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Update On Preference And Fraudulent Transfer Litigation

By Michael L. Cook

The appellate courts have been busy explaining or clarifying preference and fraudulent transfer law. Although novices may think the Bankruptcy Code (Code) is clear on its face, imaginative counsel have found gaps in the statute and generated rafts of litigation since the Code's enactment in 1979. Recent appellate decisions, summarized below, show that courts are still making new law or refining prior case law.

Preferences

New Value Defense Not Reduced by Debtor's Post-Petition Payment of Twenty-Day Goods Administrative Claim (§503(b)(9)). The Eleventh Circuit held that, "for purposes of [Code] (§547(c)(4)(B), 'otherwise unavoidable transfers' made *after* … bankruptcy [*i.e.*, (§503(b)(9) post-petition administrative priority payments] do *not* affect a [preference defendant] creditor's new value defense." *Auriga Polymers Inc. v. PMCM2, LLC* (*In re Beaulieu Group, LLC*), 2022 WL 2800195, *1 (11th Cir. July 17, 2022) (emphasis added). Reversing the bankruptcy court, the court explained that "only *pre-petition* transfers will affect a creditor's subsequent new value defense." *Id.* at *11 (emphasis added). According to the court, the new value defense in Code §547(c)(4)(B) "protects a creditor who provided new value to [the debtor] after receiving a preference payment." *Id.* at *5. But "(1) the creditor must have given new value; (2) the new value [must be unsecured], not secured by an … unavoidable security interest; and (3) the debtor did not make an otherwise unavoidable transfer to … the creditor on account of the new value." *Id.* "[O]nly the Third Circuit has directly [held] that only *pre-petition* 'otherwise unavoidable transfers' can offset a creditor's … new value defense." *Id.* at *6, [emphasis added] citing *In re Freedman's Inc.*, 738 F.3d 547, 549 (3d Cir. 2013) (post-petition payments per wage order did not impair new value defense). Here, the creditor admittedly gave $421,119 of new value to the debtor on an unsecured basis "after the final preferential transfer" and had an administrative expense priority claim of $694,502 for goods delivered within twenty days of bankruptcy. *Id.* at *3. In sum, the court held that the creditor could be paid on its administrative expense priority claim and also reduce its preference liability based on subsequent new value. The creditor was not being paid twice, but only once. The issue here was the amount of the creditor's disgorgement.

Earmarking Doctrine; No Diminution of Estate. The district court affirmed the bankruptcy court's dismissal of the trustee's preference and fraudulent transfer claims because the debtor "never had an interest in [the] funds" paid to a lender, an essential element to be proved on both claims. *Mann v. LSQ Funding Group, L.C.*, 2022 WL 2788437 (C.D. Wis. July 15, 2022). "[W]hen a new lender makes a loan to a debtor for the specific purpose of paying off a former lender, the debtor has not made a transfer of its own property because the debtor still owes the same sum, only to a different creditor." *Id.* The new lender "simply substitutes itself for the original creditor." The parties had agreed that "the funds being sent to [the former lender defendant] could only be used to pay [the debtor's] debt to [that lender]; [the debtor] had no discretion to transfer those funds to any other person or entity …. The transfer eliminated [the debtor's] debt to [the former lender], replacing it with a debt to [the new lender]," citing *In re Smith*, 966 F.2d 1527, 1533 (7th Cir. 1992).

Recorded Deed Outside of Chain of Title; Unperfected Lien. The Tenth Circuit reversed the lower court's dismissal of a trustee's preference complaint when a purported mortgagee recorded its lien four months after making a purportedly secured loan to the debtor in 2012. *In re Cates*, 2021 WL 4438141 (10th Cir. Sept. 28, 2021). Before the lien was recorded in 2013, however, the debtor transferred the property to a self-settled trust and then transferred the underlying real property back to herself in 2015 and recorded the original lien eight days prior to bankruptcy. Applying Colorado law, the Tenth Circuit explained that Colorado follows "the chain of title doctrine," meaning that a lien not recorded within a certain time is "considered to be recorded outside of the chain of title … and equivalent to not being recorded at all." For a security transfer covering real property such as the transfer at issue here, it "is perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interests of the transferee.'" *Id.* at *2, quoting Code §547(e)(1).

