtor or trustee assumes a contract under 11 U.S.C. § 365, then the estate may not avoid a prepetition payment made under that contract as a preference. In re Kiwi Intern. Airlines, Inc., 344 F.3d 311 (3d Cir. 2003); In re LCO Enters., 12 F.3d 938 (9th Cir. 1993); Seidle v. GATX Leasing Corp., 778 F.2d 659 (11th Cir. 1985). 11 U.S.C. § 365 requires that all defaults must be cured if a contract is to be assumed. If the otherwise preferential transfer had not been made prepetition, it would have to be made later as part of the cure obligation. Thus, assuming a contract and avoiding a prepetition transfer under the contract are mutually exclusive. In re Superior Toy & Mfg. Co., Inc., 78 F.3d 1169 (7th Cir. 1996). If a contract is assumed, an otherwise preferential prepetition transfer does not enable the creditor to receive more than it would have obtained in a Chapter 7 case where the contract was assumed, and 11 U.S.C. § 547(b)(5) is not satisfied. Kiwi Intern. Airlines, 344 F.3d at 311; In re Teligent, Inc., 324 B.R. 479 (S.D.N.Y. 2005); In re Greater Southeast Community Hosp. Corp. I, 327 B.R. 26 (Bankr. D.D.C. 2005). In the same manner, the assumption of a contract precludes the avoidance of prepetition payments thereunder as actually or constructively fraudulent. Assumption requires a determination that the debtor or trustee exercised sound business judgment, and such a determination is incompatible with saying that prepetition transactions involved actual or constructive fraud. In re Network Access Solutions Corp., 330 B.R. 67 (Bankr. D. Del. 2005); In re Vision Metals, Inc., 325 B.R. 138 (Bankr. D. Del. 2005).

Some unsecured creditors have attempted to extend the principle that assumption of a contract precludes the avoidance of prepetition transfers by claiming that first day orders for the
payment of prepetition debts or alleged critical vendor status mean that they did not receive more by virtue of a prepetition payment than they would have received in a Chapter 7 liquidation. Bruce H. White & William L. Medford, *Zenith Industrial and the Critical Vendor Preference Defense*, 24-Apr. AM. BANKR. INST. J. 32 (2005). Generally, courts have been skeptical of such arguments. In re Hayes Lemmerz Intern., Inc., 313 B.R. 189 (Bankr. D. Del. 2004); see also In re CVEO Corp., 320 B.R. 258 (Bankr. D. Del. 2005) (carefully scrutinizing claim that a prepetition debt would be entitled to administrative expense status and whether this would negate Section 547(b)(5)). Authorization to pay certain prepetition claims is not equivalent to ordering the debtor to do so or to the assumption of a contract. In re Bridge Info. Sys., Inc., 321 B.R. 247 (Bankr. E.D. Mo. 2005). Furthermore, if the allegedly preferential transfer had not been made, it would be speculative to say that the court would have allowed the payment of the entire prepetition debt. In re Zenith Indus. Corp., 319 B.R. 810 (Bankr. D. Del. 2005). Although it is possible for a critical vendor order to expressly waive avoidance actions, any such proposed order will be subject to strict scrutiny. In re Tropical Sportswear Intern. Corp., 320 B.R. 15 (Bankr. M.D. Fla. 2005). Absent such an express waiver, it appears that critical vendor orders will not overcome potential preference liability in the way that contract assumption does. In re Fultonville Metal Prods. Co., 330 B.R. 305 (Bankr. M.D. Fla. 2005).

B. DEFENSES TO A PREFERENCE CLAIM UNDER 11 U.S.C. § 547(c) and 11 U.S.C. § 547(h).

11 U.S.C. § 547(c) establishes nine affirmative defenses to a preference action. Even if a transfer is otherwise avoidable as a preference under Section 547(b), the transaction may still be saved if it falls within one of these exceptions. In re Network Access Solutions Corp., 320 B.R. 57 (Bankr. D. Del. 2005); see In re McGuane, 305 B.R. 695 (Bankr. N.D. Ill. 2004) (summarizing the defenses). Under 11 U.S.C. § 547(g), the transferee or other defendant bears the burden of proving all the elements of any of these defenses. In re Shelton Harrison
Chevrolet, Inc., 202 F.3d 834 (6th Cir. 2000); Barber v. Golden Seed Co., 129 F.3d 332 (7th Cir. 1997); In re R.D.F. Developments, Inc., 239 B.R. 336 (6th Cir. B.A.P. 1999); Warsco v. Household Bank F.S.B., 272 B.R. 246 (Bankr. N.D. Ind. 2002), subsequently aff’d, 334 F.3d 638 (7th Cir.), cert. denied, 540 U.S. 1073 (2003). In addition, 11 U.S.C. § 547(h), which was added by BAPCPA in 2005, provides yet another limitation on the estate’s ability to avoid certain transfers as preferential.

1. **Contemporaneous Exchange for New Value: 11 U.S.C. § 547(c)(1).**

An otherwise preferential transfer may not be avoided if the debtor and the creditor intended the transaction to be a contemporaneous exchange for new value given to the debtor, and if the exchange were in fact substantially contemporaneous. 11 U.S.C. § 547(c)(1). Many courts have spoken as though this is the mirror image of the requirement that the transfer must have been made on account of an antecedent debt in order to be an avoidable preference in the first instance. See 11 U.S.C. § 547(b)(2). If the transfer were a contemporaneous exchange for new value, then it could not have been made in satisfaction of an already established claim, and if it were made on account of an antecedent debt, then it could not have been a contemporaneous exchange for new value. See, e.g., In re Southmark Corp., 62 F.3d 104 (5th Cir. 1995), cert. denied, 516 U.S. 1093 (1996); In re Garrett Tool & Eng’g, Inc., 273 B.R. 123 (E.D. Mich. 2002) (lease payments made as they accrued were contemporaneous exchanges and not on account of an antecedent debt); In re Hertzler Halstead Hosp., 334 B.R. 276 (Bankr. D. Kan. 2005). In fact, however, Sections 547(b)(2) and 547(c)(1) are analytically distinct, and several courts have recognized that it is possible for the affirmative defense to apply even if all elements of a preference claim are established. In re Ramba, Inc., 416 F.3d 394 (5th Cir. 2005); In re Armstrong, 291 F.3d 517 (8th Cir. 2002); In re Jannel Indus., Inc., 245 B.R. 757 (Bankr. D. Mass. 2000).
Section 547(c)(1) is meant to encourage creditors to continue to deal with financially distressed debtors, if only on a cash-and-carry basis. *In re Shelton Harrison Chevrolet, Inc.*, 202 F.3d 834 (6th Cir. 2000); *In re Jones Truck Lines, Inc.*, 130 F.3d 323 (8th Cir. 1997); *In re Payless Cashways, Inc.*, 306 B.R. 243 (8th Cir. B.A.P. 2004), aff’d, 394 F.3d 1082 (8th Cir. 2005); *In re Furrs Supermarkets, Inc.*, 296 B.R. 33 (Bankr. D.N.M. 2003). The new value, of course, must flow to the debtor. See *In re P.A. Bergner & Co.*, 140 F.3d 1111 (7th Cir.) (payment to the beneficiary under a standby letter of credit did not provide new value to the debtor, who was the applicant (account party)), *cert. denied*, 525 U.S. 964 (1998); *In re Bridge Info. Sys., Inc.*, 321 B.R. 247 (Bankr. E. D. Mo. 2005) (payment of benefits to debtor’s employees was new value for debtor); *In re Foxmeyer Corp.*, 286 B.R. 546 (Bankr. D. Del. 2002) (payments made by creditor to other creditors were new value for the debtor).

“New value” for relevant purposes is defined in 11 U.S.C. § 547(a)(2) as “money or money’s worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee . . . .” Under this definition, an intangible benefit cannot be considered new value. The value must be real and reducible to a specific dollar figure. *In re S.E.L. Maduro (Florida), Inc.*, 205 B.R. 987 (Bankr. S.D. Fla. 1997); *In re Aero-Fastener, Inc.*, 177 B.R. 120 (Bankr. D. Mass. 1994); *see Shelton Harrison Chevrolet*, 202 F.3d at 834 (after delivery of vehicle, manufacturer’s statement or certificate of origin had no independent value to car dealership; dealership could sell and pass title to vehicle without statement of origin). The cancellation or discharge of a preexisting obligation is obviously not new value. *In re Futoran*, 76 F.3d 265 (9th Cir. 1996); *In re Stewart*, 282 B.R. 871 (8th Cir. B.A.P. 2002); *In re Moses*, 256 B.R. 641 (10th Cir. B.A.P. 2001); *cf. In re Riley*, 297 B.R. 122 (Bankr. E.D. Ark. 2003) (restoration of a line of credit following payment so that debtor could make further charges was
neither a contemporaneous exchange nor new value). The policy behind Section 547(c)(1) is that the net worth of the estate must be enhanced, or at least not diminished, by the new transaction. At least as much must be available to creditors after the transfer as there was before. In re Computer Personalities Sys., Inc., 320 B.R. 812 (Bankr. W.D. Pa. 2005); In re RDM Sports Group, Inc., 250 B.R. 805 (Bankr. N.D. Ga. 2000); In re Cocolat, Inc., 176 B.R. 540 (Bankr. N.D. Cal. 1995).


On the other hand, new credit is plainly new value. In re Kumar Bavishi & Assocs., 906 F.2d 942 (3d Cir. 1990); In re C.P.P. Export & Import, Inc., 132 B.R. 962 (D. Kan. 1991); see In re Filtercorp, Inc., 163 F.3d 570 (9th Cir. 1998). Clearly, new goods or services are new value.
In re H & S Transp. Co., 939 F.2d 355 (6th Cir. 1991); Payless Cashways, 306 B.R. at 243; In re Armstrong, 234 B.R. 899 (Bankr. E.D. Ark. 1999) (legal services); In re Maxwell Newspapers, Inc., 192 B.R. 633 (Bankr. S.D.N.Y. 1996) (insurance coverage). Indeed, the goods or services may come from a third party rather than the transferee, provided that the goods or services were furnished as a result of the transfer. *Jones Truck Lines*, 130 F.3d at 323 (debtor received new services as a result of weekly employee benefit payments; services came from employees rather than from benefit fund directly, but payment to benefit fund was functionally equivalent to paying wages to employees); In re Fuel Oil Supply & Terminaling, Inc., 837 F.2d 224 (5th Cir. 1988) (banks released debtor’s collateral when creditor released letters of credit provided by debtor following debtor’s performance; new value flowed from banks rather than from creditor transferee directly). The release of a lien or security interest is also new value. In re Robinson Bros. Drilling, Inc., 877 F.2d 32 (10th Cir. 1989); see In re JWJ Contracting Co., Inc., 287 B.R. 501 (9th Cir. B.A.P. 2003) (subcontractor’s release of claim against payment bond in return for payment was new value to the extent that surety was secured by remaining contract proceeds), aff’d, 371 F.3d 1079 (9th Cir. 2004).

11 U.S.C. § 547(c)(1) requires both that the exchange must have been intended by the parties to be substantially contemporaneous, and, in addition, that the exchange must have been substantially contemporaneous in fact. In re Gateway Pacific Corp., 153 F.3d 915 (8th Cir. 1998); In re Messamore, 250 B.R. 913 (Bankr. S.D. Ill. 2000). “Substantially contemporaneous” is a flexible criterion, and a court should examine the nature of the transaction, the length of any delay, the reasons for the delay, and any possibility for abuse. In re Dorholt, Inc., 224 F.3d 871 (8th Cir. 2000); Pine Top Ins. Co. v. Bank of Am. Nat’l Trust & Sav. Ass’n, 969 F.2d 321 (7th Cir. 1992); In re Marino, 193 B.R. 907 (9th Cir. B.A.P. 1996), aff’d, 117 F.3d 1425 (9th Cir.
1997); In re Hayes Lemmerz Intern., Inc., 329 B.R. 136 (Bankr. D. Del. 2005). Whether the
parties intended a contemporaneous exchange and whether the exchange actually was
substantially contemporaneous involves a case-by-case inquiry. See, e.g., In re JWJ Contracting
Co., Inc., 371 F.3d 1079 (9th Cir. 2004) (creditor released lien upon receipt of check that was
later returned for insufficient funds; debtor then paid with cashier’s check; release of lien was not
substantially contemporaneous with payment by cashier’s check); Armstrong, 291 F.3d at 517
(payment of gambling debt to casino roughly 30 days after debt was incurred was neither
intended to be contemporaneous nor substantially contemporaneous in fact); In re APS Holding
(Bankr. D. Mass. 2001) (percentage payments made to financial advisor based on success in
obtaining investors for debtor’s stock were intended to be contemporaneous payments for
services and were substantially contemporaneous in fact); In re NMI Sys., Inc., 179 B.R. 357
(Bankr. D. Colo. 1995) (employee’s advance draws against year-end bonus were not intended by
debtor corporation or by employee as contemporaneous exchanges).

A brief delay in payment will not necessarily vitiate this defense. In re General Time
Corp., 328 B.R. 243 (Bankr. N.D. Ga. 2005). Section 547(c)(1), however, was meant to protect
cash-and-carry or similar arrangements. In re Hechinger Inv. Co. of Delaware, 326 B.R. 282
no credit transaction falls under the protection of this statute. Computer Personalities Sys., 320
transactions are not contemporaneous exchanges for new value. Hertzler Halstead Hosp., 334
Many of the disputes under Section 547(c)(1) have concerned payment by check. Payment is not final until the drawee bank honors the check and debits the customer’s account. If rights or other property are exchanged for a check, there may be some dispute as to whether the transaction involved a contemporaneous exchange. For purposes of 11 U.S.C. § 547(b), a transfer by the debtor is deemed complete when the drawee bank honors the check, not when the debtor tenders the check. *Barnhill v. Johnson*, 503 U.S. 393 (1992); see *In re Greene*, 223 F.3d 1064 (9th Cir. 2000); *In re M Group, Inc.*, 308 B.R. 697 (Bankr. D. Del. 2004). For purposes of 11 U.S.C. § 547(c), however, the time of the exchange is normally deemed to be the time the check is delivered. *Braniff Airways, Inc. v. Midwest Corp.*, 873 F.2d 805 (5th Cir. 1989); *Hayes Lemmerz*, 329 B.R. at 136; *In re H.L. Hansen Lumber Co. of Galesburg, Inc.*, 270 B.R. 273 (Bankr. C.D. Ill. 2001). Thus, payment by check may involve a substantially contemporaneous exchange, provided that the check is presented and honored within a reasonable time after it is received. *In re Tennessee Chem. Co.*, 112 F.3d 264 (6th Cir. 1997); *In re Locklin*, 101 F.3d 435 (5th Cir. 1996); *In re M&L Bus. Mach. Co.*, 198 B.R. 800 (D. Colo. 1996); *In re Sonicraft, Inc.*, 238 B.R. 409 (Bankr. N.D. Ill. 1999). On the other hand, if a check is dishonored, or if there is an unreasonable delay in presenting it, then the transaction may be deemed a credit arrangement, not a substantially contemporaneous exchange. *In re Lee*, 179 B.R. 149 (9th Cir. B.A.P. 1995), *aff’d*, 108 F.3d 239 (9th Cir. 1997); *In re Stewart*, 274 B.R. 503 (Bankr. W.D. Ark.), *aff’d*, 282 B.R. 871 (8th Cir. B.A.P. 2002); see *JWJ Contracting*, 371 F.3d at 1079.


(a) **Introduction.**

One of the most frequently litigated defenses to a preference action is the ordinary course of business exception established by 11 U.S.C. § 547(c)(2). *See* Kenneth P. Coleman, *The “Ordinary Course of Business” Preference Exception: Debtor/Creditor Relationship and*
Industry Practice Can Be Key, 115 BANKING L.J. 613 (1998). The purpose of this statute is to ensure that normal and customary credit transactions are left undisturbed, so that only transfers resulting from unusual debt collection or payment practices will be set aside as preferences. Union Bank v. Wolas, 502 U.S. 151 (1991); In re Issac Leaseco, Inc., 389 F.3d 1205 (11th Cir. 2004); In re Healthco Intern., Inc., 132 F.3d 104 (1st Cir. 1997); In re Hedged-Investments Assocs., Inc., 48 F.3d 470 (10th Cir. 1995).

There are two elements to this defense: (a) the transfer must have been on account of a debt incurred in the ordinary course of the business or financial affairs of the debtor and the transferee; and (b) either (i) the transfer must have been made in the ordinary course of the business or financial affairs of the debtor and the transferee; or (ii) the transfer must have been made according to ordinary business terms. Prior to the enactment of BAPCPA in 2005, a defendant had to show both that the transfer was normal or typical as between the parties and that it was made according to ordinary business terms in addition to demonstrating that the debt was incurred in the ordinary course of business. In re Tolona Pizza Prods. Corp., 3 F.3d 1029 (7th Cir. 1993); In re Fred Hawes Organization, Inc., 957 F.2d 239 (6th Cir. 1992); In re Vogel Van & Storage, Inc., 210 B.R. 27 (N.D.N.Y. 1997), aff’d, 142 F.3d 571 (2d Cir. 1998); In re Furr’s Supermarkets, Inc., 320 B.R. 1 (Bankr. D.N.M. 2005).

In 1997, the National Bankruptcy Review Commission recommended a change in the ordinary course of business defense that would ease the burden on preference defendants. The Commission proposed retaining the requirement that the debt must have been incurred in the ordinary course of the business or financial affairs of the debtor and the transferee. This would eliminate unlawful or fraudulent transactions as well as debts incurred in the ordinary course of the business of only one of the parties. See In re Armstrong, 291 F.3d 517 (8th Cir. 2002); In re
CVEO Corp., 320 B.R. 258 (Bankr D. Del. 2005). The Commission recommended, however, that the two remaining criteria — that the transfer must have been ordinary in the course of dealings between the parties and that the transfer must have been made according to ordinary business terms — be offered in the alternative. The ordinary course of business defense would apply either if the transfer conformed to the parties’ customary practices prior to the preference period or if it conformed to industry norms. Thus, in many instances involving a longstanding relationship, a transfer could be validated solely on the basis that it was normal between the parties. On the other hand, if the relationship had been very short or if there was no established course of dealing between the debtor and the transferee, a transfer could be shielded solely on the basis that it conformed to industry customs. NATIONAL BANKRUPTCY REVIEW COMMISSION, FINAL REPORT, BANKRUPTCY: THE NEXT TWENTY YEARS, Rec. 3.2.3 (1997); see In re Issac Leaseco, Inc., 389 F.3d 1205 (11th Cir. 2004) (when parties’ relationship had been short, court virtually ignored whether challenged transfer had been normal between the parties and focused almost entirely on whether it had been according to ordinary business terms); In re U.S. Interactive, Inc., 321 B.R. 388 (Bankr. D. Del. 2005) (when there is no longstanding relationship between the parties to establish a pattern of dealings, industry norms assume greater importance).

The Commission’s recommendation was embodied in Section 409 of BAPCPA and has now been enacted. 11 U.S.C. § 547(c)(2) has been amended effective for all cases filed on or after October 17, 2005. The main body of Section 547(c)(2) contains the requirement formerly codified in Section 547(c)(2)(A) that the debt or obligation must have been incurred in the ordinary course of the business or financial affairs of both parties. In addition, the defendant must demonstrate either that the transfer was made in the ordinary course of the business and financial affairs of the parties, 11 U.S.C. § 547(c)(2)(A) (formerly codified as Section
547(c)(2)(B)), or that the transfer was made according to ordinary business terms. 11 U.S.C. § 547(c)(2)(B) (formerly codified as Section 547(c)(2)(C)). This change should be advantageous for preference defendants and lessen the burdens of establishing the ordinary course of business defense. See Kevin C. Driscoll, Jr., Bankruptcy 2005: New Landscape for Preference Proceedings, 24-Jun. Am. Bankr. Inst. J. 1 (2005).

(b) Debt Incurred in the Ordinary Course of Business or Financial Affairs: 11 U.S.C. § 547(c)(2).

The indispensable requirement of the ordinary course of business defense—that the debt must have been incurred in the ordinary course of the business or financial affairs of the debtor and the creditor—means that the underlying debtor/creditor relationship itself must be normal and for ordinary purposes. In re Finn, 909 F.2d 903 (6th Cir. 1990); In re Youthland, Inc., 160 B.R. 311 (Bankr. S.D. Ohio 1993). There is no need to show that the relevant sort of transaction occurred commonly, however, or that the debtor and the creditor had a longstanding relationship; a first-time transaction may qualify. Kleven v. Household Bank F.S.B., 334 F.3d 638 (7th Cir.), cert. denied, 540 U.S. 1073 (2003); In re US Office Prods. Co., 315 B.R. 37 (Bankr. D. Del. 2004); In re Air South Airlines, Inc., 247 B.R. 153 (Bankr. D.S.C. 2000). All that must be shown is that the transaction was nothing out of the ordinary for similarly situated parties. In re Speco Corp., 218 B.R. 390 (Bankr. S.D. Ohio 1998).

The transaction must bear the hallmarks of an arm’s-length bargain. It must not be suspect or bespeak an intent to gain some advantage over other creditors. In re Valley Steel Corp., 182 B.R. 728 (Bankr. W.D. Va. 1995); In re Kiddy Toys, Inc., 178 B.R. 928 (Bankr. D.P.R. 1994). For example, the payment of bonuses to a business entity’s principals, particularly when the business is on the verge of insolvency, is outside the ordinary course of business virtually by definition. In re Apex Automotive Warehouse, L.P., 238 B.R. 758 (Bankr. N.D. Ill.

The debt must have been incurred in the ordinary course of the business or financial affairs of both parties, not just the creditor. For example, extending credit for gambling may be part of the ordinary course of a casino’s business, but incurring such a debt is not in the ordinary course of the debtor’s business unless the debtor happens to be a professional gambler. In re Armstrong, 291 F.3d 517 (8th Cir. 2002). Similarly, while rendering legal services in a struggle for control of a corporation is within the ordinary course of a law firm’s business, incurring a debt for such legal fees is not part of the ordinary course of the corporation’s business. In re Crystal Med. Prods., Inc., 240 B.R. 290 (Bankr. N.D. Ill. 1999); see In re CVEO Corp., 320 B.R. 258 (Bankr. D. Del. 2005).

The statutory mandate that the debt must have been incurred in the ordinary course of business of both parties “is not often litigated and is usually easily satisfied in the case of transactions with unrelated parties for general business purposes.” In re Tax Reduction Institute, 148 B.R. 63 (Bankr. D.D.C. 1992); see In re First Jersey Securities, Inc., 180 F.3d 504 (3d Cir. 1999); In re Roberds, Inc., 315 B.R. 443 (Bankr. S.D. Ohio 2004) (noting that a discussion of
this element of the ordinary course of business defense is almost completely absent from the analysis of many courts; *In re Furrs Supermarkets, Inc.*, 296 B.R. 33 (Bankr. D.N.M. 2003). One area where there has been a split of authority, however, concerns cases where the debtor was operating a Ponzi scheme. Speaking very broadly, some courts have appeared to hold that the ordinary course of business defense is per se inapplicable to such an operation because the debtor has no legitimate business in the first instance. *Henderson v. Buchanan*, 985 F.2d 1021 (9th Cir. 1993); *In re Taubman*, 160 B.R. 964 (Bankr. S.D. Ohio 1993); see *In re Carrozzella & Richardson*, 247 B.R. 595 (2d Cir. B.A.P. 2000) (Ponzi-like operation was not an ordinary business, and running such an investment scheme was certainly not within the ordinary course of a law firm’s financial affairs). Other courts, however, have taken the view that just because the debtor does not have an ordinary business, this does not mean that there can be no such thing as the ordinary course of the business that the debtor does have. *In re Independent Clearing House Co.*, 77 B.R. 843 (D. Utah 1987).

Examining the relevant decisions, the Tenth Circuit has struck what appears to be a reasonable balance. The Tenth Circuit has held that payments to participants in a Ponzi scheme or other illegitimate enterprise simply cannot be in the ordinary course of business, and that this defense is not available to promoters or investors. *In re Hedged-Investments Assocs.*, 48 F.3d 470 (10th Cir. 1995). Virtually all courts would agree with that proposition. *In re Carrozzella & Richardson*, 270 B.R. 325 (Bankr. D. Conn. 2001). On the other hand, the Tenth Circuit has held that there is no reason why innocent creditors who are not investors or otherwise directly implicated in the tainted activity should not be able to claim that they dealt with the Ponzi debtor in the ordinary course of business. *Hedged-Investments*, 48 F.3d at 470; accord *In re M&L

Often the same transaction may be challenged as both a preference and a fraudulent transfer. In such a case, if the transfer is found to be actually or constructively fraudulent, this, without more, may preclude any ordinary course of business defense to a preference attack. In re M&L Business Mach. Co., 194 B.R. 496 (D. Colo. 1996); see In re Sanders, 213 B.R. 324 (Bankr. M.D. Tenn. 1997) (ordinary course of business defense could not apply to payments that debtor had made for benefit of debtor’s mother when debtor was not personally liable for the obligation and had not guaranteed it). In addition, it has been held that payments made to settle a claim or lawsuit simply cannot be in the ordinary course of business. It would be difficult to think of such payments as involving normal credit transactions. In re Valley Steel Prods. Co., 214 B.R. 202 (E.D. Mo. 1997); In re Quality Botanical Ingredients, Inc., 249 B.R. 619 (Bankr. D.N.J. 2000).


The first alternative additional element of the ordinary course of business exception is that the transfer must have been made in the ordinary course of the parties’ business or financial affairs. 11 U.S.C. § 547(c)(2)(A) (formerly codified as 11 U.S.C. § 547(c)(2)(B)); see Kenneth P. Coleman, The “Ordinary Course of Business” Preference Exception: Debtor/Creditor Relationship and Industry Practice Can Be Key, 115 BANKING L.J. 613 (1998). This involves a “subjective” inquiry as to what was normal between the parties, not what general practices are in the relevant industry. In re First Jersey Securities, Inc., 180 F.3d 504 (3d Cir. 1999); Barber v. Golden Seed Co., 129 F.3d 382 (7th Cir. 1997); In re Carled, Inc., 91 F.3d 811 (6th Cir. 1996); In re GGS Liquidation, Inc., 313 B.R. 770 (Bankr. N.D. Ill. 2004); In re Bridge
On the other hand, if the payments during the preference period were elicited or resulted from threats or dunning letters, this may be incompatible with an ordinary course of business defense. Such practices show that the creditor did not voluntarily acquiesce in the late payments. *In re Accessair, Inc.*, 314 B.R. 386 (8th Cir. B.A.P. 2004); *In re Sibilrud*, 308 B.R. 388 (Bankr. D. Minn. 2004); *In re Cyberrebate.com, Inc.*, 296 B.R. 639 (Bankr. E.D.N.Y. 2003); *In re Jotan, Inc.*, 264 B.R. 735 (Bankr. M.D. Fla. 2001); see *Jones Truck Lines, Inc. v. Full Serv. Leasing Corp.*, 83 F.3d 253 (8th Cir. 1996). Likewise, a creditor’s sudden demand for cash payments and a lowering of credit limits will show that the transfer did not fall within the normal course of dealing. *In re Stewart*, 282 B.R. 871 (8th Cir. B.A.P. 2002) (payment with certified funds after debtor’s personal checks had been dishonored); *In re Thompson Boat Co.*, 199 B.R. 908 (Bankr. E.D. Mich. 1996); see *In re P.A. Begner & Co.*, 140 F.3d 1111 (7th Cir.) (seizing debtor-account party’s funds after making payment under standby letter of credit was not in the ordinary course of business), *cert. denied*, 525 U.S. 964 (1998).

Similarly, payments that are extraordinary in amount, *In re Healthco Intern., Inc.*, 132 F.3d 104 (1st Cir. 1997); *In re Springfield Contracting Corp.*, 154 B.R. 214 (Bankr. E.D. Va. 1993) (payment four times what had been usual), or that are otherwise abnormal in light of the parties’ past dealings, generally vitiate this element of an ordinary course of business defense. *First Jersey Securities*, 180 F.3d at 504 (payment in restricted stock); *In re Gateway Pacific Corp.*, 153 F.3d 915 (8th Cir. 1998) (payments during preference period significantly later than in the past); *In re Milwaukee Cheese Wisconsin, Inc.*, 112 F.3d 845 (7th Cir. 1997); *In re Ladede Steel Co.*, 271 B.R. 127 (8th Cir. B.A.P.) (“excruciatingly late” payments during the preference period), *aff’d*, 47 Fed. Appx. 784 (8th Cir. 2002); *In re Logan Square East*, 254 B.R. 850 (Bankr. E.D. Pa. 2000) (payments made in response to threats to have a receiver appointed); *R.M. Taylor*,
245 B.R. at 629 (payments made before they were due); In re CIS Corp., 195 B.R. 251 (Bankr. S.D.N.Y. 1996) (unusually large bonus to high executive on the eve of bankruptcy); In re Everlock Fastening Sys., Inc., 171 B.R. 251 (Bankr. E.D. Mich. 1994) (payment by cashier's check on eve of bankruptcy filing).

It should be noted that special demands by the creditor, without more, will not negate this aspect of the ordinary course of business defense. There must actually have been a change in the payment pattern before Section 547(c)(2)(A) will be undermined. If the debtor continues to make payments as it always has despite the creditor’s dunning, or if the creditor simply asks the debtor to continue making payments in the customary manner and the debtor complies, then Section 547(c)(2)(A) is satisfied. In re Roberds, Inc., 315 B.R. 443 (Bankr. S.D. Ohio 2004); In re AppOnline.Com, Inc., 315 B.R. 259 (Bankr. E.D.N.Y. 2004).


The second alternative additional element of the ordinary course of business defense is that the transfer must have been according to “ordinary business terms.” 11 U.S.C. § 547(c)(2)(B) (formerly codified as 11 U.S.C. § 547(c)(2)(C) prior to BAPCPA). This inquiry is “objective,” focusing on what the norms of the relevant industry are. E.g., In re Carled, Inc., 91 F.3d 811 (6th Cir. 1996); In re Roblin Indus., Inc., 78 F.3d 30 (2d Cir. 1996); Advo-System, Inc. v. Maxway Corp., 37 F.3d 1044 (4th Cir. 1994). For many years, the Eleventh Circuit appeared to be unique in employing a subjective or quasi-subjective test in this respect. In re Craig Oil Co., 785 F.2d 1563 (11th Cir. 1986); see In re L. Bee Furniture Co., 206 B.R. 981 (Bankr. M.D. Fla. 1997). In 1998, however, the Eleventh Circuit held that Craig Oil had been misinterpreted, and that an objective or industry standard test should be used. In re A & W Assocs., Inc., 136 F.3d 1439 (11th Cir. 1998).
The sort of arrangement in question need not be usual or common; it need only fall within the range of accepted industry practices. *In re Air South Airlines, Inc.*, 247 B.R. 153 (Bankr. D.S.C. 2000); see *In re Bridge Info. Sys., Inc.*, 311 B.R. 774 (Bankr. E.D. Mo. 2004). It must not be freakish or idiosyncratic. It will pass muster, however, so long as it is within the outer limits of industry norms. *Barber v. Golden Seed Co.*, 129 F.3d 382 (7th Cir. 1997); *In re U.S.A. Inns of Eureka Springs, Ark., Inc.*, 9 F.3d 680 (8th Cir. 1993). The creditor must be prepared to present evidence of what the practices in the relevant industry are, not merely what its own practices have been. *In re DeMert & Dougherty, Inc.*, 232 B.R. 103 (N.D. Ill. 1999); *In re M Group, Inc.*, 308 B.R. 697 (Bankr. D. Del. 2004); *In re Contempri Homes, Inc.*, 269 B.R. 124 (Bankr. M.D. Pa. 2001); *In re Berger Indus., Inc.*, 260 B.R. 639 (Bankr. E.D.N.Y. 2001); see *Gasmark Ltd. Liquidating Trust v. Louis Dreyfus Natural Gas Corp.*, 158 F.3d 312 (5th Cir. 1998) (material fact issues remained concerning industry practice). To allow the creditor to establish this requirement simply by introducing evidence of its own practices could undermine the distinction between Section 547(b)(2)(B) and Section 547(b)(2)(A). *In re H.L. Hansen Lumber Co. of Galesburg, Inc.*, 270 B.R. 273 (Bankr. C.D. Ill. 2001); see *In re Gulf City Seafoods, Inc.*, 296 F.3d 363 (5th Cir. 2002) (when there was no evidence of the standard practices in the relevant industry, it was reversible error to render judgment for the preference defendant on the basis of the ordinary course of business defense); *In re Van Dyck/Columbia Printing*, 263 B.R. 167 (Bankr. D. Conn. 2001).

The defendant’s evidence of practices in the relevant industry may take the form of expert testimony, although an outside expert witness is not required. One of the defendant’s own employees may testify if he or she is familiar with industry norms. *In re Midway Airlines*, 69 F.3d 792 (7th Cir. 1995); *In re Globe Bldg. Materials, Inc.*, 325 B.R. 253 (Bankr. N.D. Ind.

Prior to the effective date of BAPCPA in 2005, several courts, in effect, balanced the ordinary course of dealings test and the ordinary business terms test. The longer the prepetition relationship between the parties has been, and the closer the questioned transfers were to their usual dealings before the preference period, the greater was the departure from standard commercial transactions that some courts allowed. In re Molded Acoustical Prods., Inc., 18 F.3d 217 (3d Cir. 1994); In re J. Allen Steel Co., 321 B.R. 764 (Bankr. W.D. Pa. 2005); In re L. Bee Furniture, Inc., 250 B.R. 757 (Bankr. M.D. Fla. 2000); Lawrence Ponoroff & Julie C. Ashby, Desperate Times and Desperate Measures: The Troubled State of the Ordinary Course of Business Defense—And What to Do About It, 72 WASH. L. REV. 5 (1997); cf. In re Issac Leaseco, Inc., 390 F.3d 1205 (11th Cir. 2004) (when parties’ prepetition relationship was very
short, court virtually ignored Section 547(c)(2)(B) — now codified as Section 547(c)(2)(A) — and focused entirely on Section 547(c)(2)(C) — now codified as Section 547(c)(2)(B)). One court went so far as to hold that, when the challenged payments fall within the bounds of the parties’ longstanding practices, there is no need to examine the norms of the relevant industry at all. *In re Color Tile, Inc.*, 239 B.R. 872 (Bankr. D. Del. 1999). This position went too far under the former version of Section 547(c)(2), however. Even if a greater variance from industry norms would be allowed if the parties had a longstanding course of dealings, industry practices could not be ignored, and a gross departure would undermine the ordinary course of business defense. *In re Allegheny Health, Educ. & Research Found.*, 127 Fed. Appx. 27 (3d Cir. 2005); *In re Terry Mfg. Co.*, 332 B.R. 630 (Bankr. M.D. Ala. 2005); *In re J. Allen Steel Co.*, 323 B.R. 425 (Bankr. W.D. Pa. 2005).

Where the challenged practice is within the norms of the relevant industry, the transfer will be held to have been made on ordinary business terms. *E.g.*, *Carled*, 91 F.3d at 811; *In re Tulsa Litho Co.*, 232 B.R. 240 (Bankr. N.D. Okla. 1998), aff’d, 229 B.R. 806 (10th Cir. B.A.P. 1999); *In re Computrex Intern., Inc.*, 334 B.R. 229 (Bankr. W.D. Ky. 2005) (routine reimbursement of employee expenses); *In re Al Cohen’s Rye Bread Bakery, Inc.*, 202 B.R. 546 (Bankr. W.D.N.Y. 1996) (utility was required by statute to enter into deferred payment plan with customers whose payments were in arrears; payments were on ordinary business terms as a matter of law); *see* Lisa Sommers Gretchko & Patrick Casey Coston, *Sharpening and Polishing the “Objective Prong” of § 547(c)(2)—A Look at the Ordinary Course of Business Preference Defense*, 17-Sept. Am. BANKR. INST. J. 32 (1998). On the other hand, transfers that are completely outside of industry practice cannot meet this criterion. *E.g.*, *In re Sunset Sales, Inc.*, 220 B.R. 1005 (10th Cir. B.A.P. 1998); *In re Stewart*, 274 B.R. 503 (Bankr. W.D. Ark.)
(payments after the day of sale were not normal in the cattle business), aff’d, 282 B.R. 871 (8th Cir. B.A.P. 2002); In re Lakeside Community Hosp., Inc., 200 B.R. 853 (Bankr. N.D. Ill. 1996) (payment of a tax debt more than one year late); In re Thompson Boat Co., 199 B.R. 908 (Bankr. E.D. Mich. 1996) (late payments not accepted in relevant industry); In re CIS Corp., 195 B.R. 251 (Bankr. S.D.N.Y. 1996) (large and unexplained bonus to executive was beyond the pale of industry custom).

