

Preferences and fraudulent transfers under the Bankruptcy Code: a primer in pain

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Most companies' experience with the Bankruptcy Code comes from defending preference actions (11 USC § 547) and fraudulent transfers (11 USC § 548) (collectively, avoidance actions). Indeed, in *Central Virginia Community College v Katz* (___US___ 126 S Ct 990 (2006)) the Supreme Court even held that the right of debtors to avoid fraudulent and preferential transfers is one of the fundamental policies underlying the code.

This chapter provides an overview of key issues and defences arising in litigation related to avoidance actions, discusses the code provisions amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, and provides some useful advice to minimise liability if and when a company is confronted with an avoidance action lawsuit.

History of avoidance actions

Fraudulent transfer law is one of the oldest forms of legal creditor protection, tracing its roots to the ancient Statute of Elizabeth, enacted in 1571. This ancestor of Section 548 of the code (along with all other US fraudulent transfer statutes) deemed void any conveyance or transfer made with the intent "to delay, hinder or defraud creditors and others of their just and lawful actions". The scope of fraudulent transfers was significantly expanded by the venerable 1601 decision in *Twyne's Case*, which established certain badges of fraud providing indirect and circumstantial ways to prove the debtor's intent to defraud its creditors.

Section 548 and other fraudulent transfer laws serve two major purposes:

- They prohibit debtors from disposing of their property either with the intent to place it improperly beyond the reach of their creditors or for less than reasonable consideration when they are insolvent by providing a legal mechanism to avoid such transfers; and
- They promote efficient and fair economic relations between debtors and creditors by helping to ensure that debtors will not attempt to evade their obligations to creditors through improper transactions.

By contrast, preference laws are a later and more indirect form of creditor protection. There are three general purposes to the code's preference statute (Section 547). The primary purpose of preference law is to promote and attempt to uphold the equality of the distribution of an insolvent debtor's assets among its creditors. This ensures that all creditors – not just the most friendly, necessary, lucky and/or aggressive creditors – receive payment on their claims.

A second stated purpose of Section 547 is to provide an incentive to creditors to deal with troubled companies, rather than racing to the courthouse door to dismember troubled companies during times of financial distress. In theory, the possibility of avoiding preferential payments should act as a deterrent to creditors going to extraordinary lengths to collect their debts.

Finally, avoidance of preferential transfers prevents the existence of *de facto* or secret liens on a debtor's assets. In effect, Section 547 prevents favoured or preferred creditors from having an unrecorded and unknown priority in the debtor's assets by requiring creditors that want priority in their payments to comply with applicable laws granting them priority. Therefore, creditors will not be misled into selling goods or providing services to a debtor that intends to pay their value to another undisclosed favoured creditor.

Other avoidance actions under the Bankruptcy Code

In addition to Sections 547 and 548, three other sections of the code allow a trustee to seek to avoid certain transfers of a debtor's interest in property.

In certain circumstances Section 544 of the code allows the trustee to avoid transfers if they are avoidable under state law. All states have some form of fraudulent conveyance and/or preference statutes, and often these laws have limitation periods that exceed those under Sections 547 and 548.

Section 545 of the code allows a trustee to avoid certain types of statutory lien which arise under state law – most importantly, landlord liens. However, the Bankruptcy Abuse Prevention and Consumer Protection Act created an exception to the avoidance of landlord liens for storage, transport or handling of the warehoused goods.

Section 549 of the code addresses avoidance of post-petition transactions. It permits trustees or debtors in possession to avoid any post-petition transfer of estate property that was authorised by neither the code nor the court overseeing the debtor's bankruptcy, or authorised only under two narrow provisions of the code. This provision contains exceptions for certain good-faith transfers of real property and transfers made by the debtor after the filing of an involuntary case.

Finally, although it is not an avoidance section, Section 550 governs the liability of the initial and subsequent transferees of voidable transfers. This provision provides rules for recovery avoiding transfers from downstream recipients of the transfers and sets forth certain defences for certain types of transfer.