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Because the lien here was "outside of the chain of title, … a bona fide purchaser would not be charged with notice of the [original lender's 2013] interest." *Id*. at *3. The court thus rejected the original lender's "argument that its deed of trust was perfected" in March, 2013. The court therefore found that "the deed of trust was unperfected between the time it was recorded (2013) and the time the debtor recorded the second quit claim deed" a few days prior to bankruptcy in 2015, "within the preference period."

Failure to State Claim for Relief; No Preemption of State Law Preference Claim. The district court granted the defendant's motion to dismiss a state law preference complaint because it failed to provide the defendant with "sufficient detail regarding the nature of the alleged preferential transfers." *Insolvency Services Group, Inc. v. Comcast Cable Communications, LLC*, 2021 WL 4477000 (D. Del. Sept. 30, 2021). Plaintiff merely alleged that "one or more transfers" occurred during the 90-day preference period. The aggregate amount of the transfers was "not less than $1,457,600.47." The plaintiff assignee for the benefit of creditors also failed "to state which of those payments went to [the moving defendant] and which went to the [other] defendants." Delaware bankruptcy courts have regularly required a preference complaint to include "(a) an identification of the nature and amount of each debt antecedent and (b) and an identification of each alleged preference transfer by (i) date, (ii) name of debtor/transferor, (iii) name of transferee and (iv) the amount of the transfer."

But the court rejected the claim that California law was "preempted by federal bankruptcy law." Declining to follow the Ninth Circuit's decision in *Sherwood Partners, Inc. v. Licos, Inc.*, 394 F.3d 1198 (9th Cir. 2005), the court stressed that "the weight of authority following *Sherwood* is critical of its holding." Following appellate decisions in California and Delaware, the court said the California preference statute "does not create an 'unavoidable conflict' with the Bankruptcy Code such as to give rise to implied preemption." The relevant California statute "complements, rather than hinders, bankruptcy's goal of insuring equitable distribution." Moreover, the "Supreme Court has rejected" the argument that "the mere existence of state and federal statutes with similar objectives compels preemption …."

Fraudulent Transfers

An Intermediary Bank May Qualify for Safe-Harbor Immunity from Avoidance Actions. The Eighth Circuit affirmed the district court's providing safe-harbor immunity from an avoidance action to the defendant, the customer of a bank tasked with receiving and disbursing funds in connection with a note purchase agreement. *Kelley v. Safe Harbor Managed Account 101, Ltd*., 31 F.4th 1058 (8th Cir. 2022). The Code provides a safe-harbor to customers when financial institutions are "acting as agent or custodian for [the] customer … in connection with a securities contract." *Id*. at 1064. The bank here was an intermediary agent for the defendant in a note purchase agreement that "fit plainly within the statutory definition of a securities contract" *Id*. at 1066. *Accord*, *In re Tribune Co. Fraudulent Conveyance Litig*., 946 F.3d 66 (2d Cir. 2019), *cert denied*; 141 S. Ct. 728 (2020) and 141 S. Ct. 2552 (2021).

Innocent Friend Insulated from Corporate Debtor's Fraudulent Transfer Liability. The defendant "was a 'mere conduit' of [a] fraudulent transfer and cannot be liable to the bankruptcy estate for funds she never knew about," held the Second Circuit on May 5, 2022. *In re BICOM N.Y., LLC*, 2022 WL 1419997 (2d Cir. May 5, 2022). Affirming the lower courts' granting of summary judgment to the defendant transferee, the court refused to "equate … mere receipt [of corporate debtor funds] with liability," reasoning that "mere conduits" of fraudulent transfers are not "initial transferees" under Bankruptcy Code §550(a)(1) ("trustee may recover" fraudulently transferred property from "the initial transferee of such transfer").