There is a split of authority as to whether arrangements that are used in the relevant industry only with distressed debtors or in workout situations can ever amount to ordinary business terms. See Janet E. Byrne Thabit, Ordinary Business Terms: Setting the Standard for 11 U.S.C. § 547(c)(2)(C), 26 LOY. U. CHI. L.J. 473 (1995). Some courts, notably the Tenth Circuit, hold that “ordinary business terms” refers to arrangements used with financially sound debtors, so that terms used only when a debtor is in difficulty cannot be ordinary. In re Meredith Hoffman Partners, 12 F.3d 1549 (10th Cir. 1993) (escrow system was not on ordinary business terms; it may have been commonly used, but only with troubled debtors), cert. denied, 512 U.S. 1206 (1994); see Molded Acoustical Products, 18 F.3d at 217. The rationale in these cases is that rigid debt collection practices used only when a debtor is in difficulty should not provide a shield against avoidance. See In re Furrs Supermarkets, Inc., 296 B.R. 33 (Bankr. D.N.M. 2003). The majority of courts, however, hold that workout agreements designed especially for debtors in financial difficulty may indeed amount to ordinary business terms, provided that they fall within the range of industry practices. A strong argument can be made that recognizing the validity of such transactions serves the basic policy of 11 U.S.C. § 547(c)(2): encouraging creditors to continue doing business with troubled debtors. Jan Weilert RV, 315 F.3d at 1192; Carled, 91 F.3d at 811; Roblin Indus., 78 F.3d at 30; U.S.A. Inns of Eureka Springs, 9 F.3d at

11 U.S.C. § 547(c)(3) protects purchase money security interests. The bankruptcy estate may not avoid a security interest that secures new value that was given at or after the signing of a security agreement describing the collateral and that was: (a) given by or on behalf of the secured party; (b) given to enable the debtor to acquire the collateral; and (c) in fact used by the debtor to acquire the collateral. The security interest must have been perfected within 30 days of the time the debtor received possession of the property. 11 U.S.C. § 547(c)(3)(B). Between 1994 and 2005, the time for perfection had been 20 days. This was changed to 30 days by Section 1222 of BAPCPA. Section 547(c)(3)(B) applies only to purchase money security interests or enabling loans, and not to any other sort of transaction. In re Air Vermont, Inc., 45 B.R. 817 (D. Vt. 1984); In re Moeri, 300 B.R. 326 (Bankr. E.D. Wis. 2003); In re Carson, 119 B.R. 264 (Bankr. E.D. Okla. 1990). This defense is not limited to creditors who make enabling loans for the acquisition of personal property, however. It may also be used by purchase money mortgagees. In re Alexander, 219 B.R. 255 (Bankr. D. Minn. 1998); see In re Pearce, 236 B.R. 261 (Bankr. S.D. Ill. 1999) (purchase money mortgage lender attempted to use this defense but was unsuccessful because it failed to perfect its lien within the specified time); see also In re Lewis, 270 B.R. 215 (Bankr. W.D. Mich. 2001) (residential refinancing lender could not use this defense when it waited too long to perfect its lien).
Section 547(c)(3) is typically the only defense that a purchase money or enabling lender may use. Those courts of appeals that have addressed the issue have held that if such a creditor cannot bring an otherwise avoidable preference under the aegis of Section 547(c)(3), then the lender may not resort to the contemporaneous exchange for new value exception of Section 547(c)(1). In re Locklin, 101 F.3d 435 (5th Cir. 1996); In re Holder, 892 F.2d 29 (4th Cir. 1989); In re Tressler, 771 F.2d 791 (3d Cir. 1985); In re Davis, 734 F.2d 604 (11th Cir. 1984); In re Arnett, 731 F.2d 358 (6th Cir. 1984); In re Vance, 721 F.2d 259 (9th Cir. 1983); see In re Lopez, 265 B.R. 570 (Bankr. N.D. Ohio 2001) (discussing the weight of authority on this question). A nonpurchase money secured lender, however, may rely on the contemporaneous exchange for new value defense to protect its security interest. In re Dorholt, Inc., 224 F.3d 871 (8th Cir. 2000); In re Moon, 262 B.R. 97 (Bankr. D. Or. 2001); see In re Filtercorp, Inc., 163 F.3d 570 (9th Cir. 1998).

Prior to 1994, 11 U.S.C. § 547(c)(3)(B) required that a purchase money security interest had to be perfected within 10 days of the time that the debtor received possession of the collateral. This conformed to the original official text of former U.C.C. §§ 9-301(2), 9-312(4) allowing a purchase money lender 10 days in which to perfect its security interest in order to achieve priority. Most states, however, later departed from this text and allowed an enabling lender at least 20 days in which to perfect. This dichotomy between state law and the Bankruptcy Code created difficulties. See Edwin E. Smith & Steven L. Harris, Provisions of the Bankruptcy Reform Act of 1994 Affecting Transactions Under the Uniform Commercial Code, C965 ALI-ABA 547 (1994).

Under the former version of Article 9, and under the current U.C.C. § 9-324, the timely perfection of a purchase money security interest is deemed to relate back, so that the interest is
held to be perfected as soon as it attaches. A few courts held that this state law relation back doctrine applied in bankruptcy, reasoning that a purchase money security interest duly perfected within 20 days under state law would be deemed timely, even though it were outside the literal 10-day period of the pre-1994 version of 11 U.S.C. § 547(c)(3)(B). In re Hesser, 984 F.2d 345 (10th Cir. 1993); In re Busenlehner, 918 F.2d 928 (11th Cir. 1990), cert. denied, 500 U.S. 949 (1991). Most courts disagreed, however, reasoning that the 10-day period of former Section 547(c)(3)(B) overrode state law, so that if a purchase money security interest were perfected more than 10 days after the debtor acquired the collateral, this defense to a preference action would not lie, even if perfection had occurred within the 20-day period specified by state law. In re Walker, 77 F.3d 322 (9th Cir. 1996); In re Hamilton, 892 F.2d 1230 (5th Cir. 1990); In re Loken, 175 B.R. 56 (9th Cir. B.A.P. 1994).

The Bankruptcy Reform Act of 1994 attempted to put an end to such disputes. As amended by that legislation, 11 U.S.C. § 547(c)(3)(B) provided that an enabling lender had 20 days in which to perfect a purchase money security interest. Section 9-324 of the current Article 9 also provides that a purchase money security interest is deemed continuously perfected if it is perfected within 20 days of the time that the debtor receives possession of the collateral. This conformity of the Bankruptcy Code with the law of most states was designed to help purchase money lenders and to save litigation. See David G. Hicks, The October Surprise: The Bankruptcy Reform act of 1994—An Analysis of Title II—The Commercial Issues, 29 CREIGHTON L. REV. 499 (1996). What constitutes perfection or when a purchase money security interest is perfected is a question of state law. The answer may vary from state to state, particularly with respect to motor vehicles. The creditor must have taken all the necessary steps within the relevant period, following the law of the relevant state, in order to claim the benefit of this

Until January, 1998, it might have been possible to argue that, if the creditor had perfected its purchase money security interest more than 20 days after the debtor acquired possession of the collateral, and if state law were more generous than the Bankruptcy Code and would allow the perfection to relate back, then a creditor could still assert the enabling loan defense. *See* Timothy R. Zinnecker, *Purchase Money Security Interests in the Preference Zone: Questions Answered and Questions Raised by the 1994 Amendments to Bankruptcy Code* § 547, 62 Mo. L. Rev. 47 (1997). This would amount to following the reasoning of *Hesser*, 984 F.2d at 345, and *Busenlehner*, 918 F.2d at 928, under the 1994 version of Section 547(c)(3)(B). The Supreme Court, however, rejected this position in January, 1998, holding that Congress meant to establish a uniform 20-day period for perfection. If the enabling lender did not take all the steps required by state law to perfect within 20 days of the time that the debtor received possession of the collateral, then, as a matter of federal law, the creditor could not use the enabling loan defense. *Fidelity Fin. Servs., Inc. v. Fink*, 522 U.S. 211 (1998); *see In re Owens*, 294 B.R. 289 (Bankr. S.D. Ohio 2003); *In re Smith*, 236 B.R. 91 (Bankr. M.D. Ga. 1999). Section 1222 BAPCPA will change this result by making the grace period for perfection of a purchase money security interest under 11 U.S.C. § 547(c)(3)(B) 30 days instead of the 20 days that had been established under the Bankruptcy Reform Act of 1994.

By its plain terms, Section 547(c)(3)(B) speaks of perfection within 30 days of the time that the debtor receives possession of the collateral. Thus, if perfection occurred more than 30 days after the debtor signed the purchase contract or title passed, the creditor may still assert the
defense if perfection occurred within 30 days of the time that the debtor actually took possession. See *In re Jeans*, 326 B.R. 722 (Bankr. W.D. Tenn. 2005); *In re B & B Utilities, Inc.*, 208 B.R. 417 (Bankr. E.D. Tenn. 1997). Moreover, if the last day of the grace period falls on a Saturday, Sunday, or legal holiday, it has been held that, as a matter of federal law, the lender has until the close of business on the next working day to perfect its security interest. *In re Boyer*, 212 B.R. 975 (Bankr. D. Or. 1997); *In re Lamons*, 121 B.R. 748 (Bankr. S.D. Ohio 1990). On the other hand, it must be remembered that the grace period runs from the time that the debtor received the collateral, not from the time that the creditor acquired its claim. Thus, if an assignee of a purchase money loan fails to perfect within 30 days of the purchase, the perfection will not relate back, even if perfection occurs within 30 days of the assignment. See *In re Reinerston*, 224 B.R. 137 (Bankr. D. Mont. 1998).

4. **Subsequent Unsecured New Value: 11 U.S.C. § 547(c)(4).**

11 U.S.C. §547(c)(4) establishes a sequence of events that will serve to defeat a preference claim. First, there must have been a transfer that otherwise would be avoidable as a preference. Second, after the transfer, the creditor must have given new value (as defined in 11 U.S.C. § 547(a)(2)) to or for the benefit of the debtor, and the new value must not have been secured by a security interest that the bankruptcy estate could not avoid. Third, as of the date of the petition, the debtor must not have repaid the new value with an unavoidable transfer. *In re Micro Innovations Corp.*, 185 F.3d 329 (5th Cir. 1999); *Southern Technical Col., Inc. v. Hood*, 89 F.3d 1381 (8th Cir. 1996); *In re J.R. Deans Co., Inc.*, 249 B.R. 121 (Bankr. D.S.C. 2000); *In re National Aerospace, Inc.*, 219 B.R. 625 (Bankr. M.D. Fla. 1998); see *In re Roberds, Inc.*, 315 B.R. 443 (Bankr. S.D. Ohio 2004) (noting that the wording of the statute may be somewhat confusing because of its use of a double negative). The principle behind this defense is that, by extending new value, the creditor has repaid the estate for the preferential transfer. *In re
Armstrong, 291 F.3d 517 (8th Cir. 2002); Micro Innovations, 185 F.3d at 329; In re Prescott, 805 F.2d 719 (7th Cir. 1986). Like the contemporaneous exchange for new value defense, Section 547(c)(4) is meant to encourage creditors to continue to do business with troubled debtors. In re Jet Florida Sys., Inc., 841 F.2d 1082 (11th Cir. 1988); In re Hertzler Halstead Hosp., 334 B.R. 276 (Bankr. D. Kan. 2005); In re Teligent, Inc., 315 B.R. 308 (Bankr. S.D.N.Y. 2004). A creditor may receive payments on a running account that reduce the debtor’s balance if the creditor thereafter extends new credit. In re Jones Truck Lines, Inc., 130 F.3d 323 (8th Cir. 1997); In re Duncan, 312 B.R. 184 (Bankr. C.D. Ill. 2004) (fresh use of credit card after otherwise preferential payment); see In re Jotan, Inc., 264 B.R. 735 (Bankr. M.D. Fla. 2001) (noting that, as with 11 U.S.C. § 547(c)(1), the value extended for purposes of Section 547(c)(4) must be new value, not merely the discharge of an antecedent debt). Indeed, any unsecured extension of new value following an otherwise preferential payment falls within the scope of this defense. In re Discovery Zone, Inc., 300 B.R. 856 (Bankr. D. Del. 2003) (allowing debtor licensee to continue to use trademark), aff’d, 43 B.C.D. 242 (D. Del. 2004); In re Vanguard Airlines, Inc., 295 B.R. 329 (Bankr. W.D. Mo. 2003). On the other hand, an unperformed executory promise to provide new credit, goods, or services is not new value within the meaning of 11 U.S.C. § 547(a)(2) because it is not money or money’s worth and thus cannot count as a new advance for purposes of Section 547(c)(4). In re Accessair, Inc., 314 B.R. 386 (8th Cir. B.A.P. 2004); In re Fultonville Metal Prods. Co., 330 B.R. 305 (Bankr. M.D. Fla. 2005); Teligent, 315 B.R. at 308 (advance billings did not show that new services were actually provided); see In re Moltech Power Sys., Inc., 326 B.R. 179 (Bankr. N.D. Fla. 2005) (manufacturing new goods for debtor was not new value when goods were never shipped); In re
NETtel Corp., Inc., 319 B.R. 290 (Bankr. D.D.C. 2004) (maintenance services on computer that was never actually installed for debtor’s use was not new value).

The effect of Section 547(c)(4) is that the creditor may offset the new unsecured value that remains unpaid against the prior avoidable preferences. In re Meredith Manor, Inc., 902 F.2d 257 (4th Cir. 1990); In re Waccamaw’s Homeplace, 325 B.R. 524 (Bankr. D. Del 2005); In re Transport Assocs., Inc., 171 B.R. 232 (Bankr. W.D. Ky. 1994). If the new value is less than the previous preferential transfers, then the transfers are avoidable only pro tanto. In re TWA, Inc. Post Confirmation Estate, 305 B.R. 221 (Bankr. D. Del. 2004); In re Comptronix Corp., 239 B.R. 357 (Bankr. M.D. Tenn. 1999); In re Workboats Northwest, Inc., 201 B.R. 563 (Bankr. W.D. Wash. 1996). If the unrepaid subsequent new value equals or exceeds the prior preferential transfers, then the estate may not recover anything. In re Chez Foley, Inc., 211 B.R. 25 (Bankr. D. Minn. 1997); In re Winter Haven Truss Co., 154 B.R. 592 (Bankr. M.D. Fla. 1993).

It is important to remember that Section 547(c)(4) establishes a subsequent advances rule, not a total net result rule. All advances and all transfers during the preference period are not aggregated and then netted to determine an overall result. Rather, new advances may be offset only against previous preferential transfers. In re Eleva Inc., 235 B.R. 486 (10th Cir. B.A.P. 1999) (defense was unavailing when new advances were made before the preferential transfer); In re U.S. Interactive, Inc., 321 B.R. 388 (Bankr. D. Del. 2005); see In re Globe Building Materials, Inc., 325 B.R. 253 (Bankr .N.D. Ind. 2005) (value was not new when debtor had already paid for it); In re Furrs Supermarkets, Inc., 296 B.R. 33 (Bankr. D.N.M. 2003); see also Robert H. Bowmar, The New Value Exception to the Trustee’s Preference Avoidance Power: Getting the Computations Straight, 69 AM. BANKR. L.J. 65 (1995). One relatively early decision
held that a subsequent advance of new value may be used as an offset only against the immediately preceding preferential transfer. *Leathers v. Prime Leather Finishes Co.*, 40 B.R. 248 (D. Me. 1984). The view of the great majority of courts, however—and the better reasoned position—is that any subsequent advance or advances may be offset against any and all earlier preferential transfers. *Micro Innovations*, 185 F.3d at 329; *In re IRFM, Inc.*, 52 F.3d 228 (9th Cir. 1995); *Meredith Manor*, 902 F.2d at 257; *In re NETtel Corp., Inc.*, 323 B.R. 1 (Bankr. D.D.C. 2005); *Roberds*, 315 B.R. at 443; *In re Bridge Info. Sys., Inc.*, 287 B.R. 258 (Bankr. E.D. Mo. 2002); *In re Jannel Indus., Inc.*, 245 B.R. 757 (Bankr. D. Mass. 2000). Preferential transfers are carried forward until they are canceled out by later new value, and a continuous netting process is used up to the petition date. *In re Globe Building Materials, Inc.*, 334 B.R. 416 (Bankr. N.D. Ind. 2005) (giving an analysis of how the calculations should be performed); *In re Accoustiseal, Inc.*, 318 B.R. 521 (Bankr. W.D. Mo. 2004) (same).

The new value advanced by the creditor need not be to the debtor; it may also be for the benefit of the debtor. Thus, new value extended to a third party could meet the requirements of Section 547(c)(4), provided that the debtor benefited thereby. *Jones Truck Lines*, 130 F.3d at 323. The focus is on the benefit received by the debtor, not on the loss or detriment to the creditor. *See Armstrong*, 291 F.3d at 517 (giving the debtor further opportunities to gamble was of no tangible value to the debtor or his creditors); *Drabkin v. A.I. Credit Corp.*, 800 F.2d 1153 (D.C. Cir. 1986); *In re Phoenix Restaurant Group, Inc.*, 316 B.R. 681 (Bankr. M.D. Tenn. 2004); *In re EUA Power Corp.*, 147 B.R. 634 (Bankr. D.N.H. 1992); *In re Bagwell*, 29 B.R. 457 (Bankr. D. Or. 1983).

Although some courts have spoken as though the subsequent new advances must remain completely unpaid as of the petition date, this does not appear to conform to the language or the
purposes of Section 547(c)(4). Scott E. Blakeley, *Section 547(c)(4): Must the New Value Remain Unpaid?,* 23 Cal. Bankr. J. 201 (1996); see Roberds, 315 B.R. at 443; see also *In re Login Bros. Book Co., Inc.*, 294 B.R. 297 (Bankr. N.D. Ill. 2003) (postpetition return of goods that had been shipped on credit prepetition canceled the new value *pro tanto* and negated the defense to that extent). By its terms, the statute requires only that the new value must not have been repaid with an otherwise unavoidable transfer. *Micro Innovations*, 185 F.3d at 329; *IRFM*, 52 F.3d at 228; *In re Toyota of Jefferson, Inc.*, 14 F.3d 1088 (5th Cir. 1994). Thus, the better view, and the growing consensus among courts, is that the defense applies if either the new advance has not been repaid at all or if it has been repaid by the debtor with a transfer that is otherwise avoidable. *In re JKJ Chevrolet, Inc.*, 412 F.3d 545 (4th Cir. 2005); *In re Parkview Hosp.*, 213 B.R. 509 (Bankr. N.D. Ohio 1997). One result of this analysis is that 11 U.S.C. § 547(c)(4) must be alleged as an alternative defense or a defense of last resort. If the debtor’s payments for the new value during the preference period are not avoidable, whether because of another defense to a preference action or otherwise, then a Section 547(c)(4) defense is undermined. *In re Terry Mfg. Co., Inc.*, 325 B.R. 638 (Bankr. M.D. Ala. 2005); *In re Phoenix Restaurant Group, Inc.*, 317 B.R. 491 (Bankr. M.D. Tenn. 2004); *Roberds*, 315 B.R. at 443.

5. **No Net Improvement for the Holder of a Floating Lien on Inventory and Receivables: 11 U.S.C. § 547(c)(5).**

Under 11 U.S.C. § 547(b), a floating lien might well be avoidable with respect to property that the debtor acquired during the preference period. 11 U.S.C. § 547(c)(5) carves out an exception that prevents such a result with respect to security interests in inventory or receivables or the proceeds of inventory or receivables that arise during the preference period. The floating lien and any transfer or payment made thereunder is not avoidable except to the extent that there has been a net improvement in the secured creditor’s position that is prejudicial
to unsecured creditors. *In re Wesley Indus., Inc.*, 30 F.3d 1438 (11th Cir. 1994); *In re Parker Steel Co.*, 149 B.R. 834 (Bankr. N.D. Ohio 1992); see Benjamin R. Norris, *Bankruptcy Preference Actions*, 121 BANKING L.J. 483 (2004). In other words, insofar as new inventory or receivables coming into existence during the preference period are merely substituted for old, there has been no net improvement in the position of a holder of a floating lien; only when there has been a net improvement could there have been a preference. *In re Melon Produce, Inc.*, 976 F.2d 71 (1st Cir. 1992); see Steven L. Schwarcz & Janet Malloy Link, *Protecting Rights, Preventing Windfalls: A Model for Harmonizing State and Federal Laws on Floating Liens*, 75 N.C.L. REV. 403 (1997). This statute has been aptly described as a “revolving loan” defense. *In re El Paso Refinery, L.P.*, 178 B.R. 426 (Bankr. W.D. Tex. 1995), subsequently rev’d on other grounds, 171 F.3d 249 (5th Cir. 1999).

In order to determine whether there has been a net improvement, the value of the collateral is compared with the amount of the debt at two dates: (a) the beginning of the preference period (i.e., 90 days for a noninsider creditor or one year for an insider), or the date within the preference period when the lender gave value under the agreement creating the security interest; and (b) the petition date. *In re Missionary Baptist Found. of Am., Inc.*, 796 F.2d 752 (5th Cir. 1986); *In re J.A.S. Markets, Inc.*, 113 B.R. 193 (Bankr. W.D. Pa. 1990). All interim variations are ignored. *In re Lackow Bros., Inc.*, 752 F.2d 1529 (11th Cir. 1985); *In re Savig*, 50 B.R. 1003 (D. Minn. 1985). Only to the extent that there has been a decrease in the deficiency—i.e., to the extent that there has been a net improvement in the secured creditor’s position—between the two dates is the transfer avoidable. *In re M. Paolella & Sons, Inc.*, 161 B.R. 107 (E.D. Pa. 1993), aff’d, 37 F.3d 1487 (3d Cir. 1994); *El Paso Refinery*, 178 B.R. at 426;
Parker Steel, 149 B.R. at 834. If the unsecured debt—i.e., the deficiency—has remained unchanged or increased, then there may be no avoidance at all. Wesley Indus., 30 F.3d at 1438.

The method used to value the collateral may be critical. The value of the collateral is a fact question, and bankruptcy courts are afforded a great deal of leeway. Much depends on the particular circumstances. The use of liquidation value has been approved, Missionary Baptist Found., 796 F.2d at 752, and, as a general rule, the collateral should be valued from the point of view of the creditor rather than the debtor. In re Clark Pipe & Supply Co., 893 F.2d 693 (5th Cir. 1990). Many courts, however, use a going concern value approach, even in Chapter 7 cases. See In re Universal Foundry Co., 163 B.R. 528 (E.D. Wis. 1993), aff’d, 30 F.3d 137 (7th Cir. 1994); In re Rennes Glass, Inc., 136 B.R. 132 (Bankr. W.D. Mich. 1992).

Although some courts have spoken loosely as though a net improvement will automatically give rise to a voidable preference, see, e.g., Wesley Indus., 30 F.3d at 1438; Melon Produce, 976 F.2d at 71, this is not really the case. By its plain terms, 11 U.S.C. § 547(c)(5) also requires that unsecured creditors must have been prejudiced. If the creditor has a floating lien on all of the debtor’s assets, then unsecured creditors are not prejudiced even if the secured creditor has improved its position between the relevant two dates. In re Castleton’s Inc., 990 F.2d 551 (10th Cir. 1993); see M. Paolella & Sons, 161 B.R. at 107. Similarly, if the creditor were fully secured or oversecured as of the initial date, there would be no deficiency, and the creditor could not possibly improve its position within the meaning of Section 547(c)(5). Missionary Baptist Found., 796 F.2d at 752; In re Foxmeyer Corp., 286 B.R. 546 (Bankr. D. Del. 2002); see Norris, Bankruptcy Preference Actions, 121 BANKING L.J. at 483. It is at least arguable that if the creditor holding a floating lien were oversecured at all relevant times, then there would be no need to reach the Section 547(c)(5) defense. In such an instance, the oversecured creditor would
only receive its own collateral or the proceeds of its collateral, just as it would in a Chapter 7 liquidation. In that case, 11 U.S.C. § 547(b)(5) would not be satisfied, and an essential element of a preference claim would fail. Thus, any consideration of Section 547(c)(5) or any other affirmative defense might be moot. In re Smith’s Home Furnishings, Inc., 265 F.3d 959 (9th Cir. 2001).


11 U.S.C. § 547(c)(6) provides that the fixing of a statutory lien may not be avoided as a preference if the lien is not avoidable under 11 U.S.C. § 545. A statutory lien is one that arises solely by force of a statute; this does not include consensual security interests or liens that arise as the result of judicial action. 11 U.S.C. § 101(53); see In re Horstman, 255 B.R. 564 (Bankr. S.D. Iowa 2000) (lien that arose with service of notice of garnishment was a judicial lien, not a statutory lien; creditor could not use the Section 547(c)(6) defense). Some courts have held that payments made to avoid the attachment of a statutory lien or to satisfy a debt that might give rise to a statutory lien are also immune to a preference attack. Cimmaron Oil Co. v. Cameron Consultants, Inc., 71 B.R. 1005 (N.D. Tex. 1987); In re 360networks (USA), Inc., 327 B.R. 187 (Bankr. S.D.N.Y. 2005); cf. In re Rand Energy Co., 259 B.R. 274 (Bankr. N.D. Tex. 2001) (following Cimmaron Oil with reservations and questioning whether payments made to avoid the fixing of a statutory lien fall within the scope of 11 U.S.C. § 547(c)(6)). The Fifth Circuit, however, has rejected the Cimmaron Oil position. The plain language of Section 546(c)(6) refers to the fixing of a statutory lien and thus the defense applies only to the actual perfection or attachment of such a lien. Payments to a party to avoid the attachment of a statutory lien simply are not within the scope of Section 547(c)(6). In re Ramba, Inc., 416 F.3d 394 (5th Cir. 2005).

Numerous types of liens fall within the ambit of statutory liens covered by Section 547(c)(6). Federal tax liens are not avoidable as preferential if they are properly perfected, In re
Wiles, 173 B.R. 92 (Bankr. M.D. Pa. 1994); In re Fandre, 167 B.R. 837 (Bankr. E.D. Tex. 1994), and neither are state or local tax liens. In re Sullivan, 254 B.R. 661 (Bankr. D.N.J. 2000); In re McConnaughey, 147 B.R. 433 (Bankr. S.D. Ohio 1992). Similarly, properly perfected mechanics liens may not be avoided. In re Lionel Corp., 29 F.3d 88 (2d Cir. 1994); In re Rainbow Trust, 216 B.R. 77 (2d Cir. B.A.P. 1997). Likewise, Texas law provides royalty and working interest owners with a lien on oil and gas sold to a first purchaser and on the proceeds of the minerals. Tex. Bus. & Com. Code § 9.343 (formerly codified as Section 9.319). This is a statutory lien that is avoidable, if at all, only under 11 U.S.C. § 545. In re Tri-Union Dev. Corp., 253 B.R. 808 (Bankr. S.D. Tex. 2000). So also a hospital’s statutory lien on a patient’s tort recovery for personal injury is not subject to a preference attack. In re Howard, 43 B.R. 135 (Bankr. D. Md. 1983). If there is a statutory procedure for perfecting a lien, and if the lien is unperfected, then the bankruptcy estate may avoid it under 11 U.S.C. § 545 if it would not be valid against a bona fide purchaser. In that case, the unperfected lienor could not make use of Section 547(c)(6). In re Nucorp Energy, Inc., 902 F.2d 729 (9th Cir. 1990) (unperfected oil and gas drilling supplier’s lien could be avoided; lienor could not take advantage of Section 547(c)(6)); see Rand Energy, 259 B.R. at 274.


11 U.S.C. § 547(c)(7) was first added to the Bankruptcy Code by Section 304(f) of the Bankruptcy Reform Act of 1994. As originally enacted, this statute shielded any alimony, support, or maintenance payments made to the debtor’s spouse, former spouse, or child in accordance with a court order or separation agreement, provided that such payments were truly in the nature of alimony, support, or maintenance and had not been assigned to another person or entity. Prior to the 1994 legislation, alimony or support payments could be avoided. See In re Sorlucco, 68 B.R. 748 (Bankr. D.N.H. 1986); Hon. Louise DeCarl Adler & Jeanne Taber, The
The 1994 statute was meant to protect innocent spouses, former spouses, and children of the debtor, especially when the transfers were not of a commercial nature. In re Carlson, 231 B.R. 640 (Bankr. N.D. Ill. 1999); see Hon. V. Michael Bigner, The 1994 Bankruptcy Code Revisions from a Domestic Relations Court Perspective, 34 U. LOUISVILLE J. FAM. L. 643 (1996); Catherine E. Vance, Till Debt Do Us Part: Irreconcilable Differences in the Unhappy Union of Bankruptcy and Divorce, 45 BUFF. L. REV. 369 (1997). 11 U.S.C. § 547(c)(7) was liberally construed to achieve its objective. In re Neuman, 265 B.R. 904 (Bankr. N.D. Ohio 2001) (payment made to child support agency and then transferred to former spouse could not be avoided; there had been no “assignment” of the sort that would vitiate the Section 547(c)(7) defense); accord In re Sanks, 265 B.R. 566 (Bankr. N.D. Ohio 2001).

In 2005, Section 217 of BAPCPA amended 11 U.S.C. § 547(c)(7) to provide that a transfer may not be avoided if it were a bona fide payment of a debt for a “domestic support obligation”. The term “domestic support obligation” is defined by 11 U.S.C. § 101(14A), which was added by Section 211 of BAPCPA. Domestic support obligations include all of the items that were covered in the former version of 11 U.S.C. § 547(c)(7), and the definitional statute goes even further. For example, 11 U.S.C. § 101(14A) makes clear that property settlements fall within the scope of domestic support obligations. Whether property settlements or divisions had fallen under the aegis of the pre-BAPCPA version of 11 U.S.C. § 547(c)(7) had been a subject of dispute. See In re Hope, 231 B.R. 429 (Bankr. D.D.C. 1999); In re Watson, 192 B.R. 238 (Bankr. D. Nev. 1996). Again, the definition of domestic support obligations includes payments assigned to governmental units and payments assigned to nongovernmental entities for purposes
of collection. Assigned payments had been excluded from the scope of the 1994 version of 11 U.S.C. § 547(c)(7). See Neuman, 265 B.R. at 904; Sanks, 265 B.R. at 566. Other provisions of 11 U.S.C. § 101(14A) broaden the sweep of Section 547(c)(7) in still other respects.

It is clear that Title II, Subtitle B (Sections 211-220) of BAPCPA was intended to grant expanded protection and priority to spousal and child support obligations. It appears likely that 11 U.S.C. § 547(c)(7) will be interpreted even more liberally in the future to shield transfers of this sort from preference avoidance.


11 U.S.C. § 547(c)(8) (codified as Section 547(c)(7) prior to 1994) provides that in any case filed by an individual whose debts are primarily consumer debts, a transfer may not be avoided when the total value of all property transferred or affected by the transfer was less than $600. The purpose of the statute is to prevent the estate from pursuing small recoveries where the benefit simply would not justify the litigation cost. In re Vickery, 63 B.R. 222 (Bankr. E.D. Tenn. 1989); see In re Baker, 246 B.R. 379 (Bankr. E.D. Mo. 2000); Paul Giorgianni, Note, The Small Preference Exception of Bankruptcy Code Section 547(c)(7), 55 Ohio St. L.J. 675 (1994).

The consumer debtor small transfer exception has typically arisen in the context of garnishments or involuntary wage deductions. E.g., In re Jackson, 260 B.R. 473 (Bankr. E.D. Mo. 2001); In re Moore, 177 B.R. 279 (Bankr. S.D. Ill. 1995); In re Passmore, 156 B.R. 595 (Bankr. E.D. Wis. 1993). If a garnishment or other transfer has been for the benefit of several creditors, then the amount paid to each creditor must be determined separately. If no creditor received $600 or more, then nothing may be recovered, no matter now great the total payment or transfer. In re Irvine, 95 B.R. 464 (Bankr. W.D. Ky. 1988); accord In re Figueira, 163 B.R. 192 (Bankr. D. Kan. 1993); see Vickery, 63 B.R. at 222.
There has been a split of authority as to whether this principle of non-aggregation applies to separate transfers (usually garnishments) made to or for the benefit of one creditor. Some courts have held that the payments within the preference period should not be aggregated for this purpose. For example, under this reasoning, three distinct transfers of $400 each to a particular creditor could not be avoided as preferential because each individual transfer would be shielded by 11 U.S.C. § 547(c)(8). *In re Clark*, 171 B.R. 563 (Bankr. W.D. Ky. 1994); *In re Howes*, 165 B.R. 270 (Bankr. E.D. Mo. 1994). The weight of authority, however—including at least one court of appeals decision—has held that all payments to any one creditor within the preference period should be aggregated, and that they may be avoided if the total is $600 or more. *In re Hailes*, 77 F.3d 873 (5th Cir. 1996); *In re Djerf*, 188 B.R. 586 (Bankr. D. Minn. 1995); *In re Alarcon*, 186 B.R. 135 (Bankr. D.N.M. 1995); *In re Bunner*, 145 B.R. 266 (Bankr. C.D. Ill. 1992).

If a transfer is too great to fit within the exception of 11 U.S.C. § 547(c)(8), then the entire transfer may be avoided. Avoidance is not limited to the amount that meets or exceeds the $600 threshold. Thus, while no part of a $599 payment could be avoided, every penny of a $600 payment could be. *In re Wilkinson*, 196 B.R. 311 (Bankr. E.D. Va. 1996); *In re Via*, 107 B.R. 91 (Bankr. W.D. Va. 1989); *Vickery*, 63 B.R. at 222.

9. **Small Transfers in Nonconsumer Cases: 11 U.S.C. § 547(c)(9).**

In 1997, the National Bankruptcy Review Commission proposed a new minimum for preference actions in nonconsumer cases analogous to 11 U.S.C. § 547(c)(8) in some respects. The Commission recommended that $5,000 should be the minimum aggregate transfer that could be avoided in a preference action in a nonconsumer case. This limitation would not have applied to insiders. 1 NATIONAL BANKRUPTCY REVIEW COMMISSION, FINAL REPORT, BANKRUPTCY: THE NEXT TWENTY YEARS, Rec. 3.2.1 (1997). The Commission recognized that estate
representatives often file “shotgun” preference actions, and that it is seldom worth the while of a creditor who has a minimal claim or who has received minimal transfers to contest such an action, even if the creditor could prevail.

In 2005, Congress enacted this proposal with some modifications. Section 409 of BAPCPA, now codified as 11 U.S.C. § 547(c)(9), provides that, in a nonconsumer case, a transfer may not be avoided as a preference if the aggregate amount of all property that constitutes or is affected by the transfer is less than $5,000. There is no exception for insiders. This provision will help preference defendants. Nuisance suits for small amounts will be curtailed in commercial cases, and a defendant will not have to worry about incurring substantial legal fees to establish a meritorious defense to a minimal preference action or about being forced to settle when threatened with a small preference claim. See Kevin C. Driscoll, Jr., Bankruptcy 2005: New Landscape for Preference Proceedings, 24-Jun. AM. BANKR. INST. J. 1 (2005). This change took effect for all cases filed on or after October 17, 2005.

In a related development, Section 410 of BAPCPA amended the venue provisions of 28 U.S.C. § 1409. As amended, 28 U.S.C. § 1409(b) now provides that, when a consumer debt is not involved, any action to recover a debt of less than $10,000 against a person who is not an insider must be commenced in the district where the defendant resides, not in the court where the bankruptcy case is pending. This provision is entirely new. With consumer debts, Section 410 of BAPCPA amended 28 U.S.C. § 1409(b) to provide that any action to recover less than $15,000 must be commenced in the district where the defendant resides, raising the cap from the previous $5,000. These provisions apply not only to preferences, but to all avoidance actions, including fraudulent transfers, and, indeed, to all lawsuits. See H.R. Rep. No. 31, 109th Cong., 1st Sess., pt. 1, 88 (2005). The net effect probably will be to deter the trustee or debtor-in-


As part of an effort to encourage voluntary compositions with creditors and the use of credit counselors, Section 201(b) of BAPCPA added yet another limitation on the bankruptcy estate’s power to avoid prepetition transfers as preferential. Curiously, this new exception was not codified among the affirmative defenses of 11 U.S.C. § 547(c). Rather, it was codified as the new 11 U.S.C. § 547(h). This statute provides that the trustee may not avoid a transfer as a preference if the transfer was made as part of an approved repayment schedule between the debtor and any creditor of the debtor created by an approved nonprofit budget and credit counseling agency. Section 547(h) is effective in all cases filed on or after October 17, 2005. It remains to be seen what impact this new provision will have.