Preference actions under Section 547

A plaintiff in a preference action (or trustee) must prove each element of Section 547 by a preponderance of evidence to avoid a transfer

under that section. The elements of a preference action are:

- a transfer;
- of an interest of the debtor in property;
- to or for the benefit of a creditor;
- for or on account of an antecedent debt;
- while the debtor is insolvent;
- made on or within 90 days before the date of the filing of the petition, or between 90 days and one year before the date of the filing of the petition if at the time of such transfer the creditor was an insider; and
- that enables the creditor to receive more than it would otherwise receive in a Chapter 7 liquidation.

Transfer of property

The code broadly defines 'a transfer' under Section 101(54) so that almost any conceivable mode of disposing of property is covered. It does not matter if the transfer is voluntary or involuntary, direct or indirect. The Bankruptcy Abuse Prevention and Consumer Protection Act amendments to the definition of 'transfer' shifted the focus of the determination from what was transferred to when the transfer occurred. Unlike prior bankruptcy preference statutes, the intent of the debtor in making the transfer is irrelevant for purposes of Section 547.

The timing of the transfer is critical to some of the statutory defences provided in Section 547(c); this timing is also important under Section 547 in order to determine when a transfer was made or perfected against a third party.

The Bankruptcy Abuse Prevention and Consumer Protection Act extended the safe harbour protection for perfecting certain transfers from 10 days to 30 days. Section 547(e)(2) provides that unless the transaction is perfected within 30 days, the transfer is deemed made on the date of perfection. The 30-day period provided in Section 547(e)(2) may be longer than that allowed by applicable state law. In cases where perfection occurs 30 days after the transaction, the transfer is deemed to be made at the time of perfection.

An interest of the debtor in property

The terms 'property' and 'interest in property' are undefined in the code. However, the Supreme Court has defined an 'interest in property' to mean only property that would have been property of the bankruptcy estate but for the transfer before the

filing of the petition. A transfer is preferential only if the transferred property or interest in property is actually owned by the debtor. Ownership of property by a debtor is determined by state law.

Funds advanced by a third party to the debtor or paid directly to a creditor on behalf of the debtor may also constitute a preference. Generally funds advanced pursuant to a written agreement designating the creditor receiving payment are not a preference if the funds are applied as agreed under what has been termed the 'earmarking doctrine'. However, if the debtor is given the ability to determine the creditor that receives the funds, it may have an interest in the property sufficient to satisfy this element.

Whether a transfer was a transfer of the debtor's assets ultimately focuses on whether the transfer diminished the debtor's estate, thereby reducing the funds or property available for the benefit of unsecured creditors.

To or for the benefit of a creditor

The term 'creditor' is another term that is broadly defined by the code and includes sureties, guarantors and endorsers. Therefore, a trustee may challenge as preferential a transfer to or for the benefit of nearly any creditor. Money or property received by a transferee that is not a creditor, or a transfer made that is not for the benefit of a creditor, does not constitute a preference. However, these transfers may be avoidable under Section 548 as a fraudulent conveyance.

For or on account of a pre-existing debt

A debt or liability on a claim is pre-existing or antecedent if the debt is incurred prior to the alleged preferential transfer. The debtor's legal obligation to pay the claim must come first, no matter whether the claim is liquidated, unliquidated, fixed, contingent, disputed, secured or unsecured. The inquiry on this element of a transfer focuses on whether the transfer diminished the debtor's estate available for the benefit of unsecured creditors. Examples of antecedent debts include:

- a retention bonus paid to a former officer of the debtor before the officer's death;
- a debtor's payment of a casino's markers more than 30 days after the markers were issued;
- a deed of trust given to a creditor of the debtor's parent corporation as security for a loan to the parent;
- a late-perfected security interest in a loan made

to a debtor; and

- a down payment returned upon failure to perform.

Made while the debtor was insolvent

The term 'insolvent' is defined by Section 101(32) of the code. This definition is a determination of insolvency made by reference to the debtor's balance sheet. Fair market value is assigned to the debtor's assets when performing the balance-sheet test for insolvency. The debtor's solvency is calculated at the time of the alleged preferential transfer and includes the value of the transferred property.

