PREFERENCES AND FRAUDULENT TRANSFERS

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

A. PREFERENCES 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 weapons available to a bankruptcy estate to set aside prepetition transactions for the benefit of creditors. The two are often used together, and the same transaction 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 APF Co., 308 B.R. 183 (Bankr. D. Del. 2004); In re Carrozzella & Richardson, 302 B.R. 415 (Bankr. D. Conn. 2003). 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. 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 Cytherogenics Corp., 226 F.3d 237 (3d Cir. 2000); In re Kmart Corp., 310 B.R. 107 (Bankr. N.D. Ill. 2004); In re Kennedy Inn Assocs., 221 B.R. 704 (Bankr. S.D.N.Y. 1998); 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 & 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; see In re Coleman, 299 B.R. 780 (W.D. Va. 2003) (avoiding powers may be used only to the extent necessary to
satisfy creditors; excess recovery for the debtor’s benefit is not permitted). 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); In re Gantos, 283 B.R. 649 (Bankr. D. Conn. 2002) (where complaint had originally alleged preference theory, complaint could not be amended to assert otherwise time-barred fraudulent transfer claim under Federal Rule of Civil Procedure 15(c); fraudulent transfer theory was different from preference theory and did not relate back to original complaint).

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 supplanted 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); Michael L. Cook, Fraudulent Transfer Liability Under the Bankruptcy Code, 17 HOUS. L. REV. 263 (1980); 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); In re Imageset, Inc., 299 B.R. 709 (Bankr. D. Me. 2003). 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.


(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., ___ F.3d __, 2004 WL 2496264 (11th Cir. 2004); Warsco v. Household Bank F.S.B., 272 B.R. 246 (Bankr. D.N.D. Ind. 2002), subsequently aff’d, 334 F.3d 638 (7th Cir. 2003), cert. denied, 124 S. Ct. 924 (2003); Carrozzella & Richardson, 270 B.R. at 92. 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., 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); In re Adams, 254 B.R. 857 (D. Md. 2000) (noting that, “aside from bankruptcy or insolvency statutes, preferences are not per se fraudulent.”), aff’d, 4 Fed. Appx. 2009 (4th Cir. 2001); In re Stein, 208 B.R. 209 (D. Or. 1997) (under Oregon law, debtor may prefer one creditor over another if transaction is fair and honest). As Justice Story wrote almost 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

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); In re Mowry, 263 B.R. 499 (Bankr. W.D. Pa. 2001).

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 had condemned payments to insiders as constructively fraudulent.
because they lacked fair consideration 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). Such reasoning has now been codified in the U.F.T.A. Thus, state law has now 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 Massachusetts Fraudulent Conveyance Law: The Adoption of the Uniform Fraudulent Transfer Act, 82 MASS. L. REV. 337 (1998).

By contrast, in collective insolvency proceedings, preferences have long been condemned, 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., __ F.3d at __, 2004 WL 2496264; In re Criswell, 102 F.3d 1411 (5th Cir. 1997); In re Arnett, 731 F.2d 358 (6th Cir. 1984). 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). 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); In re Victoria Alloys, Inc., 261 B.R. 424 (Bankr. N.D. Ohio 2001). 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 Corporate Food Management, Inc.*, 223 B.R. 635 (Bankr. E.D.N.Y. 1998); *see In re RDM Sports Group, Inc.*, 253 B.R. 298 (Bankr. N.D. Ga. 2000). 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 Bear, Stearns Sec. Corp. v. Gredd*, 275 B.R. 190 (S.D.N.Y. 2002); *see also Bressner v. Ambroziak*, 379 F.3d 478 (7th Cir. 2004) (debtor’s labor is not “property” because it is not subject to ownership; working for free is thus not a fraudulent transfer); *In re Computer Engr’ng 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

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(6th Cir. 2002); In re Coupon Clearing Serv., Inc., 113 F.3d 1091 (9th Cir. 1997); In re Marrs-Winn Co., 103 F.3d 584 (7th Cir. 1996). 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 Merchants Grain, Inc., 933 F.3d 1347 (7th Cir. 1996) (thanks to Ohio’s grain lien statute, debtor grain elevator never acquired any beneficial interest in grain before farmers were paid; payment of proceeds of grain sale to growers could not be avoided), cert. denied, 519 U.S. 111 (1997); 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 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); In re Kellman, 248 B.R. 430 (Bankr. M.D. Fla. 1999) (removal of wife’s name from bank account was not a fraudulent transfer where wife never had any beneficial interest in the account, and her name had been listed only so that she could write checks for her husband if he became ill or disabled). 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. *Dunham v. Kisak*, 192 F.3d 1104 (7th Cir. 1999); *In re Bassett*, 221 B.R. 49 (Bankr. D. Conn. 1998); *see In re Dolata*, 306 B.R. 97 (Bankr. W.D. Pa. 2004).

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); *In re Jones & Lamson Waterbury Farrell Corp.*, 208 B.R. 788 (Bankr. D. Conn. 1997) (payment to IRS was avoidable to the extent that it was applied to non-trust-fund taxes and not avoidable to the extent that it went to pay trust fund taxes). 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. The prepetition use of such funds to pay subcontractors or materialmen is not avoidable. *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). 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 Construction Lien Act, to the extent that it protected payments made to subcontractors within 90 days of the petition date, was preempted by 11 U.S.C. § 547. *In re Hechinger Inv. Co. of Delaware, Inc.*, 288 B.R. 398 (Bankr. D. Del. 2003).

Even if the debtor is a trustee of an express trust, the corpus may be deemed the debtor’s property if 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 extremely 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);
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 upheld 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. 2004); *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).

3. **Escrow Funds.**

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. *In re Cannon*, 277 F.3d 838 (6th Cir. 2002); *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).

A seemingly contrary result was reached, however, in *In re First Capital Mortg. Loan Corp.*, 917 F.2d 424 (10th Cir. 1990) (en banc), where the court held that prepetition payments made by a debtor escrowee to one of its own creditors using funds deposited in escrow were subject to avoidance as preferential transfers. This decision has received cogent criticism. Dean A. Dulchinos, Note, *Bankruptcy Law—Determining Property Interests in Funds Recovered Pursuant to the Settlement of a Section 547 Preference Action*, 15 W. NEW ENG. L. REV. 109 (1993). Perhaps the decision reflected the general reluctance to impose a constructive trust on property that the debtor has misappropriated absent the clearest evidence and unequivocal identification of the property involved, or to assert that property that the debtor held would not have been available to creditors. *See also In re Dayton Title Agency, Inc.*, 292 B.R. 857 (Bankr.
S.D. Ohio 2003). Failure to segregate or commingling of escrow funds may defeat any argument that there is specific, identifiable property to which a claimant has a special right. See In re Hechinger Inv. Co. of Delaware, Inc., 299 B.R. 340 (Bankr. D. Del. 2003).

4. 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. 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 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. In re Superior Stamp & Coin Co., Inc., 223 F.3d 1004 (9th Cir. 2000); In re Kalmar, 276 B.R. 214 (Bankr. S.D. Ohio 2002); In re Francis, 252 B.R. 143 (Bankr. E.D. Ark. 2000); 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 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); *In re Brown*, 209 B.R. 874 (Bankr. W.D. Tenn. 1997); 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
In re Heitkamp, 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); 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).

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); ILL. ANN. STAT. ch.
The upshot is that courts in states that have such statutes have consistently 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 nullify the renunciation. See *Pennington v. Bingham*, 512 So. 2d 1344 (Ala. 1987); *In re Estate of Abesya*, 470 N.W.2d 713 (Minn. Ct. App. 1991).

For bankruptcy preference and fraudulent transfer purposes, whether a transfer of an interest of the debtor in property occurred is 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), *affim’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 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 debtor 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 entirely 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 condemn transfers 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 avoid satisfying 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 many 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 most 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. 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 hold 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. Most recently, 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 the 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, 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 a violation of the automatic stay. 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.

6. Interspousal Transfers of Property Held by the Entirety.

The treatment of prepetition interspousal transfers of property held in tenancy by the entirety has been a topic of contention, as has the treatment of entireties property in bankruptcy generally. Tenancy by the entirety is a form of marital ownership recognized in approximately half the states. It can exist only between husband and wife, and it includes a right of survivorship. Generally, neither spouse can transfer his or her separate interest except to the other spouse. See Swada v. Endo, 561 P.2d 1291 (Haw. 1977) (giving a thorough discussion of
tenancy by the entirety in various jurisdictions); see also In re Conroy, 224 B.R. 282 (Bankr. D. Mass. 1998). There is, however, considerable divergence among state laws as to what the separate creditors of one spouse may reach. In some states, separate creditors may reach the life interest of the debtor spouse, but separate creditors would take that interest subject to the paramount survivorship rights of the nondebtor spouse. In re Persky, 893 F.2d 15 (2d Cir. 1989) (New York law). In other states, separate creditors may reach only the survivorship interest of the debtor spouse. In re Arango, 992 F.2d 611 (6th Cir. 1993) (Tennessee law). In many states, property held by the entirety is completely beyond the reach of separate creditors and is available only to joint creditors. In re Blatstein, 192 F.3d 88 (3d Cir. 1999) (Pennsylvania law); In re Garner, 952 F.2d 232 (8th Cir. 1992) (Missouri law); see In re Carroll, 237 B.R. 872 (Bankr. D. Md. 1999) (under Maryland law, lien of judgment creditor with judgment against husband only did not attach to entireties property). There are likewise differences in state law as to whether spouses may hold personalty by the entirety or whether such ownership can exist only in realty. Compare Garner, 952 F.2d at 232 (Missouri law recognizes tenancy by the entirety in personalty) with In re Pappas, 239 B.R. 448 (E.D.N.Y. 1999) (under New York law, when realty held by the entirety is sold, spouses receive the proceeds as tenants in common).

Under 11 U.S.C. § 541(a)(1), a debtor’s interest in entireties property comes into the bankruptcy estate. Under 11 U.S.C. § 522(b)(2)(B), however, the entireties property may be exempted to the same extent that it would be exempt under state law. Courts have disagreed on the interpretation of these statutes. See In re Daughtry, 221 B.R. 889 (Bankr. M.D. Fla. 1997) (discussing the split of authority); Paul C. Wilson, “Fresh Start” or “Head Start”: Missouri Courts Rethink the Role of Tenancies by the Entirety in Bankruptcy, 56 Mo. L. REV. 817 (1991). Some courts hold that, when one spouse files a bankruptcy petition, that spouse’s interest in

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entireties property becomes an estate asset, and that the property may be sold free and clear of the interest of the nondebtor spouse. The proceeds are then divided between the bankruptcy estate and the nondebtor spouse, and the proceeds that flow into the bankruptcy estate may be used to pay separate and joint creditors alike. Joint creditors may satisfy any deficiency after distribution against the nondebtor spouse. *In re Van Der Heide*, 164 F.3d 1183 (8th Cir. 1999); *In re Blair*, 151 B.R. 849 (Bankr. S.D. Ohio 1992), aff’d, 33 F.3d 54 (6th Cir. 1994); *Daughtry*, 221 B.R. at 889. In essence, these decisions regard the filing of a bankruptcy petition as a severance of the entirety; the nondebtor spouse and the bankruptcy estate are not “married” and hence cannot hold property by the entirety. *In re Youmans*, 117 B.R. 113 (Bankr. D.N.J. 1990).

At a policy level, these courts have been concerned that making entireties property, or the great bulk of it, available only to joint creditors would amount to giving preferential treatment to joint creditors that is not justified under the Bankruptcy Code. See *In re Monzon*, 214 B.R. 38 (Bankr. S.D. Fla. 1997); Hon. Frank W. Koger & Thomas N. Lane, *Fiction is Fractured: Bankruptcy Breaks Entireties*, 48 J. Mo. B. 507 (1992).

On the other hand, some courts hold that, if entireties property is sold in bankruptcy, the proceeds may be used to satisfy only joint creditors, and that any remaining proceeds are clear of the claims of separate creditors, at least if applicable state law would place the property and its proceeds beyond that reach of separate creditors. *Sumy v. Schlossberg*, 777 F.2d 921 (4th Cir. 1985); *In re Zella*, 196 B.R. 752 (Bankr. E.D. Va. 1996); *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), 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). If there are no joint creditors, then, in the view of these courts, entireties property is of no value to the estate, at least if state law would not allow separate creditors to reach any portion of
the debtor’s interest. *In re Himmelstein*, 203 B.R. 109 (Bankr. M.D. Fla. 1996); *In re Cerreta*, 116 B.R. 402 (Bankr. D. Vt. 1990). These courts have reasoned that no federal policy requires giving a windfall to separate creditors. Allowing separate creditors of the debtor spouse full access to entireties property or its proceeds would give them something that state law would not permit and dilute the rights of joint creditors. *In re Ginn*, 186 B.R. 898 (Bankr. D. Md. 1995); see Julio E. Castro, III, *Florida’s Treatment of Entirety Property: Do Unsecured Joint Creditor Lose the Benefit of Their Bargain or Achieve a Higher Status Than Specifically Provided by the Bankruptcy Code?*, 45 FLA. L. REV. 275 (1993).

