AMERICAN BANKRUPTCY INSTITUTE

2017 Central States Bankruptcy Workshop

Nuts & Bolts Survey of Avoidance Issues in Bankruptcy

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CONCURRENT SESSION

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TOPIC: Nuts & Bolts Survey of Avoidance Issues in Bankruptcy-
Recent Decisions to 544, 547; and 548.

1. Avoidance Actions;

a. Under §544(a):

Avoidance and lien rights turn on the rights of a hypothetical judgment lien creditor, as provided by applicable non-bankruptcy law, as a trustee, upon the commencement of a bankruptcy case, succeeds to the rights of a debtor's creditors, judicial lien holders and bona fide purchasers of real property whether or not any such entities exist at that time. 11 U.S.C. § 544(a).

The trustee is empowered to avoid any transfer or transaction that would be voidable by such an entity to recover assets for the benefit of the bankruptcy estate without regard to whether the trustee has actual knowledge of the prior transaction. Who may qualify as a bona fide purchaser of real property is determined under state law. The trustee's power as a hypothetical bona fide purchaser of real property is subject to constructive notice to the same extent as an actual purchaser under applicable state law.

b. Under §544(b), however:

i) The trustee must identify a specific creditor with an allowable claim against the estate, that would have had the right to invoke the avoidance remedy against a fraudulent transfer as of the date the debtor was put into bankruptcy. *In re Petters Co., Inc.,* 495 B.R. 887 (Bankr. D. Minn. 2013).

ii) To confer the trustee with such derivative standing, this predicate creditor must have an allowable claim against the debtor-entity that is in bankruptcy in the case in which the trustee sues for avoidance. Transfers by a predecessor-entity later merged into the debtor may not be avoided absent the existence of a claim that was enforceable against the debtor-successor entity when it went into bankruptcy. *In re Polaroid Corp.,* 543 B.R. 888 (Bankr. D. Minn. 2016), *aff'd,* 562 B.R. 368 (D. Minn. 2016).

In one view, the substantive consolidation of the estates of debtor-entities in bankruptcy does not give the trustee standing derivative of a creditor of one debtor, to avoid transfers by a different debtor, when the transferor-debtor had not been legally liable to that creditor before the bankruptcy filings. Put another way: substantive consolidation does not merge debtor-entities so as to change the legal significance of prepetition events material to rights of avoidance; it only brings all assets and rights of avoidance associated with the subject debtors into one post-

consolidation estate, without changing the legal character of such sources of recovery. *In re Petters Co., Inc.,* 550 B.R. 438 (Bankr. D. Minn. 2016). *Cf. In re Howland,* 16-5499, 2017 WL 24750, at *5-6 (6th Cir. January 15, 2017) (discussed *infra*)

c. Under §547:

A preference is:

i. Payment on an "antecedent" (meaning a previously incurred as opposed to current) debt;

ii. Made while the debtor was insolvent (meaning its assets are less than its liabilities);

iii. To a non-insider creditor, within 90 days of the filing of the bankruptcy; and

iv. That allows the creditor to receive more on its claim than it would have, had the payment not been made and the claim paid through the bankruptcy proceeding.

- Recent decision analyzing "more than" test, *In re Energy Conversion Devices, Inc.*, 548 B.R. 208, 211 (Bankr. E.D. Mich. 2016)

Defenses to Preference Actions

v. Ordinary course of business;

vi. Contemporaneous exchange for new goods or services;

vii. "New value".

