BANKRUPTCY LITIGATION
UNDER THE BAPCPA

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Bankruptcy Litigation

The BAPCPA made changes to (3.1) Preference Actions (11 U.S.C. §547), (3.2) Fraudulent Conveyance Actions (11 U.S.C. §548), (3.3) Statutory Lien Actions (11 U.S.C. §545), and (3.4) Post Petition Transfers (11 U.S.C. §549).

3.1. Changes in Preference Actions

To understand the changes made in Preference Actions, one must first have a fundamental understanding of preference actions. This section of the presentation will first discuss the elements of a preference action and when applicable will discuss the changes to these elements. This section will then discuss the procedural changes associated with preference actions adopted in the BAPCPA. Lastly, this section will discuss the most important change in this area of litigation, the change in the definition of the ordinary course of business.

3.1.1. Changes to the Plaintiff's Case in Preferences

Pursuant to section 547(b) of the United States Bankruptcy Code, a Trustee may avoid any transfer of an interest of the debtor in property:

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

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made --

(a) on or within 90 days before the date of the filing of the petition; or

(b) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if --

(a) the case were a case under chapter 7 of this title;

(b) the transfer had not been made; and

(c) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b). It is the plaintiff's burden to prove each and every one of these elements by a preponderance of the evidence. 11 U.S.C. § 547(g); *Danning v. Bozek (In re Bullion Reserve of N. Am.)*, 836 F.2d 1214 (9th Cir. 1988). Failure to satisfy this burden on any one element precludes a finding that a transfer is a preference. *Hood v. Brownyard-Sharon Park Center Inc. (In re Hood)*, 118 B.R. 417, 421 (Bankr. D.S.C. 1990); *Norman v. Jirdon Agri Chemicals, Inc. (In re Cockreham)*, 84 B.R. 757, 761 (D.Wyo. 1988). Further, because the elements above are objective, the intent of the debtor is irrelevant. *Marathon Oil Co. v. Flatau (In re Carig Oil Co.)*, 785 F.2d 1563 (11th Cir. 1986). Accordingly, it is the *effect* of the transfer which is controlling. *Barash v. Public Fin. Corp.*, 658 F.2d 504, 510 (7th Cir.

1981).

3.1.1.1. Transfer of an Interest of the Debtor in Property

Section 101 of the Bankruptcy Code defines a "transfer" as "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." 11 U.S.C. § 101(54). This definition is exceptionally broad, and therefore this author previously thought that it included virtually every conceivable transfer, including the creation or fixing of judicial liens.[1]

Apparently, this definition was not broad enough for some courts[2] and in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "BAPCPA"), Congress decided to make the definition even more broad. Under the BAPCPA, a transfer is now:

(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

[1] *See* 4 COLLIER ON BANKRUPTCY § 547.03 (15th Ed. 1991) ("Any judicial proceeding that creates or fixes a lien upon the debtor's property will constitute a preference."). In South Carolina, a lien on real property is created when the judgment is enrolled in the county where the property is located. S.C. Code Ann. § 15-35-810 (1976).

[2] *See Thompson v. Margen (In re McConville)*, 110 F.3d 47, 49 (9th Cir. 1997) (Under section 549, the attachment of a lien on real property is not a transfer of property that could be set aside.).

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(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

Section 1214, BAPCPA. Precisely because the past definition was so broad and the new definition is more broad, the true test is not whether a transfer occurred, but whether the debtor had an actual or constructive ownership interest in the transferred property. *In re Hood*, 118 B.R. 417 at 419; *In re Flooring Concepts, Inc.*, 37 B.R. 957, 961 (9th Cir. 1984).[3] In this regard, ownership is determined by the debtor's ability to control the disposition of the property.

<u>3.1.1.2. To or For the Benefit of a Creditor</u>

Section 101 of the Bankruptcy Code defines a "creditor," in relevant part, as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10)(A). Further, a "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,

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[3] In determining whether a debtor has an interest in property, state law governs.

unmatured, disputed, undisputed, secured, or unsecured.