A similar difference of opinion exists with respect to whether a prepetition interspousal transfer of an interest in entireties property may be set aside as fraudulent or preferential. Of course, when both spouses have joined in transferring entireties property to a third party, the transfer may be attacked as fraudulent or preferential. *In re Sanders*, 213 B.R. 324 (Bankr. M.D. Tenn. 1997); see *In re Gutpelet*, 137 F.3d 748 (3d Cir. 1998). Likewise, if one spouse converts his or her separate property into entireties property, the transfer may be attacked as actually or constructively fraudulent as to that spouse’s separate creditors. *In re Duncan*, 329 F.3d 1195 (10th Cir. 2003); *In re Greenfield*, 273 B.R. 128 (E.D. Mich. 2002), *aff’d*, 65 Fed. Appx. 549 (6th Cir. 2003); *In re Graves*, 70 B.R. 535 (N.D. Ind. 1987); *In re Gillissie*, 215 B.R. 370 (Bankr. N.D. Ill. 1997).

If applicable state law allows a separate creditor to reach some portion of a debtor spouse’s interest in entireties property, then a prepetition interspousal transfer of the debtor’s interest could be prejudicial to separate creditors. For example, New York law allows separate creditors to reach the debtor’s spouse’s life interest, and thus a prepetition interspousal transfer could be avoidable. *Pappas*, 239 B.R. at 448. If the transfer were voluntary, 11 U.S.C. § 522(g)
does not permit the debtor to claim any exemption in recovered property, *Duncan*, 329 F.3d at 1195; *see In re Weis*, 92 B.R. 816 (Bankr. W.D. Wis. 1986), and thus the entire value of the debtor’s interest would be available to all creditors.

If, however, applicable state law establishes that entireties property is available only to joint creditors, then an interspousal transfer of an interest in such property should not be avoidable at all. Such a transfer could not possibly harm any creditor. *Stauffer v. Stauffer*, 351 A.2d 236 (Pa. 1976); *accord Blatstein*, 192 F.3d at 88 (in Pennsylvania, an interspousal transfer of an interest in entireties property cannot be fraudulent as a matter of law); *see In re Lankry*, 263 B.R. 638 (Bankr. M.D. Fla. 2001) (under Florida law, interspousal transfer of entireties property cannot be fraudulent as to separate creditors of either spouse); *cf. Bolton Roofing Co. v. Hedrick*, 701 S.W.2d 183 (Mo. Ct. App. 1985) (under Missouri law, spendthrift provision in trust funded with entireties property was valid as against beneficiary husband’s separate creditors; if transaction were unwound, those creditors could not reach entireties property). Obviously, an interspousal transfer could not prejudice the separate creditors of the transferee. It could not prejudice the separate creditors of the transferor if state law would not have allowed them to reach any portion of the transferor’s interest. It could not prejudice joint creditors because, as to joint creditors, it is usually irrelevant how debtor spouses shuffle their property between themselves. *Stauffer*, 351 A.2d at 236; *accord Blatstein*, 192 F.3d at 88. In bankruptcy, it would be inequitable to punish either spouse for engaging in a transaction if the transaction were lawful under state law and if it did not harm any creditor. *See In re Fornabaio*, 187 B.R. 780 (Bankr. S.D. Fla. 1995).

In bankruptcy, the issue of a prepetition interspousal transfer of an interest in entireties property has often arisen in the context of discharge disputes. The better reasoned decisions hold
that, if applicable state law does not allow separate creditors to reach entireties property, then the transfer cannot be considered fraudulent, irrespective of the debtor’s subjective intentions or beliefs. Such a transfer normally would not place anything beyond the reach of any creditor. *In re Agnew*, 818 F.2d 1284 (7th Cir. 1986) (Indiana law); *In re MacDonald*, 50 B.R. 255 (Bankr. D. Mass. 1985); *In re Coester*, 12 B.R. 689 (Bankr. S.D. Fla. 1981). The same result should follow if an attempt is made to avoid such a transfer as fraudulent or preferential. *MacDonald*, 50 B.R. at 255; *In re Turner*, 45 B.R. 649 (Bankr. S.D. Ohio 1985) (wife’s prepetition transfer of her interest in entireties property to her husband could not have been fraudulent, even if she had acted with intent to prejudice her separate creditors).

At least one court has rejected this reasoning, condemning it as an overly lenient “no harm, no foul” rule. *In re Hope*, 231 B.R. 403 (Bankr. D.D.C. 1999). According to the *Hope* court, an actually or constructively fraudulent transfer of an interest in entireties property may be set aside, irrespective of its actual effect. Once avoided, the debtor may not claim any exemption in the property recovered it if the debtor transferred it voluntarily. 11 U.S.C. § 522(g). The *Hope* court, however, misplaced its reliance on cases involving the transfer of property in which the debtor held no equity or the transfer of property in which the debtor might have claimed an exemption. *See In re Bernard*, 96 F.3d 1279 (9th Cir. 1996); *In re Davis*, 911 F.2d 560 (11th Cir. 1990). Under state law, entireties property is not “exempt” in the ordinary sense, *see Hunter*, 122 B.R. at 349, and the rationale for upholding an interspousal transfer has nothing to do with the debtor’s equity in the property or lack thereof. The reason for allowing a prepetition interspousal transfer of an interest in entireties property to stand is not that no creditor happened to be prejudiced as a matter of fact, but rather that, as a matter of law, no creditor could have been prejudiced by the transaction. *Blatstein*, 192 F.3d at 88.
7. Observing Corporate Forms: Property of the Corporation and Property of the Equity Owner.

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), 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, 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.  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 378 (5th Cir. 2003) (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).

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.  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).  “Transfer” is defined in 11 U.S.C. § 101(54) as including “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an interest in property, including retention of title as a security interest and foreclosure of the debtor’s equity of redemption.”  The definition of “transfer” under the Uniform Fraudulent Transfer Act is similar.  U.F.T.A. § 1(12).

Obviously, the Bankruptcy Code’s definition is extremely broad.  U.S. ex. rel. Small Bus. Admin. v. Commercial Technology, Inc., 354 F.3d 378 (5th Cir. 2003) (hypothecation was a transfer); In re Erlewine, 349 F.3d 205 (5th Cir. 2003) (division of marital property in divorce
was a transfer); In re Triple S Restaurants, Inc., 306 B.R. 191 (Bankr. W.D. Ky. 2004); In re PSI Indus., Inc., 306 B.R. 377 (Bankr. S.D. Fla. 2003) (release of stock subscription obligation was a transfer); In re Pulliam, 279 B.R. 916 (Bankr. M.D. Ga. 2002) (rollover of funds from one individual retirement account to another was a transfer); In re Sherlock Homes of W.N.Y., Inc., 246 B.R. 19 (Bankr. W.D.N.Y. 2000) (renegotiation of contract altering debtor’s rights and liabilities was a transfer); In re Trans-Lines West, Inc., 203 B.R. 653 (Bankr. E.D. Tenn. 1996) (revocation of debtor’s subchapter S tax status was a transfer). Although creditors may wish to define “transfer” from the perspective of the recipient, the Bankruptcy Code demands that matters must be viewed from the perspective of the prepetition debtor. In re H & S Transp. Co., 939 F.2d 355 (6th Cir. 1991). The Bankruptcy Code expressly encompasses any transfer of an interest in property—including a security interest—and the definition is in no way limited to the property itself or to title or ownership. In re Lawson, 122 F.3d 1237 (9th Cir. 1997); Anand v. National Republic Bank of Chicago, 239 B.R. 511 (N.D. Ill. 1999); In re Foxmeyer Corp., 286 B.R. 546 (Bankr. D. Del. 2002); In re Stein, 261 B.R. 680 (Bankr. D. Or. 2001).

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 lien is a transfer. Morehead, 249 F.3d at 445; In re Conner, 733 F.2d 1560 (11th Cir. 1984); In re Rose Marine, Inc., 203 B.R. 511 (Bankr. S.D. Ga. 1996). The filing of a lis pendens against the debtor’s property is also a
transfer. *In re May*, 310 B.R. 405 (Bankr. E.D. Ark. 2004). 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, in 1984, the Bankruptcy Code was amended to make clear that foreclosure on 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 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 Volente*, 360 F.3d 256 (1st Cir. 2004); *Commercial Technology*, 354 F.3d at 378.
On the other hand, 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). Furthermore, a setoff is not considered a transfer properly so called; setoffs are governed by 11 U.S.C. § 553 and are not subject to attack as preferences or a fraudulent transfers. In re Haynes, 309 B.R. 577 (Bankr. D. Ariz. 2004); In re Nase, 297 B.R. 12 (Bankr. W.D. Pa. 2003); In re Holyoke Nursing Home, Inc., 273 B.R. 305 (Bankr. D. Mass. 2002), subsequently aff’d, 372 F.3d 1 (1st Cir. 2004); ; In re Wild Bills, Inc., 206 B.R. 8 (Bankr. D. 

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. 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. S.D.N.Y. 1996); In re Metro Water & Coffee Servs.,

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. Securities Inv. Protection Corp. v.
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 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 Einoder, 55 B.R. 319 (Bankr. N.D. Ill. 1985). A
growing majority, however, holds 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 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 Binghi*, 299 B.R. 300 (Bankr. S.D.N.Y. 2003).

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. 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 DeMarah*, 62 F.3d 1248 (9th Cir. 1995); *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 *In re Merrifield*, 214 B.R. 362 (8th Cir. B.A.P. 1997); *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 voluntarily transferred or concealed the property, *In re Young*, 238 B.R. 112 (6th Cir. B.A.P. 1999); *Montoya*, 285 B.R. at 490; *In re Weis*, 92 B.R. 816 (Bankr. W.D. Wis. 1988); see *In re Jones*, 304 B.R. 462 (Bankr. N.D. Ala. 2003), and thus a voluntary transfer or concealment cuts off the debtor’s right to bring an avoidance action. *In re Higgins*, 270 B.R. 147 (Bankr. S.D.N.Y. 2001); *In re Miller*, 251 B.R. 770 (Bankr. D. Mass. 2000).

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 reh’g en banc, 310 F.3d 785 (3d Cir. 2002), *on en banc reh’g*, 330 F.3d 548 (3d Cir.), cert. dismissed, 124 S. Ct. 530 (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.*, 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
given leave to bring an avoidance action for the benefit of the estate. *Official Committee of
Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir.) (en banc), cert.

The en banc *Cybergenics* decision 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 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
creditors’ committee is especially important when the defendant in an avoidance action is a
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
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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 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. N.D. Pa. 2004) (derivative standing may be granted nunc pro tunc when dismissal would be inefficient).

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 creditors 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).

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). Although there is some disagreement as to whether an avoidance action is estate property in a strict sense, 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 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); see In re Stein, 314 B.R. 306 (D.N.J. 2004) (approving bankruptcy court’s injunction against creditors’ pursuit of avoidance actions in state court after Chapter 7 trustee, acting on behalf of all creditors, had settled these claims in the bankruptcy court).

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.

4. Assignment of and Succession to Avoidance Actions.

As National Am. Ins. Co. v. Ruppert Landscape Co., 122 F. Supp. 2d 670 (E.D. Va. 2000) suggests, 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. 355 (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, 1245 S. Ct. 2103 (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.

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) (same); see also In re Associated Vintage Group, Inc., 283 B.R. 549 (9th Cir. B.A.P. 2002). 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). Therefore, the retention of the right to bring an avoidance action must be clearly 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); 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’s creditors. 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 AmeriServe Food Distrib., Inc., 315 B.R. 24 (Bankr. W.D. Pa. 2004); In re Kmart Corp., 310 B.R. 107 (Bankr. N.D. Ill. 2004) (noting that courts are divided as to the exact degree of specificity needed to preserve avoidance actions post-confirmation but that catchall language such as “all causes of
action” plainly will not do); 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).