In determining whether a debtor is solvent, contingent liabilities and assets of the debtor must be considered. However, these contingent liabilities and assets should be valued or discounted to reflect the probability they will become fixed. Further, in determining the value of a debtor's assets, going-concern value rather than liquidation value is used unless the debtor is in serious distress.

Section 547(f) creates a rebuttable presumption of insolvency during the 90 days immediately preceding the date of filing of the petition for the purposes of the preferences section of the code. The burden is on the creditor to provide evidence to prove the solvency of the debtor during this period. Creditors that are insiders are not subject to the same presumption for transfers made in the period between 90 days and one year before the bankruptcy is filed.

Made within 90 days (or one year if an insider)

The 90-day (or one-year) period is referred to as the preference reach-back period. The transfer must be made during this period in order to constitute an avoidable preference. For purposes of a bankruptcy preference action, the 90-day period (or one year if an insider) applies even if state law allows a longer period. Transfers to non-insiders occurring outside the 90-day period are safe from avoidance under Section 547 of the code, although may be subject to attack under state law.

Enables creditor to receive more than in a liquidation

The trustee must show that the transfer provided the creditor with more than it would receive in the Chapter 7 liquidation. Transfers to a fully secured creditor, or one entitled to full set-off rights, are generally not preferential because the creditor

would not receive more in a Chapter 7 liquidation. If a hypothetical Chapter 7 distribution to unsecured creditors is less than 100 per cent, any payment to an unsecured creditor during the 90-day period is preferential.

Defences to preference actions

Section 547 statutory defences

Section 547(c) provides nine separate affirmative defences that a creditor can assert to defeat a preference claim. Parties asserting these statutory defences must prove each element by a preponderance of evidence.

Contemporaneous exchange for value

Section 547(c)(1) states that a trustee may not avoid an exchange if:

- the transfer was intended by the debtor and the creditor to be a contemporaneous exchange;
- it was for new value; and
- the exchange was contemporaneous or substantially contemporaneous.

The most typical example of a contemporaneous exchange is a cash on delivery exchange of money for goods or services. The primary issues which arise under this defence are whether the creditor gave new value and whether the exchange was actually contemporaneous.

Section 547(a)(2) defines 'new value' as "money or money's worth in goods, services or new credit or release by a transferee of property previously transferred... in a transaction that was neither void or voidable". New value has been found to include settlement of valid claims and releases of security interests. However, the defence is available only for the amount of new value actually given by the creditor.

This defence grants a simple safe harbour for transactions with financially distressed entities and eliminates highly technical issues which could arise as to whether certain debts were antecedent in ordinary purchase transactions.

Ordinary course of business

Perhaps the most commonly utilised statutory defence to a preference action is the ordinary course of business defence found in Section 547(c)(2). Under this defence, a trustee may not avoid a transfer to the extent that:

- the transfer is for a payment of a debt that was incurred by the debtor in the ordinary course of business or financial affairs of both the debtor and the creditor; and
- either:
 - the payment was made in the ordinary course of business or financial affairs of the debtor and creditor; or
 - the transfer was made according to ordinary business terms.

The purpose of this defence is to allow creditors to engage in normal and customary credit transactions and limit avoidable preferences to transfers arising from unusual debt collection practices.

This defence focuses on two different parts of the underlying transaction. First, the defendant must establish that the debt was incurred by the debtor in the ordinary course of the party's business. This has generally been held to mean that the debt was incurred in an arm's-length transaction and was not unusual in the underlying business affairs of either the debtor or the creditor.

The second part of this defence considers the circumstances surrounding the transfers. Here, the defendant creditor must prove that the payments were either:

- made in the ordinary course of the party's particular business relationship (a subjective test); or
- made in the ordinary course of the business or industry in which the debtor or creditor was engaged (an objective test).