- Recent decision analyzing "new" value test, *In re Energy Conversion Devices, Inc.*, 548 B.R. 208, 211 (Bankr. E.D. Mich. 2016)

d. Under §548:

A transfer is fraudulent and the trustee is authorized to avoid any transfer of property of the debtor or obligation incurred by the debtor if:

i. such transfer or obligation was either made with actual intent to hinder, delay, or defraud present or future creditors, or

ii. was made for less than reasonably equivalent value, *and*

(1) while the debtor was insolvent or rendered insolvent as a result of the transaction, or

(2) left the debtor with an unreasonably small capital, or

(3) the debtor intended to incur or believed it would incur debts that would be beyond the debtor's ability to pay such debts when they matured.

iii. Section 548 is applicable when the acquisition and related transfers take place within two years before the petition date. If the transaction took place over two years before the petition date, the trustee must look to applicable state law under Section 544(b) to challenge the transaction.

iv. Defense of taking for value and in good faith.

e. Under §550 Limitations on Liability For Avoidance Actions

i. A transferee for value;

- Recent case law as to when one is a transferee and the "dominion and control" test, *Meoli v. The Huntington Nat'l Bank*, 848 F.3d 716, 725 (6th Cir. 2017) ("the account-holder's right to withdraw the deposits keeps the bank from obtaining dominion and control."

ii. Good faith;

- Cooperation with police forces cannot necessarily absolve not taking in good faith, and despite certain employees' good-faith efforts. *Meoli v. The Huntington Nat'l Bank*, 848 F.3d 716, 725 (6th Cir. 2017).

iii. Without knowledge of the voidability of the transfer avoided;

- Good-faith efforts versus "knowledge of the voidability," *Meoli v. The Huntington Nat'l Bank*, 848 F.3d 716, 725 (6th Cir. 2017), and the requirement of a "holistic factual determination of whether a reasonable person, given the available information, would have been alerted to a transfer's voidability.

- Did the facts "place a reasonably person on notice that the transfer was illegimate, and by extension, that it was voidable"?

- "A reasonably person may not be alerted to a transfer's voidability even if there was inquiry notice."

- "What findings the reasonable investigations would have yielded."

2. Recent Sixth Circuit Cases to Consider and Discussion;

a. *In re Energy Conversion Devices, Inc.*, 548 B.R. 208, 211 (Bankr. E.D. Mich. 2016);

i. Proof of "more than";

ii. Improvement of balance sheet is not "new" value.

b. *Meoli v. The Huntington Nat'l Bank*, 848 F.3d 716, 725 (6th Cir. 2017)

i. Is "good faith" different than "knowledge of voidability"?

ii. Where does "inquiry notice" end and lack of knowledge of voidability end?

- Judge Moore concurrence at 737: "When '[i]t is not apparent from the facts that the [transferee] had actual notice," "it cannot be said that the [transferee] acted without knowledge of the voidability of the transfer" if "the facts give rise to an inference of inquiry notice." *Meoli* at 737 citing *IRS v. Nordic Vill., Inc.* (*In re Nordic Vill., Inc.*), 915 F.2d 1049, 1056 (6th Cir. 1990) *rev'd on other grounds*, 503 U.S. 30, 112 S.Ct. 1011, 117 L.Ed.2d 181 (1992).

- Judge Moore concurrence at 737: "The majority takes pains to distinguish "inquiry notice," which it says may sometimes not be sufficient to disprove lack of knowledge, from facts that would " 'alert' a reasonable person to voidability," which all agree are sufficient to disprove lack of knowledge. Maj. Op. at 732–33. In fact, there is no daylight between inquiry notice and facts that would alert a reasonable person to voidability. And I

> agree with the majority in the essentials: For a transferee to satisfy the requirement that it took "without knowledge of the voidability of the transfer avoided," 11 U.S.C. § 550(b)(1), it must show that it lacked not only actual knowledge of the voidability of the transfer, but also knowledge of facts that would lead a reasonable person to investigate and discover the voidability of the transfer. I also agree with the majority that whether the transferee was "without knowledge," 11 U.S.C. § 550(b)(1), depends in part on "what investigative avenues existed" and "what findings the reasonable investigations would have yielded," Maj. Op. at 733. I take those statements to mean that transferees are not required to undertake unduly onerous investigations, and that whether an investigation is unduly onerous depends on the circumstances of the case."