C. THE INSIDER PREFERENCE PROVISIONS OF THE UNIFORM FRAUDULENT TRANSFER ACT.


Section 5(b) of the Uniform Fraudulent Transfer Act incorporates bankruptcy preference concepts into state law. Farstvet v. Rudolph, 630 N.W.2d 24 (N.D. 2000); see Lisa Sommers Gretchko, Uniform Fraudulent Transfer Act Makes Preferences Creatures of State Law, 18-Sept. Am. Bankr. Inst. J. 29 (1999). This statute represents a departure from the previous general rule that, outside of bankruptcy, an insolvent debtor may pay one honest debt in preference to another, even if the favored creditor is an insider. Prairie Lakes Health Care Sys., Inc. v. Wookey, 583 N.W.2d 405 (S.D. 1998); see In re Emerson, 244 B.R. 1 (Bankr. D.N.H. 1999)
(noting that reasonably equivalent value or the satisfaction of an antecedent debt is not a consideration under the insider preference statute); Jackson Law Office, P.C. v. Chappell, 37 S.W.3d 15 (Tex. App. — Tyler 2000, pet. denied) (same).

It should be noted, however, that, under the Uniform Fraudulent Conveyance Act, some courts had condemned preferential payments to insiders as constructively fraudulent. Lack of “fair consideration” was an essential element of a constructive fraud claim under the U.F.C.A., and “fair consideration” included an element of subjective good faith as well as objective reasonable equivalence in the transaction. See In re Sharp Intern. Corp., 302 B.R. 760 (E.D.N.Y. 2003), aff’d, 403 F.3d 43 (2d Cir. 2005). Some courts reasoned that a transfer to an insider was lacking in good faith, and hence in fair consideration, if the insider knew or had reason to know that the debtor was insolvent, even if the insider held an otherwise legitimate claim. See In re Sharp Intern. Corp., 281 B.R. 506 (Bankr. E.D.N.Y. 2002), aff’d, 302 B.R. 760 (E.D.N.Y. 2003), aff’d, 403 F.3d 43 (2d Cir. 2005); In re White Metal Rolling & Stamping Corp., 222 B.R. 417 (Bankr. S.D.N.Y. 1998). Section 5(b) of the U.F.T.A. codifies this principle, at least to some extent. U.F.T.A. § 5, cmt. 2; see Farstveet, 630 N.W.2d at 24. The rationale “is that an insolvent debtor is obligated to pay debts of creditors not related to him before paying those who are insiders.” U.F.T.A., Preferatory Note.

Fraudulent intent is irrelevant under the insider preference statute, as is lack of reasonably equivalent value. Comer v. Calim, 716 N.E.2d 245 (Ohio Ct. App. 1998). An insider preference thus differs from both actually and constructively fraudulent transfers in the usual sense. There are five elements to an insider preference claim, and, under 11 U.S.C. § 544(b), a trustee or debtor-in-possession may avoid a transaction using this state statute. See In re D.C.T., Inc., 295 B.R. 236 (Bankr. E.D. Mich. 2003); Emerson, 244 B.R. at 1.
First, the plaintiff’s claim against the debtor must have arisen before the transfer was made to the insider. Section 5(b) of the U.F.T.A. does not consider an insider preference to be fraudulent or improper as to subsequent creditors. *Prairie Lakes Health Care Sys.*, 583 N.W.2d at 405. Thus, a bankruptcy estate representative who wished to use this statute under 11 U.S.C. § 544(b) would have to show the existence of an actual creditor whose claim arose before the transfer in question and who could have maintained an action in his or her own right before the bankruptcy petition.

Second, the transfer must have been made to an “insider.” The definition of “insider” in U.F.T.A. § 1(7) is a broad, nonexclusive list that is similar to the definition in 11 U.S.C. § 101(31). *In re Imageset, Inc.*, 299 B.R. 709 (Bankr. D. Me. 2003); see *In re Holloway*, 955 F.2d 1008 (5th Cir. 1992); *J. Michael Putnam, M.D. P.A. Money Purchase Pension Plan v. Stephenson*, 805 S.W.2d 16 (Tex. App. — Dallas 1991, no writ).

Third, the transfer must have been made for an antecedent debt. This requirement is similar to 11 U.S.C. § 547(b)(2). If there were no antecedent debt and no contemporaneous exchange for new value, then the debtor would have received no reasonably equivalent value in exchange. In that case, the transfer would have been constructively fraudulent, if not actually fraudulent, rather than an insider preference. *Rhode Island Depositors’ Economic Protection Corp. v. Mollicone*, 677 A.2d 1337 (R.I. 1996).

Fourth, the debtor must have been insolvent at the time of the transfer. This requirement is similar to 11 U.S.C. § 547(b)(3). The plaintiff, of course, bears the burden of pleading and proving the debtor’s insolvency. *Prudential Ins. Co. of Am. v. Science Park Ltd. Partnership*, 667 N.E.2d 437 (Ohio Ct. App. 1995). Under the Uniform Fraudulent Transfer Act, as under the Bankruptcy Code, “insolvency” refers to balance sheet insolvency. U.F.T.A. § 2(a). Equitable
insolvency or an inability to pay debts as they fall due, however, creates a rebuttable presumption of balance sheet insolvency. *Id.* § 2(b). Unlike 11 U.S.C. § 547(f), the U.F.T.A. does not establish a presumption of insolvency for any particular time period.

Fifth, the insider transferee must have had “reasonable cause to believe” that the debtor was insolvent at the time of the transfer. *See In re Unglaub*, 332 B.R. 303 (Bankr. N.D. Ill. 2005) (insider preference action failed when trustee could not show that nondebtor wife knew or had reason to know of debtor-husband’s insolvency). There is no analogous provision under Section 547(b) of the Bankruptcy Code, and, in a preference action under Section 547(b), whether the transferee knew or had reason to know of the debtor’s insolvency is irrelevant. For purposes of Section 5(b) of the U.F.T.A., “reasonable cause to believe” means either actual knowledge of the debtor’s insolvency or knowledge of facts that would cause a prudent person to investigate and discover the insolvency. Gretchko, *Uniform Fraudulent Transfer Act Makes Insider Preferences Creatures of State Law*, 18-Sept. AM. BANKR. INST. J. at 29; *see Harold Pub. Co. v. Barberino*, 1993 WL 498798 (Conn. Super. Ct. Oct. 27, 1993). This knowledge or notice requirement appears to hark back to Uniform Fraudulent Conveyance Act cases holding that transfers to an insider with knowledge or reason to know of the debtor’s insolvency were not made in good faith and hence were lacking in fair consideration. *See Sharp Intern.*, 281 B.R. at 506; *White Metal Rolling & Stamping*, 222 B.R. at 417.

The insider preference statute provides a state law tool that may be used in addition to 11 U.S.C. § 547 to avoid certain prepetition preferential transfers. It should be remembered, however, that U.F.T.A. § 5(b) has no application to transfers to creditors who are not insiders. Under the U.F.T.A., as under prior state law, an insolvent debtor is free to pay one noninsider creditor in preference to another, and certainly to pay a noninsider in preference to an insider.
Transfers to a noninsider creditor to satisfy an honest antecedent debt may be avoided, if at all, only under Section 547 of the Bankruptcy Code.

2. Reachback Period and Time to Sue.

Section 9(c) of the U.F.T.A. provides that an insider preference action must be brought within one year of the time that the transfer was made or the obligation was incurred. This is similar to the one-year prepetition period during which a preferential transfer to or for the benefit of an insider may be avoided under 11 U.S.C. § 547(b)(4)(B). It is also much shorter than the four-year limitations period that the U.F.T.A. provides for avoiding ordinary actually or constructively fraudulent transfers. See In re Erstmark Capital Corp., 2002 WL 1792213 (N.D. Tex. Aug. 2, 2002), aff’d, 73 Fed. Appx. 79 (5th Cir. 2003); In re Jones, 184 B.R. 377 (Bankr. D.N.M. 1995). The one-year reachback period of Section 9(c) is a true statute of repose rather than a statute of limitations. It cuts off the right to bring an insider preference action, not merely the remedy. It is substantive, not procedural. U.F.T.A. § 9, cmt. 1; see In re Princeton-New York Investors, Inc., 219 B.R. 55 (D.N.J. 1998). Thus, if a preferential transfer to an insider occurred more than one year prepetition, the estate representative could not avoid it under Section 547 of the Bankruptcy Code or under Section 5(b) of the U.F.T.A. The state law statute of repose would have run before the petition was filed, and the filing of the bankruptcy petition would not revive the period for bringing a state law insider preference. In re Unglaub, 332 B.R. 303 (Bankr. N.D. Ill. 2005) (insider preference action failed where transfer in question was made more than one year prepetition).

3. Defenses to an Insider Preference Claim.

Section 8(f) of the U.F.T.A. establishes three affirmative defenses to an insider preference action. First, under U.F.T.A. § 8(f)(1), a transfer to an insider is not avoidable pursuant to Section 5(b) to the extent that the insider gave new value to the debtor after the
transfer was made and the new value was not secured by a valid lien. This statute is obviously based on the subsequent unsecured new value defense of 11 U.S.C. § 547(c)(4). Lisa Sommers Gretchko, *Uniform Fraudulent Transfer Act Makes Insider Preferences Creatures of State Law*, 18-Sep. *AM. BANKR. INST. J.* 29 (1999). It allows an insider defendant to reduce his or her liability by the amount of any unsecured advances made to the debtor after the challenged transfer. It does not allow the insider to offset his or her liability by the amount of any new value extended to the debtor prior to or contemporaneously with the disputed transaction. *Prairie Lakes Health Care Sys., Inc. v. Wookey*, 583 N.W.2d 405 (S.D. 1998).

Section 8(f)(2) of the U.F.T.A. provides that a transfer to an insider may not be avoided under Section 5(b) if the transfer were made in the ordinary course of the business or financial affairs of the debtor and the insider. This is obviously similar to the ordinary course of business defense to a preference action under 11 U.S.C. § 547(c)(2). It includes the element that the transaction must be in the usual course of the affairs of both parties as 11 U.S.C. § 547(c)(2) requires. Thus payments that are patently fraudulent do not qualify for the U.F.T.A. § 8(f)(2) defense. *United Jersey Bank v. Majda*, 690 A.2d 693 (N.J. Super. Ct. App. Div. 1997); *see Yeager v. Summit Group of Cent. Fla., Inc.*, 654 So. 2d 189 (Fla. Dist. Ct. App. 1995) (debtor was out of business and dissolved, and thus, when payment to insider was made, debtor had no ordinary course of business). At least one court has read Section 8(f)(2) as also including the requirement of 11 U.S.C. § 547(c)(2)(A) that the transfers must be according to the parties’ past practices. Thus, “belated, unusual, precipitous, inordinate or haphazard transfers” will not qualify. *Prairie Lakes Health Care Sys.,* 583 N.W.2d at 805. Section 8(f), however, does not impose any requirement analogous to 11 U.S.C. § 547(c)(2)(B) that the transfer must be on ordinary business terms or conform to industry norms. *In re D.C.T., Inc.*, 295 B.R. 236 (Bankr.

The third defense to an insider preference action is that the transfer was made pursuant to a good faith effort to rehabilitate the debtor and the transfer secured present value given for that purpose as well as an antecedent debt of the debtor. U.F.T.A. § 8(f)(3). In other words, an insider defendant is protected if he or she infuses new value into the debtor in a bona fide effort at rehabilitation and takes a security interest to secure that new advance as well as any antecedent debt that the debtor owes. The rationale is that an insider who has already extended credit should not be penalized for making further advances in an honest effort to rehabilitate a faltering debtor, especially if the insider takes a security interest to secure the new advance and any previous advances. Gretchko, *Uniform Fraudulent Transfer Act Makes InsiderPreferences Creatures of State Law*, 18-Sept. Am. Bankr. Inst. J. at 29. This defense has no counterpart under Section 547(c) of the Bankruptcy Code. Factors to consider in determining whether the insider acted in a good faith effort to rehabilitate the debtor include the likelihood of a successful rehabilitation, the amount of the present value given, and the size of the antecedent debt secured. U.F.T.A. § 8, cmt. 6; see *Prairie Lakes Health Care Sys.*, 583 N.W.2d at 405.

D. THE DEPRIZIO PROBLEM.

1. **Deprizio and Its Progeny.**

Few issues pertaining to preference avoidance have caused greater concern among lenders than the so-called Deprizio problem. See Steve H. Nickels, *Deprizio Dead Yet? Birth, Wounding, and Another Attempt to Kill the Case*, 22 Cardozo L. Rev. 1251 (2001). As previously discussed, the bankruptcy estate may avoid transfers if they were made *for the benefit* of a creditor, even if they were not made *to* that creditor. 11 U.S.C. § 547(b)(1). Likewise, as previously discussed, guarantors or co-obligors are “creditors” because they hold contingent
claims against the debtor. See § II.A.1., supra. Finally, the Bankruptcy Code creates a
dichotomy between avoidance and recovery. Dunes Hotel Assocs. v. Hyatt Corp., 245 B.R. 492
(D.S.C. 2000) (giving a thorough discussion of the distinction between avoidance and recovery).
A transfer may be avoided as a preference under 11 U.S.C. § 547, but recovery is governed by 11
estate is permitted to recover either from a transferee or from a party for whose benefit the initial
transfer was made. See § I.F.2., supra.

The combination of these principles has led to the issue of indirect or trilateral
preferences. See Lawrence Ponoroff, Now You See It, Now You Don’t: An Unceremonious
Encore for Two-Transfer Thinking in the Analysis of Indirect Preferences, 69 AM. BANKR. L.J.
203 (1995). Frequently lenders demand personal guaranties from insiders of a debtor, such as
officers, directors, spouses or relatives. Payments that the debtor makes to the lender benefit the
guarantor by reducing the guarantor’s contingent obligations. The preference reachback period
for an insider guarantor is one year, even though it is only 90 days for the noninsider lender. 11
U.S.C. § 547(b)(4). The upshot is that a payment made by the debtor to the lender between 90
days and one year prepetition may be preferential as to an insider guarantor, even though, as a
matter of law, it could not be preferential as to the noninsider lender. Nonetheless, under 11
U.S.C. § 550 as it was worded prior to 1994, the estate could recover from the lender, that is, the
actual transferee, or from the insider guarantor, that is, the party for whose benefit the transfer
was made. See Henk J. Brands, Note, The Interplay Between Sections 547(b) and 550 of the

The Seventh Circuit adopted this combination of principles in 1989 and permitted the
estate to recover from a noninsider creditor with respect to transfers that were preferential only
as to insider guarantors. *Levit v. Ingersoll Rand Fin. Corp. (In re V.N. Deprizio Const. Co.)*, 874 F.2d 1186 (7th Cir. 1989). Part of the rationale for this decision was that insiders are likely to ensure the payment of debts that they have guaranteed in preference to debts that they have not guaranteed in order to reduce their own exposure. Thus, the involvement of insiders acting for their own benefit justifies employing the use of the one-year reachback period, even though the reachback period for the direct transferee is only 90 days. Following *Deprizio*, those courts of appeals that addressed the issue agreed with the Seventh Circuit that a noninsider creditor could be liable for such indirect preferences. *In re Wesley Indus., Inc.*, 30 F.3d 1438 (11th Cir. 1994); *In re Suffola, Inc.*, 2 F.3d 977 (9th Cir. 1993); *In re C-L Cartage Co.*, 899 F.2d 1490 (6th Cir. 1990); *In re Robinson Bros. Drilling, Inc.*, 892 F.2d 850 (10th Cir. 1989); see *In re Southmark Corp.*, 993 F.2d 117 (5th Cir. 1993) (dicta); see also *In re Erin Food Servs., Inc.*, 980 F.2d 792 (1st Cir. 1992) (assuming, but declining to hold, that *Deprizio* was correctly decided; the First Circuit held that the transfer did not provide any quantifiable monetary advantage to an insider guarantor and thus was not for the benefit the guarantor in any event); see *In re Maine Polly, Inc.*, 317 B.R. 1 (Bankr. D. Me. 2004) (under the insider preference provision of Maine’s U.F.T.A., payment to oversecured creditor could not be considered a transfer to an insider guarantor; because underlying debt was oversecured, guarantor’s exposure was effectively nonexistent, and thus guarantor received no tangible benefit from the payment).

On the other hand, in jurisdictions that did not expressly adopt *Deprizio*, some lower courts rejected it. It seemed unfair to place a lender in a worse position simply because the lender had taken the standard precaution of obtaining guarantees from insiders. The *Deprizio* rule appeared to make little commercial sense, and it might raise the cost of credit. *Houston Heavy Equip. Co. v. Gould*, 198 B.R. 693 (S.D. Tex. 1996). It seemed at least arguable that
Congress had not intended this result. See New Bankruptcy Law Shows Congress’ Intent That Deprizio Rule Be Rejected, 63 No. 2 BNA Banking Rep. 883 (1994).


2. Contractual Solutions to Deprizio.

Faced with the possibility of preference liability for transfers that were not even preferential as to the transferee creditor itself, some lenders began to insert so-called “Deprizio waivers” in guaranties signed by the debtor’s insiders. The guarantors would waive all rights of subrogation against or reimbursement from the debtor. This, it was hoped, would avoid any Deprizio problem because the insiders would then have no claim against the debtor, not even a contingent claim, in connection with the debt in question. Thus, while transfers to the lender might benefit the insider guarantors, the guarantors would no longer be creditors of the debtor. See In re Northeastern Contracting Co., 233 B.R. 15 (D. Conn. 1999) (one insider guarantor had waived all rights to recover from the debtor and thus was not a creditor; another guarantor,
However, had merely subordinated his rights and was thus still a creditor); Gail Sanger, *Guarantee, Pledge and Security Agreement*, 758 PLI/COMM 311 (1997). Thus, if the debtor filed a bankruptcy petition, transfers that benefited the guarantors could not be avoidable preferences as to such insiders because they would not be creditors. The noninsider lender would only have to worry about transfers made within 90 days prepetition. Richard C. Josephson, *The Deprizio Override: Don’t Kiss Those Waivers Goodbye Yet*, 4-June BUS. L. TODAY 40 (1995).

*Deprizio* waivers met with a favorable reception from some commentators. See Jo Ann J. Brighton & Peter N. Tamposi, *Payments Benefitting Insider Guarantors Can Be Protected from Recovery by Artful Loan Drafting*, 20-Oct. AM. BANKR. INST. J. 10 (2001); David I. Katzen, *Deprizio and Bankruptcy Code Section 550: Extended Preference Via Insider Guarantees and Other Perils of Transferee Liability*, 45 BUS. LAW. 511 (1990). Several courts were also receptive to *Deprizio* waivers, holding that such terms prevented transfers from being preferential as to insider guarantors. Thanks to the waivers, the guarantors were not creditors. *In re Northeastern Contracting Co.*, 187 B.R. 420 (Bankr. D. Conn. 1995); *In re XTI Xonix Technologies, Inc.*, 156 B.R. 821 (Bankr. D. Or. 1993); *In re Fastrans, Inc.*, 142 B.R. 241 (Bankr. E.D. Tenn. 1992); see also *In re Southmark Corp.*, 993 F.2d 117 (5th Cir. 1993) (holding that even if payment were beneficial to an insider, payment could not be preferential as to that insider if the insider were not a contingent creditor with respect to the loan in question).

On the other hand, some commentators were dubious about *Deprizio* waivers, seeing them merely as an attempt to evade bankruptcy statutes by private agreement, and to insulate insiders from preference liability in the event of the debtor’s bankruptcy. Jay L. Westbrook, *Two Thoughts About Insider Preferences*, 76 MINN. L. REV. 73 (1991). Furthermore, some commentators pointed out that the waiver of any right of recourse against the debtor might mean
that insider guarantors could be even more inclined to see to it that the debtor paid the debts that the insiders had guaranteed in preference to those debts that they had not guaranteed. See Alvin L. Arnold, Bankruptcy: Waiver of Subrogation Defeats Deprizio, 22-Dec. REAL EST. L. REP. 4 (1992); Marshall E. Tracht, Insider Guaranties in Bankruptcy: A Framework for Analysis, 54 U. MIAMI L. REV. 497 (2000). Furthermore, at least two reported decisions refused to recognize the validity of Deprizio waivers, holding that such terms are contrary to public policy and, at bottom, a sham. In re Pro Page Partners, LLC, 292 B.R. 622 (Bankr. E.D. Tenn. 2003), subsequently aff’d, 151 Fed. Appx. 366 (6th Cir. 2005); In re Telesphere Communications, Inc., 229 B.R. 173 (Bankr. N.D. Ill. 1999).

This position rejecting Deprizio waivers out of hand rested on two questionable assumptions. The first was that Congress intended that noninsiders should be barred from taking reasonable steps to protect themselves in a potential trilateral or indirect preference situation. Nothing could have been less certain. The case against Deprizio waivers would have been on stronger ground in asserting that the insiders themselves should not be able to escape liability when they caused the debtor to make preferential payments. Even there, however, there was no inherent reason why a guarantor should not be able to waive its rights of recourse against the primary obligor, thus ceasing to be a “creditor” as defined by the Bankruptcy Code. Unless the waiver was palpably a sham with no real substance and simply concealed a continuing right of recourse against the debtor, there was no reason not to recognize such waivers as valid simply because a court thought that they were not a good idea. If genuine waivers were to be condemned, this step should have been based on clear evidence of the intent of Congress.


Section 202 of the Bankruptcy Reform Act of 1994 furnished a partial legislative answer to Deprizio. This statute added a new Section 550(c) to the Bankruptcy Code. For cases filed on
or after October 22, 1994, 11 U.S.C. § 550(c) provides that, if a transfer were made for the benefit of an insider creditor between 90 days and one year prepetition, and is thus avoidable under 11 U.S.C. § 547(b), the estate may not recover from a noninsider transferee. *In re Mid-South Auto Brokers, Inc.*, 290 B.R. 658 (Bankr. E.D. Ark. 2003) (Section 550(c) bars recovery against a noninsider transferee); *In re Vaughn*, 244 B.R. 631 (Bankr. W.D. Ky. 2000) (same). It is important to note that this statute in no way altered Section 547(b). Transfers that benefited an insider guarantor could still be avoided as preferential for the full one-year reachback period. The statute simply says that, in a *Deprizio* situation, a noninsider may not be required to return the property transferred or its value to the estate. *In re M2Direct, Inc.*, 282 B.R. 60 (Bankr. N.D. Ga. 2002); see *In re Williams*, 234 B.R. 801 (Bankr. D. Or. 1999); Marshall E. Tracht, *Insider Guaranties in Bankruptcy*, 54 U. MIAMI L. REV. 497 (2000). The insider guarantor could still be liable for recovery. *In re Denochek*, 287 B.R. 632 (Bankr. W.D. Pa. 2003); see *In re Exide Technologies, Inc.*, 299 B.R. 732 (Bankr. D. Del. 2003).

The enactment of 11 U.S.C. § 550(c) did not alter the fact that a transfer made for the benefit of an insider guarantor could still be an avoidable indirect preference. *M2Direct*, 282 B.R. at 60; *see Exide Technologies*, 299 B.R. at 732. Thus, there were several reasons why a prudent lender might wish to continue using *Deprizio* waivers. First, there are situations where no payment or other property had actually passed into the lender’s hands, but where a “transfer”—broadly defined—had nonetheless benefited an insider guarantor. Such would be the case, for example, where the lender received a security interest that benefitted an insider guarantor within one year prepetition. In such an instance, there would be no need for the bankruptcy estate to recover anything under Section 550; the property subject to the security interest would already be in the hands of the estate. *Dunes Hotel Assocs. v. Hyatt Corp.*, 245 B.R. 492 (D.S.C. 2000); *see In re Burns*, 322 F.3d 421 (6th Cir. 2003); *In re Pearce*, 236 B.R. 261 (Bankr. S.D. Ill. 1999); *In re Smith*, 236 B.R. 91 (Bankr. M.D. Ga. 1999). The estate could simply avoid the security interest under Section 547, thus leaving the creditor unsecured. *In re Williams*, 234 B.R. 801 (Bankr. D. Or. 1999) (holding that *Deprizio* applied in such cases and remained unaffected by Section 550(c)); *see Congress Credit Corp. v. AJC Intern., Inc.*, 186 B.R. 555 (D.P.R. 1995); Norris, *Bankruptcy Preference Actions*, 121 BANKING L.J. at 483. With a *Deprizio* waiver, however, this result would not have followed, at least if the court were willing to uphold such waivers. The insider would have no rights against the debtor or the estate, and thus would not be a creditor. Hence the security interest would not be indirectly preferential and could not be avoided at all. *See In re Northeastern Contracting Co.*, 187 B.R. 420 (Bankr. D. Conn. 1995); *In re XTI Xonix Technologies, Inc.*, 156 B.R. 821 (Bankr. D. Or. 1993). *But see In re Telesphere Communications, Inc.*, 229 B.R. 173 (Bankr. N.D. Ill. 1999).
Again, 11 U.S.C. § 502(d) requires a bankruptcy court to disallow the claim of any entity that is a transferee of an avoidable transfer unless that entity has returned the property or its value to the estate. This is true even if the estate is barred from maintaining an action for affirmative recovery, In re Moore, 323 B.R. 752 (Bankr. D. Or. 2005) (sovereign immunity); In re 360networks (USA), Inc., 316 B.R. 797 (Bankr. S.D.N.Y. 2004) (same), or if the bankruptcy court would lack jurisdiction to fully adjudicate the creditor’s liability and order payment. In re PRS Ins. Group, Inc., 331 B.R. 580 (Bankr. D. Del. 2005) (claimant and potential avoidance defendant was an insurance company in state court receivership), reconsideration denied, 335 B.R. 77 (Bankr. D. Del. 2005). Conceivably, if the estate had already recovered the value of an indirect preference from an insider guarantor, this provision might never come into play. If the value of an indirect preference could not be recovered from the insider who benefited from it, however, a trustee or debtor-in-possession might have used Section 502(d) against a noninsider creditor. Richard C. Josephson, The Deprizio Override: Don’t Kiss Those Waivers Goodbye Yet, 4-June BUS. L. TODAY 40 (1995); see also Norris, Bankruptcy Preference Actions, 121 BANKING L.J. at 483.

The defensive use of a claim after the statute of limitations has run provides a good analogy. The general common law rule is that statutes of limitations operate to bar only claims for recovery, not affirmative defenses. In keeping with this principle, most courts have held that when an avoidance action is time-barred under 11 U.S.C. § 546(a), a trustee or debtor-in-possession may still use the avoidable transfer for claim objection purposes under 11 U.S.C. § 502(d). The estate may obtain no affirmative recovery, but it may use the avoidable transfer as a shield rather than a sword. In re America West Airlines, Inc., 217 F.3d 1161 (9th Cir. 2000); In re KF Dairies, Inc., 143 B.R. 734 (9th Cir. B.A.P. 1992); In re Ducane Gas Grills, Inc., 320 B.R.
324 (Bankr. D.S.C. 2004); In re Metiom, Inc., 301 B.R. 634 (Bankr. S.D.N.Y. 2003); In re Loewen Group Intern., Inc., 292 B.R. 522 (Bankr. D. Del. 2003); In re Weinstein, 256 B.R. 536 (Bankr. S.D. Fla. 1999). But see In re Marketing Assocs. of Am., Inc., 122 B.R. 367 (Bankr. E.D. Mo. 1991); In re Marketing Resources Intern. Corp., 35 B.R. 353 (Bankr. E.D. Pa. 1984). By analogy, if there had been an avoidable indirect preference between 90 days and one year prepetition, a creditor’s claim might be disallowed, even though no affirmative recovery could be had against the noninsider creditor. See In re Churchill Nut Co., 251 B.R. 143 (Bankr. N.D. Cal. 2000) (holding that an adversary proceeding is not necessary when the estate representative seeks to use the preference section in a purely defensive manner and when an adversary proceeding could not possibly lead to any affirmative recovery in any event); Luc A. Despins & Dennis F. Dunne, Insolvency Practice Pointers for Certain Corporate Transactions, 1055 PLI/CORP 277 (1998). With a Deprizio waiver that a court was willing to uphold, however, the transfer would not be avoidable at all because it would not be preferential as to an insider “creditor.” Consequently, there would be no grounds for disallowance. Josephson, The Deprizio Override, 4-June BUS. L. TODAY at 40; see In re Fastrans, Inc., 142 B.R. 241 (Bankr. E.D. Tenn. 1992).

In short, 11 U.S.C. § 550(c) did less to override Deprizio than one might at first suppose or than Congress may have intended. See Williams, 234 B.R. at 801; Steve H. Nickels, Deprizio Dead Yet? Birth, Wounding, and Another Attempt to Kill the Case, 22 CARDOZO L. REV. 1251 (2001). By focusing on the parties who may be liable for recovery rather than avoidance as such, Congress left open a number of thorny issues with respect to transfers made between 90 days and one year prepetition. Therefore, prudent lenders might have been well advised to continue using Deprizio waivers. Jo Ann J. Brighton & Peter N. Tamposi, Payments Benefitting Insider
Guarantors Can Be Protected from Recovery by Artful Loan Drafting, 20-Oct. AM. BANKR. INST. J. 10 (2001); Norris, Bankruptcy Preference Actions, 121 BANKING L.J. at 483. Even if such waivers were used, however, it was not certain that all courts will honor them. In re Pro Page Partners, LLC, 292 B.R. 622 (Bankr. E.D. Tenn. 2003), subsequently aff’d, 151 Fed. Appx. 366 (6th Cir. 2005).


Finally, in 2005, Congress put an end to Deprizio and its progeny. Section 1213 of BAPCPA, codified as 11 U.S.C. § 547(i), provides that, in a trilateral preference situation, if a transfer made to a noninsider is avoided because it benefits an insider creditor such as a guarantor, the transfer shall be deemed avoided only with respect to the insider, not with respect to the noninsider. See Kevin C. Driscoll, Jr., Bankruptcy 2005: New Landscape for Preference Proceedings, 24-Jun. AM. BANKR. INST. J. 1 (2005). The legislative history indicates clearly that Congress understood the shortcomings of 11 U.S.C. § 550(c), which had been enacted in 1994, and that Congress wished to eliminate Deprizio, not merely with respect to recovery, but with respect to avoidance as well. H.R. Rep. No. 31, 109th Cong., 1st Sess., pt. 1, 143-44 (2005). Unlike most provisions of BAPCPA, Section 547(i) took effect immediately upon enactment. It applies in any case, including any adversary proceeding, pending or filed on after April 20, 2005. It has already been upheld against constitutional challenge and used to defeat a Deprizio claim for the avoidance of mortgage liens. In re ABC-Naco, Inc., 331 B.R. 773 (Bankr. N.D. Ill. 2005).

The upshot is that, in a Deprizio situation, the transfer may be avoided, if at all, only with respect to the insider, and, if there is to be any recovery, the estate may recover only from the insider. Thus, the 2005 legislation seems to have eliminated most of the rationale for inserting Deprizio waivers in guaranties, at least from the creditor’s perspective, and the controversy surrounding such provisions may disappear.
III.

FRAUDULENT TRANSFER AVOIDANCE

A. GENERAL CONSIDERATIONS.

1. Bases for Fraudulent Transfer Actions.

11 U.S.C. § 548(a) establishes a cause of action under the Bankruptcy Code for setting aside prepetition transactions that were undertaken with actual intent to hinder, delay, or defraud creditors, 11 U.S.C. § 548(a)(1)(A), or that were constructively fraudulent. 11 U.S.C. § 548(a)(1)(B). Much the same results may be achieved by using state law under 11 U.S.C. § 544(b). Thus, the representative of the estate may attack an allegedly fraudulent transfer using federal law, state law, or both. E.g., In re Triple S Restaurants, Inc., 422 F.3d 405 (6th Cir. 2005); In re Bonham 229 F.3d 750 (9th Cir. 2000); In re Taylor, 133 F.3d 1336 (10th Cir.), cert. denied, 525 U.S. 873 (1998); In re of FBN Food Servs., Inc., 82 F.3d 1387 (7th Cir. 1996).

11 U.S.C. § 544(b) allows the representative of the estate to avoid any prepetition transfer of the debtor’s property or any prepetition obligation incurred by the debtor if the same transfer or obligation could be avoided under state law by an unsecured creditor holding an allowable claim. In re Marlar, 267 F.3d 749 (8th Cir. 2001); In re Leonard, 125 F.3d 543 (7th Cir. 1997); Official Committee of Asbestos Claimants of G-I Holding, Inc. v. Heyman, 277 B.R. 20 (S.D.N.Y. 2002) (noting that Section 544(b) does not establish any substantive grounds for avoidance, but rather merely incorporates state law); In re Unglaub, 332 B.R. 303 (Bankr. N.D. Ill. 2005) (predicate creditor must exist but need not be specifically identified in complaint). Actions under this statute are not limited to ordinary state fraudulent transfer law. For example, the District of Columbia has a statute permitting a judgment creditor of a debtor-employee to recover the reasonable value of the debtor’s services from the employer if the employer is a relative of the debtor or controlled by a relative of the debtor and if the debtor has worked for
free or for grossly inadequate wages. D.C. Code § 16-579. In effect, this statute would deem the employment arrangement a fraudulent transfer of the value of the debtor’s services. A bankruptcy estate representative may bring an action based on this statute under 11 U.S.C. § 544(b). In re Schneiderman, 251 B.R. 757 (Bankr. D.D.C. 2000). By contrast, under the Uniform Fraudulent Transfer Act and 11 U.S.C. § 548, a debtor’s labor or services are not considered “property” because they are not subject to ownership, see U.S. Const. amend. XIII, and thus these statutes would not permit avoidance in such a situation. Bressner v. Ambroziak, 379 F.3d 478 (7th Cir. 2004).