11 U.S.C. § 101(5)(A)-(B). In construing these terms, the United States Supreme Court stated in *Ohio v. Kovacs*, 469 U.S. 274, 105 S.Ct. 705, 83 L.Ed.2d 649 (1985) that Congress intended for them to be used in their broadest possible sense.

The courts have obliged by finding "creditors" in even the most contingent and remote cases. *See*, *e.g., Sigmon v. Royal Coke Co. (In re Cybermech)*, 13 F.3d 818 (4th Cir. 1994) (buyer was a creditor of the seller because the buyer had paid for the goods, and therefore had a claim against the seller for a right to payment or a right to an equitable remedy for breach of performance); *Nolden v. VanDyke Send Co. (In re Gold Coast Seed Co.)*, 751 F.2d 1118 (9th Cir. 1985) (holding that a seller acquired a claim against the buyer at the time the buyer received and accepted the goods).

The transfer, however, must also benefit the creditor. Accordingly, this benefit can either be direct, *see, e.g., Bucki v. Singleton (In re Cardon Realty Co.)*, 146 B.R. 72 (Bankr. W.D.N.Y. 1992) (holding that debtor's payment to creditor/assignee of loan obligation benefitted the creditor/assignee, regardless of what she did with the money after she received it, because it paid off an antecedent debt), or indirect, *see, e.g., Sommers v. Burton (In re Conrad Corp.)*, 806 F.2d 610 (5th Cir. 1987) (holding that the debtors' transfer of restaurants in exchange for a simultaneous assumption of their debt by a third party benefitted the creditor, and therefore, constituted a voidable indirect transfer to the creditor).

Thus, if the creditor received something of value, in a preference action, the plaintiff can seek the return of that something of value. The BAPCPA did not change these provisions.

3.1.1.3. For or on Account of an Antecedent Debt

An antecedent debt is simply a debt that the debtor incurs before he makes the alleged preferential transfer. 4 COLLIER ON BANKRUPTCY § 547.05 (15th Ed. 1991). This element is present to promote the central concept governing the existence of a preference action -- the preservation of the debtor's assets. Accordingly, any transfer to a creditor that occurs during the preference period on account of an antecedent debt serves only to deplete the debtor's bankruptcy estate, and therefore is in derogation of this policy of preservation. Again, BAPCPA did not change these provisions.

3.1.1.4. Ninety Day Reachback Period; "Insider" Extension of the Preference Period

Subsection (b)(4)(A) of section 547 provides that a transfer can only be avoided where it was made on or within ninety days before the filing of the petition. 11 U.S.C. § 547(b)(4)(A). While this is generally an absolute rule, subsection (b)(4)(B) immediately follows and provides that where the transfer was made to an "insider," the time limit for avoidance is extended to one year pre-petition. An "insider," in the conventional sense, is simply someone who stands in a close relationship with the debtor and who possesses the ability to control the debtor's actions. *Pineview Care Center, Inc. v. Mappa (In re Pineview Care Center, Inc.)*, 152 B.R. 703 (D.N.J. 1993).[4] The most common examples include a relative or general partner of the debtor in cases where the debtor is an individual or a partnership, and the director(s) or officers of the debtor in cases where the debtor is a corporation. 11 U.S.C. § 101(31).

As it relates to the time that the transfer is made, the courts generally look at when the debtor parted with the thing of value. Thus, for checks, the important date for when the transfer took place is the date that the debtor's bank honored the check. If the honoring of the check was within the preference period, the Court will generally find that the transfer took place during the preference period. *See Barnhill v. Johnson*, 503 U.S. 393 (1992).