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 receiver 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 Goldberg, 277 B.R. 251 (Bankr. M.D. La. 2002). 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); see Moore v. Bay, 284 U.S. 4 (1931). Under Section 544(b) the estate representative may only seek to avoid a transfer that a prepetition creditor could have avoided under nonbankruptcy law. It does not allow the estate representative to bring an action for damages. 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.**

1. **A Split of Authority Resolved by the Bankruptcy Reform Act of 1994.**

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 Products, 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 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. *American Pad & Paper*, 307 B.R. at 459.

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 Chapter 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. 149 (Bankr. D. Del. 2004).

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

At least one court of appeals has held that 11 U.S.C. § 546(a) is jurisdictional, so that, if an avoidance claim is not brought within the time specified, a federal court lacks subject matter jurisdiction to entertain the action. *In re Butcher*, 829 F.2d 596 (6th Cir. 1987), *cert. denied*, 484 U.S. 1078 (1988). Some lower court decisions support this view. *In re Gardner*, 218 B.R. 338 (Bankr. E.D. Pa. 1998); *In re Railway Reorganization Estate, Inc.*, 133 B.R. 578 (Bankr. D. Del. 1991); *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 Shape, Inc., 138 B.R. 334 (Bankr. D. Me. 1992); 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 Olsen, 36 F.3d 71 (9th Cir. 1994); Randall’s Island Family Golf Ctrs., 288 B.R. at 701; In re Dreiling, 233 B.R. 848 (Bankr. D. Colo. 1999); see In re Porras, 312 B.R. 81 (Bankr. W.D. Tex. 2004). In addition, most courts hold that, if 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. In re Universal Factoring Co., 279 B.R. 297 (Bankr. N.D. Okla. 2002); In re Newcare Health Corp., 274 B.R. 307 (Bankr. D. Mass. 2002).

The Bankruptcy Reform Act of 1994 did not specifically address whether Section 546(a) is jurisdictional or merely a statute of limitations. Nonetheless, the Eleventh Circuit, in examining the 1994 legislative history, 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 Teligent, Inc.*, 307 B.R. 744 (Bankr. S.D.N.Y. 2004); *In re Priest*, 268 B.R. 135 (Bankr. N.D. Ohio 2000); *In re Whaley*, 229 B.R. 767 (Bankr. D. Minn. 1999). 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 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 *In re Coleman*, 299 B.R. 780 (W.D. Va. 2003).

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 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 appreciate 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); *In re Benjamin*, 210 B.R. 203 (Bankr. M.D. Fla. 1997); *In re Farmer*, 209 B.R. 1022 (Bankr. M.D. Ga. 1997). 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.
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 Richmond Produce Co., 195 B.R. 455 (N.D. Cal. 1996); 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 rights 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 A.W. Lawrence & Co, Inc., 289 B.R. 20 (N.D.N.Y. 2003) (genuine issue of material fact as to whether alleged transferee had any beneficial interest in check in question 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 C.F. Foods, L.P., 265 B.R. 71 (Bankr. E.D. Pa. 2001). Even if the transaction is unquestionably avoidable under 11 U.S.C. §§ 544(b), 548 and/or 547, a third party is immune from recovery liability under Section 550 if the funds or property in question merely passed through that party’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 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); Circuit Alliance, 228 B.R. at 225 (attorney who disbursed client’s funds according to client’s direction 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. 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 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); *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). On the other hand, the party to be held liable must have received a reasonably concrete benefit from the transaction, not merely a remote or speculative benefit. *Telesphere Liquidating Trust v. Galesi*, 246 B.R. 315 (N.D. Ill. 2000); see *C.F. Foods*, 265 B.R. at 71; 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).


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. 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. In the case of a preference action, this would mean using one of the defenses under 11 U.S.C. § 547(c), while in a fraudulent transfer action, an initial transferee could make use of 11 U.S.C. § 548(c) or a state law counterpart of that statute if the lawsuit were brought under 11 U.S.C. § 544(b). Likewise, an initial transferee could defend against avoidance using 11 U.S.C. §§ 546(e), 546(f), and/or 546(g) if any of those statutes applied.

In an action for recovery, 11 U.S.C. § 550(b)(1) provides an affirmative defense, 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.*, 2004 WL 1794495 (S.D.N.Y. Aug. 10, 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). If, in addition to giving value, the subsequent transferee acted without knowledge 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) 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 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); 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

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

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); In re Telesphere Communications, Inc., 229 B.R. 173 (Bankr. N.D. Ill. 1999). 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 Attaway, Inc., 180 B.R. 274 (Bankr. D. Or. 1995); 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.” 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...
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 B.R. 233 (Bankr. D. Conn. 2003); see In re St. Charles Preservation Investors, Ltd., 112 B.R. 469 (D.D.C.), appeal dismissed, 916 F.2d 727 (D.C. Cir. 1990).

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).


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. This means that a debt was owed and that it was incurred 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); Pereira v. United Jersey Bank, N.A., 201 B.R. 644 (S.D.N.Y. 1996). If there were no preexisting debt, then the transfer could not have been preferential. In re Roberds, Inc., 315 B.R. 443 (Bankr. S.D. Ohio 2004) (prepayments are not on account of an antecedent debt); 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 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); 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 Aero-Fastener, Inc.*, 177 B.R. 120 (Bankr. D. Mass. 1994) (transfer of goods to settle a claim for money due was on account of a debt).

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); see *In re Ball*, 257 B.R. 309 (Bankr. D. Ariz. 2001) (statutory bad check processing fee collected by county was on account of an antecedent debt; debt was deemed to have arisen no later than the commencement of debtor’s criminal prosecution). 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. 779 (Bankr. E.D. Mo. 2004); *In re Summit Fin. Servs., Inc.*, 240 B.R. 105 (Bankr. N.D. Ga. 1999); *In re Tulsa Litho Co.*, 232 B.R. 240 (Bankr. N.D. Okla. 1998). 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’rng, 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).

If the debt were incurred before the transfer, then 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 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); Vanguard Airlines, 295 B.R. at 329. A single payment or transfer may be held to be made only partially on account of an antecedent debt; if so, the transfer is avoidable only pro tanto. In re Amick, 163 B.R. 589 (Bankr. D. Idaho 1994) (payment applied to debtor’s overdue accounts was a preferential transfer only to that extent; to the extent that payment was applied to new purchases, it was not on account of antecedent debt).


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 in the ordinary course of business 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 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); In re Oneida Grain Co., 202 B.R. 606 (Bankr. C.D. Ill. 1996); see Peltz v. Hatten, 279 B.R. 710 (D. Del. 2002), aff’d, 60 Fed. Appx. 401 (3d Cir. 2003). 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). 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); 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); see Diamond v. Osborne, 102 Fed. Appx. 544 (9th Cir. 2004) (debtor was properly valued as a going concern; debtor was economically viable for months after the challenged transfers). 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 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 Allegheny Health, Educ. & Research Found., 292 B.R. 68 (Bankr. W.D. Pa. 2003). 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 Management, Inc., 174 B.R. 671 (Bankr. S.D.N.Y. 1994); see In re Terrific Seafoods, Inc., 197 B.R. 724 (Bankr. D. Mass. 1996). 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 Management, 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. 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 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. 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 J.R. Deans Co., Inc.*, 249 B.R. 121 (Bankr. D.S.C. 2000) (noting that the statutory list is nonexclusive); *In re Babcock Dairy Co.*, 70 B.R. 685 (Bankr. N.D. Ohio 1986) (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 Carrozzella & Richardson*, 302 B.R. 415 (Bankr. D. Conn. 2003) (wife of one of debtor’s principals was an insider); *In re 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 In re Camp Rockhill, Inc., 12 B.R. 829 (Bankr. E.D. Pa. 1981); 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 M Group, 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).

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, 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 was 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 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 & Assoc., 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); Lewis v. Diethorn, 893 F.2d 648 (3d Cir.) (payment to holder of an unassailable equitable lien could not be avoided; payment had no preferential effect), cert. denied, 498 U.S. 950 (1990); 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); see id. § 553. Thus the transferee’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 Simms Const. Servs. Co., Inc., 311 B.R. 479 (6th Cir. B.A.P. 2004) (attorney’s lien on debtor’s arbitration award); In re Summit Fin. Servs., Inc., 240 B.R. 105 (Bankr. N.D. Ga. 1999) (bank’s security interest in deposit when bank extended provisional credit and allowed customer to withdraw funds); In re Adams, 212 B.R. 703 (Bankr. D. Mass. 1997) (municipal water and sewer liens); In re Griffith, 194 B.R. 262 (Bankr. E.D. Okla. 1996) (security interest in covenant not to compete); In re Florline Corp., 190 B.R. 342 (Bankr. S.D. Ind. 1996) (employee’s lien against property of debtor employer for unpaid commissions). Preference actions will lie only with respect to transfers made to or for the benefit of unsecured or undersecured creditors, except in the highly unusual case where the estate has sufficient funds to make 100% distributions to unsecured claimants. In re Powerine Oil Co., 59 F.3d 969 (9th Cir. 1995), cert. denied, 516 U.S.

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., 229 B.R. 173 (N.D. Ill. 1999); see In re Abatement Environmental Resources, Inc., 307 B.R. 491 (Bankr. D. Md. 2004).

Even though security interests are not necessarily involved, most courts hold that, if a debtor wishes to assume 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 Teligen, Inc.*, 306 B.R. 752 (Bankr. S.D.N.Y. 2004); *In re Philip Servs. (Delaware)*, 284 B.R. 541 (Bankr. D. Del. 2002), aff’d, 303 B.R. 574 (D. Del. 2003).

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

11 U.S.C. § 547(c) establishes eight 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 eight exceptions. *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, 124 S. Ct. 924 (2003).

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). In many respects, 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. 11 U.S.C. § 547(b)(2). If the transfer were made on account of 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’rng, 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); Kendall v. Liquid Sugars, Inc., 227 B.R. 530 (N.D. Cal. 1998). But see In re Jannel Indus., Inc., 245 B.R. 757 (Bankr. D. Mass. 2000) (holding that 11 U.S.C. § 547(c)(1) requires only that the creditor must have given the new value because the debtor made the payment, not necessarily that the payment must have been applied to the new value). 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); 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 account party), cert. denied, 525 U.S. 964 (1998); 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); *In re Spitler*, 213 B.R. 995 (Bankr. N.D. Ohio 1997); 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. *Furrs Supermarkets*, 296 B.R. at 33; *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).

For this reason, a creditor’s forbearance from foreclosing or otherwise exercising its rights is not “new value” for purposes of this defense, even though forbearance would constitute consideration sufficient to support a contract. *In re Valley Steel Prods. Co.*, 214 B.R. 202 (E.D. Mo. 1997); *In re Allegheny Intern., Inc.*, 145 B.R. 823 (W.D. Pa. 1992); *In re Eleva, Inc.*, 235 B.R. 486 (10th Cir. B.A.P. 1999); *In re Jotan, Inc.*, 264 B.R. 735 (Bankr. M.D. Fla. 2001). Similarly, the overwhelming majority of courts hold that the settlement or dismissal of a lawsuit or claim in return for payment does not constitute new value. *In re Energy Co-op., Inc.*, 814 F.2d 1226 (7th Cir.), cert. denied, 484 U.S. 928 (1987); *In re Upstairs Gallery, Inc.*, 167 B.R. 915 (9th Cir. B.A.P. 1994); *Peltz v. New Age Consulting Servs., Inc.*, 279 B.R. 99 (Bankr. D. Del. 2002); *In re Carolyn’s Kitchen, Inc.*, 209 B.R. 204 (Bankr. N.D. Tex. 1997). There is,

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); *Cocolat*, 176 B.R. at 540; *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 CCG 1355, Inc.*, 276 B.R. 377 (Bankr. D.N.J. 2002). 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); *In re Armstrong*, 291 F.3d 517 (8th Cir. 2002) (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 Corp.*, 282 B.R. 795 (Bankr. D. Del. 2002); *In re Molten Metal Technology, Inc.*, 262 B.R. 172 (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); see *In re R.M. Taylor, Inc.*, 245 B.R. 629 (Bankr. W.D. Mo. 2000) (payments made by debtor up to 60 days before payments were due were not contemporaneous exchanges almost by definition).
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); Furr's Supermarkets, 296 B.R. at 33; In re H.L. Hansen Lumber Co. of Galesburg, Inc., 270 B.R. 273 (Bankr. C.D. Ill. 2001); In re Air South Airlines, Inc., 247 B.R. 153 (Bankr. D.S.C. 2000). 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 practices will be set aside as preferences. *Union Bank v. Wolas*, 502 U.S. 151 (1991); *In re Issac Leaseco, Inc.*, __ F.3d __, 2004 WL 2496264 (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 three elements to this defense: (a) the payment 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, 11 U.S.C. § 547(c)(2)(A); (b) the transfer must have been made in the ordinary course of the business or financial affairs of the debtor and the transferee, 11 U.S.C. § 547(c)(2)(B); and (c) the transfer must have been made according to ordinary business terms. 11 U.S.C. § 547(c)(2)(C). Although these elements are interrelated, each of the three must be established separately and independently under current law. *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 Bridge Info. Sys., Inc.*, 297 B.R. 759 (Bankr. E.D. Mo. 2003). The standard of proof is a preponderance of the evidence for each element. *In re Omniplex Communications Group, LLC*, 297 B.R. 573 (Bankr. E.D. Mo. 2003); *In re Quality Botanical Ingredients, Inc.*, 249 B.R. 619 (Bankr. D.N.J. 2000).