Using 11 U.S.C. § 544(b), a trustee or debtor-in-possession may avoid a bulk transfer using Article 6 of the U.C.C. if the debtor failed to give the requisite notice to creditors, at least in those jurisdictions where either the original version of Article 6 or the 1989 version remains in force. In re Verco Indus., 704 F.2d 1134 (9th Cir. 1983); In re Interstate Cigar Co., Inc., 285 B.R. 789 (Bankr. E.D.N.Y. 2002), aff’d, 42 B.C.D. 69 (E.D.N.Y. 2003); In re Villa Roel, Inc., 57 B.R. 835 (Bankr. D.D.C. 1985); see In re Pacific Gas & Elec. Co., 281 B.R. 1 (Bankr. N.D. Cal. 2002). Similarly, a payment made by a debtor corporation to its shareholders may be challenged as an improper dividend under state corporation statutes, and this theory may be used under Section 544(b) instead of or in addition to a normal fraudulent transfer attack. In re Le Cafe Creme, Ltd., 244 B.R. 221 (Bankr. S.D.N.Y. 2000); In re Mi-Lor Corp., 233 B.R. 608 (Bankr. D. Mass. 1999); In re Integra Realty Resources, Inc., 198 B.R. 352 (Bankr. D. Colo. 1996). Likewise, state law may be used to establish that the recipient of a fraudulent transfer held the property in a resulting or a constructive trust for the benefit of the transferor’s creditors. In re Valente, 360 F.3d 256 (1st Cir. 2004) (Rhode Island law); In re McGavin, 189 F.3d 1215 (10th Cir. 1999) (Utah law); see Chemical Bank v. Dana, 234 B.R. 585 (D. Conn. 1999).
Most litigation under Section 544(b) involves normal state fraudulent transfer statutes, however. As a practical matter, the relevant state law is usually the Uniform Fraudulent Transfer Act, which was approved by the National Conference of Commissioners on Uniform State Laws in 1984 and has now been adopted in the majority of states. *In re Turner*, 335 B.R. 140 (Bankr. N.D. Cal. 2005); *In re Brentwood Lexford Partners, LLC*, 292 B.R. 255 (Bankr. N.D. Tex. 2003); *In re Crystal Med. Prods., Inc.*, 240 B.R. 290 (Bankr. N.D. Ill. 1999); *In re Mizrahi*, 179 B.R. 322 (Bankr. M.D. Fla. 1995); see also Paul P. Daley & Mitchell Appelbaum, *The Modernization of Massachusetts Fraudulent Conveyance Law: The Adoption of the Uniform Fraudulent Transfer Act*, 82 MASS. L. REV. 337 (1998); Douglas C. Michael, *The Past and Future of Kentucky’s Fraudulent Transfer and Preference Laws*, 86 KY. L.J. 936 (1998). Where the state in question has recently adopted the U.F.T.A., courts have held that the statute is not retroactive and have applied the Uniform Fraudulent Conveyance Act when that was the former law. *U.S. v. Green*, 201 F.3d 251 (3d Cir. 2000) (Pennsylvania law); *In re Bargfrede*, 117 F.3d 1078 (8th Cir. 1997) (Iowa law); accord *In re Rauh*, 119 F.3d 46 (1st Cir. 1997) (Massachusetts law); see *In re Valley-Vulcan Mold Co.*, 237 B.R. 322 (6th Cir. B.A.P. 1999) (Ohio law); *In re Lowenstein*, 312 B.R. 6 (Bankr. D. Mass. 2004); *In re Fashion Accessories, Ltd.*, 308 B.R. 592 (Bankr. N.D. Ga. 2004). Some states have nonuniform fraudulent transfer laws that may be used under 11 U.S.C. § 544(b). *See In re Meyer*, 244 F.3d 352 (4th Cir.) (Virginia law), *cert. denied*, 534 U.S. 893 (2001). In Louisiana, an estate representative using Section 544(b) may bring a “revocatory action” or an Actio Pauliana under that state’s civil code. *See In re Goldberg*, 277 B.R. 251 (Bankr. M.D. La. 2002) (giving a thorough discussion of the origins and development of the Actio Pauliana); *In re Babcock & Wilcox Co.*, 274 B.R. 230 (Bankr. E.D. La. 2002); LA. CIV. CODE art. 2036.
11 U.S.C. § 548(a) embodies many of the same principles as the Uniform Fraudulent Conveyance Act, and the U.F.T.A. drew heavily on bankruptcy precedents and the Bankruptcy Code. See In re Hinsley, 201 F.3d 638 (5th Cir. 2000); In re Harlin, 321 B.R. 836 (Bankr. E.D. Mich. 2005); see also Morganroth & Morganroth v. DeLorean, 213 F.3d 1301 (10th Cir. 2000). Thus, with few exceptions, the basic principles governing fraudulent transfer actions are much the same regardless of the statutory basis used. Friedrick v. Mottaz, 294 F.3d 864 (7th Cir. 2002) (noting that the U.F.T.A. and 11 U.S.C. § 548 are substantially alike except for the reachback period); Buncher Co. v. Official Committee of Unsecured Creditors of GenFarm Ltd. Partnership IV, 229 F.3d 245 (3d Cir. 2000) (noting that the application of the U.F.C.A. or the U.F.T.A. would make no difference to the outcome of the case); In re Pajardo Dunes Rental Agency, Inc., 174 B.R. 557 (Bankr. N.D. Cal. 1994) (“Unless otherwise specified, common-law authorities and case-law dealing with the U.F.C.A., U.F.T.A., Bankruptcy Act of 1898 or the Bankruptcy Code may be cross-referenced whatever the statutory basis of the action at bar.”); accord Unglaub, 332 B.R. at 303; In re Sun Valley Prods., Inc., 328 B.R. 147 (Bankr. D.N.D. 2005).

2. Reachback Period for Avoiding a Fraudulent Transfer.

There are two distinct of limitations periods for bringing a fraudulent transfer avoidance action. On the one hand, the time after the filing of the petition within which an action must be filed is governed by 11 U.S.C. § 546(a). See § I.E.1., supra. On the other hand, the reachback period or the time between the transfer itself and the filing of the bankruptcy petition is governed by the statutory basis for the fraudulent transfer avoidance.

Prior to the enactment of BAPCPA, 11 U.S.C. § 548(a)(1) allowed for the avoidance of any transfer made within one year prepetition. Section 1402 of BAPCPA amended 11 U.S.C. § 548(a)(1) by changing the reachback period from one year to two years. This change, however,
is only effective for cases filed more than one year after the date of enactment — i.e., after April 20, 2006. See Samuel K. Crocker & Robert H. Waldschmidt, *Impact of the 2005 Bankruptcy Amendments on Chapter 7 Trustees*, 79 *AM. BANKR. L.J.* 333 (2005). Under any version of the fraudulent transfer statute, no transfer made outside the prepetition reachback period may be avoided, no matter how timely the action might be under Section 546. *In re Bame*, 252 B.R. 148 (Bankr. D. Minn. 2000); *In re Serrate*, 214 B.R. 219 (Bankr. N.D. Cal. 1997). On the other hand, an action under Section 548(a)(1) may be barred if it is not brought within the time limits specified by Section 546(a), even though the transfer was made within the reachback period before the bankruptcy filing. *In re Quality Pontiac Buick GMC Truck, Inc.*, 222 B.R. 865 (Bankr. D. Minn. 1998). But see *In re Stanwich Fin. Servs. Corp.*, 291 B.R. 25 (Bankr. D. Conn. 2003) (holding that the reachback period is subject to equitable tolling).

U.F.T.A. § 9(b) establishes a four-year limitations period running from the time of the transfer for bringing an action to set aside a constructively fraudulent transaction. In the case of an actually fraudulent transfer, the limitations period is the later of four years from the time of the transfer or one year from the time that the claimant learned of it or reasonably could have learned of it. U.F.T.A. § 9(a); see *Neilson v. Union Bank of California, N.A.*, 290 F. Supp. 2d 1101 (C.D. Cal. 2003); *In re Hill*, 332 B.R. 835 (Bankr M.D. Fla. 2005). If the estate representative chooses to employ the U.F.T.A. under 11 U.S.C. § 544(b), then the limitations period must not have run by the time the bankruptcy petition is filed. If the claim is not barred as of that point, it may be filed later. *In re Spatz*, 222 B.R. 157 (N.D. Ill. 1998); *In re Dry Wall Supply, Inc.*, 111 B.R. 933 (D. Colo. 1990). Under 11 U.S.C. § 546(a), the avoidance action will be timely if the state law limitations period has not run by the petition date, see *In re Bernstein*, 259 B.R. 555 (Bankr. D.N.J. 2001) (action under Section 544(b) was untimely where state law
limitations period had expired before petition date); *In re Dergance*, 218 B.R. 432 (Bankr. N.D. Ill. 1998), and if the action is brought within two years of the time that the petition is filed. *In re Blatstein*, 244 B.R. 290 (Bankr. E.D. Pa. 2000); *Dry Wall Supply*, 111 B.R. at 933. The four-year period for a constructively fraudulent transfer action is a true statute of repose and is not subject to equitable tolling, whereas the four-year period for bringing an actually fraudulent transfer action is subject to the discovery rule. *In re Heaper*, 214 B.R. 576 (8th Cir. B.A.P. 1997); *In re Southwest Supermarkets, L.L.C.*, 315 B.R. 565 (Bankr. D. Ariz. 2004).

Whatever the basis of the state law claim, the state law statute of limitations applicable to it governs the reachback period. Some states that have adopted the U.F.T.A. have a nonuniform limitations period. *In re Schaefer*, 331 B.R. 401 (Bankr. N.D. Iowa 2005) (Iowa U.F.T.A. has a five-year rather than normal four-year limitations period). In New York, the U.F.C.A. is still in force, and it does not have a limitations period of its own. A fraudulent conveyance claim under New York law is subject to a six-year limitations period under a catchall limitations statute. *In re Borriello*, 329 B.R. 367 (Bankr. E.D.N.Y. 2005); *In re Petition of Garcia Avila*, 296 B.R. 95 (Bankr. S.D.N.Y. 2003). Some sorts of actions may be covered by a special limitations period. *In re Die Fledermaus LLC*, 323 B.R. 101 (Bankr. S.D.N.Y. 2005) (under New York law, any action to recover a wrongful distribution to a member of an LLC must be brought within three years).

Irrespective of the limitations or reachback period applicable to the underlying claim, Section 546(a) clearly gives the bankruptcy estate two years from the petition to date (and an extension if the case is converted or a trustee is appointed within that time) in which to bring an avoidance action. Thus, if there is a creditor holding an allowable unsecured claim as of the petition date who could have brought an action under state law, the estate representative has an
additional two years in which to bring the action, even if the action would be time-barred if it were asserted by an individual creditor outside of bankruptcy. *In re Mi-Lor Corp.*, 233 B.R. 608 (Bankr. D. Mass. 1999); see *In re Princeton-New York Investors, Inc.*, 255 B.R. 366 (Bankr. D.N.J. 2000). If, however, the state law fraudulent transfer action is not brought within the period specified by Section 546(a), then it will be time-barred, even if the claim would still be timely under the state law limitations period. *In re Mediators, Inc.*, 105 F.3d 822 (2d Cir. 1997); *National Am. Ins. Co. v. Ruppert Landscape Co., Inc.*, 122 F. Supp. 2d 670 (E.D. Va. 2000); *In re Transcolor Corp.*, 296 B.R. 343 (Bankr. D. Md. 2003); *In re Naturally Beautiful Nails, Inc.*, 243 B.R. 827 (Bankr. M.D. Fla. 1999). Under any analysis, the reachback period of Section 548 is irrelevant in a state law fraudulent transfer action under Section 544(b). *In re Haddock*, 246 B.R. 810 (Bankr. D.S.C. 2000); *In re Montclair Homes*, 200 B.R. 84 (Bankr. E.D.N.Y. 1996); *In re A.F. Walker & Son, Inc.*, 46 B.R. 186 (Bankr. D.N.H. 1985).

B. **TRANSFERS MADE WITH ACTUAL INTENT TO HINDER, DELAY, OR DEFRAUD CREDITORS.**

1. **Standard of Proof.**

Both 11 U.S.C. § 548(a)(1)(A) and U.F.T.A. § 4(a)(1) allow for the avoidance of transfers made or obligations incurred with actual intent to hinder, delay, or defraud creditors. The representative of the estate must show that: (a) the debtor transferred property or incurred an obligation; (b) the debtor had an interest in the property in question; (c) the transfer was made or the obligation incurred with actual intent to hinder, delay, or defraud creditors; and (d) the action is brought on behalf of the creditors of the estate. *In re Spearing Tool & Mfg. Co.*, 171 B.R. 578 (Bankr. E.D. Mich. 1994); *In re Parker Steel Co.*, 149 B.R. 834 (Bankr. N.D. Ohio 1992). The plaintiff need not show an intent to defraud creditors outright or to deprive them of payment permanently. Proof an intention to hinder or delay will suffice. *Tiab Communications Corp. v. Keymarket of NEPA, Inc.*, 263 F. Supp. 2d 925 (M.D. Pa. 2003); *In re Marra*, 308 B.R.
With transfers that are merely constructively fraudulent, where no showing of any actual nefarious intent is necessary, the standard of proof generally is simply a preponderance of the evidence under either Section 548 or the law of the majority of states. E.g., In re Jackson, 318 B.R. 5 (Bankr. D.N.H. 2004); In re Dolata, 306 B.R. 97 (Bankr. W.D. Pa. 2004); In re TML, Inc., 291 B.R. 400 (Bankr. W.D. Mich. 2003); In re Empire Interiors, Inc., 248 B.R. 305 (Bankr. N.D. Ohio 2000); In re Ventimiglia, 198 B.R. 205 (Bankr. E.D. Mich. 1996); In re Kelton Motors, Inc., 130 B.R. 170 (Bankr. D. Vt. 1991). But see In re Schaefer, 331 B.R. 401 (Bankr. N.D. Iowa 2005) (under Iowa law, both actual and constructive fraud must be shown by clear and convincing evidence); In re Carrozella & Richardson, 302 B.R. 415 (Bankr. D. Conn. 2003) (same under Connecticut law); In re Baker, 273 B.R. 892 (Bankr. D. Wyo. 2002) (same under Wyoming law); In re J.R. Deans Co., Inc., 249 B.R. 121 (Bankr. D.S.C. 2000) (same under South Carolina law). Following state law rules to the effect that a more rigorous standard is usually necessary in a full-blown scienter fraud case, however, some courts have held that, where actual fraudulent intent is at issue, proof by clear and convincing evidence is required, regardless of whether bankruptcy law or state law provides the basis for the claim. Stratton v. Equitable Bank, N.A., 104 B.R. 713 (D. Md. 1989), aff’d, 912 F.2d 464 (4th Cir. 1990); In re Major Funding Corp., 126 B.R. 504 (Bankr. S.D. Tex. 1990).

The strong current of opinion now holds that actual fraudulent intent under 11 U.S.C. § 548(a)(1)(A) need only be shown by a preponderance of the evidence. In Grogan v. Garner, 498 U.S. 279 (1991), the Supreme Court held that evidentiary questions concerning the discharge of a debtor under 11 U.S.C. § 523(a)(2)(A) must be governed by a preponderance of the
evidence standard when actual fraud is alleged. Although the *Grogan* Court was not directly addressing transfer avoidance, most decisions since *Grogan* have held that the same rule governs in actions under 11 U.S.C. § 548(a)(1)(A). *In re McCook Metals, L.L.C.*, 319 B.R. 570 (Bankr. N.D. Ill. 2005); *In re Model Imperial, Inc.*, 250 B.R. 776 (Bankr. S.D. Fla. 2000); *In re Bennett Funding Group, Inc.*, 232 B.R. 565 (Bankr. N.D.N.Y. 1999); *In re Wolcott*, 194 B.R. 477 (Bankr. D. Mont. 1996); *In re Food & Fibre Protection, Ltd.*, 168 B.R. 408 (Bankr. D. Ariz. 1994); *In re Sullivan*, 161 B.R. 776 (Bankr. N.D. Tex. 1993). A minority of courts, however, have continued to adhere to the clear and convincing standard in Section 548(a)(1)(A) cases without discussing or distinguishing *Grogan*. *In re Lease-A-Fleet, Inc.*, 155 B.R. 666 (Bankr. E.D. Pa. 1993); *In re Ste. Jan-Marie, Inc.*, 151 B.R. 984 (Bankr. S.D. Fla. 1993); see *In re Taylor*, 133 F.3d 1336 (10th Cir.) (noting the split of authority but finding no need to resolve it; evidence showed actual intent to defraud, even if clear and convincing standard applied), cert. denied, 525 U.S. 873 (1998); *Dolata*, 306 B.R. at 97 (likewise noting the split of authority but finding no need to decide the question).

At least one court has spoken as though the federal preponderance of the evidence standard applies when an action based upon actual fraudulent intent is brought under state law pursuant to 11 U.S.C. § 544(b). *In re Lawler*, 141 B.R. 425 (9th Cir. B.A.P. 1992). This should not necessarily be the case, however. There is nothing in the Bankruptcy Code to indicate that Congress meant to displace state law standards of proof when the estate seeks to avoid a transaction under a state law cause of action. *Kelton Motors*, 130 B.R. at 170. Thus, if state law requires proof of actual fraudulent intent by clear and convincing evidence, that same standard should apply in bankruptcy under Section 544(b), even if a preponderance of the evidence standard would apply if the action were brought under Section 548. See *Lippe v. Bairnco Corp.*, 306

2. Determining Actual Intent: Badges of Fraud.

Establishing actual intent to hinder, delay, or defraud creditors requires an inquiry into the debtor’s subjective state of mind at the time of the transfer. In re Jeffrey Bigelow Design Group, Inc., 956 F.2d 479 (4th Cir. 1992); In re Shore, 305 B.R. 559 (Bankr. D. Kan.), aff’d, 317 B.R. 536 (10th Cir. B.A.P. 2004); In re Exide Technologies, Inc., 299 B.R. 732 (Bankr. D. Del. 2003). The focus is squarely on the state of mind of the debtor; the intentions of the immediate transferee have no bearing on the question whether the transfer was made with actual intent to hinder, delay, or defraud. In re Sharp Intern. Corp., 281 B.R. 506 (Bankr. E.D.N.Y. 2002), aff’d, 302 B.R. 760 (E.D.N.Y. 2003), aff’d, 403 F.3d 43 (2d Cir. 2005); In re Lake States Commodities, Inc., 253 B.R. 866 (Bankr. N.D. Ill. 2000); see In re Adler, Coleman Clearing Corp., 263 B.R. 406 (S.D.N.Y. 2001). If, however, the transferee dominated and controlled the debtor—as, for example, where the transferee was the sole shareholder of a corporate debtor—then the transferee’s intent may be imputed to the debtor-transferor. In re All American Petro. Corp., 259 B.R. 6 (Bankr. E.D.N.Y. 2001); see Adler, Coleman, 263 B.R. at 406; In re Bonham, 224 B.R. 114 (Bankr. D. Alaska 1998).

Because subjective intentions are at issue, the inquiry is normally highly fact-specific, and summary judgment is often inappropriate. In re Cambridge Capital, LLC, 331 B.R. 47 (Bankr E.D.N.Y. 2005); In re Porras, 312 B.R. 81 (Bankr. W.D. Tex. 2004); In re IDS Holding Co., LLC, 292 B.R. 233 (Bankr. D. Conn. 2003); In re Sackman Mortg. Corp., 158 B.R. 926 (Bankr. S.D.N.Y. 1993). In a few cases, however, actual intent may be established virtually as a

In most instances, however, direct evidence of a dishonest state of mind cannot be shown. In such cases, courts have long looked to various objective indicia or “badges of fraud” to establish the debtor’s intent. *Friedrich v. Mottaz*, 294 F.3d 864 (7th Cir. 2002); *In re McGavin*, 189 F.3d 1215 (10th Cir. 1999); *Jeffrey Bigelow Design Group*, 956 F.2d at 479; *In re Flutie N.Y. Corp.*, 310 B.R. 31 (Bankr. S.D.N.Y. 2004); *In re Schultz*, 250 B.R. 22 (Bankr. E.D.N.Y. 2000). Although a single badge of fraud will usually do no more than raise a passing suspicion,
see In re Montalvo, 333 B.R. 145 (Bankr. W.D. Ky. 2005); In re Advanced Telecommunication Network, Inc., 321 B.R. 308 (Bankr. M.D. Fla. 2005), the presence of several may create an overwhelming inference of an improper motive. Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248 (1st Cir. 1991). There is no need to adduce evidence of a majority of the badges of fraud listed in the U.F.T.A., or any particular number of badges. Brandon v. Anesthesia & Pain Mgmt. Assocs., Inc., 419 F.3d 594 (7th Cir. 2005); cf. In re Triple S Restaurants, Inc., 422 F.3d 405 (6th Cir. 2005) (even a single badge of fraud can establish an inference of improper motive when all relevant facts are uniquely within the knowledge of the defendant). Once sufficient badges of fraud have been adduced, the burden shifts to the defendant to show that the transaction was legitimate. Triple S Restaurants, 422 F.3d at 405; Tavenner v. Smoot, 257 F.3d 401 (4th Cir. 2001); Kelly v. Armstrong, 206 F.3d 794 (8th Cir. 2000); In re Valley-Vulcan Mold Co., 237 B.R. 322 (6th Cir. B.A.P. 1999); see In re Zeigler, 320 B.R. 362 (Bankr. N.D. Ill. 2005) (debtor successfully overcame presumption raised by several badges of fraud); In re Meyer, 307 B.R. 87 (Bankr. N.D. Ill. 2004) (same). If the inference raised by the badges of fraud cannot be overcome, then the transfer will be found to have been tainted by a dishonest intention, and it may be avoided. Hinsley, 201 F.3d at 638; In re Unglaub, 332 B.R. 303 (Bankr. N.D. Ill. 2005); In re PSI Indus., Inc., 306 B.R. 377 (Bankr. S.D. Fla. 2003); In re Harper, 132 B.R. 349 (Bankr. S.D. Ohio 1991).

An exhaustive compilation of all the indicia that may serve as badges of fraud would be an impossible task. In re Gateway Invs. Corp., 152 B.R. 354 (Bankr. S.D. Fla. 1993). Section 4(b) of the Uniform Fraudulent Transfer Act, however, gives a nonexclusive list of some of the objective criteria that courts commonly consider, including: (a) whether the transfer were made to an insider; (b) whether the debtor retained possession or control of the property after the
purported transfer; (c) whether the transfer were furtive or concealed; (d) whether the debtor had been sued or threatened with liability before the transfer; (e) whether the transfer involved all or substantially all of the debtor’s assets; (f) whether the debtor received reasonable consideration; and (g) whether the debtor were insolvent at the time of the transfer, or became insolvent shortly thereafter. See Friedrich, 294 F.3d at 864; Hinsley, 201 F.3d at 638; In re XYZ Options, Inc., 154 F.3d 1276 (11th Cir. 1998); In re Xyan.Com, Inc., 299 B.R. 357 (Bankr. E.D. Pa. 2003); In re Crescent Communities, Inc., 298 B.R. 143 (Bankr. S.D. Ohio 2003). The same sorts of indicia are used in actions brought under 11 U.S.C. § 548. In re Hertzler Halstead Hosp., 334 B.R. 276 (Bankr. D. Kan. 2005); In re Montalvo, 324 B.R. 619 (Bankr. W.D. Ky. 2005); In re Brentwood Lexford Partners, LLC, 292 B.R. 255 (Bankr. N.D. Tex. 2003).

Examples may serve to illustrate how badges of fraud help to establish actual intent. In In re Acequia, Inc., 34 F.3d 800 (9th Cir. 1994), distributions to controlling shareholders (i.e., to insiders) were held fraudulent where the distributions were made on the eve of bankruptcy and were not documented or recorded. Accord Gaddis v. Allison, 234 B.R. 805 (D. Kan. 1999); see Brentwood Lexford Partners, 292 B.R. at 255; In re Youngstown Osteopathic Hosp. Ass’n, 280 B.R. 400 (Bankr. N.D. Ohio 2002) (shuffling of assets among related entities using “Enronesque” accounting). Similarly, a purported payment of back salary to an insider by way of a conveyance of real property for purposes of improving the insider’s position may be fraudulent. In re Zenox, Inc., 173 B.R. 46 (Bankr. D.N.H. 1994); see In re Erstmark Capital Corp., 2002 WL 1792213 (N.D. Tex. Aug. 2, 2002), aff’d, 73 Fed. Appx. 79 (5th Cir. 2003).

Transfers to family members for little or no consideration while litigation is pending or other potential liability confronts the debtor are particularly suspect, especially if the debtor is left with few assets, Friedrich, 294 F.3d at 864; U.S. v. Green, 201 F.3d 251 (3d Cir. 2000); In re
McGavin, 189 F.3d 1215 (10th Cir. 1999); In re Kelsey, 270 B.R. 776 (10th Cir. B.A.P. 2001); In re Weeden, 306 B.R. 449 (Bankr. W.D.N.Y. 2004); In re Boba, 280 B.R. 430 (Bankr. N.D. Ill. 2002), or if the debtor continues to enjoy a right of control over or a beneficial interest in the property allegedly transferred. Goya Foods, Inc. v. Unanue, 233 F.3d 38 (1st Cir. 2000), cert. denied, 532 U.S. 1022 (2001); U.S. v. Mazzeo, 306 F. Supp. 2d 294 (E.D.N.Y. 2004); In re Colombo, 316 B.R. 429 (Bankr. W.D.N.Y. 2004) (debtor continued to enjoy use of property ostensibly transferred to her mother); Boba, 280 B.R. at 430 (debtor continued to enjoy use of property ostensibly transferred to his wife in a sham divorce). Likewise, under similar circumstances, a debtor’s transfer of assets to a family trust will almost certainly be found to involve actual intent to hinder, delay, or defraud. In re Mizrahi, 179 B.R. 322 (Bankr. M.D. Fla. 1995); see In re Miller, 175 B.R. 969 (Bankr. N.D. Ill. 1994). The same is true of a transfer to a family business entity that is being used largely for asset protection. In re Turner, 335 B.R. 140 (Bankr. N.D. Cal. 2005); In re Schaefer, 331 B.R. 401 (Bankr. N.D. Iowa 2005).


Traditionally, a beneficiary’s interest in three types of trusts has been recognized as shielded from the claims of the beneficiary’s general creditors. First, spendthrift trusts with a valid restraint on alienation protect the beneficiary’s interest until a distribution is made. Restatement (Second) of Trusts §§ 152-153 (1959). Because the beneficiary’s interest is not available to general creditors, that interest is excluded from a debtor-beneficiary’s bankruptcy estate pursuant to 11 U.S.C. § 541(c)(2). See In re Shurley, 115 F.3d 333 (5th Cir.), cert. denied, 522 U.S. 982 (1997); In re Roth, 289 B.R. 161 (Bankr. D. Kan. 2003).

Second, a discretionary trust is beyond the reach of the beneficiary’s creditors, not because of any restraint on alienation as such, but rather because of the nature of the
beneficiary’s interest. In light of the trustee’s almost unlimited discretion, the beneficiary could not compel a distribution, and hence neither may the beneficiary’s creditors. \textsc{Restatement (Second) of Trusts} § 155; see \textit{First Northwestern Trust Co. of S.D. v. I.R.S.}, 622 F.2d 837 (8th Cir. 1980). A debtor-beneficiary’s interest in a discretionary trust is likewise excluded from the bankruptcy estate under 11 U.S.C. § 541(c)(2). \textit{In re Wilson}, 140 B.R. 400 (Bankr. N.D. Tex. 1992); \textit{In re Pechanec}, 59 B.R. 899 (Bankr. E.D.N.Y. 1987).

Finally, a beneficiary’s interest in a support trust, under which the trustee may make distributions only for the beneficiary’s education, maintenance, and support, is beyond the reach of a beneficiary’s general creditors because of the limited nature of the beneficiary’s interest. \textsc{Restatement (Second) of Trusts} § 155. That interest is likewise excluded from the bankruptcy estate pursuant to 11 U.S.C. § 541(c)(2). \textit{In re Wachter}, 314 B.R. 365 (Bankr. E.D. Tenn. 2004); see \textit{In re McLaughlin}, 507 F.2d 177 (5th Cir. 1975) (Bankruptcy Act case).

The major limitation on protective trusts traditionally has been the prohibition against self-settlement. A settlor may not place her own property in a spendthrift, discretionary, or support trust for her own benefit and expect her beneficial interest in that property to remain beyond the reach of her creditors. \textsc{Restatement (Second) of Trusts} § 156. Because self-settled trusts have not shielded a debtor beneficiary’s interest under nonbankruptcy law, that interest has not been excluded from the bankruptcy estate. \textit{In re Brown}, 303 F.3d 1261 (11th Cir. 2002); \textit{In re Porras}, 224 B.R. 367 (Bankr. W.D. Tex. 1998); see \textit{Shurley}, 115 F.3d at 333 (holding that debtor-beneficiary’s interest in protective trust was invalid only to the extent of self-settlement; to the extent that other persons were the settlors, the protective provisions were valid). Generally, self-settled protective trusts have not been subject to an avoidance attack because placing one’s own assets in trust for one’s own benefit while purporting to keep them
beyond the reach of creditors has been viewed as a transaction that was void *ab initio*. The protective provisions were never valid in the first place, and therefore there is no need to set them aside. *In re Schultz*, 324 B.R. 722 (Bankr. E.D. Ark. 2005); *In re Hawley*, 2004 WL 330098 (Bankr. C.D. Ill. Feb. 20, 2004); *see Brown*, 303 F.3d at 1261.

Some foreign jurisdictions do allow self-settled protective trusts or asset protection trusts that permit settlor-beneficiaries to shield their own assets from the reach of creditors. Bankruptcy courts have typically taken a dim view of such arrangements and have regarded them as invalid, at least with respect to American settlor-beneficiaries. *In re Lawrence*, 279 F.3d 1294 (11th Cir. 2003) (affirming an order holding the debtor in contempt for failing to repatriate trust assets); *In re Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996) (Tina Brozman, J.).


In 2005, Congress attempted to close the loophole that would allow a debtor’s interest in a protective trust that was valid under nonbankruptcy law — notably a self-settled protective
trust if state or foreign law permitted it — to be excluded from the bankruptcy estate. See 11 U.S.C. 541(c)(2). Congress realized that it is not the function of the Bankruptcy Code to rewrite state or foreign trust law as such, so Congress approached the problem as a fraudulent transfer issue. H.R. Rep. No. 31, 109th Cong., 1st Sess., pt. 1, 449-50 (2005) (statement of Rep. Cannon). The result was that Section 1402 of BAPCPA created 11 U.S.C. § 548(e), which took effect in all cases filed on or after the enactment of the new legislation in April, 2005.

11 U.S.C. § 548(e)(1) provides that, in addition to any other transfer that the estate representative may avoid on any other basis, the estate representative may avoid a transfer of an interest of the debtor in property if: (a) the transfer was made to a self-settled trust “or similar device”, 11 U.S.C. § 548(e)(1)(A); (b) the transfer was made by the debtor, 11 U.S.C. § 548(e)(1)(B); (c) the debtor is the beneficiary of the trust “or similar device”, 11 U.S.C. § 548(e)(1)(C); and (d) the debtor made the transfer with actual intent to hinder, delay, or defraud an existing or prospective creditor. 11 U.S.C. § 548(e)(1)(D). The language of the last requirement appears to indicate that the estate representative must identify a specific creditor or creditors that the debtor meant to hinder, delay, or defraud.

11 U.S.C. § 548(e)(2) lists some of the indicia of fraudulent intent that may be considered. These include making the transfer in anticipation of civil or criminal liability for violations of state or federal securities law. This list in nonexclusive, however, and it is clear that Congress meant for courts to look to any of the badges of fraud normally used to establish actual fraudulent intent. See Hon. Bruce A. Markell, Changes to Avoiding Powers Brought About by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, SL068 ALI-ABA 247 (2005).
Significantly, the reachback period for avoiding transfers to a self-settled trust is 10 years. 11 U.S.C. § 548(e). This is are longer than the two-year reachback period that BAPCPA established for avoiding most fraudulent transfers. 11 U.S.C. § 548(a)(1).

It bears repeating that 11 U.S.C. § 548(e) does not override state or foreign law purporting to validate self-settled asset protection trusts as such. Rather than attacking such devices directly, Congress chose to undermine them in the bankruptcy context by using fraudulent transfer principles. Nonetheless, the traditional rule against self-settled protective trusts is based in large measure on a fraudulent transfer rationale. In essence, the self-settlement of a protective trust has been regarded as a fraudulent transfer per se, and hence there has been no need to adduce proof of fraudulent intent in the usual sense. David B. Young, The Pro Tanto Invalidity of Protective Trusts: Partial Self-settlement and Beneficiary Control, 78 MARQ. L. REV. 807 (1995); see State Cent. Collection Unit v. Brent, 525 A.2d 241 (Md. Ct. Spec. App. 1987), aff’d, 537 A.2d 227 (Md. 1988); In re Mogridge’s Estate, 20 A.2d 307 (Pa. 1941); State v. Nashville Trust Co., 190 S.W.2d 785 (Tenn. Ct. App. 1944). As a leading treatise explains, “Generally there will be actual fraud [in establishing a self-settled protective trust] but it may be difficult to prove, and so the law strikes down the transaction as presumed to be fraudulent.” GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 223 at 449 (Rev. 2d ed. 1992). By authorizing a fraudulent transfer challenge to self-settled asset protection trusts established within the past 10 years, Congress was drawing on traditional principles of trust law but adding the requirement that actual fraudulent intent must be shown.
C. CONSTRUCTIVELY FRAUDULENT TRANSFERS.


   (a) The Importance of Reasonably Equivalent Value.

   11 U.S.C. § 548(a)(1)(B) establishes four circumstances in which a prepetition transfer may be avoided as constructively fraudulent, irrespective of any subjective intent to hinder, delay or defraud creditors. Under the Uniform Fraudulent Transfer Act, which is now in force in the majority of states, the analogues to three of these four bases for avoidance are U.F.T.A. §§ 4(a)(2)(i), 4(a)(2)(ii), and 5(a). Thus, the criteria for determining whether a transfer is constructively fraudulent are normally the same regardless of whether the action is brought under Section 548 of the Bankruptcy Code or under state law via 11 U.S.C. § 544(b). See In re Chase & Sanborn Corp., 904 F.2d 588 (11th Cir. 1990); In re Sun Valley Prods., Inc., 328 B.R. 147 (Bankr. D.N.D. 2005); In re Burry, 309 B.R. 130 (Bankr. E.D. Pa. 2004); In re Southern Health Care of Ark., Inc., 299 B.R. 918 (Bankr. E.D. Ark. 2003), aff’d, 309 B.R. 314 (8th Cir. B.A.P. 2004); In re W.R. Grace & Co., 281 B.R. 852 (Bankr. D. Del. 2002); In re First Commercial Mgmt. Group, Inc., 279 B.R. 230 (Bankr. N.D. Ill. 2002); In re Tower Environmental, Inc., 260 B.R. 213 (Bankr. M.D. Fla. 1998).

   Under all constructively fraudulent transfer theories, an essential element is that the debtor must have “received less than a reasonably equivalent value in exchange” for the property transferred or the obligation incurred. 11 U.S.C. § 548(a)(1)(B)(i); U.F.T.A. §§ 4(a)(2), 5(a). Although the receipt of less than reasonably equivalent value is a necessary condition for finding that a transaction was constructively fraudulent, it is not a sufficient condition. In addition, at least one of the following tests must be met: (a) the debtor was insolvent when the transfer was made or became insolvent as a result of the transfer, 11 U.S.C. § 548(1)(B)(ii)(I); U.F.T.A.
§ 5(a); (b) the transfer left the debtor with unreasonably small assets or capital, 11 U.S.C. § 548(a)(1)(B)(i)(II); U.F.T.A. § 4(a)(2)(i); (c) the debtor intended to incur, or believed that it would incur, debts that would be beyond its ability to pay as they matured, 11 U.S.C. § 548(a)(1)(B)(ii)(III); U.F.T.A. § 4(a)(2)(ii); or (d) the transfer was made to an insider under an employment contract outside the ordinary course of business. 11 U.S.C. § 548(a)(1)(B)(i)(IV) (no analogue under the U.F.T.A. or other state law). See Buncher Co. v. Official Committee of Unsecured Creditors of GenFarm Ltd. Partnership IV, 229 F.3d 245 (3d Cir. 2000); In re Zeigler, 320 B.R. 362 (Bankr. N.D. Ill. 2005); In re Dolata, 306 B.R. 97 (Bankr. W.D. Pa. 2004); In re Keener, 268 B.R. 912 (Bankr. N.D. Tex. 2001); see also In re Cambridge Capital, LLC, 331 B.R. 47 (Bankr. E.D.N.Y. 2005) (similar criteria for constructive fraud employed under the Uniform Fraudulent Conveyance Act).

The Bankruptcy Code defines “value” for purposes of fraudulent transfer analysis as “property, or satisfaction or securing of a present or antecedent debt of the debtor, but [value] does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor.” 11 U.S.C. § 548(d)(2)(A). The U.F.T.A. definition is substantially the same. U.F.T.A. § 3(a); see In re Marlar, 252 B.R. 743 (8th Cir. B.A.P. 2000), aff’d, 267 F.3d 749 (8th Cir. 2001); In re Simione, 229 B.R. 329 (Bankr. W.D. Pa. 1999); In re Mussa, 215 B.R. 158 (Bankr. N.D. Ill. 1997). Nowhere, however, does the Bankruptcy Code define “reasonably equivalent” or “reasonably equivalent value.” See BFP v. RTC, 511 U.S. 531 (1994).

(b) Determining Whether the Debtor Received Value.

Courts, then, must take a two-step approach. The first inquiry is whether what the debtor received in exchange for the transfer constituted “value” at all, and the second is whether the value were “reasonably equivalent” to what the debtor transferred. In re R.M.L., Inc., 92 F.3d 139 (3d Cir. 1996); In re Hedged-Investments Assocs., Inc., 84 F.3d 1286 (10th Cir. 1996); In re...
MDIP, Inc., 332 B.R. 129 (Bankr. D. Del. 2005); In re General Search.com, 322 B.R. 836 (Bankr. N.D. Ill. 2005). The first step is usually easy and is guided by a statutory definition. In re Anand, 210 B.R. 456 (Bankr. N.D. Ill. 1997), aff’d, 239 B.R. 511 (N.D. Ill. 1999). For example, love and affection, the preservation of family ties, or similar motives for making a transfer to family members do not constitute value. In re Marlar, 267 F.3d 749 (8th Cir. 2001); Tavenner v. Smoot, 257 F.3d 401 (4th Cir.), cert. denied, 534 U.S. 1116 (2001); In re Hinsley, 201 F.3d 638 (5th Cir. 2000); see Thomas v. Lawrence, 302 B.R. 194 (W.D. Ky. 2003). By definition, a gratuitous transfer involves no value at all. In re Pepmeyer, 275 B.R. 539 (Bankr. N.D. Iowa 2002) (debtor received no value in making an outright gift to his daughter); see Coleman v. Simpson, 327 B.R. 753 (D. Md. 2005) (husband failed to show that he paid debtor-wife’s creditors in exchange for transfer); General Search.com, 322 B.R. at 836 (forgiveness of debt without receiving anything in return).