Under both the subjective and objective tests, courts will review the amount and the manner and timing of the payments to see whether the transactions fall within a typical range for either the party's or the industry's payment terms. In many courts, this becomes a mathematical comparison of the timing of payments made by the debtor in the pre-preference period and the timing of the payments made by the debtor in the preference period. Other courts focus their analyses more on whether the payments were made in unusual circumstances. If a defendant wishes to rely on the objective test, many courts require expert testimony to establish the relative industry standard.

Finally, under either test unusual or aggressive collection efforts will likely eliminate the ordinary course defence, even if these collection efforts result in payments made according to the terms of the contract or within prior payment timing.

Purchase money security interests

Section 547(c)(3) is a statutory protection for creditors that made purchase money or enabling loans. This defence protects transfers which create a security interest in property acquired by the debtor:

- to the extent that the security interest secures new value that was:
 - given at or after the signing of a security agreement that contains a description of such property as collateral;
 - given by or on behalf of the secured party under such agreement;
 - given to enable the debtor to acquire such property; and
 - used by the debtor to acquire such property; and
- that is perfected on or before 30 days after the debtor receives possession of such property.

This defence is fairly mechanical and applies only in a narrow range of cases.

Subsequent new value

Section 547(c)(4) prevents the avoidance of transfers to the extent that the defendant gave new value to the debtor after the transfer was made. This offers creditors the ability to assert the value of any new inventory or services supplied after the transfer at issue was made as a credit against the transfer.

The new value referred to in this provision is defined in Section 547(a)(2). The main issues under this defence are:

- establishing when the new value was advanced to the debtor;
- determining when the preferential transfers were made; and
- whether the unsecured new value was paid by the debtor.

The rationale behind this defence is to encourage creditors to extend new credit to debtors during times of financial distress as that new credit will, at the very least, be a defence to a preference suit.

Lien in receivables and inventory

Another technical defence is afforded to secured creditors holding a security interest in receivables and inventory by Section 547(c)(5). This defence provides that no transfer will be avoided as a preference if the transfer creates a perfected interest

in the inventory or receivables of the debtor, except and to the extent that the creditor improves its position either during the preference period or from the date during the preference period on which new value was given under the security agreement.

If a secured creditor either is fully secured or holds a security interest in all the debtor's assets, this provision will be moot, as transfers under these circumstances will not be preferences and will not improve the secured creditor's position.

Other statutory liens

Another mechanical preference defence, Section 547(c)(6), provides that statutory liens afforded by state or federal law that are not avoidable under Section 545 cannot be avoided as a preference. Examples of these liens include properly perfected federal, state and local tax liens.

\$5,475 floor on preferences

As initially amended by the Bankruptcy Abuse Prevention and Consumer Protection Act, Section 547(c)(9) prevents a trustee from avoiding a transfer in a case where the underlying debts are not primarily consumer debts, if the aggregate value of such transfer was less than \$5,000. In 2007 the minimum was increased to \$5,475. This provision, establishing a floor for preference actions, greatly limits parties from pursuing minimal transfers as preferences.

Other important defences to preference actions**Time to bring preference suit**

Section 546(a) provides a statute of limitation by which debtors must file suit on preference and other avoidance actions. Plaintiffs have the later of two years after the filing of the petition or one year after the appointment of a bankruptcy trustee to file suit. If the preference is not brought during this time period, the estate loses the right to assert the preference claim.

Right to a jury trial

Preference defendants have a right to request a jury trial. This right is protected by the Seventh Amendment to the Constitution. However, this right can be waived by the defendant filing a proof of claim in the bankruptcy. Therefore, potential

defendants with exposure to large preference suits who wish to consider whether filing a proof of claim is in their best interests might request a jury trial.

Securities transactions and repurchase agreements

Under Sections 546(e), 546(f), 546(g) and 546(i), numerous participants in the securities markets are protected from preference actions for payments made under:

- a master netting agreement (Section 101(38A));
- a swap agreement (Section 101(53B));
- a repurchase agreement (Section 101(47));
- a margin payment (Section 101(38)); or
- a settlement payment (Section 101(51A)).

This highly specialised set of defences was established to protect financial market transactions from the impact of a party's bankruptcy.