c. *In re Howland*, No. 16-5499, 2017 WL 24750, at *5–6 (6th Cir. Jan. 3, 2017) on substantive consolidation:

- "Although similar in some ways to veil piercing, substantive consolidation is a distinct concept unique to bankruptcy law. *See generally In re Cyberco Holdings, Inc.*, 431 B.R. 404 (Bankr. W.D. Mich. 2010) (charting the history of substantive consolidation in bankruptcy law); *see also In re NM Holdings Co., LLC*, 407 B.R. 232, 281 (Bankr. E.D. Mich. 2009) (noting the similarity to veil piercing); *In re Am. Camshaft Specialties, Inc.*, 410 B.R. 765, 785 (Bankr. E.D. Mich. 2009) (same). Whereas veil piercing seeks to hold shareholders vicariously liable for corporate wrongs, "[s]ubstantive consolidation goes in a direction different (and in most cases further) than [that]." *In re Owens Corning*, 419 F.3d 195, 206 (3d Cir. 2005). "It brings all the assets of a group of entities into a single survivor. Indeed, it merges liabilities as well." *Id*. In short, it "treats separate legal entities as if they were merged into a single survivor." *In re Cyberco Holdings, Inc.*, 431 B.R. at 410 (citation omitted). For this reason, several courts have held that substantive consolidation allows a trustee to bring avoidance claims involving transfers by the consolidated non-debtor entity—exactly what the trustee seeks to do here. *See, e.g., In re Kroh Bros. Dev. Co.*, 117 B.R. 499, 502 (W.D. Mo. 1989) ("The substantive consolidation order caused [the consolidated non-debtor entity's] property to become 'property of the estate' as defined in § 541. At that point, the trustee acquired standing under §§ 547 and 548 to pursue the money as a preference and/or an avoidable transfer."); *In re Bonham*, 229 F.3d 750, 768 (9th Cir. 2000)."

- "To state a claim for substantive consolidation, the trustee must allege:

> (i) prepetition [the entities sought to be consolidated] disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or
>
> (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."

Id. citing *In re Owens Corning*, 419 F.3d at 211 (footnotes omitted).

- The party seeking to consolidate entities has the burden of establishing either allegation. *Id.* Substantive consolidation is an "extreme" measure, only to be used "sparingly," especially when consolidating a non-debtor entity. *Id.* at 208–09, 211; *In re Am. Camshaft Specialties, Inc.*, 410 B.R. at 787.

- Under the first *Owens Corning* test, the trustee must allege facts establishing that, before filing for bankruptcy, the debtors and the to-be-consolidated entity "disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity." *In re Owens Corning*, 419 F.3d at 211.

- In *In re Howland*, No. 16-5499, 2017 WL 24750, at *5–6 (6th Cir. Jan. 3, 2017), relevant allegations fell short of demonstrating a significant disregard of corporate separateness such that the debtors' and creditors relied on the breakdown and treated the entities that the sought to consolidate as one.

- Allegation that entities "engaged in a series of transactions between themselves that flouted the corporate separateness" . . . "may show that the debtors and Meadow Lake acted as a single entity at times, it fails to allege any reliance by creditors, a necessary component to a substantive consolidation claim based on prepetition conduct." *Id.*

- "Missing are any allegations that the debtors or Meadow Lake distributed misleading financial information to creditors, failed to accurately record their transactions with creditors, or otherwise misled creditors into believing they were dealing with them as one indistinguishable entity." *Id.* citing *In re Owens Corning*, 419 F.3d at 212; *In re Am. Camshaft Specialties, Inc.*, 410 B.R. at 789.

3. Recent Seventh Circuit Cases to Consider and Discussion;

a. *Smith v. SIPI, LLC (In re Smith)*, 811 F.3d 228, 234 (7th Cir. Ill. 2016), *cert. denied,* 137 S. Ct. 103, 196 L. Ed. 2d 40.