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

The first requirement—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

The transaction must bear the hallmarks of an arm’s-length bargain. It must not be a suspect transaction 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. 1999). Clearly, a usurious or otherwise illegal transaction cannot qualify as part of the ordinary business of the parties. *In re Diagnostic Instrument Group, Inc.*, 276 B.R. 302 (Bankr. M.D. Fla.), *reconsideration denied*, 283 B.R. 87 (Bankr. M.D. Fla. 2002). So also short-term loans from insiders made solely to qualify for another loan from a noninsider is scarcely a transaction in the ordinary course of the financial affairs of the business or its principals. *In re Kelly’s Chocolates, Inc.*, 268 B.R. 345 (Bankr. W.D.N.Y. 2001). Likewise, a loan from an individual customer who was not in the business of making loans to a corporate debtor who did not normally borrow from individuals, let alone customers, does not meet the standards of 11

The transaction must be 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 Southmark Corp., 217 B.R. 499 (Bankr. N.D. Tex. 1997).

11 U.S.C. § 547(c)(2)(A) “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 Section 547(c)(2)(A) 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 is 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 Carrozella & 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 Business Mach. Co.*, 84 F.3d 1330 (10th Cir.), *cert. denied*, 519 U.S. 1040 (1996); see *Roberds*, 315 B.R. at 443; *In re National Liquidators, Inc.*, 232 B.R. 915 (Bankr. S.D. Ohio 1998).

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

(c) Transfer Made in the Ordinary Course of Business or Financial Affairs: 11 U.S.C. § 547(c)(2)(B).

The second 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)(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 GGSI Liquidation, Inc., 313 B.R. 770 (Bankr. N.D. Ill. 2004); In re Bridge Info. Sys., Inc., 287 B.R. 258 (Bankr. E.D. Mo. 2002). The amount, manner and timing of payments must be scrutinized to see if transfers made during the preference period fell within the range of the parties’ normal dealings prior to the preference period. Gasmark Ltd. Liquidating Trust v. Louis Dreyfus Natural Gas Corp., 158 F.3d 312 (5th Cir. 1998); In re Tennessee Chem. Co., 112 F.3d 234 (6th Cir., 1997); In re Berger Indus., Inc., 260 B.R. 639 (Bankr. E.D.N.Y. 2001); In re Apex Automotive Warehouse, L.P., 245 B.R. 543 (Bankr. N.D. Ill. 2000); see In re Global Tissue, L.L.C., 106 Fed. Appx. 99 (3d Cir. 2004); In re APS Holding Corp., 282 B.R. 795 (Bankr. D. Del. 2002). For example, if the creditor had habitually acquiesced in late payments and had accepted them willingly, then a late payment during the preference period may fall within the scope of Section 547(c)(2)(B). Tennessee Chem. Co., 112

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); *In re Empire Pipe & Dev., Inc.*, 152 B.R. 1012 (Bankr. M.D. Fla. 1993); 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); In re Swallen’s, Inc., 266 B.R. 807 (Bankr. S.D. Ohio 2000).

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 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 cashiers check on eve of bankruptcy filing).

It should be noted that special demands by the creditor, without more, will not vitiate the ordinary course of business defense. There must actually have been a change in the payment pattern before Section 547(c)(2)(B) 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)(B) 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 final element of this defense is that the transfer must have been according to “ordinary business terms.” 11 U.S.C. § 547(c)(2)(C). Courts hold that 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)(C) and Section 547(b)(2)(B). *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 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 Sibilrud*, 308 B.R. 388 (Bankr. D. Minn. 2004); *In re Bridge Info. Sys., Inc.*, 297 B.R. 759 (Bankr. E.D. Mo. 2003). If an expert witness is used, the testimony must meet the standards of reliability and relevance established by *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993). See *In re Roberds, Inc.*, 315 B.R. 443 (Bankr. S.D. Ohio 2004); *In re Shalom Hospitality, Inc.*, 293 B.R. 211 (Bankr. N.D. Iowa 2003). In no case can the evidence consist of inadmissible hearsay. *In re Hechinger Liquidation Trust*, 298 B.R. 240 (Bankr. D. Del. 2003). No evidence of industry practice may be necessary, however, when the debtor is acting under a clear legal obligation such as refunding a mistaken overpayment by the nondebtor party. *In re Jan Weilert RV, Inc.*, 315 F.3d 1192 (9th Cir.), *opinion amended*, 326 F.3d 1028 (9th Cir. 2003).

There is some relationship between the 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 will
be the departure from standard commercial transactions that some courts will allow. *In re Molded Acoustical Products, Inc.*, 18 F.3d 217 (3d Cir. 1994); see *In re Forman Enters., Inc.*, 293 B.R. 848 (Bankr. W.D. Pa. 2003); *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.*, __ F.3d __, 2004 WL 2496264 (11th Cir. 2004) (when parties’ prepetition relationship was very short, court virtually ignored Section 547(c)(2)(B) and focused entirely on Section 547(c)(2)(C)). At least one court has held 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); cf. *In re Allegheny Health, Educ. & Research Found.*, 292 B.R. 68 (Bankr. W.D. Pa. 2003) (declining to follow *Color Tile* where the parties’ relationship was relatively recent).

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 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 Gretcho & 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 insolvent debtors), cert. denied, 512 U.S. 1206 (1994); see also 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 troubled debtors 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 680; In re
Swallen’s, Inc., 266 B.R. 807 (Bankr. S.D. Ohio 2000) (noting that there is no inherent reason why restructuring or workout agreements could not be on ordinary business terms); In re Big Wheel Holding Co., 223 B.R. 669 (Bankr. D. Del. 1998); Ponoroff & Ashby, Desperate Times and Desperate Measures, 72 WASH. L. REV. at 5.

(e) Proposed Changes in the Ordinary Course of Business Defense.

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 parties. Thus, fraudulent or dishonest transactions would not qualify, and neither would transactions that fall within the ordinary course of the business or financial affairs of only one of the parties. See In re Armstrong, 291 F.3d 517 (8th Cir. 2002); In re Diagnostic Instrument Group, Inc., 276 B.R. 302 (Bankr. M.D. Fla.), reconsideration denied, 283 B.R. 87 (Bankr. M.D. Fla. 2002). The Commission further recommended, however, that the remaining two requirements—the “subjective” course of dealings criterion and the “objective” ordinary business terms criterion—be offered in the disjunctive. The ordinary course of business defense would apply if either the transfer conformed to the parties’ ordinary business practices prior to the preference period or if it conformed to industry norms. In most instances involving a longstanding relationship, industry practice would thus be irrelevant. The transfer could be validated solely on the basis that it was normal between the parties. An inquiry into ordinary business terms would typically take place only when the prepetition relationship between the debtor and the transferee had been too short to establish a pattern of dealing. National Bankruptcy Review Commission, Bankruptcy: The Next Twenty Years: Final Report, Rec. 3.2.3 (Oct. 20, 1997); see In re Issac Leaseco, Inc., __ F.3d __, 2004 WL 2496264 (11th Cir. 2004) (when parties’ relationship had been short, court
virtually ignored Section 547(c)(2)(B)); In re Russell Cave Co., Inc., 259 B.R. 879 (Bankr. E.D. Ky. 2001) (noting that, when the parties’ relationship is relatively recent, it is difficult to establish the “subjective” prong of the ordinary course defense, and that many courts simply look to the contract terms); 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). The Commission’s recommendation was incorporated into the bankruptcy legislation that was under consideration in the 108th Congress. It was embodied in Section 409 of H.R. 975.

This alteration in the ordinary course of business defense, if it is ultimately enacted, should simplify preference litigation and protect the longstanding dealings of debtors and creditors, even if such dealings may appear odd or unusual. This is a logical step beyond the “sliding scale” analysis that some courts already use, permitting a greater departure from industry norms the longer the parties have established their course of dealings. In re Molded Acoustical Products, Inc., 18 F.3d 217 (3d Cir. 1994); see In re Color Tile, Inc., 239 B.R. 872 (Bankr. D. Del. 1999). The proposal has found support among most commentators. Timothy M. Lupinacci, Analyzing Industry Standards in Defending Preference Actions: Equitable Purpose in Search of Statutory Clarity, 5 J. BANKR. L. & PRAC. 129 (Jan./Feb. 1996); see 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).


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 20 days of the time the debtor received possession of the property. 11 U.S.C. § 547(c)(3)(B). This statute 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 20 days); 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 more than 20 days to perfect its lien).

Section 547(c)(3) is typically the only defense that a purchase money or enabling lender can 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).

Formerly, 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 new 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 was outside the literal 10-day period of the former 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 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
The Bankruptcy Reform Act of 1994 attempted to put an end to such disputes. For cases filed on or after October 22, 1994, 11 U.S.C. § 547(c)(3)(B) provides that an enabling lender has 20 days in which to perfect a purchase money security interest. Section 9-324 of the new 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 should help purchase money lenders and save a great deal of 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 20 days, following the law of the relevant state, in order to claim the benefit of this defense. In re Horner, 248 B.R. 516 (Bankr. N.D. W. Va. 2000) (discussing various methods of perfecting a security interest in motor vehicles used by different states); In re Ball, 281 B.R. 706 (Bankr. D. Kan. 2002); In re Scott, 245 B.R. 331 (Bankr. N.D. Iowa 2000).

Until January, 1998, it might have been possible to argue that, if the creditor 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...
This would amount to following the reasoning of *Hesser*, 984 F.2d at 345, and
*Buseslehner*, 918 F.2d at 928, under the revised 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.

the 108th Congress would have changed 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 current
20 days.

By its plain terms, Section 547(c)(3)(B) speaks of perfection within 20 days of the time
that the debtor receives possession of the collateral. Thus, if perfection occurred more than 20
days after the debtor signed the purchase contract or title passed, the creditor may still assert the
defense if perfection occurred within 20 days of the time that the debtor actually took possession.

*In re B & B Utilities, Inc.*, 208 B.R. 417 (Bankr. E.D. Tenn. 1997). Moreover, if the last day of
the 20-day period falls on a Saturday, Sunday, or legal holiday, at least one court has 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). On the other hand,
it must be remembered that the 20 days run 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 20 days of the purchase, the perfection will not relate back, even if

4. **Subsequent Unsecured Advances:** 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 to or for the benefit of the debtor, and the new value must not have been secured by a lien that the bankruptcy estate could not avoid. Third, as of the date of the petition, the debtor must not have repaid the new advances 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 unsecured credit, 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); Chrysler Credit Corp. v. Hall, 312 B.R. 797 (E.D. Va. 2004); In re George Transfer, Inc., 259 B.R. 89 (Bankr. D. Md. 2001). 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 Teligent, Inc., 315 B.R. 308 (Bankr. S.D.N.Y. 2004); In re Van Dyk/Columbia Printing, 289 B.R. 304 (D. Conn. 2003). 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 credit 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); In re Vanguard Airlines, Inc., 295 B.R. 329 (Bankr. W.D. Mo. 2003). On the other hand, a mere 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); Teligent, 315 B.R. at 308 (advance billings did not show that new services were actually provided).