On the other hand, the satisfaction or securing of an antecedent debt falls within the statutory definition of value, and thus transfers made for such purposes are not constructively fraudulent, at least if the reasonable equivalency test is satisfied. As a matter of law, the dollar-for-dollar payment of a legitimate antecedent debt cannot be constructively fraudulent. In re First Alliance Mortg. Co., 298 B.R. 652 (C.D. Cal. 2003); In re SHC, Inc., 329 B.R. 438 (Bankr. D. Del. 2005); In re APF Co., 308 B.R. 183 (Bankr. D. Del. 2004); In re Carrozzella & Richardson, 302 B.R. 415 (Bankr. D. Conn. 2003); see In re Montalvo, 333 B.R. 145 (Bankr. W.D. Ky. 2005) (husband giving wife money to meet ordinary household expenses was in satisfaction of his legal obligation to support his wife; transfer was for reasonably equivalent value as a matter of law); In re Advanced Telecommunication Network, Inc., 321 B.R. 308 (Bankr. M.D. Fla. 2005) (money paid in an arm’s-length transaction to settle litigation is an

The question of reasonably equivalent value has arisen when leveraged buyouts (LBOs) and stock redemptions have been attacked as constructively fraudulent transfers. A corporation receives no value at all, let alone reasonably equivalent value, when it purchases its own stock. *In re Tri-Star Technology Co., Inc.*, 260 B.R. 319 (Bankr. D. Mass. 2001); *In re Joshua Slocum, Ltd.*, 103 B.R. 610 (Bankr. E.D. Pa.), *aff’d*, 121 B.R. 442 (E.D. Pa. 1989). That the shareholder or shareholders might have received no more than the market value of the stock, or that the stock might have been valuable to a third party, is neither here nor there. *In re F.H.L., Inc.*, 91 B.R. 288 (Bankr. D.N.J. 1988). A stock redemption is carried on a corporation’s books as a reduction in equity, not as the acquisition of an asset. *In re Roco Corp.*, 701 F.2d 978 (1st Cir. 1983). Thus, from the point of view of creditors of the corporation, the transaction is indistinguishable from the payment of a dividend or a distribution of corporate assets to the shareholders. *In re Main Street Brewing Co., Ltd.*, 210 B.R. 662 (Bankr. D. Mass. 1997); see *Robinson v. Wangemann*, 75 F.2d 756 (5th Cir. 1935).

If the corporation receives any value at all, it is not from reacquiring its own stock, but rather from collateral benefits. *See In re Joy Recovery Technology Corp.*, 257 B.R. 253 (Bankr. N.D. Ill. 2001). Such collateral benefits may include improved or unified management or an end
to paralyzing shareholder dissention. *Advanced Telecommunication Network*, 321 B.R. at 308; *In re Corporate Jet Aviation, Inc.*, 57 B.R. 195 (Bankr. N.D. Ga. 1986), *aff’d*, 82 B.R. 619 (N.D. Ga. 1987), *aff’d*, 838 F.2d 1220 (11th Cir. 1988); see *In re Sheffield Steel Corp.*, 320 B.R. 423 (Bankr. N.D. Okla. 2004) (noting that any indirect benefit that the corporation receives must be quantifiable); *In re Bowers-Simeon Chems. Co.*, 139 B.R. 436 (Bankr. N.D. Ill. 1992). If there are no such collateral benefits, the corporation will have received nothing of value. *In re Joy Recovery Technology Corp.*, 286 B.R. 54 (Bankr. N.D. Ill. 2002) (debtor-corporation received no value from shareholder’s covenant not to compete after his stock had been repurchased; as a principal of the corporation, shareholder owed such a duty in any event); *In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127 (Bankr. D. Mass. 1989).

(c) **Determining Reasonable Equivalence.**


Fair market value is not the only factor, however. Other considerations include whether the exchange resulted from arm’s-length dealing, the situation of the parties, and the good faith of the transferee. Barber v. Golden Seed Co., 129 F.3d 382 (7th Cir. 1997); In re Zedda, 103 F.3d 1195 (5th Cir. 1997); Peltz v. Hatten, 279 B.R. 710 (D. Del. 2002), aff’d, 60 Fed. Appx. 401 (3d Cir. 2003); In re Zeigler, 320 B.R. 362 (Bankr. N.D. Ill. 2005); In re Perry County Foods, Inc., 313 B.R. 875 (Bankr. N.D. Ala. 2004); In re H. King & Assoc., 295 B.R. 246 (Bankr. N.D. Ill. 2003); In re Jones, 209 B.R. 380 (Bankr. E.D. Va. 1997) (sale of property for 87% of appraised value on eve of foreclosure was reasonably equivalent value). The issue must be analyzed from the perspective of creditors of the estate. In re Prejean, 994 F.2d 706 (9th Cir. 1993); In re Consolidated Capital Equities Corp., 143 B.R. 80 (Bankr. N.D. Tex. 1992). In the case of a complex series of transactions, most courts will ignore intervening or intermediate steps and look at the bottom line: the total value of what the debtor parted with compared to the total value of what the debtor received. E.g., In re Corcoran, 246 B.R. 152 (E.D.N.Y. 2000); In re Hechinger Inv. Co. of Delaware, 327 B.R. 537 (Bankr. D. Del. 2005); In re Telesphere


The test for reasonably equivalent value is not always absolutely objective, however, and it is not to be judged with 20/20 hindsight. See In re Glendennig, 243 B.R. 629 (Bankr. E.D. Pa. 2000) (noting that “reasonably equivalent value” is far less strict and demanding than “present fair equivalent value” as used in 11 U.S.C. § 549(c)). Payments that the debtor made for business opportunities that did not ultimately materialize may very well have been made in exchange for reasonably equivalent value. In re Fairchild Aircraft Corp., 6 F.3d 1119 (5th Cir. 1993) (airplane manufacturer’s payment of airline’s fuel bills was made for reasonably equivalent value; payments were made to develop business opportunities with larger airline system, even though the opportunities did not come to fruition); Morris Communications, 914 F.2d at 458; see In re McDonald, 265 B.R. 632 (Bankr. M.D. Fla. 2001) (payment to preserve the value of an option to purchase property). In the case of an individual debtor, it is legitimate to say that entertainment, or even the gratification of idiosyncratic tastes, may constitute reasonably equivalent value. In re Grigonis, 208 B.R. 950 (Bankr. D. Mont. 1997) (debtor...
received reasonably equivalent value in return for payments for 900-line psychic counseling services). In addition, it has been held that a gambling wager is given in exchange for reasonably equivalent value because the debtor receives the entertainment value of participating in the game and, in addition, the opportunity to win. *In re Chomakos*, 69 F.3d 769 (6th Cir. 1995), *cert. denied*, 517 U.S. 1168 (1996); *In re Dolata*, 306 B.R. 97 (Bankr. W.D. Pa. 2004). Furthermore, absent evidence of fraud or collusion, a debtor cannot be said to have received less than reasonably equivalent value merely because he or she obtained less than half the marital property in a divorce proceeding. To hold otherwise would mean upsetting the stability of valid state court property divisions every time that bankruptcy followed a divorce. *In re Erlewine*, 349 F.3d 205 (5th Cir. 2003).

Whether the value that the debtor received was reasonably equivalent to the value that the debtor transferred must be evaluated from the point of view of good faith judgment at the time of the transaction; the inquiry should be whether the debtor reasonably believed that the likely benefits were worth the cost. *In re Interco Sys., Inc.*, 202 B.R. 188 (Bankr. W.D.N.Y. 1996). For example, commitment fees or similar payments made to obtain credit that was never actually extended may or may not have been made in exchange for reasonably equivalent value. Much depends on the size of the payments and the likelihood that the debtor would in fact obtain the credit. *In re R.M.L., Inc.*, 92 F.3d 139 (3d Cir. 1996). The reasonably equivalent value that the debtor receives need not be something on which creditors could levy. *In re Brentwood Lexford Partners, LLC*, 292 B.R. 255 (Bankr. N.D. Tex. 2003) (legal services constituted reasonably equivalent value); *In re Armstrong*, 234 B.R. 899 (Bankr. E.D. Ark. 1999) (debtor received reasonably equivalent value in exchange for payments to criminal defense attorney).
As a general rule, transfers for the benefit of a third party do not provide reasonably equivalent value to the debtor. *In re Rowanoak Corp.*, 344 F.3d 126 (1st Cir. 2003); *In re Image Worldwide, Ltd.*, 139 F.3d 574 (7th Cir. 1998); *In re Southern Health Care of Ark., Inc.*, 309 B.R. 314 (8th Cir. B.A.P. 2004) (debtor’s ability to claim roughly $13,500 in depreciation was not reasonably equivalent value for payment of approximately $78,500 on third party’s mortgage note); *In re Whaley*, 229 B.R. 267 (Bankr. D. Minn. 1999) (debtor did not receive reasonably equivalent value in exchange for paying his live-in girlfriend’s credit card bill). Indeed, such transfers usually provide no value at all to the debtor. *In re Greater Southwest Community Hosp. Corp. I*, 333 B.R. 506 (Bankr. D.D.C. 2005); *In re Fox Bean Co., Inc.*, 287 B.R. 270 (Bankr. D. Idaho 2002) (corporate debtor received no value in return for paying the personal debt of its principal); *In re Schultz*, 250 B.R. 22 (Bankr. E.D.N.Y. 2000) (debtor received no value in exchange for paying his nondebtor wife’s self-employment taxes); *In re Apex Automotive Warehouse, L.P.*, 238 B.R. 758 (Bankr. N.D. Ill. 1999) (distributions to Subchapter S corporation’s principal so that he could pay his taxes did not provide any value to the corporation).

There is, however, a recognized exception. If the transfer does not affect or enhances the net worth of the debtor because the debtor received an indirect benefit, such as expanded lines of credit or new business opportunities, then there may have been reasonably equivalent value for the debtor. *In re Globe Tanker Servs., Inc.*, 151 B.R. 23 (Bankr. D. Conn. 1993); *In re Computer Universe, Inc.*, 58 B.R. 28 (Bankr. M.D. Fla. 1986); see *Fairchild Aircraft*, 6 F.3d at 1119; *In re Richards & Conover Steel Co.*, 267 B.R. 602 (8th Cir. B.A.P. 2001); *In re Burry*, 309 B.R. 130 (Bankr. E.D. Pa. 2004). The focus is on what the debtor received, not on what the

Normally, the establishment of indirect benefits to the debtor will occur when the debtor and the third party are closely related or share an identity of interests, so that what benefits one will benefit the other. *In re Northern Merchandise, Inc.*, 371 F.3d 1056 (9th Cir. 2004) (debtor received reasonably equivalent value in return for paying principal’s debt; principal had turned all loan proceeds over to corporate debtor); *In re Gulf Northern Transp., Inc.*, 323 B.R. 786 (Bankr. M.D. Fla. 2005) (debtor received reasonably equivalent value in exchange for payments on officers’ purchase money loan for trucks to the extent that debtor had the use of the trucks); *In re Buffalo Restaurant Equip., Inc.*, 284 B.R. 770 (Bankr. W.D.N.Y. 2002) (corporate debtor received reasonably equivalent value in exchange for paying its principal’s ostensibly personal debt; principal had used loan proceeds to fund the corporate debtor, and lender had relied on personal skill and credit of principal rather than on corporation’s credit in making the loan for the corporation’s benefit); *In re Gerdes*, 246 B.R. 311 (Bankr. S.D. Ohio 2000) (principal of car dealership received reasonably equivalent value in exchange for paying title transfer fees and taxes owed by dealership; if dealership had not paid, principal would have been personally liable for taxes, and principal could have been personally liable if dealership had failed to transfer good title); *In re Pembroke Dev. Corp.*, 124 B.R. 398 (Bankr. S.D. Fla. 1991) (forbearance to proceed against closely related nondebtor corporation and modification of its obligations benefited debtor corporation as guarantor); see Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979 (2d Cir. 1981); *In re Cassandra Group*, 312 B.R. 491 (Bankr. S.D.N.Y. 2004) (fact issue existed as to whether corporate debtor had received reasonably equivalent value in exchange for paying for principal’s penthouse; penthouse was allegedly used for business entertaining and for lodging
important clients of corporation); In re KZK Livestock, Inc., 221 B.R. 471 (Bankr. C.D. Ill. 1998) (noting that a transfer to a third party may be reasonably equivalent value for the debtor if there is a unity of interest, but concluding that there was no such unity in the case at bar).

There has been a difference of opinion as to when collateralizing an antecedent debt is a transaction for reasonably equivalent value. Just like the payment of a pre-existing debt, granting security for such a debt means that there is value for the debtor. 11 U.S.C. § 548(d)(2)(A); U.F.T.A. § 3(a). Few courts would dispute that, when the collateral does not greatly exceed the amount of the debt secured, and when the debtor is the primary obligor, then there is reasonably equivalent value. In re Abraham, 33 B.R. 963 (Bankr. M.D. Fla. 1983); see Anand v. National Republic Bank of Chicago, 239 B.R. 511 (N.D. Ill. 1999). On the other hand, some courts have held that when the value of the collateral is substantially in excess of the amount of the antecedent debt, then the debtor does not receive reasonably equivalent value. In re Countdown of Connecticut, Inc., 115 B.R. 18 (Bankr. D. Conn. 1990); In re Vaniman Intern., Inc., 22 B.R. 166 (Bankr. E.D.N.Y. 1982). Likewise, some courts have been reluctant to find reasonably equivalent value when the debtor is a guarantor rather than the primary obligor. The rationale is that a party who is secondarily liable did not receive the benefit from the original extension of credit. In re Solomon, 299 B.R. 626 (10th Cir. B.A.P. 2003); see also In re Exide Technologies, Inc., 299 B.R. 732 (Bankr. D. Del. 2003).

Several decisions, however, have held that collateralizing an antecedent debt is automatically reasonably equivalent value. As a matter of law, the value of a creditor’s security interest in the collateral cannot exceed the value of the debt secured. Thus, even if the value of the collateral is far greater than the amount of the debt, the value that the debtor originally received is still reasonably equivalent to the value with which the debtor parted. In re
At least one state court has adopted this reasoning under the Uniform Fraudulent Transfer Act, citing the Prefatory Note to that statute. First Nat’l Bank of Seminole v. Hooper, 104 S.W.3d 83 (Tex. 2003).

The latter line of cases appears to be better reasoned. Overcollateralizing an antecedent debt is not the same thing as overpayment. The debtor still has the possession and use of the collateral. The value of the creditor’s interest does not exceed the value of the debt secured. If the creditor were to be overpaid if it foreclosed, particularly in the case of a mortgage, the foreclosure conceivably might be avoided on the ground that the debtor did not receive reasonably equivalent value, especially if the foreclosure were irregular under state law. The foreclosure, however, would be an altogether different transfer than granting the security interest in the first instance. Furthermore, it should make no difference whether the debtor is a guarantor or the primary obligor. A guaranty is a valid debt, albeit contingent and unliquidated. The value of the creditor’s interest in the debtor-guarantor’s property cannot exceed the value of the contingent debt. At bottom, too many cases seem to have confused granting a security interest with an out-and-out transfer of title, and/or the value of an antecedent obligation with the validity of collateralizing the obligation. The position espoused by the bankruptcy courts in AppliedTheory, 323 B.R. at 838, and in Anand, 210 B.R. at 456, and by the Texas Supreme Court in Hooper, 104 S.W.3d at 83, seems to make more sense.

Once it has been shown that the debtor received less than reasonably equivalent value, the transaction may be avoided if it can also be shown that the transfer occurred while the debtor was insolvent or that the debtor became insolvent as a result of the transaction. 11 U.S.C. § 548(a)(1)(B)(ii)(I); accord U.F.T.A. § 5(a). The proponent of avoidance bears the burden of proof, so that, under this theory, if the debtor is not shown to have been insolvent, the action is defeated, even though the transfer may have been for less than reasonably equivalent value. *In re Begman*, 293 B.R. 580 (Bankr. W.D.N.Y. 2003). The debtor need not have been insolvent at the time of the transaction, however. The transfer may still be avoided if the debtor became insolvent as a result of it. *Gray v. Snyder*, 704 F.2d 709 (4th Cir. 1983); *In re Dolata*, 306 B.R. 97 (Bankr. W.D. Pa. 2004); see *In re Joy Recovery Technology Corp.*, 286 B.R. 54 (Bankr. N.D. Ill. 2002) (leveraged buyout left debtor insolvent).

Except for municipalities, where a cash flow test is used, “insolvent” for purposes of this analysis means that the fair value of the debtor’s assets must have been less than the debtor’s total liabilities. 11 U.S.C. § 101(32); accord U.F.T.A. § 2(a); see *In re Zeigler*, 320 B.R. 362 (Bankr N.D. Ill. 2005) (noting the similarities in the definitions). In the case of an individual, exempt property is not included in the calculation. *In re Solomon*, 299 B.R. 626 (10th Cir. B.A.P. 2003). For individuals and business entities, a balance sheet test is used. *In re Adler, Coleman Clearing Corp.*, 263 B.R. 406 (S.D.N.Y. 2001); *In re Carter*, 212 B.R. 972 (Bankr. D. Or. 1997). The book value of the debtor’s assets is only a starting point. Book value will not necessarily reflect fair market value at the time of the transfer. *Peltz v. Hatten*, 279 B.R. 710 (D. Del. 2002), aff’d, 60 Fed. Appx. 401 (3d Cir. 2003); *In re Transit Group, Inc.*, 332 B.R. 45 (Bankr. M.D. Fla. 2005); see *In re Flutie N.Y. Corp.*, 310 B.R. 31 (Bankr. S.D.N.Y. 2004) (noting that the book value of the debtor’s assets is not necessarily dispositive in determining
insolvency but that it is entitled to some consideration). Whether the debtor were solvent or not must be determined by analyzing what a willing buyer would have given (or demanded) for the entire package of the debtor’s assets and liabilities at the relevant time. Any liability figured into the equation must have been a valid debt. In re 5900 Assocs., L.L.C., 317 B.R. 332 (Bankr. E.D. Mich. 2004), aff’d, 326 B.R. 402 (E.D. Mich. 2005). Both contingent assets and contingent liabilities must be discounted to their then-current value. In re Advanced Telecommunication Network, Inc., 318 B.R. 308 (Bankr. M.D. Fla. 2005); In re Babcock & Wilcox Co., 274 B.R. 230 (Bankr. E.D. La. 2002). The evidence must bear on the debtor’s financial condition at the time of the transfer or immediately following the exchange. In re R.M.L., Inc., 92 F.3d 139 (3d Cir. 1996); Covey v. Commercial Nat’l Bank of Peoria, 960 F.2d 657 (7th Cir. 1992); In re Jackson, 318 B.R. 5 (Bankr. D.N.H. 2004); see Zeigler, 320 B.R. at 362.

Whether the debtor were insolvent at the time of the transfer or became insolvent as a result is a highly fact-specific issue. R.M.L., 92 F.3d at 139; Gray, 704 F.2d at 709. Unlike 11 U.S.C. § 547(f) pertaining to preference avoidance, 11 U.S.C. § 548 contains no statutory presumption that the debtor was insolvent during the 90 days preceding the bankruptcy filing. Similarly, the U.F.T.A. creates no presumption that the debtor was insolvent during any particular period. Thus, in a fraudulent transfer action, the proponent bears the full burden of proving insolvency. In re Schultz, 250 B.R. 22 (Bankr. E.D.N.Y. 2000); accord In re Steder, 2002 WL 1729502 (Bankr. N.D. Ill. July 25, 2002); see In re Jotan, Inc., 264 B.R. 735 (Bankr. M.D. Fla. 2001). Section 2(b) of the U.F.T.A., however, establishes a presumption that the debtor was insolvent in the balance sheet sense if the debtor was equitably insolvent or unable to pay debts as they accrued. See In re Marlar, 267 F.3d 749 (8th Cir. 2001).

If the debtor received less than reasonably equivalent value, a transaction may also be deemed constructively fraudulent if the transfer left the debtor with unreasonably small capital or assets. 11 U.S.C. § 548(a)(1)(B)(ii)(II); accord U.F.T.A. § 4(a)(2)(i). Unreasonably small capital may refer to equitable insolvency—an inability to pay debts as they come due—even though the debtor remains solvent in the balance sheet sense. See In re Oxford Homes, Inc., 180 B.R. 1 (Bankr. D. Me. 1995). A finding of equitable insolvency is not required, however. In re Joy Recovery Technology Corp., 286 B.R. 54 (Bankr. N.D. Ill. 2002); In re Toy King Distributors, Inc., 256 B.R. 1 (Bankr. M.D. Fla. 2000). A debtor may be left with unreasonably small capital even if its assets exceed its liabilities, and even if the debtor is able to meet its obligations as they mature. Moody v. Security Pacific Business Credit, Inc., 971 F.2d 1056 (3d Cir. 1992); In re Vadnais Lumber Supply, Inc., 100 B.R. 127 (Bankr. D. Mass. 1989).

The unreasonably small capital criterion is analyzed on a case-by-case basis. Barrett v. Continental Ill. Nat’l Bank & Trust Co., 882 F.2d 1 (1st Cir. 1989), cert denied, 494 U.S. 1028 (1990). The proper inquiry is whether, following the transfer, the debtor were in a position to pay its debts as they accrued in the future or sustain its operations and still remain financially stable. In re Sheffield Steel Corp., 320 B.R. 423 (Bankr. N.D. Okla. 2004); In re Pioneer Home Builders, Inc., 147 B.R. 889 (Bankr. W.D. Tex. 1992); In re Suburban Motor Freight, Inc., 124 B.R. 984 (Bankr. S.D. Ohio 1990). This question is not to be resolved with 20/20 hindsight. Rather, a court should examine at the position of the debtor at the time of the transfer. Peltz v. Hatten, 279 B.R. 710 (D. Del. 2002), aff’d, 60 Fed. Appx. 401 (3d Cir. 2003); In re Pajaro Dunes Rental Agency, Inc., 174 B.R. 557 (Bankr. N.D. Cal. 1994); see In re Panama Williams, Inc., 211 B.R. 868 (Bankr. S.D. Tex. 1997). From that perspective, the correct inquiry is
whether the debtor’s probable stream of income would be sufficient to meet its foreseeable obligations. This involves the use of reasonable objective projections, looking forward from the time of the transfer. If the debtor’s condition at that time would have appeared likely to lead to eventual insolvency, then the debtor had unreasonably small capital. Toy King Distributors, 256 B.R. at 1; Pioneer Home Builders, 147 B.R. at 889; see White Family Cos., Inc. v. Dayton Title Agency, Inc., 284 B.R. 238 (S.D. Ohio 2002). On the other had, if reasonable forecasts grounded on past performance would have projected that the debtor would remain sound, then the debtor was not left with unreasonably small capital. Moody, 971 F.2d at 1056; see In re Bergman, 293 B.R. 580 (Bankr. W.D.N.Y. 2003). Another way of viewing the same issue is to ask whether the challenged transfer actually caused the debtor’s subsequent financial distress. If the debtor’s problems arose from unforeseeable market conditions or from factors unrelated to the challenged transaction, then the unreasonably small capital test has not been satisfied. Moody, 971 F.2d at 1056; see Joy Recovery Technology, 286 B.R. at 54 (debtor was not left with unreasonably small capital when debtor was able to continue operations for a considerable period following the challenged transaction); see also Dayton Title Agency, 262 B.R. at 719; Pioneer Home Builders, 147 B.R. at 889.


Third, if a transfer is made for less than reasonably equivalent value, it may be avoided if, at the time of the transfer, the debtor intended to incur, or reasonably believed that it would incur, debts beyond the debtor’s ability to pay. 11 U.S.C. § 548(a)(1)(B)(ii)(III); accord U.F.T.A § 4(a)(2)(ii); see In re C.F. Foods, L.P., 280 B.R. 103 (Bankr. E.D. Pa. 2002) (disbursements under a Ponzi scheme satisfy this criterion virtually by definition); In re National Liquidators, Inc., 232 B.R. 915 (Bankr. S.D. Ohio 1998) (same). Once again, the analysis must focus on the
time of the transfer and on what the debtor’s intentions or anticipations were then, not at some subsequent time.  *In re Pajaro Dunes Rental Agency, Inc.*, 174 B.R. 557 (Bankr. N.D. Cal. 1994); *see In re Kirpatrick*, 254 B.R. 378 (N.D. Ohio 2000); *In re Boriello*, 329 B.R. 367 (Bankr. E.D.N.Y. 2005) (discussing this form of constructive fraud under the U.F.C.A.); *In re Dolata*, 306 B.R. 97 (Bankr. W.D. Pa. 2004).

As with the other tests under 11 U.S.C. § 548(a)(1)(B)(ii) or its state law counterparts, there is a requirement of a causal connection between the transfer and the constructively fraudulent result.  *See In re Bergman*, 293 B.R. 580 (Bankr. W.D.N.Y. 2003).  A debtor may not use preexisting debts or unanticipated debts subsequently incurred as an excuse for avoiding an otherwise legitimate transfer.  For example, in *In re Hall*, 131 B.R. 213 (Bankr. N.D. Fla. 1991), certain property had been sold at a tax foreclosure for approximately 10% of its assessed value.  The court assumed that this was less than reasonably equivalent value.  The sale, however, did not render the debtor insolvent, either in a balance sheet sense or an equitable sense.  The court held that the debtor could not avoid the transaction on the basis of his later inability to pay either preexisting debts or debts incurred much later.  The transfer was in no sense the cause of the debtor’s problems.


Section 1402 of BAPCPA added 11 U.S.C. § 548(a)(1)(B)(ii)(IV) to the Bankruptcy Code.  This statute applies in all cases filed on or after the date of BAPCPA’s enactment in April, 2005.  Section 548(a)(1)(B)(ii)(IV) allows the estate representative to avoid an obligation or transfer if the debtor did not receive reasonably equivalent value in exchange and if the obligation was incurred or the transfer was made: (a) to or for the benefit of an insider of the debtor; (b) under an employment contract; and (c) not in the ordinary course of business.
Excessive executive bonuses, salaries, and severance packages have been a major concern, both inside and outside bankruptcy. Attacks on such transactions have often taken the form of lawsuits against the directors and managers for breaching their fiduciary duties of care and loyalty. See Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. 2003), vacated and remanded on other grounds, 413 F.3d 330 (2d Cir. 2005); In re Walt Disney Co. Deriv. Litig., 825 A.2d 275 (Del. Ch. 2003). Congress intended to make such excessive compensation avoidable as a constructively fraudulent transfer. H.R. Rep. No. 31, 109th Cong., 1st Sess., pt. 1, 154 (2005); see Samuel K. Crocker & Robert H. Waldschmidt, Impact of the 2005 Bankruptcy Amendments on Chapter 7 Trustees, 79 AM. BANKR. L.J. 333 (2005).


It is uncertain what impact this statute will have. The estate representative must first show that the debtor did not receive reasonably equivalent value in exchange for the compensation. This may not be easy. Moreover, to the extent that the debtor did receive some value and the transferee acted in good faith, the transferee would be allowed to enforce the obligation or retain the money or other property under 11 U.S.C. § 548(c). Markell, Changes to Avoiding Powers, SL068 ALI-ABA at 247. On the other hand, if the directors had, in essence, abdicated their responsibilities and allowed officers to help themselves to corporate assets, the transferees might be hard put to show that they acted in good faith. See Pereira, 294 B.R. at 449.
Furthermore, 11 U.S.C. § 548(a)(1)(B)(ii)(IV) applies only to insiders. Thus, bonuses or severance packages for noninsider ordinary employees would not fall within the scope of the statute, even if the compensation had been excessive. Markell, *Changes to Avoiding Powers*, SL068 ALI-ABA at 247. Finally, the compensation must have been outside the ordinary course of business. It is at least arguable that a broad reading of this provision would protect almost any compensation scheme, and that the only persons who might be vulnerable would be turnaround professionals, whose compensation deserves at least some protection. See Kenneth N. Klee, *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 — Business Bankruptcy Amendments*, SK092 ALI-ABA 27 (2005). On the other hand, it would be difficult to argue that a situation in which the directors have given up all oversight or responsibility for executive compensation was within the ordinary course of the debtor’s business. See Pereira, 294 B.R. at 449; see also *Walt Disney Deriv. Litig.*, 825 A.2d at 275. It may be that Congress intended to address precisely this state of affairs. Future decisions applying 11 U.S.C. § 548(a)(1)(B)(ii)(IV) will have to determine how this statute will work in practice.

D. **THE GOOD FAITH PURCHASER DEFENSE: 11 U.S.C. § 548(c).**

11 U.S.C. § 548(c) establishes a defense for a good faith purchaser in a fraudulent transfer action. This statute provides that, if a transaction is otherwise avoidable under Section 548(a), and if it is not avoidable under 11 U.S.C. §§ 544, 545, and/or 547, then a transferee who gave value and who took in good faith may retain the property transferred, claim a lien on the property, or enforce the obligation to the extent of the value given to the debtor. See *In re Northern Merchandise, Inc.*, 371 F.3d 1056 (9th Cir. 2004); Howard Gorney & Lee Harrington, *The Importance of Good Faith in Fraudulent Transfer Analysis*, 22-Mar. AM. BANKR. INST. J. 30 (2003). This federal statutory defense does not apply directly to a state law fraudulent transfer action brought under 11 U.S.C. § 544(b). *In re Structurelite Plastics Corp.*, 193 B.R. 451

Section 548(c) and its state law counterparts are affirmative defenses to avoidance, and thus the burden of proof rests on the transferee. In re Armstrong, 259 B.R. 338 (E.D. Ark. 2001), aff’d, 285 F.3d 1092 (8th Cir. 2002); In re Jones, 304 B.R. 462 (Bankr. N.D. Ala. 2004). By its plain terms, the statutory defense requires that two elements must be established. In re Adler Coleman Clearing Corp., 263 B.R. 406 (S.D.N.Y. 2001); In re Zeigler, 320 B.R. 362 (Bankr. N.D. Ill. 2005); In re Dryja, 259 B.R. 629 (Bankr. N.D. Ohio 2001). First, the transferee must have given value. In re Roosevelt, 220 F.3d 1032 (9th Cir. 2000). The focus is on what the transferee gave. In re Hannover Corp., 310 F.3d 796 (5th Cir. 2002), cert. denied, 538 U.S. 1032 (2003). Thus, the recipient of a gift or a gratuitous transfer enjoys no protection, even if that person took with the utmost good faith. See In re Unglaub, 332 B.R. 303 (Bankr. N.D. Ill. 2005); In re Skalski, 257 B.R. 707 (Bankr. W.D.N.Y. 2001). Moreover, the transferee is shielded only to the extent of the value given. In re Lindell, 334 B.R. 249 (Bankr. D. Minn. 2005); Jones, 304 B.R. at 462; In re Pajaro Dunes Rental Agency, Inc., 174 B.R. 557 (Bankr. N.D. Cal. 1994).
Second, the transferee must have taken in good faith. Good faith in this context is difficult to define precisely, and it depends on the circumstances of each case. *Hannover Corp.*, 310 F.3d at 796 (noting that there is no uniform definition of “good faith” for purposes of Section 548(c)); *In re Agricultural Research & Technology Group, Inc.*, 916 F.2d 528 (9th Cir. 1990); *In re Roco Corp.*, 701 F.2d 918 (1st Cir. 1983). Clearly, someone who actively participates in a fraudulent scheme cannot claim to be a good faith transferee for value, but matters need not reach this level in order to preclude a finding of good faith. *In re World Vision Entertainment, Inc.*, 275 B.R. 641 (Bankr. M.D. Fla. 2002); see *In re First Alliance Mortg. Corp.*, 298 B.R. 652 (C.D. Cal. 2003). Under any standard, the test is objective. See *Hannover Corp.*, 310 F.3d at 796; *In re Tiger Petro. Co.*, 319 B.R. 225 (Bankr. N.D. Okla. 2004); Gorney & Harrington, *The Importance of Good Faith*, 22-Mar. AM. BANKR. INST. J. at 30. Many courts hold that the proper inquiry is whether the transferee had knowledge of the fraudulent nature of the transaction or knowledge of facts sufficient to lead a prudent person to undertake a further investigation into the potential avoidability of the transfer. *In re M&L Business Mach. Co.*, 84 F.3d 1330 (10th Cir. 1995), cert. denied, 519 U.S. 1040 (1996); *In re Sherman*, 67 F.3d 1348 (8th Cir. 1995); *First Alliance Mortg.*, 298 B.R. at 652; *Burry*, 309 B.R. at 130.

In the case of actual fraud, knowledge of facts sufficient to excite inquiries about the debtor’s dishonest intention is the touchstone, whereas knowledge of the debtor’s poor financial condition may be critical in cases of constructive fraud. *M&L Business Mach.*, 84 F.3d at 1330; *In re Foxmeyer Corp.*, 296 B.R. 327 (Bankr. D. Del. 2003). For example, a casino with at least inquiry notice of the debtor’s insolvency at the time that it extended credit for gambling cannot claim to be a good faith transferee when the debtor repays the debt. *In re Armstrong*, 285 F.3d 1092 (8th Cir. 2002). Furthermore, to claim good faith transferee status, particularly when actual
fraud is alleged, the defendant transferee must show that the transfer bore the hallmarks of an arm’s-length transaction. Sherman, 67 F.3d at 1348; In re Kemmer, 265 B.R. 224 (Bankr. E.D. Cal. 2001).

There is a split of authority as to whether the good faith transferee for value defense is available when the debtor has been operating a Ponzi scheme or a similar illegitimate enterprise. As previously explained, transfers made pursuant to such a scheme are deemed actually fraudulent per se. A few courts have held that the good faith transferee for value defense can never apply in such a situation because, as a matter of law, any transaction that furthers this sort of activity can have no value and only deepens the debtor’s insolvency. In re Randy, 189 B.R. 425 (Bankr. N.D. Ill. 1995); see In re International Loan Network, 160 B.R. 1 (Bankr. D.D.C. 1993). The reasoning of these courts has rested on the proposition that it is contrary to public policy to enforce an illegal contract or to lend judicial support to a fraudulent undertaking.

The weight of recent authority, including decisions by at least two courts of appeals, has rejected this position. There is no “furtherance of an illegal or fraudulent enterprise” exception that would bar a party who gave reasonably equivalent value and acted without knowledge or notice of the debtor’s dishonest purpose from raising this defense in a fraudulent transfer avoidance action. In re Financial Federated Title & Trust, Inc., 309 F.3d 1325 (11th Cir. 2002); accord Hannover Corp., 310 F.3d at 796; see also In re Independent Clearing House Co., 77 B.R. 843 (D. Utah 1987). If the reasoning of Randy were carried to its logical conclusion, then all innocent low-level employees or trade creditors of a Ponzi debtor who had no knowledge and no reason to know of the dishonest nature of the debtor’s operations might find that their wages or invoice payments could be avoided under a fraudulent transfer theory. Clearly, this is not and should not be the law. World Vision Entertainment, 275 B.R. at 641.
For example, a brokerage firm that acts in furtherance of a Ponzi scheme may shield its commissions from avoidance under 11 U.S.C. § 548(c) or that statute’s state law counterparts if the firm was without knowledge or notice of the true nature of the debtor’s enterprise and if the fees or commissions charged were in line with prevailing rates so that the value given was reasonably equivalent to what was received. That the services may have had the ultimate effect of advancing a fraudulent scheme is neither here nor there. *Balbar-Strauss v. Lawrence*, 264 B.R. 303 (S.D.N.Y. 2001); *In re First Commercial Mgmt. Group, Inc.*, 279 B.R. 230 (Bankr. N.D. Ill. 2002); see *Financial Federated Title*, 309 F.3d at 1325; *In re 21st Century Satellite Communications, Inc.*, 278 B.R. 577 (Bankr. M.D. Fla. 2002). Of course, the defense will not work if the broker or other defendant had been willfully blind to the nature of the debtor’s activities. *World Vision Entertainment*, 275 B.R. at 641; see *21st Century Satellite Communications*, 278 B.R. at 577. Similarly, payments made to an unsuspecting investor in a Ponzi scheme may be protected by Section 548(c). The use of the investor’s money constitutes value to the debtor, and the investor has acted in good faith if he or she had no actual knowledge of the true nature of the enterprise and if the returns promised or paid were not so exorbitant as to put a prudent person on notice that the scheme might be fraudulent. *In re United Commercial Capital, Inc.*, 260 B.R. 343 (Bankr. W.D.N.Y. 2001); see *Hannover Corp.*, 310 F.3d at 796; see also *Tiger Petro.*, 319 B.R. at 225. Under such circumstances, a payment to an investor might be avoided as preferential, but the investor would have a defense to a fraudulent transfer action. *United Commercial Capital*, 260 B.R. at 243.

