III. Federal Fraudulent Conveyance Law:

A. One Year Limit:

Section 548 of the Bankruptcy Code provides the federal rule 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. Bankruptcy Code § 548.

The timing of the transfer, therefore, becomes exceedingly important. Obviously, from the language found in the statute, the object of section 548 was to prevent prepetition transfers, not postpetition transfers. *See Consolidated Partners Inv. Co. v. Lake*, 152 B.R. 485 (N.D. Ohio 1993). Therefore, a transfer that occurs after the bankruptcy petition is filed is not covered under this statute. *Consolidated Partners Inc. Co. v. Lake*, 152 B.R. 485 (Bankr. N.D. Ohio 1993); Matter of Fisher, 80 B.R. 58 (Bankr. M.D.N.C. 1987); *In re Sattler's Inc.*, 73 B.R. 780 (Bankr. S.D.N.Y. 1987).

In complex transactions, the specific date of the transfer could prove to be important. Generally, where a lien of some sort is granted as part of the transaction, the transfer is deemed to take place on the date the lien is perfected, provided it is done prior to the bankruptcy filing. *In re Tucker Oil Co., Inc.*, 55 B.R. 78, *appeal decided* 64 B.R. 183 (Bankr. W.D. Ark. 1985). At the same time, a granting of a security interest to a preexisting creditor during the one year period, without receiving new consideration, will alter the entire transfer or debt to the latest transaction date. *In re Kelley*, 7 B.R. 384 (Bankr. D.S.D. 1980). In deed questions, the operative date is when the deed is recorded. *In re Levy*, 185 B.R. 378 (Bankr. S.D. Fla. 1995). The obvious pattern is that the court will usually look to the date that actual title vests or the date on which the last significant part of the transfer took place. In other words, the transfer date is liberally construed to find coverage under the statute.

B. Elements required:

1. transfer

The term transfer, includes every method of disposing of or parting with property or possessions. *Hoecker v. United Bank of Boulder*, 476 F.2d 838 (10th Cir. 1973). The transfer does not have to be made directly by the debtor, as long as one can connect the transfer to the debtor, either directly or indirectly. *In re FBN Food Services, Inc.*, 185 B.R. 265, *affirmed and remanded* 82 F. 3d 1387, *rehearing denied* (N.D.Ill 1995); *Matter of Clover Donut of White Plains Corp.*, 14 B.R. 205 (Bankr. S.D.N.Y. 1981). Nevertheless, a transfer needs to be made. Therefore, a change in form or substance of the asset does not necessarily constitute a transfer. *E.g. In re Levine*, 139 B.R. 551 (Bankr. M.D. Fla. 1992) (Conversion of non-exempt property into exempt property did not constitute a transfer.).

a. Acts constituting transfers

(i) Consignment of goods -- *In re Factory Tire Distributors*, Inc., 64 B.R. 335 (W.D. Pa. 1986).

(ii) Church contributions -- *In re Young*, 82 F.3d 1407 (8th Cir. 1996) *rehearing and suggestion for rehearing en banc* denied 89 F. 3d 494.

(iii) Judgments barring debtors from reasserting claims -- *Matter of Besing*, 981 F. 2d 1488 (5th Cir. 1993) (Prejudicial dismissal was for debtor's discovery abuse.).

(iv) Transfers according to divorce decree, separation agreement, or marital property settlement -- *In re Lange*, 35 B.R. 579 (Bankr. E.D. Mo. 1983).

(v) Foreclosures -- *In re Littleton*, 888 F.2d 90 *rehearing denied* 890 F.2d 1167 (11 Cir. 1989).

(vi) Termination of lease -- see II,B,2,a,ii,(b) below.

(vii) Leveraged buyouts -- *In re Oxford Homes, Inc.*, 180 B.R. 1 (Bankr. D. Me. 1995).

(viii) Mortgage modifications -- *Matter of Venice Western Motel, Ltd.*, 67 B.R. 777 (Bankr. M.D. Fla. 1986) (transfer where net effect of modification increased principle amount of loan.).

(ix) Down payments on real property -- *In re McConnell*, 934 F.2d 662 (5th Cir. 1991); *but see Matter of Wey*, 854 F.2d 196 (7th Cir. 1988).

b. Acts not constituting transfers

(i) Conversion of non-exempt property into exempt property -- *In re Levine*, 139 B.R. 551 (Bankr. M.D. Fla. 1992); *but see In re Beckman*, 104 B.R. 866 (Bankr. S.D. Ohio 1989); *In re Breuer*, 68 B.R. 48 (Bankr. N.D. Iowa 1985); *In re O'Brien*, 67 B.R. 317 (N.D. Iowa).

(ii) Franchisor's termination of debtor's franchise-dealership contracts pursuant to terms of agreement -- *Matter of Jermoo's Inc.*, 38 B.R. 197 (Bankr. W.D. Wis. 1984); but see cases involving termination of lease by a lessor for breach of covenant contained therein, which is a transfer -- *In re Ferris*, 415 F. Supp. 33 (D.C. Okl. 1976); *In re Queen Ciry Grain, Inc.*, 51 B.R. 722 (Bankr. S.D. Ohio 1985).

2. Interest of the debtor in property, or any obligation incurred by the debtor

An essential element of an action under this section is that the debtor must have had an interest in the property transferred. *In re Jackson*, 105 B.R. 15 (Bankr. S.D. Ohio 1989). Because the interest of the debtor in the property is an undefined term in the bankruptcy code, the court will generally look to state law to help define its parameters. *In re Hulm*, 738 F.2d 323, (C.A.N.D. 1984), *cert. denied* 469 U.S. 990, 83 L. Ed. 2d 331, 105 S. Ct. 398, *on remand* 45 B.R. 523; *Matter of Simpson*, 36 F.3d 450 (5th Cir. 1994); *In re Dews*, 152 B.R. 982 (D. Colo. 1993); *In re Reynolds*, 151 B.R. 974 (Bankr. S.D. Fla. 1993); *In re Brajkovic*, 151 B.R. 402 (Bankr. W.D. Tex. 1993).

The battles are fought in two areas: (1) where the debtor owns legal title to a piece of property, and (2) where they do not possess legal title but some equitable interest. When the former is the case, it is often the debtor who must sustain the burden of proof that while legal title may be vested in his or her name, de facto or equitable title belongs to the alleged transferee. For example, in *In re Reynolds*, 151 B.R. 974 (Bankr. S.D. Fla. 1993), the debtor was the legal title holder to real estate. The court found however, that no fraudulent conveyance had taken place because the debtor did not have an interest in the property beyond the face of the document. The debtor successfully proved that he was the legal title holder of the property for the benefit of his son to allow him to obtain financing for the property, and that neither the debtor, nor the son, had ever considered the debtor to be the legal title holder.

Other times, the creditor is on the attack and is attempting to prove that the debtor had an equitable interest that was conveyed. Typically, a possessory interest in property is sufficient to trigger the provisions of § 548. *See e.g. In re Ocean Line of North Florida*, 137 B.R. 540 (Bankr. M.D. Fla. 1992).

3. incurred within one year before the date of the filing -- [see supra].

4. voluntarily or involuntarily

Fraud, as a general rule, requires some type of intent on the part of the actor. The common law, however, does recognize constructive fraud. However, constructive fraud is just another way of proving intent, as mental intent is often very difficult to prove. The fact that involuntary actions can be grounds for a fraudulent act seems contrary to common sense and the common law. Nevertheless, Congress added this interesting twist to the types of activities that constitute fraudulent conveyances, and the question must be answered whether these words serve any purpose or modify in any way the listed actions that can constitute fraudulent behavior.