One of the more interesting situations occurred when the plaintiff attempted to recover a transfer to a non-insider creditor that benefitted an insider creditor. Such an action was referred to as a "Deprizio Action." The most common example of this scenario exists where the insider creditor guarantees a loan and then directs the debtor's payment to the creditor advancing the loan. In *Levit v. IngersollRand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1989), the court examined such a situation and set forth the "Deprizio" doctrine. This doctrine essentially allowed the plaintiff to recover from non-insider transferees payments made during the extended preference period which benefitted insider creditors. While many

[4] A more exact definition of the term appears in 11 U.S.C. § 101(31).

courts adopted the "Deprizio" doctrine, *see, e.g., Ray v. City Bank & Trust Co.*, 899 F.2d 1490 (6th Cir. 1990), other courts vehemently refused to apply its reasoning. Prior to the Amendments in 1994, South Carolina bankruptcy courts followed the Deprizio doctrine. *See In re Hoffman Assoc.*, 179 B.R. 797 (Bankr. D.S.C. 1995).

The drafters of the 1994 Bankruptcy Reform Act thought that they had done away with the Deprizio doctrine, except in pre-1994 actions. They did so by adding subsection (c) to section 550. This section states:

> (c) If a transfer made between 90 days and one year before the filing of the petition –
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> (1) is avoided under section 547(b) of this title; and
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> (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 the transferee that is not an insider.

11 U.S.C. § 550(c). This author thought the resolution was pretty simple. You cannot recover from a non-insider transferee during the extended preference period.

However, some courts continued to apply the doctrine under certain circumstances. In the case of *Roost v. Associates Home Equity Servs. Inc. (In re Williams)*, 234 B.R. 801 (Bankr. D. Or. 1999), the debtor and his non-debtor wife financed the purchase of their mobile home and pledged as collateral the mobile home and its real property. The secured creditor did not file the lien contemporaneously but did file the lien more than 90 days before the bankruptcy. The trustee sought to set aside the transfer because it benefitted the debtor's wife, an insider. The trustee argued that he was not seeking to recover anything, the property was already property of the estate under Section 541 of the Banrkutpcy Code. He was only seeking to avoid the security interest. The court agreed saying that recovery of a payment would be precluded by section 550(c) but the avoidance of the security interest is not a recovery and therefore is not precluded.

The BAPCPA has added yet another anti-Deprezio section. Specifically, sub-section (i) to Section 547 states:

> If the trustee avoids under subsection (b) a transfer made between 90 days and 1 year before the date of filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer shall be considered to be avoided under this section only with respect to the creditor that is an insider.

See § 1213, BAPCPA. As it relates to this particular section, it applies to any case that is pending or commenced on or after the date of the enactment of the BAPCPA. So, this probably means that *Deprezio* is no more.

3.1.1.5. Made While the Debtor was Insolvent . . .

A debtor is essentially insolvent when his liabilities exceed his assets. 4 COLLIER ON BANKRUPTCY § 547.06 (15th Ed. 1991).[5] In this regard, there is a presumption of

[5] For a more extensive definition, *see* 11 U.S.C. § 101(32).

insolvency during the ninety day reachback period. *Id*. See Also 11 U.S.C. § 547(f). In *Transit Homes, Inc. v. South Carolina Nat'l Bank (In re Transit Homes, Inc.)*, 57 B.R. 40 (Bankr. D.S.C. 1985), however, the court held that the presumption of insolvency can be rebutted by the introduction of the debtor's filed schedules. The BAPCPA did not change this provision.

3.1.1.6. That Enables the Creditor to Receive More Than Such Creditor Would Have Received in a Hypothetical Chapter 7 Case.

Subsection (b)(5) is merely a codification of the United States Supreme Court holding in *Palmer Clay Products Co. v. Brown*, 297 U.S. 227, 56 S.Ct. 450, 80 L.Ed. 655 (1936). In that case, the court held that whether a transfer is preferential should be determined "not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, *but by the actual effect of the payment as determined when bankruptcy results*." [Emphasis added]. The BAPCPA did not change this provision.