Forward contracts

One of the most interesting preference defences also arises under Section 546(e) and involves forward contracts. In addition to protecting certain securities market transactions, Section 546(e) prevents the avoidance of settlement payments made by or to a forward contract merchant (Section 101(26)). Forward contracts are contracts involving the provision of commodities which are entered into between the debtor and creditor but which are not performed until a date specified in the future. In several cases, preference defendants which have provided commodities (ie, certain goods in which contracts for future delivery are dealt within organised markets) have been able to dismiss preference actions based on contracts to supply commodities to the debtor for the debtor's use, as opposed to being used in further trading on financial markets using the settlement payment provisions of Section 546(e) (see *In re Olympic Natural Gas Co*, 294 F 3d 737 (Fifth Cir 2002)).

Deprizio and insider guarantors

Prior to the amendments to the code by the Bankruptcy Abuse Prevention and Consumer Protection Act, the holding in *In re VN Deprizio Const Co* (874 F 2d 1186 (Seventh Cir 1989)), arguably still expanded the preference reach-back window for a non-insider from 90 days to one-year pre-petition if there was evidence that the transfer benefited an insider guarantor. After numerous attempts to overrule *Deprizio*, Section 547(i) has

finally resolved this matter by clarifying that for transfers made during the expanded one-year period, the estate can recover the value of the preferential transfer only from the insider for whose benefit the transfer was made, and not from the non-insider.

Preventative measures to minimise the risk of a preference action

It is probably impossible to eliminate completely the risk of a suit on or liability for a preferential payment. However, there are ways to minimise an adverse result if such a claim is brought:

- Ordinary course of business defence – the best way to preserve an ordinary course of business defence is to maintain routine payment schedules. For example, if invoices are due in 30 days, the creditor should take steps to ensure that payments are made within this timeframe. A minimal variance is not significant and a course of conduct that develops over time to change the invoice terms will usually also support the ordinary course of business defence.
- Cash in advance or on delivery – requiring payment of cash in advance should provide an absolute defence in any preference claim. One of the required elements of a preference described above is that the disputed payment is made on account of an antecedent debt. When payment is received in advance of providing services or goods, an antecedent debt is never created. Thus, a preference cannot exist by the definition above. Similarly, cash on delivery payment terms should protect a creditor because either there is no preference for the same reasons as a cash in advance arrangement or the contemporaneous exchange defence will apply. Obtaining cash in advance or cash on delivery terms is not always possible in the business world. However, when a customer appears headed for bankruptcy, this course is preferred to the risk of losing a later payment through a preference action.
- Obtain collateral – the previous discussion recognises that secured creditors will not have preference liability to the extent of the value of their collateral. Therefore, if a creditor can convince a debtor to pledge collateral for a debt, it may avoid a preference claim.
- Always accept payments – the only thing worse than accepting a preference payment is not accepting a preference payment:

- The debtor may not file a bankruptcy petition until after the 90-day limitation period;
- One of the preference defences may apply; and
- Even if there is clear liability, the bankruptcy trustee may settle at a discount, leaving the creditor with at least part of the payment.

Avoidance of fraudulent transfers under Section 548

Unlike preference laws, which are based primarily on ensuring that all creditors are given a reasonably equal distribution and not on possible debtor malfeasance, fraudulent conveyance law must address transactions which involve fraud or transactions which are constructively fraudulent.

Under Section 548, there are four distinct types of fraudulent transfer which are subject to avoidance:

- transfers made by debtors with the actual intent to hinder delay or defraud creditors (Section 548(a)(1)(A), actually fraudulent transfers);
- transfers made for less than reasonably equivalent value, which are constructively fraudulent (Section 548(a)(1)(B), constructively fraudulent transfers);
- transfers by a partnership to a general partner while the partnership was insolvent or which became insolvent as a result of the transfer (Section 548(b)); and
- transfers by debtors to self-settled trusts in which the debtor is a beneficiary (Section 548(e)(1)).

The most germane types of fraudulent transfer actions are actually fraudulent and constructively fraudulent transfers.