The effect of Section 547(c)(4) is that the creditor may offset the value of the new unsecured advances that remain unpaid against the prior avoidable preferences. Both the earlier preferences and the later new value are aggregated for this purpose. In re Meredith Manor, Inc., 902 F.2d 257 (4th Cir. 1990); In re Transport Associs., 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 advances equal or exceed 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, however, 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 Furrs Supermarkets, Inc., 296 B.R. 33 (Bankr. D.N.M. 2003); In re Swallen’s, Inc., 266 B.R. 807 (Bankr. S.D. Ohio 2000); see 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; Roberds, 315 B.R. at 443; In re Bridge Info. Sys., Inc., 287 B.R. 258 (Bankr. E.D. Mo. 2002); In re Contempri Homes, Inc., 269 B.R. 124 (Bankr. M.D. Pa. 2001); In re Jannel Indus., Inc., 245 B.R. 757 (Bankr. D. Mass. 2000).

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.
Although some courts have spoken as though the subsequent new advances must remain completely unpaid as of the petition date, this view 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; *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 claim *pro tanto* and negated the defense to that extent).

By its terms, the statute requires only that the new advance 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); *Chrysler Credit*, 312 B.R. at 797. 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 Parkview Hosp.*, 213 B.R. 509 (Bankr. N.D. Ohio 1997); see *In re GGSI Liquidation, Inc.*, 313 B.R. 770 (Bankr. N.D. Ill. 2004); *George Transfer*, 259 B.R. at 89; *In re Trans-End Technology, Inc.*, 228 B.R. 181 (Bankr. N.D. Ohio 1998).

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). Payments made to satisfy or to avoid the attachment of a statutory lien are also immune to a preference attack; in such a case, the creditor would be deemed secured. Cimmaron Oil Co. v. Cameron Consultants, Inc., 71 B.R. 1005 (N.D. Tex. 1987); see In re Golfview Developmental Ctr., Inc., 309 B.R. 758 (Bankr. N.D. Ill. 2004) (without mentioning Section 547(c)(6) explicitly, the court pointed out that an inchoate statutory lien is nonetheless a lien, and a lien holder is deemed secured; thus, payment to prevent the lien from becoming choate does not enable the creditor to receive more than it would obtain in a Chapter 7 liquidation); 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 only method for avoiding a statutory lien is provided by 11 U.S.C. § 545. In re Sullivan, 254 B.R. 661 (Bankr. D.N.J. 2000).
Numerous types of liens fall within this category. Federal tax liens are not avoidable as preferences 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. *Sullivan*, 254 B.R. at 661; *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 § 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). On the other hand, 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 added to the Bankruptcy Code by Section 304(f) of the Bankruptcy Reform Act of 1994. This statute shields 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 are truly in the nature of alimony, support, or maintenance and have not been assigned to another person or entity. Under previous law, alimony or support payments could be avoided. *See In re Sorlucco*, 68 B.R. 748 (Bankr. D.N.H.)

The payment of alimony or support might be distinguished from a property division pursuant to a divorce decree. The former is a transfer protected by Section 547(c)(7). At least arguably, a property division might not be a transfer of an interest of the debtor in property, but rather it would amount to giving each spouse his or her own share of the marital property. If a property division is not subject to this analysis, however, it would be shielded by 11 U.S.C. § 547(c)(7). *In re Hope*, 231 B.R. 429 (Bankr. D.D.C. 1999); *In re Watson*, 192 B.R. 238 (Bankr. D. Nev. 1996). In fact, the better view is that a property division pursuant to a separation or divorce is indeed a transfer of an interest of the debtor in property. *In re Erlewine*, 349 F.3d 205 (5th Cir. 2003).

11 U.S.C. § 547(c)(8), formerly codified as § 547(c)(7), provides that in any case filed by an individual whose debts are primarily consumer debts, a transfer may not be avoided if the total value of all property transferred or affected by the transfer were less than $600. The purpose of the statute is to prevent the estate from pursuing small recoveries where the litigation cost simply would not justify the benefit. *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. Thus, for example, 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. Recovery 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. **A Proposed Minimum for Nonconsumer Preference Actions.**

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 to a noninsider creditor that may be avoided in a preference action in a nonconsumer case. This limitation would not have applied in consumer cases or to insiders. National Bankruptcy Review Commission, *Bankruptcy: The Next Twenty Years: Final Report*, Rec. 3.2.1 (Oct. 20, 1997). The Commission believed that estate representatives sometimes 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. Legislation before the 108th Congress embodied most aspects of this recommendation. Section 409 of H.R. 975 would have created a new 11 U.S.C. § 547(c)(9), which would have provided that there can be no preference avoidance “if, in a case filed by a debtor whose debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $5,000.”
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. *Farstveet v. Rudolph*, 630 N.W.2d 24 (N.D. 2000); *see* Lisa Sommers Gretcho, *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). 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); *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 Crop. 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. There is no analogous provision under Section 547(b) of the Bankruptcy Code, and, in a preference action under Section 547, 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), like the other time periods of the U.F.T.A., 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.

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 advances defense of 11 U.S.C. § 547(c)(4). Lisa Sommers Gretcho, *Uniform Fraudulent Transfer Act Makes Insider Preferences Creatures of State Law*, 18-Sept. Am. Bankr. Inst. J. 29 (Sept. 1999). It allows a defendant insider 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)(A) 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
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. Gretcho, Uniform Fraudulent Transfer Act Makes Insider Preferences 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 U.S.C. § 550. *Congress Credit Corp. v. AJC Intern., Inc.*, 186 B.R. 555 (D.P.R. 1995). The estate is permitted to recover either from a transferee or from the 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 Bankruptcy Code*, 89 COLUM. L. REV. 530 (1989).

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).

On the other hand, in jurisdictions that have not expressly adopted *Deprizio*, some lower courts have 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. 


2. Statutory and 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 because the insiders would then have no claim against the debtor, not even a contingent claim, in connection with the debt in question. Under such provisions, the insider guarantors would waive all rights of subrogation or any other claim to reimbursement from the debtor. 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. 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 have also been 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 have been 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, commentators have pointed out that the waiver of any right of recourse against the debtor may mean that insider guarantors could be even more inclined to see to it that the debtor pays the debts that the insiders have guaranteed in preference to those debts that they have 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). At least two reported decisions have 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); *In re Telesphere Communications, Inc.*, 229 B.R. 173 (Bankr. N.D. Ill. 1999).

This minority position rejecting Deprizio waivers out of hand rests on two questionable assumptions. The first is 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 be less certain. The minority position might be on stronger ground in asserting that the insiders themselves should not be able to escape liability when they cause the debtor to make preferential payments. Even there, however, there is 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 is palpably a sham with no real substance and simply conceals a continuing right of recourse against the debtor, there is no reason not to recognize such waivers as valid simply because a court thinks that they are not a good idea. If genuine waivers are to be condemned, this step should be based on clear evidence of the intent of Congress.
By Section 202 of the Bankruptcy Reform Act of 1994, Congress 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 benefit an insider guarantor may 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); Tracht, *Insider Guaranties in Bankruptcy*, 54 U. MIAMI L. REV. at 497. The insider guarantor may 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).

3. **Continuing Problems and Proposed Legislation.**


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 is still an avoidable indirect preference. In re M2Direct, Inc., 282 B.R. 60 (Bankr. N.D. Ga. 2002); see In re Exide Technologies, Inc., 299 B.R. 732 (Bankr. D. Del. 2003). Thus, there are several reasons why a prudent lender might wish to continue using Deprizio waivers. First, there are cases where no payment or other tangible property has actually passed into the lender’s hands, but where a “transfer”—broadly defined—has nonetheless benefited an insider guarantor. Such would be the case, for example, where the lender receives a security interest that benefits 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 applies in such cases and remains 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 follow. 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

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. See In re Shared Technologies Cellular, Inc., 281 B.R. 804 (Bankr. D. Conn. 2002), aff’d, 293 B.R. 89 (D. Conn. 2003). Conceivably, if the estate has 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 use 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 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, a trustee or debtor-in-possession may still use the avoidable transfer for claim objection purposes. 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 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 has been an avoidable indirect preference, 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, 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).

Likewise, although indirect preferences within 90 days prepetition are unlikely to arise, they may exist. See In re Abatement Environmental Resources, Inc., 307 B.R. 491 (Bankr. D. Md. 2004) (noting that Section 550(c) has no application with respect to transfers made within 90 days of the petition date). Typically, a transfer to a creditor within 90 days of a bankruptcy filing will be an avoidable preference as to that creditor or not at all. There is room, however, for indirect preferences within that period. See In re Prescott, 805 F.2d 719 (7th Cir. 1986) (payment to fully secured senior lender was not preferential as to that party, but payment improved position of a junior lienholder and thus was preferential as to the junior creditor). With a Deprizio waiver, however, a creditor could assert that, unless a payment within 90 days prepetition were preferential as to the transferee, then there should be no recovery under an indirect preference theory. 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).
Finally, under Section 550(c), the trustee or debtor-in-possession may still recover an avoidable indirect preference made between 90 days and one year prepetition from the insider guarantor who received the benefit. *In re Mid-South Auto Brokers, Inc.*, 290 B.R. 658 (Bankr. E.D. Ark. 2003); *In re Denochick*, 287 B.R. 632 (Bankr. W.D. Pa. 2003); Clyde Mitchell, *Lenders and the Bankruptcy Reform Act*, N.Y.L.J., Nov. 8, 1994, at 1. A lender might find that an insider guarantor does not have sufficient funds to satisfy the estate and to honor its guarantee to the lender. With a *Deprizio* waiver, however, the transfers would not be avoidable, and the lender would not have to compete with the borrower if the lender had to turn to the guarantor for the satisfaction of its claim. See Marshall E. Tracht, *Insider Guaranties and Bankruptcy: A Framework for Analysis*, 54 U. MIAMI L. REV. 497 (2000).

In short, Section 202 of the Bankruptcy Reform Act of 1994 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 would be 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 those waivers are used, however, it is not certain that all courts will honor them. *In re Pro Page Partners, LLC*, 292 B.R. 622 (Bankr. E.D. Tenn. 2003).

Bankruptcy legislation considered in the 108th Congress attempted to address the *Deprizio* issue more thoroughly. Section 1213 of H.R. 975 would have created a new 11 U.S.C.
§ 547(i). This statute would have provided that, if a transfer made to a noninsider between 90 days and one year prepetition is avoided as preferential because it was made for the benefit of an insider creditor, the transaction would be deemed avoided only as to the insider. In other words, not merely would the estate be barred from recovering against the noninsider, as 11 U.S.C. § 550(c) currently provides; the transaction would not even be avoided with respect to the noninsider and would not be considered preferential as to that party. If such a statute is eventually enacted, it would resolve many, though perhaps not all, of the problems discussed above. See Nickels, Deprizio Dead Yet?, 22 CARDOZO L. REV. at 1251 (discussing similar legislation considered in the 106th Congress). Making the transfer nonavoidable as to the noninsider creditor during the insider preference period would eliminate most of the reasons for inserting Deprizio waivers into guaranty contracts in the first place and thus eliminate the controversy surrounding such provisions.

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 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); In re Roti, 271 B.R. 281 (Bankr. N.D. Ill. 2002).
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 Integrated Agri, Inc.*, 313 B.R. 419 (Bankr. C.D. Ill. 2004). 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 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); 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); In re Baker, 273 B.R. 892 (Bankr. D. Wyo. 2002). 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. 2001) (Virginia law). 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); see also In re Abatement Environmental Resources, Inc., 102 Fed. Appx. 272 (4th Cir. 2004); 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 In re H King & Assocs., 295 B.R. 246 (Bankr. N.D. Ill.

2. Reachback Period for Avoiding a Fraudulent Transfer.

Confusion might arise between two different sorts of limitations 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 brought 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.

11 U.S.C. § 548(a)(1) allows for the avoidance of any transfer made within one year
statute, no transfer made more than one year prepetition 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 one year of 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 one-year 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 transaction 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). 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).

If the bankruptcy estate representative brings an action under 11 U.S.C. § 544(b), the trustee or debtor-in-possession is subject to the same limitations period as creditor in whose shoes he or she stands. In this respect, it may be advantageous to the estate for the I.R.S. to be the underlying creditor. The United States and its agencies are not subject to state statutes of limitations, U.S. v. Summerlin, 310 U.S. 414 (1940), and, in bringing a fraudulent transfer action, the I.R.S. is bound by a 10-year limitations period, I.R.C. § 6502(a)(1), even if state law supplies the substantive rule of decision. See Bresson v. C.I.R., 213 F.3d 1173 (9th Cir. 2000); U.S. v.
Fernon, 640 F.2d 609 (5th Cir. 1981). Thus, if the I.R.S. is the predicate creditor in a Section 544(b) action, the estate representative is entitled to use the 10-year reachback period. In re Porras, 312 B.R. 81 (Bankr. W.D. Tex 2004). Likewise, if the Section 544(b) action is not brought under the U.F.T.A., the estate representative is bound by the limitations period that would bind the creditor in whose right the suit is brought. See In re Lowenstein, 312 B.R. 6 (Bankr. D. Mass. 2004) (discussing the reachback period applicable to an action under the Uniform Fraudulent Conveyance Act, which had no statute of limitations of its own).

