5. RECOVERY AND COLLECTION OF ASSETS

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BASICS OF BANKRUPTCY PRACTICE

VOIDABLE PREFERENTIAL TRANSFERS

by

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Preferential Transfers

1. Introduction

   a. Basic Underlying Policy

   Certain payments made before the commencement of a bankruptcy case under Title 11 of the United States Bankruptcy Code (the "Bankruptcy Code")1 are avoidable, i.e., may be recovered for the bankruptcy estate. Avoidance powers were created to promote fairness and prevent distressed business entities from paying certain "friendly" creditors at the expense of others.

   b. Purpose

      (i) Discourage creditors from racing to the courthouse, thereby driving a debtor into bankruptcy. See In re Jones Truck Lines, Inc., 130 F.3d 323 (8th Cir. 1997).

      (ii) Facilitate the policy of equality of distribution to similarly situated creditors. See U.S. v. Webster, 125 F.3d 1028 (7th Cir. 1997).

      (iii) Prevent the debtor from paying certain select creditors, such as affiliates and related entities, while ignoring others who are similarly situated, but who may be disfavored. In re Boston Pub. Co., Inc., 209 B.R. 157 (Bankr. D. Mass. 1997) (preference avoidance rule exists (a) to create a disincentive for creditors to pressure a financially distressed entity to make payments to some and not to other creditors, and (b) to promote a ratable distribution among similarly situated creditors.

2. Working Definition

   a. A preference is a pre-petition transfer made to one creditor by an insolvent debtor to the exclusion or detriment of its other creditors. The technical definition of a preference is set forth in Bankruptcy Code Section 547, There are, as more fully described below, various specific elements to prove and defenses to overcome as a matter of law before a court will void a transfer as preferential.

3. Who Can Bring Suit -- Standing And Capacity To Sue

   a. A trustee pursuant to Bankruptcy Code Sections 704, 547 and 1104.

   b. A debtor-in-possession in a Chapter 11 case pursuant to Bankruptcy Code §1107(a).

   c. A Chapter 13 debtor does not have authority to avoid preferences under Bankruptcy Code § 547, only the trustee does. In re Hill 152 B.R. 204 (Bankr.

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1 All references to the Bankruptcy Code are citations to 11 U.S.C. § 101 et .q, (1978, as amended), unless otherwise noted.

S.D. Ohio 1993). Chapter 13 debtors enjoy only those powers pertaining to the use, sale and lease of property and not all of the powers granted to a Chapter 11 debtor. United States v. Sierer, 139 B.R. 752, 755 (N.D. Fla. 1991). C.F. Toronto 165 B.R. 746 (Bankr. D.Conn. 1994).

d. Parties Other Than the Trustee or Debtor

(i) In 2002, a three judge appellate panel triggered nationwide consternation by virtue of its decision in the CyberGenics case. Official Committee of Unsecured Creditors of CyberGenics Corp. v. Chinery (In re Cybergenics Corp.), 304 F.3d 316 (3d Cir. 2002). In this decision, the Third Circuit held that a creditors' committee does not have the authority to act for a debtor to commence an action under the avoidance power sections of the Bankruptcy Code. Id. The opinion was vacated by Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.), 310 F.3d 785 (3d Cir. 2002). After a rehearing en banc, the Court reversed and held that §§ 1109(b), 1103(c)(5) and 503(b)(3)(b) evidence Congressional approval for the prosecution of derivative avoidance actions by a creditors' committee in an appropriate case. Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.), 330 F.3d 548, 41 Bankr.Ct. Dec. 98, Bankr. L. Rep. P. 78, 861 (3d Cir.), cert. dismissed, 124 S.Ct. 530, 157 L.Ed.2d 406, 72 USLW 3155, 72 USLW 3328, cert. dismissed, 124 S.Ct. 530, 157 L.Ed.2d 407, 72 USLW 3155, 72 USLW 3328 (2003); cf. In re Fox, 305 B.R. 912 (10th Cir. B.A.P.).

(ii) In Housecraft Indus. a post-CyberGenics case, the Second Circuit held that a secured creditor, acting as co-plaintiff with the trustee, has standing to bring an avoidance action, unless the secured creditor's interest conflicts with those of the estate. Tare Housecraft Indus. U.S.A., Inc., 310 F.3d 64, 72 (2d Cir. 2002).

(iii) Several Second Circuit opinions substantially follow the Housecraft Indus. approach. A creditors' committee in a Chapter 11 case may only act in of the debtor (1) on consent of the debtor, or (2) when the debtor has failed to act. If suit is based on the consent of the debtor or trustee, the court must also find that the suit would be necessary and beneficial to the resolution of the bankruptcy proceeding. In re Commodore Int'l, Ltd., 262 F. 3d 96 (2d Cir., 2001). Additionally, a creditors' committee may intervene as of right in an action to recover a voidable transfer brought by the debtor, and may fully participate in all aspects of the litigation, subject to the court's oversight. In re Adeiphia Comm. Corp., 285 B.R. 848 (Bankr. S.D.N.Y. 2002) citing Term Loan Holder Committee v. Ozer Group, L.L.C., (In re Caldor Corp, 303 F.3d 161 (2d Cir. 2002).

(iv) Other decisions before CyberGenics focused on the ability of non-trustees and non-debtors to pursue a debtor's litigation claims and allowed parties

to proceed in lieu of the trustee/debtor. In Southern Commodity a liquidating committee, created pursuant to a confirmed plan of reorganization, was permitted to sue. See In re Southern Commodity Corp. 78 B.R. 626 (Bankr. S.D. Fla. 1987); See In re Consolidated Capital Equities Corp., 143 B.R. 80 (Bankr. N.D. Tex. 1992). A representative of an estate appointed pursuant to a confirmed plan of reorganization, pursuant to 11 U.S.C. § 1 123(b)(3)(B), was permitted to sue. In re Sweetwater, 884 F.2d 1323 (10th Cir. 1989); In re Professional Inv. Properties of America, 955 F.2d 623, 626 (9th Cir. 1992), cert. denied 113 S.Ct. 63 (1992); In re Texas General Petroleum Corp. 52 F.3d 1330, 1335 (5th Cir. 1995); In re Hunt, 136 B.R. 437 (Bankr. N.D. Tex. 1991); In re APF Co., 264 B.R. 344 (Bankr. D. Del. 2001); In re Maxwell Newspapers, Inc., 189 B.R. 282, 287 (Bankr. S.D.N.Y. 1995) (creditors of Chapter 11 debtor were assigned avoidance claims as part of a confirmed plan); In re Mako, Inc., 985 F.2d 1052, 1054 (10th Cir. 1993) ("Under § 1123(b)(3)(B), a party who is neither the debtor nor the trustee, but who seeks to enforce a claim, must establish two elements: (1) that it has been appointed; and (2) that it is a representative of the estate.").

e. An examiner appointed pursuant to Bankruptcy Code § 1104. In re Franklin-Lee Homes, Inc., 102 B.R. 477 (E.D.N.C. 1989).

f. A successor to the debtor by merger. In re Amarex, 96 B.R. 330 (W.D. Okla. 1989).

g. A liquidating trustee appointed pursuant to a confirmed Chapter 11 Plan. In re Bankrest Capital Corp. 375 F.3d 51 (1st Cir. 2004).

Practice Pointer: Retention of jurisdiction to prosecute such claims should be expressly reserved in any plan of in any plan of reorganizations providing for a liquidating trustee to prosecute such claims. Appropriate disclosure also must me made before confirmation.

h. An individual creditor does not have standing. In re SRJ Enter., Inc., 151 B.R. 198 (Bankr. N.D. Ill. 1993); In re Prime Motor Inns, Inc., 135 B.R. 917 (Bankr. S.D. Fla. 1992). But see Canadian Pacific Forest Prod. Ltd. v. J.D. Irving Ltd. (In re Gibson Group, Inc.) 66 F.3d 1436 (6th Cir. 1995) (bankruptcy court erred in dismissing a creditor's prosecution under § 547 and 548 because the debtor and the committee had refused to act and the claim was colorable); Chemical Bank v. Pilevsky, 1994 WL 714287 (S.D.N.Y. 1994) (declaring "an appealable issue" the bankruptcy court's denial of a single creditor's request to pursue a preference action). Unless and until the Unsecured Creditors Committee actually and completely abandons claims, individual creditors lack standing under 11 U.S.C. § 302 (a)(1) to bring their very own fraudulent conveyance actions. In re Tribune Fraudulent Conveyance Litigation, 2013 WL 5311439 (Multidistrict Litigation USDC, SDNY 2013).

i. General partner of a Chapter 11 debtor could not avoid mortgage granted by partnership against partnership assets, since there had not been a transfer of the

general partner's assets, as the mortgage transferred only partnership assets. In re Cardinal Indus., Inc., 142 B.R. 807 (Bankr. S.D. Ohio 1992).

j. A Trustee cannot sustain an action to recover a preferential transfer where the benefit of such action is essential for the benefit of the trustee's counsel. In re Lutz, 212 B.R. 846 (Bankr. E.D. Mich. 1997).

4. How To Bring A Preference Action

Avoidance of transfer must be brought by an adversary proceeding (governed by part VII of the Federal Rules of Bankruptcy Procedure). In re Commercial Western Finance Corp., 761 F.2d 1329 (9th Cir. 1985)(a transfer avoidance cannot occur simply by confirmation of a plan providing for avoidance.)

5. Venue

a. The district court has original but not exclusive jurisdiction of all civil proceedings arising under Title 11, or arising in or related to cases under title 11. 28 U.S.C. § 1334(b).

b. Each district court is permitted to refer cases under title 11 and proceedings arising under title 11 or arising in or related to a case under title 11 to bankruptcy judges for its district. 28 U.S.C. § 157(a).

c. Bankruptcy judges are authorized to hear and determine all core proceedings arising under title 11 or arising in a case under title 11. 28 U.S.C. § 157(b)(l).

d. All proceedings "to determine, avoid or recover preferences" are core proceedings. 28 U.S.C. § 157(b)(2)(F).

e. Venue generally is properly placed in the district where the case is pending. 28 U.S.C. § 1409(a).

f. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") amended Section 1409(b) to require trustees seeking to avoid a preferential transfer of less than $10,000 to bring the action in the district in which the defendant resides. The practical effect of this amendment is to make it more difficult and expensive for the estate to recover transfers of under $10,000, "in a case filed by a debtor whose debts are not primarily consumer debts."

g. Under BAPCPA, a trustee may not recover transfers when the aggregate sought/transferred is less than $5,000.00.

6. Burden of Proof

a. The trustee must meet the burden of proof on the issue of insolvency as well as on the other elements of preference. Bankruptcy Code § 547(g). See In re Roblin Indus., Inc., 78 F.3d 30, 34 (2d Cir. 1996)(a decision describing the process by which a creditor rebutted the assumption of insolvency under § 547(f) (but insolvency was nevertheless found because the trustee subsequently produced sufficient evidence to overcome the burden of proof.)

b. The creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the defenses set forth in Bankruptcy Code § 547(c) that are more fully described below. Bankruptcy Code § 547(g); In re Grove Peacock Plaza, Ltd., 142 B.R. 506 (Bankr. S.D. Fla. 1992). (See "Defenses to Transfer Avoidance", infra, concerning affirmative defenses.)

7. Time Limitations For Avoiding Preferences

a. Statutory Limit

Section 546(a) provides:

An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of –

1. the later of -

(A) two years after the entry of the order for relief; or

(B) one year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or

2. the time the case is closed or dismissed. Id.

b. Tolling the Statute

(i) Bankruptcy Code § 546(a)'s statute of limitations is subject to equitable tolling, where relevant facts have been concealed from a trustee who has made diligent and reasonable inquiry under the circumstances. In re McGoldrick, 117 B.R. 554 (Bankr. C.D. Cal. 1990).

(ii) The fraudulent concealment doctrine has been applied to extend the time limit imposed by Bankruptcy Code § 546(a). In re Ahead By A Length Inc., 100 B.R. 157, 163, 164 (Bankr. S.D.N.Y. 1989). Under this doctrine "the plaintiff must establish (1) that the defendant concealed the existence of the claim, (2) he was unaware of the claim until some point within the applicable limitations period, and (3) that his continuing ignorance was not attributable to lack of [reasonable] diligence on his part." 100 B.R. at 163-164 (citing State of New York v. Hendrickson Brothers, Inc., 840 F.2d 1065, 1084-85 (2d Cir. 1988), cert. denied 488 U.S. 848 (1988) and Armstrong v. McAlpin, 699 F.2d 79, 88 (2d Cir. 1983)). See also Bailey v. Glover, 88 U.S. 342, 349 (1874).

8. Elements To Be Proven

a. Bankruptcy Code § 547(b) sets forth the seven elements of a preference:

(i) a transfer;

(ii) of an interest of the debtor in property;

(iii) to or for the benefit of a creditor;

(iv) for or on account of an antecedent debt;

(v) made while the debtor was insolvent;

(vi) on or within 90 days before the date of the filing of the petition (or within one year if the creditor was an insider); and

(vii) enabling the creditor to receive more than it would receive in a Chapter 7 case if the transfer ("(i)" above) had not been made.

b. Transfer

(i) BAPCPA redefines of "transfer". 11 U.S.C. § 101 (54) now provides:

(54)The term "transfer means --

(A) the creation of a lien;

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

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

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

(1) property; or

(2) an interest in property.

(ii) Under pre-BAPCPA law, the definition of transfer was:

> every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption. Bankruptcy Code § 101(54). BAPCPA does not appear to substantively change prior law.

(iii) The entry of judgment is a transfer. Nelson Co. v. Counsel For the Official Committee of Unsecured Creditors (In re Nelson Co.) 959 F.2d 1260 (3d Cir. 1992).

(iv) The date of a transfer requiring perfection of an interest in property relates back to the date of the transfer, if perfection is completed within 30 days (10 days for cases commenced before October 17, 2005, the effective date of BAPCPA) of the transfer. Bankruptcy Code § 547(e)(2)(A).

Practice Pointer: Even if perfection does not occur within 30 days (or 10 days for pre-BAPCPA cases), the transfer may still be immune from avoidance if otherwise covered by the preference defense of § 547(c)(3) concerning purchase money security interests.

(A) A transfer is perfected in real property when "a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee." Bankruptcy Code § 547(e)(1)(A).

(B) A transfer is perfected in fixtures or personal property when a competing "creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." Bankruptcy Code § 547(e)(1)(B).

(v) In any case, a transfer is not made until the debtor has acquired rights in the property transferred. Bankruptcy Code § 547(e)(3).

c. Interest of the Debtor in Property

(i) Bankruptcy Code definition of "property of the estate" in § 541, determines the limit of property that may be recovered as a preference. In re Regency Holdings, (Cayman) Inc. 216 B.R. 371 (Bankr. S.D.N.Y. 1988).

(ii) Transfer of steel to a reclaiming materialman was not preferential, as the debtor did not acquire an interest in the steel superior to the contractor and the steel was not property of the estate. In re TriCity Turf Club Inc., 323 F.3d 439 (6th Cir.2003).

(iii) A payment of withheld federal income taxes, trust fund taxes and excise taxes collected by a debtor from its customers were not transfers of "property of the debtor," but were transfers of trust property. Begier v IRS, 496 U.S. 53 (1990).

(iv) No "transfer of the property of the debtor" occurs, for § 547 purposes, when a third party pays the debtor's creditors directly. In re Corporate Food Mgt. Inc., 223 BR. 635 (Bankr. E.D.N.Y. 1998). Funds provided to a debtor for paying a specific indebtedness may in certain circumstances not be recoverable. Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351 (5th Cir. 1986), reh'g denied 801 F.2d 398 (5th Cir. 1986). Thus, under the "earmarking" doctrine, a transfer to a creditor is not a preference where the transfer results from another creditor lending the

debtor money " the specific purpose of paying [a] selected creditor." In re Kemp Pacific Fisheries, Inc., 16 F.3d 313, 316 (9th Cir. 1994) (citation omitted) (emphasis in original). One creditor is simply substituted for another as a result of such transfer.

(iii) Where money was loaned to debtor by an uncle to "cover" kited checks, the earmarking doctrine was applied, and the transfers to the lender via the checks honored as a result of the "earmarked" loans were not avoided. In re Brown, 209 B.R. 874 (Bankr. W.D. Tenn. 1997). Compare In re Flanagan, 293 B.R. 102 (Bankr. D. Conn. 2003) (earmarking defense defeated where father who lent money to pay son's debts took a security interest).

(iv) The property interest transferred must belong to the debtor. In re Unicorn Computer Corp., 13 F.3d 321 (9th Cir. 1994) (money erroneously given to the debtor and returned pre-petition did not constitute a voidable preference); Brown v. First National Bank of Little Rock. Ark., 748 F.2d 490 (8th Cir. l984)(no preference occurs when comaker pays note); In re Kleckner, 93 B.R. 143 (N.D. Ill. 1988) (fee retained by debtor's attorney in connection with a state court suit was never property of the debtor, so was not a voidable transfer); Begier v. Internal Revenue Service, 496 US
53 (1990) (payments of trust-fund taxes to the IRS not voidable preferences); Parker v. Klochko Equipment Rental Co., 590 F.2d 649 (6th Cir. 1979) (no preference for payment to materialmen from a statutory trust fund); In re Newcomb, 744 F.2d 621 (8th Cir. 1984)(no preference for payment from escrow funds); In re Clothes, Inc., 35 B.R. 487 (Bankr. D.N.D. 1983) (no preference when funds are drawn on a letter of credit); Coral Petroleum, Inc. v. Bangue Paribas-London, 797 F.2d 1351 (5th Cir. 1986) (no transfer of the debtor's property when a third party advances funds earmarked to pay the claim of a creditor). But see In re Interior Wood Products Co., 986 F.2d 228 (8th Cir. 1993) (earmarking doctrine applies only when a new creditor is substituted for an old creditor); In re Sierra Steel, Inc., 96 BR 271 (9th Cir. BAP 1989) (earmarking doctrine requires funds paid to the creditor to be traceable from the funds advanced by the third party); In re Hartley, 825 F.2d 1067 (6th Cir. 1987) (payment to creditor by third party was a preference to the extent of the value of collateral given to the third party by the debtor); In re Funding Systems Asset Management Corp., 111 B.R. 500 (W.D. Pa. 1990) (earmarking doctrine applies only if money is from a new loan).2

(v) Even when transferred funds have been identified as debtor property, some courts have established a further requirement that, in order to be a preference, a transfer must result in the diminution of the debtor's estate.

2 Case citations set forth here are based on summary in Resnick, Alan N., "Trustee' Avoiding Powers," in course material for NYU School of Law Workshop on Bankruptcy and Business Reorganizaton.

In re Smith, 966 F.2d 1527, 1535-1537 (7th Cir. 1992), cert. dismissed 113 S.Ct. 683 (1992). See also In re Westchester Tank Fabricators, Ltd., 207 B.R. 391, 397 (Bankr. E.D.N.Y. 1997)(avoidance of a post-petition transfer pursuant to § 549(a) requires a determination "there was a transfer of property which could have been part of the estate available for distribution to all creditors.") (citation omitted).

(vi) Transfer by the debtor of funds obtained from a subsequent investor in a Ponzi scheme held to be a transfer involving "interest of a debtor" in property. In re Ogden, 314 F.3d 1190 (10th Cir. 2002)

d. To or for the Benefit of a Creditor

(i) In most instances, a creditor means an entity holding a claim against a debtor that arose at the time of or before the entry of the order for relief in a debtor's case. Bankruptcy Code § 101(10).

(ii) Claim means

(A) right to payment, whether or not such right is reduced to judgment. liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured. Bankruptcy Code § 101(5).

(C) The Supreme Court has stated " used in § 101(5), 'right to payment' and 'right to an equitable remedy' mean 'nothing more or less than an enforceable obligation." Johnson v. Home State Bank, 501 U.S. 78 (1991) (quoting Pennsylvania Dep't of Public Welfare v. Davenport, 495 U.S. 552, 588 (1990)).

(iii) A transfer may be preferential as to a creditor without it being made the creditor, since a creditor may benefit from an indirect transfer. In re T.B. Westex Foods, Inc., 950 F.2d 1187 (5th Cir. 1992), on remand 1992 WL 114944 (W.D. Tex. 1992).

(A) A debtor's sister was a "creditor of the debtor" for preference purposes based on debtor's guarantee of debtor's husband's obligation to the sister. The sister's right to payment, even if contingent, constituted a "claim", and therefore the sister was a pre-petition creditor of the debtor. In re Rundlett, 149 B.R. 353 (Bankr. S.D.N.Y. 1993).