Courts have held that subjective intent to commit a fraud is not required under bankruptcy code § 548. *In re Nance*, 26 B.R. 105 (Bankr. S.D. Ohio 1982); *In re Checkmate Sterio and Electronics*, 9 B.R. 585, aff'd 21 B.R. 402 (Bankr. E.D.N.Y. 1981). In both of these cases, a trustee was applying the second method of proving fraudulent behavior. Bankruptcy Code § 548 is split into two sections. The first is discussed at i below; the second is discussed at ii. The second section of 548 is admittedly much more objective, and requires little testing of the debtor's motivations or mental state. Therefore, these cases do not answer the question of whether the involuntariness referred to in the primary paragraph of § 548 can be coupled with "actual intent," found in the first subparagraph, to create a much more relaxed standard of proof. The practical standard of proof in showing actual intent is discussed below.

a. actual intent to hinder, delay or defraud a creditor

Actual intent does not need to be proven by direct evidence or by an admission. *In re Sergio, Inc.*, 16 B.R. 898 (Bankr. D. Hawaii 1981). There exists common circumstantial indicia of a fraudulent intent that can be used to prove actual intent: (1) actual or threatened litigation against the debtor; (2) purported transfers of all or substantially all of the debtor's property; (3) insolvency or other unmanageable indebtedness on the part of the debtor; (4) a special relationship between the debtor and the transferee; and (5) retention by the debtor of property involved in putative transfer (i.e., reservation of benefits, control or dominion by the debtor -- *In re Warner*, 87 B.R. 199, *appeal dismissed* 94 B.R. 734 (M.D. Fla. 1988)). *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248 (1st Cir. 1991), on remand 149 B.R. 274. Other badges of fraud that have been noted in categorical form include:(1) absconding with the proceeds of the transfer immediately after their receipt; (2) absence of consideration when the transferor and transferee know that outstanding creditors will not be paid; (3) a huge disparity in value between the property transferred and the consideration received; and (4) the fact that the debtor was the officer, agent, or creditor of the transferor. *In re FNB Food Services, Inc.*, 185 B.R. 265 (N.D. Ill. 1995), *affirmed after remanded* 82 F.3d 1387, *rehearing denied*. Still other cases have sited additional badges of fraud: (1) the conveyance is concealed; (2) the transferee takes property in trust for the transferor and transferor remains in possession; and (3) debtor deals with property as his own. *In re Sergio, Inc.*, 16 B.R. 898 (Bankr. D. Hawaii 1981).

These badges of fraud and other suspicious behavior must be considered as a whole. A trustee does not have to prove any one of these factors with any degree of certainty. The facts, as taken together, only needs to lead to the conclusion that actual fraud existed. *In re Jeffry Bigelow Design Group, Inc.*, 956 F.2d 479 (4th Cir. 1992). The test requires a subjective determination of the debtor's motivation. Id. The standard is that fraudulent intent exists where the trustee shows that the transferor acted under circumstances precluding any reasonable conclusion other than that the purpose of the transfer was fraudulent as to his creditors. *Matter of Life Science Church of River Park*, 34 B.R. 529 (Bankr. N.D. Ind. 1983).

Which parties must be shown to have intent to defraud is unclear. Certainly, the debtor/transferor must have the requisite intent, but some courts hold that the transferee must have the intent as well. *Stratton v. Equitable Bank*, 104 B.R. 713 (D. Md. 1989), *aff'd* 912 F.2d 464 (4th Cir. 1989); *Business Systems, Inc.*, 642 F.2d 200 (C.A. Tenn 1981) (Transferee does not have to return payments if transferee entered transaction in good faith without knowledge of intent to defraud creditors.); *Presbrey v. Noble*, 505 F.2d 170 (C.A. Utah 1974) (Transferee had bonafide purchaser status which trumped rights of trustee.). The apparent logic for this rule is simple. If a bona fide purchaser, without knowledge or intent to defraud, takes the property for a value, then he or she has paid what he or she believes to be fair consideration for the item, or, at the very least, the debtor has no hope of gaining a return on the transfer after the bankruptcy has passed. In these cases, the transferee must still show that the consideration paid was in an amount that he or she believed to be reasonable. *Id*. In truth, the rule appears to be that once the badges of fraud have been proven against the debtor, then the transferee is presumed to have a similar intent, and this intent can be overcome by showing that the transferee was a bona fide purchaser for value. If proven, then the transfer cannot be undone. The policy reasons for this rule are obvious, and an adoption of this rule would benefit public policy, particularly under economic efficiency arguments (the arguments are the same justifications for a bona fide purchaser rule under the Uniform Commercial Code).

There is, however, a middle ground between the two rules. Some cases have held that a transferee is protected from the fraudulent conveyance statute to the extent of the consideration given. Of course, which of the three positions taken will depend upon the party asserting the argument. *In re Mesa*, 48 B.R. 208 (Bankr. S.D. Fla. 1985). Under the presumption that the transferred item is always more valuable than the consideration paid, trustees will inevitably always argue that only the debtor's intent needs to be proven, as this test will grant the trustee the return of the entire item with no refund to the transferee; the transferee will always argue that both party's intent needs to be proven, because by keeping the property, the transferee retains his benefit of the bargain; and finally, the most logical remedy, the one in the middle, will go unargued, but will be the source of many judicial opinions, and has been termed the good faith rule. *See In re Maddalena*, 176 B.R. 551 (Bankr. C.D. Cal. 1995) (If transferee neither knew nor should have known of the fraudulent nature of the transfer, then transferee is entitled to retain the fraudulent transfer to the extent of the value given in the exchange; if transferee knowingly or recklessly participates in the fraudulent scheme, then he or she is not protected.); *Matter of Laughlin*, 18 B.R. 778 (Bankr. W.D. Mo. 1982). In cases where the transferee's "good faith" is an issue or the subject of discussion, courts generally look for earmarks of an arms-length transaction, or whether there are gross departures, to determine whether the transferee is entitled to any special treatment. *Bullard v. Aluminum Co. of America*, 468 F.2d 11 (C.A. Ind. 1972); *In re Browning Tufters, Inc.*, 3 B.R. 487 (Bankr. N.D. Ga. 1980).

This added twist on the law makes the adequacy of consideration all that much more important, and in some cases, a necessary factor in proving a fraudulent conveyance case. *See In re Pinto Trucking Service, Inc.*, 93 B.R. 379 (Bankr. E.D. Pa. 1988) (even where debtor did become insolvent as a result of transfer, court would not conclude fraudulent conveyance where debtor received adequate and fair compensation for sale.); *In re 18th Ave. Development Corp.*, 18 B.R. 904

(Bankr. S.D. Fla. 1982) (Evidence that transfer received a fair value was sufficient to show not a fraudulent conveyance.). However, in most cases, unequal consideration will not in itself prove a fraudulent conveyance case. *See e.g., In re Gutierrez*, 160 B.R. 788 (Bankr. W.D. Tex. 1993) (Purchase at 70% of value is insufficient, without other badges of fraud, to prove fraudulent conveyance.). And there are cases that hold that valuable consideration is not an affirmative defense to a fraudulent conveyance. *Matter of Beechwood Medicenter of Flint*, 23 B.R. 939 (Bankr. E.D. Mich. 1982); *Matter of Montanino*, 15 B.R. 307 (Bankr. D.N.J. 1981) (Sale to parents living in same home was perceived to be effort to defraud creditors, and therefore, revocable, regardless of adequacy of consideration.). Upon review of the *Beechwood* case, the court had the facts of a preference case, and because of time limitations, it was trying to fit it into the fraudulent conveyance statute. The case does however stand for the proposition that, even if fair consideration is received, the transaction will be unwound where it is determined that the debtor was attempting to either prevent certain creditors for receiving what they would receive without the transfer, or the debtor was attempting to make the eventual receipt of those payments or property more difficult for one or more creditors. *Id*.

One of the highly litigated issues and one of the acts that angers trustees and creditors alike is where a debtor transfers non-exempt assets into exempt assets. While some courts hold that these internal transfers are not transfers at all, the majority of the courts do. *Supra*. Those courts that get past the initial question are inevitably faced with the question of whether the transfer to exempt property is a badge of fraud in and of itself. Creditors and trustees are often disappointed to find that the answer is no. The overwhelming number of cases state that the trustee must go one step further and prove that the transfer was made to prevent hinder or delay creditors from reaching the assets. *In re Holt*, 894 F.2d 1005 (8th Cir. 1990); *In re Breuer*, 68 B.R. 48 (Bankr. N.D. Iowa 1985); *In re O'Brien*, 67 B.R. 317 (N.D. Iowa 1986); *In re Levine*, 40 B.R. 76 (Bankr. S.D. Fla. 1984); *In re Oliver*, 38 B.R. 407 (Bankr. D. Mass. 1984). However, the additional proof necessary does to appear to minimal. *In re Barker*, 168 B.R. 773 (Bankr. M.D. Fla. 1994) (Even though placing funds into annuities was sound investment strategy, evidence appeared to show that transfer was made in attempt to hinder creditor's attempt to obtain the items.).