Section 548(c) and its state law counterparts are available to initial transferees, unlike the good faith transferee defense of 11 U.S.C. § 550(b), which is available only to subsequent transferees. See § I.F.3., *supra*. Furthermore, Section 550(b) is a defense to recovery, whereas
the good faith transferee for value principles in 11 U.S.C. § 548(c) and analogous state statutes provide a defense to avoidance. Finally, it should be noted that, if a transaction is avoidable as a preference under 11 U.S.C. § 547 or on some other basis besides a fraudulent transfer theory, then Section 548(c), by its plain terms, provides no defense. *Roosevelt*, 220 F.3d at 1032. Most recipients of preferential transfers could claim to be good faith transferees for value, but there is no such defense to preference avoidance. Rather, in a preference action, initial transferees must rely on the defenses established under 11 U.S.C. § 547(c), (h).

E. **DEALING WITH CONVERSIONS OF NONEXEMPT TO EXEMPT PROPERTY AS FRAUDULENT TRANSFERS.**

1. **Converting Nonexempt to Exempt Property Is Not Fraudulent Per Se.**

Controversies have arisen when an individual debtor has used nonexempt assets to acquire assets that are exempt under state law and then claims the state law exemptions under 11 U.S.C. § 522. The issue has often been whether the exemption should be disallowed on the ground that the conversion of nonexempt to exempt property amounted to a fraudulent transfer, and, in that event, whether the transaction should be effectively set aside and the allegedly exempt assets made available to creditors.

Extrinsic circumstances over and above the mere conversion of nonexempt to exempt property must show an actual intent to hinder, delay, or defraud creditors. Such circumstances amount to badges of fraud. They include whether the conversion took place on the eve of the bankruptcy petition, whether the conversion left the debtor with few or no assets that creditors could reach, whether the debtor converted a large amount of nonexempt to exempt property, and whether the debtor concealed the transfer or acted deceptively. *In re Smiley*, 864 F.2d 562 (7th Cir. 1989); *In re Boudrot*, 287 B.R. 582 (Bankr. W.D. Okla. 2003); *In re Wadley*, 263 B.R. 857 (Bankr. S.D. Ohio 2001); see *In re Baker*, 273 B.R. 892 (Bankr. D. Wyo. 2002) (conversion of virtually all of debtor’s assets to exempt annuities on the eve of bankruptcy filing); *In re Lenartz*, 263 B.R. 331 (Bankr. D. Idaho 2001).

Even if the transfer is found to have been made with actual fraudulent intent, it has not always followed that the proper remedy is to set the transaction aside or to treat the allegedly exempt property as though it were nonexempt. Prior to 2005, the Bankruptcy Code provided no basis for disallowing a state law exemption simply because the exempt property was acquired in order to hinder, delay, or defraud creditors. There had to be some basis in state law for disallowing a state law exemption on fraudulent transfer grounds. *In re Bradley*, 294 B.R. 64 (8th Cir. B.A.P. 2003); *In re McCabe*, 280 B.R. 841(Bankr. N.D. Iowa 2002); *In re Swift*, 124 B.R. 475 (Bankr. W.D. Tex. 1991); see *In re Allen*, 228 B.R. 132 (Bankr. W.D. Pa. 1998); Juliet M. Moringiello, *Distinguishing Hogs from Pigs: A Proposal for a Preference Approach to Pre-Bankruptcy Planning*, 6 AM. BANKR. INST. L. REV. 103 (1998). Before BAPCPA was enacted, the only remedy when there was no state law basis for avoiding an acquisition of exempt property was to deny the debtor a discharge on fraudulent transfer grounds. *Smiley*, 864 F.2d at 562; *In re Reed*, 700 F.2d 986 (5th Cir. 1983); *Boudrot*, 287 B.R. at 582. Alternatively, the
bankruptcy petition could be dismissed on the basis of bad faith filing or substantial abuse. 

*Lenartz*, 263 B.R. at 331.

2. **Homestead Exemptions Prior to BAPCPA.**

One particular area of dispute was converting nonexempt property into exempt homestead property with actual intent to hinder, delay, or defraud creditors. Under the law of some states, such a step may be attacked under the jurisdiction’s fraudulent transfer laws. Although channeling nonexempt property into a homestead, without more, is not considered fraudulent, the presence of numerous badges of fraud may lead to the disallowance of the homestead exemption, at least to the extent of the amount that was fraudulently transferred, and, in effect, to avoidance. *In re Sholdan*, 217 F.3d 1006 (8th Cir. 2000) (applying Minnesota’s U.F.T.A.); accord *In re Curry*, 160 B.R. 813 (Bankr. D. Minn. 1993).

This rule is not followed in many states with generous homestead allowances, however. For instance, Texas offers perhaps the most sweeping homestead exemption of any state. *Tex. Const.* art. XVI, §§ 50, 51; *Tex. Prop. Code* §§ 41.001-.002; see *In re McDaniel*, 70 F.3d 841 (5th Cir. 1995). Under Texas law, a debtor has an absolute right to acquire, improve, or discharge a lien against homestead property, even if the debtor does so with actual intent to hinder, delay, or defraud creditors. *In re Coates*, 242 B.R. 901 (Bankr. N.D. Tex. 2000); *In re Reed*, 12 B.R. 41 (Bankr. N.D. Tex. 1981), subsequently aff’d, 700 F.2d 986 (5th Cir. 1983). Thus, under Texas law, the use of nonexempt property to acquire, improve, or discharge a lien against a homestead may not be avoided, or the homestead exemption denied, regardless of the debtor’s state of mind or the effect on creditors. *In re Bowyer*, 932 F.2d 1100 (5th Cir. 1991); *In re Moody*, 862 F.2d 1194 (5th Cir. 1989), cert. denied, 503 U.S. 960 (1992). If the debtor converted nonexempt assets into exempt homestead property with actual fraudulent intent, the only remedy in bankruptcy prior to BAPCPA was to deny the debtor’s discharge, not to set the
transaction aside or deny the exemption. *In re Reed*, 700 F.2d 986 (5th Cir. 1983); *see Moody*, 862 F.2d at 1194.

Cases where the debtor’s acquisition of homestead property with nonexempt assets amounted to a fraudulent transfer should be distinguished from cases where the funds that the debtor channeled into a homestead were acquired by criminal or fraudulent activity. Texas law will not allow a homestead exemption to shield the fruits of a crime or fraud. *See Coates*, 242 B.R. at 901; *Reed*, 12 B.R. at 41. In such an instance, however, the remedy is not to deny the homestead exemption altogether. Rather, a court may use a constructive trust, an equitable lien, subrogation, or any other appropriate equitable device to allow the victim of the wrongdoing to reach the homestead property or its value. Such a remedy works in favor of the victim or victims only. The homestead property is not made available to creditors generally. *See In re Jones*, 50 B.R. 911 (Bankr. N.D. Tex. 1985); *see also Coates*, 242 B.R. at 901.

State law is much the same in Florida. Florida’s homestead exemption is scarcely less generous than the one in Texas. *FLA. CONST. art. X, § 4*. Under Florida law, a transfer of nonexempt assets into exempt homestead property may not be set aside, even if the debtor acted with actual intent to hinder, delay, or defraud creditors, and thus such a transfer is not grounds for challenging a homestead exemption. *Havoco of Am., Ltd. v. Hill*, 790 So. 2d 1018 (Fla. 2001), *answer to certified question conformed to*, 255 F.3d 1321 (11th Cir. 2001); *see In re Potter*, 320 B.R. 753 (Bankr. M.D. Fla. 2005); *In re Sparfven*, 265 B.R. 506 (Bankr. D. Mass. 2001) (applying Florida law). On the other hand, in Florida, as in Texas, a homestead exemption may not be used to protect the proceeds of a crime or fraud. *Havoco*, 790 So. 2d at 1018. In such a case, a court may use any appropriate equitable means to allow the victim to recover against the homestead property. *In re Financial Title & Trust, Inc.*, 347 F.3d 880 (11th Cir.
2003); *see In re Hecker*, 316 B.R. 375 (Bankr. S.D. Fla. 2004) (innocence of one spouse is not a defense to the imposition of a constructive trust or an equitable lien on homestead property). Such a step is for the benefit of the victim, however, not for the benefit of all creditors. *In re Abrass*, 268 B.R. 665 (Bankr. M.D. Fla. 2001).

The law appears to be the same in several other states, particularly those with generous homestead exemptions. The property will not be exempt from the claims of a third party who, because of the debtor's wrongdoing, holds a paramount equitable interest in the funds that were channeled into the homestead, but the transfer of honestly acquired nonexempt property into a homestead, even with actual intent to hinder, delay, or defraud, will not undermine the exemption. *In re McGinnis*, 306 B.R. 279 (Bankr. W.D. Mo. 2004) (applying Kansas law). In any state, a victim’s entitlement to subrogation, a constructive trust, or an equitable lien on the debtor’s homestead does not mean that the property is available to creditors generally. *In re Insley*, 313 B.R. 667 (Bankr. W.D. Pa. 2004) (if individual debtor had used funds fraudulently transferred from corporate debtor to acquire his residence, estate of corporate debtor would be entitled to an equitable lien, but this provided no basis for disallowing the homestead exemption altogether).


In 2005, Congress established a basis for denying a homestead exemption on fraudulent transfer grounds and making the value of the property available to general creditors, irrespective of state law. Section 308 of BAPCPA created 11 U.S.C. § 522(o). Unlike most provisions of BAPCPA, Section 522(o) took effect for all cases filed on or after the date of enactment — April 20, 2005. *In re McNabb*, 326 B.R. 785 (Bankr. D. Ariz. 2005) (new statute applied when debtor had filed his petition on April 28, 2005). Stripped to its essentials, this statute provides that any
property that the debtor or a dependent of the debtor uses as a residence or homestead, or any burial plot for the debtor or a dependent of the debtor, may not be claimed as exempt to the extent that, within the 10 years preceding the petition date, the debtor channeled nonexempt assets into that property with actual intent to hinder, delay, or defraud creditors. In other words, the exemption will not necessarily be disallowed altogether, but the value of the homestead (or burial plot) exemption will be reduced by the amount of any fraudulent transfers made within the preceding decade. To the extent that actually fraudulent transfers flowed into the property, its value is available to general creditors. See H.R. Rep. No. 31, 109th Cong., 1st Sess., pt. 1, 72-73 (2005).

This statute is designed to overcome the laws of states such as Florida and Texas that give the debtor an absolute right to shelter fraudulent transfers in homestead property. See In re Moody, 862 F.2d 1194 (5th Cir. 1989), cert. denied, 503 U.S. 960 (1992); In re Reed, 12 B.R. 41 (Bankr. N.D. Tex. 1981), subsequently aff’d, 700 F.2d 986 (5th Cir. 1983); Havoco of Am., Ltd. v. Hill, 790 So. 2d 1018 (Fla. 2001), answer to certified question conformed to, 255 F.3d 1321 (11th Cir. 2001). Under 11 U.S.C. § 522(o), the value of actually fraudulent transfers placed in homestead property will be available to creditors irrespective of state law. In re Mardone, 332 B.R. 593 (Bankr. D. Minn. 2005) (looking to badges of fraud, determining that debtor had converted nonexempt assets into homestead property with actual fraudulent intent, and denying the exemption to that extent); see Samuel K. Crocker & Robert H. Waldschmidt, Impact of the 2005 Bankruptcy Amendments on Chapter 7 Trustees, 79 AM. BANKR. L.J. 333 (2005). There will be no avoidance action in the usual sense, but the limitation on exemptions will have the same effect. See Mardone, 332 B.R. at 593.
4. **State Laws for Disallowing Personal Property Exemptions in Cases Involving Actually Fraudulent Transfers.**

In contrast to homestead exemptions, many states, even those with liberal homestead allowances, have statutes that permit the disallowance of personal property exemptions on fraudulent transfer grounds. These statutes may be used in bankruptcy. For example, Texas offers broad statutory exemptions for various sorts of personal property, TEX. PROP. CODE § 42.002-.0022, and for a wide variety of insurance policies and proceeds. TEX. INS. CODE § 1108.051. In contrast to the homestead exemption, however, Texas law specifically provides that the use of nonexempt property to acquire exempt personal property may be attacked if the debtor acquired the personal property with actual intent to hinder, delay, or defraud creditors. TEX. PROP. CODE § 42.004. This special fraudulent transfer statute may be used in bankruptcy to challenge an exemption claim and to make the supposedly exempt personal property available to creditors. *In re Coates*, 242 B.R. 901 (Bankr. N.D. Tex. 2000); *see In re Swift*, 124 B.R. 475 (Bankr. W.D. Tex. 1991). Similarly, premiums paid in fraud of creditors to acquire an exempt insurance vehicle may be recovered. TEX. INS. CODE § 1108.53. In such a case, however, creditors or the bankruptcy estate are entitled to the value of the premiums that were fraudulently paid, not the total value of the exempt insurance policy, proceeds, or annuity. Elizabeth R. Turner & Kathryn G. Henkel, *Asset Protection Techniques*, C992 ALI-ABA 1 (1995).

There are similar statutes in other states. For instance, Florida law does not recognize an exemption in personalty to the extent that the exempt property was acquired through the use of nonexempt assets and the transfer was made with actual fraudulent intent. FLA. STAT. §§ 222.29, 222.30. The Florida Supreme Court has held that these statutes are valid with respect to statutorily created exemptions, although not with respect to the constitutionally created homestead exemption. *Havoco of Am., Ltd. v. Hill*, 790 So. 2d 1018 (Fla. 2001), *answer to
certified question conformed to, 255 F.3d 1321 (11th Cir. 2001). These statutes may be used in bankruptcy to undermine claimed exemptions of personal property on fraudulent transfer grounds. *In re Levine*, 134 F.3d 1046 (11th Cir. 1998) (debtors’ purchase of exempt annuities with nonexempt funds could be set aside as a fraudulent transfer); *In re Jennings*, 332 B.R. 465 (Bankr M.D. Fla. 2005) (same). Examples of the same sort may be found in other jurisdictions. *In re Beckman*, 104 B.R. 866 (Bankr. S.D. Ohio 1989) (life insurance policies acquired in fraud of creditors could not be claimed as exempt under Ohio statute); see *Society of Lloyd’s v. Collins*, 284 F.3d 727 (7th Cir. 2002) (noting that Illinois statute permits creditors to recover value of premiums paid for otherwise exempt life insurance policies if policies were purchased with intent to hinder, delay, or defraud); *In re Schuster*, 256 B.R. 701 (Bankr. D.N.J. 2000) (noting that New Jersey statute contains an exception to the annuity exemption for any amounts paid into the annuity with intent to defraud creditors and for any periodic payment in excess of $500 per month).

F. FORECLOSURES AND SIMILAR TRANSACTIONS AS CONSTRUCTIVELY FRAUDULENT TRANSFERS.

1. Reasonably Equivalent Value and Real Estate Foreclosures: *Durrett* and Its Progeny.

Unlike former U.C.C. § 9-504 or Section 9-610 of the current Article 9, the real estate foreclosure laws of most states contain no mandate that a mortgage foreclosure or deed of trust sale must be conducted in a commercially reasonable manner, nor is there usually any affirmative requirement that a foreclosing mortgagee must attempt to obtain the fair market value of the property when it is sold. Typically, the foreclosing mortgagee is the only bidder, and the amount bid is usually the outstanding balance of the secured debt. Thus, real estate foreclosures do not yield fair market value in many cases. Maury B. Poscover, *A Commercially Reasonable Sale Under Article 9: Commercial, Reasonable and Fair to All Involved*, 28 LOY. L.A.L. REV.
235 (1994) (contrasting sales of collateral under Article 9 with real estate foreclosure sales); Rene Faulkner, Note, BFP v. Resolution Trust Corp.: Interpretations of Section 548 of the Bankruptcy Code and the Potential Effect on Mortgages and the Economy, 17 Whittier L. Rev. 579 (1996); see, e.g., Pentad Joint Venture v. First Nat’l Bank of LaGrange, 797 S.W.2d 92 (Tex. App.—Austin 1990, writ denied) (holding that the commercially reasonable requirement of Article 9 does not apply to deed of trust sales under Texas law). Typically, inadequacy of price, without more, is not considered grounds for attacking a regularly conducted real estate foreclosure sale under state law, e.g., In re Greenberg, 229 B.R. 544 (1st Cir. B.A.P. 1999) (Massachusetts law); Giordano v. Stubbs, 184 S.E.2d 165 (Ga. 1971), cert. denied, 405 U.S. 908 (1972); American Sav. & Loan Ass’n of Houston v. Musick, 531 S.W.2d 581 (Tex. 1975); see James C. Marshall, Annual Survey of Georgia Law: Commercial Law, 46 Mercer L. Rev. 95 (1994), although in some states a mortgage or deed of trust foreclosure may be set aside if the price is so low as to shock the conscience. See In re Krohn, 52 P.3d 774 (Ariz. 2004); National Canada Corp. v. Dikeou, 868 P.2d 1131 (Colo. Ct. App. 1993); United Okla. Bank v. Moss, 793 P.2d 1359 (Okla. 1990); Rife v. Wooffolk, 289 S.E.2d 220 (W. Va. 1982); Andy M. Perry, Jr., Note, BFP v. Resolution Trust Corporation: Supreme Court Shifts Focus Onto State Law in Ruling on Mortgage Foreclosure Sales, 97 W. Va. L. Rev. 225 (1994).

decided to set aside a prepetition foreclosure sale that had yielded only 57% of the property’s appraised value. The court observed that it could find no case where a foreclosure that had produced less than 70% of the property’s fair market value had been upheld. Although the Durrett court was actually applying Section 67(d) of the Bankruptcy Act, the holding had obvious implications for Section 548 of the Bankruptcy Code. Most courts took Durrett to stand for a bright line test: a prepetition foreclosure could be avoided as constructively fraudulent if the sale brought less than 70% of the property’s fair market value because any smaller percentage was per se less than reasonably equivalent value. See Timothy J. Boyce, The Supreme Court and the Death of Durrett, 23 REAL EST. L.J. 205 (1995). The Fifth Circuit itself, however, began to back away from the mechanical 70% Durrett rule, observing that it was only dicta. FDIC v. Blanton, 918 F.2d 524 (5th Cir. 1990).

Other courts agreed that a regularly conducted foreclosure sale could constitute a constructively fraudulent transfer if the sale produced less than the reasonably equivalent value of the property, but they rejected any fixed percentage test, preferring a more flexible approach that examined the facts and circumstances of each case. This line of decisions held that there was a rebuttable presumption, but only a rebuttable presumption, that a regularly conducted foreclosure had yielded reasonably equivalent value for the debtor. This analysis was expounded in In re Hulm, 738 F.2d 323 (8th Cir.), cert. denied, 469 U.S. 990 (1984), and more fully developed in In re Bundles, 856 F.2d 815 (7th Cir. 1988). Under the Hulm/Bundles approach, bankruptcy courts were to consider how widely the sale had been advertised, the marketability of the property, whether competitive bidding had been encouraged, the number of bidders present, and the bargaining positions of the parties at the sale, among other factors. See George H. Singer, Section 548(a)(2)(A) and the Mortgage Foreclosure Sale: A Per Se Rule for Reasonably

At least one court following this analysis opined that the effect of 11 U.S.C. § 548(a)(1)(B)(i) (formerly codified as § 548(a)(2)(A)) was to require mortgagees who had conducted prepetition foreclosures to show that the foreclosure sale had been commercially reasonable in the sense required by Article 9 of the U.C.C. While the receipt of less than fair market value, standing alone, would not be sufficient to disturb the foreclosure, a mortgagee was under a duty mandated by federal bankruptcy law to take all the steps required of a foreclosing creditor under Article 9. Failure to do so could result in an avoidance of the foreclosure if the price appeared low. In re General Indus., Inc., 79 B.R. 124 (Bankr. D. Mass. 1987). Under the law of many states, no such requirement exists. It appears doubtful that Congress meant to engraft the requirements of Article 9 onto state real estate law by fiat when it enacted Section 548 of the Bankruptcy Code. See Jeremy Galton, Durrett Resolved, 112 BANKING L.J. 270 (1995).

Yet a third approach was typified by In re Madrid, 21 B.R. 424 (9th Cir. B.A.P. 1982), aff’d on other grounds, 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984). The Madrid court, showing greater deference to state law, held that the correct focus should be on the conformity of the foreclosure sale to controlling state statutes and court decisions. If the foreclosure sale had been properly conducted under state law, then the price received would be conclusively presumed to constitute reasonably equivalent value within the meaning of 11 U.S.C. § 548(a)(1)(B)(i). See Vicki S. Porter, BFP v. RTC: Limiting the Use of § 548 to Set Aside Foreclosure Sales, 23 COLO. LAW. 2311 (1994).
Needless to say, creditors were disturbed by this split of authority. Although reasonable expectations were not thwarted in jurisdictions that followed Madrid, courts that followed either a Durrett or a Hulm/Bundles approach could easily overthrow prepetition foreclosures that would have been upheld as perfectly proper outside the bankruptcy context. The anomaly of interpreting 11 U.S.C. § 548(a)(1)(B)(i) (formerly codified as § 548(a)(2)(A)) to allow for an override of state foreclosure law seemed all the more glaring after the promulgation of the Uniform Fraudulent Transfer Act in 1984. Under Section 3(b) of the U.F.T.A., the price paid for an asset of the debtor at a regularly conducted, noncollusive foreclosure sale is automatically reasonably equivalent value. Cf. In re Hitzel, 312 B.R. 727 (Bankr. W.D.N.Y. 2004) (noting that, under the Uniform Fraudulent Conveyance Act, a noncollusive foreclosure could not even be considered a conveyance or transfer). Thus, prepetition foreclosures could be attacked as constructively fraudulent only under Section 548 of the Bankruptcy Code, not under state fraudulent transfer law employed under 11 U.S.C. § 544(b). See Boyce, The Supreme Court and the Death of Durrett, 23 REAL EST. L.J. at 205.

2. Reasonably Equivalent Value and Other Forced Sales.

The fear that prepetition foreclosures or forced sales might be set aside as constructively fraudulent after the debtor had filed a bankruptcy petition was by no means confined to ordinary mortgage foreclosures. Some commentators suggested, and even urged, that a Durrett or a Hulm/Bundles approach might be used in analyzing sheriff’s sales or foreclosures on personal property, even though such transactions would be unassailable under state law. See Hon. Frank W. Koger & Paula C. Acconcia, The Hulm Decision: A Milestone for Creditors, 91 COM. L.J. 301 (1986).

Some courts proceeded to put these ideas into practice. For example, in In re Aspedon, 73 B.R. 538 (Bankr. S.D. Iowa 1987), the court held that a judgment creditor’s successful bid of
$27,000 at a sheriff’s sale was not reasonably equivalent value for an undivided one-half interest in farm land with a total appraised value of roughly $110,000. The sale was avoided as constructively fraudulent. Similarly, in *In re Apollo Hollow Metal & Hardware Co.*, 71 B.R. 179 (Bankr. W.D. Mo. 1987), the court held that a creditor’s successful bid at a sheriff’s sale of $6,800 for inventory worth $30,000 did not constitute reasonably equivalent value. *Accord In re Betinsky*, 45 B.R. 244 (Bankr. E.D. Pa. 1984) (debtors’ contention that a prepetition sheriff’s sale of their personal property should be set aside as constructively fraudulent stated a valid cause of action).

Courts were more reluctant to disturb properly conducted prepetition foreclosures under Article 9 of the Uniform Commercial Code. Former U.C.C. § 9-504, like the current Section 9-610, imposed a requirement that a foreclosing creditor must dispose of the collateral in a commercially reasonable manner. *See In re General Indus., Inc.*, 79 B.R. 124 (Bankr. D. Mass. 1987); Maury B. Poscover, *A Commercially Reasonable Sale Under Article 9: Commercial, Reasonable and Fair to All Involved*, 28 LOY. L.A.L. REV. 235 (1994). It is possible, however, that a sale may be commercially reasonable and still yield a low price. Under Article 9, if a sale has been commercially reasonable, it may not be attacked by showing that a higher price might have been obtained through a sale at a different place or time or in a different manner. Quite apart from bankruptcy law, a very low sale price could raise a presumption that the sale was not commercially reasonable. *Bank Josephine v. Conn*, 599 S.W.2d 773 (Ky. Ct. App. 1980); *see In re Sackman Mortg. Corp.*, 158 B.R. 926 (Bankr. S.D.N.Y. 1993); *In re Stoller’s, Inc.*, 93 B.R. 628 (Bankr. N.D. Ind. 1988). Nonetheless, if the sale is commercially reasonable, it may not be assailed simply because the price received was less than fair market value. *In re Zsa Zsa*, Ltd., 352 F. Supp. 665 (S.D.N.Y. 1972) (upholding foreclosure sale that brought roughly 10% of retail
value of collateral), *aff’d*, 475 F.2d 1393 (2d Cir. 1973); *Sierra Fin. Corp. v. Brooks-Farrer Co.*, 93 Cal. Rptr. 422 (Cal. Ct. App. 1971) (upholding public foreclosure sale where $500 was received for collateral valued at approximately $27,600); see *Poscover, A Commercially Reasonable Sale Under Article 9*, 28 LOY. L.A.L. REV. at 235.

Despite the well-settled principle that commercially reasonable foreclosure sales under the U.C.C. may not be set aside for price inadequacy alone, some bankruptcy courts indicated in dicta that they would be willing to treat prepetition commercially reasonable foreclosure sales as constructively fraudulent if the amount received did not rise to the level of reasonably equivalent value under 11 U.S.C. § 548(a)(1)(B)(i). *See In re Ewing*, 33 B.R. 288 (Bankr. W.D. Pa. 1983), *rev’d on other grounds*, 36 B.R. 476 (W.D. Pa.), *aff’d*, 746 F.2d 1465 (3d Cir. 1984), *cert. denied*, 469 U.S. 1214 (1985); *see also Sackman Mortg.*, 158 B.R. at 926 (noting that a very low price may bespeak commercial unreasonableness, lack of reasonably equivalent value, or both); *Stoller’s*, 93 B.R. at 628; *General Indus.*, 79 B.R. at 124. In practice, however, dispositions of collateral that conformed to the requirements of Article 9 generally survived fraudulent transfer scrutiny. *Stoller’s*, 93 B.R. at 628; *see also In re Bob’s Sea Ray Boats, Inc.*, 144 B.R. 451 (Bankr. D.N.D. 1992) (debtor’s voluntary surrender of collateral in return for cancellation of debt constituted reasonably equivalent value, even though the book value of the collateral exceeded the amount of the debt; evidence showed that the debtor had paid far too much for the collateral in the first place).

Nonetheless, many creditors had real cause for concern that execution sales that were entirely proper under state law, and that certainly could not be attacked under state fraudulent transfer law, might still be set aside in bankruptcy under 11 U.S.C. § 548. Just as Section 3(b) of the U.F.T.A. prevents a regularly conducted mortgage foreclosure sale provides the debtor with
reasonably equivalent value, so Section 8(e)(2) provides that the enforcement of a security interest in conformity with Article 9 cannot be attacked as a constructively fraudulent transfer.

3. The Supreme Court Speaks: BFP v. RTC.

Many of the concerns that creditors had had with regard to prepetition foreclosures were laid to rest in 1994 with the Supreme Court’s five-to-four decision in BFP v. RTC, 511 U.S. 531 (1994). Writing for the majority, Justice Scalia rejected both the bright line percentage of fair market value test set forth in Durrett v. Washington Nat’l Ins. Co., 621 F.2d 201 (5th Cir. 1980) and the rebuttable presumption, totality of circumstances, or commercial reasonableness approach of In re Hulm, 738 F.2d 323 (8th Cir.), cert. denied, 469 U.S. 990 (1984) and In re Bundles, 856 F.2d 815 (7th Cir. 1988). Instead, the BFP Court approved the analysis of In re Madrid, 21 B.R. 424 (9th Cir. B.A.P. 1982), aff’d on other grounds, 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833 (1984): a real estate foreclosure sale that is properly conducted under state law may not be attacked as a fraudulent transfer for lack of reasonably equivalent value under 11 U.S.C. § 548(a)(1)(B)(i). The price received at a properly conducted mortgage or deed of trust foreclosure is conclusively presumed to constitute reasonably equivalent value for purposes of that statute. BFP, 511 U.S. at 531; see Vicki S. Porter, BFP v. RTC: Limiting the Use of § 548 to Set Aside Foreclosure Sales, 23 COLO. LAW. 2311 (1994); Rene Faulkner, Note, BFP v. Resolution Trust Corp.: Interpretations of Section 548 of the Bankruptcy Code and the Potential Effects on Mortgages and the Economy, 17 WHITTIER L. REV. 579 (1996).

In the majority opinion, Justice Scalia noted that the Bankruptcy Code does not define “reasonably equivalent value,” least of all in the context of a forced sale. The error of both the Durrett approach and the Hulm/Bundles analysis, in Justice Scalia’s view, lay in assuming that reasonably equivalent value must be equated with fair market value. By definition, the price paid at a distress sale does not meet the normal requirements for fair market value: what a
willing buyer would pay to a willing seller if neither party were under any compulsion to enter into the transaction. The touchstone, then, must be the price that a reasonable distress sale would have produced. If a foreclosure sale conforms to state law, then the price received is by definition what a reasonably conducted foreclosure sale would have yielded. \textit{BFP}, 511 U.S. at 531; \textit{see} Timothy J. Boyce, \textit{The Supreme Court and the Death of Durrett}, 23 REAL EST. L.J. 205 (1995).

Moreover, the \textit{BFP} Court was concerned with comity and federalism. Real estate foreclosure law and fraudulent transfer law had coexisted for centuries. Until \textit{Durrett}, it would scarcely have occurred to anyone to think of a regularly conducted, noncollusive foreclosure sale as a constructively fraudulent transfer. To follow \textit{Durrett} or \textit{Hulm/Bundles} would mean casting a potential cloud created by federal bankruptcy law on every title transferred at otherwise proper foreclosure sales. Congress may have the power to override state law and to engraft a commercial reasonableness requirement or percentage of fair market value rule onto the welter of state foreclosure laws. There is no evidence, however, that Congress had any such intention when it enacted the relevant bankruptcy statute. Absent an unequivocal expression of legislative intent to the contrary, courts should presume that, if a foreclosure would not be considered improper under state law, Congress did not mean for it to be subject to federal fraudulent transfer law once a bankruptcy petition has been filed. \textit{BFP}, 511 U.S. at 531; \textit{see} George H. Singer, \textit{Section 548(a)(2)(A) and the Mortgage Foreclosure Sale Exception: A Per Se Rule for Reasonably Equivalent Value}, 22 CAL. BANKR. J. 197 (1994); Eric S. Palace, Note, \textit{In re BFP: Just a Band-Aid?—Looking for a Stable Solution That Balances Creditors’ and Debtors’ Rights Under Bankruptcy Code Section 548(a)(2)}, 15 ANN. REV. BANKING L. 359 (1996).
BFP, then, allayed many concerns. If a prepetition foreclosure sale conformed to state law, it could not be attacked in bankruptcy as constructively fraudulent. In effect, 11 U.S.C. § 548(a)(1)(B)(i) has now been interpreted so that it conforms to Section 3(b) of the Uniform Fraudulent Transfer Act: in a foreclosure context, reasonably equivalent value is neither more nor less than what a properly conducted foreclosure sale actually yields.

4. The Situation After BFP v. RTC: Most Prepetition Real Estate and Other Foreclosures Are Upheld.

It is important to realize certain limits on the holding in BFP v. RTC, 511 U.S. 531 (1994). First, the BFP Court was careful to note that there is no presumption that an improperly conducted mortgage or deed of trust foreclosure sale has yielded reasonably equivalent value. See George H. Singer, Section 548(a)(2)(A) and the Mortgage Foreclosure Sale Exception: A Per Se Rule for Reasonably Equivalent Value, 22 CAL. BANKR. J. 197 (1994). The principle is not limited to foreclosures involving collusion, chicanery, or actual fraud. Rather, a bankruptcy court may avoid the sale under state law for any vitiating failure to conform to state foreclosure requirements or as a constructively fraudulent transfer. BFP, 511 U.S. at 531; accord In re Ryker, 272 B.R 602 (Bankr. D.N.J. 2002) (failure of mortgagee to advertise sale as New Jersey law required meant that prepetition foreclosure sale could be set aside for irregularity under state law and/or as a constructively fraudulent transfer under 11 U.S.C. § 548), rev’d on other grounds, 301 B.R. 156 (D.N.J. 2003), on remand, 315 B.R. 664 (Bankr. D.N.J. 2004). Of course, if the sale were collusive, it might be subject to avoidance as actually fraudulent under either state or federal law. See In re Imperial Tool & Mfg., Inc., 314 B.R. 340 (Bankr. N.D. Tex. 2004) (in light of several badges of fraud accompanying prepetition foreclosure, trustee’s proposed settlement of avoidance action was too low); see also In re Blatstein, 226 B.R. 140 (E.D. Pa. 1998) (noting that collusive bid rigging could constitute actual fraud), aff’d in part,
Moreover, *BFP* does not mean that a properly conducted foreclosure sale that yields a low price is always immune to attack. As Justice Scalia noted, in some states, inadequate price, without more, may be enough to set aside a foreclosure, at least if the price is so low as to shock the conscience. If a sale is to be avoided on such equitable grounds, however, this must be done pursuant to state law. *BFP*, 511 U.S. at 531; see Andy M. Perry, Jr., Note, *BFP v. Resolution Trust Corporation: Supreme Court Shifts Focus Onto State Law in Ruling on Mortgage Foreclosure Sales*, 97 W. VA. L. REV. 255 (1994). For example, in *In re Barr*, 170 B.R. 772 (Bankr. E.D.N.Y. 1994), the bankruptcy court ultimately held that the low price received at a foreclosure on property located in South Carolina could not be used to deem the transfer constructively fraudulent. The court noted that under South Carolina law, a foreclosure might be avoided if the price were so low as to shock the conscience, but the court concluded that the price in the case at bar did not meet that test. Accordingly, the *Barr* court upheld the sale. Similarly, *In re 2435 Plainfield Ave., Inc.*, 72 F. Supp. 2d 482 (D.N.J. 1999), *aff’d* 213 F.3d 629 (3d Cir. 2000), the court held that a regularly conducted tax foreclosure sale could not be considered constructively fraudulent under New Jersey’s Uniform Fraudulent Transfer Act. The court further observed that, while an otherwise regular ordinary mortgage foreclosure sale might be set aside if the price were so low as to shock the conscience, New Jersey law did not permit the application of this doctrine to tax foreclosure sales.

Apart from the fact that the *BFP* decision did not purport to give carte blanche to creditors to ignore state law in prepetition foreclosures, the *BFP* Court was careful to limit its decision to foreclosures of mortgages or deed of trust liens. The Court expressed no opinion as
to how its holding might affect other execution sales or foreclosures. 511 U.S. at 531. Nonetheless, most courts have held that other types of forced sales will be subject to the same rules, at least if there is an opportunity for competitive bidding. If the sale were properly conducted under state law, then price inadequacy alone cannot be used to turn the transaction into a constructively fraudulent transfer under 11 U.S.C. § 548(a)(1)(B). See James C. Marshall, Annual Survey of Georgia Law: Commercial Law, 46 MERCER L. REV. 95 (1994).