(B) A judgment lien perfected against a Chapter 7 debtor's real

property more than 90 days but less than one year pre-petition was avoidable, since the lien benefitted debtor's insiders who were jointly and severally liable on an underlying fraud, securities fraud and breach of contract judgment. The insiders, but for the lien, would be required to satisfy the judgment themselves and would have contribution claims against the debtor. Thus, the Court concluded, the lien benefitted these insiders as creditors. In re Sevitski, 151 B.R. 590 (Bankr. N.D. OkIa. 1993).

e. For or on Account of an Antecedent Debt

(i) An antecedent debt is incurred prior to the relevant transfer. In re Southmark Corp., 62 F.3d 104, 106 (5th Cir. 1995); In re Durant's Rental Center, Inc. 116 B.R. 362, 366 (Bankr. D. Conn. 1990); In re Cavalier Homes of Georgia, Inc., 102 B.R. 878, 885-86 (Bankr. M.D. Ga. 1989); ., 54 B.R. 470, 476 (Bankr. D. Nev. 1985).

(ii) The debtor becomes indebted for a rental payment at the time the rent is due. Durant's, supra; In re White River Corp. 799 F.2d 631, 632-33 (10th Cir. 1986); In re Coco, 67 B.R. 365, 370 (Bankr. S.D.N.Y. 1986) ("Lease payment obligations arise when they become due and payable because of the lessee's possession, not when the lease is signed.").

(iii) However, installment loan payments are not considered new debt each time a payment comes due - instead, debt is deemed to have been incurred at original loan. Consequently, payments on the loan during the preference period are subject to attack. Barash v. Public Fin. Corp., 658 F.2d 504 (7th Cir. 1981); In re Anders, 20 B.R. 468 (Bankr. N.D. Fla. 1982).

(iv) Seller returns purchaser's down payment because seller cannot perform on the contract. Subsequently, seller files for bankruptcy. Held the payment return was a preference because an "antecedent debt" accrued when the down payment was received. In re Cybermech, Inc., 13 F.3d 818, 822 (4th Cir. 1994).

(v) For purposes of determining antecedent character of a debt, for severance, it has been held that the debt arose not when debtor entered into an employment contract, but rather, when the employee was terminated. In re G. Survivor Corp., 217 B.R. 433 (Bankr. S.D.N.Y. 1998).

f. Made While the Debtor Was Insolvent

(i) The debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition. Bankruptcy Code § 547(f).

(ii) Insolvent means -

(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of

(1) property, transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and

(2) property that may be exempted from property of the estate under section 522 of this title;

(B) with reference to a partnership, financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation -

(1) all of such partnership's property, exclusive of property of the kind specified in subparagraph (A)(i) of this paragraph; and

(2) the sum of the excess of the value of each general partner's nonpartnership property, exclusive of property of the kind specified in subparagraph (A) of this paragraph, over such partner's nonpartnership debts; and

(C) with reference to a municipality, financial condition such that the municipality is -

(1) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or

(2) unable to pay its debts as they become due. Bankruptcy Code § 101(32).

(iii) Balance sheet test determines insolvency, i.e., liabilities must exceed assets. For a discussion on the solvency issue, see In re Xonics Photochemical, Inc., 841 F.2d 198, 200 (7th Cir. 1988); In re Wes Dor Inc., 996 F.2d 237 (10th Cir. 1993).

(A) In at least one case, the court looked behind stated book value of a debtor's assets and independently valued the debtor's assets and liabilities. In In re Worcester Quality Foods, Inc., 140 B.R. 21 (Bankr. D. Mass. 1993), payments were recoverable as fraudulent conveyances under Bankruptcy Code § 547 and applicable Massachusetts law, since all elements were present, even though debtor had a

book net worth of $1,080,132. After considering factors including reductions for worthless accounts receivable due from debtor's directors, a 50% write down of a receivable from an account debtor that had filed Chapter 11, and leasehold improvements that would inure to the benefit of debtor's landlord, the Court found that the debtor had a negative net worth of $3,518,482. Id.

(B) Going concern value of assets vs. liquidation value of assets:

(1) In a "Chapter 22" case, the court determined that the debtor no longer could be viewed as a going concern upon the coalescense of four factors: tightened credit; insufficient inventory; no DIP facility; and unavailable trade credit. The existence of these factors made it clear that there was no prospect for reorganization and the debtor no longer was a going concern, In re Payless Cashways, Inc., 290 B.R. 689 (Bankr. W.D. Mo. 2003).

(2) Going concern value should be used to value assets where liquidation in bankruptcy was not clearly imminent when transfers were made. In re Trans World Airlines, Inc., 134 F.3d 188 (3d Cir. 1998).

(3) Liquidation value of assets is appropriate. In re Mama D'Angelo, Inc., 55 F.3d 552 (10th Cir. 1995); In re Art Shirt, Ltd., 93 B.R. 333 (Bankr. E.D. Pa. 1988).

(iv) The effect of the presumption of insolvency on and during the 90 days just preceding the filing date is set forth in Rule 301 of the Federal Rules of Evidence:

> In all civil actions and proceedings not otherwise provided for by Act of Congress or by these rules, a presumption imposes upon the party upon whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party upon whom it was originally cast. Id.

(v) The trustee may rely on the Bankruptcy Code § 547(f) presumption of insolvency during the 90-day preference period where a transferee fails to

offer any evidence of solvency. In re Ajayem Lumber Corp., 143 B.R. 347 (Bankr. S.D.N.Y. 1992).

g. Time of Transfers

(i) The United States Supreme Court held that funds are transferred for preference purposes when checks are honored by a drawee bank (as opposed to when checks are delivered to the payee). Barnhill v. Johnson, 503 U.S. 393, 112 S. Ct. 1386 (1992). The Court held this to be a matter of federal law. Id. The Barnhill rule is limited to establishing the elements of a transfer under Bankruptcy Code § 547(b). Barnhill 503 U.S. at 402, 112 S.Ct. at 1391. Some post-Barnhill decisions have asserted that the pre-Barnhill rule fixing the transfer at the date of check delivery survives for purposes of Bankruptcy Code § 547(c). Jones v. Aristech Chemical Corp., 157 B.R. 720, 722-723 (N.D. Ga.).

(ii) An order substantively consolidating Chapter 11 cases of a parent and its subsidiaries has the effect of establishing the filing date of the first filed case as the basis for calculating the 90-day preference period in all the cases, unless a transferee can show that it relied on the separate credit of a later-filed subsidiary when it lent funds to that company. In re Mars Stores, 150 BR. 869 (Bankr. D. Mass. 1993).

h. The Creditor Receives More Than It Would in a Chapter 7 Liquidation

(i) The comparison is with what the creditor would receive in a Chapter 7. Thus, a pre-petition loan repayment was not preferential because the creditor was fully secured, and would have received payment-in-full in a Chapter 7 liquidation. CEPA Consulting Ltd. v. New York National Bank (In re Wedtech Corp.) 187 B.R. 105 (S.D.N.Y. 1995).

(ii) A payment during the preference period to a partially secured creditor has been held to be preferential, since there is a conclusive presumption that payment was applied first to the unsecured portion of the debt. Drabkin v. A.I. Credit Corp., 800 F.2d 1153, 1157 (D.C. Cir. 1986). Contra In re Kittrell, 115 B.R. 873, 883 (Bankr. M.D. N.C. 1990) (holding that payments to a creditor with a secured claim are preferential only to the extent that they exceed the value of the collateral of such claim).

(iii) If a creditor is fully secured, funds it received during the preference period are not recoverable. U.S. v. Pullman Const. Ind., Inc., 210 B.R. 302 (N.D. Ill. 1997).

(iv) Section 547 does not create substantive rights, and, thus, the 90-day preference period may be extended by virtue of Fed. R. Bankr. P. 9006(a). In re Greene, 223 B.R. 548 (N.D. Cal. 1998) (citations omitted). The Greene court cites to several other courts that disagree. In re Bergel 185

B.R. 338 (9th Cir. BAP 1995) (Section 547 is substantive, and, therefore, Fed. R. Bankr. P. 9006(a) not applicable). Id.

(v) The 90-day period is counted backward from the filing of the petition (excluding the filing date). Id. (citations omitted); In re Levinson, 128 B.R. 365 (Bankr. S.D.N.Y. 1991).

(vi) A valid assignment of an insurance policy that occurs prior to the preference period is not avoidable. In re Gibralter Resources, Inc., 211 B.R. 216 (Bankr. N.D. Tex. 1997).

(vii) A valid prepetition setoff will not be avoided, even where creditor improved its position relative to others. In re Bakersfield Westar Ambulance, Inc., 123 F.3d 1243 (9th Cir. 1997); In re Koch, 224 B.R. 572 (Bankr. E.D. Va. 1998).

(viii) The preferential effect is tested as of the filing date. In re Finn 909 F.2d 903, 905 (6th Cir. 1990); In re Tenna Corp., 801 F.2d 819, 823 (6th Cir. 1986); In re Lewis W. Shurtleff, Inc., 778 F.2d 1416, 1421 (9th Cir. 1985); In re Castletons, Inc., 990 F.2d 551, 554 (10th Cir. 1993); In re LanYik Foods Corp., 185 B.R. 103, 108 (Bankr. E.D.N.Y. 1995).

(ix) Payments or transfers by a debtor to an insider is a preference to the extent the payments or transfers exceed the amount the insider would have received in a Chapter 7 case. See, e.g., Westex, 950 F.2d 1187 (5th Cir. 1992), on remand 1992 WL 114944 (W.D. Tex. 1992). See also discussion below regarding the "Deprizio" case.

(x) Priority of distribution is to be considered. Bankruptcy Code § 507.

9. Defenses To Transfer Avoidance

a. Bankruptcy Code § 547 provides seven defenses to a recovery of a transfer that otherwise may be avoidable -

(i) a substantially contemporaneous exchange for a new value (§ 547(c)(1)),

(ii) a payment made in, and for a debt incurred in, the ordinary course of business (§ 547(c)(2)),

(iii) the attachment and perfection of a security interest in property in exchange for a loan given to enable the debtor to acquire such property and in fact used to acquire such property (provided that the security interest is perfected before 20 days after the debtor receives possession of the property) (§ 547(c)(3)),

(iv) new value given by a creditor after the transfer by a debtor (§ 547(c)(4)),

(v) no improvement in position of the lender possessing a security interest (commonly known as a floating lien on inventory or receivables) (§ 547(c)(5)),

(vi) the fixing of an unavoidable statutory lien (§ 547(c)(6)),

(vii) a payment of alimony, maintenance or support of a spouse, former spouse or child (§ 547(c)(7)), and

(viii) a transfer of less than $600 in a consumer case (§ 547(c)(8)).

b. In most cases, these affirmative defenses must be pleaded and proved by the creditor. Bankruptcy Code § 547(g). In re Chase & Sanborn Corp, 904 F.2d 588, 595 n.15 (11 Cir. 1980); In re Jet Florida Systems, Inc., 861 F.2d 1555, 1557 (11th Cir. 1988).

c. Exceptions to the trustee's preference-avoiding powers, including ordinary course of business, should be construed narrowly. In re CIS Corp., 214 B.R. 108 (Bankr. S.D.N.Y. 1997).

d. Contemporaneous Exchange

(i) The exception applies to the extent that the new value in money or money's worth is provided. In re Spada, 903 F.2d 971, 974-77 (3d Cir. 1990); In re Nucorp Energy, Inc., 902 F.2d 729, 733 (9th Cir. 1990); In re Robinson Brothers Drilling, Inc., 877 F.2d 32 (10th Cir. 1989); In re Jet Florida Systems, Inc. 861 F.2d 1555, 1558-59 (11th Cir. 1988).

(ii) The Third Circuit has held the exception applicable to a payment in exchange for the payee's issuance of a guarantee of new obligations incurred by the debtor. In re Kumar Bavishi & Associates, 906 F.2d 942, 944-46 (3d Cir. 1990), reh'g denied (July 26, 1990).

(iii) The transaction must have been intended to be contemporaneous by both parties. In re Samar Fashions, Inc. 109 B.R. 136, 139 (Bankr. E.D. Pa. 1990).

(iv) The exception does not apply to replacement of a dishonored check. In re Barefoot, 952 F.2d 795 (4th Cir. 1991).

e. Ordinary Course of Business

(i) The U.S. Supreme Court resolved the split in authority regarding whether this exception is limited to payments of trade and other short-term debt or is available with respect to payments on long-term debt, holding that the exception can be available in both circumstances. Union Bank v. Wolas, 502 U.S. 151 (1991).

(ii) Before BAPCPA, a creditor needed to prove that the debt and its payment were ordinary in relation to other business dealings between the creditor and the debtor and that the payment was ordinary in relation to the standards prevailing in the relevant industry. In re Fred Hawes Organization, Inc., 957 F.2d 239 (6th Cir. 1992), reh'g denied (April 7, 1992), reh'g denied (April 10, 1992); Logan v. Basic Distribution Corporation (In re Fred Hawes Organization), 957 F.2d 239 (6th Cir. 1992); Jones v. United Savings & Loan Assoc. (In re U.S.A. Inns of Eureka Springs, Arkansas, Inc.) 9 F.3d 680 (8th Cir. 1993); Mordy v. Chemcarb, Inc. (In re Food Catering & Housing, Inc., 971 F.2d 396 (9th Cir. 1992); Clark v. Balcor Real Estate Finance, Inc. (In re Meredith Hoffman Partners) 12 F.3d 1549 (10th Cir. 1993), aff'g 145 B.R. 682 (D. Cob. 1992), cert. denied, 114 S.Ct. 2677 (1994). Although different, circuit courts apply these standards in various ways.

(A) In the Second Circuit, the Court of Appeals has stated, "[only] when a payment is ordinary from the perspective of the industry will the ordinary course of business defense be available for an otherwise voidable preference. Defining the relevant industry is appropriate left to the bankruptcy courts to determine as questions of fact heavily dependent upon the circumstances of each individual case." In re Roblin Indus., Inc., 78 F.3d 30, 40 (2d Cir. 1996).

(B) In the Seventh Circuit, only payment terms "so idiosyncratic as to fall outside" a "broad range" of business practices should be excluded from the ordinary business exception. In re Tolona Pizza Products Corp., 3 F.3d 1029, 1033 (7th Cir. 1993). The First Circuit articulated a standard of consistency with prior practice and considered various facts in reaching that conclusion including: amount; timing; actions of officers of the debtor or creditor; lumping of payments and the relationship of the parties. In re Healthco Intern., Inc., 132 F.3d 104 (1st Cir. 1997).

(C) The Third and Fourth Circuit's standard set a tighter limit on the ordinary business exception, never permitting "a gross departure from the industry norm, not even when the parties have had an established and steady relationship." Advo-System, Inc. v, Maxway Corp. 37 F.3d 1044, 1050 (4th Cir. 1994). See also Fiber Lite Corp. v. Molded Acoustical Products Inc. (In re Molded Acoustical Products, Inc.) 18 F.3d 217 (3d Cir. 1994). But see In re Equipment Co. of America, 135 B.R. 169, 173 (Bankr. S.D. Fla. 1991) ("[R]eading 11 U.S.C. § 547(c)(2)(C) as requiring compliance with terms ordinary in the industry would negate any benefit the exception would convey").

The Eighth Circuit BAP addressed the issue in In re Gateway Pacific Corp., 214 B.R. 870 (8th Cir. BAP 1997).

(D) Delay caused by loss of first check took transaction out of the ordinary course. In re CyberRebate.Com, 2004 WL 287144(No. 03 CV5982 (JG) E.D.N.Y. Feb. 10, 2004).

(iii) BAPCPA revised Section 547(c)(2) so that a creditor now need only show that the transfer was made in the ordinary course of dealings between the debtor and transferor or ordinary standards in the industry. In other words, BAPCPA eliminated the requirement that preference defendants meet both the subjective and objective test. The practical effect is to make it easier for transferees to successfully raise an ordinary course defense.

(iv) Bankruptcy Code § 547(c)(2) is intended to protect certain recurring transactions, not one time payments in settlement of contractual claims. In re Energy Cooperative, Inc., 832 F 997, 1004 (7th Cir. 1987); In re Durant's Rental Center, Inc., 116 B.R. 362 (Bankr. D. Conn. 1990). But see In re Finn, 909 F.2d 903, 908 (6th Cir. 1990) (a transfer can be ordinary course even if first such transaction).

(v) Lateness of payments is a factor considered. In re Xonics Imaging, Inc., 837 F.2d 763, 767 (7th Cir. 1988); Samar Fashions v. Private Line, Inc.116 B.R. 417, 420 (E.D. Pa. 1990).

(vi) Payment to a creditor on a long-standing open account was protected by ordinary course of business exception, even though parties' arrangement had been modified about four months before the filing date to require the debtor to pay any previous balance due before new credit was issued and to comply with the sixty-day payment term. In re Kahn & Associates Inc., 135 B.R. 251 (Bankr. W.D. Pa. 1991). However, the 11th Circuit has held that payments were not made in the ordinary course of business where payments were late, were made by cashier's check rather than corporate check and resulted from veiled threats made by the creditor. In re Craig Oil Co., 785 F.2d 1563 (11th Cir. 1986).

(vii) New York Cases

After BAPCPA, prior case law will continue to define what course of dealing is "ordinary" as between the parties or within the industry, but only one prong of the formerly two-prong test must now be met.

(A) In re Roblin Indus., Inc., 78 F.3d 30 (2d Cir. 1996) (see above).

(B) Factors to consider: prior course of dealing; amount of

payments in question; timing of such payments, and the circumstances surrounding the payments. In re CIS Corp., 214 B.R. 108 (Bankr. S.D.N.Y. 1997).

(C) A court should consider prior course of dealing between debtor and creditor, amount of payments, and circumstances surrounding payments. In re Rave Communications, Inc., 128 B.R. 369 (Bankr. S.D.N.Y. 1991). The way parties conducted their business, not the terms stated in invoices or collection letters, defines the ordinary course of business for purposes of the Bankruptcy Code §547(c)(2) defense. Id.; Official Committee of Unsecured Creditors v. Vardi Stonehouse Inc., (In re Faleck & Margolies, Inc.) 153 B.R. 123 (S.D.N.Y. 1993).

(D) Payments made approximately thirty days after invoice, where certain payments were made by debtor even later and payments were not prompted by creditor and were made pursuant to the terms prevailing in the industry, were in the ordinary course within the meaning of Bankruptcy Code § 547(c)(2). In re Ajayem Lumber Corp., 145 B.R. 813 (Bankr. S.D.N.Y. 1992).

(E) Payments to supplier between 70 and 90 days after delivery to the debtor were not "ordinary course" payments within the meaning of Bankruptcy Code § 547(c)(2), since the evidence presented showed that 98% or more of supplier's customers paid within 60 days. In re Ramco/Fitzsimons Steel Co., Inc., 95 B.R. 299 (Bankr. W.D.N.Y. 1988). A similar result on similar facts was reached in CIS, 214 B.R. 108.

(F) Late payments may be ordinary, if there is a pattern between either the parties or the industry as a whole. In re Vogel Van & Storage Inc., 210 B.R. 27 (Bankr. N.D.N.Y. 1997).

(G) When analyzing the "ordinariness" of a transaction, the creditor's state of mind is immaterial, while the debtor's is dispositive. In re Vogel Van & Storage, Inc., 210 B.R. 270.

(H) Many Courts apply the ordinary course of business defense to first time transactions. Kieven v. Household Bank FSB, 334 F.3d 638 (7th Cir.), cert. denied 1245. Ct. 924. (2003). This is a developing trend in the case law.

f. The Secured Loan Exception

(i) Under the Bankruptcy Code, purchase money security interests are exempted from preference avoidance if perfected on or before 30 days after the debtor receives possession of such property. Bankruptcy Code § 547(c)(3). (Before BAPCPA, the deadline for perfection was 20 days.)

(ii) Similarly, under the U.C.C. in many states, the grace period runs 20 days from the date that the collateral is received. See U.C.C. § 9-317(e).

(iii) If a lien has a relation back element, secured status is established at the time the transfer of the lien is made. In re Hagen, 922 F.2d 742 (11th Cir. 1991). Where a mortgage deed was re-recorded during the preference period, the mortgage could be avoided as a preference, since debtor's interest in the real property was transferred when the mortgagee discovered it had mistakenly released the unsatisfied mortgage. In re Cameron, 151 B.R. 303 (Banks. Conn. 1993); In re Water Valley Finishing, Inc., 170 B.R. 831 (Bankr. S.D.N.Y. 1994).

(iv) Only when a secured party has done all acts required to perfect its interest within of the relevant time period will the § 547(c)(3) exception apply. Fidelity Financial Services, Inc. v. Fink, 118 S. Ct. 651, 139 L. Ed. 2d 571 (1998) (if a secured party has not perfected within the 20-day period set forth in § 547(c)(3), then even if the secured party later performs the final act of perfection to permit relation back under applicable state law, the secured party cannot sustain a § 547(c)(3) defense).

g. New Value

(i) Two methods of calculation:

(A) Credit extensions are a defense against liability for any previous preferential transfer, but can only reduce preference liability to a maximum of the total amount of credit extended. In re Dependable Food Products, Inc. 193 B.R. 662 (Bankr. E.D.N.Y. 1996); In re Baumgold Bros., 103 B.R. 436, 439-440 (Bankr. S.D.N.Y. 1989); In re Paula Saker & Co., Inc., 53 B.R. 630, 633 (Bankr. S.D.N.Y. 1985); Chrichton v. Wheeling National Bank, (In re Meridith Manor, Inc.) 902 F.2d 257 (4th Cir. 1990), aff'g 103 B.R. 118 (S.D. W. Va. 1989); Jobin v. Lalan (In re M&L Business Machine Co., Inc.); Mosier v. Ever-Fresh Foods Co. (In re IRFM, Inc.), 52 F.3d 228 (9th Cir. 1995); Successor Committee of Creditors Holding Unsecured Claims v. Bergen Brunswig Drug Co. (In re Ladera Heights Community Hospital, Inc.), 152 B.R. 964 (Bankr. C.D. Cal. 1993).