Transfers

The initial issue in any fraudulent transfer action is whether the transactions which the plaintiff seeks to avoid constitute transfers for purposes of Section 548. As noted in the discussion of preferences, transfers are defined broadly by the code (Section 101(54)). They encompass any method or manner of transferring or disposing of the debtor's interests in property. Therefore, transfers may be made directly or indirectly by the debtor and may occur on either a voluntary or involuntary basis.

One of the main issues is whether the debtor actually had an interest in the property transferred. Where the debtor is determined to have only bare legal title or no interest in the property or rights transferred, such transactions are not deemed to be subject to avoidance as transfers under Section 548.

A transfer for purposes of Section 548 is not limited to a single transaction, but can be a series of related transactions which can be collapsed by a court to create a single transfer for purposes of Section 548.

Burden of proof

Although state fraudulent transfer laws may require a higher burden of proof, the plaintiff in a Section 548 action must prove the elements of his or her case by a preponderance of evidence. However, in certain jurisdictions after a number of badges of fraud are presented, the burden of proof may shift to the defendant.

Actually fraudulent transfers under Section 548(a)(1)(A): badges of fraud

The initial inquiry for determining actual fraud centres on the debtor's intent in making the transfer. The intentions or motives of the transferee are irrelevant. Further, in fraudulent transfer actions under Section 548(a)(1)(A), neither the solvency of debtor nor the adequacy of the consideration are directly important to the decision. It is important to remember that the debtor need not intend to defraud its creditors in order to have a transfer avoided; an intent to hinder or delay their creditors is sufficient for avoidance.

As it is rare for there to be direct evidence of the debtor's subjective intent, certain indications or badges of fraud will be considered by the courts. Among the factors deemed badges of fraud are whether:

- the transfer was made to an insider or a debtor's family member;
- the debtor retained control or possession of the transferred property;
- the transfer was concealed;
- the debtor was in litigation at the time of the transfer;
- the transfer involved all or substantially all the debtor's assets;
- the debtor was insolvent at the time of the transfer and was rendered insolvent by the transfer;
- the debtor received reasonable consideration

for the transfer;

- the transfer was outside the ordinary course of the debtor's business; or
- the transfer involved the use of fictitious or shell entities.

The greater the number of badges of fraud present in a transaction, the greater the presumption or inference of the transfer being fraudulent.

Constructive fraud under Section 548(a)(1)(B)

Transfer for less than reasonably equivalent value

The initial issue in considering whether a transfer can be avoided as being constructively fraudulent under Section 548(a)(1)(B) is whether the debtor received reasonably equivalent value. The code does not define 'reasonably equivalent value' and courts have held that the determination is a factual issue and can include satisfaction of an antecedent debt. The value may be received by the debtor and still be reasonably equivalent value. Further, courts have held that business opportunities which ultimately fail may be reasonably equivalent value under appropriate facts.

One of the most critical issues in determining reasonably equivalent value involves the question of guaranties of related entities' obligations. Where parent corporations guarantee their subsidiaries' obligations, reasonably equivalent value is fairly easy to establish. However, where subsidiaries guarantee their parents' obligations or brother-sister affiliates guarantee their affiliates' obligations, proving reasonably equivalent value will be harder.

Prohibited financial conditions of the debtor

If a plaintiff in a constructive fraudulent transfer action establishes that the debtor received less than reasonably equivalent value for the transfer, the transaction can be avoided if the transfer was either to or for the benefit of an insider under a non-ordinary course of business employment contract (Section 548(a)(1)(B)(IV)), or if the debtor's financial condition meets the criteria set forth in Section 548(a)(1)(B)(I-III).

Section 548(a)(1)(B)(ii)(I): Except for governmental units under Chapter 9 of the code, the test for whether the debtor was insolvent or was rendered insolvent by the transfer is whether the fair value of

the debtor's assets exceed the amount of the debtor's total liabilities (Section 101(32)). This is generally determined by establishing what a willing arm's-length buyer would pay for the debtor's assets and liabilities. In determining the debtor's solvency, both the debtor's contingent liabilities and assets must be discounted to current value.