b. the Second Method of Proving Fraudulent Conveyance under § 548

(i) received less than equal consideration; and

Obviously, in this phase of the test, the court is comparing what left the estate to what entered into the estate. *In re Southmark Corp.*, 138 B.R. 820 (Bankr. N.D. Tex. 1992). Generally, the litmus test in this case is -- as long as the unsecured creditors are no worse off because of the transfer, then the debtor received a reasonably equivalent value to that which left the estate because of the transfer. *In re Jeffrey Bigelow Design Group, Inc.*, 956 F.2d 479 (4th Cir. 1992). This does not mean that the debtor needs to receive a dollar for dollar exchange in order to have been paid a "reasonably equivalent value." *Matter of Fairchild Aircraft Corp.*, 6 F.3d 1119 (5th Cir. 1993); *In re Southmark*

Corp., 138 B.R. 820 (Bankr. N.D. Tex. 1992). There is no magic percentage of fair market value that needs to be achieved in order to constitute reasonably equal consideration. *In re Fargo Biltmore Motor Hotel Corp.*, 49 B.R. 782 (Bankr. D.N.D. 1985) (Flat percentage basis approach is inappropriate, however, a good starting point with which to gauge a transfer's reasonableness.). However, one line of cases holds that anything less than 70% of the value is not reasonably equal. *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201 (5th Cir. 1980); *In re Thrifty Dutchman, Inc.*, 97 B.R. 101 (Bankr. S.D. Fla. 1988). In another case, *Misty Management Corp. v. Lockwood*, 539 F.2d 1205 (C.A. Nev. 1976), the court held that a transfer that was for over 70% of the collateral's value was unreasonable, where the difference amounted to $276,000. One court has stated that the relative percentage of fair market value[1] is but one factor to be compared along with good faith and the relative difference in amount paid compared to the fair market value. *In re Smith*, 24 B.R. 19 (Bankr. W.D.N.C. 1982). Other courts follow the 70% rule only in cases of private sales. *Madrid v. Lawyers Title Ins. Corp.*, 725 F.2d 1197 (9th Cir. 1984). A final line of cases holds that courts must determine reasonably equivalent value on a case by case basis. *First Federal Savings & Loan Assn. of Bismark v. Hulm*, 738 F.2d 323 (8th Cir.), *cert denied*, 469 U.S. 990 (1984).

While the court generally must look to the surrounding circumstances of the transaction to determine value, *Matter of Fairchild Aircraft Corp.*, 6 F.3d 1119 (5th Cir. 1993), it is improper for a court to consider sentimental value of the debtor or other similarly subjective criteria. *In re First Capital Holdings Corp.*, 179 B.R. 902 (Bankr. C.D. Cal. 1995). At the same time, a completely objective, mathematical standard does not apply either; a court must consider things such as whether indicia of an arms length transaction are present and other factors showing the actual fair market value of the property sold. *In re Morris Communications NC, Inc.*, 914 F.2d 458 (4th Cir. 1990) (appearing to side with the *First Federal v. Hulm*, *supra*, line of cases).

The operative date is the value of property and consideration as of the date of transfer. *In re Robinson*, 80 B.R. 455 (1987).

<u>(ii) insolvent/small capital remaining/ debt incurred beyond ability to pay</u>

Some courts hold that if the party attacking the transfer as being fraudulent meets the burden of proving that the consideration given was inadequate, the burden of the defense of the transferor's solvency, or the proof that one of the three subsections of § 548(a)(2)(B) exists, passes to the party seeking to uphold the transfer. *See e.g., In re Joshua Sloam, Ltd.*, 103 B.R. 610 (Bankr. E.D. Pa. 1989). However, most cases place this burden on the trustee. *See e.g., In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127 (Bankr. D. Mass. 1989).

(a) Insolvency

[1] Note that fair market value is the standard barometer unless the property is transferred under a forced sale environment, in which case the value is liquidation value. In re Hollar, 184 B.R. 243 (Bankr. M.D.N.C. 1995).

Courts look to see whether a debtor is either insolvent at the time of the transfer or rendered insolvent as a result of the transfer, and either one will be sufficient to pass this portion of the analysis. *In re Newtowne, Inc.*, 157 B.R. 374 (Bankr. S.D. Ohio 1993). To decide whether a debtor is insolvent, courts generally ask -- what would the buyer be willing to pay for the debtor's entire package of assets and liabilities? If the price is positive, the debtor is solvent; if the price is negative, the debtor is insolvent. *Covey v. Commercial National Bank of Peoria*, 960 F.2d 675 (7th Cir. 1992). Courts look to the debtors balance sheet. *Mellon Bank, N.A. v. Metro. Communications, Inc.*, 945 F.2d 635 (3d Cir. 1991), *cert. denied* 112 S. Ct. 1476, 117 L. Ed. 2d 620 (1992). However phrased, this method is a review of the assets and liabilities of the debtor, and a comparison between the two.

When looking at assets, the court must assign to those assets that are readily susceptible to liquidation, *In re Joshua Sloam*, 103 B.R. 610 (Bankr. E.D. Pa. 1987), their fair market value. In re Davis, 169 B.R. 285 (E.D.N.Y. 1994); *In re Pioneer Home Builders, Inc.*, 147 B.R. 889 (Bankr. W.D. Tex. 1992) (Fair market value price at time of transfer is most equitable standard.). Therefore, assets are best valued by determining what price they would bring on the open market. An open market value has been further defined as that value that a prudent business person could obtain from the sale of an asset when there is a willing buyer and a willing seller. *See Pioneer*, *supra*. Under this approach it is inappropriate to add costs and expenses associated with the sale of the assets. *Id*. The method of market price valuation focuses on what a willing buyer would pay, not necessarily what a willing seller would ultimately receive. *Id*. However, the value can be reduced by factors regarding the difficulty of the sale of the asset, but only if they affect the market price and do not relate to the costs of sale. *Id*. The value may be further adjusted by the net costs of making the asset marketable. *Id*. The court cannot take into consideration the debtor's subjective sentimental value placed upon the item. *Id*. The court can value doubtful or contingent claims at less than face value. *In re Join-In Inern. (USA) Ltd.*, 56 B.R. 555 (Bankr. S.D.N.Y. 1986). If a debtor is a guarantor on a liability, courts will generally multiply the total debt by the percent chance that the guarantee will be exercised to determine the liability to be included in the balance sheet. *Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 657 (7th Cir. 1992) (cited in 26 Collier Bankr. Cas.2d 1046). Goodwill can be considered an asset, and can be determined by average high earnings over a period of years, valuable customer lists, and/or by trade names. *In re Roco Corp.*, 701 F.2d 978 (2d Cir. 1983).

The assets are to be reduced by liabilities. Courts can refer to 11 U.S.C. § 101(4) to determine what is a liability. *See In re: Joshua Slocum, Ltd.*, 103 B.R. 610 (Bankr. E.D. Pa. 1989) (finding that shareholders stock redemptions were not liabilities under Bankruptcy Code § 101(4).

At least one court has allowed the use of the retrojection method to prove insolvency. *In re R. Purbeck & Assocs., Ltd.* 27 B.R. 953 (Bankr. D. Conn. 1983) (analyzing insolvency in a preference action). Since insolvency at a given point in time is often difficult to demonstrate by direct proof, courts permit the trustee to show that the debtor was insolvent at one point in time and then prove that the same condition existed at the time of the subject transfer. "This method ...

applies equally to situations in which the trustee starts at a point in time prior to the transfer....[to use this method, the trustee must] show the absence of any substantive or radical charges in the assets or liabilities of the bankruptcy between the retrojection dates. Possibly another burden would be to show that the evidence relating to solvency at the time of the transfer was scant." *Id.* (Evidence was scant.)

(b) Unreasonably small capital remaining

The Bankruptcy Code does not define unreasonably small capital. However, most courts hold that the definition indicates a financial condition short of insolvency. *E.g., Murphy v. Meriton Sav. Bank* (*In Re: O'Day Corp.*), 126 B.R. 370, 407 (Bankr. D. Mass. 1991). However, the condition must be severe enough that it soon turns to, or severely threatens, insolvency; otherwise, the statute is overly broad. In re *Badnais Lumber Supply, Inc.*, 100 B.R. 127 (Bankr. D. Mass. 1989). Some cases have confused unreasonably small capital remaining with the third subsection, dealing with ability to pay expenses as they become due. *See Pioneer Home Builders, Inc.*, 147 B.R. 889 (Bankr. W.D. Tex. 1972). While it is one method of reviewing capital, the method renders this provision meaningless, in light of its cousin, § 548(a)(2)(13)(iii). However, determining whether enough capital exists to continue the business would not be inappropriate or redundant. *In re Joshua Slocum, Ltd.*, 103 B.R. 60 (Bankr. E.D. Pa. 1989); *In re Vadnais Lumber Supply, Inc.,* 100 B.R. 127 (Bankr. D. Mass. 1989). *In Vadnais*, the Court held that the analysis must somehow be tied to insolvency. Since the standard is something less than insolvency, then it must somehow be tied to causing or inevitably leading to insolvency. *Id.*. Delving into the courts logic, one is faced with the conclusion that subparts ii and iii are strikingly similar.