(B) Credit extensions may only reduce avoidance liability against the immediately preceding preferential transfer Leathers v. Prime Leather Finishes Co., 40 B.R. 248, 251 (D. Me. 1984). See also In re Fulghum Construction Corp., 706 F.2d 171 (6th Cir. 1983), cert. denied, 464 U.S. 935 (1983). (Credit extensions made before the preferential transfer may not be netted against avoidance liability.)

(C) In an analysis by the M&L Business Machine court, the Leathers approach has been described as establishing that a subsequent advance can only be applied to reduce liability for preferential transfers occurring after the previous advance by the creditor or the beginning of the applicable preference period, whichever is later.[3]

(ii) Insurance coverage is new value, as the coverage is a benefit, even if provided under an existing contract. In re Maxwell Newspapers, Inc, 192 B.R. 633 (Bankr. S.D.N.Y. 1996).

(iii) Pre-petition "new value" delivered after preferential transfer other than as credit or money:

(A) Modification of the terms of an existing obligation may constitute new value. In re Spada, 903 F.2d 971 (3d Cir. 1990).

(B) Delivery of goods or performance of services may constitute new value. See, e.g., In re Southern Technical College, Inc., 89 F.3d 1381 (8th Cir. 1996) (debtor-tenant's continued occupancy of real estate without paying rent is "new value"); In re Ira Haupt & Co., 424 F.2d 722 (2d Cir. 1970) (legal and accounting services for which no payment is received can constitute "new value"); In re Maxwell Newspapers, Inc., 192 B.R. 633 (Bankr. S.D.N.Y. 1996) (insurance coverage is "new value").[4]

(C) Post-petition advances cannot be used to offset pre-petition transfers. In re Voge, Inc., 222 B.R. 204 (Bankr. W.D.N.Y. 1998); In re Bellanca Aircraft Corp., 850 F.2d 1275, 1284-

3 The "net result rule" was sometimes applied prior to the effective date of the Bankruptcy Code in 1979, but has been rejected by most courts applying § 547. The rule permitted all preference period credit extensions to be netted against all preferential transfers, whenever they occurred.

4 See footnote 3 above.

85 (8th Cir. 1988), on remand 96 B.R. 913 (Bankr. D. Minn. 1989); In re Kroh Brothers Development Co., 114 B.R. 658, 660-61 (W.D. Mo.1990), aff'd in part, rev'd in part 930 F.2d 648 (8th Cir. 1991) (reversal concerned other grounds).

(D) A Ponzi scheme investor's new value defense was not sustained where the investor's new value claim was that certain "commissions" earned were reinvested in the debtor, as there was no transfer to the debtors. In re Ramirez Rodriguez, 209 B.R. 424 (Bankr. S.D. Tex. 1997).

h. Floating Lien: The defense is only available to inventory and receivables lenders. The transfer is not preferential if the difference between the debt outstanding and the value of the collateral 90 days prior to the petition date is less than or the same as that difference on the petition date. 11 U.S.C. § 547(c)(5); see, e.g., Samson v. Alton Banking Trust Co. (In re Ebbler Furniture And Appliances, Inc.) 804 F.2d 87, 89-90 (7th Cir. 1986).

i. Statutory Liens:

(i) Section 547(c)(6) provides that the trustee may not avoid a transfer resulting from the fixing of a statutory lien that is not avoidable under Section 545. In re Nucorp Energy, Inc., 902 F.2d 729, 733-34 (9th Cir. 1990).

(ii) State lien for overpayment of unemployment insurance was a statutory and not a judicial lien under applicable non-bankruptcy law, and, as such, could not be avoided. In re Braxton, 224 B.R. 564 (Bankr. W.D. Pa. 1998).

j. Domestic Support Obligations:

(i) Before BAPCPA, 11 U.S.C. § 547(c)(7) excepted from avoidance certain alimony maintenance and support payments to a spouse, former spouse or child if made in connection with a separation or property settlement agreement, if such agreement met certain standards and was not otherwise excepted by the section.

(ii) BAPCPA simplifies Section 547(c)(7) to provide that a transfer is not a preference "to the extent such transfer was a bona fide payment of a debt for a domestic support obligation".

k. Consumer Cases: Transfers aggregating less than $600.00 in the case of an individual debtor whose debts are primarily consumer debts are not voidable.

l. Commercial Cases: BAPCPA added Section 547(c)(9) which provides a defense to a preference action if the total value of all transfers to the transferee is less than $5,000.

10. Liability For An Avoided Preference

a. Bankruptcy Code § 550(a) provides - to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from:

(i) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(ii) any immediate or mediate transferee of such initial transferee (though Section 550(b) limits the subsequent transferees from whom recovery can be had). Id.

b. When a transfer is avoided, trustee may recover the value of the property transferred from the initial, mediate or immediate transferee of initial transferee (subject to the exceptions under § 550(a)(2)). 11 U.S.C. § 550; In re Pearson Indus., Inc., 142 B.R. 831 (Bankr. C.D. Ill. 1992).

c. Insurance broker was a "mere conduit" and therefore not an initial transferee from which a law firm's trustee could recover an avoided transfer, as the insurance broker did not assert dominion or control over the transferred asset. In re Finj Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, 130 F.3d 52 (2d Cir. 1997).

d. The language of § 550(a) is important — some courts have disallowed a preference recovery because it was not "for the benefit of the estate." See, e.g., Harstad v. First American Bank, 39 F.3d 898, 903 (8th Cir. 1994) ("benefit to the estate" requires that the preference recovery would benefit unsecured creditors); Wellman v. Wellman, 933 F.2d 215, 218-9 (4th Cir. 1991), cert. denied 502 U.S. 25 (1991); Congress Credit Corporation v. AJC International, 186 B.R. 555 (D. Puerto Rico 1995); In re Pearson Indus., Inc., 178 B.R. 753 (Bankr. C.D. Ill. 1995) (even though transfer avoidable, no liability by supplier for recovery because the property to be recovered was fully encumbered by creditors' security interests). See also In re Trans World Airlines, Inc., 163 B.R. 964, 969 (Bankr. D. Del. 1994) (where the bankruptcy court found a benefit to the estate even though recovered funds would only pay down a secured claim because the lightened debt load would arguably make reorganized debtor stock received by some unsecured creditors more valuable).

e. There is no express or implied right of contribution with respect to preferential transfers. Pearson Indus., 142 B.R. 831.

f. Assignee of loan obligation was a Bankruptcy Code § 550(a) "initial transferee" from whom the trustee could recover. In re Cardon Realty Corp., 146 B.R. 72 (Bankr. W.D.N.Y. 1992).

g. In keeping with its intent to maximize repayment by debtors, BAPCPA added Section 437(c)(h) which provides:

The trustee may not avoid a transfer if such transfer was made as part of an alternative repayment schedule between the debtor and any creditor of the debtor created by an approved nonprofit budget and credit counseling agency.

h. Recovery From Initial Transferee or Beneficiary of the Transfer.

In Levit v. Ingersoll Rand Financial Corp., ("Deprizio"), 874 F.2d 1186 (7th Cir. 1989), the Seventh Circuit held that payments to creditors who dealt at arm's length with a debtor are subject to the year-long preference recovery period provided for insiders when payments are for the benefit of insiders. Thus, in that case, the trustee had the option to collect from the debtor's lender (the initial transferee) or the insider-guarantor (the entity for whose benefit the transfer was made), and could do so in the year-long time frame.

(i) The theory of Deprizio is that the payment on a loan reduces the obligations of the loan's guarantor on his or her guaranty, thereby conferring a benefit on the guarantor. The guarantor holds a contingent right of subrogation against the debtor and, therefore, is a creditor. The preference to the guarantor can be recovered from either the guarantor (the party for whose benefit the transfer was made) or the lender (the direct beneficiary of the transfer).

(ii) The 1994 Bankruptcy Reform Act: An Attempt to Overrule Deprizio

(A) In 1994, Congress amended Bankruptcy Code § 550(c) so that it now reads:

(c) If a transfer made between 90 days and one year before the filing of the petition - (1) is avoided under section 547(b) of this title; and (2) was made for the benefit of a creditor that at the time of such transfer was an insider; the trustee may not recover under subsection (a) from a transferee that is not an insider. Id.

(B) Deprizio May Have Survived the Reform Act

Though the legislative history indicates that Congress intended to overrule Deprizio in its entirety, 140 Cong.Rec.H. 10764, a drafting oversight arguably permitted part of Deprizio to survive. Section 550(c) states that a trustee may not "recover from a transferee that is not an insider" a transfer made between 90 days and one year before the filing of the petition where the transfer is

avoided under § 547(b) and was made for the benefit of a creditor that at the time of such transfer was an insider. However, under §547(b), when the challenged transfer is a lien, the trustee need only avoid the lien to undo the effect of the transfer — no recovery of *res* is required. Since on its face § 550(c) only limits the effect of § 547 to creditors from whom a transfer can be recovered the provision may not have reversed Deprizio when a trustee needed only to avoid.5

(C) BAPCPA attempts to Closes the Depizio Loophole

New Section 547(i) states that a transfer made between 90 days and a year before the petition date is (a) recoverable from a non-insider, and (b) not avoidable. (For a discussion of Congress' attempts to overrule Deprizio, see The Official Committee of Unsecured Creditors of ABC-NACO, Inc. v. Bank of America (In re ABC-NACO, Inc.), 331 B.R. 773, 777-778 (Bankr. N.D. Ill 2005).

11. Jury Trials

a. Where rights at issue in a preference action are private in nature and based on legal rather than equitable grounds, the defendant is entitled to adjudication by an Article III court. Granfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989). The Granfinanciera Court further held that, where a defendant has not submitted a claim against the bankruptcy estate, and the preference action is legal rather than equitable, the defendant is entitled to a jury trial.

b. Where a creditor invokes the claims allowance process by submitting a claim, a preference action against the creditor becomes a part of the equitable claims allowance process, to which the right to a jury trial is inapplicable. Langenkamp v. Culp, 498 U.S. 42 (1990), reh'g denied 498 U.S. 1043 (1991).

c. A proof of claim was filed to protect the defendant's judgment against the debtor if the debtor prevailed in a preference action to recover the monies deposited with the court. The Third Circuit held the defendant waived its right to a jury trial and its right to an adjudication before an Article III tribunal of the preference action. Travellers International AG v. Robinson, 982 F.2d 96 (3d Cir. 1992), cert. denied 113 S.Ct. 1946 (April 26, 1993). By filing the protective proof of claim, the defendant that was neither a creditor nor a party asserting a claim against the estate, invoked the claims allowance process in which the jury trial right is inapplicable.

5 This argument is set forth in Robert Milner, Is Deprizio Dead or Just Wounded?, Bankruptcy Court Decisions, May 2, 1995, at A3.

d. However, the waiver by virtue of the filing of a proof of claim may not be an absolute and complete waiver of the jury trial right. In re Dietert, 271 B.R. 499 (Bankr. S.D. Tex 2002) (creditor retained jury trial right, even after it filed a proof of claim, with regard to any issue that did not need to be adjudicated as part of the claims allowance or objection process).

e. A claims bar date may not be extended as a remedy to protect a creditor where the filing of a proof of claim compels a creditor to waive its right to a jury trial. In re Hooker Investments, Inc., 937 F.2d 833 (2d Cir. 1991).

f. Filing a proof of claim against one jointly-administered estate did not waive jury trial right as to other estates. Committee of Unsecured Creditors v. Schwartzman(In re Stansbury Poplar Place, Inc.) 13 F.3d 122, 126 (4th Cir. 1993).

g. The 1994 Bankruptcy Reform Act added the following to 28 U.S.C. § 157:

> (e) If the right to a jury trial applies in a proceeding that may be heard under this section by a bankruptcy judge, the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district and with the consent of all the parties. Id.

12. Implications of Stern v. Marshall U.S.

a. Holding: Congress did not have the authority under the Constitution to give bankruptcy judges the power to decide legal claims that are based entirely on State law, and have nothing to do with Federal law.

b. Further Considerations: Bankruptcy Courts can enter final judgments in cases involving §548 (fraudulent transfers) and §549 (post petition transfers) but not §544 (trustee as lien creditor); reasoning that §548 and §549 were a creation of federal statute for application in bankruptcy proceeding whereas §544 requires State law application. Springel v. Prosser, 2012 WL 2149737. See however, Feverbacher v. Moser, 2012 WL 1070138 concluding that Stern does not preclude the Bankruptcy Court from entering a final judgment on fraudulent transfer claims under §544 and §548 because fraudulent transfer claims flow directly from a federal scheme and have been a core aspect of the administration of bankruptcy estates since the 18th century. See Also, West v. Freedom Medical Inc., 465 B.R. 452, 464-465 (Bankr. S.D. Tex 2011) noting that §547 actions by its nature involve a determination of whether the defendant is a creditor of the estate.

c. Bankruptcy Judges, as Article I Judges, do not have the lifetime appointment enjoyed by District Court Judges under Article III of the Constitution.

(i) Bankruptcy Courts "lack constitutional authority to enter final judgment on State law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim." Gibson v. Tucker, 478 B.R. 906, 916 (S.D. Ind. 2012); Paloian v. Am. Express Co., 464 B.R. 770, 773 (N.D. 111 2012).

(ii) Bankruptcy Judges can make proposed findings of fact and conclusions of law to the District Court which can adopt or make an altogether separate determination.

*Practice Pointer: Failure to raise the jurisdictional defense to a bankruptcy court determining a fraudulent conveyance matter may deemed waiver or consent. In re River Entm't Co., 467 B.R. 808, 823 (WDPA 2012); In re Sunra Coffee, LLC, 2011 WL 4963155 (Bankr. HI 2011), aff'd 2012 WL 3590754 (B.A.P. 9th Cir. 08/21/12) (concluding implied consent to final adjudication when failed to respond).

<u>2011 SUPPLEMENT TO BASICS OF BANKRUPTCY CLE</u>
<u>RE: VOIDABLE PREFERENTIAL TRANSFERS</u>

Updated by: Martin A. Mooney, Esq. and Kathy McCullough Day, Esq.
May 2011

3. <u>Who Can Bring Suit – Standing and Capacity to Sue</u>

d. Parties Other Than the Trustee or the Debtor

(i) <u>In re Cooper</u>, 405 B.R. 801, 811 (U.S. Bankr. Ct., N.D.Texas, 2009). "This court is of the view that derivative standing should be viewed very differently in the Chapter 7 arena." And "[b]ut in all events, this court just does not view it as good policy to usurp the trustee's role in Chapter 7. The system works better when a statutory fiduciary is steering the ship." <u>Id</u>, at 814. Disagreeing with <u>Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery</u>, 330 F.3d 548 (3rd Cir., 2003).

(iv) <u>In re Hunt</u>, 136 B.R. 437 (Bankr. N.D. Tex., 1991), abrogated by <u>In re CompuAdd Corp.</u>, 137 F.3d 880 (5th Cir., 1998). "…we are persuaded that the same limitations period applies to a DIP and a trustee."

j. <u>In re Lutz</u>, 212 B.R. 846 (Bankr. E.D. Mich., 1997), reversed and remanded by <u>In re Lutz</u>, 241 B.R. 172 (U.S.D.C. E.D. Mich., 1998). Bankruptcy judge did not determine if the trustee's fees and expenses were reasonable and the bankruptcy court failed to conduct a hypothetical chapter 7 liquidation analysis after determining the reasonableness of the trustee's fees and expenses.

8. <u>Elements to be Proven</u>

e. For or on Account of an Antecedent Debt

(i) **<u>In re Western World Funding</u>**, 54 B.R. 470, 476 (Bankr. D. Nev., 1985).

h. The Creditor Receives More Than It Would in a Chapter 7 Liquidation

(iv) <u>In re Greene</u>, 223 F.3d 548 (N.D. Cal. 1998), was reversed and remanded by <u>In re Greene</u>, 223 F.3d 1064 (9th Cir., 2000). "Accordingly, we reiterate that, despite its technical aspect, the timing requirement of § 547(b)(4)(A) does not implicate Bankruptcy Rule 9006(a), which is strictly procedural. To the extent that Rule 9006(a) could be construed as capable of expanding the preference period beyond the statutorily-specified time, it runs afoul of the Rules Enabling Act." <u>Id</u>, at 1073.

9. Defenses to Transfer Avoidance

d. Contemporaneous Exchange

(iv) In re Barefoot, 952 F.2d 795 (4th Cir., 1991) was distinguished by Velde v. Kirsch, 543 F.3d 469 (8th Cir., 2008). The exception may apply to the replacement of a dishonored check. "In this case, however, Kirsch's bank did not release its security interest until it received the proceeds of the second check. Because the debtor held soybeans it could not sell until the security interest was released, the debtor received new value for the replacement check. Kirsch's bank held a security interest in the soybeans that had not been released. The debtor could not sell the beans for the benefit of the unsecured creditors until he received a release of the security interest from Kirsch's bank. The bank would not release the security interest until it was paid. Under these circumstances the estate received new value, soybeans now free and clear of the security interest, in return for the bank check issued to Kirsch and the bank." Id. at 474.

e. Ordinary Course of Business

(iv) In re Energy Cooperative, Inc., 832 **F.2d** 997

g. New Value

(i) Two Methods of Calculation

(A) Jobin v. Lalan (In re M&L Business Machine Co., Inc. **160 B.R. 851 (Bankr. D. Colo., 1993).**

10. Liability for an Avoided Preference

c. In re **Finley**, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey

NEW YORK BAR ASSOCIATION

OCTOBER 30, 2008

BASICS OF BANKRUPTCY PRACTICE

VOIDABLE FRAUDULENT CONVEYANCES

by

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New York City

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Fraudulent Conveyances

1. Introduction: Fraudulent conveyances are avoidable by a trustee under Bankruptcy Code Sections 548 and 544(b).[1] Bankruptcy Code Section 548 sets forth a trustee's right under federal law to avoid transfers that are constructively or actually fraudulent. Section 544(b) provides the Trustee with the ability to use applicable non-bankruptcy law to avoid certain constructive or actually fraudulent transfers.

Section 548 of the Bankruptcy Code provides, in relevant part:

a. The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily -

(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(2) (A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B) (i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

2. Who Can Bring Suit- Standing and Capacity to Sue

a. A trustee pursuant to Bankruptcy Code Sections 701, 702 and 1104.

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1 All references to the Bankruptcy Code are to citations to 11 U.S.C. § 101 et (1978, as amended), unless otherwise noted.

b. A debtor-in-possession in a Chapter 11 case pursuant to Bankruptcy Code § 1107(a).

c. A Chapter 13 debtor does not have authority to avoid preferences under Bankruptcy Code Section 547, only the trustee does. In re Hill, 152 B.R. 204 (Bankr. S.D. Ohio 1993). Chapter 13 debtors enjoy only those powers pertaining to the use, sale and lease of property and not all of the powers granted to a Chapter 11 debtor. United States v. Sierer, 139 B.R. 752, 755 (N.D. Ha. 1991). CF In re Toronto, 165 B.R. 746 (Bankr. D.Conn. 1994).

d. Parties Other Than the Trustee or Debtor

(i) In 2002, a three judge appellate panel triggered nationwide consternation by virtue of its decision in the CyberGenics case. Official Committee of Unsecured Creditors of CyberGenics Corp. v. Chinery (In re Cybergenics Corp.), 304 F.3d 316 (3d Cir. 2002). In this decision, the Third Circuit held that a creditors' committee does not have the authority to act for a debtor to commence an action under the avoidance power sections of the Bankruptcy Code. The opinion was vacated by Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.), 310 F.3d 785 (3d Cir. 2002). After a rehearing *en banc*, the Court reversed and held that §§ 1109(b), 1103(c)(5) and 503(b)(3)(b) evidence Congressional approval for the prosecution of derivative avoidance actions by a creditors' committee in an appropriate case. Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.), 330 F.3d 548, 41 Bankr. Ct. Dec. 98, Bankr.Rep. P. 78,861 (3d Cir.), cert. dismissed, 124 S.Ct. 530, 157 L.Ed.2d 406, 72 USLW 3155, 72 USLW 3328, cert. dismissed, 124 S.Ct. 530, 157 L.Ed.2d 407, 72 USLW 3155, 72 USLW 3328 (2003); *cf.* In re Fox, 305 B.R. 912 (10th Cir. B.A.P.)

(ii) In Housecraft Industries a post-CyberGenics case, the Second Circuit held that a secured creditor, acting as co-plaintiff with the trustee, has standing to bring an avoidance action, unless the secured creditor's interest conflicts with those of the estate. In re Housecraft Industries U.S.A., Inc., 310 F.3d 64, 72 (2d Cir. 2002).