- A sale of bankruptcy debtors' real property at a tax sale did not provide reasonably equivalent value and thus was constructively fraudulent, even though the sale complied with state law for tax sales, since the tax sale procedure for bidding the lowest amount acceptable to pay the delinquent taxes in exchange for the tax lien bore no relationship to the value of the property.

b. *FTI Consulting, Inc. v. Merit Mgmt. Grp., LP*, 830 F.3d 690 (7th Cir. Ill. July 28, 2016), *cert. granted, Merit Mgmt. Grp., LP v. FTI Consulting, Inc.,* 2017 U.S. LEXIS 2831.

i. Issue: Whether the safe harbor under 11 U.S.C.S. § 546(e) from avoidance of certain transfers by a bankruptcy trustee protected transfers that were simply conducted through financial institutions and other named entities, where the entity was neither the debtor nor the transferee.

ii. Holdings:

- The phrases "by or to" and "for the benefit of" in § 546(e) were ambiguous, requiring reference to the statute's purpose and context.

- Section 546(e) should be read to apply to transfers that were eligible for avoidance under 11 U.S.C.S. §§ 544, 547, and 548.

- Transfers made by or to (or for the benefit of) in the context of § 546(e) referred to transfers made to "transferees," which did not include financial intermediaries.

- Section 546(e) did not provide a safe harbor against avoidance of transfers between non-named entities where a named entity acted as a conduit.

iii. Issue on appeal: Whether the "safe harbor" for securities transactions applies under § 546(e) when a financial institution acts only as a "mere conduit" with no beneficial interest in the stock being sold in a leveraged buyout.

c. Gresk v. Bulmer (In re Bulmer), 2017 Bankr. LEXIS 379, *1 (Bankr. S.D. Ind. Feb. 10, 2017)

   i. Issue: Chapter 7 trustee sought to avoid, as constructively fraudulent under § 548(a)(2)(A), transfers of a debtor's interests in nine properties to his ex-wife when they were still married.

   ii. Holding: The transfers were not fraudulent for the following reasons:

      1. As of the date of the transfers, six of the properties were held by the debtor and his wife as tenants by the entireties. Only creditors who held claims upon which the Debtor and his wife were jointly liable could reach this property, and there was no evidence that the Debtor's wife was liable on the scheduled debt. As of the date of the transfers, these six properties would have been "property of the estate" but would have been exempt from recovery by the trustee and from distribution to creditors of the debtor's bankruptcy estate as entireties property.

      2. The debtor received reasonably equivalent value for his interests in three other properties he transferred because his ex-wife agreed to pay debts the debtor owed and did so following their divorce.

d. *Official Comm. of Unsecured Creditors of Great Lakes Quick Lube LP v. T.D. Invs. I, LLP (In re Great Lakes Quick Lube LP)*, 816 F.3d 482, 483 (7th Cir. Wis. Mar. 11, 2016)

   i. Issue: Does an agreement between a debtor and a landlord that terminated two leases that may have been of considerable value constitute a "transfer" of an interest in property?

   ii. Holding: The prepetition surrender of a lease is a transfer as that term is defined in 11 U.S.C. § 101(54)(D) and may be avoidable under § 547 or § 548.

e. *Unsecured Creditors Comm. of Sparrer Sausage Co. v. Jason's Foods, Inc.*, 826 F.3d 388 (7th Cir. Ill. 2016)

   i. Issue: Whether payments which a debtor made to one of its suppliers were to be returned to the bankruptcy estate as avoidable preferences under § 547(b).

ii. Holdings:

- The bankruptcy judge's decision to truncate the historical period until the debtor's financial distress began was not clear error.

- While there was no reason to disturb the bankruptcy judge's decision to use the average-lateness method to determine the debtor's and the supplier's dealings during the historical period, rather than the total-range method, the judge's baseline comprised an arbitrary and too-narrow range of days.

    1. Bk court used pre-petition average days-to-pay of 22 + or – 6 days to determine that 11 invoices were paid outside the ordinary course of business.