Following BFP, most courts have held that a regularly conducted tax foreclosure sale of the debtor’s property may not be set aside as constructively fraudulent, even if the price received was below fair market value. E.g., In re Grandote Country Club Co., Ltd., 252 F.3d 1146 (10th Cir. 2001); In re Murray, 276 B.R. 869 (Bankr. N.D. Ill. 2002); In re Hemstreet, 258 B.R. 134 (Bankr. W.D. Pa. 2001); In re Washington, 232 B.R. 340 (Bankr. E.D. Va. 1999); In re Russell-Polk, 200 B.R. 218 (Bankr. E.D. Mo. 1996); In re Hollar, 184 B.R. 243 (Bankr. M.D.N.C. 1995); In re McGrath, 170 B.R. 78 (Bankr. D.N.J. 1994); see In re T.F. Stone Cos., 170 B.R. 884 (Bankr. N.D. Tex. 1994) (postpetition tax foreclosure could not be set aside for price inadequacy under 11 U.S.C. § 549), subsequently aff’d, 72 F.3d 466 (5th Cir. 1995). But see In re Butler, 171 B.R. 321 (Bankr. N.D. Ill. 1994) (questioning in dicta whether BFP should apply to tax foreclosures). Tax sales typically require published notice and a public sale. The procedures for the foreclosure of a tax lien are normally sufficiently similar to a mortgage or deed of trust foreclosures that there is no reason why the analysis of BFP should not apply to a regularly conducted tax sale. Grandote Country Club, 252 F.3d at 1146; Murray, 276 B.R. at 869; Washington, 232 B.R. at 340; Russell-Polk, 200 B.R. at 218; Hollar, 184 B.R. at 243; see Cathy L. Reece & Scott T. Ashby, Pre-Bankruptcy Foreclosures After BFP, 41 No. 1 PRAC. LAW. 59 (Jan. 1995).
Likewise, some courts have upheld the prepetition forfeiture of a vendee’s interest under a contract for deed. In *In re Vermillion*, 176 B.R. 563 (Bankr. D. Or. 1994), the court held that, if the forfeiture conforms to state law, then the cancellation of the vendee’s debt will be conclusively presumed to constitute reasonably equivalent value. In basic agreement with *Vermillion*, decisions from New Mexico have held that *BFP* applies to the forfeiture of a vendee’s interest under a contract for deed if the transaction is regular under state law. Under New Mexico law, however, even a regular cancellation may be set aside if, in light of all the circumstances, the transaction shocks the conscience by giving the vendor an inequitable windfall or working an oppressive forfeiture against the vendee. Thus, in keeping with *BFP*, the forfeiture might be set aside, not as a constructively fraudulent transfer under 11 U.S.C. § 548, but rather under a state law shock-the-conscience test. That test, however, is very difficult to satisfy. *McCanna v. Burke*, 197 B.R. 333 (D.N.M. 1996); *In re Czel*, 202 B.R. 778 (Bankr. D.N.M. 1996).

Finally, it appears that Article 9 secured creditors need have little fear that a prepetition commercially reasonable disposition of the collateral will result in fraudulent transfer avoidance if the debtor later files a bankruptcy petition. *BFP* may not apply directly to foreclosure sales of personalty. Nonetheless, although a very low price may raise a presumption that the sale was not commercially reasonable, the reasoning of *BFP* would indicate that, if the sale is to be avoided, it must be for lack of commercial reasonableness under Article 9. See Jeremy Galton, *Durrett Resolved*, 112 BANKING L.J. 270 (1995); Peter H. Weil & Edwin E. Smith, *Bankruptcy Issues for the Secured Creditor*, 708 PLI/COMM 647 (1995). One decision, however, seems to suggest that this reasoning might not be accepted in all courts. In *In re Prince Gardner, Inc.*, 220 B.R. 63 (Bankr. E.D. Mo. 1998), the court held that a secured party’s private sale of the collateral had not
necessarily yielded reasonably equivalent value. The court noted that the security of titles to land, which had been a prime concern in *BFP*, was not at issue in the sale of personalty. Furthermore, the private sale had not produced the widest possible competitive bidding. The court also noted that there was some question as to whether the sale had been commercially reasonable. Of course, if the sale had not been commercially reasonable under state law, there would be no presumption that the sale had produced reasonably equivalent value in any case.

5. Many Courts Do Not Apply *BFP* When There Was No Opportunity for Competitive Bidding.

Although many courts have been willing to apply *BFP v. RTC*, 511 U.S. 531 (1994) quite liberally, the rationale has often been that foreclosure sales offer the opportunity for competitive bidding and help to ensure something more than a low price impose by fiat. *See, e.g.*, *In re Grandote Country Club Co., Ltd.*, 252 F.3d 1146 (10th Cir. 2001); *In re Greenberg*, 229 B.R. 544 (1st Cir. B.A.P. 1999); *In re Samaniego*, 224 B.R. 154 (Bankr. E.D. Wash. 1998); *In re Fulmer-Vaught*, 218 B.R. 56 (Bankr. W.D. Mo. 1996). It is at least arguable that conformity to state law, without more, should not necessarily shield a forced loss of the debtor’s property from avoidance if the collateral is not exposed to any market, even a distress sale market. Janet Flaccus, *Pre-Petition and Post-Petition Mortgage Foreclosure and Tax Sales and the Faulty Reasoning of the Supreme Court*, 51 Ark. L. Rev. 25 (1998); *see also In re Prince Gardner, Inc.*, 220 B.R. 63 (Bankr. E.D. Mo. 1998).

law, anyone interested in buying property at a tax foreclosure simply indicates a willingness to pay the amount of the outstanding taxes. The buyer is then selected by a random drawing. The court held that the sale in question could be attacked as constructively fraudulent. There could be no presumption of reasonably equivalent value where there was not even a distress sale market and where the buyer had acquired property worth between $10,000 and $50,000 for only $450. Similarly, in *In re Wentworth*, 221 B.R. 316 (Bankr. D. Conn. 1998), the court refused to apply *BFP* where the debtor had lost property through a strict nonjudicial tax foreclosure. Ownership had been transferred without any possibility of judicial oversight and without any opportunity for competitive bidding or a public sale. In the same vein, the court in *In re Murphy*, 331 B.R. 107 (Bankr. S.D.N.Y. 2005) held that a prepetition tax forfeiture of the debtor’s property that was valid under New York law could be attacked as a constructively fraudulent transfer. Because there was no public sale or competitive bidding, there were no grounds for invoking a presumption that reasonably equivalent value had been received.

Likewise, although several courts have upheld the forfeiture of a vendee’s interest under a contract for deed if the forfeiture conforms to state law, the court in *In re Grady*, 202 B.R. 120 (Bankr. N.D. Iowa 1996) was of a different opinion. The *Grady* court reasoned that state law generally does not give a vendee the protection of published notice or a public sale. Thus the forfeiture of property worth roughly $40,000 in return for the cancellation of a debt of approximately $16,000 could be set aside as a constructively fraudulent transfer.

Even if a mortgage foreclosure conforms to state law, the transaction might be subject to attack if there were no opportunity for competitive bidding. In *In re Fitzgerald*, 237 B.R. 252 (Bankr. D. Conn. 1999), the court, relying on the reasoning of *Wentworth*, 221 B.R. at 316, and *Grady*, 202 B.R. at 120, held that a strict judicial foreclosure in conformity with Connecticut law
did not necessarily establish that the debtor had received reasonably equivalent value. There had been no opportunity for competitive bidding or for market forces to come into play, and hence the *Fitzgerald* court was unwilling to hold that the transaction was immune from constructively fraudulent transfer avoidance as a matter of law. *Accord In re Fitzgerald*, 255 B.R. 807 (Bankr. D. Conn. 2000). *Contra In re Talbot*, 254 B.R. 63 (Bankr. D. Conn. 2000) (under Connecticut law, court oversight serves as a substitute for competitive bidding in strict judicial foreclosure cases, and the state has a compelling interest in the security of land titles; therefore, conformity to state law strict foreclosure procedures establishes a conclusive presumption of reasonably equivalent value).

The court in *In re Chase*, 328 B.R. 675 (Bankr. D. Vt. 2005) added its weight to the decisions holding that a strict foreclosure in conformity with state law will not automatically create a presumption of reasonably equivalent value or insulate a transaction from constructively fraudulent transfer scrutiny. In such a situation where there is no exposure to market forces, *BFP* does not apply. The *Chase* court concluded that, if the strict foreclosure resulted in the cancellation of debt worth 90% or more of the property’s fair market value, there should be a rebuttable presumption that the transaction had been an exchange for reasonably equivalent value. Conversely, in a modified application of *Durrett*, the court concluded that there should be a rebuttable presumption (not a per se rule) that a strict foreclosure for less than 70% of fair market value was not an exchange for reasonably equivalent value. In *Chase*, the property had an appraised value of roughly $151,000, and the strict foreclosure had resulted in the cancellation of a debt of approximately $111,000. Neither presumption applied, and so the court conducted a *Hulm/Bundles* or totality of the circumstances analysis. The court concluded that the debtor had not received reasonably equivalent value and that the transaction could be avoided.
as constructively fraudulent. The mortgagee would be required to pay the $40,000 difference between the debt that was canceled and the market value of the property.

In a similar fashion, several decisions have questioned whether the reasoning of BFP applies to the forfeiture of a debtor’s property pledged to a pawnbroker. In In re Carter, 209 B.R. 732 (Bankr. D. Or. 1997), the court refused to hold that such a forfeiture could never be set aside as constructively fraudulent, even if all of the requirements established by state statutes and regulations governing pawnbrokers had been met. The court noted that pawnbrokers often advance far less than the property’s value, and that debtors frequently resort to pawnbrokers when they are in desperate straits. Moreover, unlike most foreclosures of mortgages or deeds of trust, there is no sale when the pawnbroker forecloses. Finally, the Carter court noted, the overriding state interest in the security of land titles that had been a major concern in BFP was not involved in transactions with pawnbrokers. The Carter court refused to apply BFP reasoning to grant summary judgment for the pawnbroker. At a subsequent trial, however, the pawnbroker prevailed. The evidence established that the fair market value of the pawned property was roughly $750, that the debtor had received a loan of $600 when she pawned the property, and that, at the time of the forfeiture, she would have had to pay $690 to redeem. On these facts, the court held that the debtor had received reasonably equivalent value. In re Carter, 212 B.R. 972 (Bankr. D. Or 1997).

In In re Bell, 279 B.R. 890 (Bankr. N.D. Ga. 2002), the pawnbroker had less success. The debtor had failed to pay the redemption price of $5,300 for a vehicle worth more than $10,000. Title to the vehicle had passed before the petition date, and thus the pawnbroker would not violate the automatic stay by selling the vehicle. The debtor, however, maintained that the forfeiture of the vehicle was a constructively fraudulent transfer. The court agreed that the
satisfaction of a debt of $5,300 was not reasonably equivalent value for a vehicle worth more than $10,000, although it appeared that all transactions had complied with Georgia law governing pawnbrokers. Pending a full development of the record at a trial on the merits, the court issued a preliminary injunction restraining the pawnbroker from disposing of the vehicle. Compliance with the pawnbroker statutes was not, without more, an adequate defense to a constructively fraudulent transfer claim. Similarly, in In re Jones, 304 B.R. 462 (Bankr. N.D. Ala. 2003), the court held that the debtor had not received reasonably equivalent value when he had pawned the title to his car worth roughly $7,350 in return for an advance of $1,500 and then forfeited the vehicle by failing to repay a total redemption amount of $1,800. The transaction was constructively fraudulent.

Although it is certainly plausible to argue that there should be no presumption of reasonably equivalent value when there has been no opportunity for competitive bidding, it is also plausible to take the position that the states have established regulatory schemes for many types of involuntary transfers. Conformity to such regulations should be recognized as a necessary and sufficient condition for establishing reasonably equivalent value for avoidance purposes. To hold otherwise arguably means creating needless uncertainty and flouting comity. Marie T. Reilly, A Search for Reason in “Reasonably Equivalent Value” After BFP v. Resolution Trust Corp., 13 AM. BANKR. INST. L. REV. 261 (2005). Congress did not address this controversy in BAPCPA, and it appears likely that many courts, although not all, will continue to avoid prepetition involuntary transfers when there was no opportunity for competitive bidding or exposure to a distress sale market.
6. **A Comparison: Attacking Prepetition Foreclosures As Preferences Under 11 U.S.C. § 547(b).**

Although *BFP v. RTC*, 511 U.S. 531 (1994) and its progeny protect regularly conducted prepetition foreclosures from avoidance as constructively fraudulent transfers in most instances, a different analysis might apply when an acquisition of collateral by an oversecured creditor at a mortgage foreclosure or similar sale is challenged as a preference. For constructively fraudulent transfer purposes, the proper inquiry is whether the debtor received reasonably equivalent value in exchange. 11 U.S.C. § 548(a)(1)(B)(i). For preference purposes, however, the proper inquiry is whether the mortgagee received more than he or she would have received in a hypothetical Chapter 7 liquidation. 11 U.S.C. § 547(b)(5); *see In re Andrews*, 262 B.R. 299 (Bankr. M.D. Pa. 2001) (discussing the differences). Furthermore, with reference to a preference claim, the time for valuing what the creditor received is the petition date; the hypothetical liquidation is deemed to occur then, not when the transfer (foreclosure) actually took place. *See Palmer Clay Prods. Co. v. Brown*, 297 U.S. 227 (1936); David Gray Carlson, *Security Interests in the Crucible of Voidable Preference Law*, 1995 U. Ill. L. Rev. 211 (1995) (in a preference action, creditor bears the consequences of appreciation or depreciation of the collateral between the time of the transfer and the petition date).

Prior to 1994, many courts applied preference law to prepetition foreclosures by oversecured creditors when the creditor had bid in the amount owed and received property that was worth more. *E.g.*, *In re Park North Partners, Ltd.*, 80 B.R. 551 (N.D. Ga. 1987); *In re Winters*, 119 B.R. 283 (Bankr. M.D. Fla. 1990); *In re Fountain*, 32 B.R. 965 (Bankr. W.D. Mo. 1983). This position was by no means universal, however. *In re Ehring*, 900 F.2d 184 (9th Cir. 1990). Following the decision in *BFP*, 511 U.S. at 531, some courts have held that the policy concerns that the Supreme Court expressed concerning the strong interest of the states in...
establishing foreclosure rules and in the security of titles applied to preference avoidance just as much as to fraudulent transfer law, and hence a properly conducted prepetition foreclosure is no more avoidable as a preference than as a constructively fraudulent transfer. *In re Rocco*, 319 B.R. 411 (Bankr. W.D. Pa. 2004); *In re Pulcini*, 261 B.R. 836 (Bankr. W.D. Pa. 2001); *In re FIBSA Forwarding, Inc.*, 230 B.R. 334 (Bankr. S.D. Tex.), aff’d, 244 B.R. 94 (S.D. Tex. 1999); see Marie T. Reilly, *A Search for Reason in Reasonably Equivalent Value “ After BFP v. Resolution Trust Corp.*, 13 AM. BANKR. INST. L. REV. 261 (2005). These decisions might be open to the criticism that the issues of whether the creditor received more than it would have received in a hypothetical subsequent liquidation and whether the debtor received reasonably equivalent value are not identical. Furthermore, as a matter of policy, it is at least arguable that federal bankruptcy concerns are stronger, and state interests are weaker, when a prepetition foreclosure is attacked on specifically bankruptcy preference grounds rather than on the basis that the debtor did not receive reasonably equivalent value. *In re Rambo*, 297 B.R. 418 (Bankr. E.D. Pa. 2003); see Andrews, 262 B.R. at 299; Craig H. Averch & Blake L. Berryman, *Mortgage Foreclosure As a Preference: Does BFP Protect the Lender?* 7 J. BANKR. L. & PRAC. 281 (1998).

Nonetheless, there may well be a good deal of merit in applying BFP in a preference context. At least one court appears to have adopted a per se rule that, just as the price received at a properly conducted foreclosure sale is reasonably equivalent value as a matter of law, so the amount that the creditor receives may be virtually conclusively presumed to be what the creditor would obtain in a Chapter 7 liquidation. *In re Cottrell*, 213 B.R. 33 (M.D. Ala. 1997); see *Rocco*, 319 B.R. at 411. This approach has much to be said in its favor. In order to conclude that a regularly conducted prepetition foreclosure does not meet the requirements of 11 U.S.C.
§ 547(b)(5), one would have to say that a distress sale conducted by a hypothetical Chapter 7 trustee would produce more than a creditor’s foreclosure sale that conformed to state law. Nothing could be less certain. See Ehring, 900 F.2d at 184; Rocco, 319 B.R. at 411; FIBSA Forwarding, 244 B.R. at 94; Reilly, A Search for Reason, 13 AM. BANKR. INST. L. REV. at 261.

Even if one accepts the doubtful proposition that a liquidation sale conducted by a hypothetical Chapter 7 trustee would yield the full fair market value of the property, it does not necessarily follow that a prepetition foreclosure that produced less than fair market value would satisfy the requirements of 11 U.S.C. § 547(b)(5). In Rambo, 297 B.R. at 418, an oversecured mortgagee had foreclosed prepetition. The mortgagee had received property worth more than the amount of its debt, but the court determined that it did not follow that the mortgagee had received more than it would have gotten in a hypothetical subsequent liquidation, even if that liquidation would have yielded a higher price. First, by the time of the bankruptcy petition, additional interest would have accrued. Second, under state law, the debtor could have exempted a portion of the equity in the property if the trustee had sold it. Third, a hypothetical Chapter 7 trustee would have had additional expenses, including fees, the costs of sale, and the tax consequences of the sale. By the time that all of these considerations were taken into account, there would have been nothing left for unsecured creditors if the hypothetical trustee had sold the property for its full fair market value. The property would have had no value to the estate, and therefore a reasonable and prudent trustee would have abandoned it. Alternatively, the trustee would not have opposed a motion by the mortgagee to lift the automatic stay. The upshot was that the prepetition foreclosure had not resulted in the creditor receiving more than it would have gotten in a hypothetical Chapter 7 case, even assuming that the trustee could have sold the property for its full value, and thus the foreclosure could not be avoided as a preference.
G. ATTACKING PREPETITION DONATIONS AS CONSTRUCTIVELY FRAUDULENT TRANSFERS.

1. The Question of Reasonably Equivalent Value in Exchange for a Donation.

Until a few years ago, one of the most controversial topics concerning bankruptcy avoidance powers was the treatment of religious donations. Mary Jo Newborn Wiggins, A Statute of Disbelief ?: Clashing Ethical Imperatives in Fraudulent Transfer Law, 48 S.C.L. REV. 771 (1997). Several courts took the view that an insolvent debtor should be just to creditors before being generous, no matter how noble the motive for the generosity might be. In re Bloch, 207 B.R. 944 (D. Colo. 1997); see In re Grant, 10 F. Cas. 973 (C.C.D. Mass. 1842) (No. 5,693). Whether individual debtors should be permitted to include a substantial allowance for tithing in a Chapter 13 plan was also a point of contention. Many courts regarded such proposals with a jaundiced eye. In re Saunders, 215 B.R. 800 (Bankr. D. Mass 1997); In re Andrade, 213 B.R. 765 (Bankr. E.D. Cal. 1997) (discussing earlier decisions at length); see Note, Tithing in Chapter 13—A Divine Creditor Exception to Section 1325? 110 HARV. L. REV. 1125 (1997). The dismissal of a Chapter 7 case for substantial abuse because the debtor had made and continued to make generous donations was no less likely to arouse strong emotions. In re Faulkner, 165 B.R. 644 (Bankr. W.D. Mo. 1994); In re Lee, 162 B.R. 31 (Bankr. N.D. Ga. 1993); see Brian Wildermuth, Note, In re Lee: Tithing As Grounds for Dismissal Under 707(b) of the Bankruptcy Code, 26 U. TOL. L. REV. 725 (1995).

Nothing, however, was quite so apt to generate bitter arguments as setting aside prepetition tithes as constructively fraudulent transfers. Jonathan Lipson, First Principles and Fair Consideration: The Developing Clash Between the First Amendment and Constructive Fraudulent Conveyance Laws, 52 U. MIAMI L. REV. 247 (1997). On the one hand, there was the strong policy that a debtor should not be permitted simply to give away his or her money when creditors were not being paid. In re Newman, 203 B.R. 468 (D. Kan. 1996); Daniel Keating,
Bankruptcy Tithing and the Pocket-Picking Paradigm of Free Exercise, 1996 U. ILL. L. REV. 1041. On the other hand, many people found it shocking that religious organizations were compelled to disgorge donations given and accepted in good faith. In re Hodge, 220 B.R. 386 (D. Idaho 1998); David Lynn Mortensen, In re Young: A Correct but Unnecessary Constitutional Decision, 1998 BYU L. REV. 647.

Prior to 1999, reported decisions did not deal with prepetition tithes as actually fraudulent transfers; the analysis came under a constructive fraud theory. There was little real controversy as to whether the debtors in question had been insolvent at the time of the donations. The battle focused on whether the debtor had received reasonably equivalent value in exchange for the contributions. Typically, the defendant’s argument was that fulfilling a moral or spiritual obligation constituted reasonably equivalent value. In re Newman, 183 BR. 239 (Bankr. D. Kan. 1995), aff’d, 203 B.R. 468 (D. Kan. 1996).

It is, of course, possible to argue that emotional or spiritual gratification does not constitute reasonably equivalent value at all because it provides no economic benefit. See Zahra Spiritual Trust v. U.S., 910 F.2d 240 (5th Cir. 1990) (nonbankruptcy case applying Texas fraudulent transfer law), appeal after remand, 38 F.3d 569 (5th Cir. 1994); In re Guerrera, 225 B.R. 32 (Bankr. D. Conn. 1998) (satisfaction of assisting a family member in difficulties is not reasonably equivalent value); see also In re Whaley, 229 B.R. 767 (Bankr. D. Minn. 1999) (love, affection, or the easing of strain when debtor paid his live-in girlfriend’s credit card bill was not reasonably equivalent value). This argument is relatively weak, however. There is no requirement that reasonably equivalent value must involve something upon which creditors could levy. In re Armstrong, 234 B.R. 899 (Bankr. E.D. Ark. 1999) (services of criminal defense attorney constituted reasonably equivalent value); Lipson, First Principles and Fair
Consideration, 52 U. MIAMI L. REV. at 247. The entertainment value of gambling and the chance to win is reasonably equivalent value given in return for a debtor’s bets, so that, as a general rule, prepetition wagers are not subject to avoidance. In re Chomakos, 69 F.3d 769 (6th Cir. 1995), cert. denied, 517 U.S. 1168 (1996); In re Dolata, 306 B.R. 97 (Bankr. W.D. Pa. 2004). Likewise, psychic hotline services constitute reasonably equivalent value given in exchange for a debtor’s payments. In re Grigonis, 208 B.R. 959 (Bankr. D. Mont. 1997). It would appear odd to say that religious or moral satisfaction cannot constitute reasonably equivalent value when the thrill of gambling can.

A more just and subtle analysis is that, regardless of what benefits may flow from religious donations, those benefits are not given in exchange for the debtor’s payments. Thus, tithes could be set aside as constructively fraudulent, not necessarily because the debtor failed to receive reasonably equivalent value, but rather because whatever value the debtor did receive was not given in return as a quid pro quo. In re Gomes, 219 B.R. 286 (Bankr. D. Or. 1998); In re Hodge, 200 B.R. 884 (Bankr. D. Idaho 1996), rev’d on other grounds, 220 B.R. 386 (D. Idaho 1998). If the benefits were given as part of a bargained-for exchange, it would be senseless to speak of the debtor’s payment as a gift or donation, U.S. v. American Bar Endowment, 477 U.S. 105 (1986), and the payment certainly would not be tax deductible. Hernandez v. C.I.R., 490 U.S. 680 (1989).

If the only factor at issue were the literal interpretation of fraudulent transfer statutes, there seems little question that prepetition religious or charitable donations would have had to be considered constructively fraudulent transfers if they were made while the debtor was insolvent. See In re Young, 82 F.3d 1407 (8th Cir. 1996), vacated & remanded, 541 U.S. 1114 (1997), opinion reinstated on remand, 141 F.3d 854 (8th Cir.), cert. denied, 525 U.S. 811 (1998).
much the same way, political donations may be avoided as constructively fraudulent transfers. A debtor would scarcely admit that he or she had received reasonably equivalent value in exchange for such a payment, and certainly the transferee would deny giving value. *1992 Republican Senate-House Dinner Committee v. Carolina’s Pride Seafood, Inc.*, 858 F. Supp. 243 (D.D.C.), *vacated pursaunt to settlement*, 158 F.R.D. 233 (D.D.C. 1994). The Free Exercise Clause of the First Amendment was also a major consideration, however, and the interpretation of that constitutional provision and related legislation was critical in the controversy over avoiding prepetition charitable contributions.

2. **The Effect of the Religious Freedom Restoration Act.**

In the 1960’s and the 1970’s, the Supreme Court appeared to give a very expansive interpretation of the Free Exercise Clause. If the government placed a significant burden on the free exercise of religion, then the government had to show a compelling interest for doing so, and, in addition, the means chosen had to be the least restrictive or burdensome ones available to achieve that interest. *Wisconsin v. Yoder*, 406 U.S. 205 (1972); *Sherbert v. Verner*, 374 U.S. 398 (1963). In 1990, however, the Court appeared to abandon this test and held that the government may burden religious practice if it acts through neutral laws of general applicability that are enforced evenhandedly. *Employment Div., Dept. of Human Res. of Oregon v. Smith*, 494 U.S. 872 (1990). There would no longer be any need to determine whether the government had imposed a significant burden, whether the government had a compelling interest, or whether the means chosen were the least burdensome or intrusive ones available.

Judged by this standard, there could be little question that avoiding prepetition religious donations as constructively fraudulent transfers was legitimate, even if tithing or similar donations were required by the debtor’s religion. *In re Newman*, 203 B.R. 468 (D. Kan. 1996); *cf. 1992 Republican Senate-House Dinner Committee v. Carolina’s Pride Seafood, Inc.*, 858 F.

The Supreme Court’s *Smith* decision did not meet with a favorable response among religious groups or in Congress, although, at least initially, bankruptcy concerns were not always uppermost in the minds of critics. In order to ensure that both the states and the federal government would fully accommodate religious belief and practice, Congress, with the support of President Clinton, enacted the Religious Freedom Restoration Act of 1993 (“RFRA”), Pub. L. No. 103-141, 107 Stat. 1488, *codified at* 42 U.S.C. §§ 2000bb - 2000bb-4. The heart of RFRA was an effort to reinstate the former test of *Sherbert v. Verner* and *Wisconsin v. Yoder*: if the government imposed a significant burden on religious belief or practice, then the government had to show that it had a compelling interest and that it had chosen the least burdensome or restrictive means available to achieve that interest. 42 U.S.C. § 2000bb-1.

RFRA did not necessarily achieve all the results for which its supporters had hoped. Often courts found that the burden imposed on religious belief or practice was not significant, or that the government did have a compelling interest and had chosen the least restrictive means for achieving it. Ira C. Lupu, *The Failure of RFRA*, 20 U. ARK. LITTLE ROCK L.J. 575 (1998).
Sometimes the belief or practice in question was found not to be “religious” within the meaning of the First Amendment or of RFRA. See U.S. v. Meyers, 95 F.3d 1475 (10th Cir. 1996) (so-called “Church of Marijuana” held not to be a religion), cert. denied, 522 U.S. 1006 (1997).

It was certainly possible to argue that most steps permitted or required by bankruptcy statutes could withstand the level of scrutiny demanded by RFRA. See In re Turner, 193 B.R. 548 (Bankr. N.D. Cal. 1996) (requiring petition preparer to disclose Social Security number did not significantly burden free exercise, even though preparer claimed to be an adherent of “mark of the beast” doctrines). In particular, it was at least arguable that setting aside prepetition tithes burdened the religious institution, not the debtor; that there was no chilling effect on donations; and that there was a compelling governmental interest in enlarging the bankruptcy estate and ensuring equal distribution. Bloch, 207 B.R. at 944; In re Newman, 183 B.R. 239 (Bankr. D. Kan. 1995), aff’d, 203 B.R. 468 (D. Kan. 1996); see Bruce W. Megard, Jr., Tithing and Fraudulent Transfers in Bankruptcy: Confirming a Trustee’s Power to Avoid the Tithe After City of Boerne v. Flores, 71 AM. BANKR. L.J. 413 (1997). The contrary argument was also plausible, however. Interfering with tithing could be seen as a significant burden on religious practice that benefited private creditors rather than the government. In re Hodge, 220 B.R. 386 (D. Idaho 1998); see Douglas Laycock, Religious Freedom and International Human Rights in the United States Today, 12 EMORY INTERN. L. REV. 951 (1998).

In 1996, the issue reached a court of appeals. A divided panel of the Eighth Circuit held that the debtors’ prepetition tithes were constructively fraudulent transfers and thus otherwise avoidable. Setting the donations aside, however, would constitute a significant burden on the debtors’ free exercise of their religion, and there was no compelling government interest involved. Hence the tithes were shielded by RFRA, and they could not be recovered by the

The critical question that the *Young* court did not address was whether RFRA itself was constitutional. The parties did not raise the matter initially, and the Eighth Circuit assumed that the statute was valid. RFRA was open to constitutional challenges, however. It could be viewed as overreaching by Congress and a violation of the separation of powers. Congress had, by statute, purported to overrule the Supreme Court’s interpretation of the First Amendment. *In re Tessier*, 190 B.R. 396 (Bankr. D. Mont. 1995), *appeal dismissed*, 127 F.3d 1106 (9th Cir. 1997); *see* Christopher L. Eisgruber & Lawrence G. Sager, *Why the Religious Freedom Restoration Act Is Unconstitutional*, 68 NYU L. Rev. 437 (1994). In addition the statute could be seen as a violation of the Establishment Clause. Particularly in the bankruptcy context, RFRA would single out religious contributions for special treatment without giving comparable protection to donations made to secular charities. *In re Saunders*, 215 B.R. 800 (Bankr. D. Mass. 1997); *see* Jed Rubenfeld, *Antidisestablishmentarianism: Why RFRA Really Was Unconstitutional*, 95 Mich. L. Rev. 2437 (1997).

In 1997, the Supreme Court spoke to RFRA’s constitutionality in a nonbankruptcy decision, *City of Boerne v. Flores*, 521 U.S. 507 (1997). That case involved the application of a city zoning ordinance to a church in a manner that the church maintained fell foul of RFRA. The Court held that Congress had exceeded its powers under the Enabling Clause of the Fourteenth Amendment, the ostensible authority for RFRA. While Congress may act to remedy constitutional wrongs, there was no evidence that facially neutral laws had been enacted in a fit of religious or antireligious bigotry. Moreover, Congress has no authority to tell the judiciary what the Constitution means or to overrule a Supreme Court interpretation of the First
Amendment by statute. In a concurring opinion, Justice Stevens added that RFRA violated the Establishment Clause, an issue that the majority did not reach.

Shortly after City of Boerne was decided, the petition for certiorari in the Eighth Circuit’s Young case came before the Supreme Court. The Court vacated and remanded, instructing the Eighth Circuit to reconsider Young in light of City of Boerne. 521 U.S. 1114 (1997). It appeared that the question of prepetition tithes in bankruptcy might receive a definitive resolution at last.


Although the Supreme Court had struck down RFRA in City of Boerne v. Flores, 521 U.S. 507 (1997), it was at first difficult to tell exactly how far the Court meant for the ruling to extend. It could be argued that the Supreme Court had meant to invalidate RFRA entirely and for all purposes on separation of powers grounds, and some lower courts initially took this view. Waguespack v. Rodriguez, 220 B.R. 31 (W.D. La. 1998), appeal dismissed, 168 F.3d 486 (5th Cir. 1999); In re Andrade, 213 B.R. 765 (Bankr. E.D. Cal. 1997); In re Gates Community Chapel of Rochester, Inc., 212 B.R. 220 (Bankr. W.D.N.Y. 1997). In addition, it was arguable that RFRA violated the Establishment Clause, as Justice Stevens had stated in his concurring opinion. See In re Tessier, 190 B.R. 396 (Bankr. Mont. 1996), appeal dismissed, 127 F.3d 1106 (9th Cir. 1997).

On the other hand it was plausible to maintain that the Supreme Court had only meant to invalidate RFRA as it applied to the states, thus leaving the states free to reach their own solutions as to how religious belief and practice should be accommodated. See In re Saunders, 215 B.R. 800 (Bankr. D. Mass. 1997). This was the view taken by many leaders of Congress. It was also accepted by state politicians, and a number of states have enacted “little RFRA”s applicable to their own governments. See Christopher L. Eisgruber & Lawrence G. Sager, Congressional Power and Religious Liberty after City of Boerne v. Flores, 1997 SUP. CT. REV.
79. Under this approach, RFRA still applies to the federal government because it is a legitimate exercise of legislative power; Congress may restrain the federal government within limits more narrow than the Constitution would require. If this is the case, then RFRA might still apply to prevent a bankruptcy court from avoiding a prepetition religious donation as a constructively fraudulent transfer. *In re Hodge*, 220 B.R. 386 (D. Idaho 1998).

This was the position taken by the Eighth Circuit when the *Young* case was remanded. The court reinstated its earlier holding that RFRA shielded prepetition tithes. It also held that *City of Boerne* had invalidated RFRA only as to the states, and that Congress could limit the reach of otherwise valid bankruptcy statutes. *In re Young*, 141 F.3d 854 (8th Cir.), *cert. denied*, 525 U.S. 811 (1998). Subsequently, other courts of appeals held that *City of Boerne* meant merely that RFRA was invalid only insofar as it purported to apply to the states under the Enabling Clause of the Fourteenth Amendment, and that RFRA is still valid as applied to the federal government. *O’Bryan v. Bureau of Prisons*, 349 F.3d 399 (7th Cir. 2003); *Guam v. Guerrero*, 290 F.3d 1210 (9th Cir. 2002); *Henderson v. Kennedy*, 265 F.3d 1072 (10th Cir. 2001), *cert. denied*, 535 U.S. 986 (2003); *Kikumura v. Hurley*, 242 F.3d 950 (10th Cir. 2001). Nonetheless, it was unclear how RFRA might apply if a bankruptcy estate representative attempted to use state law, or whether setting aside prepetition donations could meet RFRA’s standards in any case. See *In re Gomes*, 219 B.R. 286 (Bankr. D. Or. 1998).

Against this background of uncertainty over how RFRA might apply in bankruptcy, a number of bills were introduced in Congress that would prohibit the avoidance of prepetition tithes. Apparently more concerned with permitting the donee to keep the contribution than with protecting the debtor’s free exercise rights, some of these bills would have allowed religious institutions to retain actually fraudulent as well as constructively fraudulent transfers. See David

The 1998 law amended 11 U.S.C. §§ 544(b), 548 so that most prepetition tithes cannot be avoided as constructively fraudulent transfers. Donations made by an individual up to 15% of his or her gross income in that year are in a safe harbor. Greater amounts may be protected if the debtor can show that the larger contributions were consistent with past practices of giving 11 U.S.C. § 548(a)(2), (d)(3); see id. § 544(b)(2); cf. Gomes, 219 B.R. at 286 (before the enactment of the 1998 legislation, the court noted that Congress had not established an “ordinary course of giving” defense to constructively fraudulent transfer avoidance). Donations that exceed 15% of the debtor’s gross income and that are not in conformity with the debtor’s past giving practices may be avoided as constructively fraudulent. *In re Jackson*, 249 B.R. 373 (Bankr. D.N.J. 2000). If a donation is avoided as constructively fraudulent, the full amount is recoverable, not merely the amount by which the donation exceeded 15% of the debtor’s gross income. *In re Zohdi*, 234 B.R. 371 (Bankr. M.D. La. 1999); see *Jackson*, 249 B.R. at 373. Moreover, the law does not apply to gifts that amount to actually fraudulent transfers. Presumably, sudden and substantial donations on the eve of bankruptcy might be considered to be tainted with badges of fraud in an appropriate case. *See In re Smihula*, 234 B.R. 240 (Bankr. D.R.I. 1999).
In addition, unlike RFRA, the Religious Liberty and Charitable Donation Protection Act is not limited to specifically religious donations; it applies equally to gifts made to secular charities. See Zohdi, 234 B.R. at 371 (donation to a state university). The recipient must qualify as a religious or charitable entity under I.R.C. § 170(c)(1), (2). 11 U.S.C. § 548(d)(3). Thus, unlike RFRA, the Religious Liberty and Charitable Donation Protection Act is not open to challenge on Establishment Clause grounds. In re Witt, 231 B.R. 92 (Bankr. N.D. Okla. 1999) (upholding the legislation against an Establish Clause challenge and citing Walz v. Tax Comm’n of City of New York, 397 U.S. 664 (1970)). Furthermore, bankruptcy courts will not have to struggle with whether a recipient is a religion or a religious organization with the meaning of the First Amendment. See Paul Horwitz, Scientology in Court: A Comparative Analysis and Some Thoughts on Selected Issues in Law and Religion, 47 DePaul L. Rev. 85 (1997); Chad Horner, Note, Beyond the Confines of the Confessional: The Priest-Penitent Privilege in a Diverse Society, 45 Drake L. Rev. 697 (1997). This issue sometimes arose under RFRA, although not in a bankruptcy context. E.g., U.S. v. Meyers, 95 F.3d 1475 (10th Cir. 1996) (holding that the so-called “Church of Marijuana” was not a religion for First Amendment or RFRA purposes), cert. denied, 522 U.S. 1006 (1997).

The 1998 legislation applies only to donations made by individuals. Normally, this should present few problems. There is likely to be scant judicial support for establishing a right for business entities to make religious or charitable donations while they are insolvent. See In re C.F. Foods, Inc., 2001 WL 1632272 (E.D. Pa. Dec. 20, 2001) (donations that corporate debtor had made to various religious organizations and charities were avoided as constructively fraudulent; defendants did not even attempt to use Religious Liberty and Charitable Donation Protection Act, and the court rejected their arguments under RFRA and the First Amendment).
should be noted, however, that there is no protection for donations when the debtor is itself religious or charitable organization. See Gates Community Chapel, 212 B.R. at 220. Presumably, prepetition gifts made by such an organization could be subject to avoidance on a constructively transfer theory.