(iii) Several Second Circuit opinions substantially follow the Housecraft Industries approach. A creditors' committee in a Chapter 11 case may only act in lieu of the debtor (1) on consent of the debtor, or (2) when the debtor has failed to act. If suit is based on the consent of the debtor or trustee, the court must also find that the suit would be necessary and beneficial to the resolution of the bankruptcy proceeding. In re Commodore International, Ltd., 262 F. 3d 96 (2d Cir. 2001). Additionally, a creditors' committee may intervene as a matter of right in an action to recover a voidable transfer brought by the debtor, and may fully participate in all aspects of the litigation, subject to the court's oversight. In re Adelphia Communications Corp., 285 B.R. 848 (Bankr. S.D.N.Y. 2002) citing Term Loan Holder Committee v. Ozer Group, L.L.C. (In re Caldor Corp.), 303 F.3d 161 (2d Cir. 2002).

(iv) Other decisions before CyberGenics focused on the ability of non-trustees and non-debtors to pursue a debtor's litigation claims and allowed parties to proceed in lieu of the trustee/debtor. In Southern Commodity, for example, a liquidating committee created pursuant to a confirmed plan of reorganization was permitted to sue. In re Southern Commodity Corp., 78 B.R. 626 (Bankr. S.D. Fla. 1987); See, In re Consolidated Capital Equities Corp. 143 B.R. 80 (Bankr. N.D. Tex. 1992). A representative of an estate appointed pursuant to a confirmed plan of reorganization, pursuant to 11 U.S.C. § 123(b)(3)(B), was permitted to sue. In re Sweetwater 884 F.2d 1323 (10th Cir. 1989); In re Professional Investment Properties of America, 955 F.2d 623, 626 (9th Cir. 1992), cert. denied 113 S.Ct. 63 (1992); In re Texas General Petroleum Corp., 52 F.3d 1330, 1335 (5th Cir. 1995); In re Hunt, 136 B.R. 437 (Bankr. N.D. Tex. 1991); In re APF Co., 264 B.R. 344 (Bankr. D.Del. 2001); In re Maxwell Newspapers, Inc., 189 B.R. 282, 287 (Banks. S.D.N.Y. 1995) (creditors of Chapter 11 debtor were assigned avoidance claims as part of a confirmed plan); In re Mako, Inc., 985 F.2d 1052, 1054 (10th Cir. 1993) ("Under § I 123(b)(3)(B), a party who is neither the debtor nor the trustee, but who seeks to enforce a claim, must establish two elements: (1) that it has been appointed; and (2) that it is a representative of the estate.").

3. Do All Claims Give Rise to a Cause of Action

a. Issue Does a creditor with a claim that arose after the act constituting a fraudulent conveyance occurred have standing to commence an action, or is standing limited to creditors with claims that arose before or at the time of the transfer?

(i) The Uniform Fraudulent Conveyance Act ("UFCA") (in effect in New York)[2] allows existing and future creditors to bring fraudulent conveyance actions based on:

(A) actual intent to hinder, delay or defraud; or

(B) transfers made for less than reasonably equivalent value by a transferor that was left with unreasonably small capital or that intended to incur debts beyond its ability to pay.

(ii) Under the UFCA, only existing creditors can bring claims based on transfers for less than reasonably equivalent value by an insolvent transferor. N.Y. Debt. & Cred. Law § 270 (McKinney 1993).

(iii) The Bankruptcy Code does not make this distinction among types of fraudulent conveyance claims and allows the trustee, on behalf of existing and future creditors, to bring all types of claims.

(iv) Notwithstanding this statutory scheme, at least three courts have held, in the leveraged buyout context, that creditors whose claims arose after the completion of the transfer, i.e., the LBO, did not have standing to bring the action on the theory that creditors with knowledge of the LBO, that extend credit with such knowledge, assume the risk and should not be able to later use the fraudulent conveyance laws when they suffer a loss. Credit Managers

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2 Numerous states adopted the UFCA after its approval by the National Conference of Commissioners on Uniform State Laws. In 1984, the National Conference of Commissioners on Uniform State Laws approved the Uniform Fraudulent Transfer Act ("UFTA") to replace the UFCA in states where the UFCA had previously been adopted. 5 Collier on Bankruptcy, §548.04[2]-[3] (15th ed. rev. 1996). To date, 33 states have adopted the UFTA. Four states, including New York, and the U.S. Virgin Islands continue to be governed by the UFCA.

Association v. Federal Co., 629 F. Supp. 175 (C.D. Cal. 1985); Ohio Corrugating Co. v. Security Pacific Business Credit Inc., (In re Ohio Corrugating Co.) 70 BR. 920 (Bankr. N.D. Ohio 1987); Kupetz v. Continental Illinois Nat. Bank & Trust Co., 77 B.R. 754 (C.D. Cal. 1987), aff'd, 845 F.2d 842 (9th Cir. 1988); Wieboldt Stores, Inc. v. Schottenstein, 94 BR. 488 (N.D. Ill. 1988).

(v) To the contrary is In re Morse Tool, Inc., 108 B.R. 389 (Bankr. D. Mass. 1989), complaint dismissed 1992 Bankr. LEXIS 1956 (Banks. D. Mass. 1992), in which the Credit Managers - Ohio Corrugating - Kupetz line of cases had merit but held that the legislative intent in the UFCA and the Bankruptcy Code must be given effect. See also, Zahn v. Yucaipa Capital Fund 218 B.R. 656 (D.R.I. 1998) (analyzing standing regarding a failed LBO and comparing the UFTA and the Bankruptcy Code.

4. Bringing A Fraudulent Conveyance Case

Avoidance of transfers must be brought by an adversary proceeding (governed by part VII of the Federal Rules of Bankruptcy Procedure). In re Commercial Western Fin. Corp., 761 F.2d 1329 (9th Cir. 1985)(avoidance cannot occur simply by the entry of an order confirming a plan that provides for avoidance of a transfer).

5. Venue and Jurisdiction

a. The district court has original but not exclusive jurisdiction of all civil proceedings arising under Title 11 of the United States Code, or arising in or related to cases under Title 11 28 U.S.C. § 1334(b).

b. Each district court is permitted to refer cases under title 11 and proceedings arising under title 11 or arising in or related to a case under title 11 to bankruptcy judges for its district. 28 U.S.C. § 157(a).

c. Bankruptcy judges are authorized to hear and determine all core proceedings arising under title 11 or arising in a case under title 11. 28 U.S.C. § 157(b)(l).

d. Proceedings "to determine, avoid or recover fraudulent conveyances" are core proceedings. 28 U.S.C. § 157(b)(2)(H).

e. Generally venue, is properly placed in the district where the case is pending. 28 U.S.C. § 1409(a). The Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"), however, amended section 1409(b) to require a trustee to file avoidance actions seeking less than $10,000 in the district in which the defendant resides.

6. Burden of Proof

a. Actual Fraud - To avoid an actually fraudulent conveyance, the trustee has the burden of proving each element of its case by clear and convincing evidence. In re Actrade Fin. Tech. Ltd., 337 B.R. 791, 809 (Bankr. S.D.N.Y. 2005) (requiring that actual fraud under Bankruptcy Code § 548(a)(1)(A) be proved by clear and convincing evidence); See Lustig v. Hickey (In re Hickey) 168 B.R. 840, 844 (Bankr. W.D.N.Y. 1994) and SIPC v. Rossi (In re Cambridge Capital) 331 B.R. 47, 58 (Bankr. E.D.N.Y. 2005) (both requiring clear and convincing evidence of actual fraud under Debtor and Creditor Law, § 276).

b. Constructive Fraud - To succeed on an avoidance claim based on constructive fraud under either the Bankruptcy Code or the Debtor and Creditor Law, the plaintiff must demonstrate the evidence for constructive fraud by a preponderance of the evidence. Lippe v. Bairnco Corp., 249 F. Supp. 2d 357, 376 (S.D.N.Y. 2003) (discussing burdens of proof under Debtor and Creditor Law §273); In re Bennett Funding Group, Inc., 232 B.R. 565, 570 (Bankr. N.D.N.Y. 1999) analyzing burdens of proof under Bankruptcy Code § 548(a)(1)(B); Carrozzella & Richardson v. Richardson (In re Carrozzella & Richardson), 302 B.R. 415, 419 (Bankr. D. Conn. 2003).

7. Time Limitations

a. Statute of Limitations

Section 546(a) provides:

An action or proceeding under section 544, 545, 547, 548, or 553 of this title maynot be commenced after the earlier of -

(1) the later of-

(A) two years after the entry of the order for relief; or

(B) one year after the appointment or election of the first trustee under sections

702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or

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

b. Tolling the Statute

(i) The statute of limitations in Bankruptcy Code Section 546 is subject to equitable tolling where relevant facts have been concealed from a trustee who has made diligent and reasonable inquiry under the circumstances. In re McGoldrick, 117 B.R. 554 (Bankr. C.D. Cal. 1990). See also, In Pack, 252 B.R. 701, 708 (Bankr. E.D. Tenn. 2001) (collecting cases on equitable tolling).

(ii) The fraudulent concealment doctrine has been applied to extend the time limit imposed by Bankruptcy Code Section 546(a). In re Ahead By A Length, Inc., 100 B.R. 157, 163, 164 (Bankr. S.D.N.Y. 1989). Under this doctrine "the plaintiff must establish (1) that the defendant concealed the existence of the claim, (2) he was unaware of the claim until some point within the applicable limitations period, and (3) that his continuing ignorance was not attributable to lack of [reasonable] diligence on his part." 100 B.R. at 163-164 (citing State of New York v. Hendrickson Bros., Inc., 840 F.2d 1065, 1084-85 (2d Cir. 1988), cert. denied 488 U.S. 848 (1988); Armstrong v. McAlpin 699 F.2d 79, 88 (2d Cir. 1983)). Bailey v. Glover 88 U.S. 342, 349 (1874).

8. Statutory Requirements - 11 U.S.C. § 548

a. After BAPCPA, if the elements of a fraudulent conveyance are otherwise present, a trustee may avoid any transfer of a debtor's interest in property, or any obligation incurred by the debtor made within two years before a bankruptcy filing. 11 U.S.C. § 548(a)(1). (For cases filed before October 17, 2005, the reach back period was only one year.) The New York Debtor and Creditor Law provides a six-year limitation period. NY C.P.L.R. § 213(1)

b. Transfers Made With Fraudulent Intent

(i) The transfer was made or obligation incurred with actual intent to hinder, delay, or defraud creditors. 11 U.S.C. § 548(a)(1); In re O.P.M. Leasing Serv., Inc., 28 B.R. 740 (Bankr. S.D.N.Y. 1983).

(ii) New York common law recognizes a cause of action for aiding and abetting the wrongful diversion of corporation funds, although the N.Y. BCL § 510, 719 and 720 do not authorize "aiding and abetting" actions. O.P.M.; Atlanta Shipping v. Chemical Bank, 818 F.2d 240, 250-1 (2d Cir. 1987). However, to be held liable a party must be shown to have knowingly completed acts with the purpose of aiding and abetting an illegal scheme. Id.

(iii) In the case of a "transfer," the statutory definition must be fulfilled:

(A) Under BAPCPA, "transfer" means:

(A) the creation of a lien;

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

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

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

i. property; or

ii. an interest in property.

(B) Before BAPCPA, the Bankruptcy Code defined "transfer" as: a direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption. 11 U.S.C. § 101(54). See also, Matter of Wey, 854 F.2d 196, 198 (7th Cir. 1988) (there must be a transfer for relief to be available under Bankruptcy Code § 548); In re Kelsey, 270 B.R. 776 (Cir. BAP 2001).

(C) A transfer is completed, if perfected before the bankruptcy filing, when perfected as against a bona fide purchaser; if not so perfected prior to the bankruptcy filing, then the transfer occurs immediately before the filing date. 11 U.S.C. § 548(d)(l).

(D) A debtor cannot use section 548 to reinstate executory contracts that were terminated pre-petition. In re Coast Cities Truck Sales, Inc., 147 B.R. 674, 677 (D.N.J. 1992), aff'd, Coast Cities Truck Sales, Inc. v. Navistar Intern. Transp. Co., 5 F.3d 1488 (3d Cir. 1993); In re Metro Water and Coffee Services, Inc., 157 B.R. 742 (Bankr. W.D.N.Y. 1993) (a pre-petition concession agreement termination due to debtor defaults is not an avoidable transfer); In re Durso Supermarkets, Inc., 193 B.R. 682, 701 (Bankr. S.D.N.Y. 1996) (pre-petition termination of a real property lease was a transfer, but was not a fraudulent conveyance).

(E) Reach-back Period. Since BAPCPA's effective date, transfers made or obligations incurred within two years before the filing of the petition ("reach-back period") are subject to avoidance under Bankruptcy Code Section 548. (Under previous law, the reach-back period was one year.) However, under Bankruptcy Code Section 548(d)(1), transfers that occurred before the beginning of the reach-back period, but which remain unperfected, are subject to attack as fraudulent transfers. 11 U.S.C. § 548(d)(l); Butler v. Lomas and Nettleton Co., 862 F.2d 1015 (3d Cir. 1988) (under Pennsylvania law, transfer occurred on date of Sheriff's sale, rather than date of recordation of Sheriff's deed). Under New York law, a transfer for Bankruptcy Code Section 548(d)(1) purposes occurs at time of foreclosure sale. N.Y. Real Prop. Law § 291 (McKinney 1993); In re Brown, 104 B.R. 609 (Bankr. S.D.N.Y. 1989), appeal denied other grounds, Brown v. Vanguard Holding Corp., 119 B.R. 413 (S.D.N.Y. 1990); But see, In re Sackman Mortgage Corp., 158 B.R. 926 (Bankr.

S.D.N.Y. 1993). Transfer date was deemed to be immediately before bankruptcy filing for purpose of the Bankruptcy Code § 548(d)(1) one-year limitation period, where deed was never recorded as a result of the automatic stay. In re Brown v. Vanguard, supra. Cf In re Bennett, 154 B.R. 140 (Bankr. N.D.N.Y. 1992); see also In re Davis, 281 B.R. 626, 634 (Bankr. W.D.Pa. 2002)(analyzing distinction between "lien theory" and "title theory" states).

BACPA added Section 548(e), which provides a ten-year reach back period for transfers to certain self-settled trusts.

Note that under New York Debtor and Creditor Law, the reach-back period is six years. N.Y. C.P.L.R. § 213(1).

(iv) Proving Intent

(A) The debtor's intent is an issue of fact to be determined by the circumstances of each case. In re Chadborne Indus. Ltd., 71 B.R. 86 (Bankr. S.D.N.Y. 1987).

(B) Intent may be inferred from the debtor's and transferee's acts regarding the property transferred, i.e., who received and retained possession of the property and who controlled the debtor. In re Adler, Coleman Clearing Corp., 263 B.R. 406 (S.D.N.Y. 2001).

(C) Transfer of property that may be designated as "exempt" may be voidable where debtor exhibits the requisite intent. Tavenner v. Smoot, 257 F.3d 401 (4th Cir. 2001).

(D) Courts have used certain "badges of fraud" that circumstantially may infer actual intent because the intent to defraud is rarely susceptible to direct proof. See, e.g., In re Kaiser, 722 F.2d 1574, 1582-84 (2d Cir. 1983); Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248, 1254 (1st Cir. 1991); In re McSheridan, 184 B.R. 91 (9th Cir. BAP 1995) Cir. BAP 1995). The Kaiser Court considered the following:

(1) was the consideration received adequate or was there any consideration,

(2) was the transferee a relative, close friend or associate of the debtor,

(3) did the debtor retain possession, benefit and use of the property,

(4) did the debtor's financial condition change after the transfer,

(5) was a pattern established of certain types of transactions after the onset of financial difficulties, and

(6) did the debtor transfer all or substantially all of his or her assets to a corporate entity that he or she controls.

(E) Actual intent must be proven by clear and convincing evidence. In re National Safe Northeast Inc., 76 B.R. 896 (Bankr. D. D.C. 1987) (citations omitted). The requisite intent may be proven by "a clear pattern of purposeful conduct." In re Checkmate Stereo and Electronics, Ltd., 9 B.R. 585, 612 (Bankr. E.D.N.Y. 1981), aff'd, 21 B.R. 402 (E.D.N.Y. 1982).

(F) Courts closely scrutinize transfers between related parties. Tavenner v. Smoot, 257 F.3d 401 (4th Cir. 2001).

(G) A write-off of a debt may be a fraudulent conveyance if undertaken with fraudulent intent and/or was for less than reasonably equivalent value. In re Erie Mariene Enter., Inc., 213 B.R. 799 (Bankr. W.D. Pa. 1997).

(H) Fraudulent Transfer Protections: In 1998, Congress amended Section 548(a) to provide that a trustee's fraudulent transfer powers may not be used to avoid a "transfer of a charitable contribution to a qualified religious or charitable entity or organization" if

(1) the contribution does not exceed 15% of the debtor's gross annual income for the year in which the contribution is made; or

(2) the contribution exceeds the 15% specified above, but was consistent with the debtor's charitable contribution practices.

Section 544(b) also was amended to provide that the trustee's avoiding powers do not apply to "a transfer of a charitable contribution (as that term is defined in section 548(d)(3))" and to provide that any claim by any person to recover a transferred contribution "under Federal or State law in a Federal or State court shall be preempted by the commencement of the case."

Under the amended version of § 548(d) a "charitable contribution" is defined as "a charitable contribution, as that term is defined in section 170(c) of the Internal Revenue Code of 1986, if that contribution—

(A) is made by a natural person; and

(B) consists of—

(i) a financial instrument (as that term is defined in section 731(c)(2)(c) of the Internal Revenue Code of 1986) or

(ii) cash."

A qualified religious or charitable entity or organization is defined as an entity described in § 170(c)(l) or § 170(c)(2).

c. Transfers Made Without Fraudulent Intent

(i) Debtor receives less than a reasonably equivalent value in exchange for such transfer or obligation.

(ii) "Reasonably equivalent value" is present where the consideration received by the debtor is not disproportionately small in comparison to the value or

property debtor has transferred. In re Duke & Benedict, Inc. 265 B.R. 524 (Bankr. S.D.N.Y. 2001).

(iii) Courts are to evaluate consideration exchanged by the debtor and transferee in the specific transaction the trustee seeks to avoid. Balabar-Strauss v. Lawrence, 264 B.R. 303 (S.D.N.Y. 2001) (if a transfer is for equivalent value it is not subject to avoidance, even if the debtor was engaged in conduct that even in retrospect was a Ponzi scheme).

(iv) Gross inadequacy of price is a ground for setting aside a foreclosure sale, if state law so provides, but it is not a federal standard independent of state law. In re Lindsay, 59 F.3d 942 (9th Cir. 1995), cert. denied 116 S. Ct. 778 (1996) (construing BFP v. Resolution Trust Corporation, 511 U.S. 531, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994)). Likewise, "commercial reasonableness is a ground to set aside a foreclosure sale only if state law so provides. Id. (citation omitted). In re Barr, 170 B.R. 772 (Bankr. E.D.N.Y. 1994) (while citing BFP, it was held that "the disposition of the case will depend on whether the foreclosure sale sub judice was accordant procedurally and substantively with applicable South Carolina [state] foreclosure law.").

(v) See discussion below concerning foreclosure sales as fraudulent transfers.

(vi) The Third Circuit, interpreting the UFCA, has concluded that purchasers and other transferees who have paid "less than fair consideration" cannot avoid revocation of the transaction as a fraudulent conveyance if "they have a fraudulent intent or a lack of good faith." United States v. Tabor Court Realty Corp,. 803 F.2d 1288, 1298 (3d Cir. 1986), cert. denied 483 U.S. 1005 (1987). Similarly, the Second Circuit has interpreted the UFCA (as enacted in New York) as requiring good faith of a transferee. Atlanta Shipping Corp., Ins. v. Chemical Bank, 818 F.2d 240, 248-49 (2d Cir. 1987); N.Y. Debtor & Creditor Law § 272. (More on "reasonably equivalent value" below.) The Tabor court drew a parallel between the UFCA and Section 548(c) of the Bankruptcy Code: neither should protect a party where, "although their conduct was not intentionally fraudulent, [they] exhibited a lack of good faith." Tabor, 803 F.2d at 1299.

(vii) A mortgage given by a Chapter 11 debtor could be avoided under

Bankruptcy Code Section 548, because the mortgage was given to secure a line of credit for the debtor's corporate parent and debtor did not receive benefit constituting "reasonably equivalent value." The court found that the debtor received "no indirect benefit" from the transfer, since at the time it granted the mortgage it had ceased operating, and was "moribund". In re Marquis Products Inc., 150 B.R. 487, 492 (Bankr. D. Me. 1993).

(viii) Insolvency Defined

(A) The debtor must be insolvent on date a transfer complained of was made or rendered on such a date insolvent by such transfer. 11 U.S.C. § 548(a)(2)(A) and (B)(I).