Irrespective of the limitations 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 and 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 one-year reachback period of Section 548 is irrelevant in a state law fraudulent transfer action under Section 544(b). In re Haddock, 246 B.R.

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


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. 628 (Bankr. D. Conn. 2004); In re Boudrot, 287 B.R. 582 (Bankr. W.D. Okla. 2002); In re Zenox, Inc., 173 B.R. 46 (Bankr. D.N.H. 1994); In re Ste. Jan-Marie, Inc., 151 B.R. 984 (Bankr. S.D. Fla. 1993).

Richardson, 302 B.R. 415 (Bankr. D. Conn. 2003) (under Connecticut law, both actual and constructive fraud must be shown by clear and convincing evidence); 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, many 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 provided 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 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); Ste. Jan-Marie, 151 B.R. at 984; 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); In re McLaren, 236 B.R. 882 (Bankr. D.N.D. 1999)(same).

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. In re American Way Serv. Corp., 229 B.R. 496 (Bankr. S.D. Fla. 1999) (noting that, under Michigan law, the standard of proof in an actually fraudulent transfer action is clear and convincing evidence, whereas the standard is merely a preponderance of the evidence under federal law); see In re Stern, 317 F.3d 1111 (9th Cir. 2003) (under California law, actual fraudulent intent must be established by clear and convincing evidence), cert. denied, 124 S. Ct. 1657 (2004); U.S. v. Mazzeo, 306 F. Supp. 2d 294 (E.D.N.Y. 2004) (same under New York law); Lippe v. Bairnco Corp., 249 F. Supp. 2d 357 (S.D.N.Y. 2003) (New York law requires clear and convincing evidence to establish actual fraudulent intent, whereas constructive fraud requires only a preponderance of the evidence).

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. 2004); In
re Exide Technologies, Inc., 299 B.R. 732 (Bankr. D. Del. 2003); In re Sullivan, 161 B.R. 776 (Bankr. N.D. Tex. 1993). 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 were 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); 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 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 KZK Livestock, Inc., 190 B.R. 626 (Bankr. C.D. Ill. 1996); In re Sackman Mortg. Corp., 158 B.R. 926 (Bankr. S.D.N.Y. 1993); see In re Corcoran, 246 B.R. 152 (E.D.N.Y. 2000). In a few cases, however, actual intent may be established virtually as a matter of law. In re Hinsley, 201 F.3d 638 (5th Cir. 2000); Cadle Co. v. Newhouse, 2002 WL 1888716 (S.D.N.Y. Aug. 16, 2002) (granting summary judgment on actually fraudulent transfer claim where facts were truly egregious), aff’d, 74 Fed. Appx. 152 (2d Cir. 2003). In particular, if the debtor ran a Ponzi scheme or some similar illegitimate enterprise, transfers made in the course of the operation could scarcely have any purpose except to hinder, delay, or defraud creditors. In re Agricultural Research & Technology Group, Inc., 916 F.2d 528 (9th Cir. 1990); In re M&L Business Mach. Co., 198 B.R. 800 (D.

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 Brown, 265 B.R. 167 (Bankr. E.D. Ark. 2001), 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). Once several badges of fraud have been adduced, the burden shifts to the defendant to show that the transaction was legitimate. 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); In re Meyer, 307 B.R. 87 (Bankr. N.D. Ill. 2004) (debtor successfully rebutted the presumption raised by several badges of fraud). 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 PSI Indus., Inc.*, 306 B.R. 377 (Bankr. S.D. Fla. 2003); *In re Harper*, 132 B.R. 349 (Bankr. S.D. Ohio 1991); see *Tavenner*, 257 F.3d at 401; *In re Food & Fibre Protection, Ltd.*, 168 B.R. 408 (Bankr. D. Ariz. 1994).

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. *PSI Indus.*, 306 B.R. at 377; *In re Brentwood Lexford Partners, LLC*, 292 B.R. 255 (Bankr. N.D. Tex. 2003); *In re American Way Serv. Corp.*, 239 B.R. 496 (Bankr. S.D. Fla. 1999).

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

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); Boba, 280 B.R. at 430 (debtor continued to enjoy use of property ostensibly transferred to his wife in a sham divorce); In re Moss, 258 B.R. 405 (Bankr. W.D. Mo. 2001); cf. U.S. v. Lawrence, 189 F.3d 838 (9th Cir. 1999) (debtor-settlor’s continued use and control of trust assets for his own purposes was properly considered in enhancing criminal sentence for bankruptcy fraud). 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).
C. **CONSTRUCTIVELY FRAUDULENT TRANSFERS.**


    (a) **The Importance of Reasonably Equivalent Value.**

    11 U.S.C. § 548(a)(1)(B) establishes three 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 are U.F.T.A. §§ 4(a)(2)(i), 4(a)(2)(ii), and 5(a). Thus, the criteria for determining whether a transfer were constructively fraudulent are substantially 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 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 Management 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 three 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. §

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); Anand v. National Republic Bank of Chicago, 239 B.R. 511 (N.D. Ill. 1999); In re Southern Health Care of Ark., Inc., 309 B.R. 314 (8th Cir. B.A.P. 2004); In re Richards & Conover Steel Co., 267 B.R. 602 (8th Cir. B.A.P. 2001). 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. 2001); *In re Hinsley,* 201 F.3d 638 (5th Cir. 2000); see *Thomas v. Lawrence,* 302 B.R. 194 (W.D. Ky. 2003); *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 *U.S. v. Mazzeo,* 306 F. Supp. 2d 294 (E.D.N.Y. 2004).

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 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 Tower Environmental, Inc.**, 260 B.R. 213 (Bankr. M.D. Fla. 1998) (money paid in an arm’s-length transaction to settle civil or criminal litigation is an exchange for reasonably equivalent value); *In re Stipetich,* 294 B.R. 635 (Bankr. W.D. Pa. 2003) (debtor undoubtedly received value for transfer of property to pay an antecedent debt, but fact question remained as to whether value of property exceeded the debt and thus whether the exchange was for reasonably equivalent value). On the other hand, a debtor receives no value from the repayment of a sham or illusory loan. *In re Strasser,* 303 B.R. 841 (Bankr. D. Ariz. 2004). Furthermore, although a dollar-for-dollar transfer made to satisfy a legitimate antecedent debt cannot be constructively fraudulent, it may be avoidable as a preference. *In re Computer Personalities Sys., Inc.**, 284 B.R. 415 (Bankr. E.D. Pa. 2002); *In re All-Type Printing, Inc.**, 274 B.R. 316 (Bankr. D. Conn. 2002); *In re Jotan, Inc.**, 264 B.R. 735 (Bankr. M.D. Fla. 2001).
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. 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 Bowers-Simeon Chems. Co., 139 B.R. 436 (Bankr. N.D. Ill. 1992). If there are no such collateral benefits, however, 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 Vadhais Lumber Supply, Inc.*, 100 B.R. 127 (Bankr. D. Mass. 1989).

(c) *Determining Reasonable Equivalence.*

If what the debtor received did constitute value, the next step is to inquire whether the value was reasonably equivalent. Many courts have taken “reasonably equivalent value” to be similar to “fair consideration” under Section 3 of the Uniform Fraudulent Conveyance Act. *In re International Loan Network, Inc.*, 160 B.R. 1 (Bankr. D.D.C. 1993); *In re Otis & Edwards, P.C.*, 115 B.R. 900 (Bankr. E.D. Mich. 1990); see *In re Structurlite Plastics Corp.*, 224 B.R. 27 (6th Cir. B.A.P. 1998). But see *In re Foxmeyer Corp.*, 286 B.R. 546 (Bankr. D. Del. 2002) (pointing out that “reasonably equivalent value” under the U.F.T.A. and the Bankruptcy Code is objective, whereas “fair consideration” under the U.F.C.A. required both objective reasonable equivalence and subjective good faith on the part of the transferee); *In re Adler, Coleman Clearing Corp.*, 247 B.R. 51 (Bankr. S.D.N.Y. 1999) (same), aff’d, 263 B.R. 406 (S.D.N.Y. 2001). Whether the debtor received reasonably equivalent value is a question of fact. *In re Dullea Land Co.*, 269 B.R. 33 (8th Cir. B.A.P. 2001); *In re Porras*, 312 B.R. 81 (Bankr. W.D. Tex. 2004); *In re Goldberg*, 235 B.R. 476 (Bankr. D. Idaho 1999). Fair market value is only one factor to consider. Other considerations include whether the exchange resulted from arm’s-length dealing and what the situation of the parties was. *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 Perry County Foods, Inc.*, 313 B.R. 875 (Bankr. N.D. Ala. 2004); *In re H. King & Assocs.*, 295 B.R. 246 (Bankr. N.D. Ill. 2003); *In re Stein*, 261 B.R. 680 (Bankr. D. Or. 2001); *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 Youngstown Osteopathic Hosp. Ass’n, 280 B.R. 400 (Bankr. N.D. Ohio 2002); In re Telesphere Communications, Inc., 179 B.R. 544 (Bankr. N.D. Ill. 1994); In re Pajaro Dunes Rental Agency, Inc., 174 B.R. 557 (Bankr. N.D. Cal. 1994).


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 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 taxes did not provide any value to the corporation).

There is, however, a well-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 transferee gave. In re Bargfrede, 117 F.3d 1068 (8th Cir. 1997); In re Broumas, 203 B.R. 385 (D. Md. 1996).

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 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).

Typically, a “downstream” transfer from a parent corporation to a subsidiary will be held to provide reasonably equivalent value to the parent, at least if the subsidiary is adequately capitalized and the transfer is not part of a transaction that places assets beyond the reach of the parent’s creditors. *In re Metro Communications, Inc.*, 95 B.R. 921 (Bankr. W.D. Pa. 1989), *subsequently rev’d on other grounds*, 945 F.2d 635 (3d Cir. 1991); *In re Lawrence Paperboard Corp.*, 76 B.R. 866 (Bankr. D. Mass. 1987). On the other hand, benefits that a parent corporation receives for transfers made by a subsidiary are presumed to be of purely nominal value, absent specific proof to the contrary. *Pajaro Dunes*, 174 B.R. at 557; *In re Grabill Corp.*, 121 B.R. 983 (Bankr. N.D. Ill. 1990). Moreover, benefits that a subsidiary receives for transfers that it made to or on behalf of a parent usually do not constitute reasonably equivalent value. *Image Worldwide*, 139 F.3d at 574; *In re Wes Dor, Inc.*, 996 F.2d 237 (10th Cir. 1993) (subsidiary’s pledge of assets to guarantee payment of parent’s outstanding debts was not made for reasonably equivalent value).

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 Anand*, 210 B.R. 456 (Bankr. N.D. Ill. 1997), aff’d, 239 B.R. 511 (N.D. Ill. 1999); accord *In re Kaplan Breslaw Ash, LLC*, 264 B.R. 309 (Bankr. S.D.N.Y. 2001); *In re Mason*, 189 B.R. 932 (Bankr. N.D. Iowa 1995); see *In re M. Silverman Laces, Inc.*, 2002 WL 31412465 (S.D.N.Y. Oct. 24, 2002). 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, particularly 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 debt, albeit contingent and unliquidated. While there might have been a lack of reasonably equivalent value in exchange for the guaranty itself, the collateralization of an antecedent guaranty is a distinct transaction, and 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 validity of an antecedent obligation with the validity of collateralizing the obligation. The position espoused by the bankruptcy court 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 if 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); *In re Jones*, 209 B.R. 380 (Bankr. E.D. Va. 1997).
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). 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); In re Pioneer Home Builders, Inc., 147 B.R. 889 (Bankr. W.D. Tex. 1992). 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); 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 debtor’s entire package of assets and liabilities at the relevant time, placing all of the debtor’s contingent liabilities and contingent assets at their then-current value. 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); see In re Babcock & Wilcox Co., 274 B.R. 230 (Bankr. E.D. La. 2002) (discussing the problem of estimating the value of future potential tort claims, the extent of insurance coverage, and discounting to present value). Under the U.F.T.A., the debtor’s equitable insolvency or inability to pay debts as they accrue creates a presumption of balance sheet or bankruptcy insolvency. U.F.T.A. § 2(b); see In re Marlar, 267 F.3d 749 (8th Cir. 2001).