(c) Incurred debt beyond ability to pay

There is scant authority specifically referring to 548(a)(2)(B)(iii). The language of this provision requires that the debtor intended to incur, or believe he would incur, debts that would be beyond his ability to pay. Bankruptcy Code § 548(a)(2)(B)(iii). Therefore, a fundamental issue is whether this provision applies at all in cases where the transfer is involuntary, especially when the debtor is admittedly solvent. All cases that do discuss the provision examine the intent of the debtor when the transfer was made. The provision requires an affirmative act by the debtor. The court in *In Re Hall*, 131 B.R. 213 (Bankr. N.D. Fla. 1991), has held that involuntary transfers were not contemplated by 548(a)(2)(B)(iii). *Id.* (Reconciling with general "involuntary" language of 548).

C. Who may bring claim:

The statute grants the federal fraudulent conveyance cause of action to trustees and debtors-in-possession, and therefore, a creditor generally does not have standing to prosecute an action for fraudulent conveyance. *In re Auxano, Inc.*, 87 B.R. 72 (Bankr. W.D. Mo. 1988); *In re Grell*, 83 B.R. 652 (Bankr. W.D. Mo. 1988); *In re Hess*, 21 B.R. 465 (Bankr. W.D. Va. 1982). However, courts hold that an individual creditor can bring an action for recovery of an alleged fraudulent transfer provided they can show that the trustee or creditor's committee failed to zealously prosecute the action on behalf of estate. *In re Gibson Group, Inc.*, 66 F.3d 1436 (6th Cir. 1995); *In re v. Savings*

Oil & Heating Co., Inc., 91 B.R. 655 (Bankr. E.D.N.Y. 1988); *In re Conley*, 159 B.R. 323 (Bankr. D. Idaho 1993).

In one case, *Glinka v. Abraham and Rose Co, Ltd.*, 199 B.R. 484 (D. Vt. 1996), the court allowed a creditor and the trustee to jointly pursue a fraudulent conveyance action. The court found that by itself, the estate lacked the funds to pursue the claim, and that allowing the creditor to join the trustee imposed no net financial burden on the bankruptcy estate.

IV. South Carolina Fraudulent Conveyances/Statute of Elizabeth.

South Carolina Code § 27-23-10 et seq, known as the Statute of Elizabeth, states, essentially, that "any transaction which may be had or made to or for any intent or purpose to delay, hinder or defraud creditors and others of their just and lawful rights to that property shall be deemed and taken to be clearly and utterly void, frustrate and of no effect." This is qualified by § 27-23-40, which states:

> Nothing contained in § 27-23-10 to 27-23-30 shall extend or be construed to impeach, defeat, make void or fraustrate any [transfer] made upon or for good consideration and bonafide to any person or body politic or corporate.

Although the statute of Elizabeth's protection extends to any and all parties who are defrauded in connection with the conveyance of property, *Mathis v. Barton*, 460 S.E. 2d 406 (S.C. App. 1995) (citing *Lebovitz v. Mudd*, 2293 S.C. 49, 358 S.E.2d 698 (1987), when a creditor actually becomes a creditor can prove to be important. South Carolina case law makes a distinction between existing creditors and subsequent creditors. The applicable date of reference is the date of the challenged transfer. A creditor whose claim straddles the transfer date shall be treated according to when the majority of the claim accrued. *Id.*

Creditors who were creditors at the time the transfer took place -- i.e., existing creditors -- can set aside a fraudulent conveyance upon a showing that:

(a) where the transfer was made for valuable consideration --

> (1) the transfer was made by the grantor with actual intent of defrauding his creditors;
>
> (2) the grantor was indebted at the time of the transfer; and
>
> (3) the grantor's intent is imputed to the grantee; or

(b) where the transfer is made without valuable consideration --

> (1) the grantor was indebted to the creditor at the time of the transfer;

> (2) the conveyance was voluntary; and
>
> (3) the grantor failed to retain sufficient property to pay the indebtedness to the plaintiff in full, not merely at the time of the transfer, but in the final analysis when the creditor seeks to collect his debt.

Id.[structure of text altered for clarification].

Subsequent creditors, those creditors where at least fifty percent of the claim accrued after the allegedly fraudulent transfer, may set aside a transfer if they show (1) the conveyance was without consideration and (2) it was made with a view to future indebtedness or with actual fraudulent intent on the part of the grantor to defraud creditors. The obvious difference between the two is that an existing creditor can choose between proving lack of consideration and actual fraud whereas a subsequent creditor must always prove lack of consideration, and some type of intent. *Id.* With the exception of the elements requiring a creditor to prove that the debtor was indebted to him at the time of the transfer, all of the aforementioned elements are discussed below in order. As for proof that the grantor was indebted to the creditor at the time of the transfer, it has never been flushed out, but it would seem fairly obvious that if one is able to prove that he is an existing creditor -- fifty percent of debt owed prior to transfer -- then these elements are self actualizing, provided a creditor remembers that part of his proof is to show when the debt occurred and the amount.

A. Valuable consideration.

Obviously, for an existing creditor, the first question that must be answered is whether or not the transfer was for valuable consideration. Valuable consideration means something more than nominal. *Matthews v. Matthews*, 35 S.E. 2d 157, 207 S.C. 170 (S.C. 1945). Generally, in South Carolina, a contract need only mention consideration for it to be considered a bonafide exchange for value. However, under fraudulent conveyance law, the standard is higher, and courts will look past the four corners of the document to discern whether the exchange amounted to an arms length transaction. *See First Citizens Bank and Trust Co. of South Carolina v. Scofield*, 335 S.E. 2D 248, 286 S.C. 520 (S.C. app. 1985) (for $5.00 and "Love and Affection" insufficient language to circumvent Statute of Elizabeth). Valuable consideration is the fair equivalent of the property conveyed. Additionally, any value given must inure to the benefit of the debtor in order to be considered. *Dufresne v. Regency Realty, Inc.of Hilton Head Island*, 366 S.E. 2d 256, 295 S.C. (S.C. App. 1987) (Value given to someone other than the debtor does not county as consideration for fraudulent conveyance purposes.).

B. Fraudulent Intent

If valuable consideration was given, the creditor is forced to prove fraudulent intent. In usual circumstances,

> fraudulent intent . . . can be shown only by a consideration of the attendant facts and circumstances, a resort to which must usually be had in order to distinguish between transactions which are bona fide, and those which are not. The Courts frequently must resort to evidence or circumstances which are not properly explained, when such circumstances lead to the belief that a fraudulent intent was present. . . . For fraud is not to be expected to seek the glare of day, or the presence of witnesses for its consummation. It is usually effected in secret, and it is only from circumstances [that it may be presumed].
>
> Certain circumstances so frequently attend conveyances to defraud creditors that they are recognized and referred to as "badges of fraud." These badges tend to excite suspicions as to the bondfides of a challenged conveyance. Unexplained, they may

> warrant an inference of fraud. Whether the inference is warranted depends in large measure on whether a satisfactory explanation is presented.
> . . . Among the generally recognized badges of fraud are:
> [1] insolvency or indebtedness of the transferor;
> [2] lack of consideration for the conveyance;
> [3] relationship between the transferor and the transferee;
> [4] the pendency or threat of litigation;
> [5] secrecy or concealment;
> [6] departure from the usual method of business;
> [7] the transfer of the debtor's entire state;
> [8] the reservation of benefit to the transferor;
> [9] retention by the debtor of possession of the property.
> Although it has been said that a single badge of fraud may stamp a transaction as fraudulent, it is more generally held that one circumstance recognized as a badge of fraud may not alone prove fraud; where there is a concurrence of several such badges of fraud an inference of fraud may be warranted.

Coleman v. Daniel, 199 S.E.2d 74, 261, S.C. 198 (S.C. 1973).