(1) Insolvent is defined in 11 U.S.C. § 101(32) and is established when debts exceed assets. In re Coated Sales, Inc., 144 B.R. 663 (Bankr. S.D.N.Y. 1992). This formula is commonly referred to as the "balance sheet test." Klein v. Tabatchnick, 610 F.2d 1043, 1048 (2d. Cir 1979).

(2) Evidence of a debtor's insolvency on the date before and after an alleged transfer (in a preference case) is evidence of the debtor's insolvency on the date of the transfer. Id.

(B) Absent a determination of absolute or fixed amounts, solvency may be proved or disproved by viewing facts from which insolvency may be inferred. Constructor Maza, Inc. v. Banco De Ponce, 616 F.2d 573 (1st Cir. 1980); In re Kaylor Equipment & Rental, Inc., 56 B.R. 58 (Bankr. E.D. Tenn. 1985); Briden v. Foley, 776 F.2d 379 (1st Cir. 1985); New York Credit Men's Adjustment Bureau v. Adler, 2 B.R. 752 (S.D.N.Y. 1980).

(1) Debtor was engaged in business and was left with an "unreasonably small capital" with which to continue. 11 U.S.C. § 548(a)(2)(B)(ii) and (iii).

(2) Debtor intended to incur or believed it would incur debts that would be beyond debtor's ability to pay. 11 U.S.C.

§ 548(2)(B)(iii). See In re Vaniman Int'l Inc., 22 B.R. 166 (Bankr. E.D.N.Y. 1982). (Insolvency of debtor is irrelevant, or still must have received less than "reasonably equivalent value.").

(C) Liquidation value is the appropriate valuation if, at the time of the alleged transfer, the business was so close to shutting down as to make the going concern standard unrealistic. In re Mama D'Angelo, Inc., 55 F.3d 552 (10th Cir. 1995) (acknowledging, but rejecting, authorities that state going concern value is appropriate and the subsequent dismemberment of the estate should not be considered).

(D) Going concern value is appropriate where it appears the enterprise will continue. Id.

(E) For a discussion of liquidation versus going concern value in the fraudulent transfer context, see SIPC v. Ensmingler (In re Adler Coleman Clearing Corp.) 247 B.R. 51, 110-111 (Bankr. S.D.N.Y. 1999).

9. Foreclosure Sale as a Fraudulent Transfer

a. Foreclosure of the debtor's equity of redemption is a transfer and, thus, such a foreclosure may result in a fraudulent transfer if -

(i) the foreclosure sale occurs when the debtor is insolvent or it renders the debtor insolvent, and

(ii) the debtor receives less than reasonably equivalent value from the proceeds of the sale. 11 U.S.C. § 548(a)(2).

b. The U.S. Supreme Court has held that "reasonably equivalent value" is the price received at a foreclosure sale when applicable state foreclosure laws are fulfilled. BFP v. Resolution Trust Corp. 511 U.S. 531, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994).

(i) Facts of BFP v. RTC are as follows:

(A) Owner of real property petitions for bankruptcy protection following a properly-noticed foreclosure sale of real property.

(B) Thereafter, the debtor files a complaint to set aside the sale as a fraudulent transfer claiming "reasonably equivalent value" was not received.

(i) Ruling: "We deem.. . that a fair and proper price, or a 'reasonably equivalent value,' for foreclosure property, is the price in fact received at the foreclosure sale, so long as all the requirements of the state's foreclosure law have been complied with." BFP v. Resolution Trust Corp., 114 S.Ct. at 1765.

(ii) The BFP test for determining if a foreclosure sale price meets the "reasonably equivalent value" standard appears consonant with a method that was already adopted by the Bankruptcy Court for the Southern District of New York. In re Brown, 104 B.R. 609, 616 (Bankr. S.D.N.Y. 1989), appeal denied 119 B.R. 413 (S.D.N.Y. 1990) (a procedurally proper foreclosure sale, conducted in a commercially reasonable manner is presumptively valid, even though a low price is realized).

c. Decisions After BFP v. RTC

(i) Foreclosure sale price is "reasonably equivalent value" under § 548 of the Bankruptcy Code, as long as foreclosure laws of the local jurisdiction have been satisfied. In re Barr, 170 B.R. 772, 776 (Banks. E.D.N.Y. 1994).

(ii) Although the price realized at a tax foreclosure sale is likely to be "considerably lower" than at a mortgage foreclose sale, so long as the transferee was in compliance with state law, the transfer in a tax foreclosure must be deemed to have been for reasonably equivalent value. In re McGrath, 170 B.R. 78 (Bankr. D.N.J. 1994); but see, In re Wentworth, 221 B.R. 316, 391 (Bankr. D.Conn. 1998) (refusing to extend BFP to tax lien foreclosures under the laws of the State of

Maine, because under Maine law the foreclosure is not subject to judicial oversight, there is no competitive bidding and no public sale); In re Vermillion, 176 B.R. 563 (Bankr. D.Or. 1994) (distinguishing BFP).

(iii) "The Bankruptcy Court is without authority to avoid a tax foreclosure sale conducted in accordance with state law." In re Comis, 181 B.R.145, 150 (Bankr. N.D.N.Y. 1994). The Comis court went on to set forth that "the Bankruptcy Code should be construed to adopt, rather than to displace, pre-existing state law' unless a federal statutory purpose to the contrary is manifest." Id. (citing BFP v. RTC) Additionally, Comis says, citing to BFP v. RTC, "fair market value presumes market conditions that, by definition, simply do not obtain in the context of a forced sale . . . market value cannot be a criterion of equivalence in the foreclosure sale context."

(iv) The debtor must prove irregularity in the conduct of a prepetition foreclosure sale to avoid such sale as a fraudulent conveyance. In re Theoclis, 213 B.R. 880 (Banks. D. Mass. 1997); In re Main Inc., 1999 WL 689715 (E.D. Pa. Sept. 3, 1999).

10. Avoidance Under Bankruptcy Code 544(b)

a. Elements Under Bankruptcy Code Section 544(b), a trustee may avoid a transfer or an obligation if -

(i) the transfer was made or the obligation was incurred by the debtor, voluntarily or involuntarily, and

(ii) such transfer or obligation would be voidable by an actual creditor holding an unsecured claim under non-Bankruptcy Code fraudulent conveyance laws.

b. New York Fraudulent Conveyance Law: Under New York's Debtor and Creditor Law, Art. 10, § 270-281, a creditor may set aside a conveyance and attach or levy upon the property conveyed, if the conveyance by the debtor is deemed to be fraudulent. A conveyance by the debtor, without fair consideration, who is or will be rendered insolvent thereby is deemed to be fraudulent, without regard to actual

intent. (See below for more discussion of fraudulent transfers under New York law.)

c. Advantages and Disadvantages

(i) The major advantage of using Bankruptcy Code Section 544 is that the statute of limitations is six years instead of one year under Bankruptcy Code Section 548.

(ii) If a conveyance is voidable and may be recovered for the benefit of a single unsecured creditor, under state law the trustee is able to avoid the entire transfer or obligation for the benefit of the estate and all creditors. See, In re Davis, 785 F.2d 926, 927 (llth Cir. 1986).

(iii) A Chapter 11 debtor-in-possession may recover corporate assets illegally transferred to third parties, though the pre-petition debtor was as guilty as the third party, as the debtor-in-possession has the rights and powers as a trustee who acts for the blameless creditors of the estate. In re Wedtech Corp. 88 B.R. 619 (Bankr. S.D.N.Y. 1988).

(iv) The major limitation on the use of New York's Article 10 is that the trustee can only act to the extent that there is at least one unsecured creditor who has standing to invoke the Article 10 remedy.

(v) An advantage to using New York's Article 10 is that if the transfer is found to have been made with actual intent (as opposed to constructive fraud) the plaintiff may recover attorneys fees. D&CL § 276-a.

11. Partnerships: Transfers of interest to a general partner in property or obligation incurred by debtor partnership, made or incurred within one year before filing of petition, is avoidable if partnership was or became insolvent as a result. 11 U.S.C. § 548(b); See Scherer v. Leslie Fay Sales (In re Jercyn Dress Shop) 516 F.2d 864 (2d Cir. 1975).

12. Defenses to Avoidability

a. Bona fide transferee's lien or interest: Transferee or obligee of a Bankruptcy Code § 548 transfer who takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred to extent that transferee/obligee gave value to debtor in exchange. 11 U.S.C. § 548 (c)); In re Health Gourmet, Inc., 29 BR. 673 (Bankr. Mass. 1983).

b. Property transferred was not property of debtor's estate.. See e.g., Nordberg v. Sanchez (In re Chase & Sanborn Corp.) 813 F.2d 1177 (11th Cir. 1987).

c. "Good faith" transferee

(i) Transfers must represent actual arm's length transactions. Bullard v. Aluminum Company of America, 468 F.2d 11 (7th Cir. 1972).

(ii) Transfers where transferee had no knowledge of insolvency or fraudulent intent by transferor. United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), cert. denied 483 U.S. 1005 (1987); Chorost v. Grand Rapids Factory Show Rooms, Inc., 77 F. Supp. 276 (D.C.N.Y. 1948), aff'd 172 F.2d 327 (3d Cir. 1949).

(iii) A transferee of the initial transferee of property from a debtor (or any subsequent transferee) may assert the bona purchaser defense under Bankruptcy Code § 550(b)(1) if she can prove that she gave reasonably equivalent value, not necessarily fair market value. In re Laguna Beach Motors, Inc., 159 B.R. 562, 568 (Bankr. C.D. Cal. 1993).

d. Bankruptcy Code § 549 permits the avoidance of certain post-petition transfers. Avoided transfers under Bankruptcy Code § 544, 547, 548 and 549 are treated identically for purposes of Bankruptcy Code § 550, entitled "Liability of Transferee of Avoided Transfer."

e. Defendants in fraudulent conveyance actions have the burden of demonstrating that they are entitled to the benefits of the statute permitting an initial transferee who takes for value and in good faith to retain any interest transferred to the extent of any value given the debtor in exchange for the transfer. In re Candor Diamond Corp., 76 B.R. 342 (Bankr. S.D.N.Y. 1987).

13. Guaranties

a. Intercorporate guaranties can be classified as follows:

(i) Upstream - Sub guaranties Parent's debt.

(ii) Downstream - Parent guaranties Sub's debt.

(iii) Cross stream - Sub-1 guaranties Sub-2's debt.

b. Intercorporate guaranties raise fraudulent conveyance concerns because the entity providing the guaranty may not receive reasonably equivalent value for the obligation assumed. Downstream guaranties have generally been thought to be safe from fraudulent conveyance attack because the parent generally obtains a benefit (in the form of increased equity) from its subsidiary (but see "c.", below). The same is not true of upstream and cross stream guaranties.

c. Downstream Guaranties: In General Electric Credit Corp. of Tennessee v. Murphy (In re Rodriguez) 895 F.2d 725 (11th Cir. 1990), a holding company owned a subsidiary that purchased an aircraft and financed the transaction. The shareholder of the holding company guaranteed the loan but the holding company did not. Nonetheless, the holding company acted as if it had guaranteed the loan and made payments to the lender. When the holding company failed to continue making payments, the aircraft was repossessed and sold for less than the amount of the debt. When the holding company went into bankruptcy, its trustee attempted to recover the payments made to the lender as fraudulent conveyances.

(i) The court held that the payments by the holding company would not have been fraudulent conveyances if the payments created equity in the aircraft for the subsidiary. Because no equity was created, the holding company did not receive reasonably equivalent value.

(ii) The court also noted that if the payments were made pursuant to a guarantee executed at the time of the loan, the payments would not have been fraudulent conveyances because the guaranty would have enabled the subsidiary to obtain the loan.

d. Upstream Guaranties: In In re Chase & Sanborn Corp., 904 F.2d 588 (11th Cir. 1990), a subsidiary guaranteed a $22 million loan to the parent in exchange for $369,288 in loan proceeds. The subsidiary later paid back $4 million of the parent's debt. The subsidiary's trustee attempted to avoid the guaranty and the payments as fraudulent conveyances.

(i) In addressing the guaranty, the court held that, in determining "reasonably equivalent value," the amount of the guarantor's liability must be discounted from the face amount by the probability that the

guaranty would be called. See also In re Xonics Photochemical, Inc., 841 F.2d 198 (7th Cir. 1988) (similar method employed for determining a guarantor's solvency).

(ii) As the loan was secured by other collateral and other guaranties, the amount of the loan proceeds actually received by the sub constituted reasonably equivalent value for the guaranty.

(iii) As the guaranty was valid and enforceable, the payments were made in partial satisfaction of the guaranty.

e. Cross stream Guaranties — "Family Style" Loan Agreements: GECC made working capital loans to three affiliated corporations under separate loan agreements which were later converted into a single consolidated loan agreement which was cross collateralized and cross guaranteed. Advances were made under a consolidated borrowing formula. The debtors filed bankruptcy petitions and challenged both the cross guaranties and the cross collateralization as fraudulent conveyances on the theory that (and to the extent that), on an entity by entity basis, the obligations exceeded the amount of the loan proceeds actually received. Tryit Enterprises v. General Electric Capital Corp. (In re Tryit Enterprises) 121 B.R. 217 (Bankr. S.D. Tex. 1990).

(i) On its own, the court determined that the debtors failed to show evidence of the existence of an actual unsecured creditor at the time that the consolidated loan agreement and related agreements were signed. Thus, the suit was dismissed on procedural grounds. Even assuming the debtors had made the requisite showing, the court would have found in favor of GECC on the basis that the consolidated groups should be treated as a single enterprise. The factors in favor of such a finding were (i) the bills of the debtors were paid out of a single office, (ii) each of the debtors paid a proportionate share of the office expense, (iii) there were common principals of the debtors, and (iv) the debtors held themselves out as a single business enterprise.

(ii) The court was not troubled by the fact that the debtors might have received disproportionate shares of the loan proceeds. Instead, the court focused on other benefits to find fair consideration such as the

fact that individually, the debtors would not have qualified for this type of financing, and the financing allowed them to pay off the prior loans.

14. Liability For An Avoided Transfer

a. Bankruptcy Code § 550(a) provides -

"- to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from:

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee (though Section 550(b) limits the subsequent transferees from whom recovery can be had)."

b. When a transfer is avoided, the trustee may recover the value of the property transferred from the initial, mediate or immediate transferee of the initial transferee (subject to the exceptions under § 550(a)(2)). 11 U.S.C. § 550; In re Pearson Indus., Inc., 142 B.R. 831 (Bankr. C.D. Ill. 1992).

c. The language of § 550(a) is important — some courts have disallowed a preference recovery because it was not "for the benefit of the estate." See, e.g., Harstad v. First American Bank, 39 F.3d 898, 903 (8th Cir. 1994) ("benefit to the estate" requires that the preference recovery would benefit unsecured creditors); Weilman v. Wellman, 933 F.2d 215, 218-9 (4th Cir. 1991), cert. denied 502 U.S. 925 (1991); Congress Credit Corp. v. AJC Int'l 186 B.R. 555 (D. Puerto Rico 1995); In re Pearson Indus., Inc., 178 B.R. 753 (Bankr. C.D. Ill. 1995) (even though transfer avoidable, no liability by supplier for recovery because the property to be recovered was fully encumbered by creditors' security interests). In re Trans World Airlines, Inc., 163 B.R. 964, 969 (Bankr. D. Del. 1994) (where the bankruptcy court found a benefit to the estate even though recovered funds would only pay down a secured claim because the lightened debt load would arguably make reorganized debtor stock received by some unsecured creditors more valuable). But see In re Coleman, 285 B.R. 892, 911 (W.D. Va. 2002) (creditor need not be directly benefited); Dunes Hotel Assoc. v. Hyatt Corp., 245 B.R. 492 (D.S.C. 2000).

15. Jury Trial Right

a. An action to set aside a fraudulent transfer is an equitable action and jury trial is not necessarily available. See, e.g., Whitlock v. Hause, 694 F.2d 861 (lst Cir. 1982).

b. A fraudulent transfer action also seeking money damages is an action at law and would be subject to jury trial in bankruptcy court (assuming a proof of claim had not been filed). Nickinello v. Roberson (In re Huey) 23 B.R. 804 (9th Cir. BAP 1982).

c. Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 109 S.Ct. 2782, 2787 (1989) holds that "a person who has not submitted a claim against a bankruptcy estate has a right to a jury trial when sued by the trustee to recover an allegedly fraudulent monetary transfer." Thus, the right to jury trial depends upon the nature of a particular action.

d. At least one case seems to distinguish Granfinanciera by holding that no jury trial right exits in real estate fraudulent conveyance cases for two reasons:

- First, fraudulent conveyance actions to avoid land conveyances may be different than fraudulent conveyance cases involving personal property or fungible funds, since at common law actions for land were both legal and equitable. In re Pasguariello, 16 F.3d 525 (3d Cir. 1994). An action to recover possession of real property, often known as ejectment, was an action at law. Id. (citations omitted).

- "Second, unlike land, the dollars in Granfinanciera were fungible, so recovery of a money judgment for the amount of money fraudulently conveyed was viewed as equivalent to an avoidance of the conveyance." (citation omitted).

e. The Bankruptcy Reform Act of 1994 added the following to 28 U.S.C. § 157:

(1) If the right to a jury trial applies in a proceeding that may be heard under this section by a bankruptcy judge, the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district and with the consent of all the parties.

f. By filing the protective proof of claim, a defendant that is neither a creditor nor a party asserting a claim against the estate, invokes the claims allowance process in which the jury trial right is inapplicable.

g. However, the waiver by virtue of the filing of a proof of claim may not be an absolute and complete waiver of the jury trial right. In re Dietert, 271 B.R. 499 (Bankr. S.D. Tex 2002) (creditor retained jury trial right, even after it filed a proof of claim, with regard to any issue that did not need to be adjudicated as part of the claims allowance or objection process).

h. A claims bar date may not be extended as a remedy to protect a creditor, where the filing of a proof of claim compels a creditor to waive its right to a jury trial. In re Hooker Inves., Inc., 937 F.2d 833 (2d Cir. 1991).

i. Filing a proof of claim against one jointly-administered estate did not waive jury trial right as to other estates. Committee of Unsecured Creditors v. Schwartzman (In re Stansbury Poplar Place, Inc.) 13 F.3d 122, 126 (4th Cir. 1993).

16. Family Law Cases

a. Section 548 of the Bankruptcy Code is applicable to a transfer made pursuant to a decretal paragraph in a marital dissolution order or pursuant to a property settlement, if the transfer falls within the statutory scheme of §548. Goldstein v. Lange (In re Lange), 35 B.R. 579 (Bankr. RD. Mo. 1983).

b. The transfer of property from a debtor to a former wife in exchange for the release of marital rights, including support or inheritance, under applicable North Carolina law, was a voidable fraudulent conveyance and under §548 of the Bankruptcy Code. Gray v. Snyder, 704 F.2d 709 (Cir. 1983). On appeal, the Court of Appeals vacated in part and remanded for further fact finding on the issue of whether the wife's release of her marital rights could constitute "reasonably equivalent value" within the meaning of § 548 of the Bankruptcy Code. Id.

c. Where the former husband, a chapter 11 debtor, sought to nullify a prepetition property settlement pursuant to § 548 and applicable state fraudulent conveyance laws, the district court held the consent decree memorializing the property settlement to be binding on the debtor and the nondebtor former spouse. Falk v. Hecker (In re Falk) 98 B.R. 472 (D. Minn. 1989); but see, In re Hope, 231 B.R. 403, 422-423 (Bankr. D.D.C. 1999); In re Haskell, 1998 WL 809520, *6-8 (Bankr. D. Ill. 1998).

d. Where debtor's default in a divorce action resulted, among other things, in the transfer of the debtor's interest in the marital homestead to his now ex-wife, such

conduct was a transfer under § 548 of the Bankruptcy Code. In re Clausen, 44 B.R. 41 (Bankr. D. Minn. 1984). As there was no evidence of an exchange of value, the transfer upon default was found to be a fraudulent conveyance for the purpose of placing the homestead beyond the reach of the debtor's creditors. Id. Thus, the debtor was not discharged under § 727(a)(2)(A) of the Bankruptcy Code. Id.

e. Lottery winnings transferred under a separation agreement were found to be marital property, and therefore property of the debtor's estate, and such transfer may be challenged as a fraudulent conveyance under § 548. Cozzin v. Ford (In re Ford) 1999 U.S. App. Lexis 33421 (6th Cir).

f. Some bankruptcy courts have given preclusive effect to a state court's approval of an agreed property division as "fair and equitable" in a domestic relations case, as they have found the existence of such a finding to be tantamount to a determination by the domestic relations court that the transfers made by the parties were supported by reasonably equivalent value. In re Falk, 98 B.R. 472 (Bankr. D. Minn. 1984).

g. Other bankruptcy courts have criticized such a per se rule and have found that the standards for measuring the fairness of a property division in a domestic relations case and reasonably equivalent value under fraudulent conveyance law are "separate and distinct." Cozin v. Ford (In re Ford), 1999 U.S. App. Lexis 33421(6" Cir).