The Code does not define "initial transferee," leading to a raft of fact-intensive appellate decisions on the subject. Generally, a financial intermediary or conduit would not be a "transferee" of the debtor's property because it does not have control over that property. *See, e.g.*, *In re Pony Express Delivery Servs. Inc*., 440 F.3d 1296, 1304 (11th Cir. 2006) (insurance broker received premium payments from debtor more than three weeks after paying insurance carriers on debtor's behalf; held, insurance broker was not initial transferee under §550); *Bonded Fin Servs., Inc. v. European AM Bank*, 838 F.2d 890, 893 (7th Cir. 1988) ("minimum requirement of status as a 'transferee' is dominion over the money or other asset, the right to put the money to one's own purposes").

Creditors' Committee Had Derivative Standing to Sue on Behalf Estate. The district court reversed the bankruptcy court's vacating of a stipulation giving a creditors' committee standing to bring fraudulent transfer claims on behalf of the debtors' estates. *In re X-treme Bullets, Inc*., 2022 WL 2134089 (D. Nev. June 14, 2022). The bankruptcy court never explained why it had rescinded the court-approved derivative standing stipulation when it had the authority to approve that stipulation. The district court also reversed the bankruptcy court's order dismissing the fraudulent transfer action. Because the bankruptcy court had approved the stipulation, the committee had standing to sue.

Ninth Circuit precedent permits derivative standing agreements. *See, e.g.*, *In re Parmatex*, 199 F.3d 1029, 1030-1 (9th Cir. 1999). On the facts here, the bankruptcy court's rescinding the stipulation constituted an abuse of discretion because it unfairly prejudiced the debtors' estates. According to the Ninth Circuit, so long as the bankruptcy court exercises its oversight and verifies that the litigation is necessary and beneficial, allowing a creditors' committee to represent the estate presents no undue concerns. Other circuits agree and permit derivative standing stipulations. *See, e.g.*, *In re Commodore Int'l Ltd*., 262 F.3d 96, 99 (2d Cir. 2001). No circuit, however, has found that derivative standing stipulations are impermissible. The Second Circuit has recognized "the long-accepted practice of conferring derivative standing on… committees." Rejecting the defendant's argument about the committee's lack of Article III standing, the court held it to be irrelevant because the committee was suing not on its own behalf, but on behalf of the debtors in possession. "The appropriate inquiry is whether the Debtors would have had standing to bring the claims, not whether the Committee had suffered an injury-in-fact."

State Law Strict Foreclosure Does Not Provide Reasonably Equivalent Value. The Second Circuit affirmed the district court's holding that the transfer of the debtor's home, "worth at least $22,000 in exchange for the satisfaction of" a $1,290 County tax lien was "not for 'reasonably equivalent value'." *Gunsalus v. County of Ontario*, 37 F.4th 859 (2d Cir. 2022). Distinguishing this case from the facts in *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 548 (1994) (courts consider "whether the debtor has received value that is substantially comparable to the worth of the transferred property"), the Second Circuit stressed that the County in *Gunsalus* used the New York "strict foreclosure regime" rather than the foreclosure by sale in *BFP*. Indeed, the Supreme Court in *BFP* noted that foreclosures by sale "avoided the draconian consequences of strict foreclosure." 511 U.S. at 541. In New York's strict foreclosure, for example, the debtors forfeited their "entire interest" in their home, "regardless of any accumulated equity." New York's "strict foreclosure procedures … offer far fewer protections than the" sale procedure in *BFP*. Unlike the sale in *BFP*, the County sold the debtors' home "after foreclosure." Once the state court entered its final foreclosure judgment, it gave "the County possession of, and title to the home" under New York's "strict foreclosure" procedure. "There is no foreclosure sale … and the transferee can then sell the property …." The relevant transfer "had already occurred by the time the County auctioned off the property … solely for the benefit of the County …." *Id*. The "County pocket[ed] the difference between the tax debt [$1,290] and the sale proceeds [$22,000] and [was] not accountable to other creditors …." As the Second Circuit "previously admonished, 'there is a strong presumption of not allowing a secured creditor to take more than its interest.'" *In re Harris*, 464 F.3d 263, 273 (2d Cir. 2006). *Accord*, *In re Lowry*, 2021 WL 6112972 (6th Cir. Dec. 27, 2021) (reversed lower courts' approval of Michigan tax foreclosure sale; held that "amount paid on foreclosure bore no relation at all to the value of the property"; no reasonably equivalent value); *In re Smith*, 811 F.3d 228, 234 (7th Cir. 2016) ("… *BFP* does not extend to Illinois tax sales)".