C. Knowledge of Grantee.

In order to set aside a fraudulent conveyance made where value is given, the creditor must show that the fraudulent intent of the debtor is imputable to the grantee. *Sumner v. Janicare, Inc.*, 366 S.E. 2D 20, 294 S.C. 483 (S.C. App. 1988). This requires that the transferee have knowledge or participate in the scheme, which can be proven by circumstantial evidence. *SCNB v. Halter*, 359 S.E. 2D. 74, 293 S.C. 121 (S.C. App. 1987). Actual knowledge of, or participation in, the debtor's fraudulent intention on the part of the transferee need not be established in order to justify a conclusion that the transaction was fraudulent. The transaction is subject to attack if at the time of the transfer the transferee had notice of circumstances which would arouse the suspicion of any ordinary prudent man and cause him to make inquiry as to the purpose for which the transfer was being made, which would disclose the fraudulent intent of the maker. *Coleman v. Daniel*, 199 S.E. 2D 74, 261 S.C. 198 (S.C. 1973). Knowledge on the part of a purchaser that the seller is indebted or insolvent has frequently been held sufficient to place a purchaser on notice and to require him to investigate. *Id*. The purchaser need not know of the specific debt that the creditor asserts is being hindered or prejudiced as a result of the transfer. *Id.* Perhaps the most ambiguous element is the requirement that an existing creditor must prove that a transfer without consideration was voluntary. A voluntary conveyance is a transfer made without consideration or for a mere nominal consideration. *Durham v. Blanchard*, 438 S.E. 2D 259 (S.C. App. 1993). Where nominal or some amount of consideration is paid, the transfer is considered voluntary to the extent the value of the property is more than the consideration paid. *Kirby v. Horne Motor Co.*, 366 S.E. 2D 259 (S.C. App. 1988).

D. Voluntariness of transfer

A voluntary conveyance is a transfer made in good faith without consideration or for a mere nominal consideration. *Durham v. Blackard*, 438 S.E. 2d 259 (S.C. App. 1993). "A voluntary conveyance which violates the statute [of Elizabeth] will be set aside to the extent of the value of the property transferred less any consideration received in exchange therefore." Id. at 263.

E. Insolvency

When an existing creditor is showing that the grantor failed to retain sufficient property to pay the indebtedness to the plaintiff in full, they are in essence attempting to prove insolvency. The court in *Gardner v. Kirven*, 191 S.E. 814, 816 (1937) seems to suggest that the plaintiff needs to show that "[i]f in the final event the property of the debtor is not sufficient to pay his debts existing at the time of this voluntary conveyance, then such conveyance is null and void as to such debts." *Id.* Clearly, the *Garvin* holding suggest that a creditor may show insolvency at the time the debt is sought to be collected. *Garvin* supports the position that in conveying property, debtor's must retain sufficient property to satisfy their debts when they become due. The amount of property that must be retained "means a sufficient amount of property not merely at the time of the transfer, but an amount from which in the final analysis the creditors are able to collect their indebtedness in full." *Id*. at 816.

No South Carolina Court has held that this element is presumed or abandoned when the debtor/grantor has filed bankruptcy. Nevertheless, it would seem that a creditor's or trustee's duties in proving this element go beyond simple proof that the debtor filed bankruptcy. The creditor or the trustee must show that the debtor is infact insolvent. The mere filing of a petition is insufficient because one can file bankruptcy for one of two reasons -- (1) the inability to pay ones debts as they become due, and (2) not having enough assets to pay ones debts. According to *Durham v. Blackard,* 438 S.E. 2d 259 (S.C. App. 1993), a creditor may have to prove that the debtor has insufficient assets to pay the debt, after the transfer. *See Durham*, 438 S.E. 2d at 263 ("McMillan failed to retain sufficient property to pay his debt to Blackard."). Additionally, in *Dufresne v. Regency, Inc*., 366 S.E. 2d 256 (S.C. App. 1987), the court focused on the assets of the debtor versus the liabilities, further evidencing that the a creditor must prove insolvency. *See also, Garvin v. Kirven*, 191 S.E. 814 (1937) (The grantor must reserve a sufficient amount of property to pay his creditors.). A debtor may have filed for bankruptcy using only the first condition. However, it seems almost tautological to state that if the debtor has enough assets to pay his debts without the necessity of recovering the fraudulent conveyance, the trustee would be hard pressed to justify the suit. Therefore, while the burden to show insolvence is more than showing that a petition was filed, the burden is met once the Trustee establishes that without the recovery of the fraudulent conveyance, the estate will not distribute a 100% payout to creditors.

F. Was made with a view to future indebtedness

It appears that the court in *Matthews v. Burton*, and in *Parker Peanut Co. v. Felder*, 20 S.E. 2D 716 (S.C. 1942), was referring to some proof that the debtor knew of the impending indebtedness at the time of the transfer. Although the court in *Gentry v. Lanneau*, 32 S.E. 523 (1899) was even more relaxed and suggested that the creditor need only prove that the transfer was made in anticipation of some future indebtedness.

V. South Carolina Uniform Commercial Code Bulk Sales Act Fraudulent Conveyance Statute.

Under the South Carolina version of the Uniform Commercial Code, the legislature has implanted a fraudulent conveyance statute to help protect creditors. The Bulk Transfer Act, found at South Carolina Code § 36-6-100 et seq., seeks to protect creditors from two possible events: from an enterprise that may sell its stock to an insider for less than what it is worth and from an enterprise that sells its stock only to distribute the proceeds to an individual who disappears. The act seeks to accomplish this purpose solely by providing notice to the creditors of the selling enterprise. See

Official Comment 4 to S.C. Code Ann. § 36-6-101 (S.C. Code Ann.). The provision that gives the Bulk Transfers act its teeth is S.C. Code §§ 36-6-104 and 105, which essentially states that transfers in bulk of all or a major part of a business's inventory is not effective against existing creditors of that business unless the transferee gives notice to the creditor at least ten days before the transferee takes possession of or pays for the goods, whichever is first. S.C. Code § 36-6-104. If the creditors are not given the statutory notice neither good faith nor fair consideration are defenses for the transferee. *See In re Pritchard*, 8 B.R. 88 (Bankr. Cal. 1981) (good faith is immaterial); *Darby v. Ewing's Home Furnishings*, 278 F. Supp. 917 (D.C. Ok. 1967) (fair consideration is no defense).

D. Preferences

D.1. Elements of a Preference Cause of Action

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 the creditor;

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

(3) made while the debtors 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 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 trustee's burden to prove each and every one of these elements. *Id.* at § 547(f); *Danning v. Bozek*, 836 F.2d 1214 (9th Cir. 1988). Failure to meet this burden on any one element precludes a finding that a transfer is a preference. *In re Hood*, 118 B.R. 417 (Bkrtcy.D.S.C. 1990); *In re Cockreham*, 84 B.R. 757 (D.Wyo. 1988). Further, because the elements above are objective, the intent of the debtor is irrelevant. *Marathon Oil Co. v. Flatau*, 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 (7th Cir. 1981).

B. 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 a debtor's equity of redemption." 11 U.S.C. § 101(54). This definition is exceptionally broad, and therefore includes virtually every conceivable transfer, including the creation or fixing of judicial liens.[2] Precisely because this definition is so 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 (Bkrtcy.D.S.C. 1990); *In re Flooring Concepts, Inc.*, 37 B.R. 957 (9th Cir. 1984).[3] In this regard, ownership is determined by the debtor's ability to control the disposition of the property. *Id.*

For example, in *In re Cybermech, Inc.*, 13 F.3d 818 (4th Cir. 1994), the Fourth Circuit Court of Appeals addressed the question of whether a debtor corporation's return of another corporation's down payment on the purchase of office machines constituted an avoidable preference. In the court held that the debtor did have an interest in the payment funds because the debtor, upon receipt of the funds, could deposit it, commingle it with other funds, withdraw from it, transfer it or otherwise use the payment funds in anyway it so desired. *Id.* at 820. Therefore, the debtor's "ability to exercise complete 'dominion and control over the funds' was sufficient to 'demonstrate an interest in property' under the preferential transfer provision . . . the [money] transferred . . . was a transfer of an 'interest of the debtor in property.'" *Id.* at 821 (quoting *In re Smith*, 966 F.2d 1527 (7th Cir. 1992)).

[2] *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 is created when the judgment is enrolled. S.C. Code Ann. § 15-35-810 (1976).