<u>2011 SUPPLEMENT TO BASICS OF BANKRUPTCY CLE</u>
<u>RE: VOIDABLE FRAUDULENT CONVEYANCES</u>

Updated by: Martin A. Mooney, Esq. and Pedram Shahram, Law Clerk
May 2011

2. <u>Who Can Bring Suit</u> – Standing and Capacity to Sue

c(i) While most courts require that the Trustee bring the action under section 548 [*Knapper v. Bankers Trust Co*. 407 F.3d 573, 583 (3rd Cir. 2005) holding that Chapter 13 Debtor cannot invoke the powers and authority of Trustee in avoiding transfer of property under §544(b), that the power belongs to the Trustee], recent case law, however, permit that the action can be brought by the debtor alone. [*In re Dickson*, 427 B.R. 399, 406 (B.A.P. 6th Cir. 2010) holding that Chapter 13 Debtor has standing to bring actions on behalf of the estate under §544(b) and 547].

c(ii) In addition, *In re Cohen,* 305 B.R. 886, 900 (B.AP. 9th Cir. 2004), a Chapter 13 Debtor had statutory standing, concurrent with the trustee, to exercise §544 avoiding powers for the benefit of the estate and, even if no statutory standing existed, Chapter 13 Debtor had third-party standing.

(d)(v) *In re Professional Investment Properties of America*, the 9th Circuit held the "if a creditor is pursing interests common to all creditors or is appointed for the purpose of enforcement of the plan, the creditor may exercise the trustee's avoidance powers" 955 F.3d 623, 526 (9th Cir. 1992).

(vi) However, the general consensus is that an outright sale to the third party is not permitted, unless the estate retains some continued interest, or unless the sale is of the estate's interest under §544(b) – state-law based claims – as opposed to federal claims under §548. [See 5 Collier on Bankruptcy ¶548.02 [4]; citing *In re Moore*, 608 F.3d. 253 (5th Cir. 2010)].

(vii) Notably, while courts permit individual creditor to bring a claim for fraudulent transfer action on behalf of the bankruptcy estate, creditors do not have standing to bring forth an action on their own right and for their own benefit even if they would have standing to do so outside the bankruptcy. [*In re PWS Holding Corp.*, 303 F.3d 308 (3rd Cir. 2002)].

4. <u>Bringing A Fraudulent Conveyance Case</u>

Fed. R. Bankr. Pro. 7009, which incorporates Rule 9 of the Fed. R. Civ. Pro., requires that allegation of fraud be plead with particularity. The complaint must at least be sufficiently specific to give the defendant full notice of the claims that are being asserted, thus allowing the defendant to prepare an adequate answer, affirmative defense and/or

counterclaims. [Collier on Bankruptcy ¶ 548.11[1][a][ii]; see *In re O.P.M. Leasing Servs., Inc.,* 35 B.R. 854 (Bankr. S.D.N.Y. 1983)]

Courts have held, however, "Fed. R. Civ. Pro. 9(b) does not apply to claims for avoidance of constructively fraudulent transfer because such claims are not based on actual fraud, but instead rely on defendant's financial condition and the sufficiency of consideration provided by the transferee." *In re Caremerica, Inc.,* 409 B.R. 346 (Bankr. E.D.N.C. 2009); *In re Verestar, Inc.,* 343 B.R. 444 (S.D.N.Y. 2006). Instead, constructively fraudulent transfer claims under 548(a)(1)(B) must satisfy Rule 8(a) more laxed pleading standard. [5 Collier ¶ 548.11[1] [b]; Fed. R. Civ. Pro. 8(a) (2)]

8. Statutory Requirements following

(b)(iii)(F) Under the Uniform Fraudulent Transfer Act ("UFTA"), "if the transaction was made with the actual intent to hinder delay, or defraud, it is four years after the transaction, or one year after the discovery of the transaction, whichever is later. UFTA §9(a). If the transaction is lacking actual intent, and is only constructively fraudulent, the statute of limitations is four years without an extension for concealment. UFTA §9(b). Notably, however, a trustee is permitted to bring an action more then four years after the transaction if the bankruptcy petition itself was filed within four years." [5 Collier on Bankruptcy ¶548.09 [1][b]]

Ten years after the Transaction: "§548(e) addresses transfers made to self-settled trusts or similar trusts or similar devices with the intent to hinder, delay, or defraud creditors, these transfers remain vulnerable to avoidance for ten years." [5 Collier on Bankruptcy ¶548.09 [1][d]]

11. Partnerships following (11)

Note: Pursuant to §101 of the Bankruptcy Code, a partnership is not considered to be insolvent unless it liabilities exceed not only the partnerships asset, but also the surplus of the combined worth of all general partner.

12. Defenses to Avoidability

Note: Section 548(c) requires both value and good-faith. Thus, if the transferee take in good-faith, but does not give value, the trustee can avoid the transfer. The transferee's only recourse is to claim a lien on the property transferred. [Collier ¶ 548.09[2]]; *In re Rosen Auto Leasing, Inc.,* 346 B.R. 798, 805 (B.A.P. 8th Cir. 2008)]

[*Charitable Contributions:*] Under § 548(a)(2), a safe harbor defense exists for transferees who have received qualifying charitable contributions. Contributions qualify if they do not exceed 15 percent of the debtor's annualized income during the year. [Colliers ¶ 548.09[6][b]] The term "contribution", however, an area of some dispute, has been held to be the debtor's annual amount of contributions to the charity made during the year in question, such that the court must add all the qualifying contributions made and compare it to the 15 percent ceiling, rather than compare each separate transfer to that limit. [Colliers ¶ 548.09[6][b]; H.R. Rep No. 556, 105th Cong. 2d Sess. 8 (1998); *Universal Church v. Geltzer*, 463 F.3d 218, 255 (2d Cir. 2006)]

16. Family Law Cases

h. Bankruptcy courts have different approaches to whether, or not, prepetition interspousal transfers of an interest in entireties property can be avoid as fraudulent. For instance, "when both spouses have joined in transferring entireties property to a third party, and there are joint creditors, the trustee may seek to avoid." [5 Collier ¶ 548.08[2]; *In re Sanders*, 213 B.R. 324 (Bankr. M.D. Tenn. 1997)]. "Likewise, if one spouse converts his of her separate property into entireties property, the transfer may be attacked as actually or constructively fraudulent as to the spouse's separate creditors." [5 Collier ¶ 548.08[2]; *In re Duncun*, 329 F.3d 1195 (10th Cir. 2003).

   If state law allows a creditor to reach the portion of the debtor's spouses interest in entireties property, then a prepetition interspousal conveyance of the debtor's interest can be prejudicial the creditor. [5 Collier ¶ 548.08[2]].

   Note: New York Law allows separate creditors to reach the debtor spouse's life interest, and thus a prepetition interspousal transfer could be avoided. [5 Collier ¶ 548.08[2]; *In re Pappas,* 239 B.R. 448 (E.D.N.Y. 1999).

   The U.S. Supreme Court, in *BFP v. Resolution Trust Crop.*, "resolved that question of whether the trustee could bring a constructive fraudulent transfer claim to recover property lost by debtor in a foreclosure sale. There the Court held that the price obtained in a regularly conducted noncollusive foreclosure sale constitutes reasonably equivalent value as a matter of law for the property conveyed." Christopher W. Frost, *Reasonably Equivalent Value in Divorce Proceedings: How Far Does BFP Extend?*, Bankruptcy Law Letter, Vol. 30, Issue 1 (Jan. 2010). The 9th Circuit, *In re Bledsoe*, "examined the scope and reasoning of *BFP v. Resolution Trust Corp.*, in the context of division of property under a martial dissolution judgment." *Id.* There the 9th Circuit extended the Supreme Court's holding in *BFP* to martial dissolution judgments, holding that the state court's division of property in a properly conducted and contested divorce proceeding "conclusively establishes 'reasonably equivalent value' for the purpose of §548, in the absence of fraud." *Id.; In re Bledsoe,* 569 F.3d 1106 (9th Cir. 2009).

NEW YORK BAR ASSOCIATION
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BASICS OF BANKRUPTCY PRACTICE

TRUSTEE'S STRONG ARM POWERS

by

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Trustee's Strong Arm Powers Introduction

1. Introduction

a. Bankruptcy Code Section 544 of the Bankruptcy Code,[1] the "strong arm statute", makes transfers that are avoidable under state law avoidable in bankruptcy. In re Consolidated Pioneer Mortg. Entities, 211 B.R. 704 (S.D. Cal. 1997) (Bankruptcy courts look to state law to determine extent of debtor's property interest for purpose of avoidance).

2. Hypothetical Judicial Lien Creditor Status

a. Trustees are given the rights and powers of a judicial lien creditor. See 11 U.S.C. § 544(a)(1) (1978, as amended). Bankruptcy Code Section 544(a)(l) gives the trustee this status:

(i) as of the commencement of the case (the date of the filing of the petition)

(ii) without regard to any knowledge of the trustee or any creditor

(iii) of a creditor who at the commencement of the case both -

(A) extends credit to the debtor, and

(B) obtains a judicial lien on all the property of the debtor on which a creditor on a simple contract could have obtained such a judicial lien

(iv) whether or not such a creditor exists.

b. Lien Avoidance The trustee's status as hypothetical judicial lien creditor is often used to avoid unperfected security interests.

(i) A judicial lien creditor has priority over an unperfected security interest. N.Y. U.C.C. § 9-301(l)(b) (McKinney 1993). Thus, a trustee may avoid a security interest that is not properly perfected on the bankruptcy filing date, in accordance with the requirements of Article 9 of the Uniform Commercial Code (UCC). But see In re Howard's Appliance Corp., 874 F.2d 88 (2d Cir. 1989) (creditor with unperfected security interest was protected as the beneficiary of a constructive trust imposed on the collateral because of the debtor's wrongful conduct in moving the collateral to a different state without giving notice to the creditor). The outcome in Howard's Appliance has been questioned by several courts. See Matter of Haber Oil Co., Inc., 12 F.3d 426 (5th Cir. 1994); In re Gurley, 222 B.R. 124 (Bankr. W.D. Tenn., 1998);

1 All references to the Bankruptcy Code are citations to 11 U.S.C. § 101, et seq. unless otherwise noted.

In re Lansberry, 177 B.R. 49 (Bankr. W.D. Pa. 1995); In re Foos, 183 B.R. 149 (Bankr. N.D. Ill. 1995).

(ii) Purchase Money Security Interests: A purchase money security interest, perfected within twenty days in several states, and either ten or fifteen in others, after the debtor receives possession of the collateral, takes priority over the rights of a creditor who obtains a lien between the time the security interest attaches and the time that the security interest is perfected by filing. U.C.C. § 9 301 (c)(2).

(iii) New York is among the states that employs the 20 day rule. N.Y. U.C.C. § 9-301(2). Therefore, if an Article 9 purchase money security interest in unperfected when the bankruptcy case is commenced, but is perfected by the filing of financial statements during the applicable UCC § 9-301(2) "relation back" period, the trustee cannot avoid the security interest.

3. Judgment Creditor Status: The trustee has the status of a hypothetical creditor who extended credit to the debtor at the time when the petition is filed and who had a writ of execution that is returned unsatisfied at that time, whether or not such a creditor exists. 11 U.S.C. § 544(a)(2).

4. Trustee as Hypothetical Bona Fide Purchaser of Real Property

a. Bankruptcy Code Section 544(a)(3) gives the trustee this hypothetical status -

(i) without regard to any knowledge of the trustee or any creditor

(ii) of a bona fide purchaser of real property (other than fixtures) from the debtor against whom applicable law permits a transfer to be perfected

(iii) who at the time of the petition

(A) acquires the status of a bona tide purchaser, and

(B) has perfected such transfer.

b. Bankruptcy Code Section 544(a)(3) is designed to enable the trustee to avoid real estate transfers, including mortgages, deeds, leases, and other types of transfers, that are required to be recorded in order to be effective against a bona fide purchaser. These transfers must have been unperfected on the bankruptcy filing date if they are to be avoided. Additionally, application of Bankruptcy Code § 544(a)(3) has permitted a trustee to defeat the rights of a third party who has an equitable interest in the debtor's real estate pursuant to a constructive trust. See Belisle v. Plunkett 877 F.2d 512 (7th Cir. 1989), cert. denied 493 U.S. 893 (1989). But see In re Omegas Group. Inc., 16 F.3d 1443 (6th Cir. 1994); In re Mill Concepts Corp., 123 B.R. 938 (Bankr. D. Mass. 1991); In re Brown, 182 B.R. 778 (Bankr. E.D. Tenn. 1995).

c. Bona fide purchaser is defined by laws of the state in which the real property is located. In re Palmer, 140 B.R. 765 (Bankr. C.D. Cal. 1992).

d. Constructive Notice: A purchaser often takes property subject to an unrecorded interest of a prior transferee if the prior transferee's possession of the premises or other indicia would constitute "constructive notice" of an interest. Courts have held that the trustee's status, in such circumstances, is limited to that of a bona fide purchaser with constructive notice, notwithstanding the Bankruptcy Code's admonition that the trustee's rights are "without regard to any knowledge of the trustee or of any creditor." 11 U. S. C. § 544(a)(3). See, McCannon v. Marston, 679 F.2d 13 (3d Cir. 1982) (trustee may not avoid unrecorded conveyance of a condominium unit in a bankrupt hotel where purchaser's possession of the unit obligated the trustee under state law to inquire into the purchaser's interest). But see Core Section 20 Land Group, Ltd., 261 BR. 718 (Bankr. M.D. Fla. 2000) McCannon v. Marston, has been followed in several contexts:

(i) Trustee had constructive notice by virtue of possession of state court receiver appointed to foreclose unperfected security interest in real estate. In re The De Rochfort Co. Ltd., 22 B.R. 826 (Bankr. S.D. Fla. 1982).

(ii) Trustee had constructive notice by virtue of possession of tenant of purchaser, even if land contract was unrecorded. In Matter of Fitzpatrick, 29 B.R. 701 (Banks. W.D. Wis. 1983).

(iii) Trustee had constructive notice from a notice of lis pendens filed by plaintiff in state court action to impose a constructive trust on real estate recorded in name of debtor. In re Gurs, 34 B.R. 755 (9th Cir. BAP 1983).

(iv) A debtor-in-possession had constructive notice of another party's unrecorded interest in real property based on that party's "clear and open possession." In re Probasco, 839 F.2d 1352, 1354 (9th Cir. 1988) (citations omitted). C.f. In re Normandin, 106 B,R. 14 (Bankr. D. Mass. 1989).

e. The McCannon rule has been held inapplicable where a debtor-in-possession could not be charged with knowledge of federal tax liens at the time of commencement of the case because the tax claim was not filed until approximately three months after the petition. U.S. v. Seier, 139 B.R. 752 (N.D. Fla. 1991).

f. The Fourth Circuit Court of Appeals severely limited the use of Bankruptcy Code Section 544(a)(3) by a debtor-in-possession in a Chapter 11 case. In re Hartman Paving, Inc., 745 F.2d 307 (4th Cir. 1984). The Court held that the debtor's actual knowledge of an unrecorded interest in real property is imputed to a debtor-in-possession. Id. Thus, the debtor-in-possession's rights as a hypothetical bona fide purchaser are severely circumscribed. Knowledge, such as this, if imputed to the debtor-in-possession, would reduce the utility and effect of Bankruptcy Code § 544(a)(3) in Chapter 11 cases. However, other courts have held that actual knowledge does not vitiate the debtor-in-possession's bona fide purchaser status. Lawrence P. King, 4 Collier on Bankruptcy 1554.01, 544-3 (l5th ed. 1993).

g. New York courts have taken a different approach, having generally held that the actual knowledge of the prepetition debtor, the debtor-in possession or a trustee of a prior interest in property does not bar a trustee from sustaining a claim of bona fide purchaser

status. In re Kennedy Inn Associates, 221 B.R. 704, 712 (Bankr. S.D.N.Y. 1998) ("Section 544(a)(3) gives a debtor in possession the rights and power of a 'bona fide purchaser of real property' without regard to any actual 'knowledge' possessed by it.") (citations omitted). A trustee or debtor in possession, however, is chargeable with constructive knowledge. (citations omitted). Under applicable New York law, constructive knowledge is limited to knowledge arising from (i) [A]n examination of the record, Andy Assocs., Inc. v. Bankers Trust Co., 49 N.Y.2d 13, 424 N.Y.S.2d 139, 399 N.E.2d 1160 (1979); (ii) reasonable inquiry of those in actual possession, Wardell v. Older, 70 A.D.2d 1008, 418 N.Y.S.2d 196 (3rd Dep't 1979); or (iii) reasonable inquiry on the basis of all of the circumstances. In re Hardaway Restaurant, Inc., 31 B.R. 322 (Bankr. S.D.N.Y. 1983); In re Bygraph Inc., 56 B.R. 596, 603 (Bankr. S.D.N.Y. 1986); In re Davidson Rehab. Assoc., 103 B.R. 440 (Bankr. S.D.N.Y. 1989). Moreover, under New York law, a prospective bona fide purchaser may be charged with constructive notice of all in the record. Doyle v. Lazarro, 33 A.D.2d 142, 306 N.Y.S.2d 268 (3d Dep't 1970), aff'd, 33 N.Y.2d 981, 353 N.Y.S.2d740 (1974). See Andy Assocs., Inc. v. Bankers Trust Co., 424 N.Y.S.2d at 145. If no such inquiry is made, the purchaser is charged with what a reasonable inquiry concerning the defect would have revealed. Williamson v. Brown, 15 N.Y. 354, 362 (1857) (finding that a prospective purchaser would have been on notice of an inconsistency within a release document and by reasonable further inquiry would have learned of an order amending a foreclosure judgment that set forth that a portion of the foreclosed lien remained extant, the trustee was unable to avoid the lien under § 544(a)(3)). In re Mosyello, 190 B. R. 165 (Bankr. S.D.N.Y. 1995), aff'd,193 B. R. 147 (S.D.N.Y. 1996), aff'd, 104 F.3d 352 (2d Cir. 1996). The New York bankruptcy courts have added a gloss on the analytic mode set forth by the New York Courts — "reasonable inquiry on the basis of all the circumstances." In re Kennedy Inn Assoc., 221 B. R. 704 (Banks. S.D.N.Y. 1998); In re Bygraph, Inc., 56 B.R. 596 (Bank S.D.N.Y. 1986); In re Hardaway Restaurant. Inc., 31 B.R. 322 (Bankr. S.D.N.Y. 1983).

5. Trustee as Statutory Successor to Actual Creditor

a. The trustee may avoid any transfer of the debtor's property or any obligation incurred by the debtor that is voidable under nonbankruptcy law by an actual creditor who has an allowable unsecured claim. 11 U.S.C. § 544(b).

b. The trustee is given the status of an actual unsecured creditor, and is allowed to avoid transfers that are not otherwise avoidable by the trustee as a hypothetical judicial lien creditor or bona fide purchaser under Section 544. For example, assume that the debtor fraudulently transferred an interest in property four years before a bankruptcy filing. The trustee, as a judicial lien creditor, may not prevail and avoid the transfer as long as the interest transferred is perfected prior to bankruptcy. Additionally, the conveyance is not avoidable under Section 548, because the transfer occurred more than one year prior to the bankruptcy filing. (Now, two years under the Bankruptcy Abuse Prevention and Consumer Protection Act.) However, the trustee may be able to avoid the transfer of the interest under Bankruptcy Code Section 544(b). However, this power is only available to the trustee if he or she is able to identify an unsecured creditor who has the right to defeat the security interest as a fraudulent conveyance under applicable non bankruptcy law.

c. The extent of the trustee's power under Bankruptcy Code Section 544(b) is often greater than that of the actual creditor, although the power of the trustee under this section depends upon the existence of a creditor who has the right to avoid the transfer. Moore v. Bay, 284 U.S. 4 (1931). In Moore, the Supreme Court interpreted § 70(e) of the former Bankruptcy Act, which is similar to, and the statutory precursor of, Bankruptcy Code § 544(b), and held the trustee's powers as successor to actual creditors was not limited to the amount of claim of those creditors who could have avoided the transfer under nonbankruptcy law. The Bankruptcy Code adopts the Moore rule, since under Bankruptcy Code § 544(b), the trustee's power is not limited to the actual creditor's claim.

d. A transfer under Bankruptcy Code § 544(b) is avoided for the benefit of the estate and not just for the benefit of the actual unsecured creditor who had the right to avoid the transfer under applicable non-bankruptcy law. The unsecured creditor who had the right to avoid the transfer under nonbankruptcy law loses standing to avoid the transfer once a bankruptcy petition is filed. See Moore v. Bay.

e. Most common use of Bankruptcy Code § 544(b): Fraudulent Conveyances. The trustee invokes (1) Bankruptcy Code § 548, or (2) state fraudulent conveyance law and § 544(b), when attempting to avoid an apparently fraudulent transfer. See, e.g., In re White Metal Rolling and Stamping Corp., 222 B.R. 417 (Bankr. S.D.N.Y. 1998); In re Checkmate Stereo & Electronics, Ltd., 21 B.R. 402 (E.D.N.Y. 1982); In re B.Z. Corp., 34 B.R. 546 (Bankr. E.D. Pa. 1983); Matter of Tabala, 11 B.R. 405 (Bankr. S.D.N.Y. 1981).