3.1.2. Impact of BAPCPA on Procedures Associated with Preference Action

The BAPCPA added some procedural hurdles to the elements of a preference action. Specifically, the BAPCPA provides:

A. Corporate debtors cannot avoid transfers of less than $5,000. *See* BAPCPA, § 409 (Oddly, Congress actually adds a paragraph 9 to subsection 547(c) thereby making this limitation an affirmative defense. So technically, a plaintiff can bring an action to avoid a transfer of less than $5,000 thereby requiring the defendant to raise the affirmative defense.).

B. Plaintiffs must bring an action in the district court for the district in which the defendant resides where the recovery is for less than
(i) $1,000 against an insider;
(ii) a consumer debt of less than $15,000; or
(iii) a debt against a non-insider of less than $10,000.
See BAPCPA § 410.

C. The 10 day grace period provided for in Section 547(e)(2) for the perfection of security interests is expanded to a 30 day grace period. *See* BAPCPA § 403.

D. The 20 day grace period provided for in Section 547(c)(3)(B) for perfection of a security interest in a purchase money security interest is expanded to a 30 day grace period. *See* BAPCPA § 1222.

It is clear from these amendments that Congress wants fewer small preference actions and wants fewer actions in situations where the timing of the perfection of a security interest is close to being contemporaneous.

3.1.3. Defense -- The Ordinary Course of Business Exception

While section 547(c) sets forth a number of instances where a trustee cannot avoid a preference transfer, the BAPCPA's perhaps greatest impact is on the ordinary course of business defense. This exception is embodied in the text of subsection 547(c)(2) which provides that a trustee cannot avoid a transfer:

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor or the transferee; and

(C) made according to ordinary business terms.

The essential purpose of this exception is "to leave undisturbed normal financial relations because it does not detract from the general policy of the section to discourage unusual action by either the debtor or its creditors during the debtor's slide into bankruptcy." *Morrison v. Champion Credit Corp. (In re Barefoot)*, 952 F.2d 795, 801 (4th Cir. 1991). In this regard, the creditor who claims the exception also possesses the burden of proof. *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044, 1047 (4th Cir. 1995). Further, the creditor must satisfy its burden by a preponderance of the evidence. *Id*.

Remember that little "and" between subsection (B) and subsection (C)? The BAPCPA changed that little "and" to an "or." Prior to BAPCPA, the defendant had to prove (A) and (B) and (C). Now, the defendant has to prove former subsections (A) and either (B) or (C). Specifically, §547(c)(2) will read:

> to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was –
>
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
>
> (B) made according to ordinary business terms.

BAPCPA, § 409. Under the new law, the debt must still be incurred in the ordinary course of business. Once this element is established, the defendant can show either that the practice was ordinary between the parties or is ordinary in the industry.

In so amending the current law, it appears that Congress has abandoned the sliding scale approach found in *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044 (4th Cir. 1995). Instead, the Court will now look at whether the defendant can show either that the payment was ordinary between the parties or ordinary in the industry.

3.2. Fraudulent Conveyance Actions

The BAPCPA has weighed in as it relates to three areas of Section 548. First, the BAPCPA specifically makes transfers to insiders under employment contracts, not in the ordinary course of business, subject to the constructive fraud provisions of § 548(a)(1)(B). See BAPCPA §1402. Because of its inclusion in the constructive fraud provision, the defendant can defend on the basis of a reasonably equivalent value being given for the transfer. Further, the application of § 548 to employment contracts is not delayed. Instead, this section is effective on the date of the enactment for cases filed on or after the date of the enactment. So, if a case was filed after the enactment of the BAPCPA, a plaintiff could challenge a transfer under an employment contract that occurred within two (2) years of the filing of the bankruptcy.