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

Another illustrative case is *In re Hood*, 118 B.R. 417 (Bkrtcy.D.S.C. 1990). There, the debtor was facing an imminent sheriff's levy when a friend of the debtor's intervened by offering to personally pay the debtor's debts. The debtor's creditors, however, refused to accept her checks. The debtor then took his friend's personal checks to the bank where they were exchanged for cashier checks and used to pay off the creditors. After finding that the transfer satisfied the other elements of a preference, the court turned to the ultimate question of whether or not the debtor possessed an interest in the transferred funds. Accordingly, the court held that the debtor did not have an interest in the funds because the debtor did not and could not control the disposition of the funds. In so holding, the court adopted and applied the "earmark" doctrine. This doctrine essentially states that funds loaned to a debtor by a third party that are "earmarked" for a particular creditor do not belong to the debtor. Its application requires:

(1) The existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt. Where the payment is made directly by the third party to the creditor, this requirement is inapplicable;

(2) Performance of that agreement according to its terms; and

(3) Transaction, when viewed as a whole, including the transfer of new funds out to the old creditor, does not result in the diminution of the estate.

Id. at 420 (citing *In re Bohlen Enter.*, 859 F.2d 561 (8th Cir. 1988)). Applying the doctrine, the court found that (1) the debtor and his friend entered an agreement that earmarked the funds for the payment of the debtor's creditors; (2) the debtor's friend directly paid the creditors; (3) the agreement was performed according to its terms; (4) the funds transferred were never property of the debtor nor did they become property of the debtor; and (5) the transfer did not diminish the debtor's bankruptcy estate. *Id*. Therefore, the court concluded that the transfer was not an interest of the debtor in property simply because the debtor did not and could not control the disposition of the property. *Id.* at 421.

C. To or For the Benefit of a Creditor . . .

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, 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., 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); *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., In re Cardon Realty Co.*, 146 B.R. 72 (Bkrtcy.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., 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).

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

Subsection (b)(4) 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. *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 the cases where the debtor is an individual or a partnership, and the director(s) or officers of the debtor in the cases where the debtor is a corporation. 11 U.S.C. § 101(31).

One of the more interesting situations where these two elements play a featured role occurs where the trustee attempts to recover a transfer to an outside creditor that benefits an insider creditor. The most common example of this scenario exists where the insider creditor guarantees a loan and then directs its 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 allows the trustee to recover from non-insider transferees for payments made during the extended preference period which benefits insider creditors or guarantors. While many courts have adopted the "Deprizio" doctrine, *see, e.g.,Ray v. City Bank & Trust Co.*, 899 F.2d 1490 (6th Cir. 1990), other courts have vehemently refused to apply its reasoning. For example, in *In re Midwestern Co., Inc.*, 102 B.R. 169 (W.D.Mo. 1989), the court opposed the *Levit* decision because it felt that section 547 unambiguously set forth two distinct time limits for each type of creditor. In this regard, the *Midwestern* court held

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

that an outside creditor is only liable for a transfer made within the ninety day limitation while an insider creditor is only liable for a transfer made within the extended preference period of one year. While the *Midwestern* court was attempting to give "full meaning" to section 547, the court in *In re Mercon Indus., Inc.*, 37 B.R. 549 (Bkrtcy.E.D.Pa. 1984), reached an identical result by concluding that a debtor's payment to an outside creditor for the benefit of an insider creditor constituted two distinct and separate transfers -- one to the primary creditor (outsider) and one to the guarantor (insider).

While this dispute was eventually settled with the passing of the 1994 Bankruptcy Reform Act disposing of the Deprizio doctrine, it is still relevant to any pre-1994 actions. More importantly, South Carolina bankruptcy courts follow the Deprizio doctrine. *See In re Hoffman Assoc.*, 179 B.R. 797 (Bkrtcy.D.S.C. 1995).

E. 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.

While the term "antecedent" is easy enough to grasp, the existence of a "debt" depends upon the existence of a claim. In *In re Cybermech*, the creditor, Royal Cake Co, Inc. (hereinafter "Royal") entered a sales agreement with the debtor, Cybermech, Inc. (hereinafter "Cybermech") whereby Royal paid Cybermech a substantial down payment for various equipment. Due to financial troubles, however, Cybermech soon informed Royal that it would be unable to perform the contract and returned the down payment. Three weeks later, Cybermech filed a voluntary Chapter Seven petition. The trustee quickly moved to have the returned down payment set aside as a preference. Royal, however, challenged the trustee and alleged, among other things, that the returned payment was not an antecedent debt because (1) Cybermech never owed a debt to Royal; and (2) even if Cybermech did, the debt was not antecedent to the transfer. The court disagreed and held that because Royal possessed a claim against Cybermech for performance under the contract, Royal was a creditor, and Cybermech owed Royal the debt of performance.[5] In so holding, the court stated that the terms "claim" and "debt" were coextensive; where one exists then so does the other:

> The Code defines "debt" as "liability on a claim." 11 U.S.C. § 101(12). By making "claim" the operative term in the definition of debt, "Congress gave debt the same broad meaning it gave claim." [Citation omitted]. Indeed, it is clear that "the terms 'debt' and 'claim' are coextensive: a creditor has a 'claim' against the debtor; the debtor owes a 'debt' to the creditor." [Citations omitted]. By

[5] For a discussion of how the *Cybermech* court determined that Royal was a creditor, and thus possessed a claim, *see supra.* Section II(B).

> defining debt as "liability on a claim," Congress did not impose an additional element, namely that legal liability be established through litigation. "[W]hen a claim exists, so does a debt." [Citation omitted]. They are but different windows in the same room.

Id. at 822. Therefore, Cybermech did owe a debt to Royal and said debt was antecedent to the transfer because Cybermech contracted the debt well before it returned the money.

F. 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).[6] In this regard, there is a presumption of insolvency during the ninety day reachback period. *Id.* In *Transit Homes, Inc. v. South Carolina Nat'l Bank*, 57 B.R. 40 (Bkrtcy.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.

G. 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). There, 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

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

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]. In this regard, the court in *Elliot v. Frontier Prop./LP*, 778 F.2d 1416, 1421 (9th Cir. 1985) stated:

> This analysis requires that in determining the amount that the transfer "enables the creditor to receive," 11 U.S.C. § 547(b)(5) (1982), such creditor must be charged with the value of what was transferred *plus* any additional amount that he would be entitled to receive from a Chapter 7 liquidation. The net result is that, as long as the distribution in bankruptcy is less than one-hundred percent, *any* payment " on account" to an unsecured creditor during the preference period will enable the creditor to receive more than he would have received in liquidation had the payment not been made. [Emphasis theirs].[7]

This section is also applicable to secured creditors. In *Smith v. Creative Fin. Management, Inc.*, 954 F.2d 193, 199 (4th Cir. 1992), the court stated:

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[7] The Supreme Court demonstrated this principle in *Palmer* with the following example:

> [W]here the creditor's claim is $10,000, the payment on account of $1,000, and the distribution in bankruptcy is 50%, the creditor to whom the payment on account is made receives $5,500, while another creditor to whom the same amount was owing and no payment on account was made will receive only $5,000.

Palmer, 297 U.S. at 229, 56 S.Ct. at 451, 80 L.Ed. at 656.

> While the bankruptcy code recognizes and respects the preeminent status given to the secured creditor by state commercial codes, a creditor is "secured" under the code only to the extent of the value of his interest in the property of the estate . . . Section 547(b)(5) does not, as Creative seems to argue, add any special protections for the secured creditor. Indeed, the term "secured creditor" is not even included in that section . . . As the plain language of [section] 547(b)(5) convey, the court must focus, not on whether a creditor may have recovered all of the monies owed by the debtor *from any source whatsoever*, but instead upon whether the creditor would have received less than a 100% payout in a Chapter 7 liquidation.

See also 4 COLLIER ON BANKRUPTCY § 547.08 (15th Ed. 1991) ("The analysis [for unsecured creditors] is similar for secured creditors . . . .").