(i) In several states, the Uniform Fraudulent Conveyance Act (UFCA), first adopted in 1918, governs as applicable nonbankruptcy law.

(ii) In 1984, the Commissioners on Uniform State Laws adopted a replacement to the UFCA - the Uniform Fraudulent Transfer Act (UFTA). See 7A Uniform Laws Annot. The UFTA has been adopted in the majority of states.

(iii) New York is a UFCA state. Thus, a New York Chapter 7 Trustee can "step into the shoes" of an unsecured creditor to seek to avoid a transfer of real property under New York law. N.Y. Debt. & Cred. Law § 270 et seq. (McKinney 1994). In re White Metal Rolling and Stamping Corp., 222 B.R. 417 (Bankr. S.D.N.Y. 1998); In re Fair, 142 B.R. 628 (Bankr. E.D.N.Y. 1992).

f. One reason for using state fraudulent conveyance law together with § 544(b), instead of relying on Section 548 of the Bankruptcy Code, is to take advantage of longer statutes of limitation provisions.

(i) Bankruptcy Code Section 548 is limited to transfers made within two years prior to a bankruptcy filing. (For bankruptcy cases filed before October 17, 2005, recovery under Section 548 was limited to transfers made within one year of the filing.)

(ii) State statutes of limitation on fraudulent conveyance actions are typically longer than one year. The UFTA has its own statute of limitations section

(the UFCA does not have its own statute of limitations section). Section 9 of the UFTA provides that the limitation is:

(A) four years after the transfer was made or, if later, within one year after it reasonably could have been discovered, if the transfer was made with actual intent to hinder, delay, or defraud creditors;

(B) four years after the transfer was made if made without reasonably equivalent value and either (1) the debtor was insolvent or left insolvent because of the transfer, (2) the transfer left the debtor with unreasonably small assets for the business or for a transaction in which he was engaged or about to engage, or (3) the debtor intended or should have reasonably believed he would incur debts beyond the debtor's ability to pay as they become due; or

(C) one year after the transfer occurred if it was a preference made by an insolvent debtor to an insider/creditor who had reasonable cause to believe that the debtor was insolvent.

(iii) The New York State limitation is six years from the commission of the fraud or, if discovery of the fraud is delayed, two years from discovery or the time when with reasonable diligence the fraud could have been discovered. N.Y. Civ. Prac. L. & R. 203(g) and 213(8).

g. Some New York Debtor & Creditor Law § 276 fraudulent conveyance principles, as discussed by the Second Circuit Court of Appeals.

(i) Multi-lateral transactions may be "collapsed" and treated as a single transaction if warranted by the facts presented. HBE Leasing Corp. v. Frank, 48 F.3d 623 (2d Cir. 1995). The holding of HBE Leasing was distinguished in Mann v. Hanil Bank, 920 F.Supp. 944 (E.D. Wis. 1966).

(ii) Transfer may not be avoided as a fraudulent conveyance, unless it prejudices a complaining creditor. Id. at 636 - 637.

(iii) Transfer made with actual intent to hinder, delay or defraud present or future creditors is voidable, regardless of whether debtor receives fair consideration for the transferred property. Id. at 639.

(iv) Transfer motivated by actual intent may not be voided if the transferee who paid fair consideration did not have actual or constructive knowledge of such intent. Id.

h. Example applying New York Law:

A trustee could not recover payments to mortgage servicing agent under § 544(b), as mortgage servicing agent was a holder in due course, who took payment free of any personal defenses of the debtor under § 3-305(2) of the New York U.C.C. In re Joe Sipala & Son Nursery Corp., 214 B.R. 281 (Bankr. E.D.N.Y. 1997).

6. Time Limitations on Avoidance Actions

a. Statutory Limit

Section 546(a) provides:

> An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of -
>
> (1) the later of-
>
> (A) two years after the entry of the order for relief; or
>
> (B) one year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or
>
> (2) the time the case is closed or dismissed.

b. The Bankruptcy Reform Act of 1994[2] changed § 546(a) to the text set forth above. Cases commenced before the October 22, 1994 are governed by prior law.

c. Tolling the Statute

(i) Bankruptcy Code § 546(a)'s statute of limitations is subject to equitable tolling, where relevant facts have been concealed from a trustee who has made diligent and reasonable inquiry under the circumstances. In re McGoldrick, 117 B.R. 554 (Banks. C.D. Cal. 1990).

(ii) The fraudulent concealment doctrine has been applied to extend the time limit imposed by Bankruptcy Code § 546(a). In re Ahead by a Length, Inc., 100 B.R. 157, 163, 164 (Bankr. S.D.N.Y. 1989). Under this doctrine "the plaintiff must establish (1) that the defendant concealed the existence of the claim, (2) he was unaware of the claim until some point within the applicable limitations period, and (3) that his continuing ignorance was not attributable to lack of [reasonable] diligence on his part." 100 B. R. at 163-164 (citing State of New York v. Hendrickson Brothers, Inc., 840 F.2d 1065, 1084-85 (2d Cir. 1988), cert. denied 488 U.S. 848 (1988) and Armstrong v. McAlpin, 699 F.2d 79, 88 (2d Cir. 1983)). See also Bailey v. Glover, 88 U.S. 342, 349 (1874).

2 Hereafter, "Reform Act."

2011 SUPPLEMENT TO BASICS OF BANKRUPTCY CLE
RE: TRUSTEE'S STRONG ARM POWERS

Updated by: Martin A. Mooney, Esq. and Jorge A. Rodriguez, Esq.
May, 2011

1. Introduction
   a. "Although the Trustee's strong-arm powers arise under federal law, the scope of those powers is determined by the law of the state in which the subject property is located." 2009 WL 4269604 (10th Cir.BAP (Colo.)

2. Hypothetical Judicial Lien Creditor Status
   b. Lien Avoidance
      (i). Unperfected Security Interest. The party seeking avoidance has burden of proof that security interest is unperfected. In re Brouillette, 389 B.R. 214, 218 (Bankr. D. Kan. 2008).
      (ii). Purchase Money Security Interest. See, N.Y. U.C.C. Law § 9-312 (McKinney)
      (iii). New York's 20 day rule. See, N.Y. U.C.C. Law § 9-312(f) (McKinney)("A perfected security interest in… goods in possession of a bailee, other than the one that has issued a negotiable document for the goods, remains perfected for 20 days without filing if the secured party makes available to the debtor the goods… for the purpose of… ultimate sale or exchange…").

4. Trustee as Hypothetical Bona Fide Purchaser of Real Property
   b. Security interest unperfected due to erroneous indexing was avoided, despite actual knowledge of existence of mortgage. In re Badagliacca, 403 B.R. 288, 289 (Bankr. W.D.N.Y. 2009).
   c. Bona Fide Purchaser. "In New York, a bona fide purchaser must have purchased the property 'in good faith without notice and for valuable consideration'", In re Muse, 07-10665, 2010 WL 4501062 (Bankr. N.D.N.Y. Nov. 2, 2010)). "Under New York law, such notice consists of actual notice and constructive notice of what may be revealed by (1) an examination of the record, (2) reasonable inquiry of those in actual possession, or (3) reasonable inquiry on the basis of all circumstances." Id. "Although New York's substantive law provides that actual knowledge will operate to prevent one from attaining the status of a BFP, 'bankruptcy law renders a trustee's actual knowledge of a lien or defect irrelevant by virtue of the provisions of § 544(a)(3).'" Id.
   d. Constructive Notice.
      (i). Possession of state court receiver. None.
      (ii). Possession of tenant of purchaser. None.
      (iii). *Notice of lis pendens.* See, In re Perosio, 277 F. App'x. 110, 113 (2d Cir. 2008)("the lis pendens are not avoidable, they would provide constructive notice of [mortgagor]'s interest to a hypothetical purchaser buying at the time bankruptcy proceedings were initiated.").

(iv). *Clear and open possession.* "[C]lear and open possession of the Property put the Trustee on constructive notice of [Creditor]'s equitable interest therein, and therefore the Trustee may not avoid that interest under § 544(a)(3)." In re Stewart, 325 F. App'x. 82, 85 (3d Cir. 2009).

(v). *Duty to investigate.* In case where mortgage misstated the lot number in its description of the property, and therefore created an unperfected interest on the property, the trustee was unable to avoid the bank's mortgage because a hypothetical bona fide purchaser would have been under the duty to investigate the mortgage to determine whether the mortgage was burdening the property. In re Colon, 563 F.3d 1171, 1186 (10th Cir. 2009).

(vi). *Filing of schedules.* The filing of schedules in voluntary petition for bankruptcy does not provide the trustee with constructive notice needed to deprive her of strong arm powers under §544(a). In re Muse, 07-10665, 2010 WL 4501062 (Bankr. N.D.N.Y. Nov. 2, 2010). But see, In re Lauver, 372 B.R. 751, 760 (Bankr. W.D. Pa. 2007).

f. Actual Knowledge. "Defendant's actual notice, or knowledge, of the defective lien on the Residence is immaterial to a § 544 avoidance action brought as debtor in possession." In re Sullivan, 10-62818 - MHM, 2011 WL 350432 (Bankr. N.D. Ga. Feb. 3, 2011). "*Hartman Paving* stands alone in the face of all other circuits as well as numerous district and bankruptcy courts who hold that the actual knowledge of a debtor in possession is immaterial to § 544(a)(3)." Id.

5. Trustee as Statutory Successor to Actual Creditor

a. See, In re JTS Corp., 617 F.3d 1102, 1109 (9th Cir. 2010) ("Under § 544(b)(1) of the Bankruptcy Code, a "trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law.").

c. See, In re JTS Corp., 617 F.3d 1102, 1112 (9th Cir. 2010). However, a trustee is also subject to the same defenses a transferee could raise in the state action. See, In re Musicland Holding Corp., 424 B.R. 95, 103 (Bankr. S.D.N.Y. 2010) ("[T]he trustee must stand in the shoes of that actual creditor. It naturally follows, therefore, that if the transferee of the property would have a valid defense in a state fraudulent conveyance case brought by the actual creditor, the trustee would be subject to the same defense…if the applicable statute of limitations had expired before the bankruptcy petition was filed, the trustee's action under § 544(b) would be subject to the same statute of limitations defense."). Where more than one triggering creditor exists, "the estoppel or barring of one will not affect the trustee's right to proceed." 5 Collier ¶ 544.07[3], at 544–22. "[I]n order to satisfy the standing requirements of Section 544, the same creditor that has an allowed unsecured claim on the Petition Date must also have been a creditor of the transferor on the Transfer Date….the Trustee 'must first show that there is an actual unsecured creditor holding an allowable unsecured claim ... who, under [state] law, could avoid the transfers in question." In re Allou Distributors, Inc., 392 B.R. 24, 34 (Bankr. E.D.N.Y. 2008).

e. Section 544(b) only permits claims to avoid a fraudulent transfer, regardless of any other state law claims for damages stemming from the fraudulent transfer. See, In re Tronox Inc., 429 B.R. 73, 103 (Bankr. S.D.N.Y. 2010).

(iii.) See, In re Cersosimo, 05-89735-DTE, 2009 WL 3182989 (Bankr. E.D.N.Y. Sept. 29, 2009)(transfer may be found fraudulent and avoided for lack of fair consideration).

f(iii) "Constructive fraud claims predicated upon Debtor and Creditor Law §§ 273 and 273–a, are governed by the six-year statute of limitations set forth in CPLR 213(1), and arise at the time that the alleged fraudulent conveyance is made." Citicorp Trust Bank, FSB v. Makkas, 67 A.D.3d 950, 952, 889 N.Y.S.2d 656, 658 (N.Y. App. Div. 2009). "In cases of actual fraud, however, a claim is timely if brought either within six years of the date that the fraud or conveyance occurs, or within two years of the date that the fraud or conveyance is discovered or should have been discovered, whichever is longer." Citicorp Trust Bank, FSB v. Makkas, 67 A.D.3d 950, 953, 889 N.Y.S.2d 656, 658 (N.Y. App. Div. 2009)

g. Some N.Y. Debt. & Cred. Law § 276 fraudulent conveyance principles

(i). See, In re CNB Int'l, Inc., 440 B.R. 31, 42 (W.D.N.Y. 2010).

(iii). Actual intent to hinder, delay or defraud must be pleaded with specificity. St. John's Univ., New York v. Bolton, 08-CV-5039 NGG JMA, 2010 WL 5093347 (E.D.N.Y. Dec. 10, 2010). Plaintiff must allege specific objective facts giving rise to reasonable inference of fraudulent intent. Id. "These badges of fraud include evidence such as: (1) gross inadequacy of consideration; (2) a close relationship between transferor and transferee; (3) the transferor's insolvency as a result of the conveyance; (4) a questionable transfer not in the ordinary course of business; (5) secrecy in the transfer; (6) retention of control, possession, benefit, or use of the property by the transferor after the conveyance; and (7) the general chronology of the events and transactions under inquiry." Id.

6. Time Limitations on Avoidance Actions

c. Tolling the Statute.

(i). "11 U.S.C. § 546 is subject to the doctrine of equitable tolling." In re Maxon Eng'g Services, Inc., 397 B.R. 228, 230 (Bankr. D.P.R. 2008) aff'd, CIV. 08-2274CCC, 2009 WL 1597635 (D.P.R. June 5, 2009). "The majority of cases considering the application of equitable tolling have involved allegations of concealment of a fraud, such as where a debtor fraudulently transfers assets and conceals the transfers, which would not seem to be applicable to a general preference claim, since the preferential payment is not itself fraudulent." Id. "[T]he defendant must have at least been a party to the wrongful conduct." Id.

NEW YORK BAR ASSOCIATION
OCTOBER 30, 2008
BASICS OF BANKRUPTCY PRACTICE

EQUITABLE SUBORDINATION

by

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New York City

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Equitable Subordination

1. Basic Principles of Equitable Subordination

(a) Bankruptcy Code § 510(c)1 represents the current codification of the equitable power of a bankruptcy court to subordinate claims.

(b) Section 510 of the Bankruptcy Code is a codification of the common law doctrine of equitable subordination. In re Papercraft Com., 211 B.R. 813 (W.D. Pa. 1997).

2. The Seminal Decision And Standard For Liability

(a) Facts and Case History The seminal equitable subordination case is Pepper v. Litton, 308 U.S. 295 (1939). In Pepper the dominant and controlling shareholder of the corporate debtor engaged in a "fraudulent scheme," using his insider position to manipulate transactions with the debtor and to elevate his status over a competing creditor who was trying to collect her claim from the debtor's assets. Specifically, the shareholder obtained judgment notes for his purported services to the corporation and, after placing the corporation into bankruptcy, bought most of its assets at a bankruptcy sale. The Fourth Circuit upheld the priority of the insider's claim, reasoning that a bankruptcy court lacked power to subordinate a claim based on a validly-obtained state court judgment.

(b) Supreme Court Holding The U.S. Supreme Court disagreed. Although each step in the insider's scheme was technically legal, a bankruptcy court, as a court of equity, has the authority to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." Pepper, at 308. The Court stated that a claim can be subordinated if its allowance "would not be fair or equitable to other creditors." at 309. In view of the controlling shareholder's abuse of his insider status by reason of the breach of his fiduciary duty, subordination of his claim was held appropriate.

3. Applicable Statutory Authority

(a) Bankruptcy Code § 510(c) in pertinent part provides:

Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may: (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest. Id.

(b) Congress left development of standards for application of the equitable subordination doctrine to the courts. In re Pheoll Mfg. Co., 128 B.R. 1016, 1020 (Bankr. N. D. III. 1991).

4. Nature Of The Remedy

1 All references to the Bankruptcy Code are citations to 11 U.S.C. § 101 et seq. (1978, as amended), unless otherwise noted.

(a) Equitable subordination is remedial rather than penal in nature. In re Mobile Steel Co., 563 F.2d 692, 701 (5th Cir. 1977). (The holding in Mobile Steel was superceded by Statute). Diasonics, Inc. v. Ingalls, 121 B.R. 626 (Bankr. N.D. Fla. 1990). See also, Aluminum Mills Corp. v. Cititicorp. North Am. (In re Aluminum Mills Corp. 132 BR. 869, 893-94 (Bankr. N.D. Ill. 1991) ("This doctrine does not exist to punish errant creditors but to 'adjust the claims of creditors as they stand in equitable relation to each other.") (quoting Virtual Network Services, 98 B.R. 343, 351 (N.D. Ill. 1989), aff'd. 902 F.2d 1246 (7th Cir. 1990)).

(b) Equitable subordination thus permits a court "to undo or to offset any inequity in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of estate distributions." In re Vietri Homes. Inc., 58 B.R. 663, 665 (Bankr. D. Del. 1986).

(c) [A] claim … should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct." Mobile Steel, 563 F.2d at 701.

(i) If the claim exceeds the extent of the harm, the claim should only be subordinated to that extent. See In re Osborne, 42 B.R. 988, (W.D. Wis. 1984). See also In re Mobile Steel Co., 563 F.2d 692, 701 (5th Cir. 1977).

(ii) Although this general rule is widely accepted, it is not always followed. See, In re American Lumber Co., 5 B.R. 470 (D. Minn. 1980) (subordinating entire $1 million secured claim even though the losses did not exceed $50,000). Moreover, it has been observed that a court may subordinate an entire claim if the injury to the other creditors is not easily quantified. But See, Matter of Clark Pipe and Supply Co., Inc., 893 F.2d 693, 702 (5th Cir. 1990).

(iii) However, in the context of the failed leveraged buy-out of the O'Day Corp., where the trustee sought to avoid a secured lender's liens as fraudulent conveyances, the court imposed equitable subordination as a punitive remedy. In re O'Day Corp., 126 B.R. 370 (Bankr. D. Mass. 1991). The court found, among other things, that the granting of security interests to a lender to finance the buy-out transaction constituted a fraudulent conveyance because security interests granted to the lender were not given for fair consideration, since the proceeds of the loan to the O'Day Corp. were paid to shareholders. The court in O'Day in addition to finding a fraudulent conveyance, equitably subordinated the lender's claims to those of unsecured creditors. It was unclear whether the three pronged equitable subordination standard (discussed below) was met in the case. Id.

(iv) In an LBO case, the court looks to the substance of the transaction, as opposed to its form, to decide whether to equitably subordinate the claims of former shareholders turned creditors to general unsecured creditors. In re Structurlite Plastics Corp., 224 B.R. 27 (6th Cir. BAP 1998).

(d) The Equitable subordination remedy is available not only to trustees and debtors in possession, but to creditors who are seeking to subordinate another creditor's claim to its own. In re Granite Partners, L.P., 210 B.R. 508 (Bankr. S.D.N.Y. 1997). Compare New Jersey Steel Corp. v. Bank of New York, 223 B.R. 406 (S,D.N.Y. 1998) (equitable subordination is limited to bankruptcy setting and was unavailable to a party to an intercreditor dispute where the conduct complained of did not relate to the conduct regarding the debtor).

(e) Equitable subordination doctrine does not apply to claims made to avoid fraudulent conveyances under the New York Debtor & Creditor Law § 276. HBE Holdings Corp. v. Frank, 48 F.3d 623 (2d Cir. 1995).

5. General Rules

(a) The widely accepted three-prong standard for equitable subordination is set forth in Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692 (5th Cir. 1977):

> [T]he conditions must be satisfied before exercise of the power of equitable subordination is appropriate:
>
> (i) the claimant must have engaged in some type of inequitable conduct;
>
> (ii) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and
>
> (iii) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.
>
> Mobile Steel, 563 F.2d at 699-700.

(b) The First, Sixth, Seventh, Eighth and Eleventh Circuit Courts have adopted the Mobile Steel standard. In re 604 Columbus Ave. Realty Trust, 968 F.2d 1332,1353 (1st Cir. 1992); In re Baker & Getty Financial Services, Inc., 974 F.2d 712, 717-718 (6th Cir. 1992); Matter of Lifschutz Fast Freight, 132 F.3d 339 (7th Cir. 1997); Kham & Nate's Shoes No. 2 v. First Bank of Whitine, 908 F.2d 1351,1356 (7th Cir. 1990); In re Bellanca Aircraft Corp., 850 F.2d 1275, 1282 (8th Cir. 1988); In re Lemco Gypsum, Inc., 911 F.2d 1553 (11th Cir. 1990).

(c) The U.S. Supreme Court has endorsed the Mobile Steel three- prong test as still valid. United States v. Noland, 116 S. Ct. 1524, 1526 and 1528 (1996) (concluding that the equitable subordination doctrine could not be used to deny administrative expense priority to a post-petition tax penalty because to do so would counter Congressional policy decisions embodied in the Bankruptcy Code). However, the court also stated that it was NOT deciding "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated," since that conclusion was unnecessary in reaching the result. Noland 116 S. Ct. at 1528.

(d) Cases in the Second Circuit regarding the Mobile Steel test:

(i) In re Tampa Chain Co., Inc., 53 B.R. 772, 779 (Bankr. S.D.N.Y. 1985) (applying the Mobile Steel standard, the court applied equitable

subordination to insider/shareholders where several badges of fraud were present in their dealings with the debtor).