    2. The 7th Circuit concluded that the bankruptcy court should have used 22 + or - 8 days, reducing the defendants liability from $242,000 to $60,000.

4. Opinion From The Bench;

The Bigger Picture: Is There a "Proper" Scope for Fraudulent-Transfer Remedies?

a) Beware an overly-mechanical approach or a micro-focus, as to avoidance for constructive fraud.

    i) *In re Duke and King Acquisition Corp.,* 508 B.R. 107 (Bankr. D. Minn. 2014) (avoidance under fraudulent transfer law does not lie to undo debtor's acquisition of going-concern businesses in debtor's formation and inception, absent pleading and proof of actual specific intent to hinder, delay, or defraud contemporaneous or future creditors of the debtor itself. Put another way: a plaintiff cannot use the avoidance remedy to undo what was no more than a bad deal for the debtor in the acquisition of its business operations).

    ii) *In re Petters Co., Inc.,* 548 B.R. 551 (Bankr. D. Minn. 2016) (deposits made by debtor into its business checking account, that had the effect of rectifying negative balances that had resulted from the bank honoring overdrafts, are not avoidable as fraudulent transfers).

b) State appellate courts may not favor the enlargement of fraudulent-transfer remedies to the extent that the bankruptcy courts have.

    i) *Finn v. Alliance Bank,* 860 N.W.2d 638 (Minn. 2015) (rejecting the "Ponzi scheme presumptions" going to intent, reasonably equivalent

value, and insolvency previously adopted by several federal circuits and numerous federal trial courts; rejecting the judicial recognition of presumptions under the Uniform Fraudulent Transfer Act absent facial provision in the UFTA; seemingly expressing significant doubt as to the applicability of fraudulent-transfer remedies to the remediation of a failed Ponzi scheme)

ii) *But see In re Petters Co., Inc.,* 550 B.R. 457 (Bankr. D. Minn. 2016) (notwithstanding *Finn*'s refusal to recognize presumptions, UFTA's remedies do apply to transfers made in the rolling fraud of a Ponzi scheme, as long as all elements of statute are pleaded and proved as to specific transfers).

c) As generalist forums, federal district and circuit courts may share this reticence.

548(a)(1)

(A)
Actual Fraud

Requires intent to hinder delay or defraud

- Focus is on state of mind of debtor
- Neither malice nor insolvency required
- Culpability of transferees not required

(B)
Constructive Fraud

Omits any element of intent

- Focus is on adequacy or equivalence of consideration
- Transferor's intent immaterial
- Requires insolvency or inadequacy of remaining capital or inability to pay debts as they become due

Trustee has the burden of proving necessary elements.

Must prove each element by a preponderance of the evidence.

Rarely evidence of actual intent to defraud, so courts look at circumstantial evidence – badges of fraud, including:

(1) absconding with proceeds of transfer immediately after receipt.

(2) absence of consideration when transferor/transferee know creditors will not be paid

(3) huge disparity in value between property transferred and consideration received

(4) transferee is related party or creditor of a related party

(5) Debtor insolvent

(6) Special relationship between Debtor and transferee

(1) Transfer of Debtor's property

(2) Transfer within 2 years of bankruptcy

(3) Debtor received less than reasonably equivalent value for transfer and

(A) Debtor was insolvent when transfer made or rendered insolvent by transfer; or

(B) was engaged or about to be engaged in business or a transaction for which his remaining property was unreasonably small capital; or

(C) Debtor intended to incur debts beyond his ability to repay as they matured; or

(D) Transfer made to or for benefit of insider

*Insolvency determined by a balance sheet analysis. 7th Circuit – what a willing buyer would pay for debtor's entire assets and liabilities. If amount a party would pay is positive, Debtor is solvent. If amount party would pay is negative, then the Debtor is insolvent.

Paloian v. LaSalle Bank Nat'l Ass'n (In re Doctors Hosp. of Hyde Park)
2013 Bankr. LEXIS 4244 (Bankr. N.D. Ill., Oct. 4, 2013)