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 Sieder, 2002 WL 1729502 (Bankr. N.D. Ill. July 25, 2002); see In re Jotan, Inc., 264 B.R. 735 (Bankr. M.D. Fla. 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. 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 and still remain financially stable. 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 hand, 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 Dolata, 306 B.R. 97 (Bankr. W.D. Pa. 2004); In re All American Petro. Corp., 259 B.R. 6 (Bankr. E.D.N.Y. 2001).

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. Moreover, because 11 U.S.C. § 548(a)(1)(B)(ii)(III) requires a constructively fraudulent intent on the part of the debtor in making the transfer, the Hall court believed that this
statute could not be used to avoid involuntary transfers, at least where 11 U.S.C. §§ 548(a)(1)(B)(ii)(I), (II) did not apply.

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


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 Jones*, 304 B.R. 462 (Bankr. N.D. Ala. 2004); *In re Armstrong*, 259 B.R. 338 (E.D. Ark. 2001), **aff’d**, 285 F.3d 1092 (8th Cir. 2002). 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 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 Skalski, 257 B.R. 707 (Bankr. W.D.N.Y. 2001). Moreover, the transferee is shielded only to the extent of the value given. Jones, 304 B.R. at 462; In re Pajaro Dunes Rental Agency, Inc., 174 B.R. 557 (Bankr. N.D. Cal. 1994). The value must be reasonably equivalent to what the transferee received, and the values exchanged must be judged as of the time of the transaction. Hannover Corp., 310 F.3d at 796; see Jones, 304 B.R. at 462 (noting that giving less than full fair market value will not necessarily defeat this defense).

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; 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 reasoning. 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 its 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 Management 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 were 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 has 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. Under such circumstances, a
payment to an investor might be avoided as preferential, but the investor would have a defense to

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).

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

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.

Merely using nonexempt assets to acquire exempt property, standing alone, is not sufficient to avoid the transaction or to deny the debtor a discharge, even if such a transfer could be considered constructively fraudulent in some sense. *Norwest Bank Nebraska, N.A. v. Tveten*, 848 F.2d 871 (8th Cir. 1988); *In re Cataldo*, 224 B.R. 426 (9th Cir. B.A.P. 1998); *In re Dunbar*, 313 B.R. 430 (Bankr. C.D. Ill. 2004); *In re Bradley*, 282 B.R. 430 (Bankr. W.D. Ark. 2002), aff’d, 294 B.R. 64 (8th Cir. B.A.P. 2003). Congress intended for the debtor to be able to maximize exemptions in order to foster a fresh start. H.R. Rep. No. 595, 95th Cong., 1st Sess. 361 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6317; accord, S. Rep. No. 989, 95th Cong., 2d Sess. 76 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5862; see *In re Armstrong*, 931 F.2d 1233 (8th Cir. 1991). Extrinsic circumstances over and above the 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 does not necessarily follow that the proper remedy is to set the transaction aside or to treat the allegedly
exempt property as though it were nonexempt. The Bankruptcy Code provides no basis for
disallowing a state law exemption simply because the exempt property was acquired in order to
hinder, delay, or defraud creditors. There must be some basis in state law for disallowing a state
law exemption on fraudulent transfer grounds before a bankruptcy court may take this step. *In re
Bradley*, 294 B.R. 64 (8th Cir. B.A.P. 2003); *In re McCabe*, 280 B.R. 841 (Bankr. N.D. Iowa
W.D. Pa. 1998); Juliet M. Moringiello, *Distinguishing Hogs from Pigs: A Proposal for a
more appropriate remedy when there is no state law basis for avoiding an acquisition of exempt
property is 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 may be dismissed on the basis of bad faith filing or substantial abuse.
*Lenartz*, 263 B.R. at 331.

One area of dispute that has attracted particular concern has been a debtor’s use of
nonexempt assets to acquire a homestead, especially in a state with a generous homestead
allowance. 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 pay
down 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, the
use of otherwise exempt property to acquire, improve, or pay down a lien against a homestead
may not be set aside, 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); see Barbara J. Houser & Robert Taylor, Pre-Bankruptcy Planning Using State Law Exemptions, 389 PLI/REAL 153 (1993). If the debtor channeled nonexempt assets into exempt homestead property with actual intent to hinder, delay, or defraud creditors, the proper remedy in bankruptcy is to deny the debtor’s discharge, not to avoid the transaction or deny the exemption. Reed, 700 F.2d at 986; 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 used 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 a case, however, the remedy is not to disallow the homestead exemption altogether or to make the property available to creditors generally. Rather, equity will impress the homestead property with a constructive trust, an equitable lien, or some similar device for the benefit of the victim or victims of the debtor’s miscreance. See In re Jones, 50 B.R. 911 (Bankr. N.D. Tex. 1985); see also Coates, 242 B.R. at 901.

Not all states are like Texas in this respect. For example, the Eighth Circuit has held that, under Minnesota law, a homestead exemption will not protect a transfer of nonexempt property that was actually fraudulent under that state’s U.F.T.A. While channeling nonexempt property into a homestead, without more, is not an avoidable fraudulent transfer, badges of fraud showing an actual intent to hinder, delay, or defraud creditors will vitiate a homestead exemption under Minnesota law. In re Sholdan, 217 F.3d 1006 (8th Cir. 2000); accord In re Curry, 160 B.R. 813 (Bankr. D. Minn. 1993).
Florida’s homestead exemption scheme is scarcely less generous than the one in Texas. See Fla. Const. art. X, § 4. Bankruptcy courts in Florida were formerly divided as to whether a homestead exemption should be disallowed if the debtor had used nonexempt property to acquire, improve, or pay down a lien against a homestead with actual intent to hinder, delay, or defraud creditors. Noting the split of authority, and finding no clear-cut answer in state court decisions, the Eleventh Circuit certified the question to the Florida Supreme Court. Havoco of Am., Ltd. v Hill, 197 F.3d 1135 (11th Cir. 1999), certified question answered, 790 So. 2d 1018 (Fla. 2001), answer to certified question conformed to, 255 F.3d 1321 (11th Cir. 2001).

The answer that the Florida Supreme Court gave sounded remarkably like Texas law. 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). The Florida Supreme Court carefully distinguished a number of decisions in which the debtor had obtained the funds used to acquire, improve, or discharge a lien against a homestead by dishonest means. In such a case, equity would allow the victim of the debtor’s wrongdoing to reach the homestead property. Under Florida law, however, the transfer of honestly acquired nonexempt assets into homestead property could never be a basis for undermining the homestead exemption, even if the debtor had acted with actual intent to hinder, delay, or defraud creditors.

In the wake of the Florida Supreme Court’s decision, it is clear that a fraudulent transfer of nonexempt assets may not be used as a basis for disallowing a Florida homestead exemption. See In re Sparfven, 265 B.R. 506 (Bankr. D. Mass. 2001) (applying Florida law). If the debtor obtained the funds channeled into the homestead property by dishonest means, however, a bankruptcy court may make use of subrogation, a constructive trust, an equitable lien, or any other tool of the chancery that may be appropriate under the circumstances. In re Financial
Federated 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 an equitable lien or constructive trust). Such a step would be 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 rule appears to be the same in some other states with generous homestead exemptions. The property will not be exempt as to a third party who, because of the debtor’s wrongdoing, holds a paramount equitable interest in the funds used to acquire or improve it, but the transfer of honestly acquired nonexempt funds into a homestead, even with actual intent to hinder, delay or defraud creditors, will not undermine the exemption. In re McGinnis, 306 B.R. 279 (Bankr. W.D. Mo. 2004) (applying Kansas law). Of course, in any state, if the debtor has acquired exempt property with monies obtained dishonestly, the victim is entitled to an equitable lien, a constructive trust, or whatever equitable remedy may be appropriate under the circumstances, but this 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).

If a state has a statute that would disallow an exemption on fraudulent transfer grounds, that law may be used in bankruptcy. Many states have such statutes, particularly for personal property. For example, Texas offers broad statutory exemptions for various sorts of personal property, TEX. PROP. CODE § 42.002, 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 personalty may be
attacked if the debtor acted with actual intent to hinder, delay, or defraud creditors. \textit{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. \textit{Coates}, 242 B.R. at 901; \textit{see Swift}, 124 B.R. at 475. Similarly, premiums paid in fraud of creditors to acquire an exempt insurance vehicle may be recovered. \textit{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, \textit{Asset Protection Techniques}, C992 ALI-ABA 1 (1995).

One may find 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. \textit{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. \textit{Hill}, 790 So. 2d at 1018. These statutes may be used in bankruptcy to undermine claimed exemptions of personal property on fraudulent transfer grounds. \textit{In re Levine}, 134 F.3d 1046 (11th Cir. 1998) (debtor’s purchase of exempt annuities with nonexempt funds could be set aside as a fraudulent transfer). Examples of the same sort may be found in other jurisdictions. \textit{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); \textit{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 creditors); \textit{In re
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 new Article 9, the real estate foreclosure laws of most states contain no mandate that a mortgage 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) (noting 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

Regularly conducted real estate foreclosures have long produced less than the fair market value of the property, yet no one ever seriously thought of foreclosure sales as constructively fraudulent. See Eric S. Palace, Note, 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). It came as something of a surprise, therefore, when the Fifth Circuit in Durrett v. Washington Nat’l Ins. Co., 621 F.2d 201 (5th Cir. 1980) 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 Equivalent Value*, 22 CAL. BANKR. J. 197 (1994); Palace, Note, *In re BFP: Just a Band-Aid?*, 15 ANN. REV. BANKING L. at 359.

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

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 overturn 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. *See 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-
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.),

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. *BFP*, 511 U.S. at 531; see Timothy J. Boyce, *The Supreme Court and the Death of Durrett*, 23 REAL EST. L.J. 205 (1995).

Moreover, the *BFP* Court was concerned with comity and federalism. Real estate foreclosure law and fraudulent transfer law had coexisted for centuries. Until *Durrett*, it would scarcely have occurred to anyone to think of a regularly conducted, noncollusive foreclosure sale as a constructively fraudulent transfer. To follow *Durrett* or *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. *BFP*, 511 U.S. at 531; 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); Eric S. Palace, Note, *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, rev’d in part on other grounds, 192 F.3d 88 (3d Cir. 1999); Vicki S. Porter, *BFP v. RTC: Limiting the Use of § 548 to Set Aside Foreclosure Sales*, 23 COLO. LAW. 2311 (1994).

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 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. 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-

Likewise, several 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

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. **Several Courts Hesitate to Apply *BFP* When There Was No Opportunity for Competitive Bidding.**

Although most 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).

Most courts, for example, have upheld tax foreclosure sales when there is an opportunity for bidding and a public sale. E.g., Grandote Country Club, 252 F.3d at 1146; 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. 283 (Bankr. M.D.N.C. 1995). In In re Sherman, 223 B.R. 555 (10th Cir. B.A.P. 1998), however, the court addressed a Wyoming tax foreclosure sale. Under Wyoming 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.

Likewise, although most 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. Conceivably, the court might have reached the same conclusion under a state law equitable shock-the-conscience test rather than by refusing to apply the presumption of reasonably equivalent value and holding the transfer constructively fraudulent.

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).

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 set 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.

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 applies 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 the property 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, courts regularly 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). Following the decision in *BFP*, 511 U.S. at 531, however, 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 was no more avoidable as a preference than as a constructively fraudulent transfer. *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). These decisions are 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 much 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).

At least one court appears to have adopted a per se rule that, just as the price received at a properly conducted foreclosure 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. *See In re Cottrell*, 213 B.R. 33 (M.D. Ala. 1997). Although this approach recognizes the difference between preferences and fraudulent transfers, there
seems to be scant justification for saying that, as a matter of law, a prepetition foreclosure can never be a preference.

Perhaps the best analysis was given in Rambo, 297 B.R. at 418, where an oversecured mortgagee had foreclosed prepetition. The mortgagee had received more than the amount of its debt, but it did not follow that the mortgagee had received more than it would have gotten in a hypothetical subsequent liquidation. 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. 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, and thus the foreclosure could not be avoided as a preference. See also Andrews, 262 B.R. at 299.