(ii) In re Interstate Cigar Coy Inc., 182 B.R. 675 (Bankr. E.D.N.Y. 1985) (the creditors' committee sought to have the claim of an affiliate corporation of the debtor subordinated; the court first determined that cash advances to the debtor underlying the claim were capital contributions, then also stated that analysis under the Mobile Steel three-point test would have yielded the same result).

(iii) In re Pouughkeepsie Hotel Associates Joint Venture, 132 B.R. 287, 292 (Bankr. S.D.N.Y. 1991) (reciting a three-point test similar to the Mobile Steel standard for equitable subordination).

(iv) In re 80 Nassau Associates, 169 B.R. 832 (Bankr. S.D.N.Y. 1994) (employing the Mobile Steel test).

(v) In re 9281 Shore Road Owners Corp., 214 B.R. 676 (Bankr. E.D.N.Y. 1997) (setting forth the Mobile Steel test).

(vi) In re Granite Partners, L.P., 210 B.R. 508 (Banks. S.D.N.Y. 1997).

(vii) In re LeCafe Crème, Ltd., 240 B.R. 221 (Bankr. S.D.N.Y. 2000).

(e) The doctrine most often arises in connection with claims of corporate insiders or those who stood in a fiduciary relationship with the debtor to prevent them from converting equity interests into claims or from improving the priority of their claims in anticipation of bankruptcy. Kham & Nate's Shoes, No 2 v. First Bank of Whiting, 908 F.2d at 1351, 1356 (7th Cir. 1990); In re Heartland Chemicals 136 B.R. 503 (Bankr. C.D. Ill. 1992). See Pepper v. Litton, 308 U.S. 295 (1939).

(f) The doctrine also has been applied to non-insider, non-fiduciary claims. See, In re Osborne, 42 B.R. 988 (D. Wis. 1984) and In re American Lumber Co., 5 B.R. 470 (D. Minn. 1980). The "quality of [the] conduct that will be deemed 'inequitable' under § 5 10(c) depends on the nature of the legal relationship between the debtor and the party whose claim is subject to attack on equitable subordination grounds." In re Badger Freightways, Inc., 106 B.R. 971, 976 (Bankr. N.D. Ill. 1989).

(i) Generally, for equitable subordination to be imposed against a non-insider's or non-fiduciary's claims, an objectant must show very substantial misconduct (In re Just For the Fun of It of Tennessee, Inc., 7 B.R. 166, 180 (Bankr. E.D. Tenn. 1980)), or "gross misconduct tantamount to 'fraud, overreaching or spoilation or the detriment of others'" (In re Teltronics Services, Inc., 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983)). See also In re Giorgio, 862 F.2d 933, 939 (1st Cir. 1988) (holding that for non-insider, non-fiduciary creditors, conduct required for subordination must be "egregious and severely unfair in relation to other creditors"); In re Heartland Chemicals, 136 B.R. at 516 (same).

(ii) An exception to this general rule exists where the outside creditor sufficiently controls or dominates the will of the debtor, its operations or decision making processes, and exercises that control to the detriment of others. In re Teltronics Services. Inc., 29 BR. 139, 170 (Bankr. E.D.N.Y. 1983). See also Tuxedo Beach Club Corp. v. City Federal Savings Bank, 749 F. Supp. 635, 647 (D.N.J. 1990); In re Sleepy Valley, Inc., 93 B.R. 925, 932 n. 11, 933 (Bank. W.D. Tex. 1988); In re Ludwig Honold Mfg. Co., Inc., 46 B.R. 125 (Bankr. E.D. Pa. 1985). "What is required is operating control of the debtor's business, because only in that situation does a creditor assume the fiduciary duty owed by the officers and directors." In re Badger Inc., 106 B.R. at 977.

(iii) Note, however, in the usual case, a financial lending institution, such as a commercial bank, owes no fiduciary duties to its customer. In re W.T. Grant Co., 699 F.2d 599, 609 (2d Cir. 1983), cert. denied 464 U.S. 822 (1983); Matter of Clark Pipe and Supply Co., Inc., 893 F.2d 693, 702 (5th Cir. 1990) (following Grant and Badger supra.

6. Burden of Proof

(a) Generally

(i) A creditor has the initial burden of establishing the amount and legitimacy of its claim. Teltronics Services,29 B.R. 139 (Bankr. E.D.N.Y. 1983). A proof of claim properly executed and filed by a claimant is prima facie evidence of the validity and amount of the claim. Fed. R. Bankr. P. 3001(f). See also In re Mobile Steel Co., 563 F.2d 692, 701 (5th Cir.1977) (under pre-Bankruptcy Code law).

(ii) The party seeking to equitably subordinate a claim must overcome the claimant's prima facie case. Teltronics Services, 29 B.R. at 169 ("objectant must prove by a preponderance of the evidence that the claimant engaged in such substantial inequitable conduct [such fraud or breach of fiduciary duty, to the detriment of the debtor's other creditor that subordination is warranted."). See also Mobile Steel, 563 F.2d at 701-02; In re N&D Properties, Inc., 799 F.2d 726, 731 (11th Cir. 1986).

(iii) If the objecting party produces sufficient evidence to overcome the claimant's *prima facie* case, the burden of going forward shifts to the claimant to establish that the challenged transaction is an arm's length transaction. Matter of Missionary Baptist Foundation Inc., 712 F.2d 206 (5th Cir. 1983); In re MultiPhonics, Inc., 622 F.2d 709, 714 (5th Cir. 1980).

(b) Burden of Proof Different For Insiders and Non-Insiders. The burden of proof required to subordinate claims on equitable grounds is not uniform in all cases. When the claimant is an insider or fiduciary, the trustee need only present material evidence i. e. , make a prima facie showing) of the claimant's inequitable conduct to shift the burden of proving the fairness and good faith of such conduct to the claimant. If the claimant is not an insider of the debtor, the trustee's burden

is far greater: he must prove "egregious" or "gross" misconduct. Matter of Fabricators, Inc., 926 F.2d 1458 (5th Cir. 1991); Matter of Herby's Foods Inc., F.3d 128, 133-4 (5th Cir. 1993); In re Lemco Gypsum, Inc., 911 F.2d 1553, 1557 (11th Cir. 1990), cert. denied 930 F.2d 925(11th Cir. 1990); In re Holywell Corp. 913 F.2d 873, 880 (11th Cir. 1990); In re N&D Properties, Inc., 799 F. 2d 726, 731 (11th Cir. 1986); In re 604 Columbus Ave. Realty Trust, 968 F.2d 1332, 1360 (1st Cir. 1992); In re Granite Partners, L.P., 210 B.R. 508 (Bankr. S.D.N.Y. 1997) (holding that when a party seeks equitable subordination of noninsider, nonfiduciary claims, level of pleading and proof is even higher than when subordination of insider's or fiduciary's claim is sought).

7. Undercapitalization of Debtor As a Basis For Equitable Subordination

(a) A creditor's claims ought not to be equitably subordinated solely on the basis of the debtor's having been undercapitalized at the time of (or because of) the lender's extension of credit. In fact, the Ninth Circuit has expressly held that undercapitalization alone is not sufficient to justify equitable subordination of insiders' claims. In re Branding Iron Steak House, 536 F.2d 299, 302 (9th Cir. 1976) (claim of individual who provided nearly all financial backing to corporation that operated single restaurant, and who was an officer and director of corporation, was not equitably subordinated, even though a bankruptcy judge correctly found business was undercapitalized, because "subordination requires some showing of suspicious, inequitable conduct beyond mere initial undercapitalization of the enterprise."). See also In re Dry Wall Supply, Inc., 111 B.R. 933, 939 (D. Col. 1990) (affirming Bankruptcy Court's dismissal of complaint seeking equitable subordination of lender's lien; complaint alleged that lender financed leveraged buyout of debtor when (i) lender knew or should have known that loan transaction would render debtor insolvent; and (ii) the loan was made without adequate consideration; held, allegations did not "approach the level of gross misconduct."); Stratton v. Equitable Bank, N.A., 104 B.R. 713 (D. Md. 1989), affd. 912 F.2d 464 (4th Cir. 1990) (ill-advised business decision by lender to advance funds to undercapitalized debtor was not conduct that required equitable subordination).

(b) Undercapitalization was also an issue in the Mobile Steel case. There the Court articulated the following standard:

> [T]he amount of capitalization that is adequate is "what reasonably prudent men with a general background knowledge of the particular type of business and its hazards would determine was reasonable. . . in the light of any special circumstances which existed at the time of the incorporation of the now defunct enterprise."

In re Mobile Steel Co., 563 F.2d 692, 703 (5th Cir. 1977), (citing N. Lattin, The Law of Corporations § 15, 77 (1971) ("This general definition is helpful because it focuses on the culpability of the organizer- stockholders and pegs the assessment to more specific standards which do not involve open-ended quantitative questions.") (emphasis added).

8. Two Trends

(a) Courts have emphasized that they will not generally find a bank's conduct "inequitable" where it acted within its authority under its loan agreement with the debtor. Kham & Nate's Shoes No.2. Inc. v. First Bank of Whiting, 908 F.2d 1351, 1356-59 (7th Cir. 1990); Smith v. Associates Commercial Corp. (In re Clark Pipe and Supply Co.) 893 F.2d 693, 699-702 (5th Cir. 1990), cert. denied 899 F.2d 11(5th Cir. 1990); In re Heartland Chemicals 136 B.R. 503 (Bankr. C.D. Ill. 1992).

(i) Clark Pipe: Where loan agreement gave bank (holding security interest in accounts receivable) the authority to reduce advance ratio so debtor would have just enough funds to sell inventory and thereby convert inventory into collateralized receivables, and despite loan officer's clear intention to position the bank most advantageously prior to bankruptcy, equitable subordination was not justified.

(A) Although bank had powerful control over debtor's finances pursuant to the loan agreement, this was not sufficient to give rise to subordination. Debtor had power to act autonomously and disregard advice of bank.

(B) Bank did not mislead other creditors.

(ii) Kham & Nate's Shoes:

(A) " 'Inequitable conduct' in commercial life means breach plus is some advantage-taking. . . ." Kham & Nates, 908 F.2d at 1357. "[W]e are not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do 'more' - just how much more resting in the discretion of a bankruptcy judge assessing the situation years later. Contracts specify the duties of the parties to each other, and each may exercise the privileges it obtained." Id. at 1356.

(B) In deciding when and whether to terminate financing, " bank was entitled to advance its own interests, and it did not need to put the interests of Debtor and Debtor's other creditors first." Id. at 1358.

(b) The Third, Sixth, Seventh, Eighth and Tenth Circuit Courts have held that claims can be equitably subordinated without any proof of inequitable conduct on the part of the subordinated creditor. See Burden v. United States, 917 F.2d 115 (3rd Cir. 1990) (same); In re Mansfield Tire & Rubber Company, 942 F.2d 1055, 1062 (6th Cir. 1991), cert. denied 502 U.S. 1092 (1992) (same); In re Virtual Network Services Corp., 902 F.2d 1246, 1249 (7th Cir. 1990) (tax penalty claim); Schultz Broadway, Inn v. United States, 912 F.2d 230 (8th Cir. 1990) (same); In re CF&I Fabricators of Utah, Inc., 53 F.3d 1155, 1158 (10th Cir. 1995) (same). See also Matter of Jezarian v. Raichle an re Stirling Homex Corp., 579 F.2d 206 (2d Cir. 1978), cert. denied 439 U.S. 1074 (1979) (decided prior to enactment of

Bankruptcy Code § 5 10(b)) (claims of defrauded equity holders subordinated to general creditors).

(i) This view has been confined to cases involving generally "non-pecuniary loss" such as tax penalties (see cases above, other "penalty claims") (Matter of Colin, 44 B.R. 806 (Bankr. S.D.N.Y. 1984)), and certain other narrowly defined claims (Stirling Homex) 579 F.2d 206 (equity security holders).

(ii) Ordinarily, this view has not been applied to cases involving bank creditors or other non-government secured parties. Aluminum Mills 132 B.R. at 894 ("[inequitable conduct] still a requirement where the claims of secured creditors are hereby challenged."); Cutty's Burnee, Inc., 133 B.R. 934 (Bankr. ND. III. 1991).

(A) The creation of a "non-pecuniary loss" standard also appears to be the implication of the post-Virtual Network cases in the Seventh Circuit. See Kham & Nates, 908 F.2d 1351 (7th Cir. 1990); In re EDC, Inc., 930 F.2d 1275 (7th Cir. 1991).

(B) Some courts have stated a broader rule as follows: subordination may lie where there is either creditor misconduct or the claim is of a type susceptible to subordination. See Schultz Broadway Inn, 912 F.2d at 233; Mansfield Tire & Rubber, 942 F.2d at 1062; In re Pheoll Mfg.Co., 128B.R. 1016, 1020(Bankr.N.D. Ill. 1991).

(iii) But see In re O'Day Corp., 126 B.R. 370 (discussing equitable subordination as a remedy in the context of a failed leveraged buyout financing transaction, where the Court imposed equitable subordination as a punitive remedy where just pecuniary loss proven).

(c) The U.S. Supreme Court has yet to decide if inequitable conduct is necessary for equitable subordination. U.S. v. Noland, 116 S. Ct. 1524 (1996).

2011 SUPPLEMENT TO BASICS OF BANKRUPTCY CLE
RE: EQUITABLE SUBORDINATION

By: Martin A. Mooney, Esq. and Jason A. Little, Esq.
May, 2011

2. The Seminole Decision And Standard For Liability:

(a) The basic principals established in *Pepper v. Litton*, 308 U.S. 295 (1939) lay the groundwork for the doctrine of equitable subordination. This decision is covered in the original October 30, 2008 Basics of Bankruptcy Practice.

"Equitable subordination, which is founded upon estoppel, is the doctrine invoked by the courts to deny equal treatment to creditors based on some inequitable or unconscionable conduct in which they have engaged, or a special position which they occupy vis-a-vis the bankrupt that justifies subordination of their claims." *In re 1567 Broadway Ownership Assoc.*, 202 B.R. 549, 554 (S.D.N.Y. 1997) (citing *In re Credit Industrial Corp.*, 366 F.2d 402, 408-09 (2d Cir. 1966).

Section 510 of the Bankruptcy Code is a codification of the common law doctrine of equitable subordination. *In re Papercraft Com.*, 211 B.R. 813 (W.D. Pa. 1997).

The Supreme Courts decision in *Pepper v. Litton*, 308 U.S. 295 (1939).

(1) This is the seminal case for equitable subordination.

(2) The Supreme Court held, that despite the technical legality of the fraudulent scheme by a dominant and controlling shareholder of the corporate debtor who had the ability to manipulate transactions with debtor to secure priority over a competing creditor, as a court of equity, a bankruptcy court has the authority to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." *Pepper*, 308 U.S. at 308.

(3) The Supreme Court in *Pepper* also held that a claim may be equitably subordinated by a bankruptcy court if it is "fair and equitable to other creditors." *Pepper*, 308 U.S. at 309.

3. Statutory Authority for Equitable Subordination:

(a) The common law principles of a bankruptcy courts equitable power to subordinate claims is codified in 11 U.S.C. § 510(c).

(b) 11 U.S.C. § 510(c) provides: Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may – (1) under the principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or (2) order that any lien securing such a subordinated claim be transferred.

(c) Pursuant to 11 U.S.C. § 510(c), the claims and interests subject to equitable subordination are those claims and interests that are "allowed".

(1) A "claim" is defined as - (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured; (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

(2) Pursuant to 11 U.S.C. § 506(a)(1) "an allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. . . ."

(3) Pursuant to 11 U.S.C. § 506(d) a lien that secures a claim against the debtor that is not an allowed secured claim is void unless – (1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or (1) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

4. Nature of Remedy:

(a) *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977), stands for the proposition that equitable subordination is remedial as opposed to punitive in nature. *Id.* at 701. It also stands for the proposition that equitable considerations can justify only the subordination of claims, not their disallowance. *Id.* at 699. *In re Outdoor Sports Headquarters, Inc.*, 168 B.R. 177 (Bkrtcy S.D. Ohio 1994), however, holds that it is within a courts equitable powers to disallow a claim based on equitable principles. *Id.* at 182. In so doing, the Court in *In re Outdoor Sports Headquarters, Inc.* determined that 11 U.S.C. § 510, despite the plain language pertaining only to subordination of allowed claims, does not overrule prior case law giving the courts the equitable power to disallow a claim. *Id.* at 181.

The court in *In re Envirodyne Industries, Inc.*, 176 B.R. 825 (Bkrtcy N.D. Ill 1995) held that under certain circumstances, when determining two classes of unsecured creditors it is not necessary to determine one of the classes engaged in wrongful conduct in order to properly subordinate a claim. *Id.* at 832.

(d) Under two circumstances a creditors committee has standing to bring an adversary suit in the context of a bankruptcy proceeding for equitable subordination. *In re STN Enterprises*, 779 F.2d 901 (2d Cir. 1985). The two circumstances include when a trustee or debtor in possession has unjustifiably failed to bring suit or abused its discretion in not suing to avoid a preferential transfer and when with the debtor's consent and the suit is in the best interest of the bankruptcy estate. *In re Applied Theory Corp.*, 493 F.3d 82, 85-86 (2d Cir. 2007). In both instances the creditors committee is required to obtain court approval. *Id.*

A creditors standing to allege claim of equitable subordination is not derivative; individual creditors have interest in subordination separate and apart from interest of bankruptcy estate as a whole. *In re SRJ Enterprises, Inc.*, 151 B.R. 189 (Bkrtcy N.D. Ill. 1993) (see also *Matter of Vitreous Steel Products Co.*, 911 F.2d 1223, 1231 (7ths Cir. 1990); *In re J.S. II, L.L.C.*, 389 B.R. 570 (Bkrtcy N.D. Ill. 2008)). However, where a trustee has been appointed, it is the proper party to bring a claim for equitable subordination. *In re Applied Theory Corp.*, 345 B.R. 56, 59 (S.D.NY. 2006); *aff'd In re Applied Theory Corp.*, 493 F.3d 82 (2d Cir. 2007). However, courts recognize the rights of secured creditors to bring an equitable claim for its own benefit. *In re Vitreous Steel Prods. Co.*, 911 F.2d 1223, 1231 (7th Cir. 1990); *In re Hoffinger Indus.*, 327 B.R. 389, 394 (Bkrtcy E.D. Ark. 2005).

Debtor in a Chapter 7 case lacks standing to bring a claim for equitable subordination. *In re Blumenberg*, 263 B.R. 704 (Bkrtcy E.D.N.Y. 2001).

5. General Rules

(a) While the three part test established in *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977 has been widely adopted, the third prong of the analysis carries minimal significance as the current Bankruptcy Code specifically provides for the remedy of equitable subordination whereas the former Bankruptcy Act for which *In re Mobile Steel Co.* was decided did not. *In re Hydrogen, L.L.C.*, 431 B.R. 337 (Bkrtcy S.D.N.Y. 2010) (holding a complaint that satisfies the first two prongs of the *Mobile Steel* test would survive a motion to dismiss).

(d) *In re Hydrogen, L.L.C.*, 431 B.R. 337 (Bkrtcy S.D.N.Y. 2010) applies three-prong test in *In re Mobile Steel Co.*

(e) The correct citation for first case cited in subsection is *Kham & Nate's Shoes No.*
2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990).

(f)(i) The court in In re Granite Partners, L.P., 210 B.R. 508, 515 (Bkrtcy S.D.N.Y.
1997) also reaffirmed the proposition that where noninsider, nonfiduciary claims are involved, "the level of pleading and proof is higher. Although courts now agree that equitable subordination can apply to an ordinary creditor, the circumstances are 'few and far between'". *Id.* (citing *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356 (7th Cir. 1990); *accord In re Paolella & Sons, Inc.*, 161 B.R. 107, 119 (E.D. Pa. 1993) ("Equitable subordination has seldom been invoked, much less successfully so, in cases involving non-insiders and/or non-fiduciaries"), *aff'd* 37 F.d 1487 (3d Cir. 1994); see also *In re Bolin & Co., LLC*, 437 B.R. 731, Bkrtcy D. Conn. 2010)). "Courts have described the degree of wrongful conduct warranting equitable subordination of an ordinary creditor's claim as gross and egregious, tantamount to fraud, misrepresentation, overreaching or spoliation or involving moral turpitude. *Id.*

8. Two New Trends:

(c) The Seventh Circuit, citing *U.S. v. Noland*, 116 S. Ct. 1524 (1996), affirmed the principal that some inequitable conduct is required in order to subordinate a creditors claim. *Matter of Lifschultz Fast Freight*, 132 F.3d 339, 344-45 (7th Cir. 1997).

A creditors claim can be equitably subordinated even where the inequitable conduct was unrelated to the acquisition or assertion of the particular claim whose status was at issue. *In re Enron Corp.*, 2005 WL 3832053 (S.D.N.Y. 2005) (citing *Wilson v. Huffman*, 818 F.2d 1135, 1146 (5th Cir. 1987)