Tax Penalty Obligations and Payments of Tax Penalty Obligations Not Voidable. The Fourth Circuit affirmed the lower courts' holding that "tax penalty obligations are not voidable and, relatedly, tax penalty payments are not recoverable." *In re Yahweh Center, Inc.*, 27 F.4th 960 (4th Cir. 2022). After the bankruptcy court had confirmed the debtor's Chapter 11 reorganization plan, the plan trustee sued the federal government "to void tax penalties incurred by [the debtor] and to recover tax penalty payments that the [debtor had] already paid," alleging that the penalties and penalty payments were "constructively fraudulent obligations and fraudulent transfers" because the debtor had not received "reasonable equivalent value' in exchange for the penalties and penalty payments."

The court first rejected the government's sovereign immunity defense. Relying on Code §106(a), the court held that it foreclosed "the government's position because [the statute] provides that "that sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section." Not only does subsection (a)(1) cover §544, under which the trustee was proceeding, but subsection (a)(2) also enables the court to "hear and determine any issue with respect to the application of such sections to governmental units. Also, because the governmental filed a proof of claim, it had "waived sovereign immunity with respect to a claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which the claim of such governmental unit arose citing (§106(b) and *Gardner v. New Jersey*, 329 U.S. 565, 573-74 (1947) (when a governmental unit "files a claim against [the estate] it waives any immunity which it might otherwise might have had respecting the adjudication of the claim.").

The court relied on a Sixth Circuit decision, *In re Southeast Waffles, LLC*, 702 F.3d 850 (6th Cir 2012), to reject the trustee's claim that the tax penalties and tax penalty payments here should be avoided. The Sixth Circuit had explained that "noncompensatory penalties accessed and collected by the IRS do not fit neatly into the fraudulent transfer context." 702 F.3d at 859. The Fourth Circuit accepted the Sixth Circuit's reasoning that the IRS is "an involuntary creditor" and "[t]ax penalties arise not through contractual bargaining but by operation of statute, and no value is or can be given in exchange." In this case, neither the debtor nor the IRS had agreed on tax penalties and had entered into no written "record" for these penalties. "The tax code required the IRS to impose taxes, tax penalties and interest against [the debtor]. The IRS had no choice." Tax penalties "are not obligations incurred."

The previous payments of "tax penalty obligations" were not voidable "because they resulted in a dollar-for-dollar reduction in the tax obligation debt and thus constitute "reasonably equivalent value.'" "[P]ayment of a legitimate obligation reduces that obligation dollar for dollar and constitutes 'reasonable equivalent value.'" Because "the underlying tax penalty obligation is not voidable, neither are [the debtor's] payments on that obligation."

Comment

These decisions address matters not expressly covered by the Code (*Mann*; *Cates*; *BICom*; *X-treme Bullets*) or issues that have been ambiguous (*Gunsalus*; *Kelley*; *Auriga*; *Insolvency Services*; *Yahweh Center*). In sum, they all balance fairness and common sense with the Code's policy goals.

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