H. Primary 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 most important of these "defenses" is the ordinary course of business exception. This exception is embodied in the text of subsection (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.*, 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.*

In *In re Jeffrey Bigelow Design Group*, 956 F.2d 479 (4th Cir. 1992), the Fourth Circuit Court of Appeals held that subsection (c)(2)(A) and (B) are analyzed pursuant to a subjective test. There, the court stated that the "'focus of [the] inquiry must be directed to an analysis of the business practices which were unique to the particular parties under consideration.'" *Id.* at 486 (quoting *Waldschmidt v. Ranier*, 872 F.2d 739, 743 (6th Cir. 1989). This inquiry is "'peculiarly factual, . . .'" *Id.* (quoting *In re First Software Corp.*, 81 B.R. 211, 213 (Bkrtcy.D.Mass. 1988), and "[a]ttention should be drawn to the reality of the situation and not the formal structure." *Id.* at 488. In this regard, the court emphasized that "form must not be elevated above substance." *Id.*

The Fourth Circuit utilized a different approach, however, in examining subsection (c)(2)(C). In *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044 (4th Cir. 1995), the creditor was a direct mail advertising firm that required its customers to prepay for its services. One of these customers was the debtor. In the ninety-day period preceding the debtor's bankruptcy petition, the debtor made twelve payments to the creditor. Two of the payments were prepayments while the remaining ten payments were for services previously rendered.

The creditor had waived the last ten payments and had allowed the debtor to pay when able. Shortly after the debtor filed for Chapter 11 protection, the trustee moved to avoid the latter ten payments as preferences. The creditor countered that said payments fell within the ordinary course of business exception, and therefore, were unavoidable.

The court began its analysis by refusing to apply subsection (c)(2)(A) and (B)' s subjective test for subsection (C). *Id.* at 1048 ("[b]ecause subsection B and C are written in the conjunctive, the use of subsection B's subjective approach under subsection C would render subsection C superfluous . . . [w]e refuse to say that Congress wrote a separate subsection for no reason at all."). The court then held that subsection (C) should be analyzed under an objective test whereby a court looks to the industry norms for the determination of "ordinary business terms." *Id.* The court then explained the application of this test:

> [T]he extent to which a preference payment's credit terms can stray from the industry norm yet still satisfy [section] 547(c)(2)(C) depends on *the duration of the debtor-creditor relationship*. "[T]he more cemented (as measured by its duration) the pre-insolvency relationship between the debtor and the creditor, the more the creditor will be allowed to vary its credit terms from the industry norm yet remain in the safe harbor of [section] 547(c)(2)(C)." *Id.* at 225. A "sliding-scale window" is thus placed around the industry norm. On the one end of the spectrum, "[w]hen the relationship between the parties is of recent origin, or formed only after or shortly before the debtor sailed into financially troubled seas, the credit terms will have to endure a rigorous comparison to credit terms used generally in a relevant industry." *Id.* In such a case, only those "departures from [the] relevant industry's norms which are not so flagrant as to be 'unusual' remain within subsection C's protection." *Id.* at 226.

> On the other end of the spectrum, "when the parties have had an enduring, steady relationship, one whose terms have not significantly changed during the pre-petition insolvency period, the creditor will be able to depart substantially from the range of terms established under the objective industry standard inquiry and still find a haven in subsection C." *Id.*

Id. at 1049 (quoting *Fiber Lite Corp. v. Molded Acoustical Products, Inc.*, 18 F.3d 217 (3d Cir. 1994)). In so holding, the court also emphasized that "subsection C never tolerates a gross departure from the industry norm, not even when the parties have had an established and steady relationship." *Id.* at 1050.

Applying their "newly adopted" sliding scale approach to subsection (c)(2)(C), the court found that the creditor had failed to meet its burden of satisfying subsection (c)(2)(C). Because the creditor's normal business practice was to require prepayment, their waiving of the requirement for the debtor constituted a gross departure from their industry norm. Therefore, and despite their longstanding relationship with the debtor, the creditor was held liable for the preference payment.

<u>I. Defense -- The New Value Exception</u>

Another defense worthy of mention is the new value exception. It is embodied in section 547(c)(1)(A)(B) which provides:

> (c) The trustee may not avoid under this section a transfer --
>
> (1) to the extent that such transfer was --
>
> (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to

be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange.

The exception's existence and purpose is to protect transactions that do not diminish the bankruptcy estate. *In re Martin*, 188 B.R. 689 (M.D.Ala. 1995). In this regard, it is the intent of the parties which constitutes the most critical element. *See In re Hersman*, 20 B.R. 569 (Bkrtcy.N.D.Ohio 1982) ("The key inquiry, therefore, is whether the parties at the outset intended the exchange to be contemporaneous."). Legislative history reveals the type of transaction that this exception was designed to cover:

> However, for the purposes of this paragraph, a transfer involving a check is considered to be "intended to be contemporaneous," and if the check is presented for payment in the normal course of affairs . . . that will amount to a transfer that is "in fact substantially contemporaneous.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 373 (1977), U.S. Code Cong. & Admin. News, p. 5787 (1978). A check, then, is the classic example. *See In re Davis*, 22 B.R. 644 (Bkrtcy.M.D.Ga. 1982) (holding that the only type of credit transaction which would result in a transfer under the new value exception is a check transaction, which is for all practical intents and purposes really a cash transaction). Conversely, a credit card transaction is the classic bad example. In *In re Hersman*, the court explained:

> Where goods are paid for by a check, the payor had funds in the banking institution upon which the check is drawn when he makes the check payable to the person furnishing the goods. The payee need only present the check for payment . . . When using a credit card to pay for goods, a consumer is

> generally seeking that which its name implies -- the extension and receipt of credit. By using a credit card, the credit card consumer does not intend a contemporaneous exchange for value. Instead, what is generally intended is the receipt of goods or services presently and time to pay for the same in the future . . . .

In re Hersman, 20 B.R. at 573.

A transaction, however, need not only be contemporaneous, but it must create new value as well. While the question of new value is always a question of fact, *In re Spada*, 903 F.2d 971 (3d Cir. 1990), its form can be virtually anything. *See In re Prescott*, 805 F.2d 719 (7th Cir. 1986) (stating that new value includes new credit, goods, services and property). In *In re Townsend-Robertson Lumber Co.*, 144 B.R. 407 (Bkrtcy.E.D.Ark. 1992), the court found new value in the retention of fees for the storing of a Chapter 7 debtor's lumber. In *In re Mantelli*, 149 B.R. 154 (9th Cir.BAP Cal. 1993), however, the court held that a debtor's payment to his wife of a civil contempt sanction did not create new value because the payment was not made for goods or services, but in lieu of a five day jail sentence.

A. Turnover Orders

Section 542(a) generally provides that a third party noncustodian that has custody or control over property of the estate that either the Trustee may use, sell or lease or that the debtor may exempt must turn that property over to the Trustee, unless the property is of inconsequential value or benefit to the estate. Section (b) provides that an individual that owes a matured debt shall pay that debt to the order of the trustee, unless the debt is being set-off under Section 553. Subsections 542(c) and (d) provides specific instances where the third party does not have to turn the property over to the Trustee. Specifically, if the party does not know of the commencement of the case, or if the third party is transferring life insurance benefits. 542(e) also requires the turnover of books and records from individuals such as attorneys and accountants to the Trustee. Note that Section 542(e) does not waive or constitute any exception to the attorney-client privilege.

The court will exceed its equitable power if it orders turnover of property held by a creditor without first providing adequate protection for that property. *In re Empire for Him, Inc.*, 1 F.3d 1156 (11th Cir. 1993).

E. Exemptions

Exempted property is property that the debtor may keep. If a debtor owns too expensive or too much property for a particular section, the debtor must surrender the excess to the estate or sell the property and keep the cash equivalent of the exempted property. Property that is fully liened is not subject to an exemption. Many of South Carolina's Exemptions are located at S.C. Code Ann. 15-41-30:

1. Up to 5,000.00 in a residence or burial plot owned by a debtor or a dependent of the debtor.
2. Up to 1,200.00 in a motor vehicle (Ex. a debtor has a 6,000 car. The debtor can sell the car for 6,000 and keep 1,200 in cash.)
3. Up to 2,5000.00 in household goods, wearing apparel, furnishings, appliances, books, animals, crops or musical instruments held primarily for personal, family or household use.
4. Up to 500.00 in jewelry
5. Up to 1,000.00 in liquid assets (cash, drafts, securities, notes etc) This exemption is only available if the debtor does not take a homestead exemption.
6. Up to 750.00 in professional implements, tools of the trade and books
7. Any interest that the debtor has in an unmatured life insurance contract, but not a credit life insurance contract.
8. Up to 4,000.00 in dividend, interest or loan value of any lie insurance contract.