The analysis in Rambo, 297 B.R. at 148, appears just and accurate. The holding in BFP, 511 U.S. at 531, is not controlling as to whether a regularly conducted prepetition foreclosure may be set aside as a preference rather than as a constructively fraudulent transfer, and it is difficult to justify a per se rule that such a transaction may never be avoided on preference grounds. At the same time, however, cases where preference avoidance would be possible are
few and far between. The fact that the creditor may have received more than the amount of the
debt does not, without more, mean that 11 U.S.C. § 547(b)(5) has been satisfied.

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
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

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

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 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). In 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 pursuant 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.


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

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 estate. *In re Young*, 82 F.3d 1407 (8th Cir. 1996), *vacated & remanded*, 521 U.S. 1114 (1997), *opinion reinstated on remand*, 141 F.3d 854 (8th Cir.), *cert. denied*, 525 U.S. 811 (1998).

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 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 RFRAs”
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. Op. 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

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

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). It 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). 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).

The Religious Liberty and Charitable Donation Protection Act deals only with bankruptcy matters and appears to be solidly grounded on the Bankruptcy Clause. The 1998 legislation, unlike RFRA, could be seen as a narrowly focused effort to deal with specific problems in accommodating religious belief and practice. Unlike RFRA, it applies only to federal bankruptcy proceedings, and it applies evenhandedly to religious and secular charitable donations. Even if RFRA were ultimately held to be completely unconstitutional, the new law could stand. Although cases may arise where prepetition donations are attacked as actually fraudulent, or where a corporation’s or a charitable organization’s prepetition contributions are set aside as constructively fraudulent, the controversy over pursuing prepetition tithes as constructively fraudulent transfers would now appear to be largely settled.

It should be added that, although many courts have interpreted the Religious Liberty and Charitable Donation Act broadly, some courts have declined to extend the statute beyond the specific areas that Congress addressed: avoiding prepetition donations as constructively

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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 if such loans were made or guaranteed by the government or by a nonprofit institution. 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. At least two courts have disagreed. Not only did Congress make no changes in 11 U.S.C. § 523(a)(8) when it enacted the Religious Liberty and Charitable Donation Protection Act, but discharging a debt otherwise covered by that statute would place the burden of the debtor’s donations on the government and/or nonprofit institutions, not on ordinary creditors. In re McLeroy, 250 B.R. 872 (N.D. Tex. 2000); In re Ritchie, 254 B.R. 913 (Bankr. D. Idaho 2000); see also In re Innes, 284 B.R. 496 (D. Kan. 2002) (suggesting that the Religious Liberty and Charitable Donation Protection Act has no application to Section 523(a)(8) but finding it unnecessary to reach a definitive holding when the amount of the donations in question was minimal). Other courts, however, have decided that reasonable donations acceptable under a Chapter 13 plan may be taken into account in determining whether the debtor is entitled to an undue hardship discharge under Section 523(a)(8). In re Meling, 263 B.R. 275 (Bankr. N.D. Iowa 2001) (rejecting McLeroy and Ritchie and holding that the debtor’s donations to her church would be considered a reasonable and necessary expense that could be taken into account in determining whether debtor was entitled to an undue hardship discharge); accord In re McLaney, 314 B.R. 228 (Bankr. M.D. Ala. 2004); In re Durrani, 311 B.R. 496 (Bankr. N.D. Ill. 2004); see Savage, 311 B.R. at 835 (noting the split of authority but finding it unnecessary to resolve it). In addition, at least one court has held that making substantial
religious donations while the debtor has considerable tax liabilities may lead to a denial of a discharge under 11 U.S.C. § 523(a)(1)(C) for attempting to evade or defeat a tax. In re Lynch, 299 B.R. 62 (Bankr. S.D.N.Y. 2003).

IV.

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


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 three subsections that limit the avoidance 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 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, 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. 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). 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 transactions), 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 transactions), or § 761(15) (margin payments in commodities transactions). These definitional statutes are singularly unhelpful. See Brad Gelder, Bankruptcy Code: Trustee Recovery Actions, Voidable Claims Considered, 3 No. 19 LAWYERS J. 5 (Sept. 21, 2001). The statutory definitions have been described as “opaque,” “circular,” “cryptic,” and “unilluminating.” Zahn v. Yucaipa Capital Fund, 218 B.R. 656 (D.R.I. 1998); In re Financial Management Sciences, Inc., 261 B.R. 150 (Bankr. W.D. Pa. 2001); In re Healthco Intern., Inc., 195 B.R. 971 (Bankr. D. Mass. 1996). Congress apparently wanted courts to look to how the terms “margin payment” and “settlement payment” are used in the relevant industries and then to adopt the appropriate trade usage. A comprehensive statutory definitional scheme was not attempted. In re Adler, Coleman Clearing Corp., 263 B.R. 406 (S.D.N.Y. 2001); In re Grand

Not surprisingly, 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 Hamilton 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 Management 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 made to reduce a margin account. It need not be made in response to a margin call. In re David, 193 B.R. 935 (Bankr. C.D. Cal. 1996); In re Blanton, 105 B.R. 321 (Bankr. E.D. Va. 1989).

Although the definitions of the relevant types of payments are broad and flexible, they are not boundless. A purely sham transaction in which no consideration was actually exchanged, for example, could not be considered a payment, and hence it could not be a settlement payment or a margin payment. Adler, Coleman, 263 B.R. at 406; see In re Adler, Coleman Clearing Corp., 218 B.R. 689 (Bankr. S.D.N.Y. 1998). 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) did not apply. *In re Integra Realty Resources, Inc.*, 198 B.R. 352 (Bankr. D. Colo. 1996). Likewise, it has been held that money paid for an option to purchase stock that might or might not be issued in the future could not be deemed a settlement payment, and hence that the stockbroker defense could not be used. *Kaiser Merger Litig.*, 168 B.R. at 991. Similarly, payments to the holders of a debtor’s commercial paper are simply payments to creditors, not settlement or margin payments within the scope of 11 U.S.C. § 546(e). *In re Republic Fin. Corp.*, 75 B.R. 840 (Bankr. N.D. Okla. 1987). So also it is at least doubtful whether an extracontractual setoff or pure 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). A major component of the rationale for these decisions holding that there was no settlement payment or margin payment is that avoiding the transactions in question as constructively fraudulent and/or preferential transfers would not upset the system of intermediaries and guaranties in the securities and commodities industries that Congress meant to protect. See *Kaiser Merger Litig.*, 168 B.R. at 991; *Integra Realty Resources*, 198 B.R. at 352; *Republic Fin.*, 75 B.R. at 840.

3. **The Payment Must Have Been Made by or to One of the Enumerated 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)); or a securities clearing agency (defined in 11 U.S.C. § 101(48)). Controversies under 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. Obviously, if neither the payor nor the payee was a commodity broker, a forward contract merchant, a stockbroker, a financial institution, or a securities clearing agency, 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). *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. *In re International Gold Bullion Exch.*, 53 B.R. 660 (Bankr. S.D. Fla. 1985); see also *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. In re Hechinger Inv. Co. of Delaware, 274 B.R. 71 (D. Del. 2002) (giving a thorough discussion of the conflicting decisions); see 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, Bankruptcy Code: Trustee Recovery Actions, Voidable Claims Considered, 3 No. 19 LAWYERS J. 5 (Sept. 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 transactions. Jewel Recovery, Inc. v. Gordon, 196 B.R. 348 (N.D. Tex. 1996); accord In re Adler, Coleman Clearing Corp., 263 B.R. 406 (S.D.N.Y. 2001).

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 Management 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).

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.

If the requirements of 11 U.S.C. § 546(e) are otherwise satisfied, the statute provides a good defense to avoidance under state law or under the preference or constructively fraudulent transfer provisions of the Bankruptcy Code. In re Adler, Coleman Clearing Corp., 247 B.R. 51 (Bankr. S.D.N.Y. 1999), aff’d, 263 B.R. 406 (S.D.N.Y. 2001). By its plain terms, however, the
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 is beyond the scope of this paper, but several of them 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).

In the same vein, 11 U.S.C. § 555 protects the right of a stockbroker, financial institution, or securities clearing agency to cause the liquidation of a securities contract, while 11 U.S.C. § 556 provides similar protection for the right of a commodity broker or forward contract merchant to cause the liquidation of a commodity contract or forward contract. 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, 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).


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 dealer 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). 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 enacted 11 U.S.C. § 546(f) in 1984, two years after Section 546(e). Section 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, 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 in connection with a repurchase agreement. A “repo participant” is defined as any entity that has an outstanding repurchase agreement (including a reverse repurchase agreement) with the debtor within 90 days of the petition date. 11 U.S.C. § 101(46). It follows that 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).
Other statutes likewise offer protection for repo transactions. 11 U.S.C. § 548(d)(2)(C) provides that a repo 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 shield such a payment from avoidance as a constructively fraudulent transfer. It would also help to establish a good faith transferee for value defense under 11 U.S.C. § 548(c). 11 U.S.C. § 559 allows a repo participant to cause the liquidation of a repurchase agreement with the debtor notwithstanding the debtor’s bankruptcy. 11 U.S.C. § 362(b)(7) exempts from the automatic stay any right by a repo participant to set off any mutual debt against the debtor if the claim is for a margin payment or settlement payment in connection with a repurchase agreement.


The third current 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) 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, in connection with a swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

“Swap participant” is defined in 11 U.S.C. § 101(53C) as any entity that has an outstanding swap agreement with the debtor. The definition of “swap agreement” in 11 U.S.C. § 101(53B) is not very helpful. 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.

11 U.S.C. § 546(g) has seldom been employed or discussed in reported opinions. In In re Interbulk, Ltd., 240 B.R. 195 (Bankr. S.D.N.Y. 1999), however, Judge Tina Brozman gave an excellent analysis of the statute. Judge Brozman determined that forward freight agreements between the debtor and a creditor were indeed swap agreements. The contracts 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.” 11 U.S.C. § 546(g), however, also requires that the transfer must have been made “under a swap agreement.” A plain and natural reading of this phrase is 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). Legislation under consideration in the 108th Congress would have changed the outcome in Interbulk. Section 907 of H.R. 975 would have amended Section 546(g) so that the statute would protect 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” would be alternative criteria, and the Interbulk creditor would have prevailed.

Other statutes also protect swap transactions. 11 U.S.C. § 548(d)(2)(D) provides that a swap participant who receives a transfer 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 to cause the termination of a swap agreement notwithstanding the debtor’s bankruptcy, while 11 U.S.C. § 362(b)(17) exempts a swap participant’s right of setoff under or in connection with a swap agreement from the operation of the automatic stay. See Enron, 310 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).

D. PROPOSED PROTECTION FOR MASTER NETTING AGREEMENTS.

Showing the same concern for protecting certain market transactions that undergirds 11 U.S.C. §§ 546(e), 546(f), and 546(g), Congress has considered adding a new subsection to Section 546 that would shield from avoidance transfers made under master netting agreements. A full discussion of this and related legislative proposals is beyond the scope of this paper, but the matter does deserve mention.

Section 907 of H.R. 975 in the 108th Congress would have created a new statute to be codified as 11 U.S.C. § 546(j). Modeled on 11 U.S.C. §§ 546(e), 546(f), and 546(g), the enactment would have provided:

> 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.

A new 11 U.S.C. § 101(38A) would have offered a relatively straightforward definition of “master netting agreement,” while a new 11 U.S.C. § 101(38B) would have defined “master netting agreement participant” as any entity that is a party to a master netting agreement with the debtor at any time before the filing of the petition.

Section 907 of the bill also would have created a new 11 U.S.C. § 561, which would be analogous to 11 U.S.C. §§ 555, 556, 559, and 560. The new Section 561, with certain exceptions, would have preserved contractual rights to terminate, liquidate, accelerate, or offset under a master netting agreement and across contracts notwithstanding the debtor’s bankruptcy. Similarly, a new provision in the automatic stay statute, which would have been codified as 11 U.S.C. § 362(b)(27), would have exempted a right of setoff under a master netting agreement from the operation of the automatic stay. Finally, H.R. 975 would have added a new 11 U.S.C. § 548(d)(2)(E), which would have been analogous to 11 U.S.C. §§ 548(d)(2)(B), 548(d)(2)(C), and 548(d)(2)(D). Section 548(d)(2)(E) would have provided that a master netting agreement participant who receives a transfer in connection with a master netting agreement, and, in most
cases, under an individual contract covered by a master netting agreement, would be deemed to take for value to the extent of the transfer. This would assist in establishing the good faith transferee for value defense under 11 U.S.C. § 548(c).