The 1998 legislation also addressed postpetition bankruptcy concerns. Section 4(b) of the Religious Liberty and Charitable Donation Protection Act amended 11 U.S.C. § 707(b) so that a pattern of tithing or secular charitable giving is no longer grounds for dismissing a Chapter 7 case on substantial abuse grounds, even if such giving continues postpetition. See In re Norris, 225 B.R. 329 (Bankr. E.D. Va. 1998) (applying this statute). On the other hand, a debtor who begins to make substantial contributions only after a bankruptcy filing, or shortly before, may still face dismissal for substantial abuse. Smihula, 234 B.R. at 240.

Similarly, 11 U.S.C. § 1325(b)(2) was amended so that religious or charitable contributions of up to 15% of the debtor’s gross income may be legitimately excluded from the claims of creditors in a Chapter 13 plan. Of course, the expenditure in question must be in the nature of a true donation and not consideration for the acquisition of goods or services. In re Savage, 311 B.R. 835 (1st Cir. B.A.P. 2004) (tuition for sending the debtor’s son to a religious school did not quality); In re Watson, 309 B.R. 652 (1st Cir. B.A.P. 2004) (same), aff’d, 403 F.3d 1 (1st Cir. 2005). There is no comparable protection for including donations in a Chapter 11 or a Chapter 12 plan. Even in Chapter 13, one court has held that the 1998 legislation does not give a debtor an absolute right to use up to 15% of his or her gross income for donations under a plan. Such large contributions could not be considered reasonably necessary expenses when they far exceeded the debtor’s prepetition level of giving and when unsecured creditors would receive only a tiny return on their claims. In re Buxton, 228 B.R. 606
(Bankr. W.D. La. 1999). Other courts have disagreed, however, holding that 11 U.S.C. § 1325(b)(2)(A), by its plain terms, now gives debtors an absolute right to use up to 15% of their gross income for religious or charitable donations under a Chapter 13 plan regardless of what the debtor’s past practices may have been and regardless of whether the donations are reasonably necessary. If a plan calling for such donations may be challenged at all, it must be under the good faith requirement of 11 U.S.C. § 1325(a)(3). In re Cavanagh, 242 B.R. 707 (Bankr. D. Mont.) (it was not bad faith for recent convert to include tithing as part of plan), aff’d, 250 B.R. 107 (9th Cir. B.A.P. 2000) (giving a very thorough discussion); accord In re Kirschner, 259 B.R. 416 (Bankr. M.D. Fla. 2001).

It should be added that, although many courts have interpreted the Religious Liberty and Charitable Donation Act broadly, most courts have declined to extend the statute beyond the specific areas that Congress addressed: avoiding prepetition donations as constructively fraudulent transfers, tithing under a Chapter 13 plan, and dismissal for substantial abuse under 11 U.S.C. § 707(b). For example, 11 U.S.C. § 523(a)(8) generally excepts student loans from discharge. The debt may be discharged, however, if it imposes an undue hardship on the debtor or the debtor’s dependents. Some debtors have tried to argue that their religious and charitable donations must be considered in determining whether there would be an undue hardship, contending that Congress meant to encourage such giving. A minority of courts have accepted this position. In re McLaney, 314 B.R. 228 (Bankr. M.D. Ala. 2004); In re Durrani, 311 B.R. 496 (Bankr. N.D. Ill. 2004), aff’d, 320 B.R. 357 (N.D. Ill. 2005); In re Melina, 263 B.R. 275 (Bankr. N.D. Iowa 2001). The majority view, however, is that a debtor may not continue to make substantial religious or charitable donations while student loans go unpaid, and that such giving may not be taken into account for undue hardship discharge purposes under Section

IV.

PROTECTION AGAINST AVOIDANCE FOR CERTAIN FINANCIAL, SECURITIES, COMMODITY AND SIMILAR MARKET TRANSACTIONS

A.  **THE STOCKBROKER DEFENSE: 11 U.S.C. § 546(e).**

1.  **The Policy of 11 U.S.C. § 546(e).**

Under the Bankruptcy Act, there was no protection against the avoidance of settlement or margin payments in securities, financial, or commodities market transactions. Such payments could be set aside as preferences or fraudulent transfers. *Seligson v. New York Produce Exch.*, 394 F. Supp. 125 (S.D.N.Y. 1975). Congress was concerned that such avoidance would upset the system of guarantees and commitments on each side of a commodities or securities trade, and Congress wished to prevent the insolvency of one firm from destabilizing the entire industry. *H. R. Rep. No. 420, 97th Cong., 2d Sess., 1 (1982), reprinted in 1982 U.S.C.C.A.N. 583; see Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348 (N.D. Tex. 1996). Reflecting this concern, Section 546 of the Bankruptcy Code contains four subsections that limit the avoiding powers in an effort to preserve market stability.

The first of these provisions is 11 U.S.C. § 546(e), which was enacted in 1982. Section 546(e) establishes the so-called “stockbroker defense.” *See Wider v. Wooten*, 907 F.2d 570 (5th Cir. 1990). The statute was amended slightly by Section 907 of the BAPCPA. As amended in 2005, with the changes shown in italics, 11 U.S.C. § 546(e) provides:

Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to a
commodity broker, forward contract merchant, financial institution, financial participant, or securities clearing agency, that is made before the commencement of the case, except under Section 548(a)(1)(A) of this title.

A plain reading of the statute shows that three conditions must be met in order for the defense to apply. First, the prepetition transfer in question must have been a settlement payment or a margin payment under a securities, commodity, or forward contract. Second, the prepetition transfer must have been made by or to one of the enumerated entities. Third, the debtor-transferor must not have made the transfer with actual intent to hinder, delay, or defraud creditors so that the payment would be avoidable under 11 U.S.C. § 548(a)(1)(A). See In re Loranger Mfg. Corp., 324 B.R. 575 (Bankr. W.D. Pa. 2005); see also Christopher J. Redd, Treatment of Securities and Derivatives Transactions in Bankruptcy Part I, 24-Aug. AM. BANKR. INST. J. 36 (2005). Each of these criteria will be considered in turn.

2. The Transfer Must Have Been a Settlement Payment or a Margin Payment.

First, the prepetition transfer must have been either a “settlement payment” as defined in 11 U.S.C. § 101(51A) (settlement payments with respect to forward contracts) or § 741(8) (settlement payments with respect to securities contracts), or else a “margin payment” as defined in 11 U.S.C. § 101(38) (margin payments for forward contracts), § 741(5) (margin payments in securities contracts), or § 761(15) (margin payments in commodities contracts). These definitional statutes are singularly unhelpful. See Brad Gelder, Bankruptcy Code: Trustee Recovery Actions, Voidable Claims Considered, 3 No. 19 LAWYERS J. 5 (Sep. 21, 2001). Section 907 of BAPCPA expanded the definitions of “forward contract,” “securities contract,” and “commodity contract” to which the definitions of “settlement payment” and “margin payment” are tied. See Rhett G. Campbell, Financial Markets Contracts and BAPCPA, 79 AM. BANKR. L.J. 697 (2005).

Many courts have given a broad reading to the term “settlement payment,” holding that anything that would be so called in the relevant industry falls within the purview of 11 U.S.C. § 546(e). In re Comark, 971 F.2d 322 (9th Cir. 1992); In re Kaiser Steel Corp., 952 F.2d 1230 (10th Cir. 1991) (citing securities industry publications on the meaning of settlement payment), cert. denied, 505 U.S. 1213 (1992); In re Hamiton Taft & Co., 196 B.R. 532 (N.D. Cal. 1995), aff’d, 114 F.3d 991 (9th Cir. 1997). A settlement payment has been considered virtually any exchange of consideration for the final or interim completion of a securities or forward contract transaction. In re Olympic Natural Gas Co., 294 F.3d 737 (5th Cir. 2002) (net settlement payments under forward contracts were protected by 11 U.S.C. § 546(e)); Kaiser Steel Corp. v. Charles Schwab & Co., Inc., 913 F.2d 846 (10th Cir. 1990); Financial Mgmt. Sciences, 261 B.R. at 150. “Margin payment” has likewise been construed broadly in accordance with industry practice. In re Yeagley, 220 B.R. 402 (Bankr. D. Kan. 1998). The term includes any payment

Although the definitions of settlement and margin payments may be broad, they are not boundless. *See In re U.S. Wireless Corp., Inc.*, 333 B.R. 688 (Bankr. D. Del. 2005) (debtors’ payment of taxes incurred by employee as the result of the exercise of a stock option was not even arguably within the scope of Section 546(e)). Several courts have refused to recognize certain types of transactions as falling within the parameters of 11 U.S.C. § 546(e) on the ground that payments of the sort in question would not be deemed settlement or margin payments in the securities or commodities industry. Frequently, although not inevitably, this has been accompanied by the contention that avoiding the transaction in question would not threaten market stability or the system of intermediaries and guaranties that Congress meant to protect. *See Kaiser Merger Litig.*, 168 B.R. at 991; *In re Integra Realty Resources, Inc.*, 198 B.R. 352 (Bankr. D. Colo. 1996); *In re Republic Fin. Corp.*, 75 B.R. 840 (Bankr. N.D. Okla. 1987).

First, transactions that are nothing more than payments to creditors pure and simple have been held not to be settlement or margin payments. For example, payments to the holders of a debtor’s commercial paper do not fall within the scope of Section 546(e). *Republic Fin.*, 75 B.R. at 840. Likewise, it is highly doubtful that an extracontractual setoff or straightforward debt collection could ever count as a settlement payment under a forward contract. *In re Aurora Natural Gas, LLC*, 316 B.R. 481 (Bankr. N.D. Tex. 2004); *In re GPR Holdings, LLC*, 316 B.R. 477 (Bankr. N.D. Tex. 2004).

Second, many courts have held that transactions that are unlawful, tainted, or shady would not be considered settlement or margin payments as the term is commonly used and understood. This is so regardless of whether the debtor acted with actual intent to hinder, delay,
or defraud creditors. For example, in *Grafton Partners*, 321 B.R. at 527, the court held that nonpublic transactions in illegally unregistered securities are not common in the securities industry, and hence that any payment made in connection with such a transaction would not be deemed a settlement payment as the term is ordinarily used. Furthermore, Congress intended Section 546(e) to shield only lawful transactions.

A similar result was reached in *In re Enron Corp.*, 323 B.R. 857 (Bankr. S.D.N.Y. 2005), which involved the debtor’s purchase of its own stock while it was insolvent. The court held that under the law of Oregon, the state of incorporation, a corporation’s redemption of its own stock while it is insolvent is unlawful and absolutely void, not merely voidable. Since the transaction was illegal and void, there was nothing to settle and hence there could be no settlement payment. Moreover, the court held, the securities industry does not commonly use the term “settlement payment” in connection with transactions that are unlawful and void. Finally, setting the transaction aside and recovering the payment would not disrupt market stability. Any disruption was caused by the fact that the stock redemption was void *ab initio* under state law irrespective of the subsequent bankruptcy. Thus, the policy concerns undergirding Section 546(e) were not implicated. *Accord In re Enron Corp.*, 328 B.R. 58 (Bankr. S.D.N.Y. 2005).

In another Enron case, the court held that there was at least a fact issue as to whether payments made to redeem the debtor’s short term debt instruments prior to maturity, contrary to the terms of the offering memorandum and at a price far above their then current market value, could be considered as settlement payments. It was an open question whether such transactions were ordinary in the securities industry or whether the payments would be deemed settlement payments in trade usage. *Enron*, 325 B.R. at 671; see Christopher J. Redd, *Treatment of
Other decisions reinforce this sort of analysis. For example, a purely sham transaction in which no consideration was actually exchanged could not be a payment, at all, and, \textit{a fortiori}, it could not be a settlement or margin payment. \textit{Adler, Coleman}, 263 B.R. at 406; \textit{see In re Adler, Coleman Clearing Corp.}, 218 B.R. 689 (Bankr. S.D.N.Y. 1998). Similarly, a spinoff stock transfer has been held to be a de facto distribution of dividends when no consideration was given by the recipients. There was no payment, let alone a settlement payment, and hence 11 U.S.C. § 546(e) could not apply. \textit{Integra Realty Resources}, 198 B.R. at 352. So also money paid for an option to purchase stock that might or might not be issued in the future would not be deemed a settlement payment in the securities industry, and the stockbroker defense did not apply. \textit{Kaiser Merger Litig.}, 168 B.R. at 991.

3. \textbf{The Payment Must Have Been Made by or to One of theEnumerated Entities.}

The second requirement of 11 U.S.C. § 546(e) is that the payment must have been made by or to one of the five types of enumerated entities: a commodity broker (defined in 11 U.S.C. § 101(6)); a forward contract merchant (defined in 11 U.S.C. § 101(26)); a stockbroker (defined in 11 U.S.C. § 101(53A)); a financial institution (defined in 11 U.S.C. § 101(22)); a financial participant (defined in 11 U.S.C. § 101(22A)), or a securities clearing agency (defined in 11 U.S.C. § 101(48)). Some of these definitional statutes were changed slightly by BAPCPA, and the definition of financial participant, 11 U.S.C. § 101 (22A), was entirely new with the 2005 legislation. The definition is complex, but it refers, in essence, to very large financial market players having financial contracts with at least $1,000,000,000 in notional or actual principal amount or at least $100,000,000 in mark-to-market positions. Clearing organizations are also included. Financial participants were added to the list of enumerated or protected entities in

Controversies over this prong of the stockbroker defense have fallen into two categories. The first type of dispute is whether the party to whom the payment was made or who made the payment was actually one of the types of entities listed in the statute. Furthermore, most courts hold that, even if the party in question was one of the listed entities, it must have been acting in its capacity as such. Obviously, if neither the payor nor the payee was a commodity broker, a forward contract merchant, a stockbroker, a financial institution, a financial participant, or a securities clearing agency, or if neither party was acting in its capacity as one of these entities, then the defense of 11 U.S.C. § 546(e) would not apply, even if the transfer otherwise qualified as a margin payment or a settlement payment. Zahn v. Yucaipa Capital Fund, 218 B.R. 656 (D.R.I. 1998) (leveraged buyout involving transfer of stock of privately held corporation was avoided as constructively fraudulent where no party involved fell into any of the listed categories; Section 546(e) could not be used); In re Aurora Natural Gas LLC, 316 B.R. 481 (Bankr. N.D. Tex. 2004) (noting that not every party to a forward contract is necessarily a forward contract merchant or acting in that capacity); see In re Mirant Corp., 310 B.R. 548 (Bankr. N.D. Tex. 2004) (same in the context of a postpetition transaction under 11 U.S.C. §§ 362(b)(6), 556).

For example, when the debtor was an investment advisor who ran a Ponzi scheme, payments that the debtor had made to investors near the top of the pyramid could be avoided as
preferences notwithstanding 11 U.S.C. § 546(e). The debtor was not a “stockbroker” as defined by 11 U.S.C. § 101(53A) because, in a strict sense, the debtor did not have any “customers” within the meaning of 11 U.S.C. § 741(2). \textit{Wider v. Wooten}, 907 F.2d 570 (5th Cir. 1990). The defense also was held not to apply when the debtor was simply a dealer in precious metals rather than a broker. Transfers that the dealer had made could be avoided as preferences. \textit{In re International Gold Bullion Exch.}, 53 B.R. 660 (Bankr. S.D. Fla. 1985); see also \textit{In re Republic Fin. Corp.}, 75 B.R. 840 (Bankr. N.D. Okla. 1987) (defense was unavailing where debtor had not been acting as a stockbroker but had simply been paying creditors who held debtor’s commercial paper).

The second sort of controversy under the second prong of the Section 546(e) defense has arisen in connection with efforts to avoid leveraged buyouts (“LBOs”) as constructively fraudulent transfers when one of the enumerated entities has been involved as an intermediary. The question is whether there was really any payment “by or to” that entity. \textit{In re Hechinger Inv. Co. of Delaware}, 274 B.R. 71 (D. Del. 2002) (giving a thorough discussion of the conflicting decisions); see \textit{Zahn}, 218 B.R. at 656 (noting the split of authority but finding no need to resolve the issue on the facts of the case). Whether Section 546(e) may be used as a defense against a constructively fraudulent transfer attack on an LBO in such an instance implicates a tension between fundamental policy concerns. Brad Gelder, \textit{Bankruptcy Code: Trustee Recovery Actions, Voidable Claims Considered}, 3 No. 19 LAWYERS J. 5 (Sep. 21, 2001). On the one hand, a few persons, often insiders, should not be permitted to benefit from questionable prepetition transactions with the debtor at the expense of the body of creditors generally. On the other hand, in enacting 11 U.S.C. § 546(e) and related statutes, Congress clearly meant to protect the stability of securities and financial markets and to prevent the unwinding of completed

The leading case holding that 11 U.S.C. § 546(e) cannot be used to prevent the avoidance of an LBO as a constructively fraudulent transfer, even if the literal requirements of the statute appear to be satisfied, is *In re Munford*, 98 F.3d 604 (11th Cir. 1996), cert. denied, 522 U.S. 1068 (1998). The Eleventh Circuit maintained that avoiding an LBO as a constructively fraudulent transfer would not upset the system of guaranties or cause instability in the relevant markets. Avoidance and recovery would be at the expense of shareholders, not at the expense of brokers or financial institutions. More specifically, the Eleventh Circuit held that the payments were not made “by or to” any of the enumerated entities in the requisite sense because no broker, agency, or financial institution ever acquired a beneficial interest in the payments. Such entities would have to be considered mere conduits rather than transferees within the meaning of 11 U.S.C. § 550.

A number of lower courts in other jurisdictions have agreed with the Eleventh Circuit that Section 546(e) should not apply to prevent the avoidance of LBOs on grounds other than actual fraud. Some courts, like the Eleventh Circuit itself, have maintained that a broker or financial institution in such a transaction is a mere conduit, and hence no payment is made “by or to” the intermediary in any meaningful sense. *In re Healthco Intern., Inc.*, 195 B.R. 971 (Bankr. D. Mass. 1996); see *In re Grand Eagle Cos., Inc.*, 288 B.R. 484 (Bankr. N.D. Ohio 2003); *Jewel Recovery*, 196 B.R. at 348. Others have reasoned that LBO transfers should not be considered true settlement payments. *Wieboldt Stores, Inc. v. Raleigh*, 131 B.R. 655 (N.D. Ill. 1991); see *Healthco*, 195 B.R. at 971. All have agreed, however, that the stability of the system of brokers, clearing agencies, and guarantees that Congress wished to protect would not be seriously
threatened by unwinding an LBO on a constructively fraudulent transfer theory. *See Grand Eagle Cos.*, 288 B.R. at 484.

The Third Circuit and the Tenth Circuit have taken a different view. *In re Resorts Intern., Inc.*, 181 F.3d 505 (3d Cir.), *cert. denied*, 528 U.S. 1021 (1999); *In re Kaiser Steel Corp.*, 952 F.2d 1230 (10th Cir. 1991), *cert. denied*, 505 U.S. 1213 (1992); *see also In re Financial Mgmt. Sciences, Inc.*, 261 B.R. 150 (Bankr. W.D. Pa. 2001) (giving a good discussion of *Resorts Intern.*). In a case that did not involve an LBO, the Ninth Circuit indicated that it agreed with the reasoning of these decisions. *See In re Comark*, 971 F.2d 322 (9th Cir. 1992). In the view of the Third and the Tenth Circuits, the phrase “made by or to” one of the relevant entities is simple and straightforward. There is no basis for adding a judicial gloss by inquiring whether the broker or financial institution must have been a transferee within the meaning of 11 U.S.C. § 550. Section 550, after all, deals with recovery, whereas Section 546(e) is a protection against avoidance, which is not the same thing. If there is to be a requirement that the intermediary must have had a beneficial interest in the payment in order for Section 546(e) to apply, then Congress should make that decision, not the courts. *Resorts Intern.*, 181 F.3d at 505 (explicitly disagreeing with the Eleventh Circuit’s decision in *Munford*); *accord Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846 (10th Cir. 1990); *see PHP Liquidating, LLC v. Robbins*, 291 B.R. 603 (D. Del. 2003). Furthermore, there is a possibility of real instability in securities markets if completed transactions, including LBOs, may be freely unwound in bankruptcy. *Kaiser Steel*, 952 F.2d at 1230; *Hechinger Inv. Co.*, 274 B.R. at 71; *see PHP Liquidating, LLC v. Robbins*, 291 B.R. 592 (D. Del. 2003), *aff’d*, 128 Fed. Appx. 839 (3d Cir. 2005).

The debate over whether 11 U.S.C. § 546(e) should be available to protect against the avoidance of LBOs if the literal requirements of the statute are satisfied seems likely to continue.
See Gelder, *Bankruptcy Code: Trustee Recovery Actions*, 3 No. 19 LAWYERS J. at 5. There appears to be ample room for honest disagreement as to how much weight should be given to the plain terms of the statute as opposed to the policies undergirding the enactment and, indeed, how far the policy concerns extend.

4. **The Payment Must Not Be Avoidable As an Actually Fraudulent Transfer under the Bankruptcy Code.**


A decision from 2001 may indicate that the actual fraud exception could be extended on policy grounds. *In In re Adler, Coleman Clearing Corp.*, 263 B.R. 406 (S.D.N.Y. 2001), an introducing broker-dealer had engaged in various manipulations to create preferred SIPA claims for certain customers against the debtor clearing house. There was evidence that the introducing broker had acted with actual intent to hinder, delay, or defraud most of the debtor’s creditors, Disagreeing with the bankruptcy court, the district court held that this fraudulent intent could not be imputed to the debtor itself, and thus, in a strict sense, 11 U.S.C. § 548(a)(1)(A) was inapplicable. Nonetheless, on policy grounds, the district court was unwilling to allow 11 U.S.C. § 546(e) to shield transactions that amounted to a fraud on the securities market.
5. **Related Statutes.**

Several statutes in the Bankruptcy Code reflect the policy embodied in 11 U.S.C. § 546(e) of protecting transactions in the securities and commodities trading industries against the hazards of bankruptcy. A full discussion of those provisions and the changes to them made by Section 907 of BAPCPA is beyond the scope of this paper, but several of these statutes should be mentioned. 11 U.S.C. § 548(d)(2)(B) provides that any of the entities enumerated in 11 U.S.C. § 546(e) that receives a margin payment or settlement payment takes for value to the extent of the payment. Section 548(d)(2)(B) is thus designed to help assure that payments made in the customer-dealer-clearing house chain will not be set aside as constructively fraudulent transfers. *See In re Paramount Citrus, Inc.*, 268 B.R. 620 (M.D. Fla. 2001). It would also help to establish the good faith transferee for value defense under 11 U.S.C. § 548(c). *See* Christopher J. Redd, *Treatment of Securities and Derivatives Transactions in Bankruptcy Part I*, 24-Aug. AM. BANKR. INST. J. 36 (2005).

In the same vein, 11 U.S.C. § 555 protects the right of a stockbroker, financial institution, financial participant, or securities clearing agency to liquidate, terminate, or accelerate a securities contract, while 11 U.S.C. § 556 provides similar protection for the right of a commodity broker, financial participant, or forward contract merchant to liquidate, terminate, or accelerate a commodity contract or forward contract. 11 U.S.C. § 553(b)(1), as amended by BAPCPA, prevents the bankruptcy estate from avoiding a prepetition setoff covered by Section 555. Section 362(b)(6) exempts from the operation of the automatic stay the setoff rights of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency if the right arises under or in connection with a commodity contract, security contract, or forward contract, and if the setoff involves a margin payment or settlement payment. *See In re Mirant Corp.*, 310 B.R. 548 (Bankr. N.D. Tex. 2004)
(discussing alleged forward contract setoffs in the context of Sections 362(b)(6) and 556). 11 U.S.C. § 362(o), added by BAPCPA, prohibits any court or administrative agency from enjoining or staying a transaction within the scope of Section 362(b)(6).


A repurchase agreement or “repo” consists of the sale of specified securities by a dealer to a buyer for cash, accompanied by a contemporaneous agreement to repurchase the securities for the same price plus an agreed additional amount at a specific future date. A reverse repurchase agreement or “reverse repo” is the same transaction from the point of view of the party who purchases with an agreement to resell. In re Bevill, Bresler & Schulman Asset Management Corp., 878 F.2d 742 (3d Cir. 1989). Both repos and reverse repos are included in the Bankruptcy Code’s definition of “repurchase agreements.” 11 U.S.C. § 101(47). This statute was expanded by Section 907 of BAPCPA to explicitly encompass repo transactions involving mortgage-related securities and to include agreements such as a security agreement related to a repurchase agreement. Repo transactions have certain features in common with a loan, and they are essential to liquidity in the market for federal, state, and local government securities and mortgage-backed securities. The avoidance of repo transfers in bankruptcy could have devastating consequences in the markets for such securities. Bevill, Bresler, 878 F.2d at 742; In re Comark, 145 B.R. 47 (9th Cir. B.A.P. 1992).

In order to provide additional protection for the repo market, Congress originally enacted 11 U.S.C. § 546(f) in 1984, two years after Section 546(e). This statute was amended by Section 907 of BAPCPA. With the 2005 changes shown in italics, 11 U.S.C. § 546(f) provides:

Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 741 or 761 of this title, or settlement payment, as defined in section 741 of this title, made by or to a repo participant or financial participant, in connection with a
repurchase agreement that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

The structure of Section 548(f) is parallel to Section 548(e), and it shields in a similar fashion margin and settlement payments made by or to a repo participant or financial participant in connection with a repurchase agreement. A “repo participant” is defined as any entity that, at any time before the bankruptcy petition, had an outstanding repurchase agreement (including a reverse repurchase agreement) with the debtor. 11 U.S.C. § 101(46). Prior to BAPCPA, the definitional statute had limited repo participants to entities that had an outstanding repurchase agreement with the debtor within 90 days of the petition date. If the repo participant is one of the entities listed in Section 546(e) — a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency — then any margin payment or settlement payment would be protected by 11 U.S.C. § 546(e) as well as Section 546(f). In re Comark, 971 F.2d 322 (9th Cir. 1992); see Comark, 145 B.R. at 47. Section 546(f) was enacted to cover situations in which the repo participant by or to whom the payment was made did not fall into one of these categories. In re Hamilton Taft & Co., 114 F.3d 991 (9th Cir. 1997). Congress did not intend for Section 546(f) to be the exclusive means of shielding margin or settlement payments in repo transactions, and, in fact, most cases have analyzed such payments under Section 546(e) rather than Section 546(f). In re Hamilton Taft & Co., 196 B.R. 532 (N.D. Cal. 1995), aff’d, 114 F.3d 991 (9th Cir. 1997). Financial participants, defined by 11 U.S.C. § 101(22A), were added to the enumerated entities in Section 546(f) in 2005. This new category has already been discussed in connection with 11 U.S.C. § 546(e).

Other statutes likewise offer protection for repo transactions. 11 U.S.C. § 548(d)(2)(C) provides that a repo participant or financial participant who receives a margin or settlement payment in connection with a repurchase agreement takes for value to the extent of the payment.
This would help to establish a good faith transferee for value defense under 11 U.S.C. § 548(c). See Christopher J. Redd, Treatment of Securities and Derivatives Transactions in Bankruptcy Part I, 24-Aug. Am. BANKR. INST. J. 36 (2005). 11 U.S.C. § 559 allows a repo participant or financial participant to liquidate, terminate, or accelerate a repurchase agreement with the debtor notwithstanding the debtor’s bankruptcy. 11 U.S.C. § 553(b)(1), as amended by BAPCPA, prevents the bankruptcy estate from avoiding a prepetition setoff covered by Section 559. 11 U.S.C. § 362(b)(7) exempts from the automatic stay any right by a repo participant or financial participant to set off any mutual debt against the debtor if the claim is for a margin payment or settlement payment under or in connection with a repurchase agreement. 11 U.S.C. § 362(o), added by BAPCPA, prohibits any court or administrative agency from enjoining or staying a transaction within the scope of Section 362(b)(7).


The third statute that attempts to protect payments under financial, securities, and similar contracts is 11 U.S.C. § 546(g), which was enacted in 1990. Similar in structure to Sections 546(e) and 546(f), Section 546(g) was amended by BAPCPA. With the 2005 additions shown in italics and the deletions in brackets, the statute provides:

Notwithstanding sections 544, 545, 547, 548(a)(1)(B) and 548(b) of this title, the trustee may not avoid a transfer [under a swap agreement,] made by or to a swap participant or financial participant under or in connection with any swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

The addition of financial participants by BAPCPA and the definition of that term have already been discussed. “Swap participant” is defined in 11 U.S.C. § 101(53C) as any entity that had an outstanding swap agreement with the debtor. The definition of “swap agreement” in 11 U.S.C. § 101(53B) was largely a list of examples prior to the 2005 amendments. Section 907 of
BAPCPA amended the definitional statute to broaden the categories of contracts included under the heading of swap agreements, but 11 U.S.C. § 101(53B) is still a laundry list of various types of swaps with the addition of a catch-all provision stating that the term includes any similar agreement. No functional definition was attempted. See Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697 (2005). An industry publication, however, states that:

A swap is a bilateral agreement, frequently between a commercial entity involved with commodities or subject to interest rate, currency or equity price fluctuations and a financial intermediary, whereby cash payments are exchanged periodically (or a lump sum at termination) between the parties based upon changes in the price of the underlying asset or index as determined by an agreed-upon benchmark.


The 2005 amendments to 11 U.S.C. § 101(53B) should make it easier to invoke the Section 546(g) defense. For example, the broadened laundry list clearly includes equity swaps and ends any uncertainty as to whether these sorts of transactions are shielded by 11 U.S.C. § 546(g). *Enron*, 328 B.R. at 58 (holding that, prior to the effective date of the BAPCPA amendments in October, 2005, it was uncertain whether equity swaps should be considered true swaps or whether they were so considered in the industry; the very efforts to change the statute showed that there was room for doubt). On the other hand, if the underlying transaction is
deemed illegal and void, then it cannot be shielded by the swap agreement defense any more than by the stockbroker defense. If the transaction is a nullity, and not merely avoidable, then it could scarcely be a swap or anything else that would provide protection. *In re Enron Corp.*, 323 B.R. 857 (Bankr. S.D.N.Y. 2005); *accord Enron*, 328 B.R. at 58.

One of the changes in 11 U.S.C. § 546(g) appears designed to alter the result in *In re Interbulk, Ltd.*, 240 B.R. 195 (Bankr. S.D.N.Y. 1999). In that case, Judge Tina Brozman determined that forward freight agreements between the debtor and a creditor were indeed swap agreements, but that the transaction in question was not protected by Section 546(g). The contracts in question called for a final settlement payment to be made based on the difference between the contract rate and the average rate of the Baltic Freight Index for the relevant period. The debtor owed the creditor money under the forward freight agreements but had failed to pay. The creditor had obtained an order in a French court attaching a debt that a third party owed to the debtor. This attachment was otherwise avoidable as a preference under 11 U.S.C. § 547(b). The issue was whether the transfer was shielded by 11 U.S.C. § 546(g).

Judge Brozman held that 11 U.S.C. § 546(g) did not apply, although several of the criteria of the statute were satisfied. The forward freight agreements were swap agreements, and the creditor was a swap participant. The transfer had thus been made “by or to a swap participant,” “in connection with a swap agreement,” and “before the commencement of the case.” Prior to BAPCPA, however, 11 U.S.C. § 546(g) also required that the transfer must have been made “under a swap agreement.” The plain and natural reading of this phrase was that the transfer must have been made according to some means prescribed in the agreement itself. The attachment of a debt in a French court did not meet this criterion. Thus, because the transfer had not been made “under a swap agreement,” it was not protected by 11 U.S.C. § 546(g). Section
907 of BAPCPA changed this analysis. Section 546(g) has been altered so that the statute protects a “transfer, made by or to a swap participant or financial participant under or in connection with any swap agreement …” (emphasis added). Thus, “under” and “in connection with” are now alternative criteria, and the Interbulk creditor would have prevailed if the 2005 version of the statute had been in effect.

Other statutes also protect swap transactions. 11 U.S.C. § 548(d)(2)(D) provides that a swap participant or financial participant who receives a transfer under or in connection with a swap agreement takes for value to the extent of the transfer. This provision is thus analogous to 11 U.S.C. §§ 548(d)(2)(B), 548(d)(2)(C), which are discussed above. 11 U.S.C. § 560 protects the right of a swap participant or financial participant to liquidate, terminate, or accelerate a swap agreement notwithstanding the debtor’s bankruptcy, while 11 U.S.C. § 553(b)(1), as amended by BAPCPA, prevents the bankruptcy estate from avoiding a prepetition setoff covered by Section 560. 11 U.S.C. § 362(b)(17) exempts a financial participant’s or swap participant’s right of setoff under or in connection with one or more swap agreements from the operation of the automatic stay. Cf. Enron, 306 B.R. at 465 (holding that Section 362(b)(17) did not apply to protect counterparty’s state court action seeking a declaratory judgment that there had never been a valid swap agreement in the first instance, and that relief from the stay would not be granted).

11 U.S.C. § 362(o), added by BAPCPA, prohibits any court or administrative agency from enjoining or staying any action within the scope of Section 362(b)(17).


BAPCPA added still another form of protection from the avoiding powers for certain types of financial contracts. Prior to 2005, it was unclear whether or to what extent 11 U.S.C. §§ 546(e), 546(f), and 546(g) protected netting or setoff across or between different types of financial products or contracts, even if the parties had an agreement that allowed such a step.

Modeled on Sections 546(e), 546(f), and 546(g), Section 546(j) took effect for cases filed on or after October 17, 2005. Section 546(j) provides:

Notwithstanding sections 544, 545, 547, 548(a)(1)(B) and 548(b), the trustee may not avoid a transfer made by or to a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby that is made before the commencement of the case, except under section 548(a)(1)(A) and except to the extent that the trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement.

11 U.S.C. § 101(38A), the statute defining master netting agreement, incorporates by reference 11 U.S.C. § 561(a), and thus makes clear that a master netting agreement is a contract allowing liquidation, termination, offset, or acceleration across or among securities contracts, commodity contracts, repurchase agreements, or swap agreements. 11 U.S.C. § 101(38B) defines a master netting agreement participant as any entity that, at any time before the petition, was a party to a master netting agreement with the debtor.

Other statutes created by BAPCPA provide additional protection for transfers made pursuant to a master netting agreement. 11 U.S.C. § 548(d)(2)(E) provides that a master netting agreement participant who receives a prepetition transfer in connection with a master netting agreement is deemed to have taken for value to the extent of the transfer, thus establishing one prong of the good faith transferee for value defense under 11 U.S.C. § 548(c). 11 U.S.C. § 561
protects the right of a master netting agreement participant to terminate, liquidate, accelerate, or offset under or in connection with a master netting agreement notwithstanding the debtor’s bankruptcy, while 11 U.S.C. § 553(b)(1), as amended by BAPCPA, provides that an otherwise preferential prepetition setoff under a master netting agreement may not be avoided. 11 U.S.C. § 362(b)(27) provides that a setoff under or in connection with a master netting agreement is not subject to the automatic stay, and 11 U.S.C. § 362(o) establishes that a transaction within the scope of Section 362(b)(27) may not be enjoined or stayed by any court or administrative agency.

BAPCPA’s addition of protections for master netting agreements, coupled with the changes to 11 U.S.C. §§ 546(e), 546(f), 546(g), and related statutes, would appear to solidify the web of protection for financial markets transactions and to exempt such transactions from the effects of bankruptcy to a large extent. See Campbell, Financial Markets Contracts and BAPCPA, 79 AM. BANKR. L.J. at 697. Nonetheless, as cases such as In re Grafton Partners, L.P., 321 B.R. 527 (9th Cir. B.A.P. 2005), In re Enron Corp., 325 B.R. 671 (Bankr. S.D.N.Y. 2005), and In re Enron Corp., 323 B.R. 857 (Bankr. S.D.N.Y., 2005) show, it may not be possible to shelter tainted or irregular transactions from avoidance, even if no actual intent to hinder, delay, or defraud can be demonstrated. Thus, while financial markets transactions may enjoy a good deal of protection from the provisions of the Bankruptcy Code, one should not assume that this protection is total or absolute. See Christopher J. Redd, Treatment of Securities and Derivatives Transactions in Bankruptcy Part II, 24-Sep. AM. BANKR. INST. J. 36 (2005).