9. Any professionally prescribed health aids for the debtor or a dependent of a debtor.
10. The debtors right to receive: a social security benefit, a veteran's benefit, a disability benefit, alimony, support or separate maintenance and a payment of a stock, bonus, pension, sharing, annuity or similar plan on account of age, disability, death or length of service.
11. The debtor may also receive any property traceable to: an award under a crime victim reparation law, a payment on account of bodily injury of the debtor or of the wrongful death or bodily injury of another individual of whom the debtor was or is a dependent, a payment under a life insurance contract that insured a person to whom the debtor was s dependent on the date of the insured's death.
12. Any interest or right in an individual retirement account.
13. The debtor's interest in an ERISA qualified employee pension plan.

14. South Carolina has other exemptions:

a. Fraternal benefit association
b. Right to annuity or retirement allowance from the S.C. Retirement System, the Retirement System for Judges and Solicitors, the Retirement System for the General Assembly, the police Officers retirement System or any private municipality retirement system.
c. Any pension fund held before or after the Fireman's pension funds held by any municipality.
d. 50,000 in cash surrender value or proceeds from an individual life insurance policy for the benefits of the debtors, spouse, children or other dependents.
e. 50,000 in cash surrender value or proceeds from a group life insurance policy for the benefits of the debtors, spouse, children or other dependents.
f. Workers Compensation pursuant to S.C. Code Ann. 42-9-360
g. Public Aid and Assistance pursuant to S.C. Code Ann. 43-5-190
h. Crime Victim's Compensation pursuant to S.C Code Ann. 16-3-1300
i. Partnership Property pursuant to S.C. Code Ann. 33-41-720.

15. Other Federal Exemptions include:

a. Social Security paid or payable 42 U.S.C. 407
b. Veteran's benefits 38 U.S.C. 3101
c. Disability or death compensation for government employees 5 U.S.C. 1830
d. Civil Service retirement annuity 5 U.S.C. 8346
e. Armed Services retirement or retainer pay annuity 10 U.S.C. 1440
f. Military survivor annuity, 10 U.S.C. 1450
g. Foreign service retirement and disability 22 U.S.C. 4060
h. Annuities for survivors of judicial officials 28 U.S.C. 376

i. Longshoremen's and harbor workers compensation and benefits, 33 U.S.C. 916
j. Benefits from Servicemen's or veteran's Group Life Insurance 38 U.S.C. 770(g)
k. War risk hazard compensation benefits 42 U.S.C. 352(e)
l. Railroad retirement annuity for supplemental annuity 45 U.S.C. 231(m)
m. Railroad workers unemployment compensation 45 U.S.C. 352 (e)
n. The Clothing of seamen 46 U.S.C. 1110
o. CIA retirement 50 U.S.C. 403

G. Valuation of Security Interest

Section 506 determines the actual amount of a secured claim, but does not govern if the claim itself is specifically allowed. A creditor is secured if it has a lien on the property or if the property is subject to setoff pursuant to Section 553. The creditor is secured to the value of the creditor's interest in the property or the extent of the amount of setoff. If the amount of the collateral is less than the claim, then the creditor is unsecured for the remainder of the claim. 506(b) states that if the value of the collateral exceeds the amount of the creditor's claim, then the creditor's claim can be increased by expenses and interest incurred by the creditor. 506(c) requires that the Trustee charge the secured creditors for certain necessary expenses to preserve the property, 506(d) summarily voids liens secured by claims that are not properly allowed claims.

A debtor's Chapter 13 property is valued according to the cost a debtor would incur in obtaining a like asset for the same use. This is also known as replacement value. Determining the replacement value requires deductions for certain costs including warranties, storage and reconditioning. *Associates Commercial Corp v. Rash*, 520 U.S. 953 (1997).

Replacement value for a vehicle may be calculated by averaging wholesale values in the "blue book" and then by adjusting the value according to other evidence introduced by the parties. *In re Getz*, 242 B.R. 916 (B.A.P. 6th Cir. 2000).

Valuation of collateral securing a creditor's claim is flexible and is not limited to a single point in time for purposes of determining whether a creditor is entitled to accrue interest under 506(b). In re T-H New Orleans Ltd. Partnership, 116 F.3d 790 (5th Cir. 1987).

Under 506(b) no recovery exists for postpetition interest on an oversecured claim, but recovery of reasonable fees and costs are permitted. *United States v. Ron Pair Enterp. Inc*., 489 U.S. 235 (1989).

The Chapter 11 debtor in possession may not surcharge an oversecured bank's collateral to pay debtor's attorneys of the services are not necessary and do not confer a benefit to the banks. *In re Compton Impressions, Ltd.,* 217 F.3d 1256 (9th Cir. 2000).

H. Treatment of Secured Claims in Chapter 11 Plans

In Chapter 11 Bankruptcy, The debtor usually files the plan pursuant to Section 1121. The plan must place creditors into substantially similar classes pursuant to 1122. Secured Creditors usually have their own class. Section 1123 provides that the plan may impair or leave unimpaired any class of secured or unsecured claims, (1123(b)(1) but if the plan leaves a class unimpaired, then the plan must specifically state it. (1123(a)(2).) Section 1124 defines an unimpaired class as a class that is completely protected under the plan. Unimpaired classes are deemed to have protected the plan, as those creditors will receive the full amount of their security interest. Section 1129(a)(8).

For a plan to be confirmed each class must have accepted the plan under 1129(a)(7) or the class must be crammed down under 1129(b). A class has accepted the plan if at least 2/3 in amount and more than ½ in number of the creditors in the class have accepted the plan. 1126(c). The court may also "knock out"creditors whose acceptance or rejection of the plan was not in good faith. 1126(e). So as a class of secured creditors, the plan can either leave them unimpaired so that the secured creditors get the total amount of their lien and are deemed to have accepted the plan. The secured creditors can accept the plan, or they can reject the plan and the debtor can try to "cram" the plan down on them, forcing them to accept the plan. Section 1129(b)(2) provides the mechanism to "cram down" around a secured creditor. The plan must be fair and equitable and provide that the holders retain the liens securing the claims, that each holder receive deferred cash payments totaling at least the allowed amount of such claim (or for the sale and proceeds of the liened items) or the realization by the holders of the indubitable equivalent of such claims. Thus, it is very hard to "cram down" on a secured creditor, unless the creditor is getting what they would have gotten outside of bankruptcy. Thus, it is smart for most Chapter 11 plans to go ahead and set the secured creditors up as an unimpaired class, deemed to have accepted the plan.

Claims may be classified separately if the claims are not substantially similar, if there are good business reasons for doing so, or if in the claimants have sufficiently different interests under the plan. Claims may not be classified separately solely in order to gerrymander an affirmative vote on reorganization. *Matter of Wabash Valley Power Assoc.*, 72 F.3d 1035 (7th Cir. 1995) *cert denied,* 519 U.S. 965 (1996).

In determining whether a classification is reasonable, the court should look to purposes that classification serves: (1) voting to determine whether a plan can be confirmed; and (2) treatment of claims under the plan. Each class must represent a voting interest that is sufficiently distinct to merit and separate voice. John Hancock Mutual Life Ins. Co. v. Route 37 Bus. Park. Assocs., 987 F.2d 154 (3d Cir. 1993).

Any alteration of rights constitutes an impairment, even if the value of the rights is enhanced. *Matter of Wabash Valley Power Assoc.*, 72 F.3d 1035 (7th Cir. 1995) *cert denied,* 519 U.S. 965 (1996).

A claim is impaired unless the plan does not alter the legal, equitable, and contractual rights to which a claim or interest entitles the holder. *In re Windsor on the River Assoc. Ltd.*, 7 F.3d 127 (8th Cir. 1993).

The purchase of claims for the purpose of securing the approval or rejection of a plan is not per se bad faith. *In re 255 Park Plaza Assocs. L.P.,* 100 F.3d 1214 (6th Cir. 1996).

A postpetition secured lender is not entitled to vote on a plan of reorganization. *In re Kliegl Bros. Univ. Elec. Lighting Co.*, 149 B.R. 306 (E.D.N.Y. 1992).

When all requirements for a confirmation of a reorganization plan are met except for 1129(a)(8), the bankruptcy court must confirm the plan despite the objection of an impaired class or classes so long as the plan does not discriminate unfairly and is fair and equitable with respect to the impaired classes. *In re Bonner Mall Partnership*, 2 F.3d 889 (9^{th} Cir. 1993).