Second, Section 548 of the Bankruptcy Code provides the limitations period available to trustees and debtors-in-possession. The section provides that a trustee may avoid any transfer of an interest of the debtor that was made or incurred on or within one year before the date of the filing of the petition, if procured through fraudulent means of the debtor. 11 U.S.C. § 548(a)(1)(A). The BAPCPA amends this section of 548. Specifically, instead of a 1 year reach back period, the BAPCPA provides for a two year reach back period. See BAPCPA §1402. However, Section 1406 of the BAPCPA provides that this amendment to 548 from 1 year to 2 years, applies only to cases commenced under title 11 more than one year after the date of the enactment. So, Congress decided to delay this amendment an additional six months from when other parts of the BAPCPA will become effective.

Third, the BAPCPA gives the trustee the ability to set aside certain transfers within 10 years of the filing of the bankruptcy. Specifically, subsection (e) was added to Section 548 and provides as follows:

> (e) (1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition if -
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> (A) such transfer was made to a self-settled trust or similar device;
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> (B) such transfer was by the debtor;
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> (C) the debtor is a beneficiary of such trust or similar device; and
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> (D) the debtor made such transfer with actual intent to hinder,

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delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

(2) For the purposes of this subsection, a transfer includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by -

(A) any violation of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))), any State securities laws, or any regulation or order issued under Federal securities laws of State securities laws; or

(B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 of 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 781 and 78o(d)) or under section 6 of the Securities Act of 1933 (15 U.S.C. 77f).

Like actions based upon employment contracts, this section takes effect upon the enactment of BAPCPA and does not have any delay in its effectiveness.

3.3. Statutory Lien Actions (11 U.S.C. §545)

Section 545(2) of the Bankruptcy Code allows a trustee to set aside certain statutory liens. Currently, the trustee can set aside unrecorded tax liens. This provision does not change. However, some trustees have sought to set aside recorded tax liens under Section 6323 of the Internal Revenue Code (the "IRC"). This section of the IRC protects bona fide purchasers for value without notice of the tax lien. Under Section 545(a)(3), the trustee becomes a bona fide purchaser of real property and there is plenty of precedent for the idea that the trustee takes the property without notice.

The BAPCPA seeks to prevent the trustee from exercising his boda fide purchaser status pursuant to Section 6323 of the IRC. Specifically, the BAPCPA adds the following to Section 545(2) "except in any case in which a purchaser described in section 6323 of the Internal Revenue Code of 1986, or in any other similar provision of State or local law." BAPCPA §711.

Further, currently, the Trustee has the ability to set aside certain warehouseman's liens. The BAPCPA changes this provision by specifically stating that "the trustee may not avoid a warehouseman's lien for storage, transportation or other costs incidental to the storage and handling of goods." BAPCPA §406.

3.4. Post Petition Transfers (11 U.S.C. §549)

Section 549 of the bankruptcy code allows a trustee to set aside post-petition conveyances outside of the ordinary course of business. Section 549(c) limits this ability when the transferee is a good faith purchaser for present fair equivalent value and without knowledge of the bankruptcy filing. In the case of *Thompson v. Margen (In re McConville)*, 110 F3d 47 (9th Cir. 1997), the court held that a lender without knowledge of the bankruptcy filing that made a post petition loan secured by a mortgage from the debtor was not a good faith purchaser and was not protected by Section 549(c). The BAPCPA overrules this result and includes lenders as being protected by 549(c). The BAPCPA does this by altering the definition of transfer found in Section 101(54). See BAPCPA §1201. The BAPCPA also modifies the automatic stay to prevent the use of Section 362 to void the post petition transfer. *See* BAPCPA §311(a) (the stay does not prevent the fixing "of any transfer that is not avoidable under section 544 and that is not avoidable under section 549").

Conclusion

Thus, the BAPCPA appears to have strengthened the estate's ability to seek to recovery fraudulent conveyances through added provisions relating to extending the reach back period and the types of recoveries. At the same time, the BAPCPA appears to have weakened the estate's ability to recover preference actions because of the jurisdictional limits and the change in the affirmative defense of ordinary course of business.