Transfers leaving the debtor with unreasonably small capital – Section 548(a)(1)(B)(ii)(II): Even if a debtor is not insolvent after a transfer, the transaction may also be deemed to be a fraudulent transfer if the debtor has unreasonably small capital or assets to continue its business operations or ultimately meet its obligations. This analysis is highly factual and focuses on whether the debtor's retained or acquired assets would permit it to continue its operations after the transaction or whether the debtor would be forced into insolvency. As a general rule, if a debtor is able to operate and meet its obligations for some time after a transfer was made, a finding of unreasonably small capital will generally not be made.

Incurring debts beyond the debtor's ability to pay – Section 548(a)(1)(B)(ii)(III): A transfer for less than reasonably equivalent value can be avoided if the debtor intended to incur or reasonably believed it would incur debts beyond the debtor's ability to pay. This analysis focuses on the debtor's intentions at the time of the transfer. Under this provision, it is not sufficient to show the debtor became insolvent shortly after the transfer in question, but there must be a showing that the debtor actually incurred debts beyond its means to repay.

Aiding and abetting fraudulent transfers: There have been a number of recent actions seeking to impose liability on third parties because they aided and abetted debtors in making fraudulent transfers. While these actions have been generally unsuccessful, they do represent a new risk of litigation under avoidance action theories.

Defences to Section 548 fraudulent transfer actions

Of course, as with preferences, there are defences to fraudulent conveyances. Although less numerous, the main defences can be found in Sections 548 and 546 of the code.

Section 548(c) defences

Perhaps the most common statutory defence is the Section 548(c) good-faith defence. Section 548(c) is a savings clause for an initial transferee that gives value (albeit insufficient value) to the debtor for the transfer made or obligation incurred and acts in good faith. It provides a safe harbour for the transferee to receive the benefit of its bargain. This defence applies in both actual fraudulent transfer and constructively fraudulent transfer cases.

Section 548(c) has two elements: taking for value and taking in good faith. Initially, the 'for value' element seems the easier of the two to prove. This is intuitive from the mere fact that reasonably equivalent value is one of the elements of the transferor's case. In addition, in most cases the value is an amount either of money paid or money lent. For example, the transferor sells real property (worth \$100,000) to the transferee for \$50,000. Clearly, the transferee received a \$50,000 benefit and thus it would have to be determined whether that transfer was in good faith.

However, wrinkles do appear. For example, what if that consideration is not a tangible amount or thing, but an intangible right or obligation? This raises the issue of whether an undertaking to perform certain services or to discharge certain obligations constitutes value. Intangible value is difficult to prove.

'Good faith' is an even more notoriously hard-to-define concept. A showing of good faith depends on the facts and circumstances of the transfer. A finding of good faith, or the lack of it, will not be the same in any two cases. Needless to say, the definition of 'good faith' in a Section 548(c) defence is amorphous and requires an in-depth investigation of the facts and circumstances underlying the transfer.

Lienors and obligees are also protected by this provision. The test of good faith under Section 548(c) is objective, and one in which the transferee has the burden of proof.

Section 548(d) defences

The defences found in Section 548(d) address margin payments made under financial contracts, such as swap agreements, future contracts and repurchase agreements – the same types of contract protected by the safe harbour provisions of Section 546. These defences buttress the provisions found in Section 546 relating to these safe harbour contracts.

One of the interesting things that Section 548(d) does, in conjunction with Section 546, is to establish a presumption of value to these types of transfer. Only by showing actual fraudulent intent may a trustee proceed against one of the parties to a financial contract. Due to this strong presumption, trustees are reluctant to proceed against these financial participants if the underlying transfer was made pursuant to one of these contracts.

Conclusion

Avoidance actions – whether considered wise policy choices or insults to creditors after their injury by the debtors bringing the litigation – are an economic reality recognised by every business which engages in a significant amount of transactions with US companies. Being aware of the issues which may arise in these cases and taking steps to minimise the risk of being sued successfully will hopefully make these facts of life somewhat less painful.

Miles S Apple and Richard C Porter also contributed to this chapter.